# Mexico Weekly Flash

## Next week…

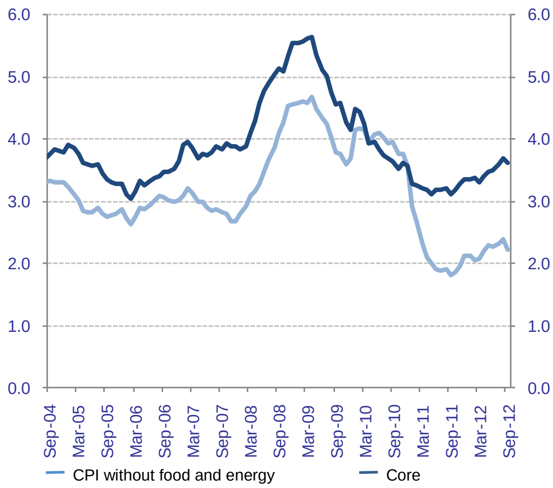
- **Monetary pause set to continue despite inflation being over 4.0%.**

  This coming Friday Banxico will release its monetary policy decision where we expect to see no changes in the lending rate. Since the last meeting, inflation rose from 4.57% to 4.77% y/y and we expect it to remain above 4.0% to at least the first quarter of 2013 thanks to the prices increases seen in food and energy showing higher-than-expected persistence. Despite this inflation level, we believe the monetary pause will continue, based on three factors: i) there is currently no evidence showing secondary effects on prices, as shown by below-target core inflation and rate of around 2.2% if we take out food and energy; ii) the most recent figures for the foreign sector (e.g. manufacturing exports and automotive output) show signs of a slowdown making it difficult for market slack to reverse; and iii) medium-term inflation forecasts were not affected by the recent increase in headline inflation. All these factors linked to a likely decline in inflation in the second half of next year lead us to believe the monetary pause will continue over 2013. Nonetheless, the monetary stance could harden if there is evidence of knock-on effects on prices.

- **Foreign capital inflow to the Mexican bond market are not decreasing at present, nor will they in the medium-term**

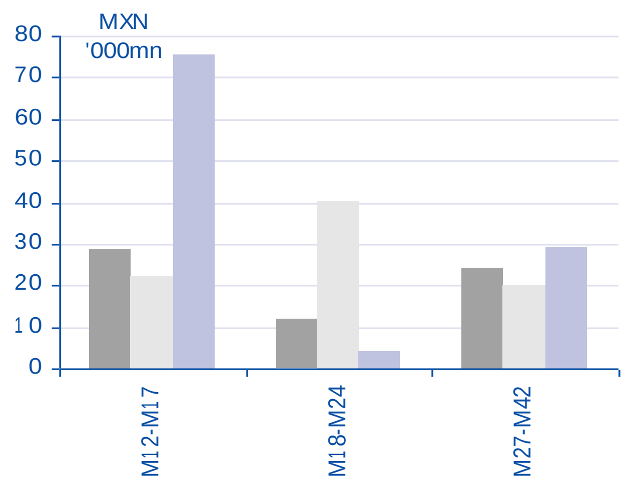
  We expect overseas investors to continue to increase their exposure to the long part of the curve in light of the economic reform agenda planned for Mexico and fewer variables linked to risk in comparison with the rest of the world. Strategy monitoring further on.

Chart 1
**Core inflation and inflation not including food or energy. % change y/y**




Source: BBVA Research and INEGI

Chart 2
**Foreign capital inflows to Mbond curve in 2012 (billion pesos)**




Source: BBVA Research with Chicago Mercantile Exchange

# Calendar: Indicators

## Retail sales in August (October 22)

| | | | |
|---|---|---|---|
| Forecast: -1.2% m/m (2.2% y/y) | Consensus: | Previous: | -1.4% m/m, (3.0% y/y) |

## Aggregate Services Indicator in August (October 22)

| | | | |
|---|---|---|---|
| Forecast: 0.5% m/m (8.9% y/y) | Consensus: | Previous: | 2.8% m/m (9.1% y/y) |

## IGAE in August (October 24)

| | | | |
|---|---|---|---|
| Forecast: -0.6% m/m (3.6% y/y) | Consensus: | Previous: | 0.7% m/m (4.2% y/y) |

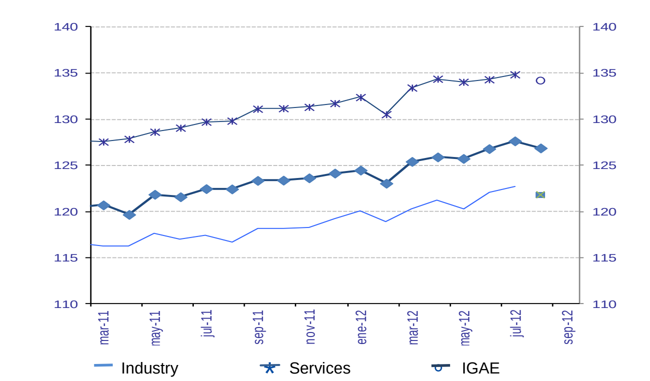
Activity Indicators: retail sales and IGAE in August. With the figures for industrial output for the month already known, it will be important to see how the tertiary sector performed in August. It should be stated that industrial output saw a negative surprise, contracting (-)0.8% m/m (3.8% annual, seasonally adjusted). This contraction was largely due to lower foreign demand which led to decreased production in key areas such as the automotive industry, with a decline of (-)3.5% m/m, far below what was seen just in the second quarter where transport equipment increased by 1.9% on average. The most exposed sectors to foreign demand contracted on average by (-)1.6% m/m in August while those most linked to the domestic market expanded by around 0.3% m/m. In this way, it will important to see how retail sales performed on the service side and the aggregate services indicator. In both instances we believe they will have seen a negative effect due to the slowdown overseas leading, in turn, to higher uncertainty. The decline in the consumer confidence indicator points to this, with monthly contractions in the three of the last four months despite stable job creation in the formal sector. We therefore forecast the IGAE in services to have contracted around (-)0.5% m/m in August, meaning the aggregate IGAE will have declined by 0.6% m/m, in line with the slowing economic horizon in the third quarter of 2012.

## Inflation for the first two weeks in October (October 24)

| | | |
|---|---|---|
| Forecast: 0.48% bi-weekly (4.68% y/y) | Consensus: 0.47% bi-weekly | Previous: -0.44% m/m, (4.77% y/y) |

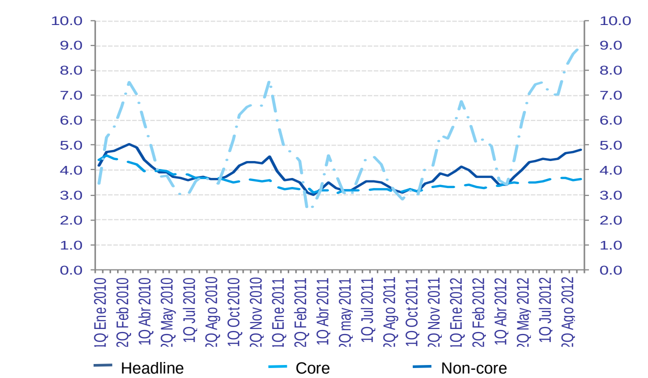
Wednesday 9 sees the release of inflation figures for the first two weeks of the month. We expect it to come have declined slightly from the 4.77% y/y seen in September. Despite this, several supply shocks continue to hit the non-core sub-index, such as the lack of eggs due to the bird flu outbreak and higher prices across the rest of livestock products due to high grain prices. In addition, the upward adjustments in electricity prices will start to be seen in the non-core index in October due to the start of the winter season. This coincides with the upward adjustments in some fruit and vegetable prices which, together, mean that with the aforementioned shocks the bi-weekly increase in non-core inflation is high. In terms of core inflation, we expect a 0.23% bi-weekly increase meaning it should come in at 3.64% y/y, slightly above its September figure. Nevertheless, we estimate the prevailing slack in the economy, the higher competition in some sectors and the recent strengthening of the peso should keep price increases contained in non-food goods and services. In this sense, we underline that the rise in inflation to above 4.0% is mainly due to supply factors linked to commodities. Although these shocks have lasted longer than expected, they should not lead to knock-on effects for other prices in a context where consumer spending remains weak.

Chart 3
**IGAE, seasonally-adjusted series (2003=100)**




Source: BBVA Research with INEGI data

Chart 4
**Inflation breakdown (% change y/y)**




Source: BBVA Research with INEGI data

# Markets

- **Overseas investment strategy monitoring: Foreign capital inflow to the Mexican bond market are not decreasing at present, nor will they in the medium-term.**

Three patterns characterize the investment strategies of foreigners:

1) Inflows to the short part of the curve do not vary over time (they remain constant);

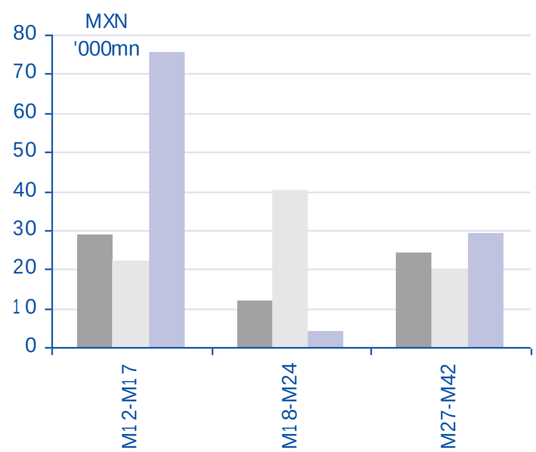
2) Foreign capital which mainly takes advantage of relative value moves along the curve, actively taking part in "flattener" and "*steepener*" operations;

3) Investments to take advantage of the *carry* (arbitrage between Cetes and NDF) when it is attractive and, when not, greater exposure to the short part of the MBond curve.

Given the relative value in the long part of the curve continuing to be attractive and the flows to the short part not reducing to flatten out at very low global rates, and higher official liquidity provisions, we maintain our constructive view of tranche strategy: long in the 3Y and 30Y, short in the middle section.

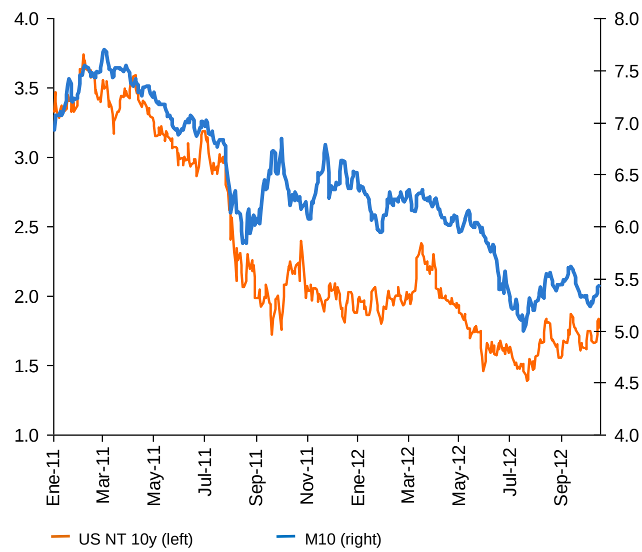
We also expect overseas investors to continue to increase their exposure to the long part of the curve in light of the economic reform agenda planned for Mexico and fewer variables linked to risk in comparison with the rest of the world.

Chart 5
**Foreign capital inflows to Mbond curve in 2012 (billion pesos)**




Source: BBVA Research and Bloomberg

Chart 6
**10-year Bonds: Mexico and US (%)**




Source: BBVA Research and Bloomberg

# Technical Analysis

## IPC


The weekly upturn took the IPC to levels near 43,000pts and the market RSI to trade in the over-purchasing zone slightly above 70pts. We had already stated that in these over-purchasing conditions and with the dispersal being seen in the 10- and 30-day rolling averages (almost 1,000pts), we see difficulties for the market to trade beyond a range between 43,000pts (psychological resistance) and 43,400pts (where the high part of the short-term upward channel trades). With this, we recommend maintaining a low investment level, cashing-in with issuers having seen good performance in recent weeks and waiting for the market to return to testing supports.

Previous Rec. (10/15/12): In order to be able to continue respecting this support, the IPC is highly dependent on the US market not seeing a negative trend change. For the time being, we maintain our forecast of a move toward 43,000pts.

Source: BBVA, Bancomer, Bloomberg

## MXN


The dollar ended the week with two upswings taking it slightly above the 30-day rolling average. The RSI points to a bounce toward MXN13.00 where the previous high sits. It has traded between MXN12.70 and MXN13.00 over the last month. If it breaks through the high part of this range, it could move toward MXN13.30.

Previous Rec. (10/15/12). It was unable to break the MXN12.95 at the close where the 30-day rolling average sits right now. Until it breaks this level at close, we will not see a short-term entry signal.

Source: BBVA, Bancomer, Bloomberg

## 3Y M BOND


3-YEAR M BOND (yield): The bond bounced above the 30-day rolling average. With the positive upward cross through the 10- and 30-day averages, we could expect a return to the 4.9%-5% range. Floor at 4.75%.

Previous Rec. (10/15/12). We recommend waiting an upward break through 4.8% to consider a move toward 5%.

Source: BBVA, Bancomer, Bloomberg

## 10Y M BOND


10-YEAR M BOND (yield): The bond managed to hit above the 5.4% resistance level. Given the relative position of the 10- and 30-day averages, we could suppose a return to 5.5-5.6%.

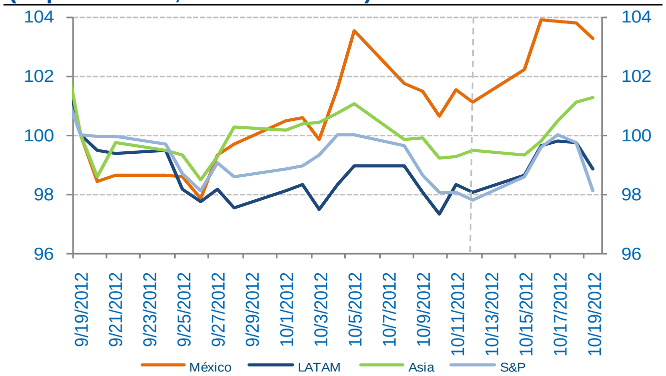
Previous Rec. (10/15/12). Only if it hits above 5.4% could we consider a trend change.

Source: BBVA, Bancomer, Bloomberg

# Markets

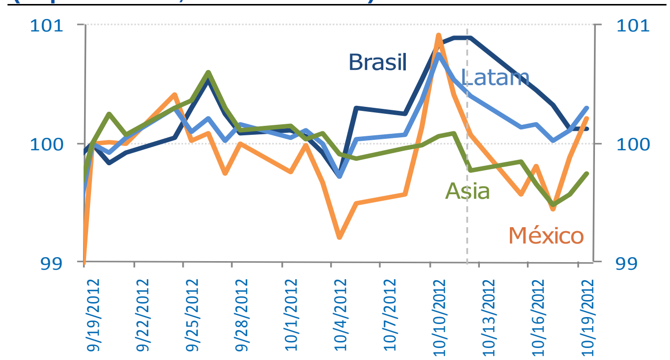
- **Better-than-expected US economic figures mainly for industrial output and housing starts led to gains on stock markets and strengthening currencies. Nonetheless, this performance reversed at the end of the week with lower-than-expected US corporate reports and the lack of progress in measures to solve the European crisis.**

Chart 7
**Stock Markets: MSCI Indices (September 19, 2012 index=100)**




Source: Bloomberg & BBVA Research

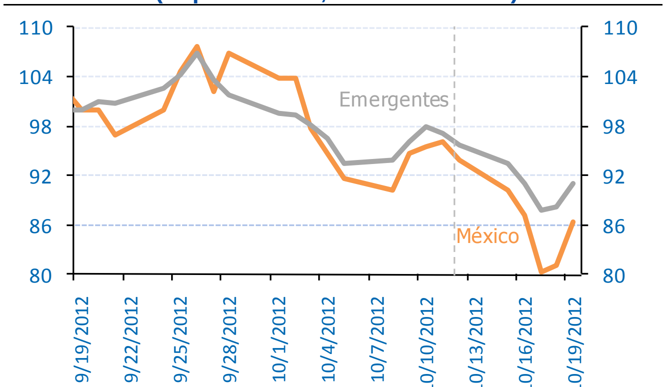
Chart 8
**Foreign exchange: dollar exchange rates (September 19, 2012 index=100)**




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

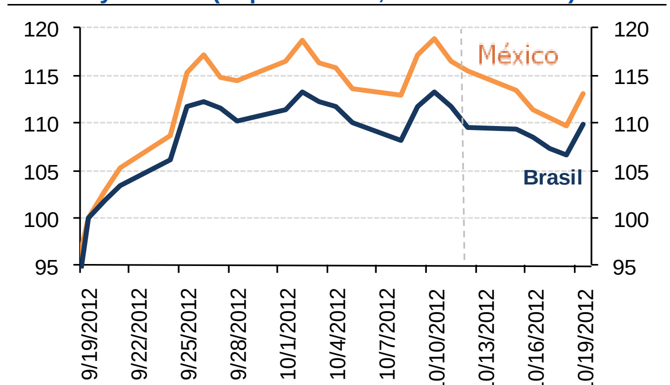
- **Weekly decline in risk aversion thanks to US economic figures which weakened on the last day after the European summit failed to discuss a Spanish bailout.**

Chart 9
**Risk: EMBI+ (September 19, 2012 index=100)**




Source: Bloomberg & BBVA Research

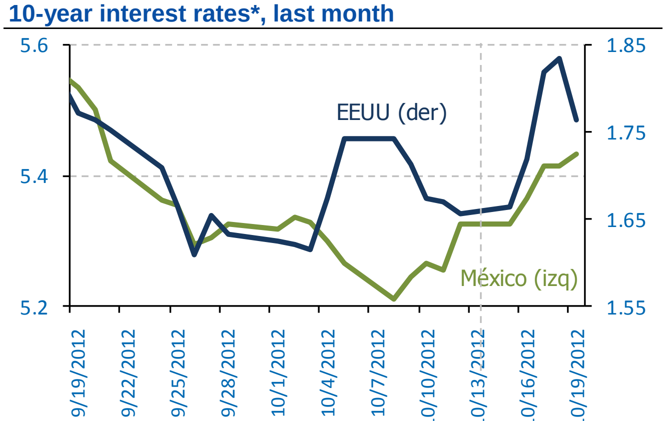
Chart 10
**Risk: 5-year CDS (September 19, 2012 index=100)**




Source: Bloomberg & BBVA Research

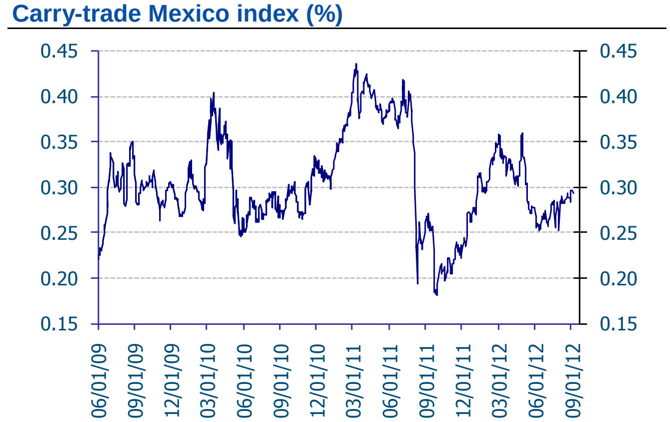
- **Lower US interest rates and higher Mexican rates due to a day of risk aversion at the end of the week.**

Chart 11
**10-year interest rates*, last month**




Source: Bloomberg & BBVA Research

Chart 12
**Carry-trade Mexico index (%)**

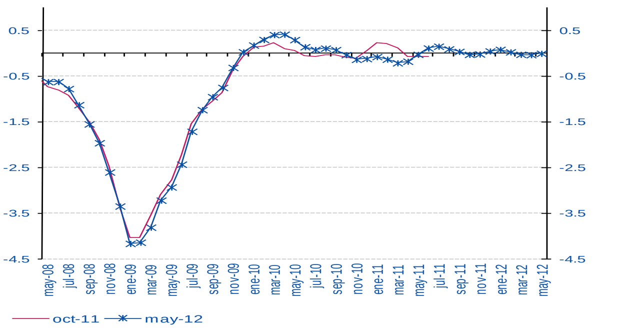


Source: BBVA Research with data from Bloomberg

# Activity, inflation, monetary conditions

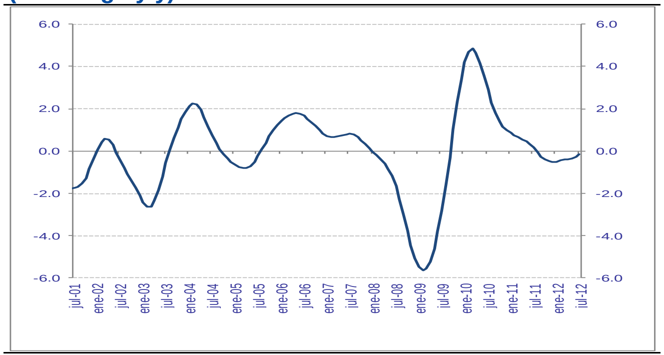
- **Output holds positive albeit moderate performance, situation indicators point to 3Q12 with quarterly rates above 0.5%.**

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.

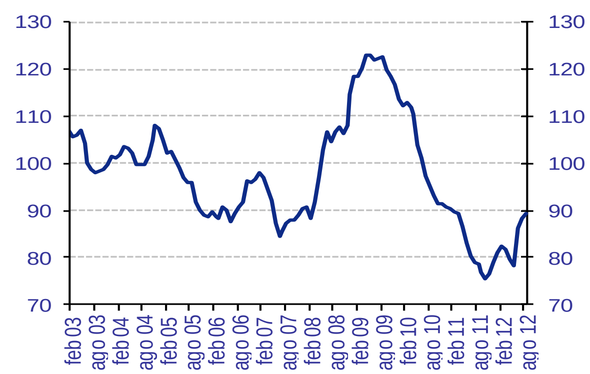
Chart 14
**Advance Indicator of Activity, trend (% change y/y)**



Source: INEGI

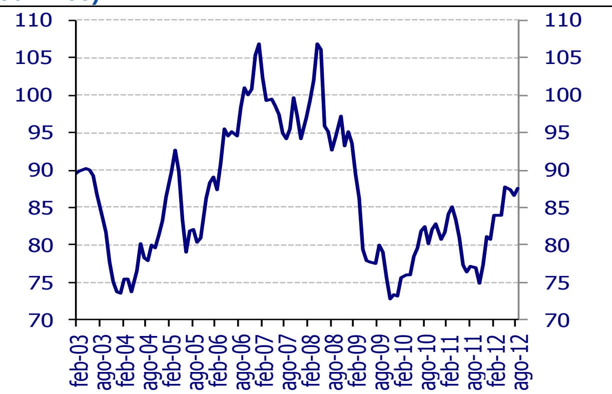
- **Recently we have seen upward surprises in inflation and output.**

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.

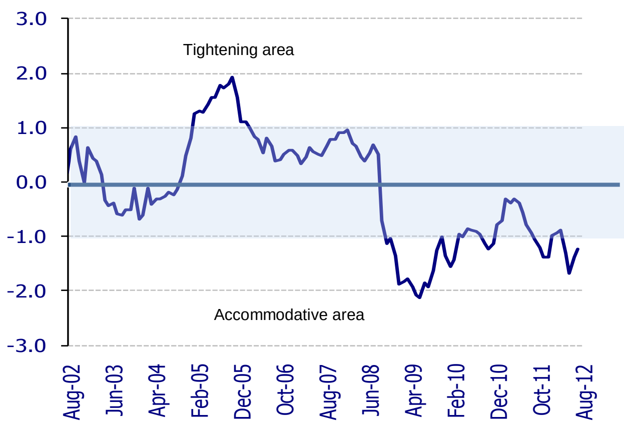
Chart 16
**Activity Surprise Index (2002=100)**



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.

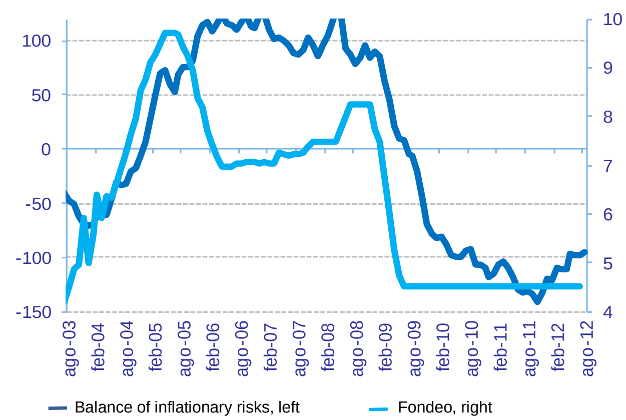
- **Monetary conditions slightly reduced their looseness after currency appreciation.**

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 IBR signals greater weight of inflationary risks over those of growth and, therefore, more likelihood of monetary restriction

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