

Mexico

Weekly Watch

February 25, 2011

Next week...

Economic Analysis

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Banxico set to keep monetary policy rate unchanged

The latest bimonthly inflation data have been moderate and, if there are no changes, inflation would remain within the range estimated by Banxico, despite the upward risks represented by both higher international commodity prices and adverse climate factors. As for economic activity, although the most recent data seem to suggest higher than expected growth, there is still no evidence that this situation might generate significant pressures on prices. Based on these arguments and on the recent “accommodating” announcement made by the Central Bank, it is reasonable to believe that the Bank of Mexico will keep the lending rate at 4.5% for one more month. In fact, we believe that as far as prices and economic activity are concerned, the monetary pause could be maintained in 2011. However, the risks of an earlier increase in the lending rate have increased compared to previous months.

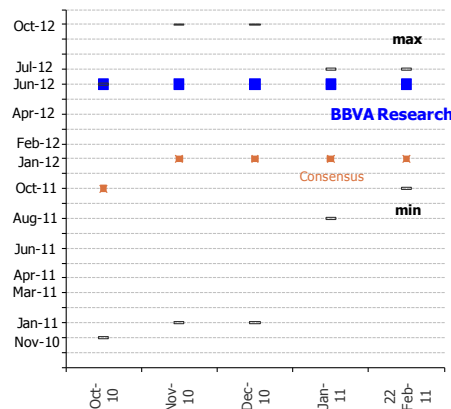
Although risk elements for prices have arisen in recent weeks, in the minutes of the Monetary Policy meeting held in January, Banxico stressed that inflation expectations are the main factor for adjusting its monetary policy, which so far are consistent with the inflation target.

Political tension in the Middle East will continue to set the standard

During the week, political tension in the Middle East raised global risk aversion, interrupting the exchange rate stability seen in previous weeks and giving rise to a decorrelation between the domestic curve and the Treasuries curve. The exchange rate reached 12.23 ppd on the intraday market last Wednesday. It closed the week at 12.12 ppd. Should oil price rises and risk aversion caused by political tension in the Middle East continue, the situation for the peso and the local curves would become more complicated. Exchange rate pressures would continue and the curve’s volatility would become more noticeable, with no marked trend in dynamism (short-term Bear Flattener most likely). As soon as risk aversion declines, we would see the peso return to 12 ppd and a risk of the curve bouncing back in response to the expected Treasuries correction in this context. However, correlation of the medium and long parts of the curve should be smaller, since these tranches are already at high levels.

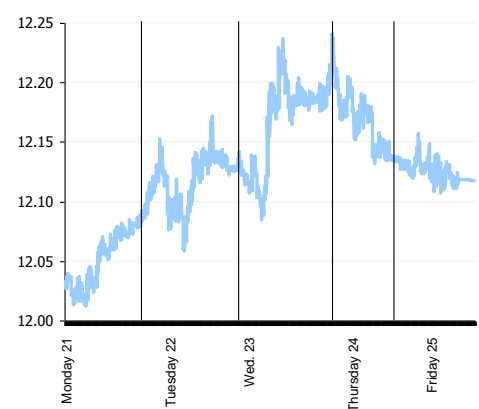
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Chart 1
Expectations regarding the next move in the lending rate



Source: BBVA with data from the Banamex Expectations Survey

Chart 2
Intraday exchange rate during the week (ppd)



Source: BBVA Research with Banxico data

Economic Analysis

Calendar: Indicators

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Consumer and producer confidence in February

Producer March 3 3.4% m/m, 23% y/y (Prev.: -2.1% m/m, 24.7% y/y)

Consumer March 4 1.5% m/m, 13.8% y/y (Prev.: -1.1% m/m, 12.3% y/y)

Producer confidence rose slightly in February, although it will remain at moderate levels during the first quarter of the year. We should remember that confidence data are published together with a series of relevant indicators. For example, we will continue to see the expected recovery of manufacturers in improved domestic demand and a continued favorable outlook for external demand. Other relevant indicators will be the opinion on the right moment for investing and the expected level of company orders. In general, we believe that consumer confidence indicators improved in February.

Consumer confidence will continue to recover driven by sustained growth in total and formal employment, and by a less negative contribution of real wages. One particularly relevant aspect will be the question related to durable goods consumption, an indication of consolidation of perceived consumption improvement. Consumer confidence is still far from the maximum level reached prior to the crisis.

**January 2011 Public Finance Report
Wednesday, March 25**

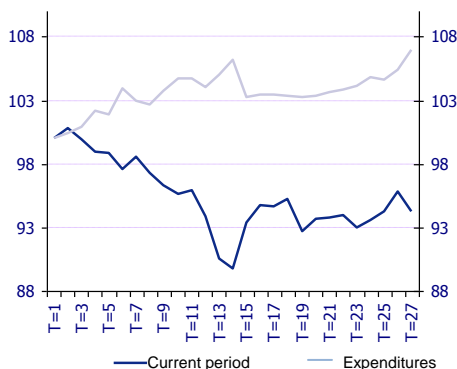
The public finance report for the first month of the year will be published next week. This is relevant information because, although the full data for 2010 have already been published, there are usually minor corrections to the data for the previous month, and the official balances for last year will therefore be complete. Revenue performance should also be monitored, as it deteriorated significantly in 2009. Despite the fact that Congress approved VAT and SRI increases for 2010, recovery has been slow. There is no doubt that the deficit targets set in the budgets will be achieved adequately. However, revenue recovery is crucial in order to be able to maintain the safety margin that public finances have shown in recent years, so that during the current economic expansion stage positive primary surpluses can be attained in order to support debt reduction in the public sector.

Banxico, decision on monetary policy

Friday, March 4. Decision: maintain (4.5%); Consensus: maintain

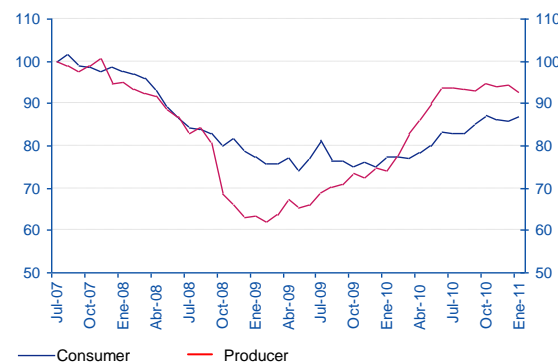
The lending rate will remain unchanged. The latest data on economic activity and inflation are consistent with a prolonged pause, although with greater risks of an earlier rise.

Chart 3
Budget revenue and spending during the crisis (Oct. 2008=100)



Source: BBVA Research and Banxico

Chart 4
Confidence: consumer and producer (Jul07=100, max.)



Source: BBVA Research and INEGI

Market Analysis

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Markets

Week with high volatility and decorrelation with Treasuries: risk aversion, the main determining factor

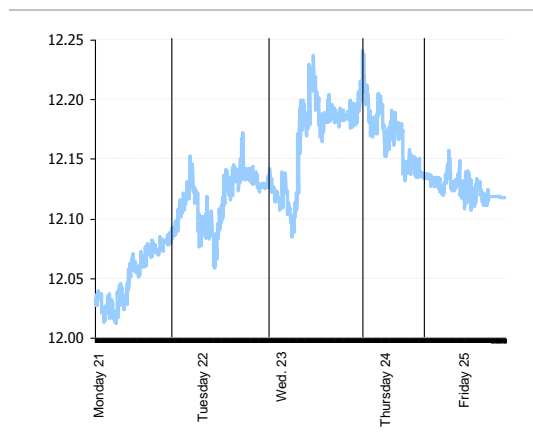
During the week, the curve level closed slightly upwards. The medium and long parts closed with no changes. However, the week showed high volatility as a result of global risk aversion. The strong increase in oil prices and its impact on other commodities unleashed a context of economic uncertainty that also led to inflationary risks. Treasuries acted as a safe haven, while economic data have been mixed.

Should oil price rises and risk aversion caused by political tension in the Middle East continue, the situation and volatility of the local curves would become more complicated. On the one hand there would be less pressure on the part of Treasuries (their price would continue to rise or fluctuate at current levels), and on the other hand, as risk aversion declines, we should be cautious about Treasuries bouncing back. In our opinion, the medium and long parts of the local curve are at levels that already discount this possible return of Treasuries to pre-aversion levels, but not so in the short term, which has more room for moving upwards. However, this return in the absence of aversion will generate volatility. We consider that Bear Flatteners concentrated in the medium part are the option for minimizing volatility in this scenario, or more conservatively, long Butterflies in medium tranches.

Global volatility translated into a strengthening of the USD against the MXN, supported by relatively low real interest rates

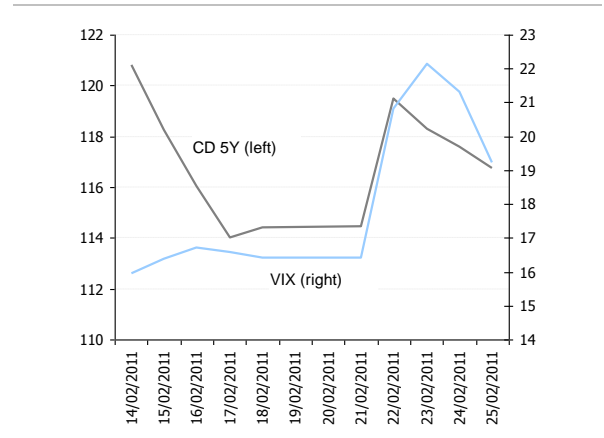
Last week, the USD-MXN exchange rate was one of the worst hit in Latam under the current global environment, possibly due to relatively low real rates and the outlook of monetary pause for the coming months. Although at the end of the week the MXN recovered some of the ground lost (thanks to the employment indicators in the US and purchases of some corporations and institutions), weekly depreciation was 0.7%. Over the next few days major correlation of implied MXN volatility with the VIX and an operating range between the 50 and 100-day rolling averages (12.1456 and 12.2598) cannot be ruled out.

Chart 5
Intraday exchange rate during the week (ppd)



Source: BBVA Research with Banxico data

Chart 6
VIX & CDS Mexico



Source: BBVA Research with data from Bloomberg

Mexico City, February 25, 2011

**Market Analysis
Equities**

Technical Analysis

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Technical Analysis

CPI



Source: BBVA, Bancomer, Bloomberg

CPI: As we have mentioned in recent weeks, until the CPI does not exceed the previous maximum level and the 30-day rolling average and the upper part of the current short-term channel, the trend will continue to be downward. A closing above 37,600 pts would send a major technical sign by placing the CPI in a situation where a significant upturn could begin. In the absence of this move, the floor level where the market might give us the opportunity to enter is delimited by the range between 36,000 pts (lower part of the channel) and 35,600 pts (minimum level in November).

Previous rec.: A breakthrough of 38,000, together with the exit from the market of the short-term negative channel would send a clear upward message for the coming weeks with a new target at 39,000 pts.

MXN

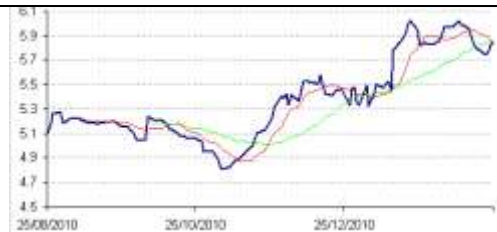


Source: BBVA, Bancomer, Bloomberg

MXN: Upturn in the week, with an attempt to break the P\$12.20 level upwards, operating during a couple of days above this level, but without recording a close. The drop in the last session of the week makes more likely a new return to the P\$12.00 area, still within the range in which it has operated for more than one month.

Previous rec.: Oscillators are not over-sold and maintain their downward trend.

3Y M BOND



Source: BBVA, Bancomer, Bloomberg

3Y M BOND: (performance): Continues the adjustment and is below rolling averages of 10 and 30 days. This maintains the correction outlook at around 5.5%. To revert, it would need to exceed 5.9%.

Previous rec.: The MACD indicates that this correction can be extended to the next support of 5.6%.

10Y M BOND



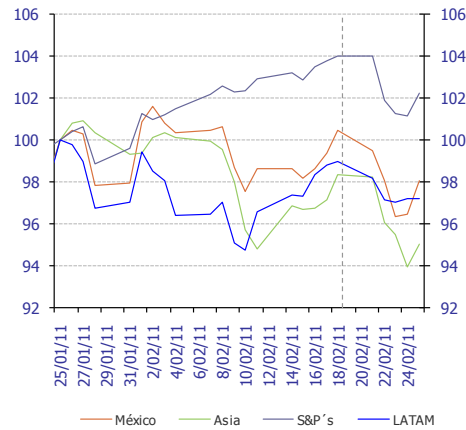
Source: BBVA, Bancomer, Bloomberg

10Y M BOND (yield): Below the 10-day rolling average. Maintains expansion against the 30-day average, so we maintain a correction view of around 7.3%.

Previous rec.: Could move toward the 30-day rolling average (7.3%), should short-term rolling averages expand.

Markets

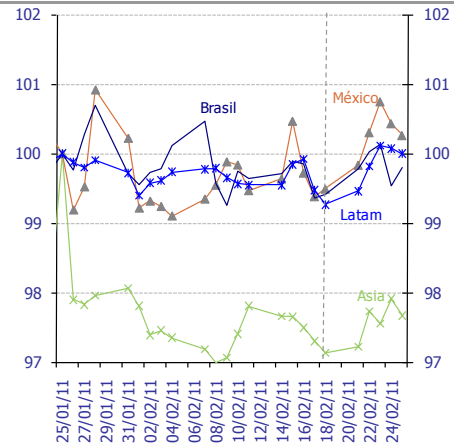
Chart 5
Stock markets: MSCI indices (Jan 25 2011 index = 100)



Source: Bloomberg & BBVA Research

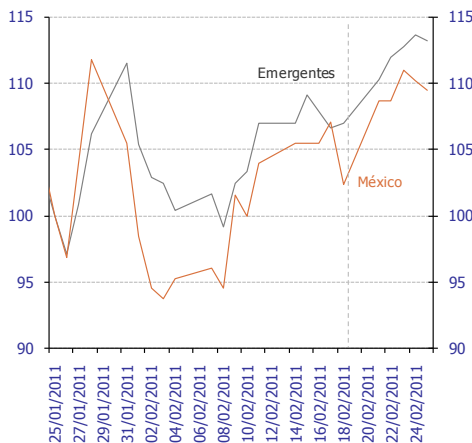
Better than expected consumer confidence data in the US which reduce, in part, the losses in stock markets and Latam currencies, related to fears that oil price rises will halt economic recovery

Chart 6
Foreign exchange: Dollar Exchange Rates (Jan 25 2011 index = 100)



Source: Bloomberg and BBVA Research. Note: LATAM includes Argentina, Brazil, Chile, Colombia and Peru. Asia includes the Philippines, South Korea, Taiwan, Singapore, Indonesia and Thailand. Non-weighted averages.

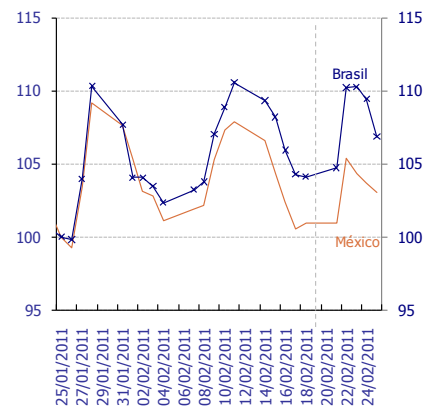
Chart 7
Risk: EMBI+ (January 25, 2011 index = 100)



Source: Bloomberg and BBVA Research.

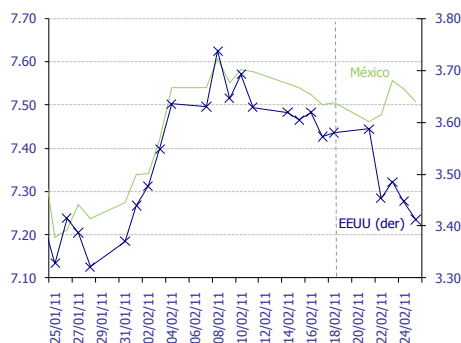
Reduced risk aversion towards the end of the week as a result of reduced fears of a disruption of the global oil market owing to the sociopolitical conflict in North Africa

Chart 8
Risk: 5-year CDS (January 25 2011 index = 100)



Source: Bloomberg and BBVA Research.

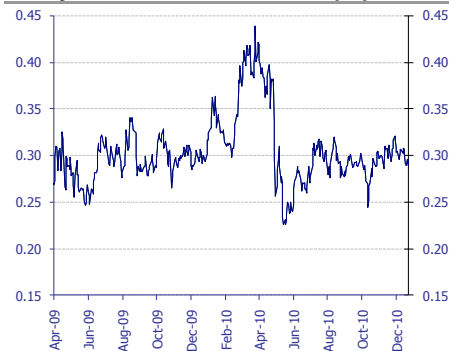
Chart 9
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

Fall in rates in the US as a result of the "flight to quality" by investors and positive growth data in the US. The rates in Mexico correlate with US rates towards the end of the week

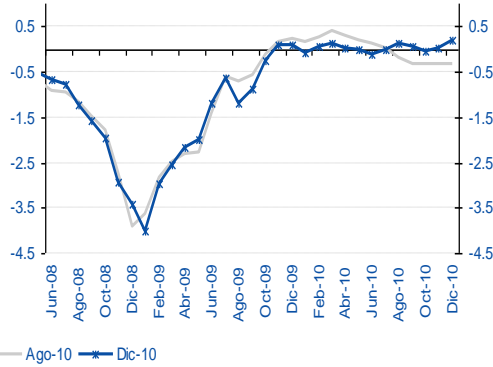
Chart 10
Carry-trade Mexico index (%)



Source: Bloomberg and BBVA Research

Activity, inflation, monetary conditions

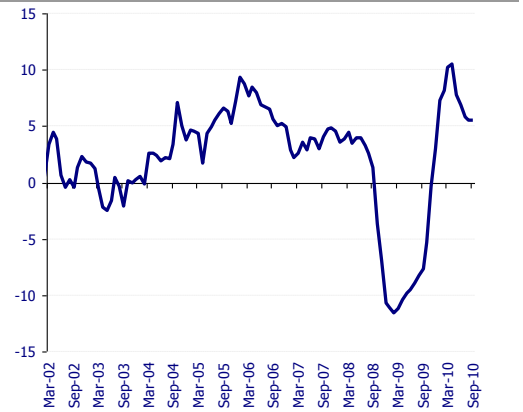
Chart 11
BBVA Synthetic Activity Indicator for the Mexican economy



Source: BBVA Research with data from INEGI, AMIA and BEA
Weighted sum of 21 different activity, expenditure and expectation indicators, based on trend series.

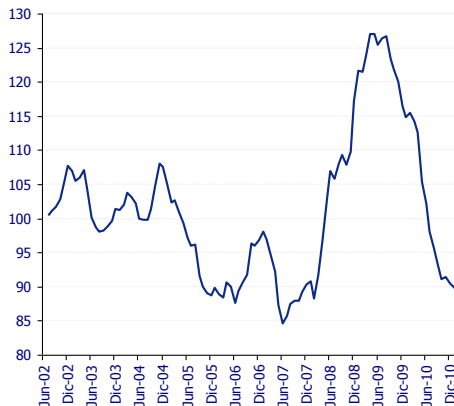
Economic activity in Mexico has improved, but the speed of recovery appears to have moderated

Chart 12
Advance Indicator of Activity (% variation y/y)



Source: INEGI

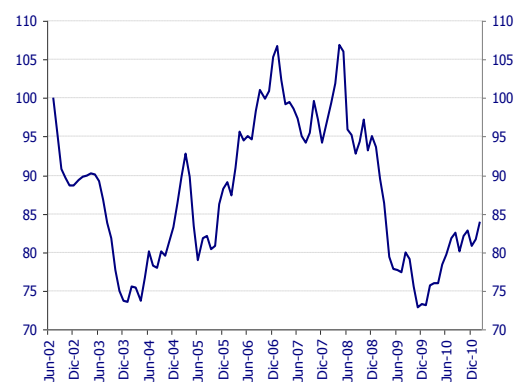
Chart 13
Inflation Surprise Index (July 2002=100)



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

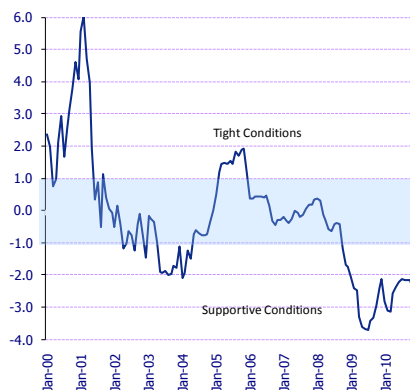
Inflation surprises fell throughout most of 2010, while activity surprises were moderate.

Chart 14
Activity Surprise Index (2002=100)



Source: BBVA Research with data from Bloomberg. Difference between recorded data and the Bloomberg consensus for seven activity variables in Mexico. Standardized index. Rises (falls): positive (negative) surprises.

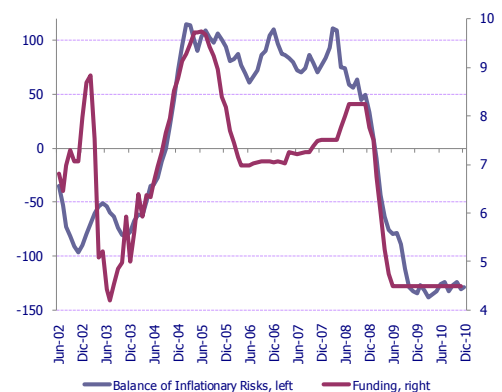
Chart 15
Monetary Conditions Index



Source: BBVA Research

The monetary conditions in which the economy is moving are accommodative. No upward movements to the reference rate are therefore expected in the short term

Chart 16
Balance of Inflationary Risks* and Lending Rate (standardized and %; monthly averages)



Source: BBVA Research. *Standardized, weighted index (between inflation and economic growth); uses economic indicators for activity and inflation. A rise in the IBR signals greater weight of inflationary risks over those of growth and, therefore, more likelihood of monetary restriction

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