

Monthly, January 2010

### A look at the month

- Uncertainty around the sustainability of China's growth and the regulatory reform proposal in the U.S. limiting the operations and size of large banks led to a fall on stock exchanges last week and increased generalized risk aversion across emerging markets.
- A more favorable global scenario than over the previous week is required for Mexico to continue consolidating its lower negative difference over other emerging markets. In this context, economic recovery will favor domestic assets, including the peso, which will see a gradual reduction in depreciation with regard to its long-term balance between 11.5 and 12.5 ppd.
- A clearer message on Banxico's monetary stance and the increased bond trend among overseas agents favor a lower curve slope. However, the low liquidity level and international market volatility are playing against this.
- **To watch!** In accordance with the 2010 Finance Plan, the relative weight of medium- and long-term issuance of instruments will increase, after declining in 2009. In addition, there will be new benchmarks for 5- and 10-year bonds and 30-year Udibonos, issued under the "syndicated bonds" system. The possible effects the issuance policy changes could have on interest rates will need to be watched.

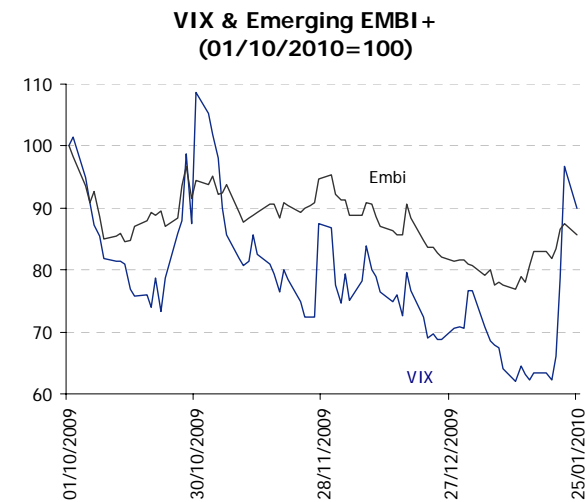
Javier Amador Díaz  
[javier.amador@bbva.bancomer.com](mailto:javier.amador@bbva.bancomer.com)

Ociel Hernández Zamudio  
[o.hernandez@bbva.bancomer.com](mailto:o.hernandez@bbva.bancomer.com)

### Doubts on the sustainability in China's growth rate significantly reduced the appetite for risk on markets

Uncertainty around the sustainability in China's growth, in response to the recent monetary restriction measures, is affecting the appetite for risk on global financial markets. This put the brakes on market rises, which intensified at the end of 2009, and led to an intense debate on the revaluation levels of some risk assets. Chinese authorities seem to be showing initial signs of worry at a possible overheating in the economy. In addition, there is market concern at the monetary measures already in place<sup>1</sup> possibly affecting economic growth in the country and damaging global business recovery. Annualized quarterly growth higher than forecasts in 4Q09 (+10.7%, the highest growth rate since 2007) and signs that inflation is heading up contributed to the negative impact by increasing uncertainty on additional measures which could be taken to curb on demand.

Further, worries on the fiscal status of some Eurozone countries, especially Greece, were added. Finally, and no less important, is U.S. President Obama proposed legislative reform on banking regulations to limit the operations of the largest financial institutions<sup>2</sup>.



Source: Bloomberg & BBVA Bancomer ERD

<sup>1</sup> These are efforts by the authorities to reduce the credit growth rate. In this way, after an increase in the benchmark interest rate, Chinese regulators in issuing verbal "guidance" to all banks imposed loan quotas and warned the most aggressive banks to temporary curb credit growth, in the midst of increasing worries over asset bubbles and inflationary risks.

<sup>2</sup> In accordance with this proposal, banks would be forbidden from owning, investing in or underwriting *hedge funds* or *private equity funds*. In addition, retail banks taking deposits could not operate financial assets to obtain profits with their own equity (i.e. not from clients). Lastly, an attempt will be made to limit consolidation in the financial sector, putting a brake on the largest banks increasing stakes in the liability market.

**Is this a turning point for financial markets? It would seem that the rally in financial risk assets which had been favored by stimulus packages and available liquidity needs consolidation in economic recovery.**

Stock markets saw significant losses in this reduced risk appetite scenario, with a generalized dollar appreciation being recorded. Risk measures experienced major increases in the last week after reaching and stabilizing at minimum levels, near those before the financial crisis began. In this way, despite the preference for returns having to be maintained without sudden financial shocks, markets could be seeing a change in perception in anticipation of a bounce back in output whose strength is uncertain and which, as mentioned in previous reports, was taken as given.

It should be said that before this increase in risk aversion, a dollar appreciation trend had been recorded, albeit in a revaluation scenario for the riskiest assets, including those in emerging economies. This means that for the first time since the start of the financial crisis in September 2008, the dollar-high risk asset relationship changed, pointing to the importance of so-called "refuge effect" investment strategies being lower. In the future, if the perception that U.S. economic growth will drive global economic recovery consolidates and if the (unjustified) fears on a disordered adjustment in Chinese economic activity are reduced, we would expect the dollar strengthening performance and positive returns on higher-risk assets to consolidate. Nonetheless, in the short-term financial volatility could extend, in anticipation of greater uncertainty on the strength of economic recovery and the final decision on the new financial system regulatory proposals.

**The different between markets is changing in line with perceived macroeconomic risks**

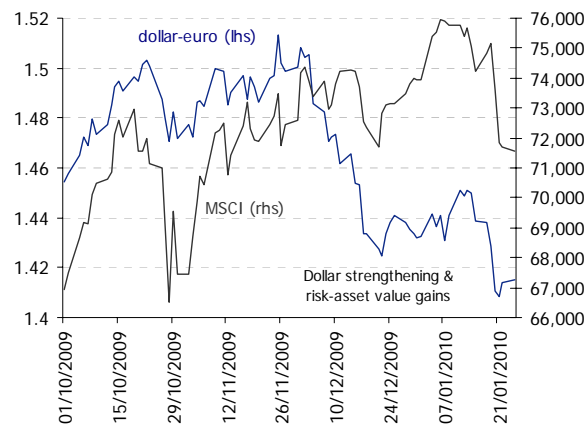
Macroeconomic perspectives see a growing differentiation between regions. In this way, they seem more favorable and less risky for the U.S. economy in comparison with Europe. The perspective gap is extending in accordance with the release of more favorable indicators which, over 4Q09 were in line or provided surprise upticks for the U.S., while they were in line or provided surprise downticks for Europe. The difference in recovery speed is clearer for domestic demand indicators. This helps explain the recent gradual dollar appreciation trend against the euro, which we expect to remain for the remainder of 2010. With regard to emerging economies, markets seem to favor economies closer to the American cycle during higher risk appetite periods, such as in recent months and, especially in January (this is true for Mexico) while more intense reactions to China are starting in commodity export economies<sup>3</sup> such as Australia and Brazil, for example.

**The Mexican financial variables started to reverse negative differentiation. In a positive global context, the appreciation margin for the peso will be higher**

In this lower risk appetite scenario, Mexican financial variables were affected in a relatively lower proportion. CPI performance was relatively better: in the first weeks of January gains were higher and, after the strong falls this week, its accumulated loss in dollars over the year is relatively low (-2.1% over -7.3% for Brazil or -5.5% for China).

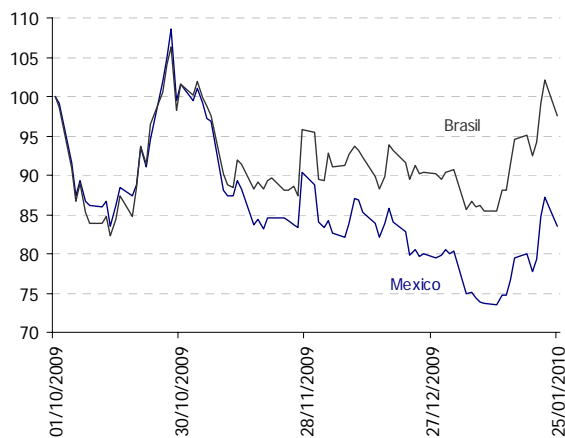
The peso was also relatively stronger than other emerging currencies. Even after this week's depreciation, the present 12.92 ppd level equates to a 1.3% appreciation in January, comparing favorably with depreciations in other emerging currencies over the same period (e.g. -4.1% for the Brazilian real). With regard to risk measures, up to last week performance was consistent with

**Emerging MSCI & Dollar-Euro ER (local currency & ER, dpe)**



Source: Bloomberg & BBVA Bancomer ERD

**5-year CDS (01/10/2009=100)**



Source: Bloomberg & BBVA Bancomer ERD

<sup>3</sup> The feeling is that raw material inventories in China reached very high levels and, as a consequence, their demand is likely to decrease in the future, especially if the measures attempting to slow demand in the country continue.

that seen for the revaluation of aforementioned risky financial assets. Now, on the one hand, the CDS in Mexico continues to show more favorable evolution (an increase equal to 5.9% against an increase of 9.5% for Brazil); on the other, the EMBI+ shows higher increases in perceived risk for Mexico. In all, Mexican financial assets have been closing the wide gap opened up with regard to the development of variables in other emerging economies for most of 2009.

As opposed to what was seen with other emerging economy currencies, the Mexican currency is still depreciated in comparison to levels before the crisis began in the fall of 2008. An uptick in economic growth in line with that in the U.S., the reduced risk aversion and the return of capital flows, financial stability, carry trade opportunities and Mexico's low exposure to demand from emerging economies are factors supporting the peso's revaluation, still depreciated in comparison to its long-term balance level of between 11.5 and 12.5 ppd, and which will appreciate to the high end of this range.

**A clearer message on Banxico's monetary stance and the increase in bond trend by overseas agents favor a lower curve slope. However, the low liquidity level and international market volatility are playing against this.**

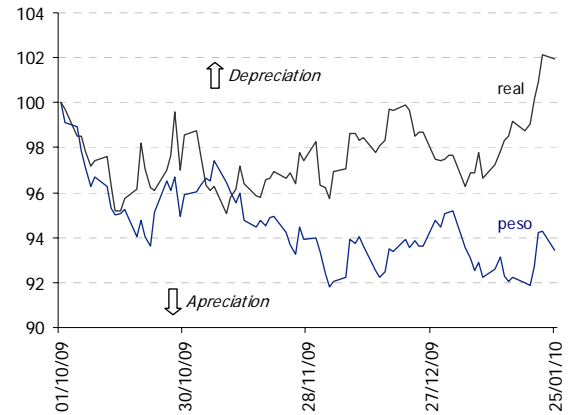
The Bank of Mexico stated that in the absence of indirect effects on inflation from increased public prices and indirect taxes, and if inflation forecasts remain anchored, the impact of temporary shocks on inflation should not be counteracted. With this, Banxico is clearly setting out its monetary policy strategy for a foreseeable temporary increase scenario for inflation rates over 2010. The above points to incoming information continuing to be appraised in coming months and the Board not being in any hurry to raise the interest rate, except in reaction to adverse inflationary expectations and/or a build-up of supply shocks that leads to a new upward revision of forecasts.

While economic recovery is so gradual that the output gap continues in negative terrain, these margin conditions should cushion the changes in taxes and public prices for consumers. We believe that in the scenario set out Banxico will keep the monetary pause throughout 2010, although the possibility of a higher lending rate will increase in the last months of the year when, according to our forecasts, inflation could be higher than the average evolution range expected by Banxico and the recovery process becomes more advanced.

The transparency of this monetary stance (*"The Bank of Mexico should not, in principle, counteract the direct impact on prices from the fiscal measures"*<sup>4</sup>), had an influence not only on monetary policy expectations from the market – an increase in the lending rate in the first months of the year being practically ruled out right now – but also from analysts, and consequently on the yield curve slope. Despite the curve volatility due to uncertainty on international markets, the M10 benchmark rate remained around the 7.8% threshold, far from the 8.0% recently reached.

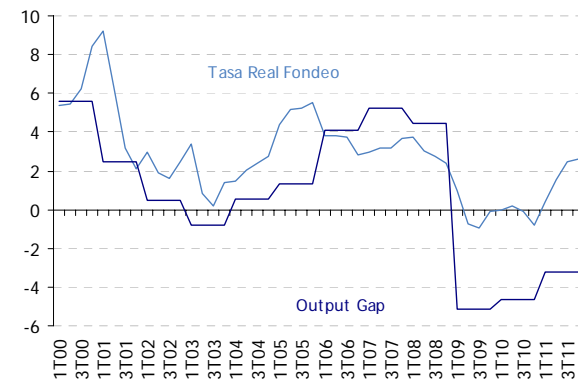
We believe that there is still margin for downward adjustment in the long tranches (5 and 10 years) over 2010. However, space is more limited and will surely be temporary due to different risk factors to be incorporated: a) as inflation increases, the inflation premium is likely to remain high; b) consolidation of the monetary pause will come with a higher discount for an increase in short-term interest rates to levels near the balance; c) the high public deficit developed economies face keeps international interest rates under pressure, which leads to a curb on falls in domestic interest rates given the carry strategies; d) some emerging countries face credibility problems in debt payment, which will continue to be a factor for uncertainty on international markets; e) the SHCP tax and credit authorities will slight increase the supply of medium- and long-term bonds, as well as the issuance form for new series ("Syndicated Bonds"), f) low liquidity levels remain on the secondary market.

ER vs usd ((01/10/2009=100))



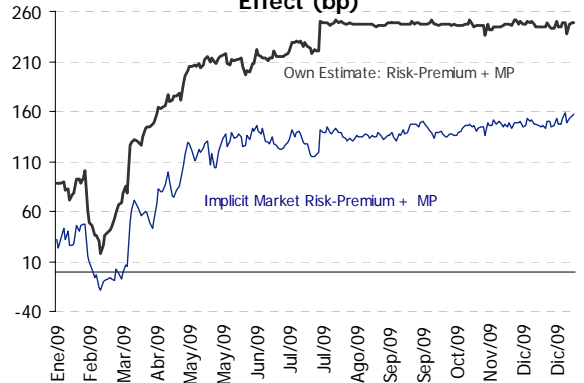
Source: Bloomberg & BBVA Bancomer ERD

Output Gap & Real Fondo (%)



Source: BBVA Bancomer ERD own estimates (GDP, Potential GDP, fondo & inflation)

Structural Yield-Curve Risk-Premium (M10 - 1m) + Monetary Policy Stance Effect (bp)



Source: BBVA Bancomer ERD. Market Risk: (10yIRS-10y Bond) minus (3m IRS-3m yield) - adjusted by IRS TIIE Swap premium. Risk-Premium Own Estimate: (equilibrium between 50 and 100 bp)

<sup>4</sup> Agustín Carstens, Governor of the Bank of Mexico (January 8, 2010)

**To watch!**

In accordance with the 2010 Finance Plan presented by the Tax and Public Credit authorities, the relative weight of medium- and long-term issuance of instruments will increase this year, after declining in 2009. On the demand side, preference for these instruments may increase due to the reform of the ISSSTE pensions system, meaning greater resources buying public debt. On the supply side, the issuance strategy plans to continue placing debt with a reduced benchmark number, albeit with major amounts in circulation. There will be new benchmarks for 5- and 10-year bonds and 30-year Udibonos. In addition, the issuance procedure for these instruments will be sale via “Bond Syndication”, where the amount issued in a single collection will be high and where the Market Makers are expected to accumulate a high amount at the start. From these issuances, regular reopening to the market will continue through auctions of these instruments by market maker institutions. In this way, this quarter is expected to see new bond benchmark issued for M10 and S30, where a considerable amount will be sold in a single collection. The announcement for issuance date and amount is expected.

The effects both the issuance policy change on new benchmarks and a higher bond supply on interest rates will need to be watched. Being higher amounts than in usual auctions, the new issuance scheme could put upward pressure on yields, albeit in the short-term and temporarily. If the aim of reducing the time needed to establish new benchmark bonds is fulfilled, the impact on interest rates should be negligible. In turn, by planning greater bond supply in 2010, it will be key for market liquidity levels to increase to as to minimize the possibility of a change in interest rates on the curve. However, the time and domestic and international market conditions will determine this.