

Mexico Weekly Flash

Next week...

- **Inflation slowdown in October set to continue with no demand pressures**

Next week sees the release of inflation figures for the first two weeks of November. We expect inflation to continue the slowdown begun in October. We believe non-core inflation will continue to slowdown thanks to the negative effects from the bird flu outbreak continuing to fade and the fair bill system implemented at CFE meaning inflation from electricity prices will reduce. We also forecast annual core inflation will see a slight reduction thanks to the good service price performance and to lower goods price pressures in October. After being majorly affected by multiple supply shocks, inflation has started to ease and will continue to fall over the rest of the year. Nonetheless, it will not manage to come in below 4% until the start of next year. As long as no new supply shocks crop up, inflation could fall quicker if global economic output slows since until now demand has not been a price pressure factor.

- **Risk aversion reduces although uncertainty remains**

Mot risk assets closed slightly up in Friday's session after hitting negative territory in early morning trading. The negative open came from the concern over the cycle since more negative surprises were seen in the US (industrial output was -0.4% compared to the expected 0.2%) after disappointing figures on Thursday from the country and the EMU. This, alongside growing tensions in the Middle East, set off a strengthening in safe-haven assets. Nevertheless, investor sentiment perked up after Obama's meeting with Congress as early statements showed a more flexible position among Democratic and Republican legislators equally. In this sense, stock markets ended slightly up, safe-haven assets fell back some from their early gains and the DXY index closed up, although not before losing some of the terrain gained during the day. The MXN saw better relative performance among LatAm currencies. However, this was also due to a technical adjustment. Meanwhile, the MBonds curve saw an upward albeit marginal move. It should be stated that although John Boehner, Speaker of the House of Representatives described conversations with Obama as "constructive", he also pointed out that "he would accept an increase in government revenue if it came with spending cuts" (in other words, a fiscal cliff). In light of the above, we believe markets will remain cautious in the future. Next week, investors will again be centered on Greece (there is a scheduled video conference on Tuesday) and economic figures. In our opinion, all this will lead to markets continuing to be highly volatile in the short-term.

Calendar: Indicators

Inflation for the first two weeks in November (Thursday, November 22)

Forecast: 0.75% bi-weekly (4.3% y/y)	Consensus: 0.72% bi-weekly	Previous: 0.51% q/q (4.6% a/a)
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Commercial establishments in September (Wednesday, November 21)

Forecast: 0.2% m/m (3.3% y/y)	Consensus: N.A.	Previous: 1.1% m/m (4.7% y/y)
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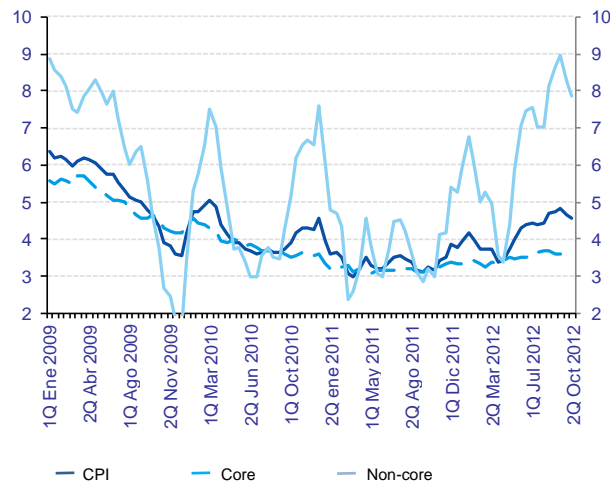
Indicators for occupation and employment, October (Friday, November 23)

Forecast: 4.8% of EAP	Consensus: N.A.	Previous: 4.7% of EAP
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The retail survey will show the slowdown already anticipated by the ANTAD indicator among similar shops. It should be stated that based on said indicator, deflated by the INPC and seasonally-adjusted, sales in similar ANTAD shops open for over a year increased 5.8% in September and contracted (-)5.8% in October. It should be underlined that workers' average income in real terms both in the formal private sector and among all workers was negative in annual terms in comparison with the last quarter which, despite high job creation, could be a factor behind the slowdown in domestic demand indicators. Based on IGAE figures for September, the service sector saw one of the largest slowdowns in recent months, contracting (-)0.3% in monthly terms, meaning growth was 0.7% for the third quarter being the sector seeing the largest slowdown in activity, after expanding around 1.1% in the second quarter.

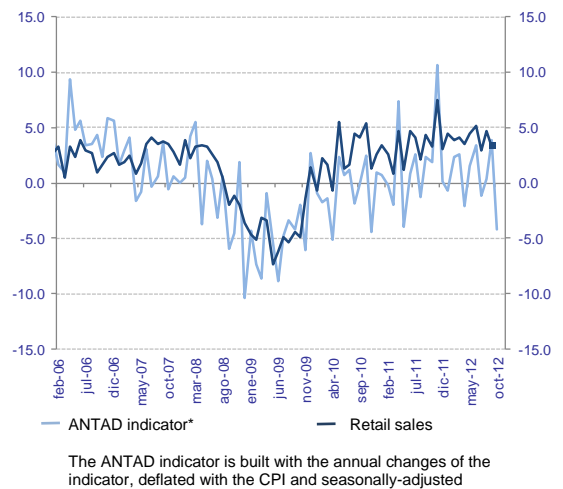
This week also sees the release of the performance in the unemployment rate and complementary employment rates such as under-employment or employment in critical conditions in October. It should be stated that these indicators showed a slow downward adjustment, specifically the unemployment rate went from 5% of the EAP on average in the last five quarters to 4.8% in the third quarter. We estimate that in October it stayed at the same rate while underemployment remained around 8% of those in employment, in line with the low salary levels of most workers.

Chart 3
Inflation breakdown (% change y/y)



Source: BBVA Research with INEGI data

Chart 4
Retail Sales and ANTAD Indicator (% change y/y)

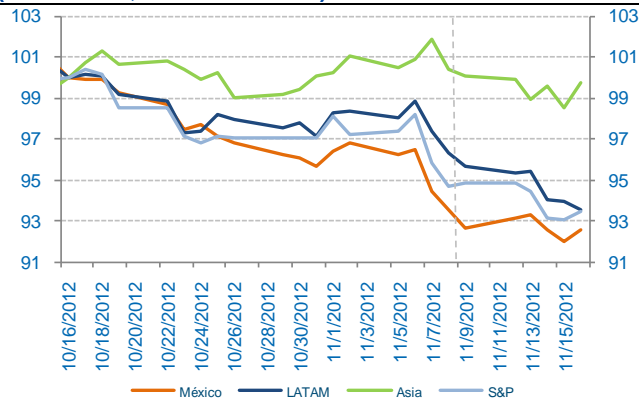


Source: BBVA Research, INEGI and ANTAD

Markets

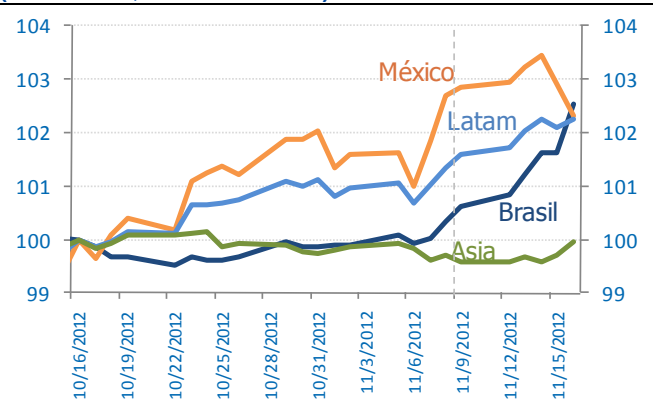
- The optimism after the first meeting between the US President and legislators to reach an agreement on the fiscal issue led to gains on the Mexican stock market and a major strengthening of the peso on the last day of the week.

Chart 7
Stock Markets: MSCI Indices
(October 16, 2012 index=100)



Source: Bloomberg & BBVA Research

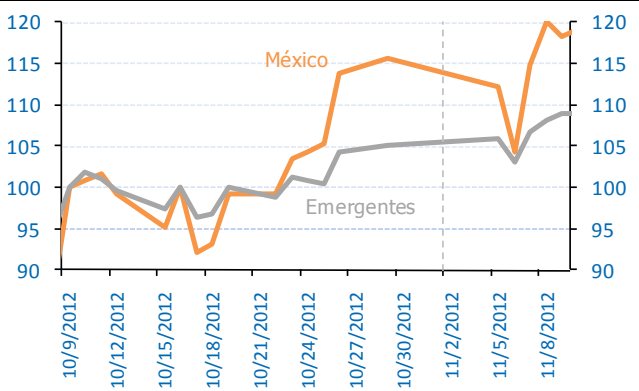
Chart 8
Foreign exchange: dollar exchange rates
(October 16, 2012 index=100)



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

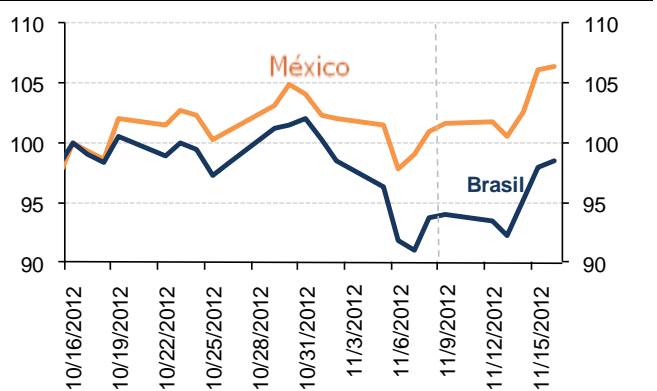
- Despite the optimism surrounding the aforementioned meeting, uncertainty remains around the possibility of an agreement avoiding the entry into effect of new taxes and automatic spending cuts in 2013

Chart 9
Risk: EMBI+ (October 16, 2012 index=100)



Source: Bloomberg & BBVA Research

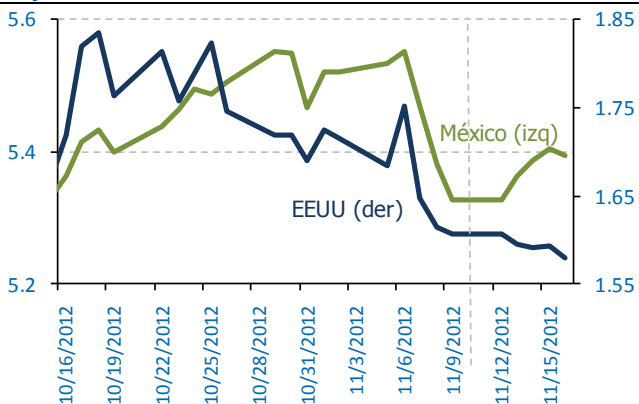
Chart 10
Risk: 5-year CDS (October 16, 2012 index=100)



Source: Bloomberg & BBVA Research

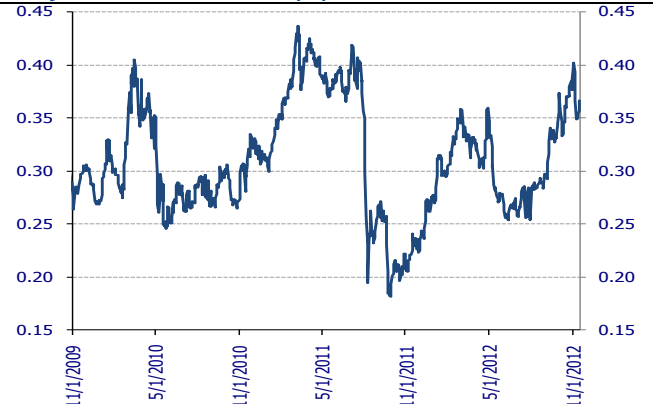
- The positive correlation returned between Mexican and US rates after changes in the opposite sense were seen over the week.

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

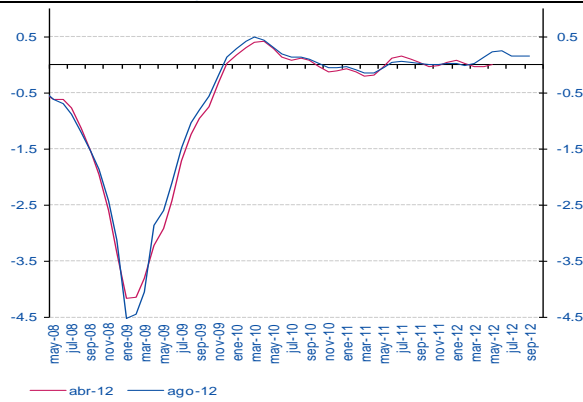


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

- Output slowed in the third quarter, indicators from the third quarter point to this continuing to see a soft slowdown

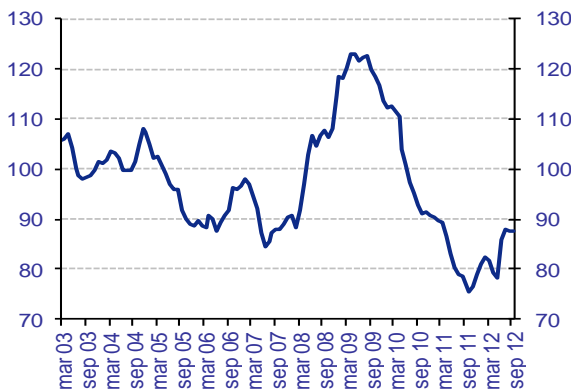
Chart 13
BBVA Research Synthetic Activity Indicator for the Mexican economy



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.

- It has recently seen a slight downward bias while inflation has stopped seeing upward surprises.

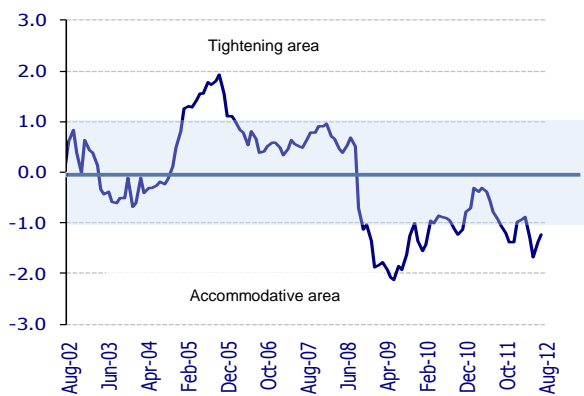
Chart 15
Inflation Surprise Index (July 2002=100)



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

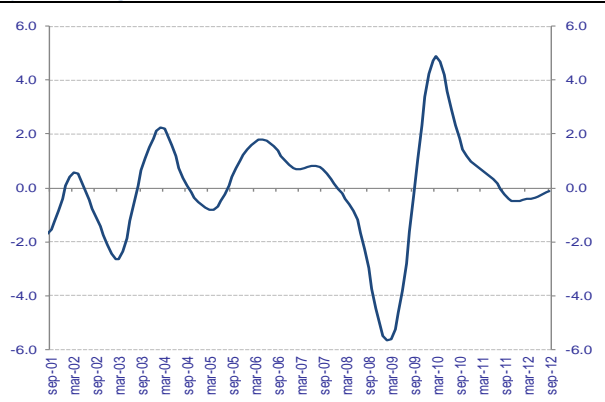
- Monetary conditions slightly reduced their looseness after currency appreciation.

Chart 17
Monetary Conditions Index



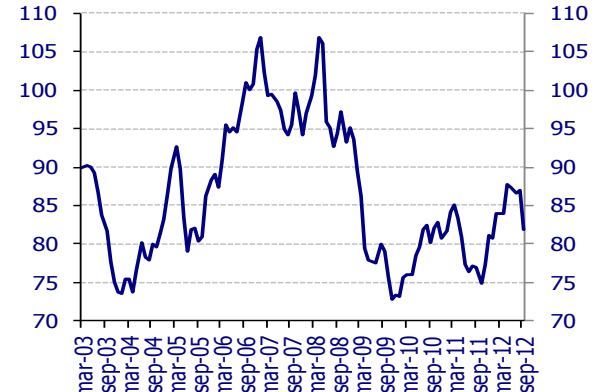
Source: BBVA Research

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



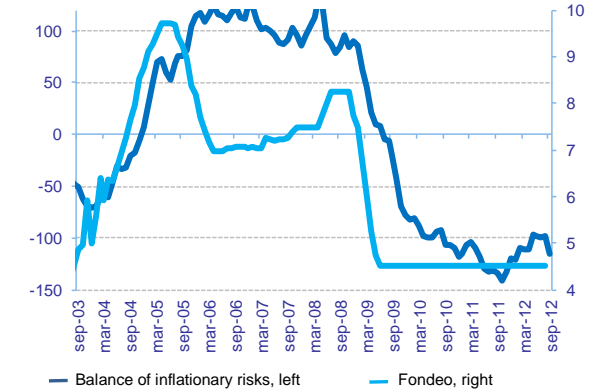
Source: INEGI

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.

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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