Mexico Weekly Flash

Next week…

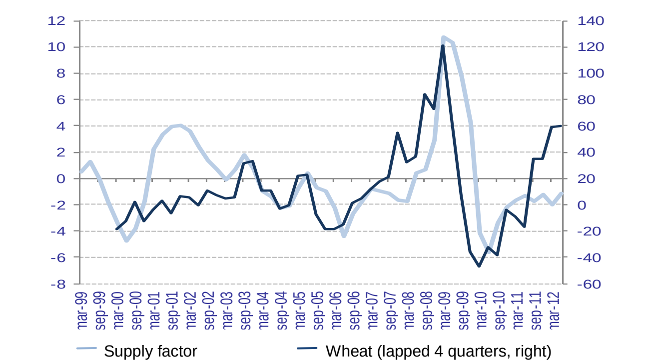
- **Focus on supply shocks, the factors behind the recent inflation rise.**

  Inflation reached its yearly low (3.4%) in April and since then it has risen to hit 4.45% in the first two weeks in August, higher than the Banxico target variability range. This upswing, albeit of concern, does not mean there are general price pressures. It is due to price rises in products more sensitive to external shocks on prices and output levels (e.g. food and energy). In the meantime, prices more linked to domestic demand performance such as services remain stable with low inflation (2.4% y/y). The inflation rate can be broken down into two factors, one linked to goods and services demand in the economy and the other to supply factors, i.e. linked to international prices and the exchange rate trading level.[1] By breaking down inflation into these factors, it is clear that the current inflationary shock is mainly due to supply factors, such as the international wheat price (see chart 1), which are expected to be temporary. Demand is still not a price pressure factor (as seen in output capacity in use and the jobless rate which have yet to recover their pre-crisis levels, among other variables) and we therefore believe this inflation target deviation, albeit important, does not imply general price pressures.

- **Markets continue cautious awaiting news on the turmoil in Europe and global liquidity**

  The MXN continued to fluctuate without a defined trend (limited range of 13.04-13.25) although it is likely that statements expected in September (both in terms of liquidity and EU sovereign measures) lead to greater volatility in the future. In fixed income, Fed minutes point to a long-term liquidity scenario which should benefit the Mexican bond market. We believe the long part has higher value and therefore maintain our recommendation to stay long in the back tranches and short in the medium part.

Chart 1
Supply inflation factor and wheat prices (% change y/y)



Source: BBVA Research.

Chart 2
Carry-trade index MXN vs. BRL (Rate difference 12m vs. US, adjusted for 1m implied volatility)

Source: BBVA Research and Bloomberg

[1] See Box 2, "Supply factors affecting inflation in Mexico in the face of no major demand pressures" in Mexico Economic Outlook 3Q2012, available at http://www.bbvaresearch.com/KETD/fbin/mult/1208_MexicoOutlook_3Q12_tcm348-351688.pdf

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No trends in the MXN in a continued cautious market.

Although the flow of news and economic events was stronger in the first half of the month, last week the MXN remained without any clear direction, fluctuating in a limited range of 13.04-13.25. The lack of trend continues to be down to a cautious market in the face of mixed determining factors in the US but which in the short-term could drive higher volatility. On the one hand, the lack of flexibility in conditions for Greece continues to affect the region's risk premiums. On the other, investor expectations of a new stimulus package at the Fed increased since the last minutes of the board. All this could become clearer in coming days with statements from Bernanke and Draghi at the end of the week. In addition, it is important to highlight that once the summer holidays end, liquidity will return. In this way, maintained caution over coming days would not be surprising. Nonetheless, we repeat that toward September events could further weaken the currency. This would only be contained if Bernanke maintains a more expansionary discourse.

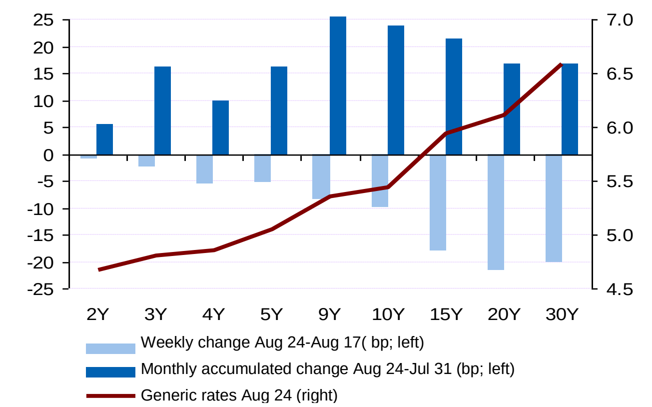
Curves have support thanks to greater overseas appetite for Mbonds

After the upward correlation of Mbonds in the first weeks of August, the long part of the curve was supported at the end of the week by higher overseas appetite. We estimate international rate levels explain up to 25% of inflows into the Mbonds market since 2008. Since we do not expect a lasting upward scenario for USTs in the medium-term, overseas appetite for the curve is likely to remain. Fed minutes confirmed that we are far from a seeing a scenario of higher rates and, therefore, USTs will continue to drive liquidity into emerging markets. The Mbond curve fell 6bp on average, with the long maturities seeing the best rally (dropping 8bp on average). The long part has higher value and we therefore maintain our recommendation to stay long in the back tranches and short in the medium part. Foreigners are buying into long parts and, in some instances, already count for 50% of holdings in this sector.

Weak relative performance on LatAm stock markets awaiting global measures

Stock markets saw slight profit-taking over the week in the face of mixed global figures. The political agenda in the first weeks of September continues to be the focus point for investors and, in the meantime, risk assets are showing trades in relatively limited ranges. In this sense, LatAm stock markets saw a relatively weak performance in comparison to other markets. Over the week, only Peru and Venezuela saw positive performances. In turn, Mexico managed to respect the 39,800pts support level. For the time being, markets are set to remain focused on economic events where US output signals will be a determining factor for the domestic market.

Chart 5
Mexico: Fixed rate yield curve (generic % and bp changes)



Source: BBVA Research and Bloomberg

Chart 6
Carry-trade index MXN vs. BRL (Rate difference 12m vs. US, adjusted for 1m implied volatility)

Source: BBVA Research and Bloomberg

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Technical Analysis

IPC

Source: BBVA, Bancomer, Bloomberg

After several downward sessions, the IPC ended the week by testing the 39,800pts zone where it started a slight upswing. It may be helped by the fact that issuers such as Amx and Femsa already saw a major adjustment and are trading with over-selling signals. At this time, we can only consider a pull-back toward the 40,400/40,500pts zone. If the market manages to come in above this level, we could consider it taking up an upward move again. We believe that it is still not the time to come in strong onto the market since IPC oscillating indicators have yet to hit over-selling zones and the 10-day rolling average has only just passed down through the 30-day. Therefore, the gap between both does not suggest a major short-term upswing.

Previous Rec. (20/8/12). The IPC has not had major short-term outlook changes, continuing to trade laterally in the 40,400pts to 41,500pts range.

MXN

Source: BBVA, Bancomer, Bloomberg

The dollar saw not major moves over the week, remaining around MXN13.15. The major resistance sits at MXN13.35 where the 200-day rolling average and the upper part of the short-term negative channel converge. We believe any upswing will be highly limited to this level. Breaking the MXN13.00 floor, the supports are MXN12.85 and MXN12.50.

Previous Rec. (8/20/12). We recommend taking positions awaiting a bounce with resistances at MXN13.30 and MXN13.50, maintaining a stop loss below MXN13.00.

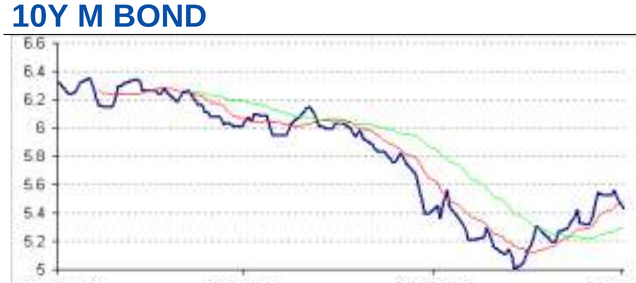
3Y M BOND

Source: BBVA, Bancomer, Bloomberg

3-YEAR M BOND (yield): The 10-day rolling average has started to change trend after the upswing in previous weeks. This could lead to a return toward 4.72% in the 30-day rolling average, the upward short-term trend remaining in place.

Previous Rec. (8/20/12). We maintain a target in the 4.9-4.95% range.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

10-YEAR M BOND: (yield): Hitting initial resistance at 5.6% and starting an adjustment. This moves means it has not hit below the 10-day rolling average. It could seek out the 5.25% zone in the 30-day rolling average to start an upward move again.

Previous Rec. (8/20/12). We maintain an initial target of 5.6% and then 5.8%. Initial support level at 5.4%.

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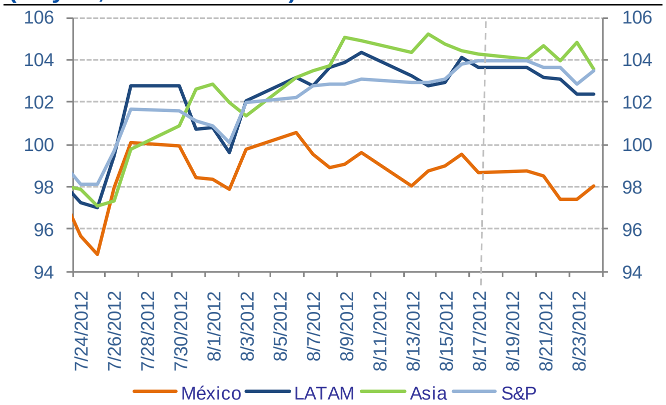
Markets

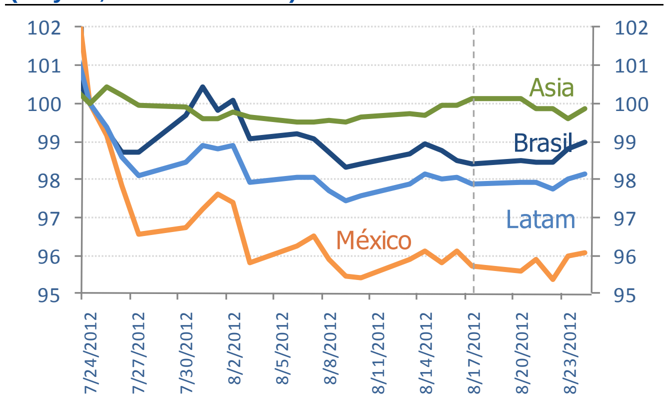
- **Investors remain in expectation of more details on possible additional expansionary measures from the FED and the ECB at their meetings in the next two weeks. This was reflected by marginal trading on share and currency markets.**

Chart 7
Stock Markets: MSCI Indices (July 24, 2012 index=100)



Source: Bloomberg & BBVA Research

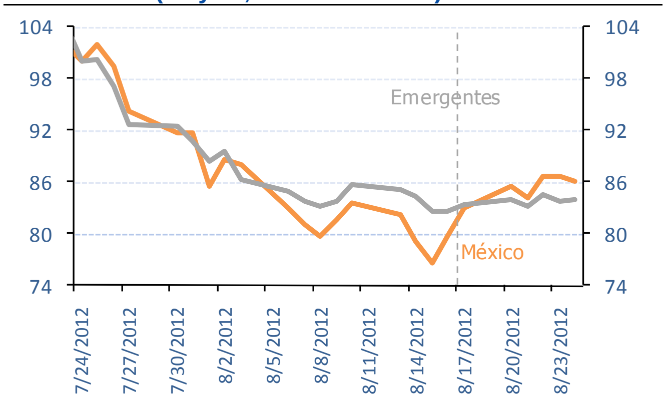
Chart 8
Foreign exchange: dollar exchange rates (July 24, 2012 index=100)



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

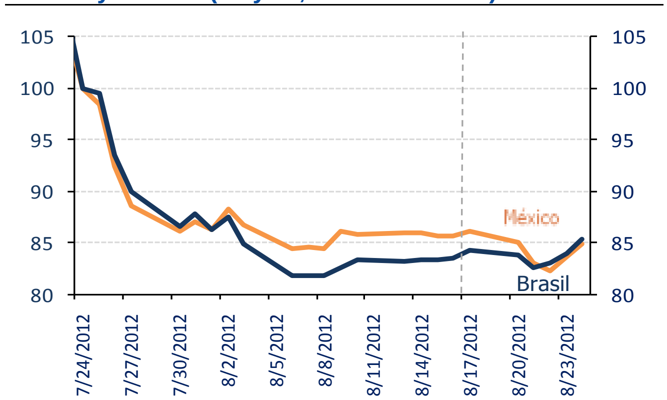
- **Global risk aversion indicators fall slightly mid-week after the release of minutes from the last Federal Reserve meeting in the US.**

Chart 9
Risk: EMBI+ (July 24, 2012 index=100)



Source: Bloomberg & BBVA Research

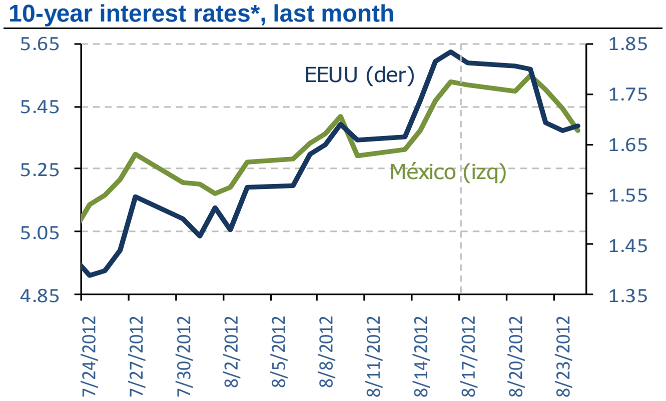
Chart 10
Risk: 5-year CDS (July 24, 2012 index=100)



Source: Bloomberg & BBVA Research

- **Fall in US rates after the release of minutes from the US Federal Reserve FOMC meeting, leading to higher expectations of additional monetary stimulus packages on markets. Mexican rates fall due to positive correlation with US 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

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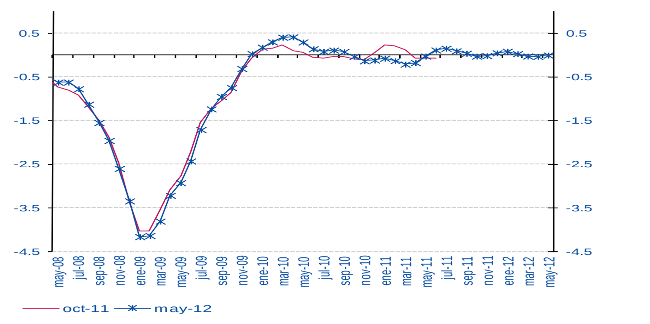
Activity, inflation, monetary conditions

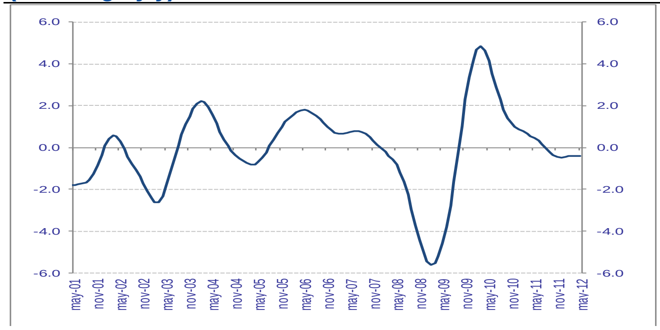
- **Output holds positive performance, situation indicators point to 3T12 with quarterly rates above 0.5%.**

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.

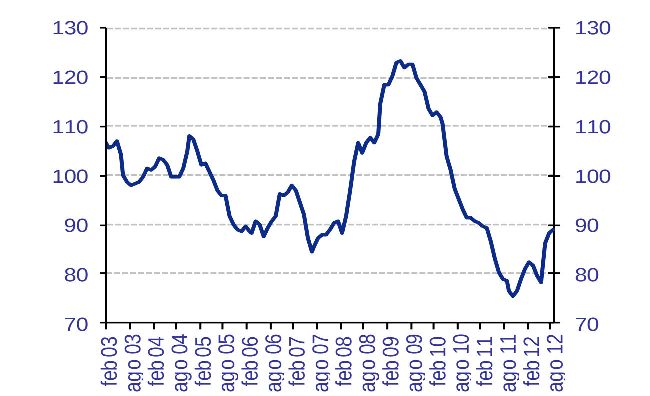
Chart 14
Advance Indicator of Activity, trend (% change y/y)



Source: INEGI

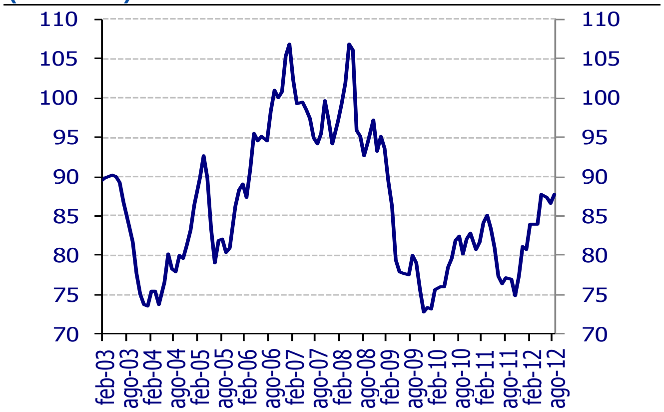
- **Inflation sees surprise upswing as does output.**

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.

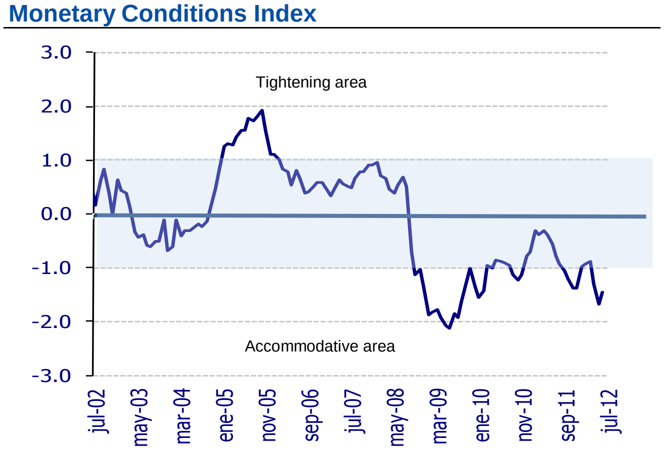
Chart 16
Activity Surprise Index (2002=100)



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.

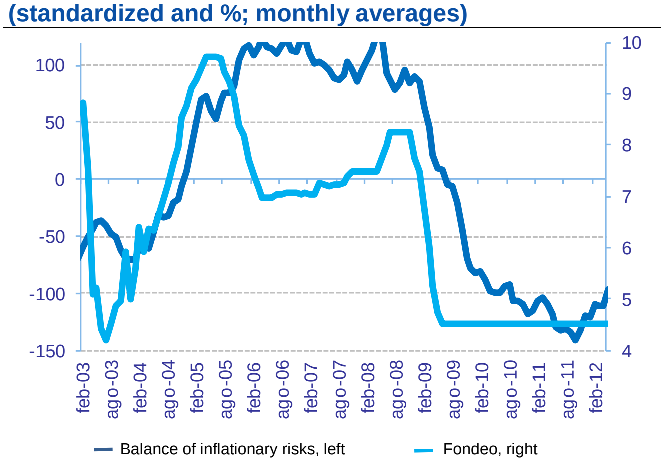
- **Monetary Conditions relax after higher inflation in June.**

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

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