Mexico Weekly Flash

Next week…

- ### Spotlight on the labor market

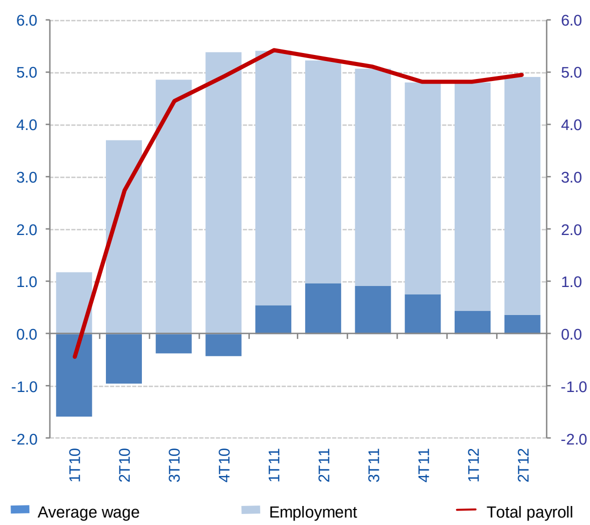
Last week delivered the first situation figures for the second half of the year with consumer and manufacturer confidence in July. The data were better-than-expected, with positive changes in both sets albeit with a slight fall in export outlook due to a weaker performance scenario in the US. In this sense, the economic scenario in Mexico remains more favorable than in the US and, especially, in Europe. The release today, Friday, August 3, of the minutes from the latest monetary policy meeting mentions caution for the balance of risks in Mexican output due to the downward bias in the global output scenario subject to major risks from Europe and the US.

One of the domestic supports for growth is a job market with higher significant continuous employment increases, especially in the formal market. In the formal private sector, employment has been growing at an average annual rate of 4.6% in the last eight quarters which, added to the 0.4% annual growth in real wages over the same period, provides a growth figure of around 5% in real income from the formal labor market. We should not, however, overlook that available household income from the entire labor force, both formal and informal (with data from the National Occupation and Employment Survey, ENOE), shows a real decline in the recent quarters due to the fall in real income per hour worked. This coming week sees the release of formal employment data for July and the 2Q12 ENOE (*see page 2*).

- ### We expect to see domestic assets continuing to react to global and domestic factors

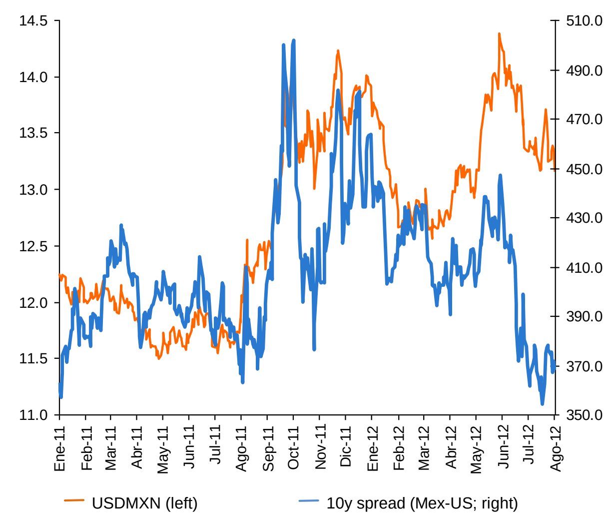
Despite difference on the Banxico Board, perspectives continue to point to a prolonger monetary pause. In this way, the domestic yield curve and the MXN will continue to be more correlated with global factors.

Chart 1
Private Formal-sector Payroll (% change y/y and contributions)



Source: BBVA Research

Chart 2
Mexico: 10-year interest rate spread (Mexico less US, bp) and USDMXN



Source: BBVA Research, Banxico, Indeval

Calendar: Indicators

Inflation in July (August 9)

Forecast: 0.63% m/m	Consensus: 0.57% m/m	Previous: 0.46% m/m

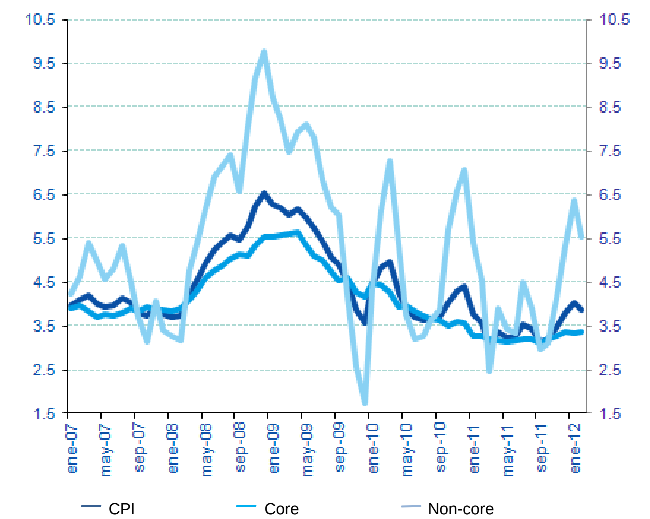
Inflation for July will be released on August 9 which, in annual terms, should see a further increase from 4.3% in June to 4.5%. This increase in consumer prices is due to price pressure for goods in the core index, some tourist services, electricity prices and the price shock in products such as eggs and poultry after the outbreak of bird flu. We expect the increase in livestock prices after the aforementioned outbreak to be brief despite the strength. In turn, core inflation will come in around 3.6% y/y, also up on the 3.5% y/y figure for June. We believe core inflation is already near its year-high and should see a moderate drop at the end of the year given the lack of pressure from demand. We believe total inflation will return below 4% at the end of the year thanks to the favorable comparison to 2011, in a context where some external shocks which have had an effect will start to dissipate.

Total employment in 2Q12, unemployment rate (August 10)

Forecast: 5.0%	Consensus: N.A.	Previous: 5.1%

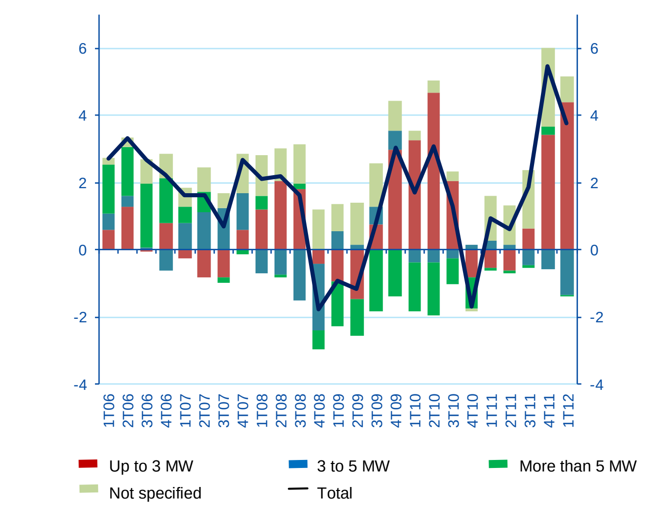
The National Occupation and Employment Survey (ENOE) indicators to be released on Thursday will provide a more rounded look on employment in the second quarter. Up to now, we only had access to formal private sector information, around 15 million people, in comparison to the near-47 million total workers in Mexico. In turn, the performance in variables such as the unemployment and under-employment rates will be key, as well as indicators linked to the job market such as the participation rate, the partial unemployment rate and the percentage of workers in critical conditions (near 12% of those in work in 1Q12). The composition of salary ranges to employment growth will be especially important: in 1Q12, around 67% of those in work received between 0 and 2 times minimum wage, 4.4% more than in the same period last year; meanwhile 15% of those in work had income of between 2 and 5 times minimum wage, (-)1.3% fewer than in 1Q12. The contraction in job income in real terms is likely to have continued in the second quarter of the year. This has been true in the last 16 quarters.

Chart 3
Inflation breakdown (% change y/y)



Source: BBVA Research with SHCP data

Chart 4
Employment by level of income (y/y % change)



Source: BBVA Research with data from INEGI and SNIIM

We expect to see domestic assets continuing to react to global and domestic factors

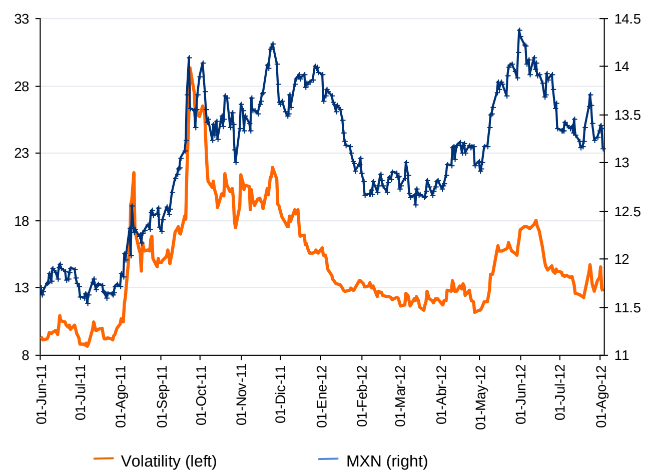
Banxico minutes, released at the end of last week, showed a difference of opinion between Board members regarding current financial conditions: while some believe the current monetary policy is more restrictive (due to the strengthening of the MXN and the global monetary easing), other members see it as more slack due to the relative weakness of the MXN. In addition, some members stated that the flattening of the yield curve (with all other factors constant, especially the policy rate) could be seen as monetary conditions in relative terms being more severe. One member even stated that conditions for an increase in the lending rate could not be ruled out. In contrast, other members appeared to maintain a neutral position (or even a downward bias). In this way, the document continues to support our outlook for a prolonged monetary pause. This means the domestic yield curve should continue to move in line with global risks and capital flows.

The MXN strengthened on Friday with the positive surprise in US jobs figures and after digesting Draghi's statement (ECB) from Thursday

After a week with high volatility, the MXN closed with gains of around 0.7%, almost exclusively in response to global factors more than to the release of Banxico minutes. With no substantial change to monetary perspectives, MXN positions should not change in the short-term due to domestic factors.

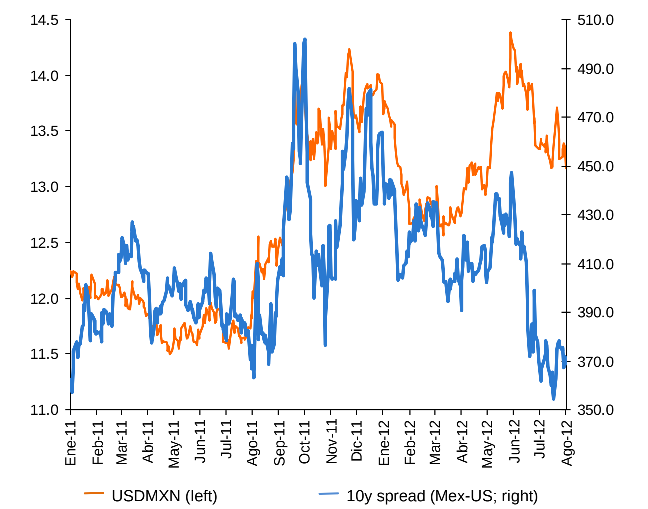
According to Banxico, the MXN has been highly resilient in the face of global conditions and reflects the major foreign capital inflows into fixed income instruments. In this way, the outlook in coming months continues to point to a stronger currency based on global determining factors. We cannot rule out a relatively stronger MXN over the week with an economic calendar lacking major statements and in the face of an expected fall in risk premiums.

Chart 5
Mexico: MXN/USD and implied 1-month volatility (ppd and %)



Source: BBVA Research and Bloomberg

Chart 6
Mexico: 10-year interest rate spread (Mexico less US, bp) and USDMXN



Source: BBVA Research and Bloomberg

Technical Analysis

IPC

Source: BBVA, Bancomer, Bloomberg

Despite a negative weekly balance on the IPC, at no time was a technical sale signal in the short-term triggered. The market fully respected both the previous minimum (40,434pts) and the 30-day rolling average which ended the week at 40,439pts. While the IPC continues to trade over this support level, the short-term trend remains unchanged and the positive tone is maintained. A downward break through this level would set the next floor at 40,000/39,800pts and then 38,800/38,500pts. In this way, we are keeping the resistance range between 42,000 and 42,200pts, where we would recommend taking profits in the face of the over-purchasing to be seen on short-term oscillating indicators.

Previous Rec. (30/7/12). It should be recalled that there has been not major adjustment since the bounce started at 37,000pts. While there is not trend change on the daily chart, we will hold positions.

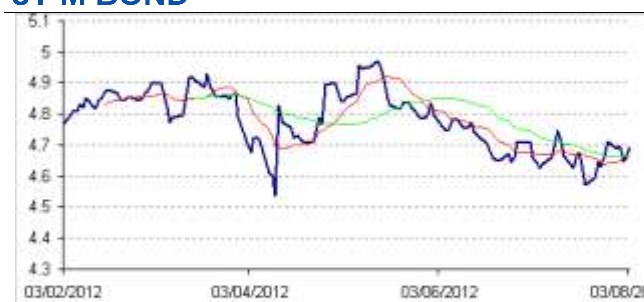
MXN

Source: BBVA, Bancomer, Bloomberg

The dollar started the week with a bounce taking it to the MXN13.50 zone, where several short-term resistances sat. Thereafter, it began a downward move taking it below the MXN13.25 support, hitting the previous minimum of MXN13.10. The oscillating indicators are still not seeing high over-selling and so we cannot rue out a move toward MXN13.00, where we would again recommend taking short-term positions.

Previous Rec.: (30/7/12). We believe the floor for this adjustment should be in the MXN13.25 zone, where we would recommend taking long positions with a stop loss at MXN13.22.

3Y M BOND

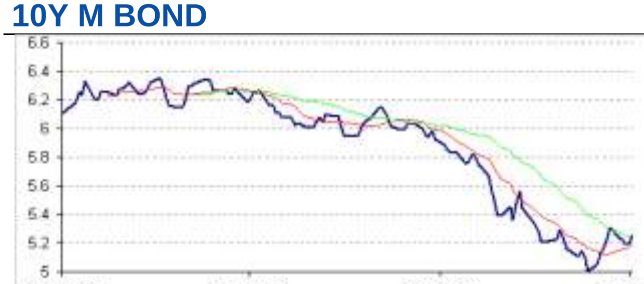


Source: BBVA, Bancomer, Bloomberg

3Y M BOND (yield): Returns to try and respects the 10- and 30-day rolling average zone. We maintain our forecast resistance at 4.75%. Above this level would mean a trend change.

Previous Rec. (July 23, 2012). We believe it could hit 4.75% and only breaking up through this level would point to a trend change.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

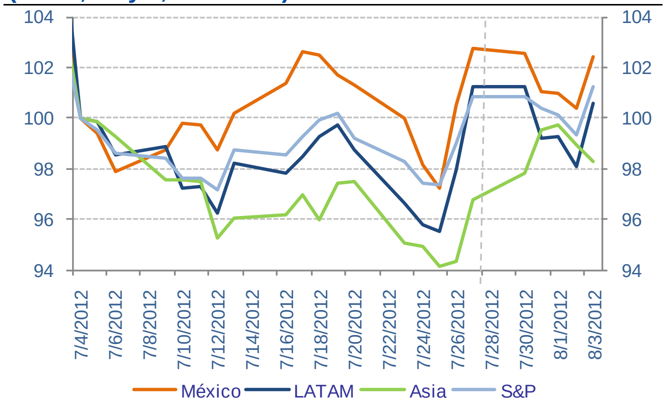
10Y M BOND (yield): Ends the week glued to the 130-day rolling average. The 30-day average has changed trend and we can expect a bounce toward 5.6%. Oscillating indicators also support this bounce. Stop loss under 5.18%.

Previous Rec. (30/7/12). With the position of the oscillating indicators, this break could appear seeking out 5.6%

Markets

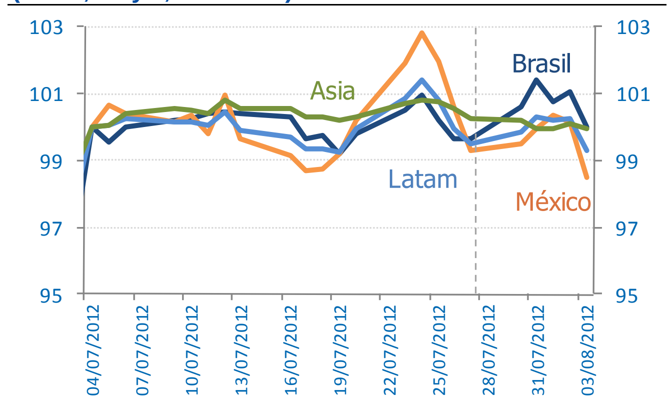
- **Better-than-expected non-farm payroll in the US at the end of the week led to gains on stock markets which partly reversed the losses from monetary authority statements without clear signs of more stimulus. Emerging market currencies strengthened over the week.**

Chart 7
Stock Markets: MSCI Indices (Index, July 4, 2012=100)



Source: Bloomberg & BBVA Research

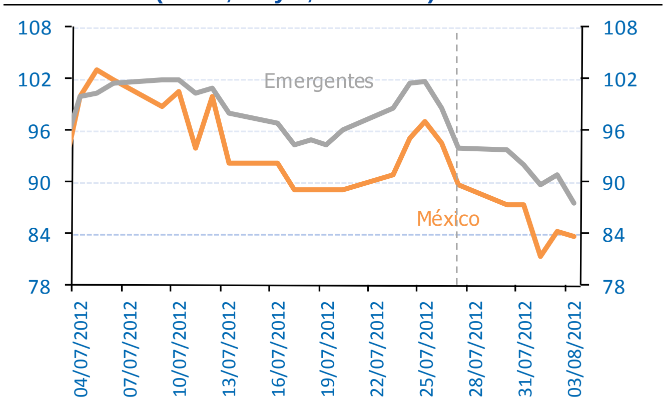
Chart 8
Foreign exchange: dollar exchange rates (Index, July 4, 2012=100)



Source: Bloomberg and BBVA Research Note: LATAM includes Argentina, Brazil, Chile, Colombia and Peru. Asia includes the Philippines, South Korea, Taiwan, Singapore, Indonesia and Thailand.
Non-weighted averages

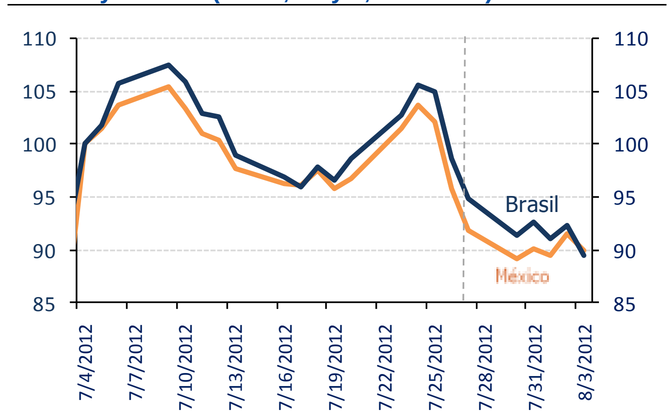
- **Fall in risk aversion due to expected ECB bond purchases and better-than-expected US data**

Chart 9
Risk: EMBI+ (Index, July 4, 2012=100)



Source: Bloomberg & BBVA Research

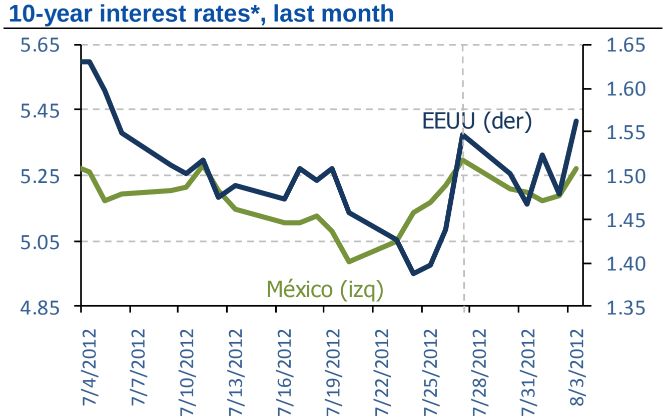
Chart 10
Risk: 5-year CDS (Index, July 4, 2012=100)



Source: Bloomberg & BBVA Research

- **Increase in Mexican interest rates mainly due to lower risk aversion and US T-bill rates.**

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

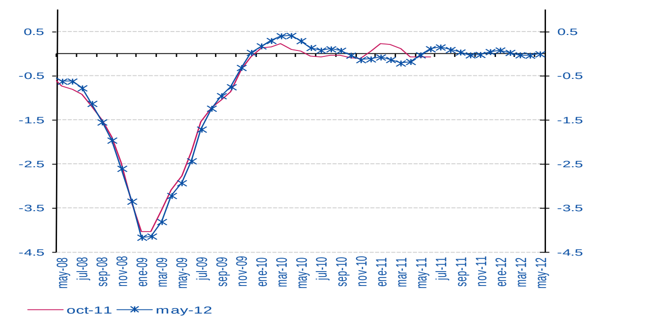
Chart 12
Carry-trade Mexico index (%)

Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

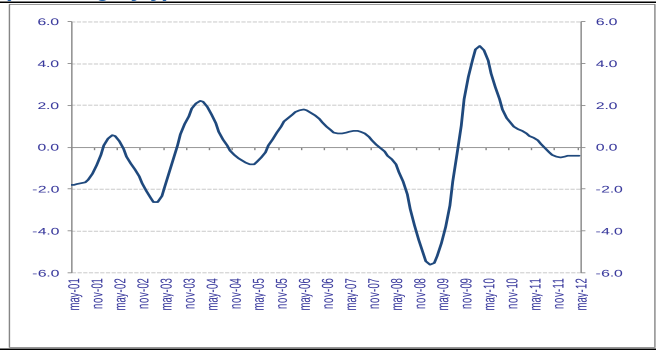
- **Output holds positive performance, situation indicators point to 2Q12 with quarterly rates around 0.7%.**

Chart 13
BBVA Research Synthetic Activity Indicator for the Mexican economy



Source: BBVA Research with data from INEGI, AMIA and BEA
Weighted sum of 21 different indicators of activity, expenditure and expectation, based on trend series.

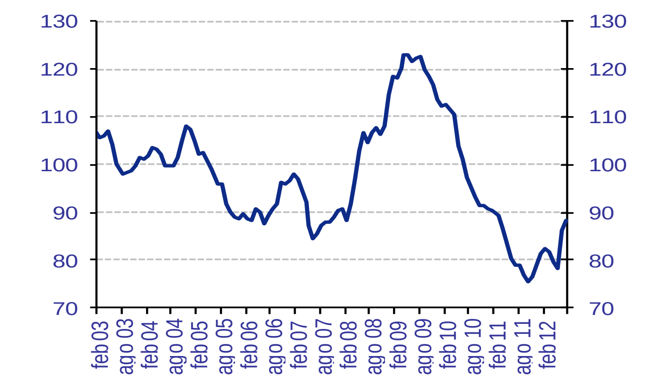
Chart 14
Advance Indicator of Activity, trend (% change y/y)



Source: INEGI

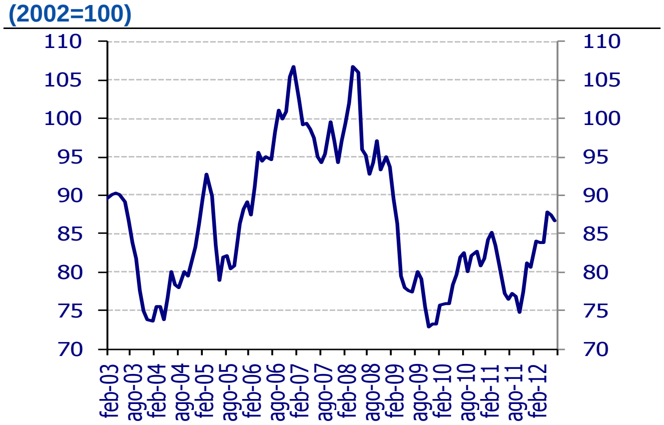
- **Inflation ceases downward surprises while output moved up.**

Chart 15
Inflation Surprise Index (July 2002=100)



Source: BBVA Research with data from Banxico from the monthly surveys on the expectations of economic specialists in the private sector.

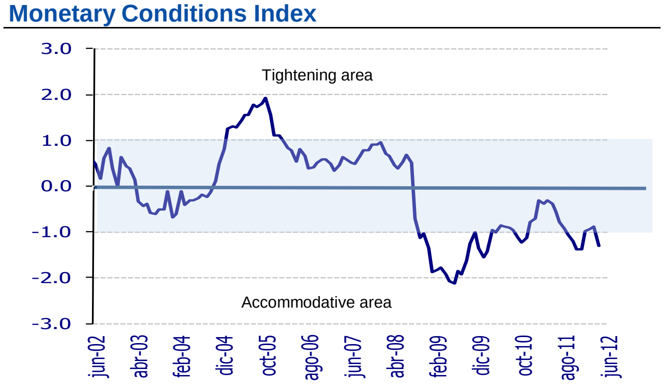
Chart 16
Activity Surprise Index (2002=100)



Source: BBVA Research with data from Bloomberg. Difference between recorded data and the Bloomberg consensus for seven activity variables in Mexico. Standardized index. Rises (falls): positive (negative) surprises.

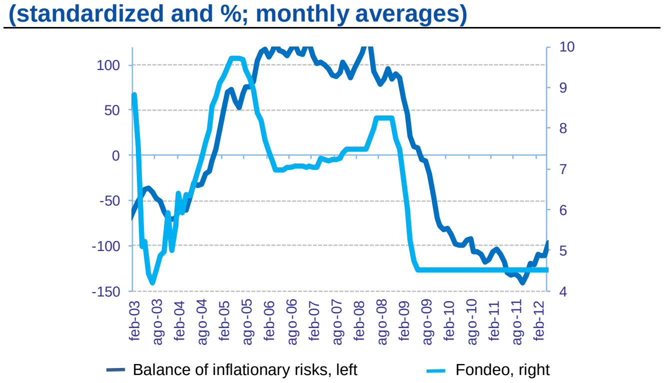
- **Monetary Conditions relax after higher inflation in June.**

Chart 17
Monetary Conditions Index



Source: BBVA Research

Chart 18
Balance of Inflationary Risks* and Lending Rate (standardized and %; monthly averages)



Source: BBVA Research. * Standardized and weighted index (of inflation and economic growth) based on economic indicators of economic activity and inflation. A rise in the index points to a greater weight of inflationary risks over growth risks and thus a greater possibility of monetary restriction

Claudia Ceja
claudia.ceja@bbva.bancomer.com
+5255 5621 9715
Octavio Gutiérrez Engelmann
o.gutierrez3@bbva.bancomer.com
+5255 5621 9245
Iván Martínez
ivan.martinez.2@bbva.com

Pedro Uriz
pedro.uriz2@bbva.com

Julian Cubero
juan.cubero@bbva..com

Ociel Hernández
o.hernandez@bbva.bancomer.com
+5255 5621 9616
Rodrigo Ortega
r.ortega@bbva.bancomer.com
+52 55 5621 9701

Alejandro Fuentes Pérez
a.fuentes@bbva.bancomer.com
+52 55 5621 9705
Arnoldo López
arnoldo.lopez@bbva.com

Cecilia Posadas
c.posadas@bbva.com

BBVA | RESEARCH | Av. Universidad 1200, Col. Xoco, Mexico 03339 D.F. | researchmexico@bbva.bancomer.com | www.bbvaresearch.com

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