Mexico Weekly Flash

Next week…

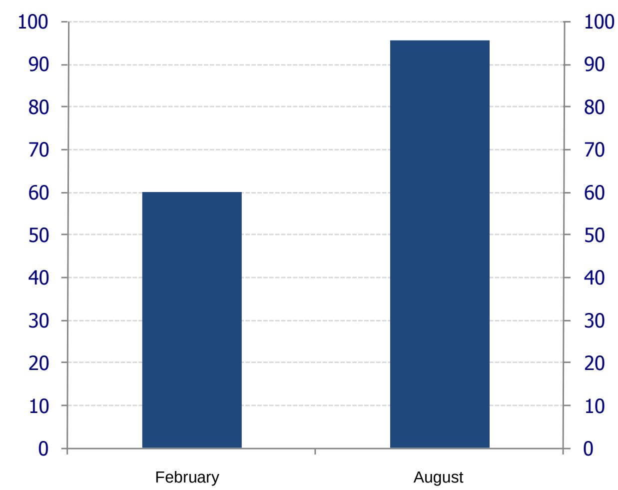
- **Banxico: Unchanged monetary policy decision with a neutral tone**

This coming Friday sees Banxico release its monetary policy decision. Risks over the global economy remained without major changes in recent weeks and markets focus is trained on possible monetary stimulus measures from the FED and ECB. On the domestic front, GDP growth figures for the second quarter showed a slightly surprising upswing (0.9% q/q vs. the expected 0.7% q/q) although they did come in below those in the first quarter (1.2% q/q). This points to economic activity maintaining a moderate growth rate. In terms of inflation, upward short-term risks due to the increase in commodity prices remain; nonetheless, given the slack in the economy, no demand pressures are being seen on prices meaning inflation is forecast to end the year under 4%. While the upward inflation and downward output risks remain, we maintain a forecast for monetary pause for the rest of the year with the chance of a cut if output gets worse.

Domestic curve and MXN toward levels anticipating greater liquidity

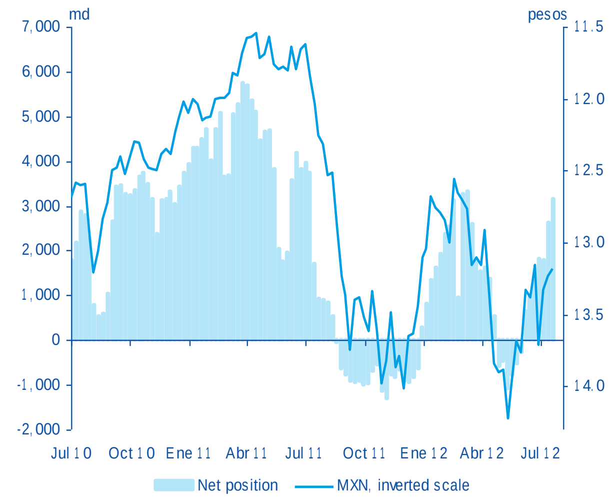
Domestic curves have gradually moved toward levels that would anticipate more liquidity being injected by the Fed and the ECB. We should continue to see in this weekly panorama low interest rates with a bias to flattening between the long part and the rest of the curve. In turn, the MXN has shown itself highly sensitive to more liquidity outlooks on global markets: on Friday, the MXN saw one of the largest advances among emerging currencies.

Chart 1
Analysts expecting a monetary pause for all of 2012 (% of analysts surveyed)



Source: Financial Market Analysts' Forecast Survey - Banamex

Chart 2
CME: Long Non-Trading Positions in MXN (USD$mn)



Source: BBVA Research with Chicago Mercantile Exchange

Calendar: Indicators

Consumer Confidence Indicator for August (September 4)

Forecast: 0.5% m/m 97.4 pts	Consensus: N.A.	Previous:	1.2% m/m 96.9 pts

Producer Confidence Indicator for August (September 4)

Forecast: 0.4% m/m 53.5 pts	Consensus: N.A.	Previous:	0.5% m/m 53.3 pts

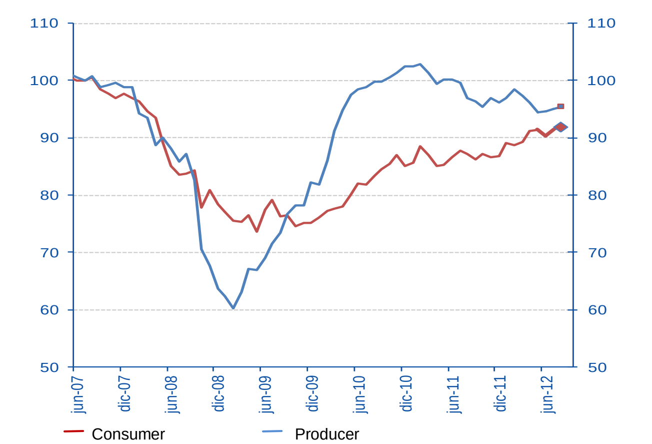
The producer and consumer confidence indicators are set to be released this week. Consumer confidence has benefited from the constant increase in employment at the IMSS, increasing at a rate of 0.4% per month on average since the end of 2009. It should be stated that since the lowest point in terms of job numbers at the IMSS in June 2009, just over 1.9 million jobs have been created in the private sector up to July 2012. Consumer confidence growth will be linked to the good performance in private consumption in the second quarter of the year and, in general, with solid domestic demand indicators. It should be said that the service sector contributed 0.7 of the 0.9 pts growth in quarterly GDP in the second quarter of the year. In turn, manufacturing producer confidence is set to see slight growth in line with the improved performance in relevant indicators such as US industrial output and automotive output, although this is in a downturn scenario dating from mid-2010.

August Inflation (September 7)

Forecast: 0.27% m/m 4.53% y/y	Consensus:0.27% m/m	Previous:	0.56% m/m 4.42% y/y

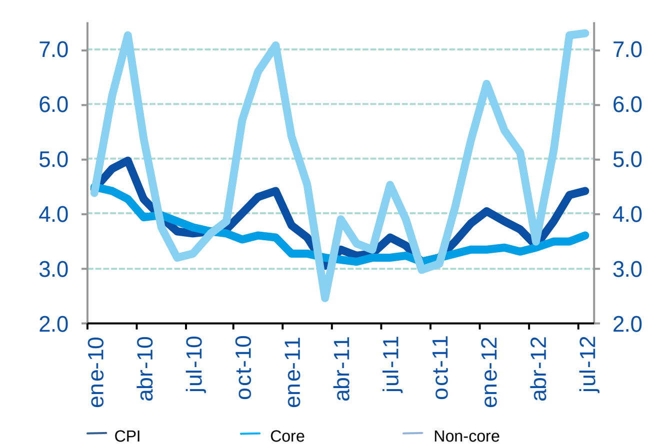
Next Friday sees the release of inflation in August which we expect to have expanded by 0.27% meaning, in annual terms, it will have increased to 4.5% y/y. We estimate that core inflation increased 0.24%, meaning, in annual terms, it also continues to rise, hitting 3.7% y/y. Inflation has increased since April due to different shocks coming together, such as higher global grain prices, the outbreak of bird flu in Jalisco, the high oil prices and the persistent weakening of the peso since last summer. Nonetheless, we believe that to date these shocks have not led to generalized price pressures, as seen in service inflation which to July was 2.5% y/y. Low service inflation, the high unemployment rate and slow consumer recovery show slack remains in the economy. Inflation is set to remain above 4% in coming months due to said shocks but we believe it will start to come down from October due to the adverse of effects of the shocks dissipating, thus closing the year under 4%. Nevertheless, the risk of new supply shocks possibly arising is there which would complicate inflation converging under said threshold.

Chart 3
Confidence: consumer and producer (Jul07=100)



Source: BBVA Research with INEGI data

Chart 4
Inflation breakdown (% change y/y)



Source: BBVA Research with INEGI data

Domestic curves toward levels anticipating greater liquidity in US and Europe.

Domestic curves have gradually moved toward levels that would anticipate more liquidity being injected by the Fed and the ECB over the week. The question now is not if the Fed will accentuate its expansive posture but rather how and when. We believe that beyond how a more expansive policy will be reached, extending the period where the Fed maintains low rates or injecting more liquidity (QE3), or both, the effect of domestic rates will be similar.

We should continue to see low interest rates with a bias to flattening between the long part and the rest of the curve, including the medium tranches. In the end, all this means a high liquidity scenario, high growth risks, domestic economic output standing out from other developed and emerging economies and a fiscal position without situational risks - with short-term upward, albeit manageable, inflation.

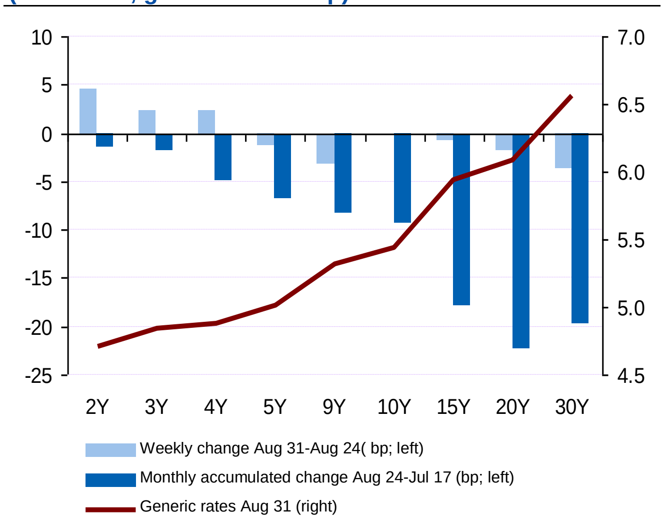
We maintain our recommendation of taking positions in the long sections, where we also forecast foreign investors are hitting similar concentration levels to those seen in the belly a few weeks ago.

MXN sensitive to global liquidity outlook

In Friday's session, the BRL and MXN saw better performance than most emerging currencies and the G10 since both ended with gains of around 1%. The move in the MXN is down to the possibility that the Fed injects liquidity and, especially, to its effects on US growth forecasts. Nonetheless, the currency saw losses over the week and pressure due to risk factors in Europe and the stop-loss kicking in.

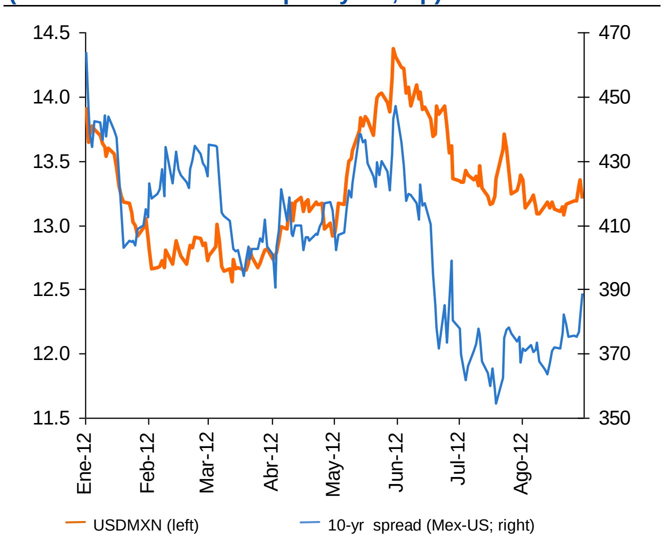
The coming days will be full of domestic events. Markets will be focused on the IMEF manufacturing index, released on Monday, and then monthly CPI and the Banxico meeting. We still do not expect to see changes in the central bank's stance (i.e. we maintain our outlook for a prolonged monetary pause) but given the short-term upward inflation pressures, any different bias could effect domestic fixed income assets and, at a lower level, the MXN. We believe, however, that optimism will remain in coming days while no concerns resurface in the EMU.

Chart 5
Yield curve
(Fixed rate, generic % and bp)



Source: BBVA Research and Bloomberg

Chart 6
MXN and 10-year bond interest rate spread
(USDMXN and M10 except 10y-TN, bp)



Source: BBVA Research and Bloomberg

Technical Analysis

IPC

Source: BBVA, Bancomer, Bloomberg

The market ended the weak trading below the 10 and 30-day rolling averages. Although it tested and respected the 39,800/39,700pts support range over the week, the risk the market may end breaking down through this floor remains. The opening between the 10- and 30-day rolling averages of the IPC is still not high (500pts) and the RSI maintains a downward trend without having hit the over-selling zone. As we have stated, breaking this support downwards would be important in the short-term since it would set the next floor in the 38,500pts zone where the 200-day rolling average sits.

Previous Rec. (8/27/12). We believe that it is still not the time to come onto the market since oscillating indicators have yet to hit over-selling zones and the 10-day rolling average has only just passed down through the 30-day.

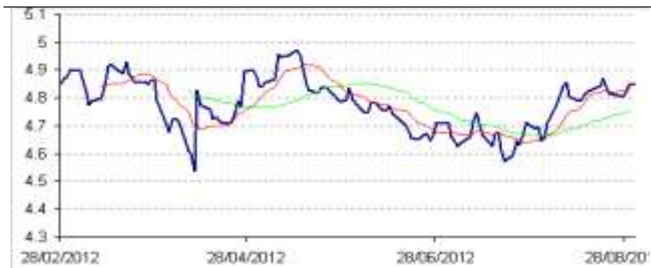
MXN

Source: BBVA, Bancomer, Bloomberg

The dollar finally leaves the lateral range (MXN13.05-13.20) where it has traded over almost 20 sessions. It saw an upswing toward the MXN13.35 zone but was not able to break through this resistance. At this time, we only recommend taking long positions if it manages to close above the 200-day rolling average (MXN13.35) looking to hit MXN13.75.

Previous Rec. (8/27/12). We believe any upturn is highly limited to the 200-day rolling average at MXN13.35.

3Y M BOND

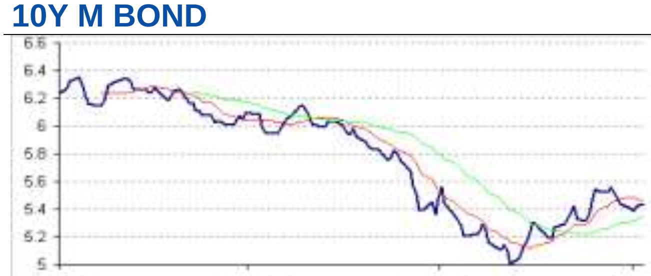


Source: BBVA, Bancomer, Bloomberg

3 YEAR M BOND (yield): The bond managed to remain trading above the 30-day rolling average and, therefore, the short-term upward trend. Major support at 4.75%; if it manages to break through 4.85% it could maintain the move toward levels near 5%.

Previous Rec. (8/27/12). This could return toward 4.72% at the 30-day rolling average, the upward short-term trend remaining in place.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

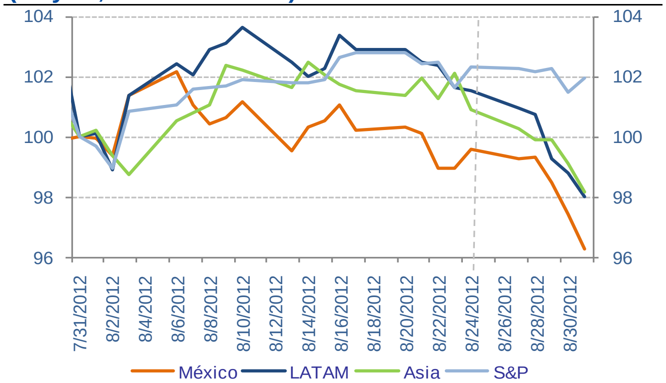
10Y M BOND (yield): Returning to the 30-day rolling average zone, respecting it and maintaining the current upward trend. Floor at 5.3% and initial resistance at 5.6%. Above this level, it could test the 5.6/5.8% zone.

Previous Rec. (8/27/12). It could seek out the 5.25% zone in the 30-day rolling average to start an upward move again.

Markets

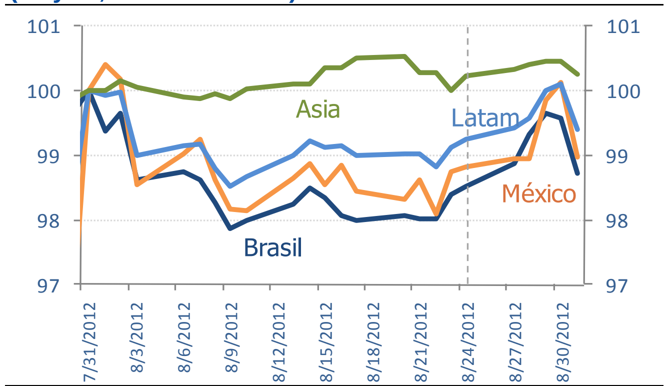
- **Strengthening moves in LatAm currencies after the chair of the Federal Reserve emphasized the likelihood of additional quantitative easing remaining on the table. The stock market in Mexico saw losses at the end of the week influenced by the change in the index composition to come into effect this coming Monday. In Brazil, the government's announcement of measures to reduce the cost of energy had an effect on the stock market falls.**

Chart 7
Stock Markets: MSCI Indices (July 31, 2012 index=100)



Source: Bloomberg & BBVA Research

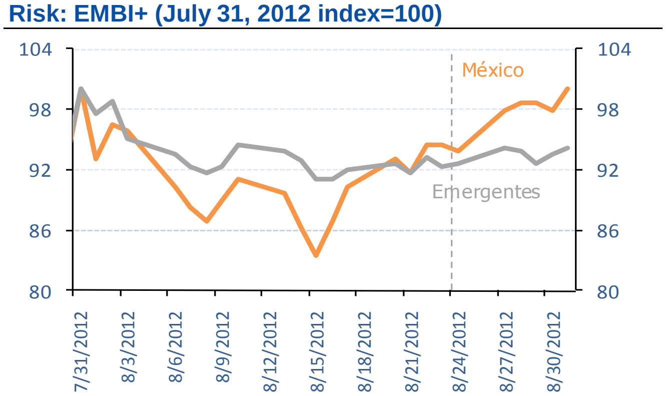
Chart 8
Foreign exchange: dollar exchange rates (July 31, 2012 index=100)



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

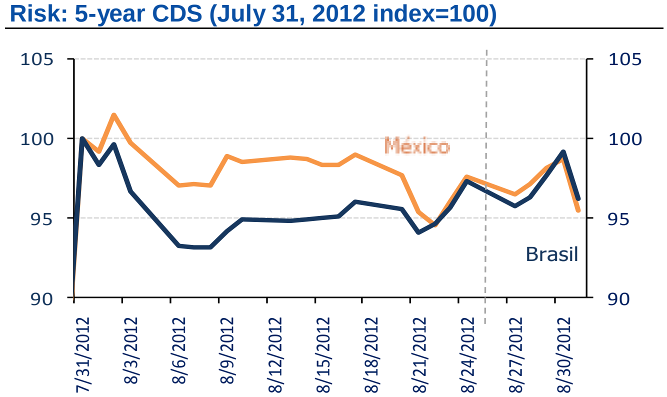
- **Fall in risk aversion toward the end of the week affected by the speech from the Federal Reserve chairman who showed greater concern over high unemployment.**

Chart 9
Risk: EMBI+ (July 31, 2012 index=100)



Source: Bloomberg & BBVA Research

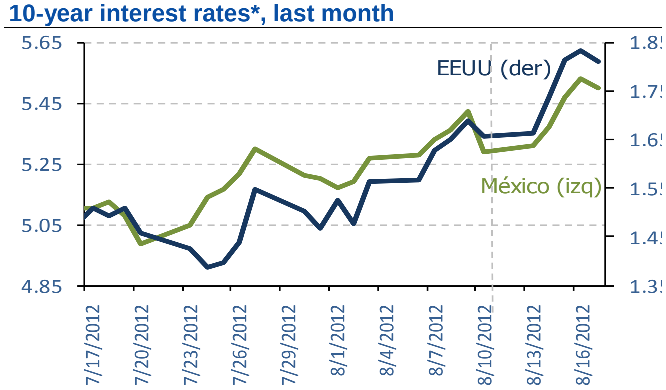
Chart 10
Risk: 5-year CDS (July 31, 2012 index=100)



Source: Bloomberg & BBVA Research

- **Fall in U.S. interest rates due to expected higher liquidity. Rates in Mexico move in line with Treasury rates.**

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

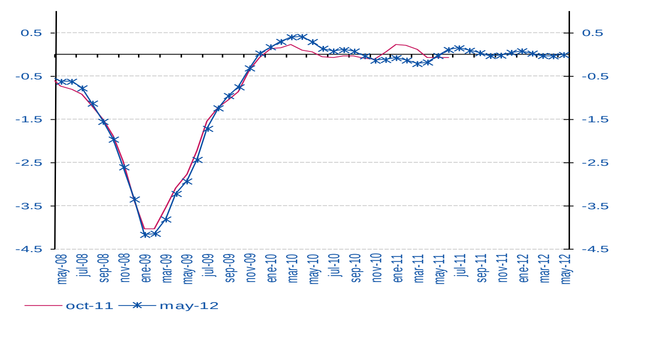
Chart 12
Carry-trade Mexico index (%)

Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

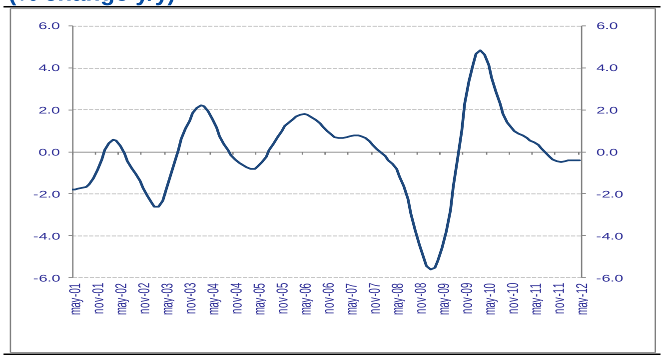
- **Output holds positive performance, situation indicators point to 3T12 with quarterly rates above 0.5%.**

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.

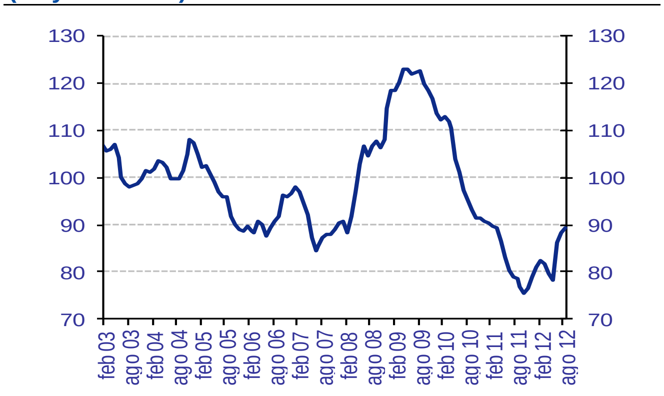
Chart 14
Advance Indicator of Activity, trend (% change y/y)



Source: INEGI

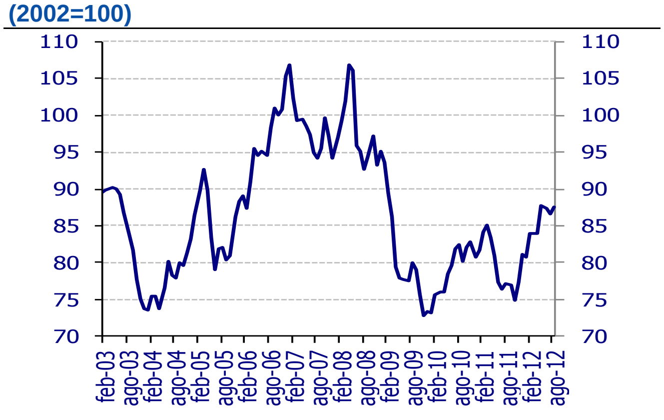
- **Recently we have seen upward surprises in inflation and output.**

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.

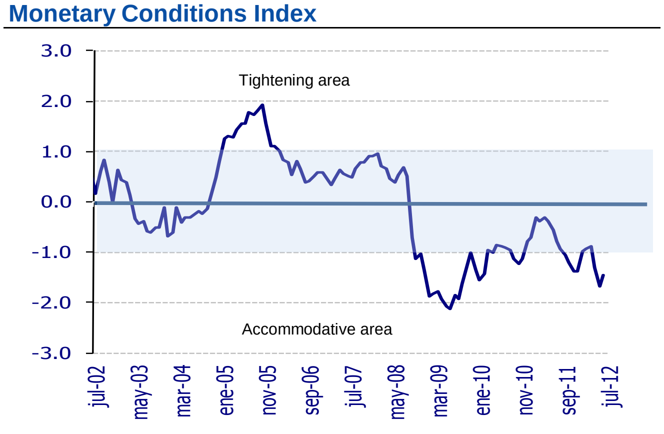
Chart 16
Activity Surprise Index (2002=100)



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.

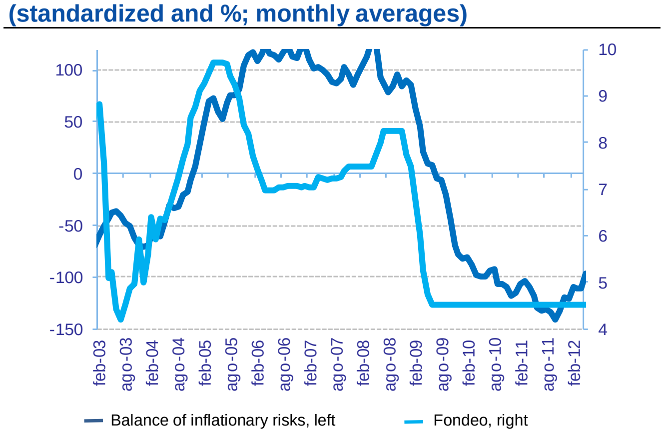
- **Monetary Conditions relax after higher inflation.**

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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