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Mexico Economic Outlook

4th QUARTER 2015 | MEXICO UNIT

01
Gently rising growth trend in spite of awkward conditions

02
Domestic demand has been a positive surprise and the prime mover of growth this year

03
Inflation will end 2015 at a historical low of around 2.4%

Index

1. Summary 2

2. Slower global growth in 2015 and a limited improvement in 2016 4

3. Gently rising growth trend in spite of awkward conditions 13

3.1 Modest improvement in the pace of growth in 2016 13

Box 1. *Fibra E*: a vehicle to promote investment in the energy sector and infrastructure 22

3.2 As we were expecting, annual inflation showed further falls in the third quarter 23

3.3 The central bank adopts a less restrictive tone, but the Fed remains the key catalyst for an initial policy rate hike 27

3.4 The Fed returns to the forefront after focusing attention on the December meeting 29

4. Indicators and forecasts 32

Closing date: November 13, 2015

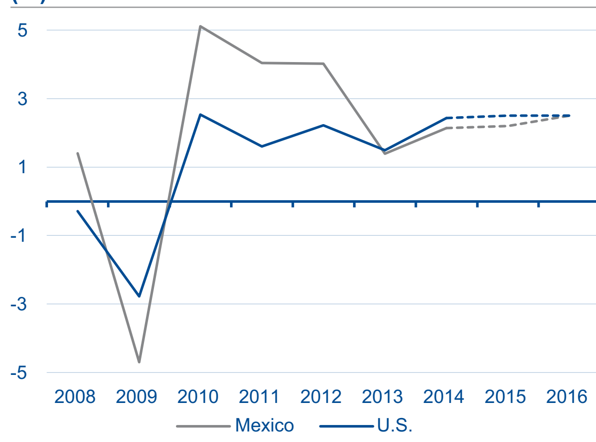
1. Summary

The forecasts for world growth are lower than in the previous quarter. According to our estimates, world GDP grew by 3.4% in 2014, will do so by only 3.2% in 2015 and is set to rally to 3.5% next year, which is barely the average for the past five years. For the first time since the 80s, over 2011-15 there was on the whole a simultaneous slowdown in GDP in the developed countries and in the emerging and developing economies overall. The burn-out of China's growth model is above all acting as a drag on the external demand of other emerging markets, particularly in the case of commodity exporters and those countries most integrated into its production lines. The prospects of an improvement in world GDP from 2016 should hinge on greater growth among the developed countries as the excessive private sector debt levels are whittled down. Growth could in turn be boosted by structural reforms that increase productivity in these countries.

Given the improvements in the US labour market, and the prospect of inflation picking up in the United States based on rising wages, we still think that the first US rate hike will take place in December, which the market is also factoring in, although a delay until the first quarter of next year is not totally out of the question.

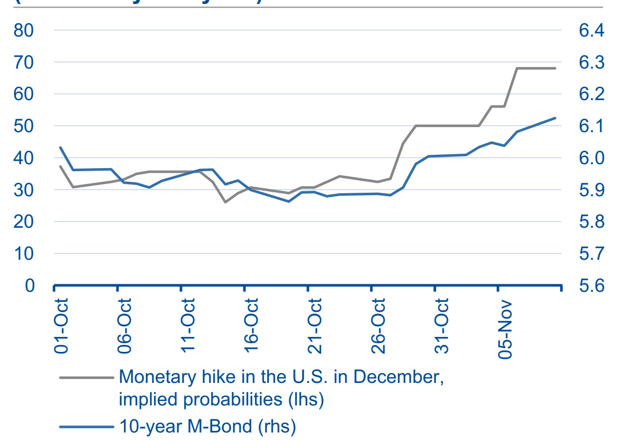
Turning to Mexico, we estimate that GDP will grow 2.2% in 2015 and 2.5% in 2016, having previously predicted 2.5% and 2.7%. The revision to the scenario is as a result of the lack of improvement in industrial production in the United States in the past few months, the absence of public spending on infrastructure and a downward revision of that country's growth scenario for 2016 from 2.8% to 2.5%. Furthermore, the cuts in federal government spending in Mexico in 2016 imply that this will cease to be a driver of growth. In a bid to mitigate the reduction in investment, a new financing vehicle called the Fibra E has been launched, which seeks to monetise pre-existing infrastructure and plough the funds from this monetisation process into additional infrastructure projects.[1] We view this mechanism as very positive, but to be at its most effective it will need considerable time to mature.

Figure 1
Annual GDP growth of Mexico and the United States (%)



Source: INEGI, BEA and BBVA Research.

Figure 2
Implied probability of a 25bp federal funds rate hike in December according to the futures market and the yield on the 10-year M-Bond (Probability and yield)



Source: INEGI and BBVA Research.

[1] See Box 1. *Fibra E*: a vehicle to promote investment in the energy sector and infrastructure.

The surprise on the high side in recent months has come from the services sector (which includes trade). We think that this improvement has been influenced by the peso depreciation, which lifts disposable income via remittances and the tourism industry, among other areas. All in all, over the first eight months of the year average services sector growth was 3.2%, which contrasts with growth of a mere 1.0% for the industrial sector.

The energy reform has continued to progress and the bidding process for the fields in the first two stages of Round 1 has been completed. Despite this, the low oil price has been instrumental in both a lower level of contract awards being made than was previously estimated and a delay in investments in deep waters (those that tend to be the heaviest), which implies that the gains from the energy reform will take longer to materialise.

In the medium term we estimate that the energy reform will still generate additional public investment and revenues, though at a rate below that previously expected, given the persistence of low world oil prices. Thus, as the oil price recovers, the additional investment that is projected in the energy sector (of some USD25bn a year in the medium term) should manage to contribute over one percentage point to Mexico’s economic growth.

Headline inflation has hit a new historic low of 2.5%. The low inflation over the year has been sustained by the slack in the economy, the telecoms sector reform, the fading impact of the tax hike and a helpful performance by agricultural product prices. Within this context, only low exchange rate pass-through to goods prices is observable, which has been offset by decreases in the cost of certain services, mainly linked to the telecoms sector. We predict that inflation will see out the year at around 2.4%. Looking to 2016, inflation is likely to begin to creep up as the economic conditions improve, assuming that the exchange rate will stay at a high level. We therefore estimate that inflation will average 3.3% in 2016.

As regards monetary policy, the statement by the central bank lends weight to a scenario of synchronisation of its target rate with the process of federal funds rate hikes in the United States, but both the high degree of slack and low inflation suggest that Banxico’s cycle of rate hikes ought to be slower than that of the Fed. We therefore think that Banxico will raise its benchmark rate to 3.25% and 3.50% by the end of 2015 and 2016 respectively, with a bias tilted towards a later lift-off than the first Fed policy rate hike, if this does finally transpire.

The implied probability priced into the financial futures market of a December MPR hike in the United States rose to 70% after the positive surprise from the October job creation figure and wage rises in the United States. Moreover, prior to these figures the Chair of the Federal Reserve had flagged that a federal funds rate rise at the December meeting was a “real possibility”. This prompted significantly higher government bond rates in both the United States and Mexico, as well as increased dollar strength against other currencies. The dollar’s persistent strength in a situation where there is little appetite for risk worldwide leads us to predict that the peso exchange rate will close this year at a level similar to those at the moment, and that the appreciation forecast for next year will be moderate, as we see a dollar rate of MXN15.90 at year-end 2016.

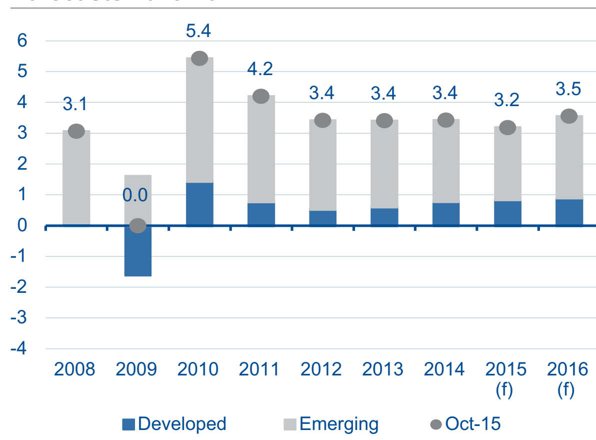
2. Slower global growth in 2015 and a limited improvement in 2016

According to our estimates,[1] global GDP has grown more slowly than we forecast and at a similar rate to that observed at the beginning of the year (+0.6% QoQ, +2.4% YoY), making four consecutive quarters of growth below the 2010-14 average. At a global level, activity has performed worse than expected in the past few months, mainly due to the ongoing deceleration in the principal emerging economies, in a context in which doubts over the strength of the economic cycle and the financial stability of China have triggered a significant spike in financial tensions and further corrections in commodity prices.

The balance of the first half of the year and the negative bias in the available activity indicators for the third quarter in geographies such as the US, Latin America and Mexico have been accompanied by a downward revision of the growth forecasts for the principal emerging economies for the full year. As a result, global GDP growth could close 2015 at an annualised 3.2% (0.2% less than we forecast three months ago), the lowest since 2009 (see Figure 2.1). The gradual recovery of the developed block will not be sufficient to offset the moderation in the emerging, given that the latter will grow barely 4% compared with average growth in the five previous years of more than 5.5%.

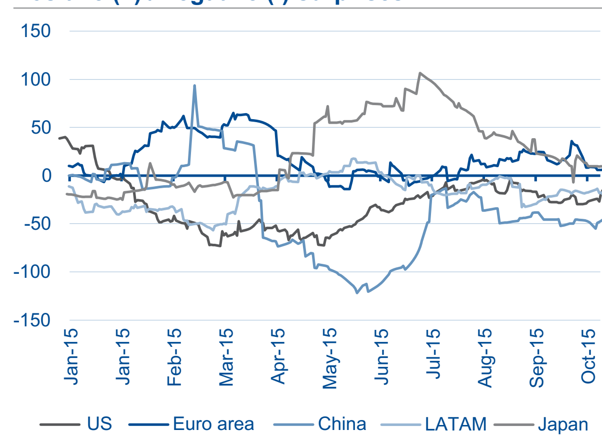
The outlook for 2016 is slightly more favourable (global growth could recover to 3.5%, 0.3% below our forecast three months ago), sustained by a better relative performance of both the developed and the emerging economies. Nevertheless, the recent intensification of some of the risk spots with greater impact at a global level, such as the deceleration of the manufacturing sector in China and its repercussions on the commodity cycle and world trade, increases the uncertainty and accentuates the downside risks for the recovery of those countries which are more dependent on external demand and savings. The potential deterioration in the medium-term growth outlook of developed economies such as the US is another factor to take into account in the outlook for global growth.

Figure 2.1
World GDP: annual growth (%) Forecasts 2015-16



Source: BBVA Research

Figure 2.2
Economic Surprise Index Positive (+) / negative (-) surprises



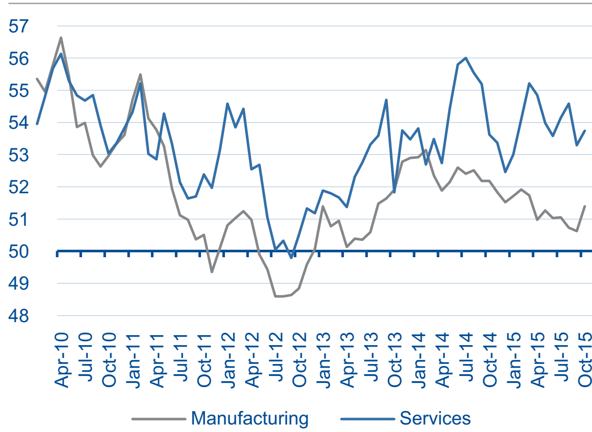
Source: BBVA Research & Citigroup

[1] Estimate based on BBVA Research's global activity indicator. Methodology detailed at http://bit.ly/1nl5RIn

In contrast to other recent episodes, the intensity of the deceleration in the emerging block is the determining factor in the loss of momentum of world growth. The Economic Surprise Indices (Figure 2.2) for China, which is growing at less than 7% YoY, and Latin America, in contraction, are reflected in negative level practically since the beginning of the second half of 2015. For the time being, the recovery in domestic demand and the continuation of easing monetary conditions are limiting the impact of the correction in the emerging block on the principal developed economies, and in particular on the eurozone. However, the moderation of the business sentiment indicators in recent months, together with the stabilisation of growth in the US at slightly lower levels than we anticipated, are evidence that the differentiation between the economic blocks is starting to narrow, and that the risk of contagion could increase if the momentum of the recent deterioration in the emerging countries continues.

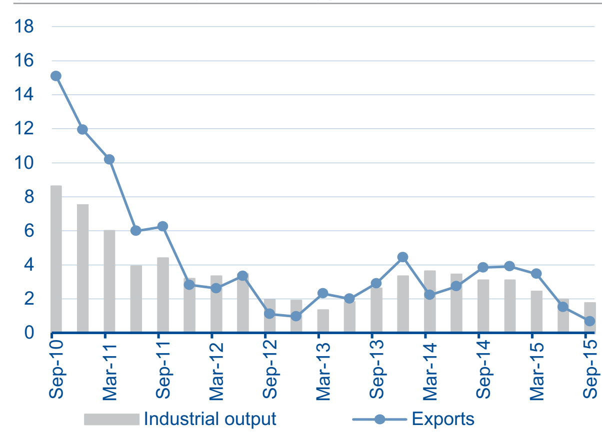
The divergence between the evolution of activity in the industrial and services sectors, which is favourable to the latter, is equally representative of the nature of the moderation of the global economic cycle. The progressive deceleration of the business confidence index for the manufacturing sector, which in September was close to levels compatible with a stagnation of activity, is in contrast to the services business confidence indicator, which remains in the expansion zone. This is reflected in global industrial production growth of less than 2% YoY in August (the slowest pace of growth since the beginning of 2013) and in a sharp deceleration of goods exports (in August, these were barely higher than a year ago). In contrast, retail sales growth in the US and in the eurozone have managed to stabilise at around 2% YoY (although, in the first case, this is a deceleration compared to the pace of growth in mid-2014), and in China, retail sales growth has also stabilised at 10%. This performance has been driven by the support provided by domestic demand in the developed economies block, partly thanks to help from factors such as the correction in the oil price and falling interest rates, and the increased weight of services in the demand of some emerging economies, such as China.

Figure 2.3
World manufacturing and services PMIs



Source: BBVA Research & Markit

Figure 2.4
World: industrial output and exports of goods (% YoY, quarterly frequency)



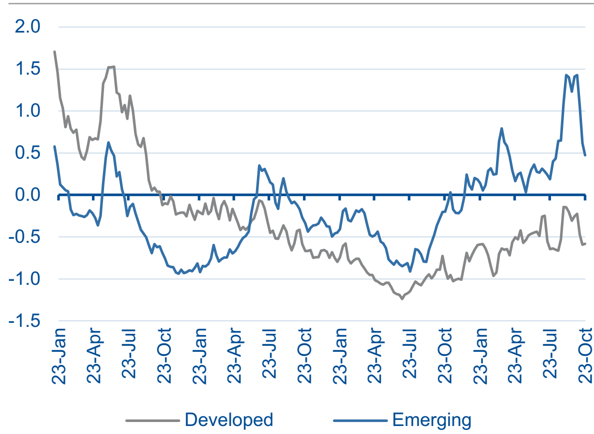
Source: BBVA Research & CPB

All in all, the stabilisation of commodity prices at low levels and the sustained rise in financial tensions in the emerging economies –accompanied by heavy capital outflows, sharp currency depreciation and a widening of sovereign spreads– are evidence that the balance of global risks is still to the downside.

The slowdown of demand appears to be the principal justification against the increased supply in order to explain the fall in oil prices from USD65/bbl in the middle of the year to a level below USSD50/bbl in October. The oil price dynamic is similar to that of other commodities such as copper and aluminium, which is consistent with the existence of a common factor linked to the slowdown in demand. This is one of the elements that underlie the deterioration in the growth outlook for geographical areas such as Latin America, as well as for the energy and industrial sectors in the US, and which are obviously helping to maintain perceptions of financial risk at high levels in the whole emerging block. It is worth noting that the transition from a growth model based on the rising commodity cycle, the financial instability brought about by capital outflows and the potential impact of such substantial currency depreciation on inflation expectations constitute relevant sources of vulnerability.

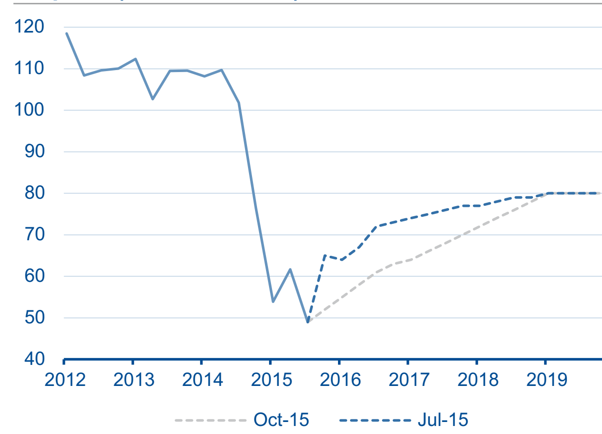
Since the end of 2014, the BBVA Financial Tensions Index of Emerging Markets has been at levels above the average of the last decade, retracing the all-time high for 2011 in October 2015 (Figure 2.5), and its highest levels since the financial crisis in 2008-09. The correction, triggered by China, has eventually extended to the principal economies, and even more particularly to Latin America, with these two geographies accounting for the bulk of the net capital outflows from the block which, at the end of October, had reached a similar amount to the outflows in the early months of 2013 (Fed's taper tantrum). The most significant spikes have been in countries most exposed to the commodity cycle and with greater external vulnerability, in terms of both deficit on the current account and foreign currency-denominated private-sector financing. Idiosyncratic factors, such as political uncertainty and the existence of geopolitical risks in Brazil and Turkey, have reinforced the lack of confidence and accentuated the increase in financial volatility. As in other similar episodes of reallocation of capital flows and risk aversion, the financial assets of the developed economies have acted as safe havens, putting downward pressure on long-term public debt yields.

Figure 2.5
BBVA Financial Tensions Index



Source: BBVA Research & Bloomberg

Figure 2.6
Oil price (USD/bbl, Brent) and forecasts



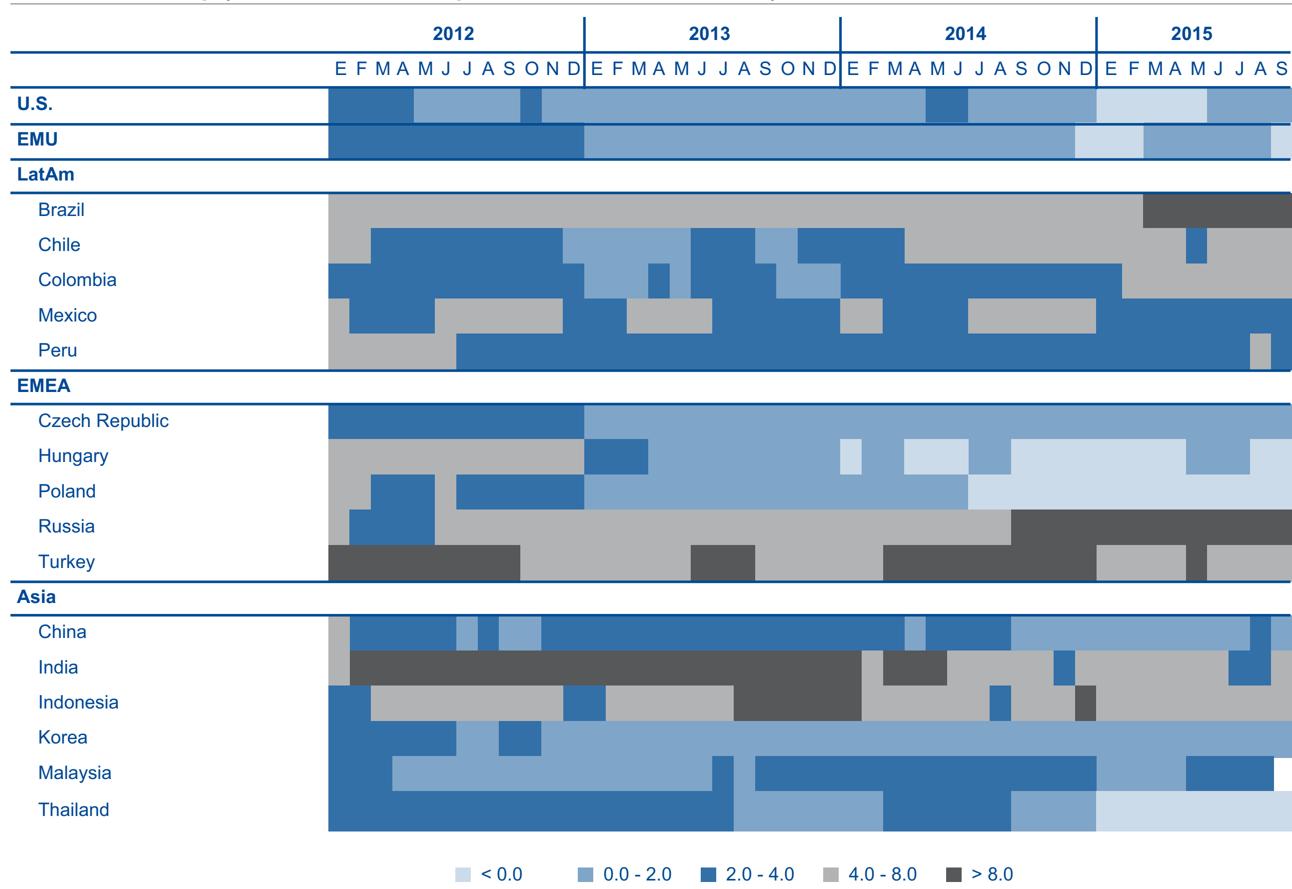
Source: BBVA Research & Haver

The context of lower global growth and moderating commodity prices has put further downward pressure on prices and inflationary expectations in the medium term in the developed markets. This, together with the potential risks which would come hand in hand with a more pronounced correction of activity in China, has altered the monetary policy strategy expected of the principal central banks in the developed world. Specifically, the Fed did not raise its reference rate in September as had been expected, due to the financial instability observed during the summer months and the doubts about the cyclical strength of the emerging economies and the potential impact of this on the US recovery. Given the Fed's data-dependent strategy, the probability of a rate

hike before the year-end depends on any new information and what conclusions the central bank draws from it. The meeting on 27 October once again reinforced the prospect of a hike in December, which remains the most probable (although highly uncertain) outcome. The delayed start to the Fed's monetary policy normalisation has had an impact on monetary conditions in the eurozone via the exchange rate which, together with the concerns about the slow convergence of inflation towards 2%, has triggered the ECB's announcement of possible additional stimulus measures. Both the decline in inflation and the recent appreciation of the euro are restricting the improvement in financial conditions brought about by the quantitative easing programme.

The emerging block's central banks are faced with the dilemma of dealing with the weakness of the economic cycle, while simultaneously anchoring inflation expectations (the currency depreciation is starting to translate into higher prices in some countries) and the stability of their capital accounts. As a result, and depending on the room for manoeuvre provided by the levels of real interest rates, some central banks have decided to lower their reference rates (this is the case in China, and also India and Korea). Meanwhile others, principally in Latin America (Chile, Colombia and Peru), have opted for monetary tightening due to the risk of inflation, which is consolidating above their target ranges. In future, and independent of idiosyncratic factors, emerging central bank action will continue to be largely conditioned by the Fed's response - whether it decides to introduce the first rate hike in December or to delay it even longer - and on any new monetary stimulus measures introduced by the ECB and/or the Bank of Japan.

Figure 2.7
Inflation heat map (headline rate, %, Sep 2015, latest available data)



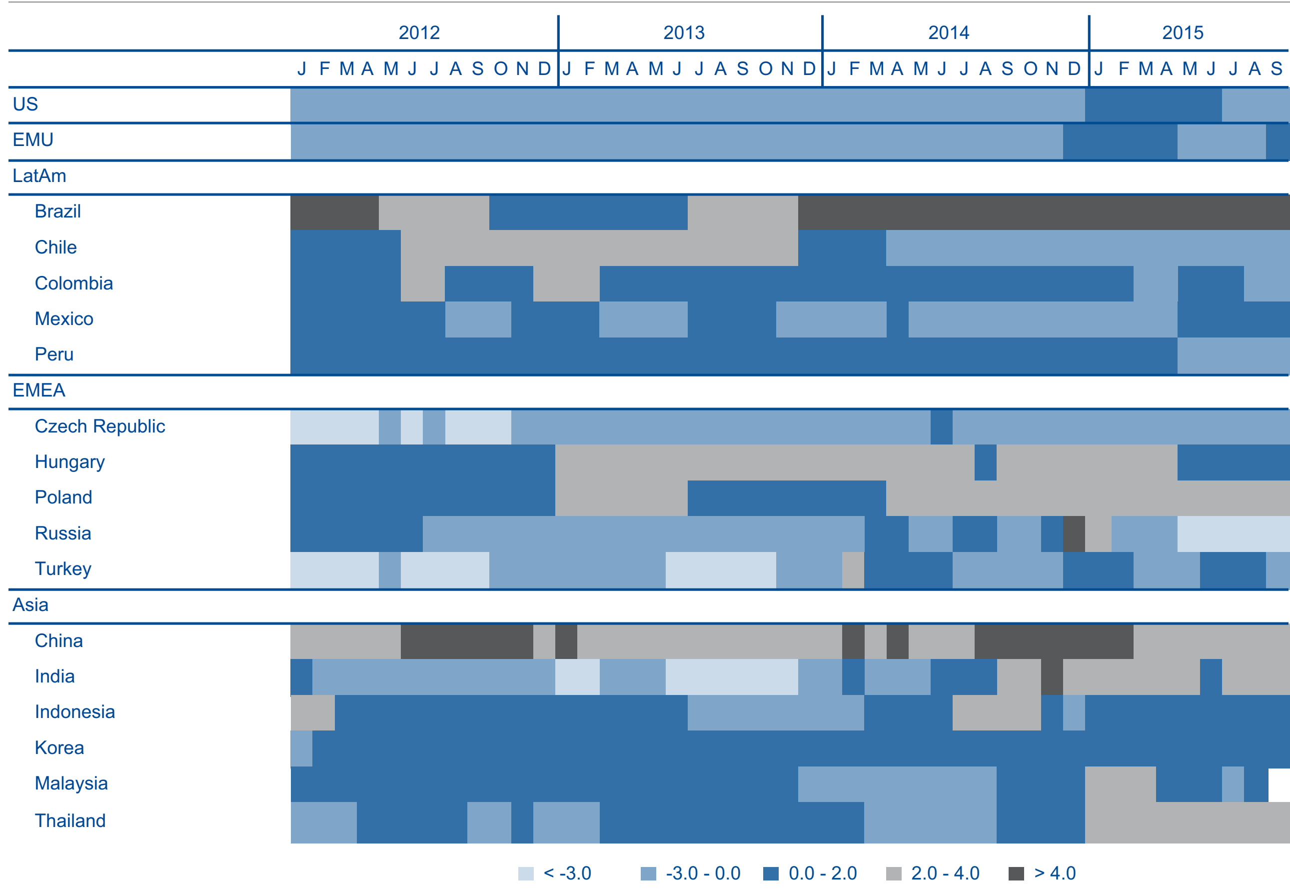
Source: BBVA Research & Haver

Much of the recent stabilisation observed in risk assets and the capital inflows into emerging countries is precisely in response to the expectation that the principal central banks will maintain or reinforce their policies in support of the economic cycle: in the case of China to avoid a hard landing and in the case of the Fed and the ECB to support the recovery in a more uncertain external environment, with growing disinflationary pressures, little room to adopt counter-cyclical fiscal policies and restrictions on introducing structural reforms to kick-start sustained growth.

Even when monetary policy could mitigate the impact of a scenario of slower growth on global financial conditions, the scope it has to kick-start the economic cycle is reduced, taking into account the low levels of interest rates and the high volume of liquidity already in existence. The combination of a financial shock in China, which takes the annual growth of that economy well below 6%, with an even slower recovery of the developed economies block than observed to date is a significant risk scenario, both because of its plausibility (limited, but not negligible) and its severity, given its potential impact on the world economy.

Figure 2.8

Real interest rate heat map (reference rates of monetary policy less headline inflation, %)



Source: BBVA Research & Haver

USA: downwards revision to GDP growth expected for 2016 due to the deterioration in the external environment

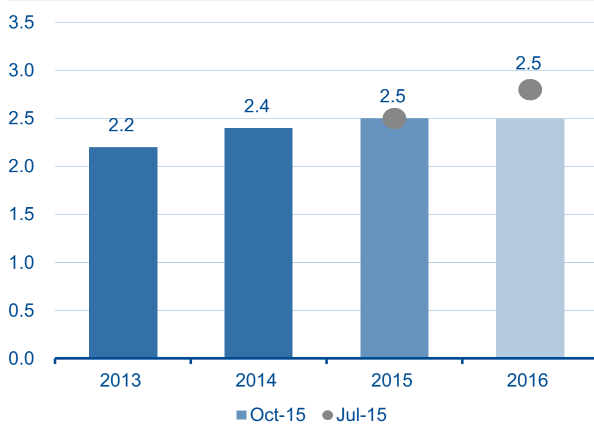
As regards the detailed analysis of the principal economies, note the stabilisation of economic growth in the US at lower rates than in other recovery episodes. After the positive surprise in activity in the second quarter, that made up for the bad start to the year, GDP growth could close the third quarter at 1.5% YoY (vs. the 3.9% of the three preceding months) and maintain this pace of growth until the end of 2015.

Private consumption remains key to the healthy momentum of economic recovery, although the slower growth of employment in recent months and the moderate wage increases reduce its potential to increase the contribution to domestic demand and offset the drops in both exports and investment in the energy sector (the fall in production and the erosion of oil companies' profitability anticipate a sharper correction in investment in the sector). The rhythm of improvement in residential investment does not guarantee any substantial recovery in domestic spending in the short term.

Also, the increasing weight of the emerging economies in US trade (exports to China, Mexico, Brazil and Chile account for slightly more than 25% of the total), together with the accumulated dollar appreciation since the end of 2014, will continue to have a negative impact on US exports. For all the above reasons, GDP growth could reach 2.5% in 2015 (in line with our forecast last quarter) and repeat this figure in 2016, which would imply a downwards revision of 0.3% vs. the previous forecast.

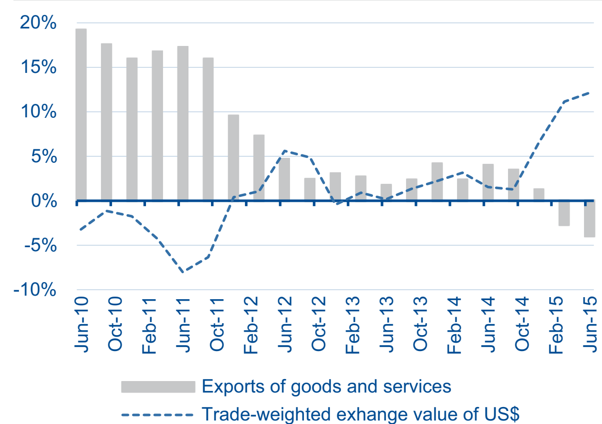
The risks for the US economy in a more unfavourable global environment are determining the Fed's reaction function, in deciding to hold interest rates unchanged in September. These risks affect economic growth but also inflationary expectations: the correction of import prices pushed headline inflation back down to 0% in September, while core inflation (excluding housing) stood at 1%. The impact of dollar appreciation on exports is another factor to take into account, as is the uncertainty regarding the effect of higher interest rates in the US on global financial conditions.

Figure 2.9
USA, economic growth, % annual change



Source: BBVA Research

Figure 2.10
US exports and USD exchange rate, % YoY



Source: BBVA Research & Haver

Although the Fed's communication strategy continues to emphasise the need to adapt the monetary tightening scenario to the flow of economic data, the lack of consensus among the FOMC members regarding whether to raise rates before the year-end or wait until 2016 has increased. In any case, the pace of rate increases is expected to be very gradual, probably reaching levels at end-2016 below those that we expected a quarter ago, and no higher than 1%. The downward adjustment of economic growth forecasts beyond 2016 to rates slightly below 2.5% and inflation rates converging gradually towards 2.0% also justify a scenario of interest rates anchored at historically low levels. Against this backdrop, the dollar would remain relatively strong vs. the principal currencies, due to the divergences in monetary policy strategy between the other central banks in the developed world (with possible increases in monetary stimulus on the part of the ECB and the Bank of Japan), and the vulnerabilities of the reference emerging economies.

China: upwards revision of GDP growth expected for 2015, although this will not dispel the uncertainties over the pace of future economic deceleration

China's cyclical position is obviously one of the principal variables to watch at a global level. The sharp stock market correction in August served as a warning of the risks posed by a financial shock in the country of a severity to compromise the growth in domestic spending. The magnitude of the capital outflows and the spike in financial volatility resulted in the introduction of a considerable battery of monetary policy measures directed at easing the deterioration in liquidity and its potential impact on the financing model of the corporate sector, which is heavily leveraged. The unexpected official announcement regarding the daily yuan exchange rate and the progressive cuts in reference rates fall into the same context, and are also characterised by a progressive deceleration of economic activity, which has taken GDP growth below 7% YoY in the third quarter.

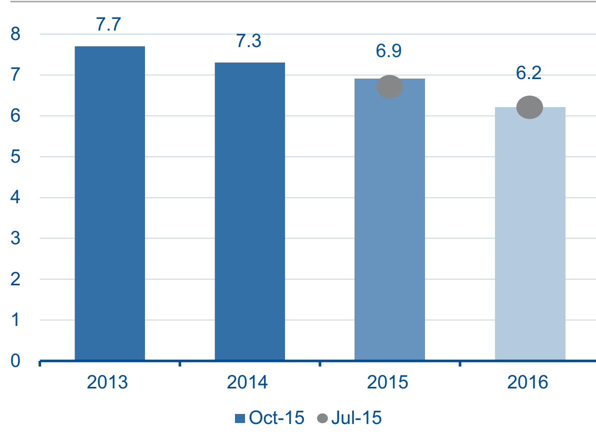
Irrespective of the reliability or otherwise of national accounts statistics, what is clear is that the advance indicators of activity and business confidence reveal that China has entered into a new phase of slower growth, led by the adjustment of the manufacturing sector, and one in which services are acquiring increasing importance (in 2015, services represent 48% of GDP, 7pp more than in 2006) which, nonetheless, is not enough to make up for the contraction in industrial activity. The transition towards structurally lower rates of growth has relevant consequences for the global economic cycle, as is already being reflected in the performance of commodities and goods trade. At the domestic level, the persistent fall in producer prices since the beginning of 2012, together with the moderation of inflation towards 2% (both headline and core), is representative of the economic adjustment process in China.

The revision of earning expectations for quoted Chinese corporates, together with the increase in their leverage ratios and the moderation in bank credit, increase the risks of a more acute deterioration of domestic spending that observed to date. In addition, note that the extreme concentration of corporate debt in the hands of the most highly-leveraged companies (including public-sector companies) and those with greater exposure to the internal cycle (construction and the real estate market)[2] increases the vulnerability of the private sector – including the private-sector banks – to a financing shock and lower earnings.

It seems that the authorities will continue to employ monetary stimulus measures (further interest-rate cuts have not been ruled out, in spite of the fact that there have already been five such cuts in the year to date) and to exploit the central government's scope to use fiscal policy to ensure that economic growth does not fall below 6% YoY. Our forecasts suggest GDP growth of 6.9% for 2015 and 6.2% for 2016, with inflation at 1.6% and 2.0% respectively.

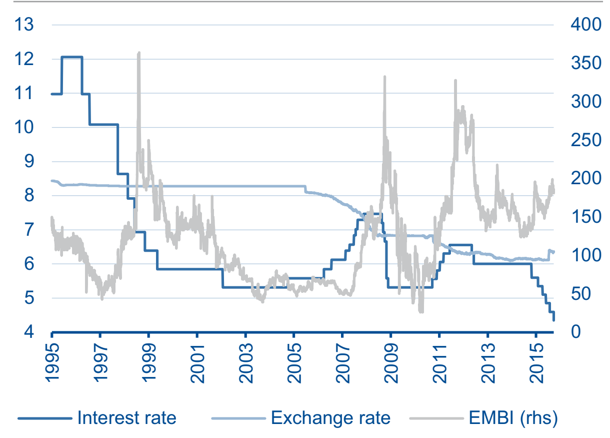
[2] See Corporate Leverage in Emerging Markets: a concern? IMF Global Financial Stability Report, October 2015.

Figure 2.11
China, economic growth, % annual change



Source: BBVA Research

Figure 2.12
China: reference rate (%), USD/RMB exchange rate and sovereign spread (EMBI, bp)



Source: BBVA Research & Haver

Eurozone: resilient domestic demand with the ECB ready to avoid further declines in inflation

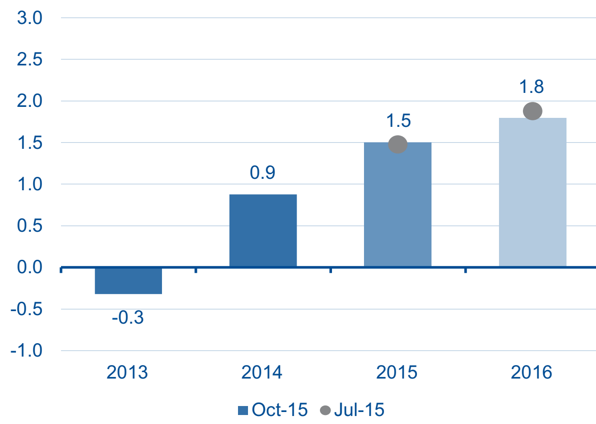
In the eurozone, the economic recovery continues although the pace has not intensified as we anticipated three months ago. The rate of QoQ GDP growth has stabilised at 0.3-0.4%, supporting the expectation that annual growth could reach 1.5% in 2015 as a whole. The fall in the oil price, low interest rates and the incipient recovery in new flows of credit to the private-sector underlie the improvement in domestic demand (in particular, in consumption). There continues to be very little improvement in fixed capital investment, despite the positive signals given by the business confidence indicators and the easier financing conditions. The relatively good performance of exports of goods in the area as a whole is in contrast to the more sluggish performance of world trade – which is, in turn, partly due to the fact that 60% of eurozone trade is with developed countries. Euro depreciation could also be favouring the competitiveness of exports.

Although the area's balance of risks to growth remains tilted to the downside, due to both the uncertainties regarding the world economic cycle and the persistence of elements of idiosyncratic vulnerability (principally political instability associated with the electoral processes underway and some delay in the implementation of structural reforms in some key economies), the pace of eurozone GDP growth could increase to 1.8% in 2016 (less than 10bp less than we expected last quarter). Italy and France, where growth rates have remained low in 2015, should explain the improvement in the overall figure, which has so far been sustained by the recovery in the peripheral economies.

In spite of this, the improvement in activity will continue to be gradual and will not come hand in hand with an upturn in inflationary expectations. At present, inflation figures are still responding to the fall in oil prices during recent months, such that the headline rate should remain at close to 0% until the end of this year, and close to 1% in 2016. For the time being, core inflation has stabilised at slightly below 1%.

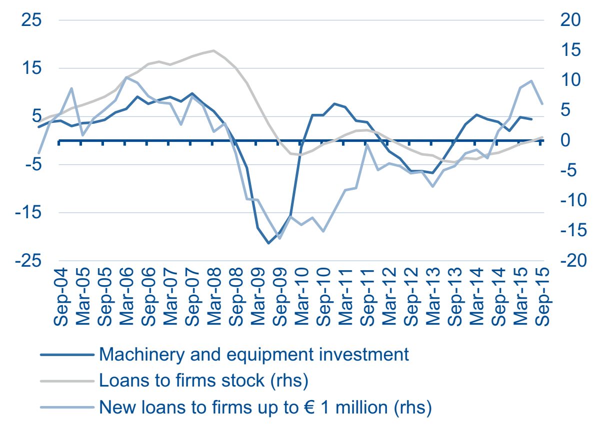
The accentuation of the risks to the downside to inflation forecasts, largely due to cheaper imported goods, together with the recent appreciation of the euro, once again raises the question as to how much room for improvement there is in monetary conditions in the eurozone. The ECB is extremely sensitive to this scenario, and this would justify the adoption of new stimulus measures in the short term. The combination of further reference rate cuts (probably the marginal deposit facility) and the expansion of the debt purchase programme (in terms of length and/or the amount of liquidity injected) will be in an endeavour to anchor long-term interest rates at low levels for longer, together with some euro depreciation to contain the deflationary pressures.

Figure 2.13
Eurozone, economic growth, % annual change



Source: BBVA Research

Figure 2.14
Eurozone: investment and bank lending (% YoY)



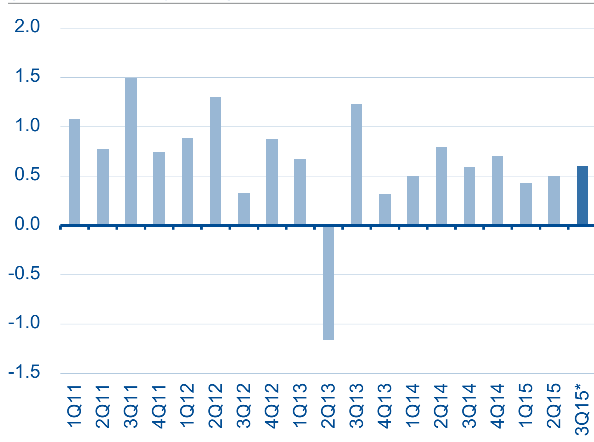
Source: BBVA Research, Eurostat & ECB

3. Gently rising growth trend in spite of awkward conditions

3.1 Modest improvement in the pace of growth in 2016

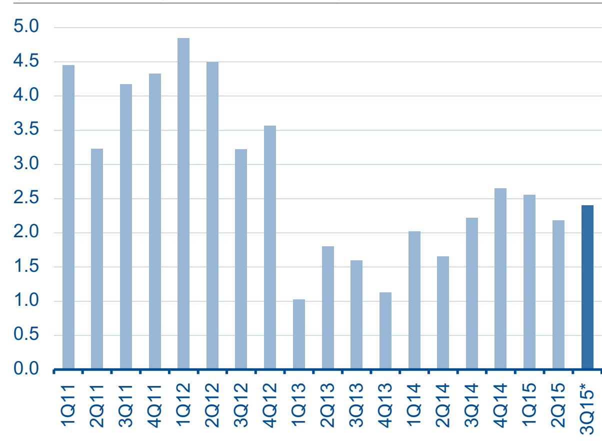
GDP registered an annual growth rate of 2.1% in 2014, while in the first half of 2015 the AGR was 2.4%. For the third quarter of the year, INEGI's flash estimate (nowcast) suggests that GDP will have grown by 0.6% QoQ (Figure 3.1) and 2.3% in annual terms, where both rates refer to the seasonally adjusted series. In its initial series, the preliminary AGR for GDP in 3Q15 was 2.4%. Here we note that all of these growth estimates are preliminary and liable to change after INEGI publishes the final third quarter GDP figures.

Figure 3.1
Gross Domestic Product (QoQ % change, sa)



sa = seasonally adjusted. QoQ=quarter-on-quarter.
* The quarterly growth rate for 3Q15 is preliminary.
Source: BBVA Research with information from INEGI

Figure 3.2
Gross Domestic Product (YoY % change, initial series)



* The annual growth rate for 3Q15 is preliminary.
Source: BBVA Research with information from INEGI

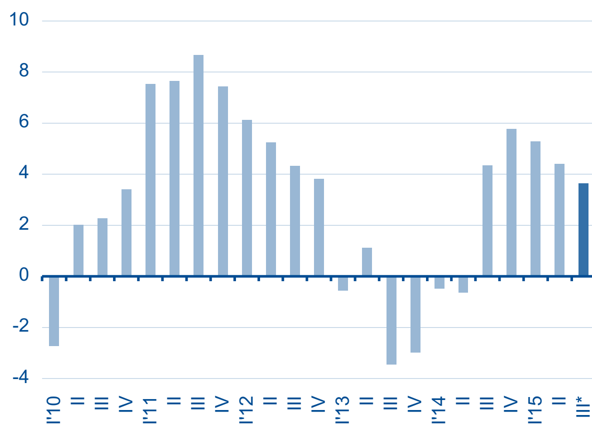
The GDP growth figures for the first nine months of the year suggest a moderate economic performance, in which annual GDP growth in 2015 should be under 2.5%. If we add to this the outlook of an unkind international setting (from Mexico's standpoint) of a low price per barrel of export oil, a potential interest rate rise on world markets and only a modest pace of economic growth in the United States (Mexico's chief trading partner), we can expect the Mexican economy's performance to continue to be subdued in the fourth quarter this year and over the next.

As will be seen in the next few sections, the drop in oil exports, the deceleration of non-oil exports and the slow-down in public sector spending in real terms represent major constraints on any robust expansion of activity over the rest of 2015 and possibly over a substantial portion of 2016.

3.1.1 Domestic demand: flagging gross fixed investment contrasts with recent improvements in private consumption

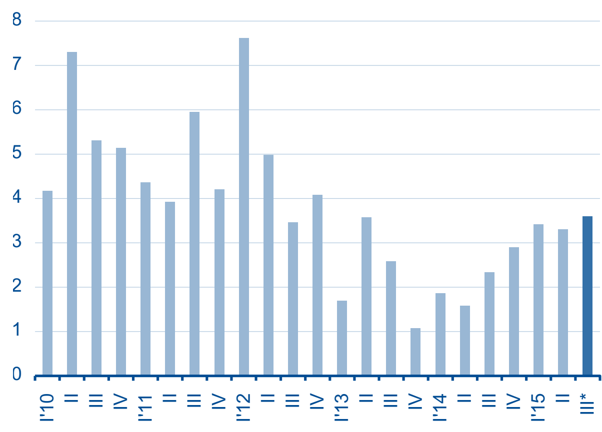
While the AGR of gross fixed investment over the first three quarters of 2015 (Figure 3.3) showed a slowing trend, more robust expansion will have to be accompanied by a pick-up in investment. Among the factors which could manage to lift investment and improve its outlook are the structural reforms of recent years, such as in the energy sector, while investment will be able to gather the strength required to underpin Mexico's economic growth as the bidding phases in the energy reform process are completed.

Figure 3.3
Gross fixed capital formation index (YoY % change in the index's quarterly average)



*III indicates the average for the months of July and August 2015.
Source: BBVA Research using information from INEGI

Figure 3.4
Private consumption index (YoY % change in the index's quarterly average)



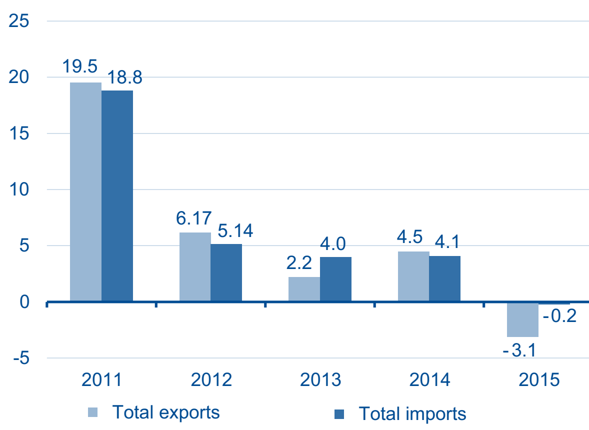
*III indicates the average for the months of July and August 2015.
Source: BBVA Research using information from INEGI

By way of a contrast with investment, private sector consumption has been performing increasingly well since the second half of 2014, which shows through in its rising AGR (Figure 3.4). It should be said, though, that in spite of the steady improvement in the pace of private consumption growth, its AGR in the first three quarters of 2015 is still modest, at only slightly over 3.0%. Our view is that the series of improvements in private consumption is the product of a higher real wage given the fall in inflation and formal job creation, as well as the positive effect of the currency depreciation on both the tourist industry and remittances.

3.1.2 External sector: the recent performance by goods exports and imports

The AGR for cumulative total exports and imports from January to September 2015 was -3.3% and -0.2% respectively (Figure 3.5). These figures depict a weak external sector in 2015 when set against the positive performance it showed over the same interval in 2014, which was marked by positive growth rates for both exports (4.5%) and imports (4.1%). It is worth noting that the deceleration of 2015 has taken place gradually throughout the year (Figure 3.5).

Figure 3.5
Cumulative goods exports and imports from January to September (YoY % change)



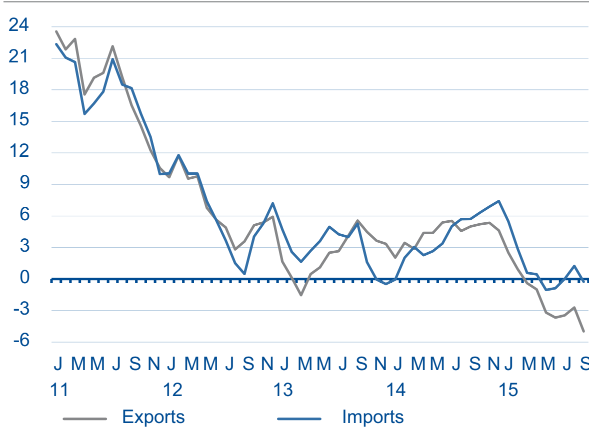
Source: BBVA Research using information from INEGI.

Figure 3.6
Monthly goods exports and imports (YoY % change)

Source: BBVA Research using information from INEGI.

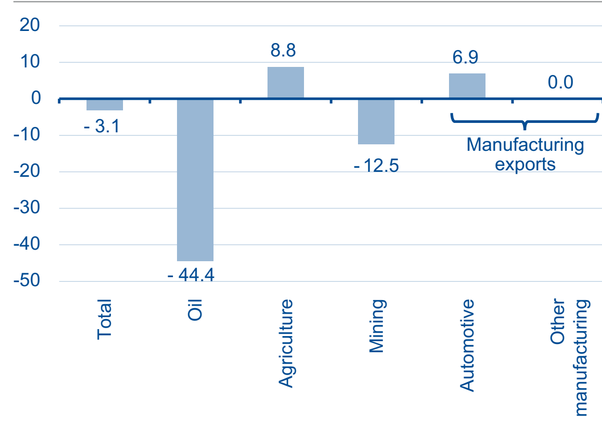
The deterioration in overall goods exports was largely due to shrinkage in the value of oil exports (Figure 3.9). This was produced by a drop in the price per barrel of export crude over 2015 relative to the price prevailing in 2014 (Figure 3.9). In more precise terms, in 9M14 the average price per barrel of Mexican export crude was USD93.00, while over the same time in 2015 it plunged to USD47.90. As a result, the relative size of oil exports was dramatically reduced, as oil exports dropped from representing 11.5% of cumulative total exports in 9M14 to 6.6% for the same period in 2015.

Figure 3.7
Goods exports and imports (YoY % change in the three-month moving average)



Source: BBVA Research using information from INEGI.

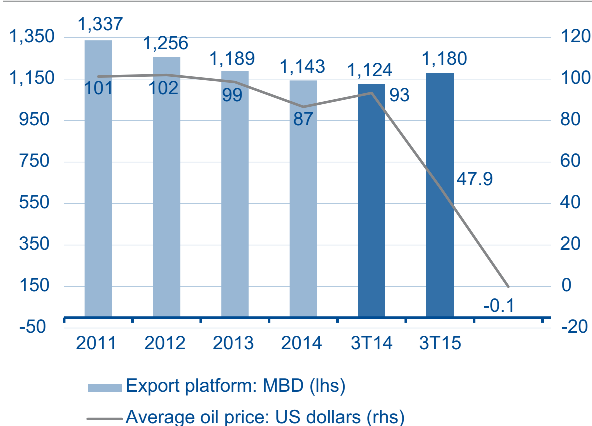
Figure 3.8
Cumulative goods exports from January to September 2015 (YoY % change)



Source: BBVA Research using information from INEGI.

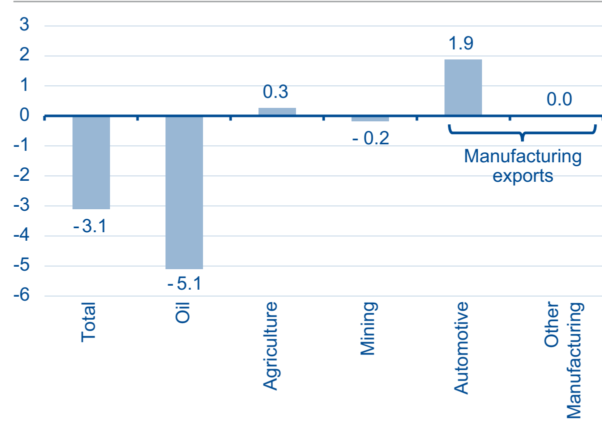
Another factor which has influenced the contraction of overall goods exports is the negligible growth of non-automotive manufacturing exports, which represented almost 59% of overall exports in 9M15. Moreover, although 2015 automotive exports grew at close to 7% over the first nine months and accounted for 30% of total exports, this has not been enough to offset the contraction in oil exports and the lack of growth by non-automotive manufacturing exports (Figures 3.8 and 3.10).

Figure 3.9
Crude oil exports: platform and export price average
(Mb/d and USD/bbl of crude)



Q3 indicates average figures for the third quarter of the year.
Source: BBVA Research using information from INEGI

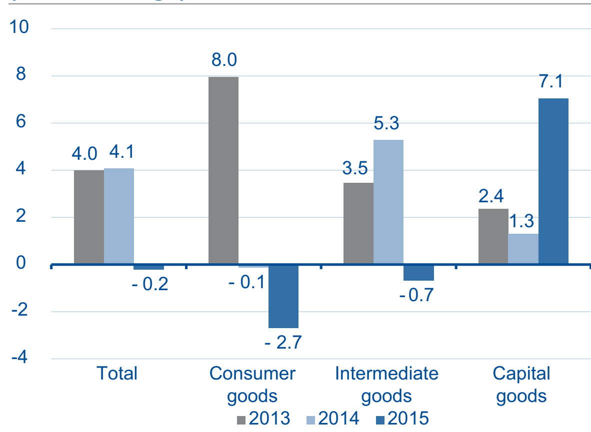
Figure 3.10
Cumulative goods exports from January to September
(contribution to growth, percentage points)



Manufacturing includes the automotive and non-automotive items.
Source: BBVA Research using information from INEGI

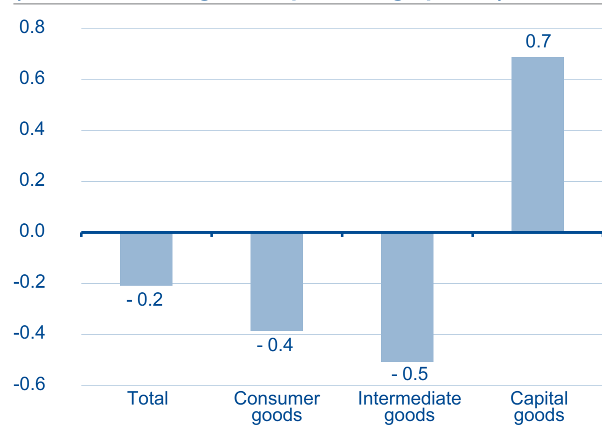
With respect to goods imports, their AGR was a cumulative -0.2% over the first nine months of the year. This setback contrasts with the growth of 4.1% for the same interval in 2014. Given that a high proportion of imports are intermediate goods that are used in producing exports, it follows that the performance of the latter to a large extent determines trends for imports, particularly all of those classified as intermediate goods imports (Figure 3.11).

Figure 3.11
Cumulative goods imports by type from January to September
(YoY % change)



Source: BBVA Research using information from INEGI

Figure 3.12
Cumulative goods imports from January to September 2015
(contribution to growth, percentage points)



Source: BBVA Research using information from INEGI

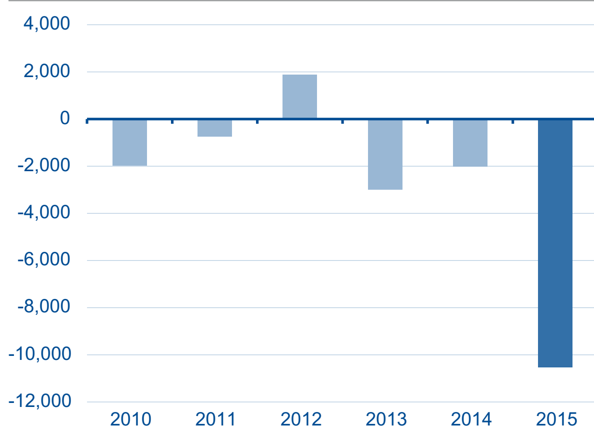
Specifically, 76% of total goods imports that have entered over 2015 are intermediate goods exports, while 14% of the total refers to consumer goods imports and the remaining 10% is comprised of capital goods imports. Although in 9M15 only the capital goods imports category showed a positive growth rate (Figure 3.11), due to its only limited share of total imports, the contribution of this category to overall goods import growth in this time was only marginal, besides the fact that it was not enough to make up for the contraction in consumer and intermediate goods imports (Figure 3.12).

3.1.2.2 Trade deficit

The goods import and export performance over 9M15 that has been referred to is echoed in a cumulative trade deficit of USD10.5bn. This overall deficit was substantially larger than was registered over the same time in 2014 (USD2.0bn, see Figure 3.13) and on average over 2010-14 (almost USD1.2bn).

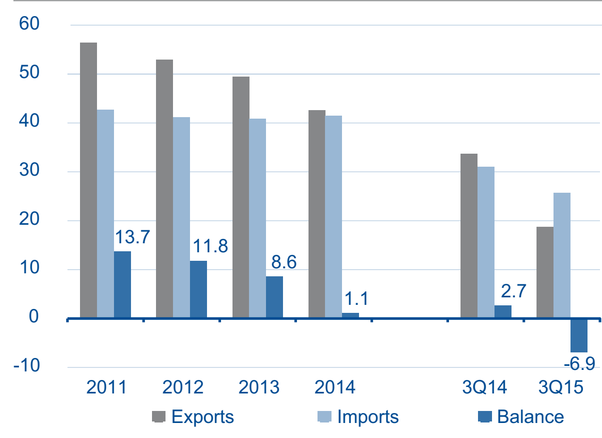
One of the chief causes of this higher trade deficit figure in 2015 is the shortfall in Mexico's oil balance. As a result of the major drop in the price per barrel of Mexican export crude, over the first nine months of the year the country's oil balance posted a deficit of USD6.9bn (Figure 3.14), which represented 66% of the overall trade deficit in 9M15.

Figure 3.13
Cumulative balance of trade from January to September (USD mn)



Source: BBVA Research using information from INEGI.

Figure 3.14
Cumulative balance of oil trade from January to September (USD bn)



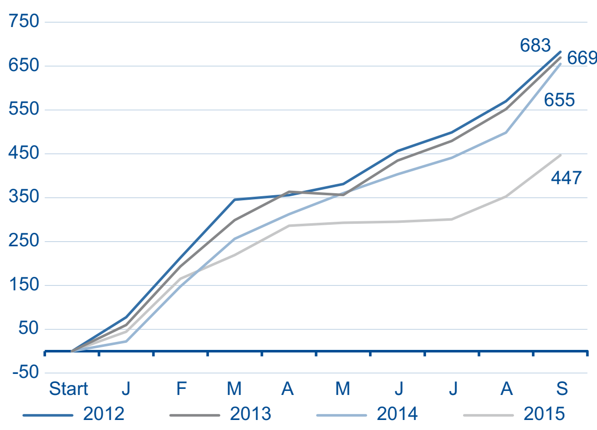
Source: BBVA Research using information from INEGI.

On the other hand, should the trade deficit persist in the coming years as a result of the plunge in the value of oil exports, the external sector could cease to play a positive role in the growth of Mexico's economic activity. This would in turn limit the country's potential economic growth in the medium term. This could nonetheless be avoided with the materialisation of the first substantial effects on exports of the energy reform which has been progressively implemented of late.

3.1.3 Healthy progress by formal private sector employment

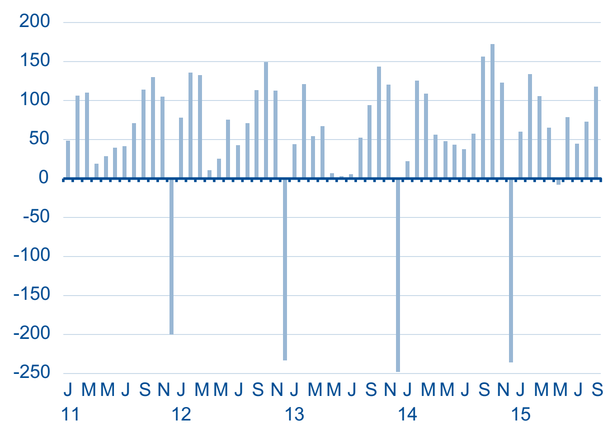
The total number of workers registered with the Instituto Mexicano del Seguro Social (the IMSS, Mexico's Social Security Agency) reflects the formal employment generated by the country's private sector, and in the past few months this figure has climbed significantly. Here we note that the rise in IMSS-registered workers from January to September 2015 (669,000) managed to outstrip the increase observed over the same period in each of the previous two years (2014: 655,000; 2013: 447,000) (Figure 3.15).

Figure 3.15
Cumulative monthly rise in new IMSS-registered workers (thousands of persons)



Source: BBVA Research using information from INEGI.

Figure 3.16
Monthly rise in the overall number of IMSS-registered workers (thousands of persons)



Source: BBVA Research using information from INEGI.

It should be remembered that owing to seasonal effects from selling over Christmas, the total number of IMSS-registered employees drops off in December every year, which is largely due to temporary employment contracts that are not renewed. Generally speaking, registrations of workers with the IMSS tend to surge in the first four months of the following year. Subsequently, in the following three months, registrations of new jobs with the IMSS edge up in monthly terms and then, from month eight to month eleven, registration rises briskly again (Figure 3.16).

3.1.4 Public finances: a gradual slowdown in public sector spending

The real annual growth rate of cumulative public sector budget revenues over the first nine months of 2015 was 3.4%. Within this, non-oil public sector revenues saw YoY growth over this period of 22.4%, while oil revenues sagged by -36.7% (Table 3.1).

Tax revenues performed well, growing by a real 29.5% in 9M15. This brighter showing seems to have been attributable to: i) more thorough compliance monitoring by the authorities; ii) changes brought in with the 2014 tax reform which led to annual income tax returns for that year being filed in 2015, and iii) the more substantial collection achieved by the special excise tax on production and services (IEPS) for petrol and diesel, which went from showing a deficit item of MXN23.2bn in 9M14 to a positive one of MXN156.1bn for the same months in 2015.

Table 3.1
Public sector budget revenues, January to September 2015 (MXN bn, cumulative)

	Sum	Real % chge.	% struc.
Total	**3,037.6**	**3.4**	**100.0**
Federal Government	2,319.6	7.1	76.4
Tax	1,793.6	29.5	59.0
Income Tax	935.2	24.9	30.8
VAT	539.1	4.9	17.7
Non-tax	526.0	-32.6	17.3
Agencies & companies	231.5	5.9	7.6
Gvmnt. productive co.	486.5	-11.9	16.0
Pemex	262.1	-12.6	8.6
CFE	224.4	-11.1	7.4
Total	**3,037.6**	**3.4**	**100.0**
Oil income	595.9	-36.7	19.6
Non-oil income	2,441.7	22.4	80.4

Source: BBVA Research using information from the SHCP.

Table 3.2
Public sector budget expenditure, January to September 2015 (MXN bn, cumulative)

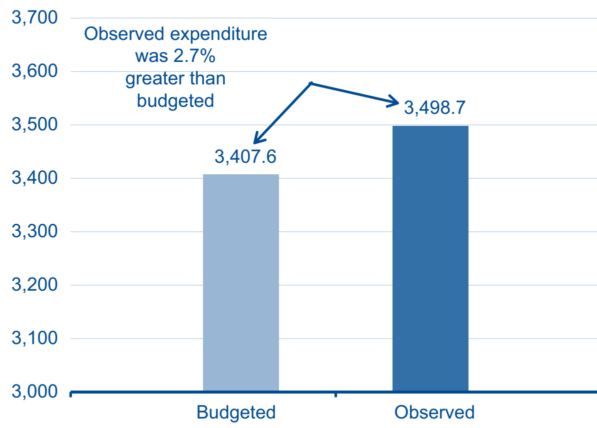
	Sum	Real % chge.	% struc.
Total	**3,498.7**	**3.9**	**100.0**
Projected expenditure	2,733.8	2.4	78.1
Current expenditure	2,066.7	3.5	59.1
Capital expenditure	667.0	-0.7	19.1
Non-projected expen.	765.0	9.6	21.9
Investments in states	479.9	4.2	13.7
Borrowing cost	259.0	22.0	7.4
Adefas* and other	26.1	2.6	0.7

Adefas: Liabilities carried over from previous years
Source: BBVA Research using information from the SHCP.

With regard to public sector budget expenditure, from January to September 2015 this grew by 3.9% in real terms YoY (Table 3.2). This real AGR has gradually come down over the year, which is illustrated by the fact that at the end of Q1 it was 11.9%, while by the end of Q2 it had dropped to 7.4%, and then in Q3 it eased back further to 3.9%. As the real AGR of total public sector budget expenditure falls, the effect of this type of spending as a source of growth for Mexico's economic activity should diminish too.

The downward trend described above suggests that public sector spending in the final quarter of 2015 will continue to come off the pace.

Figure 3.17
Public sector budget expenditure, January to September 2015: projected and observed (MXN bn, cumulative)



Source: BBVA Research using information from the SHCP

Table 3.3
Public sector finances, January to September (MXN bn, cumulative)

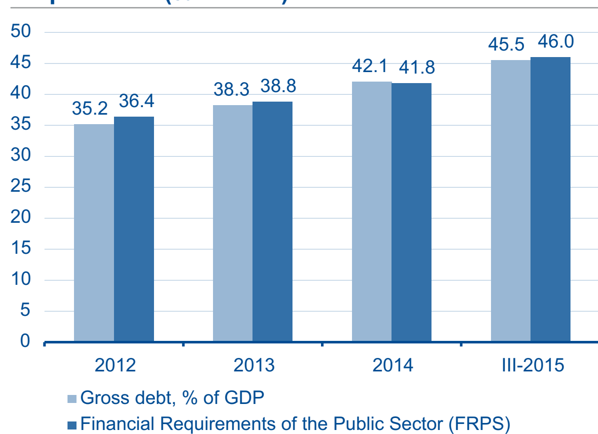
	2014	2015	Real % chge.
Public Balance	-405.8	-438.9	ns
Pub. Bal. w/o Prod. investment	-134.2	-83.5	ns
Budget Balance	-418.5	-461.2	ns
Budget Revenue	2,854.5	3,037.6	3.4
Net Budget Expenditure	3,273.0	3,498.7	3.9
Federal Govnmt. Balance	-353.9	-331.1	ns
Agencies & Co. Balance	-64.5	-130.0	ns
Primary Balance	-195.8	-179.0	ns
Budget Balance	-212.2	-202.2	ns
Federal Government	-185.8	-143.8	ns
Agencies & Companies	-26.4	-58.4	ns
Pemex	-108.2	-141.4	ns
Other institutions	81.8	83.0	-1.3
Indirectly-controlled institut.	16.4	23.2	37.4

ns=not significant
Source: BBVA Research using information from the SHCP

Within the expenditure-side components, it is striking that the heading which exhibits the biggest growth rate is Borrowing cost in relation to public sector debt, as in September the cumulative outlay on this item rose by a real 22% YoY. This figure comes in sharp contrast to growth in Current expenditure (3.5%) and Capital expenditure (-0.7%) by the public sector.

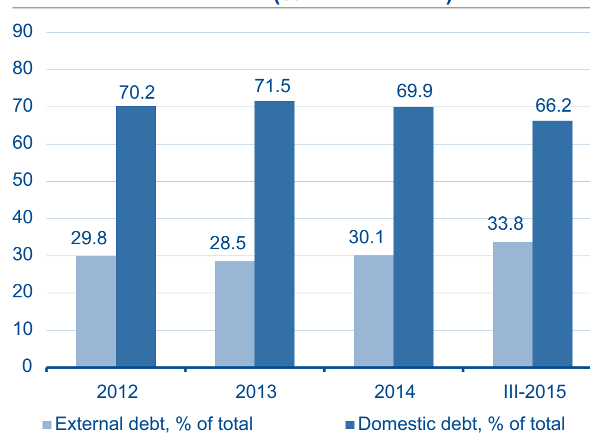
On the other hand, total public sector deficit figure over 9M15 is up on last year (Table 3.3). The persistence of the public sector deficit and rising figure for this in recent years are factors which have led to a higher outright level of public sector debt. Clear evidence of this is the fact that the balance of gross public sector debt as a percentage of GDP at the end of 2014 was 42.1%, which rose by 3.4 percentage points over the following nine months to 45.5% in September 2015 (Figure 3.18).

Figure 3.18
Gross debt and Public Sector Borrowing Requirement (% of GDP)



Source: BBVA Research using information from the SHCP.

Figure 3.19
Percentage breakdown of public sector debt: domestic and external (% of total debt)



Source: BBVA Research using information from the SHCP.

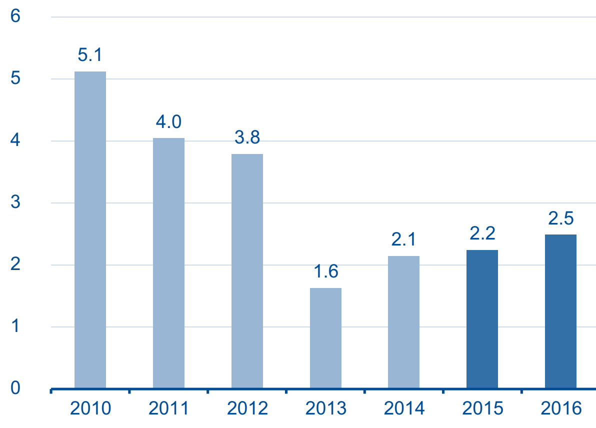
Just recently, external borrowing has increased its relative weight as a proportion of Mexico's overall public sector debt (Figure 3.19). This might, among other reasons, be due to the better financial conditions attaching to borrowing in foreign currency or the effect of the peso's recent depreciation on the value of foreign debt when expressed in peso terms.

3.1.5 Outlook for the Mexican economy for the end of 2015 and 2016

We predict that growth over the rest of the year will be similar to that in the preceding quarters. This arises from a good performance by private consumption, although this is dampened by the poor performance by the export sector and less impetus from public sector spending. We therefore expect the AGR for GDP in 2015 to come in at 2.2%, which is slightly above the rate of 2.1% that we saw in 2014.

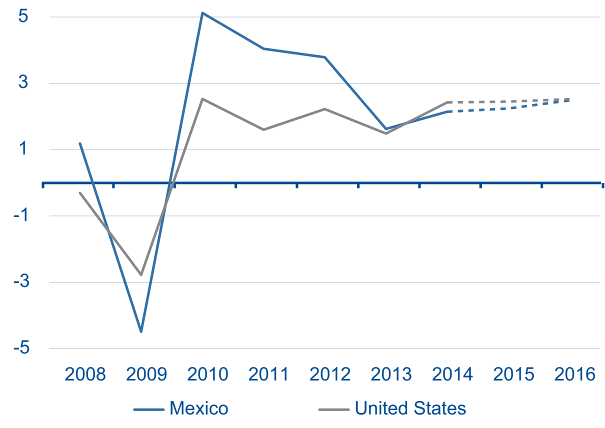
Moving to 2016, we foresee the United States growing at a comparable rate to this year, and the world oil price seeing only a very small improvement, for which reason we think that the factors outlined in the previous paragraph will run on into 2016, which lead us to a forecast of GDP growth for Mexico next year of 2.5%.

Figure 3.20
Annual growth of Mexico's GDP (YoY % change)



YoY = Year-on-year
Source: BBVA Research using information from INEGI

Figure 3.21
GDP: Mexico and the United States (YoY % change, sa)



sa = seasonally adjusted. YoY = Year-on-year
Source: BBVA Research using information from INEGI and BEA

Box 1. *Fibra E*: a vehicle to promote investment in the energy sector and infrastructure

In presenting the third government report, the President's office announced a new scheme for financing projects in connection with Mexico's energy sector and infrastructure known as the *Fibra E*.

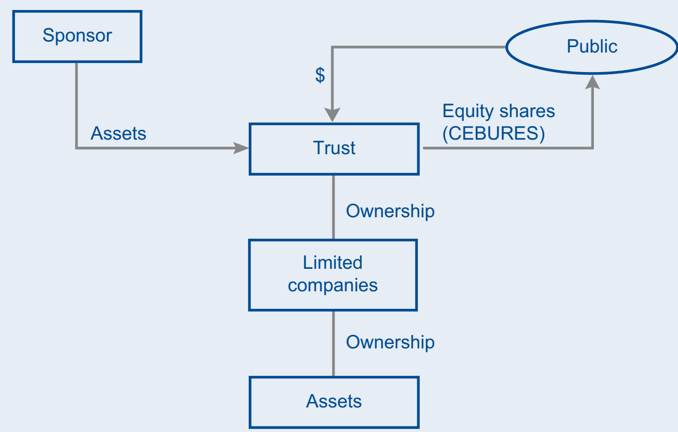
Besides promoting investment in the energy sector and infrastructure, this new scheme seeks to offset the drop in national investment in a context of reduced public investment that derives from the fall in oil revenues. The financing scheme consists of monetising pre-existing assets in a way that closely resembles Master Limited Partnerships (MLPs) in the United States. Specifically, the vehicle takes the legal form of a trust that exclusively comprises energy and/or infrastructure sector assets (e.g. gas pipelines) and is initially set up by a sponsor. The Fibra E issues CBFEs (energy and infrastructure trust bonds) among investors, whereupon it obtains financing exclusively earmarked for subsequent investment - again in assets in the energy and/or infrastructure sectors. Investors, in turn, acquire rights over a share in the trust and the cash flow deriving from this. Thus the ownership of the trust is divided between the investing public and the sponsor, who under the legal form of an MLP retains at least 2% of the capital.

The flows from the trust usually come from contractual arrangements for leasing, or concessions to operate, the trust assets themselves with third parties and are free of corporate income tax. This represents one of the main attractions for investors in this type of vehicle, and is a feature that they share with the traditional Fibras. It is important to point out that by law the trust is designed to distribute cash flows among the investors, which means that 95% of the annual net income must be paid out in dividends.

It should be remembered that the trust does not have direct ownership of the assets, but rather over shares in "promoted companies" which in turn own assets. On the other hand, the trust can issue debt to supplement the funding of new projects.

Although our view is that the scheme employed by the Fibra E is very positive, in that it promotes the channelling of funding into infrastructure and energy sector investment, we think that the big advantages expected will require time to mature.

Figure 3.22
General structure of the Fibra E



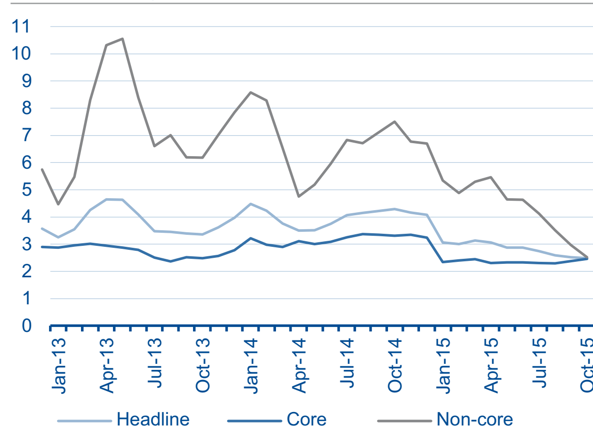
Source: BBVA Research

3.2 As we were expecting, annual inflation showed further falls in the third quarter

From April to October this year, headline inflation stuck to a downward trend which has taken it to below the central bank's target level and consecutive historic lows in the past six months. This welcome performance was helped by several factors: i) the slack in the economy; ii) the favourable base effect from dilution of the supply shock that was occasioned by the tax rises for certain goods in January 2014; iii) the falls in the cost of telecommunications services; iv) the smaller rises in petrol prices and reductions in electricity rates; v) considerably kinder trends in livestock prices compared to the previous year, and vi) central bank credibility, which has allowed inflation expectations to remain anchored despite certain shifts in relative prices.

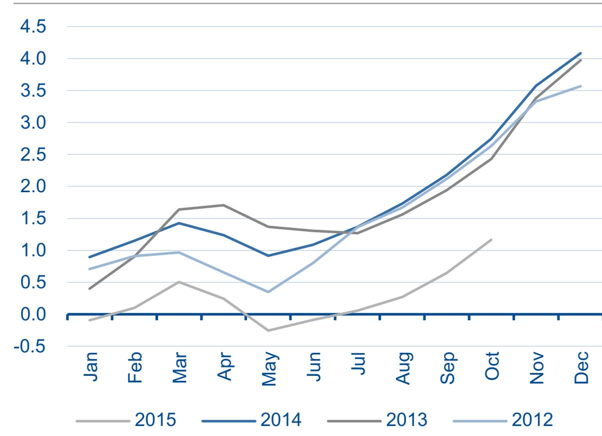
The cheaper telecommunications prices are associated with the sector reform that was passed, while lower electricity rates are a product of the energy reform, though also the result of lower prices of the inputs used in generating electricity. The effect on inflation of this drop in telecoms and energy prices is mainly direct, though there could also be a minor indirect impact on the economy, which means that companies can at least partly absorb the higher costs arising from the recent peso depreciation. In other words, the lower costs in terms of energy and telecoms inputs are likely to have provided companies with some leeway (in a situation where there is slack in the economy) to assimilate the greater exchange rate burden within their margins, at least temporarily. This would contribute to exchange rate pass-through being confined to durable goods as well as an absence of second round effects on the price formation process, as we have been observing in the economy. Up to now, the peso's depreciation has only brought about a change in relative prices and therefore ought not to have any enduring effects on prices next year.

Figure 3.23
Inflation and components
YoY % change



Source: BBVA Research using INEGI data

Figure 3.24
Cumulative inflation by year
Percentage points



Source: BBVA Research using INEGI data

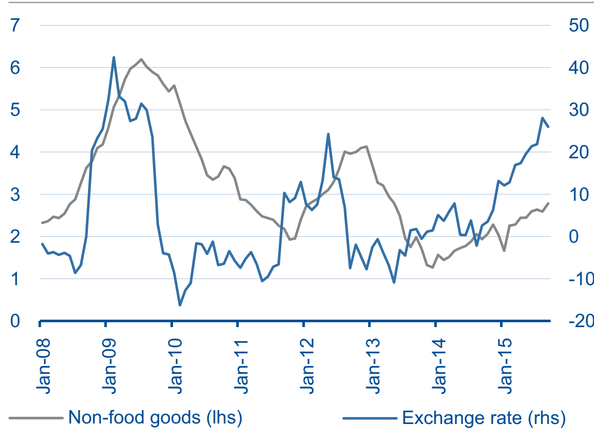
This is why, in spite of the peso's heavy depreciation over the past 12 months, headline inflation has come down in each of the first three quarters of the year and we expect it to follow suit in the fourth as well. In Q2, annual inflation averaged 2.94%, marking its second straight historic low for a quarter in the recent history of the National Consumer Price Index (INPC) after averaging 3.07% in Q1. For the first time, inflation fell below the central bank's 3.0% target in the second quarter, then in 3Q15 the annual headline rate dipped further, to an average of 2.61%, while in October it dropped even more, to 2.48%.

Meanwhile, average annual core inflation remained relatively stable over the opening three quarters of the year, registering 2.39%, 2.32% and 2.33% respectively. These average readings compare favourably with the figure of 3.30% for the final quarter of 2014. We note here that, prior to this year's decrease, annual core inflation had held up at close to 3.0% since the first quarter of 2011, showing a quarterly average of 3.13% between 2011 and the fourth quarter of 2014. With respect to the non-core component, average annual inflation came down from 5.17% to 3.53% between Q1 and Q3, dropping further, to 2.52%, in October. Thus, as Figure 3.24 illustrates, for the first time in history cumulative inflation in the first half of the year was negative, at -0.09 percentage points (pp), and it closed the third quarter at a mere 0.65pp (compared to an average of 2.08pp in the three years previously), while to October it only reached 1.16pp, which was 1.58pp below the cumulative level for the same period one year beforehand (2.74pp).

Within core inflation, the paths taken by its two chief components chart the adjustment in relative prices we have described above. This shift has involved rises in annual inflation for goods, while the annual variation in service prices has been such that these have held steady at low levels. Annual goods inflation rallied from 2.43% in January to 2.73% in October, in a pattern that was brought about by the upward trend in non-food goods prices. In annual terms, the variation for this component rose from 1.66% in January to 3.01% in October. If we look at quarterly averages, this component's annual inflation rate rose by 0.60pp over Q1-Q3, from 2.07% to 2.67%. This means that although annual non-food goods inflation is staying down, there is clearly a direct exchange rate pass-through effect to prices (see Figure 3.25). Going forward, if we bear in mind that the peso exchange rate will remain at a high level, and that, given the prevalence of global risk aversion, there is not likely to be any return to more moderate levels in the near future, the upward trend for prices of this kind is likely to continue into the next few months. This is also a possibility on account of what has been something of a recovery in domestic demand in recent months (see Figure 3.26), which could provide businesses with room to continue to pass on the higher cost of imported products (be these final goods or inputs) to their final prices. On the other hand, after displaying a downward trend over the first eight months of the year, the food goods component has shown YoY rises in the past two months (September and October). Meanwhile, annual services inflation remains steady at a low level. This averaged 2.26%, 2.15% and 2.22% in the first three quarters and read 2.25% in October. Such stability at a low level is primarily due to the reductions in telecoms service prices (see Figure 3.27) and the high degree of slack in the economy.

Figure 3.25

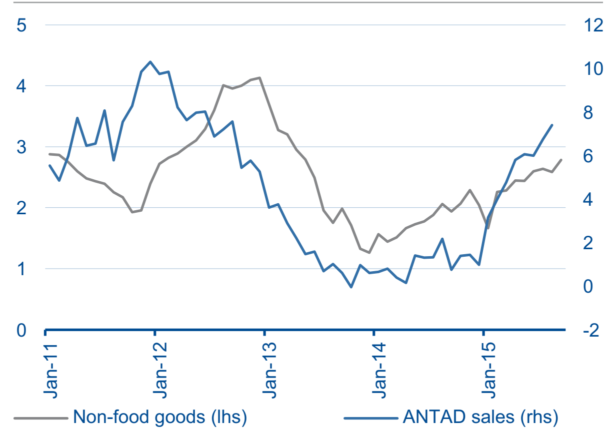
Annual inflation of non-food goods and annual rate of peso depreciation (%)



Source: BBVA Research using INEGI data

Figure 3.26

Inflation of non-food goods and ANTAD sales (YoY % change and YoY % change, 4-month moving average)



Source: BBVA Research using INEGI data

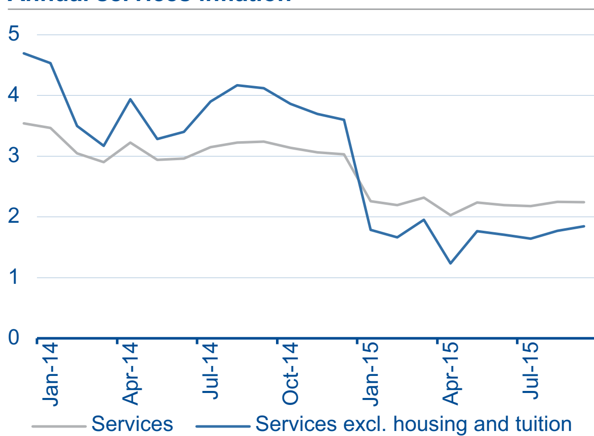
Finally, annual inflation of the non-core sub-index, which includes the products with the most volatile prices, such as agricultural and livestock, energy, and public rates, continues to show a considerable slowdown. Annual inflation of the non-core component came down steadily over the first three quarters from 5.17% to 4.91% and 3.53%. In October it eased off further, to 2.52%. This deceleration is mainly due to two factors: i) lower annual inflation of livestock product prices, which have fallen from 14.20% in January to 2.17% in October, and ii) the smaller rise in energy prices, where the annual rate came back from 4.20% in January to 1.01% in October.

With respect to the annual inflation forecast for this year, we have seen a materialisation of the downward bias that we identified, for which reason we are revising it lower, from 2.5% to 2.4%. As has been true over the whole year, this remains below the consensus estimate

Considering that the factors behind the upward trend of non-food goods inflation derive from a shift in relative prices which has had no second-round effects on price formation, our outlook for inflation over 2015-16 is still encouraging in a context of ample slack in the economy. Meanwhile, the effects of the telecoms reform have been evident, and inflation trends have also been helped by the effects on electricity rates of lower prices of the fuels that are used in generating it. Given the prospect of only gradual recovery for the economy, we do not envisage demand pull on prices.

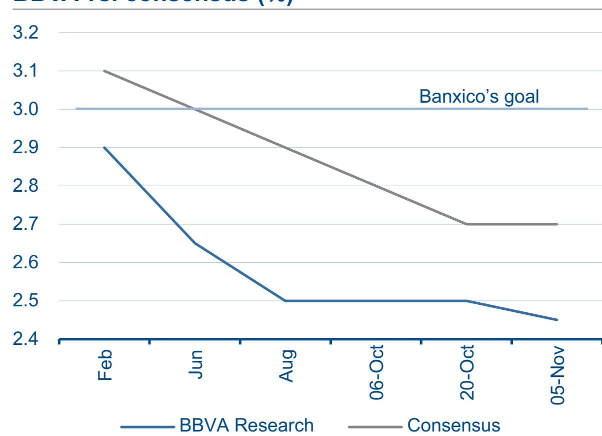
The path of core inflation, which is the definition that provides the best indication of how inflation will behave in the medium term, is still being helped by the slack in the economy. Moreover, as is discussed in the section on economic activity, we have revised our growth forecast down for 2015 and 2016, which implies adding more slack to the economy, even though this is already ample as things stand. This will contribute to the pass-through from peso depreciation continuing to be limited, as well as second-round effects remaining highly unlikely.

Figure 3.27
Annual services inflation



Source: BBVA Research using INEGI data

Figure 3.28
Forecast annual inflation at yearend 2015: BBVA vs. consensus (%)



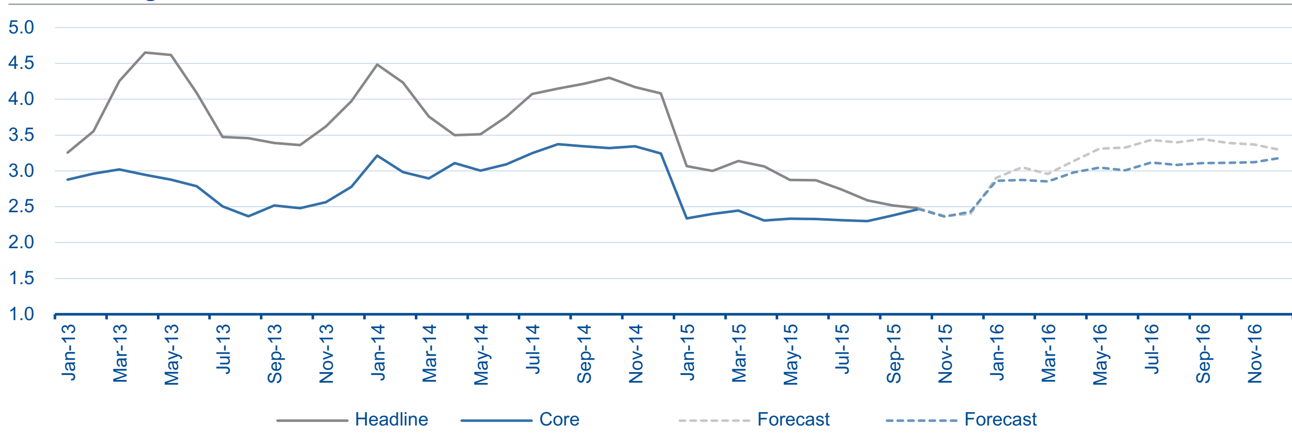
Source: BBVA Research using data from the Survey of Private Sector Analysts.

In qualitative terms, our inflation scenario remains unchanged. Nonetheless, in quantitative terms, we have revised our forecast for headline inflation at the close of 2015 down slightly, from 2.5% to 2.4%, while we are standing by our forecast for the end of 2016 of 3.3%. Along with these forecasts, we estimate that headline inflation will average 2.8% in 2015 and 3.3% in 2016. On the other hand, we predict that annual core inflation will average 2.4% this year, which is 0.7 percentage points less than in 2014 (3.2%). For 2016 we expect this component to average 3.2%, the same level as in 2014.

If the smaller rise in energy prices persists (i.e. there is no repeat of the significant increases in petrol prices of previous years and no reversal of the benign price trend for fuels used in electricity generation), then not only will lower inflation in 2015 have materialised, but this should also help inflation's convergence towards the target rate of 3.0% become a permanent feature, to the extent that the lower prices would also be likely to have indirect effects on other prices given time. The non-core inflation sub-index will probably therefore perform more favourably in the coming years compared to those previously, and contribute to lasting lower inflation rates being achieved.

Our forecasts are subject to risks to both the downside and the upside. The chief downside risks are: i) a lower than expected level of activity in the economy which gives rise to further widening of the GDP gap, and ii) the chances of additional falls in mobile telephone service charges if sector competition becomes fiercer. On the other hand, upside risks would come from the peso exchange rate if its current level consolidates or there is further peso depreciation.

Figure 3.29
Inflation forecasts
YoY % change



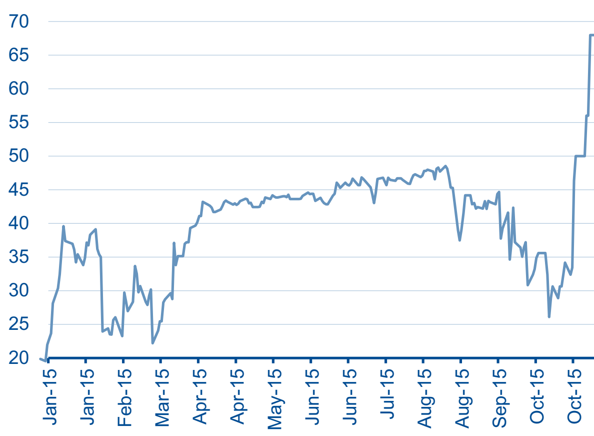
Source: BBVA Research using INEGI data

3.3 The central bank adopts a less restrictive tone, but the Fed remains the key catalyst for an initial policy rate hike

In its latest monetary policy decision statement the Federal Reserve of the United States (Fed) altered its message, which increased the likelihood of a policy rate hike in the United States at the time of its meeting on 16 December. In precise terms, when it explicitly mentioned for the first time that it will assess whether it is appropriate to raise the target range of the federal funds rate at the next meeting, the Fed made it clear that there is a real possibility of lift-off this year rather than no earlier than 2016, as market participants had been discounting up until the announcement.

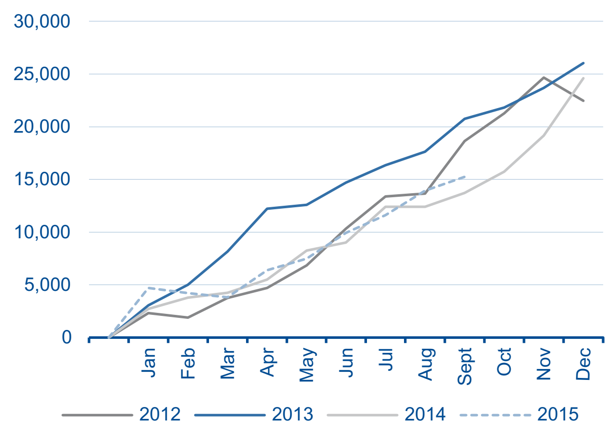
Unlike the Fed, Mexico's central bank gave its October monetary policy statement a less restrictive tone as a result of the deterioration in the balance of risks with respect to both domestic and global activity, in an environment of inflation at historically low levels.

Figure 3.30
Implied probability of a 25bp federal funds rate hike at the December meeting. Futures market (%)



Source: BBVA Research using data from Bloomberg.

Figure 3.31
Change in foreign-held M-bonds. Cumulative flows (USD mn)



Source: BBVA Research using data from Banxico.

In this situation the shift in message by the Fed is thought to increase the chances of seeing an MPR hike in Mexico for the reasons we go on to cite.

According to Mexico's central bank, action by the Fed poses the chief risk to consolidating inflation convergence toward the target, via a depreciation of the peso's exchange rate and an upturn in inflation expectations. The central bank has also shown itself to be concerned over the risks to financial stability that such an event might engender. Almost one year on since the peso's depreciation began (currently running at an annual 19%), the exchange rate pass-through to prices has been limited and confined to durable goods prices. With respect to financial stability, the central bank's prime concern is a sudden flight by foreign investors from Mexico's fixed-income market with the advent of higher rates in the United States, although, up to September, long-term bond holdings by foreigners have held stable. Thus, even though there has thus far been no sign of any deterioration in the price formation process or price stability, the fact that the central bank has signalled that risks of this kind could be exacerbated once the Fed's rate hike materialises suggests that Banxico could take action by raising

its target rate in the interests of containing such risks. The minutes from the latest monetary policy meeting in fact reveal that within the policy committee there are even voices in favour of a pre-emptive shift in monetary stance.

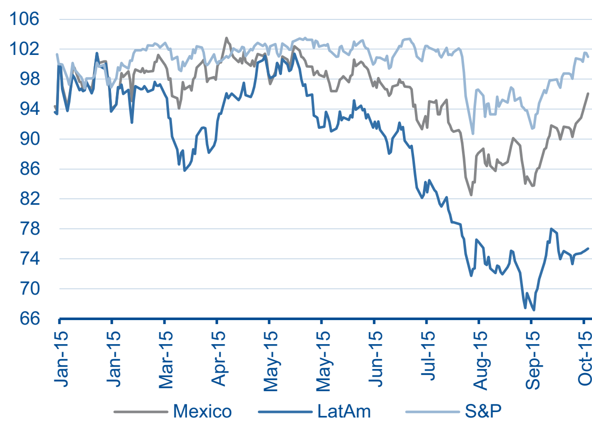
Nonetheless, assuming that the first policy hike in Mexico would be aimed at mitigating the risks discussed above, it is worth pointing out that the deterioration of the balance of risks in connection with economic activity is a factor that would have more of a bearing on the future path taken by monetary policy than the date of the first move. In other words, the weakness of the domestic cycle and the slack that prevails in the economy will influence decisions that the central bank takes with regard to the speed of the hikes, which we expect to be very gradual, even more so than is expected in the case of hikes in the United States.

To summarise, the risks embodied by potential Fed action as regards inflation and financial stability in Mexico lend weight to our view that Banxico will synchronise its first monetary policy rate move with the US federal funds rate hike, which we expect to come in December. After that, we expect the weakness of domestic activity to be the predominant factor that guides Banxico's monetary stance, which will be reflected in a very gradual upward path for the reference rate that is slower than that predicted for rates in the United States. It should be noted, though, that there are risks of a delay to lift-off in the United States, which could materialise if the performances of domestic activity, employment and inflation fail to live up to the Fed's expectations.

3.4 The Fed returns to the forefront after focusing attention on the December meeting

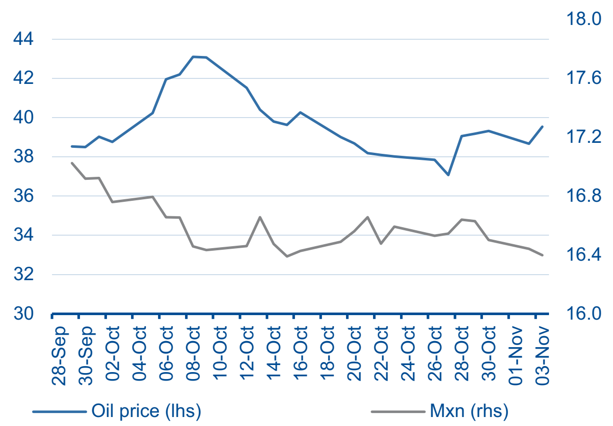
Question marks over the pace of the deceleration in China's economy and its potential effects on the world economy fuelled uncertainty in the financial markets and fleetingly bridled the speed at which investors had been switching funds into dollar-denominated instruments. At the end of August, a lower-than-expected manufacturing production figure in China came on top of other indicators and action taken by the government (e.g. the yuan's devaluation) that ratcheted up investor concern over a hard landing for China's economy, which in turn led to an increase in risk aversion to a level not seen since the height of the euro crisis in September 2011. A sell-off of higher-risk assets had knock-on effects in the markets of both the developed countries and the emerging economies, affecting all asset classes. In the space of four days, the S&P 500 plunged 11.3%, the MSCI Europe 11.5% and the MSCI Emerging Markets 9.0%, while the WTI oil price sank to a low for the year of USD38/bbl; the redemption yield on the 10-year T-Note again touched 2.0% and LatAm currencies slumped by over 3.0%. The Mexican peso's dollar rate sank to a historic low of MXN17.20 with the unleashing of risk aversion, which was a factor of uncertainty that had remained contained throughout the entire year. Remarkable in spite of the volatility was the fact that Mexico's sovereign risk, as gauged by the 5-year credit default swap, held at under 160bp (basis points), which was a level below that of other countries that have a similar credit rating and markedly short of readings during previous bouts of risk aversion when it broke through 600bp. Likewise, flows from abroad to long-term fixed interest instruments continued to be positive, even surpassing 2014 levels for the YtD overall.

Figure 3.32
Stock markets. 01/01/2015=100 (index)



Source: BBVA Research using information from Bloomberg

Figure 3.33
Dollar exchange rate and the oil price (USD/MXN, USD/bbl)



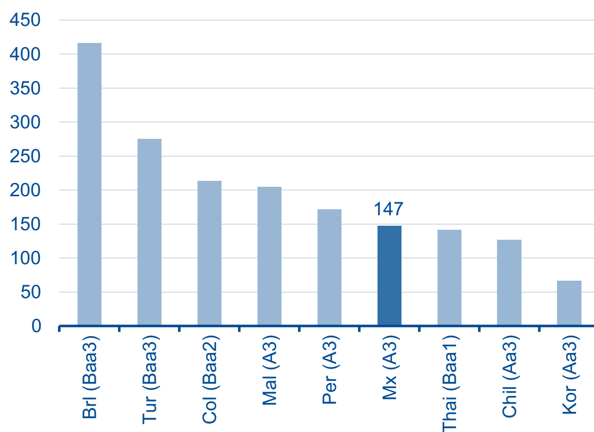
Source: BBVA Research using information from Bloomberg

Aside from the volatility on financial markets, the most significant impact of the doubts over China's cycle was in the way these influenced the decision by the US Federal Reserve (Fed) to hold the federal funds rate unchanged. In its September statement, the Fed made explicit reference to the fact that events in the global economy represented a downside risk to both the recovery of the US economy and hitting their inflation target, despite making it clear that there were no significant changes to its economic scenario. The decision to hold the reference rate unchanged and the mention of risks from the global economy, as well as certain lower-

than-expected figures for the US economy (e.g. the rise in non-farm payrolls for September) led to market participants pushing back their expectations for lift-off by the Fed to 2016, which in turn reduced some of the heat from the prime volatility factor that had been blighting emerging market assets over the course of the year. Together with an oil price spike in October, this meant that, with risk aversion having returned to its historical average level, emerging market currencies strengthened by 1.5% on average. Notable here was the Mexican peso's appreciation of 2.6% in October, which was the seventh largest among the emerging currencies and its first for any month since last February, as it closed the month at a dollar rate of MXN16.50. Interestingly, three of the currencies that made the biggest gains in the month (the Colombian peso, the Brazilian real and the Russian ruble) were those of oil-exporting countries.

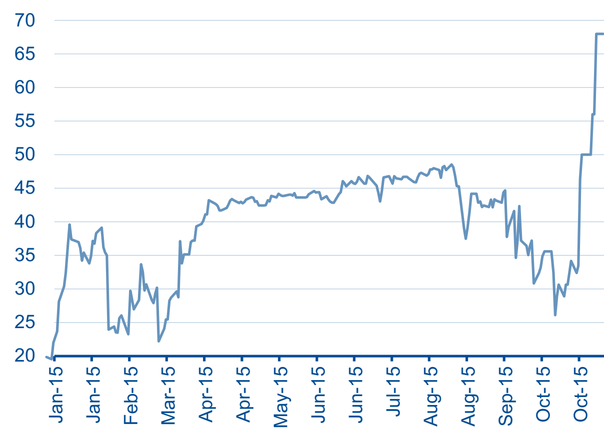
Meanwhile, long-term interest rates have continued to move with expectations over the start of monetary policy normalisation. So far in 2015, the 10-year Mbono rate has continued to shadow that of the 10-year T-Note (see Figure 3.36). On average, 10-year bond rates in both the United States and Mexico were notably steady in Q3 and temporarily brought to a halt the climb they had shown in the first half of the year. Such relative stability in the quarter was mainly due to two partially-related factors. On the one hand, the heightened concern over China triggered a rise in global volatility which hit the market appetite for risk. A situation of greater risk aversion in turn prompted increased demand for assets perceived as being of the lower-risk variety, chiefly US T-Notes. This scaling up of demand allowed US long-term rates to steady at low levels. On the other hand, as was said previously, the global slowdown was even influential on the Fed's statement and at its September meeting it transmitted a tone of increased caution, which was interpreted as a sharp reduction in the implied probability of a policy rate hike before the year-end. Thus the average yield on the 10-year T-Note in Q3 (2.22%) was similar to that in Q2 (2.16%), while, in like fashion, rates on the Mexican 10-year Mbono averaged 6.05% in Q3, which was only 9 basis points more than in the previous quarter.

Figure 3.34
5-year Credit Default Swap by credit rating (basis points)



Note: Brl: Brazil; Tur: Turkey; Col: Colombia; Mal: Malaysia; Per: Peru; Mx: Mexico; Thai: Thailand; Chil: Chile; Kor: South Korea
Source: BBVA Research using information from Bloomberg

Figure 3.35
Futures market implied probability of a 25bp federal funds rate hike at the December meeting (%)

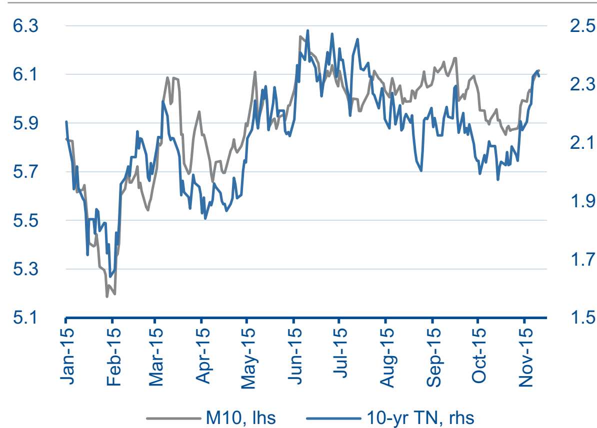


Source: BBVA Research using information from Bloomberg

Notwithstanding the points above, the signs are that this lull with relative stability in the financial markets could be only temporary, judging by the restrictive tone adopted by the Fed in its statement at the end of October and the positive surprise produced by the employment figure that same month. Back then in October, besides bringing back to the table the possibility of lift-off in December, the Fed for the first time explicitly made reference to the possibility of raising the rate at its next meeting, which squares with the removal from its statement of all mention of risks emanating from the global economy. This shift in the message brought about a rise in the implied probability, according to the futures market, of seeing a 25bp federal funds rate hike at the December policy meeting from 32% to 50% (Figure 3.35). This probability rose once more, to 70%, after news of a rise of 271,000 jobs in October non-farm payroll employment, a figure that handsomely surpassed the estimate of 180,000 jobs and was accompanied by an increase in wages and salaries, which was an element that had been absent in immediately preceding months.

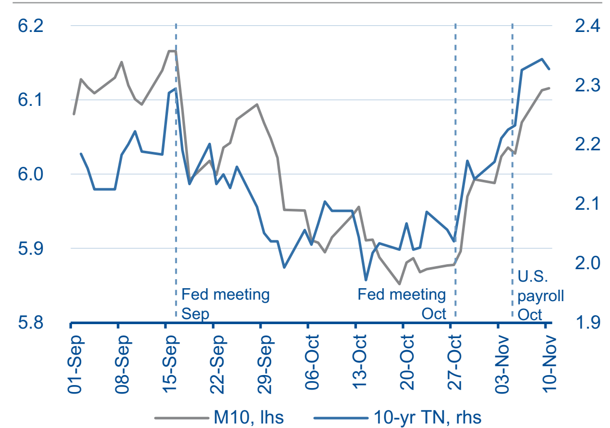
Interest rates responded significantly to both events. First, after the Fed explicitly stated for the first time that a rise in the reference rate at its next meeting (in December this year) was now a real possibility, and then after the bullish surprise from the US job creation figure for October reinforced the chances of a Fed rate hike. Thus additional rises were noted in long-term rates in both the United States and Mexico, with the rate on the 10-year T-Note reaching 2.3% (the highest level since July), while the 10-year Mbono rose above 6.1%.

Figure 3.36
Redemption yield on 10-year government bonds (%)



Source: BBVA Research using information from Bloomberg

Figure 3.37
Redemption yield on 10-year government bonds (%)



Source: BBVA Research using information from Bloomberg

On the currency market, the dollar again firmed against the key currencies worldwide (which we can gather from the DXY index, which includes the world's six key currencies), meaning that it is now ahead of the levels seen before the increase in risk aversion that was sparked by China and very close to the high for the year, which it hit in March. In Mexico, the peso back-pedalled over some of the ground it had gained in October following the Fed announcement and, above all, after the employment figure came out, to a dollar rate of over MXN16.60. We expect that in the run-up to December the peso's market price will become increasingly responsive to the data on activity and employment in the US economy and close the year averaging at a dollar rate of around MXN16.50.

4. Indicators and forecasts

Table 5.1
Macroeconomic forecasts: Gross Domestic Product

(YoY growth rate)	2012	2013	2014	2015	2016
United States	2.2	1.5	2.4	**2.5**	**2.5**
EMU	-0.8	-0.3	0.9	**1.5**	**1.8**
Germany	0.6	0.2	1.6	**1.6**	**1.8**
France	0.2	0.7	0.2	**1.1**	**1.6**
Italy	-2.8	-1.7	-0.4	**0.8**	**1.4**
Spain	-2.1	-1.2	1.4	**3.2**	**2.7**
UK	0.7	1.7	2.9	**2.4**	**2.2**
Latin America *	2.8	2.5	0.8	**-0.3**	**0.5**
Mexico	3.8	1.6	2.1	**2.2**	**2.5**
Brazil	1.8	2.7	0.2	**-2.5**	**-0.5**
EAGLES **	5.8	5.6	5.2	**4.7**	**5.0**
Turkey	2.1	4.1	2.9	**2.8**	**3.3**
Asia-Pacific	5.7	5.9	5.7	**5.6**	**5.4**
Japan	1.7	1.5	-0.1	**0.8**	**1.0**
China	7.7	7.7	7.3	**6.9**	**6.2**
Asia (exc. China)	4.1	4.5	4.3	**4.4**	**4.8**
World	3.4	3.4	3.4	**3.2**	**3.5**

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Bangladesh, Brazil, China, India, Indonesia, Irak, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 10 November 2015.
Source: BBVA Research and IMF

Table 5.2
Macroeconomic Forecasts: inflation (Average)

(YoY growth rate)	2012	2013	2014	2015	2016
United States	2.1	1.5	1.6	**0.2**	**1.8**
EMU	2.5	1.4	0.4	**0.1**	**1.1**
Germany	2.1	1.6	0.8	**0.2**	**1.3**
France	2.2	1.0	0.6	**0.1**	**1.0**
Italy	3.3	1.3	0.2	**0.2**	**1.0**
Spain	2.4	1.4	-0.2	**-0.4**	**1.2**
UK	2.8	2.6	1.5	**0.1**	**1.3**
Latin America *	7.8	9.2	12.6	**16.4**	**26.6**
Mexico	4.1	3.8	4.0	**2.8**	**3.3**
Brazil	5.4	6.2	6.3	**8.9**	**6.8**
EAGLES **	5.2	5.2	4.6	**4.5**	**4.1**
Turkey	8.9	7.6	8.9	**7.7**	**8.5**
Asia-Pacific	3.8	4.0	3.3	**2.3**	**2.8**
Japan	0.0	1.6	2.7	**0.4**	**1.2**
China	2.6	2.6	2.1	**1.6**	**2.0**
Asia (exc. China)	4.8	5.2	4.4	**2.9**	**3.5**
World	4.5	4.2	3.9	**3.8**	**4.8**

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Bangladesh, Brazil, China, India, Indonesia, Irak, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 10 November 2015.
Source: BBVA Research and IMF

Table 5.3
United States indicators and forecasts

	2013	2014	2015	2016	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16
Macroeconomic Indicators												
GDP (real % change)	1.5	2.4	**2.5**	**2.5**	0.6	3.9	1.5	**3.1**	**1.9**	**2.9**	**2.4**	**2.8**
Personal consumption (real % change)	1.7	2.7	**3.1**	**2.7**	1.7	3.6	3.2	**2.4**	**2.2**	**2.9**	**2.8**	**2.8**
Gov. consumption (real % change)	-2.9	-0.6	**0.7**	**0.8**	-0.1	2.6	1.7	**-0.4**	**0.8**	**0.8**	**0.8**	**0.8**
Gross fixed investment (real % change)	4.2	5.3	**4.4**	**5.9**	3.3	5.1	2.9	**8.3**	**5.3**	**6.6**	**5.6**	**7.0**
Construction	3.8	5.2	**6.3**	**4.3**	7.4	8.3	1.8	**4.5**	**4.1**	**4.5**	**4.5**	**4.9**
Industrial prod. (real annual % change)	1.9	3.7	**1.4**	**0.7**	3.5	1.4	0.9	**-0.4**	**-0.1**	**0.8**	**0.8**	**1.4**
Current account balance (% of GDP)	-2.4	-3.0	**-2.6**	**-2.6**	-2.7	-2.5	-2.9	**-2.6**	**-2.4**	**-2.4**	**-2.6**	**-2.9**
Final annual inflation	1.5	0.8	**1.6**	**1.4**	-0.1	0.1	0.0	**1.6**	**2.1**	**1.4**	**1.9**	**1.4**
Average annual inflation	1.5	1.6	**0.2**	**1.8**	-0.1	0.0	0.1	**0.9**	**2.2**	**1.7**	**1.6**	**1.6**
Primary fiscal balance (% of GDP)	-4.1	-2.8	**-2.5**	**-2.4**				**-2.5**				**-2.4**

Note: **Bold** figures are forecast
Source: BBVA Research

Table 5.4
Mexico Indicators and Forecasts

	2013	2014	2015	2016	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	1.6	2.1	**2.2**	**2.5**	2.5	2.2	**2.3**	**1.9**	**2.2**	**2.3**	**2.5**	**3.0**
Per inhabitant (US dollars)	10,631	10,618	**9,342**	**9,561**	9,763	9,550	**8,962**	**9,092**	**9,189**	**9,491**	**9,642**	**9,923**
US$ billions	1,259	1,271	**1,130**	**1,169**	1,181	1,156	**1,085**	**1,100**	**1,124**	**1,161**	**1,179**	**1,213**
Inflation (average, %)												
Headline	3.81	4.02	**2.75**	**3.25**	3.07	2.94	2.62	**2.40**	**2.97**	**3.26**	**3.42**	**3.37**
Core	2.72	3.18	**2.39**	**3.16**	2.39	2.32	2.33	**2.53**	**3.03**	**3.18**	**3.26**	**3.16**
Financial Markets (average, %)												
Interest rates												
Bank funding	3.50	3.00	**3.02**	**3.40**	3.00	3.00	3.00	**3.08**	**3.25**	**3.33**	**3.50**	**3.50**
28-day Cetes	3.16	3.00	**3.25**	**3.41**	2.94	3.01	3.05	**3.15**	**3.25**	**3.38**	**3.46**	**3.50**
28-day TIIE	3.80	3.35	**3.44**	**3.72**	3.30	3.31	3.32	**3.43**	**3.55**	**3.68**	**3.76**	**3.80**
10-year Bond (%, average)	5.59	6.01	**5.96**	**6.18**	5.60	6.01	6.11	**6.12**	**6.06**	**6.10**	**6.14**	**6.34**
Exchange rate (average)												
Pesos per dollar	13.0	13.3	**15.1**	**14.5**	15.1	15.5	16.6	**16.6**	**16.7**	**16.3**	**16.2**	**16.0**
Public Finances												
*FRPS (% of GDP)	-3.7	-4.6	**-4.1**	**-3.5**	-	-	-	**-4.1**	-	-	-	**-3.5**
External Sector[3]												
Trade balance (US$ billions)	-1.2	-2.8	**-13.0**	**-14.2**	-2.2	-1.9	-6.5	**-2.5**	**-2.6**	**-3.0**	**-6.5**	**-5.2**
Current account (US$ billions)	-30.5	-25.0	**-32.5**	**-35.4**	-8.6	-8.0	**-7.9**	**-8.0**	**-8.4**	**-8.5**	**-9.0**	**-9.4**
Current account (% of GDP)	-2.4	-2.0	**-2.9**	**-3.0**	-2.9	-2.8	**-2.9**	**-2.9**	**-3.0**	**-2.9**	**-3.1**	**-3.1**
Employment												
Formal Private (annual % change)	3.5	3.5	**4.2**	**3.7**	4.5	4.4	4.4	**3.5**	**4.2**	**3.6**	**3.6**	**3.3**
Open Unemployment Rate (% active pop.)	4.9	4.8	**4.4**	**4.6**	4.2	4.3	4.6	**4.5**	**4.7**	**4.5**	**4.7**	**4.6**

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Mexico Indicators and Forecasts

	2013	2014	2015	2016	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16
Aggregate Demand [4] (annual % change, seasonally-adjusted)												
Total	2.0	3.1	**2.7**	**2.8**	2.9	3.1	**3.0**	**2.0**	**2.7**	**2.6**	**2.8**	**3.2**
Domestic Demand	1.9	1.8	**1.1**	**2.2**	-0.0	1.2	**1.9**	**1.4**	**2.5**	**2.2**	**1.9**	**2.2**
Consumption	2.4	2.0	**2.5**	**2.2**	3.5	2.6	**2.0**	**1.9**	**1.6**	**1.9**	**2.5**	**2.8**
Private	2.6	2.0	**2.6**	**2.5**	3.5	2.6	**2.3**	**2.0**	**1.8**	**2.1**	**2.9**	**3.2**
Public	1.5	2.5	**1.9**	**0.3**	3.2	2.8	**0.5**	**1.4**	**0.4**	**0.4**	**0.3**	**0.1**
Investment	-1.0	2.2	**3.9**	**2.5**	5.9	4.9	**3.4**	**1.7**	**1.6**	**1.9**	**2.8**	**3.8**
Private	-0.9	4.6	**5.1**	**4.1**	7.0	6.2	**4.7**	**2.8**	**3.6**	**3.3**	**4.3**	**5.2**
Public	-1.5	-6.9	**-1.3**	**-4.7**	1.2	-0.8	**-2.4**	**-3.0**	**-7.1**	**-4.5**	**-4.3**	**-2.9**
External Demand	2.2	7.3	**7.6**	**4.6**	12.2	8.9	**6.2**	**3.7**	**3.3**	**3.7**	**5.3**	**6.1**
Imports	3.0	6.2	**4.3**	**3.8**	4.1	5.6	**5.3**	**2.2**	**4.3**	**3.5**	**3.7**	**3.8**
GDP by sectors (annual % change, seasonally-adjusted)												
Primary	0.8	3.5	**4.5**	**3.1**	6.7	2.8	**5.4**	**3.3**	**2.6**	**2.7**	**2.8**	**4.3**
Secondary	-0.6	1.9	**1.0**	**2.5**	1.5	0.6	**1.4**	**0.4**	**1.9**	**2.3**	**2.8**	**2.9**
Mining	-0.5	-2.2	**-5.8**	**-2.0**	-5.5	-7.9	**-5.6**	**-4.2**	**-2.5**	**-2.5**	**-1.5**	**-1.5**
Electricity	0.5	1.8	**3.0**	**3.3**	3.3	1.7	**4.0**	**2.8**	**2.8**	**2.7**	**3.9**	**3.9**
Construction	-4.7	1.8	**2.4**	**nd**	4.6	2.9	**nd**	**nd**	**nd**	**nd**	**nd**	**nd**
Manufacturing	1.2	3.8	**3.0**	**3.5**	3.7	2.4	**3.2**	**2.6**	**3.4**	**3.5**	**3.7**	**3.6**
Tertiary	2.7	2.2	**2.9**	**2.5**	3.0	3.1	**2.5**	**2.8**	**2.3**	**2.3**	**2.4**	**2.9**
Retail	2.9	3.3	**3.6**	**3.3**	5.8	3.3	**3.2**	**2.3**	**2.7**	**3.3**	**3.3**	**3.7**
Transportation, mail and warehouse	2.7	1.9	**2.9**	**3.1**	3.1	3.1	**2.8**	**2.6**	**2.6**	**2.9**	**3.5**	**3.4**
Massive media information	5.1	2.2	**6.9**	**6.5**	5.7	4.7	**7.5**	**9.6**	**7.0**	**6.2**	**6.0**	**6.8**
Financial and insurance	10.5	2.0	**1.7**	**4.0**	1.0	0.1	**2.0**	**3.6**	**4.6**	**2.9**	**3.8**	**4.8**
Real-estate and rent	1.0	2.1	**2.3**	**1.9**	1.8	3.2	**1.7**	**2.5**	**1.8**	**1.7**	**1.7**	**2.5**
Prof., scientific and technical servs.	0.9	1.2	**3.1**	**1.9**	2.8	5.0	**2.6**	**2.0**	**2.1**	**1.9**	**1.7**	**2.1**
Company and corporate management	-1.4	6.4	**0.0**	**1.8**	-2.7	-1.9	**2.9**	**1.9**	**1.3**	**1.6**	**1.9**	**2.2**
Business support services	4.3	0.0	**2.0**	**1.2**	2.5	0.5	**2.5**	**2.4**	**1.3**	**1.3**	**1.0**	**1.4**
Education	0.8	1.5	**0.8**	**0.8**	0.6	0.6	**0.5**	**1.6**	**0.9**	**0.9**	**0.8**	**0.7**
Health and social security	2.5	0.6	**1.4**	**0.8**	1.4	1.7	**1.3**	**1.1**	**0.8**	**0.9**	**0.7**	**0.9**
Cultural and sport	4.0	-0.8	**3.9**	**2.6**	3.8	6.0	**3.1**	**2.9**	**2.5**	**2.0**	**2.6**	**3.3**
Temporary stay	1.8	2.9	**3.7**	**2.2**	3.7	4.4	**3.8**	**2.8**	**1.6**	**1.8**	**2.4**	**2.8**
Other services, except government activities	2.2	1.4	**1.6**	**1.2**	2.7	0.9	**1.2**	**1.7**	**0.7**	**0.6**	**1.7**	**1.8**
Government activities	-0.4	2.5	**2.9**	**-1.4**	4.9	4.2	**0.6**	**1.9**	**-1.6**	**-1.4**	**-2.7**	**0.2**

1: Residential investment
2: Fiscal balance (% GDP)
3: Accumulated, last 12 months
4: Base 1993=100; GDP by sector base 2003=100. The observed data of the primary sector, secondary and tertiary seasonally-adjusted by INEGI, the rest own seasonally-adjusted
bd: billions of dollars
dpb: dollars per barrel
*FRPS: Financial Requirements of the Public Sector
na: not available
Note: **Bold** figures are forecast
Source: BBVA Research with Federal Reserve, Bureau of Labor Statistics, Banco de Mexico, INEGI and SHCP data

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Mexico Economic Outlook
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