Mexico

Weekly Watch

March 4, 2011

Economic Analysis

J. Julián Cubero
juan.cubero@bbva.bancomer.com

Market Analysis

Macro Latam Strategy
Chief Strategist
Octavio Gutiérrez Engelmann
o.gutierrez3@bbva.bancomer.com
+5255 5621 9245

Next week…

… Inflation will continue to fall in February

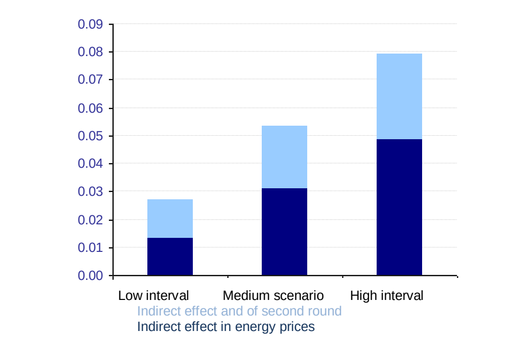
On Friday Banxico adopted a notably more cautious message with regard to inflation, in view of the deteriorating balance of risks as a result of recent supply shocks. Although there is no pressure on prices from the demand side, the Central Bank emphasized that the balance of risks on inflation has deteriorated as a result of the negative supply shocks in some agricultural products and the chance that the peso exchange rate will be affected by changes in global fund flows.

Given the uncertainty of the global situation, oil price rises are equally important. Their role has been intensified by doubts about the resolution of the political crisis in the Middle East and North Africa. Their possible impact on prices is one of the reasons for the tougher ECB statement, which appears to be set for a preventive rise in interest rates. In the case of the Mexican economy, our estimates show that the effect of an temporary increase of 10% in the oil price is consistent with a rise in the INCP consumer price index of between 0.03% and 0.08%, as both a direct (prices of energy products in the basket) and indirect effect (price rises in other goods and services affected by cost increases resulting from the oil price). These rises are very moderate compared with those estimated for economies that import oil and that do not subsidize prices at times of steep rises. This policy isolates Mexico from the price shock, although it will be affected in any event by the lower income of our main economic partner. In addition, uncertainty remains on the impact of commodity food prices. Even so, we expect February inflation to continue to fall to 3.6% from 3.8% in January.

Pressure on the curve in the two key scenarios could limit greater short-term gains by the MXN

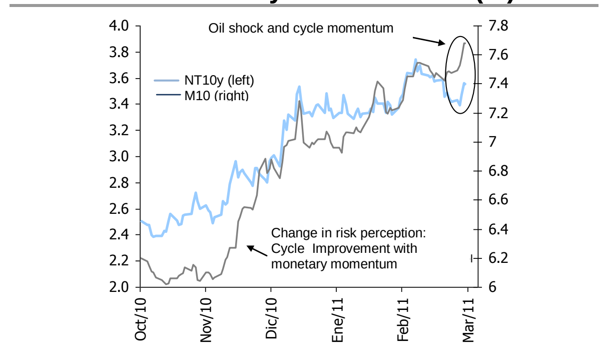
The scenario of greater global aversion (high commodity prices and potential impact leading to economic slowdown) is triggered by increased risk premiums and a reduced appetitive for the curve; on the other hand, the cyclical scenario of recovery (when prospects of monetary actions become relevant) also generate pressure on bonds. The yield curve and its steepness suggest that as inflation begins its upturn, and Banxico's first move becomes apparent, the curve will steepen faster at the short end (“ *(“Bear Flattener”).* ”) The MXN could see gains being limited in the short term as a result of geopolitical risks, the greater attractiveness of other Latin American currencies that have already begun to increase their monetary rates, and positioning factors in Chicago.

Chart 1
The effect of a 10% increase in oil prices on the INPC consumer index



Source: BBVA Research

Chart 2
Mexico and U.S.: 10-year bond rates (%)



Source: BBVA Research with Banxico data

Economic Analysis

Calendar: Indicators

Pedro Uriz
pedro.uriz2@bbva.bancomer.com

Inflation

Wednesday, March 9

Expected: 0.38% m/m (3.58% y/y); Previous: 0.49% m/m (3.78% y/y); Consensus (0.37% m/m)

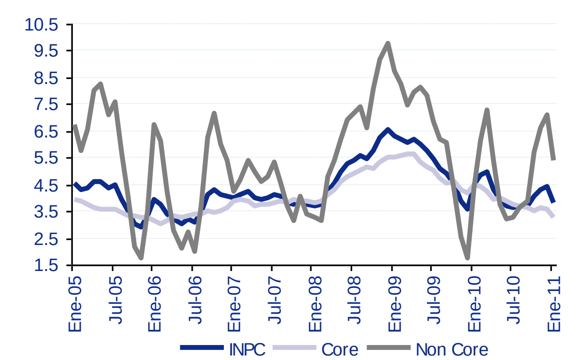
February inflation figures will be published on Wednesday 9. We forecast an increase of 0.38% m/m, so in annual terms inflation will have fallen from 3.78% year-on-year in January to 3.58% in February. This figure will be extremely important, as it will help confirm or dissipate concerns that have arisen due to the freezing conditions in the north of the country that affected wide areas of agricultural production, with potential effects on non-core inflation. Despite this, we consider that the increases in these products will continue to be compensated by reductions in the prices of other agricultural products in other parts of the country, at the top of its production cycle, as happened in the first half of the month. In addition, core inflation will have to be carefully monitored for the performance of processed food prices, which have been affected at the start of the year by major increases in the price of tortillas. We estimate that core inflation will increase by 0.43% m/m in February, so that in annual terms it will rise to 3.29%, a stable figure with respect to January, when it stood at 3.27%. Uncertainty in domestic and foreign goods markets has increased, and this has generated concerns on possible unforeseen increases in inflation. We believe that the shocks will in principle be temporary in nature and that inflation will close the year under 4%. However, we have to put an upward bias on our forecast given the risk that these events may last longer and have a greater effect.

Table 1
Forecast inflation for February 2011

	Peso	Monthly change (%)				Annual change (%)		
	(%)	Average 2003-2009	Dic-10	Ene-11	Feb-11	Dic-10	Ene-11	Feb-11
CPI-Mx	**100.0**	**0.31**	**0.50**	**0.49**	**0.38**	**4.40**	**3.78**	**3.58**
Core-Mx	*74.8*	*0.42*	0.43	0.46	*0.43*	3.58	3.27	*3.29*
Goods	37.0	0.43	0.48	0.73	0.51	3.82	3.60	3.68
Food products	14.7	0.50	1.08	1.41	0.61	4.35	4.51	4.71
Other Goods	22.4	0.39	-0.02	0.20	0.44	3.38	2.88	2.88
Services	37.7	0.41	0.39	0.23	0.36	3.36	3.00	2.96
Rent	17.9	0.48	0.17	0.23	0.23	2.64	2.34	2.14
Education	5.2	0.35	0.00	0.31	0.26	4.64	4.62	4.61
Other serv.	14.7	0.37	0.74	0.21	0.53	3.58	3.06	3.16
Non Core-Mx	*25.2*	*-0.06*	0.70	0.57	*0.22*	7.09	5.39	*4.46*
Farm products	8.1	-0.63	1.41	-0.27	-0.26	6.96	4.03	2.84
Fruits//Vegetables	3.3	-2.93	2.64	-0.82	-1.11	14.00	7.50	4.48
Meat//Eggs	4.8	0.94	0.55	0.18	0.40	2.46	1.77	1.83
Public managed	17.2	0.29	0.25	0.98	0.49	7.16	6.15	5.36
Energy	7.8	0.00	0.25	0.92	0.52	6.44	6.12	5.84
Controled prices	9.4	0.78	0.25	1.11	0.34	8.39	6.20	4.49
					Biweekly Revision			*Biweekly Revision*

Source: BBVA Research and Banxico

Chart 3
Inflation breakdown (% y/y change)



Market Analysis

Fixed Income Analysis Mexico
Chief Strategist
Ociel Hernández
o.hernandez@bbva.bancomer.com
+5255 5621 9616

Liliana Solis
liliana.solis@bbva.bancomer.com
+5255 5621 9877

FX Mexico // Brazil
Claudia Ceja
claudia.ceja@bbva.bancomer.com
+5255 5621 9715

Technical Analysis
Alejandro Fuentes
a.fuentes@bbva.bancomer.com
+52 55 5621 9975

Markets

The domestic yield cure is under pressure from two scenarios at the same time

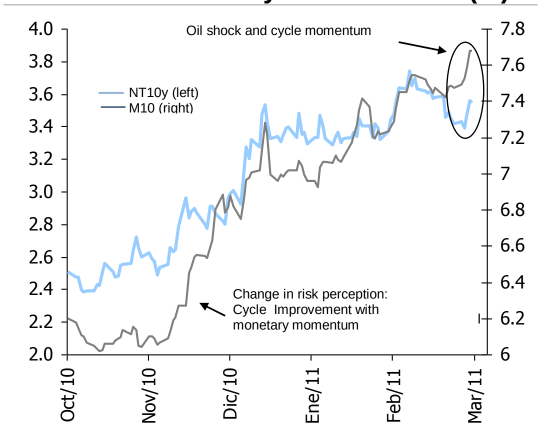
First, the scenario of greater global aversion, a product of high oil and commodity prices, with the implicit risks of a lower rates of economic activity, has triggered higher premiums and lower appetite for the curve. In other words, the curve is not being capitalized as a safe-haven asset. The cyclical scenario is also generating pressure on bonds because the prospects of greater recovery in activity dominate and monetary factors gain weight. This situation maintains commitment to the yield curve.

The yield curve and its steepness suggest that as inflation begins its upturn, and Banxico's first move becomes apparent, the curve will steepen more at the short end ("Bear Flattener").

Appreciation in the MXN over the week with a slight recovery in appetite for risk, but later gains in the currency will be limited.

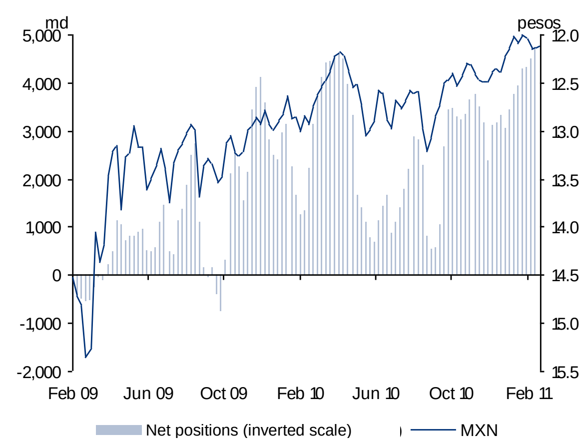
The MXN gained 0.98% over the week, favored by greater appetite for risk in global markets, as well as a general weakening of the USD (particularly against the EUR, with which the MXN has shown a high level of correlation over recent weeks), resulting from different monetary policies. However, we consider that there are three elements that limit short-term gains (in the 11.95 zone) and that even justify a correction towards the 12.05-12.10 zone: 1) persistent geopolitical conflicts in the Middle East and North Africa and high oil prices; 2) positioning factors (in accordance with CME data, despite the weekly fall of USD 700m, the speculative long peso position on March 1 stood at USD 4.01, close to its highest since April 2010); and 3) appetite for carry strategies that favors other Latin American countries which have already embarked on more restrictive policies than Mexico's (e.g. Brazil and Chile). We therefore maintain caution in the short term and favor range strategies.

Chart 5
Mexico and U.S.: 10-year bond rates (%)



Source: BBVA Research with Banxico data

Chart 6
MXN: Long non-trading positions in Chicago (CME. USD million)



Source: BBVA Research with data from Bloomberg

Mexico City, March 4, 2011

Market Analysis

Equities

Technical Analysis

Alejandro Fuentes Pérez (*)
a.fuentes @bbva.bancomer.com
5255 5621 9705

(*) Writer(s) of the report

Technical Analysis

CPI Stock Market Index

Source: BBVA, Bancomer, Bloomberg

IPC: The week ended with a new failed attempt to break through beyond the 30-day moving average. Since the start of the year, when the IPC fell below this technical indicator, this is the fourth time that the market has tried to reverse the trend, but it has not had the necessary force to end above the level of short-term technical resistance. The current short-term range is between 35,600 pts. and 37,200 pts. While uncertainty regarding commodity prices continues it will be difficult for the IPC to abandon this negative channel.

Previous Recommendation: If there is no breakthrough of the 30-day moving average, 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).

MXN

Source: BBVA, Bancomer, Bloomberg

MXN: Adjustment during the week that leaves the dollar under the short-term moving averages and returns it to the USD/MXN 12.00 zone. The oscillating indices showing momentum in the overselling zone and, given the sideways movement for a month and a half, we may expect a new upturn from the floor. This prospect of a rise disappears with a close of under MXN 11.95.

Previous recommendation: The fall to the close of the week increases the chance of a new return to the MXN 12.00 zone.

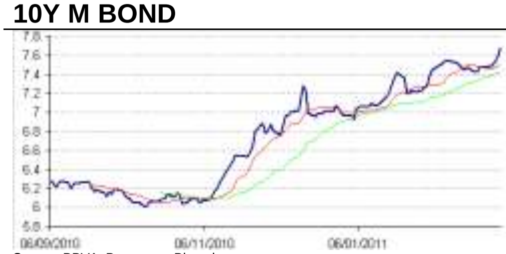
3Y M BOND

Source: BBVA, Bancomer, Bloomberg

3Y M BOND: (yield): Movement within the range of 5.77% and 6.03% for little more than a month. An upward breakthrough in the upper part of this channel would put the next target at 6.2%. There is overbuying in the short-term oscillating indicators, so we reckon there will be an adjustment in the middle part of the channel at 5.9%.

Previous recommendation: This maintains the correction outlook at around 5.5%. To revert, it would need to break through above 5.9%.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

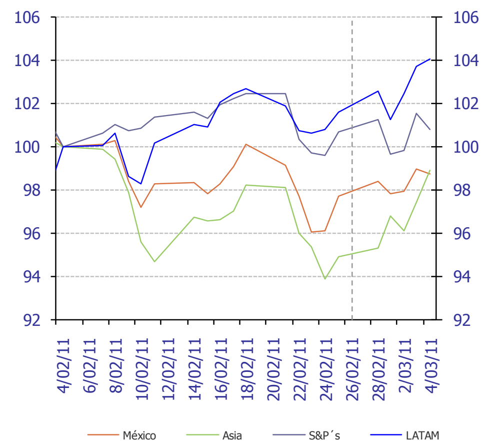
10Y M BOND (yield): Upturn from 10-day moving average. Next resistance at 7.8%, and support at 7.5% and 7.4%. The limited opening of averages suggests that the upturn may be maintained.

Previous recommendation: Maintains open position against the 30-day average, so we reckon there will be an adjustment around 7.3%.

Markets

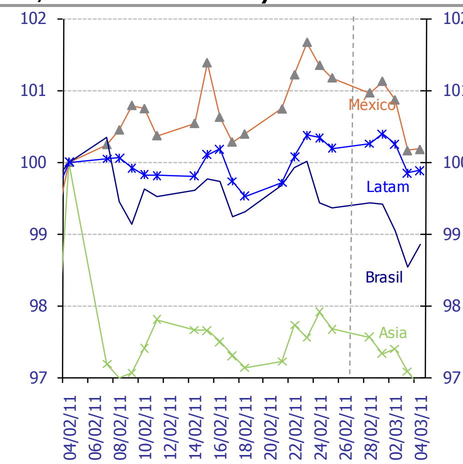
Concerns about a fall in consumption due to the rise in oil prices and zero wage growth in the U.S. generated falls in the stock markets and depreciations in Latin American currencies. The peso stood out by registering a marginal depreciation

Chart 5
Stock Market: MSCI indices (Feb 4, 2011 index = 100)



Source: Bloomberg & BBVA Research

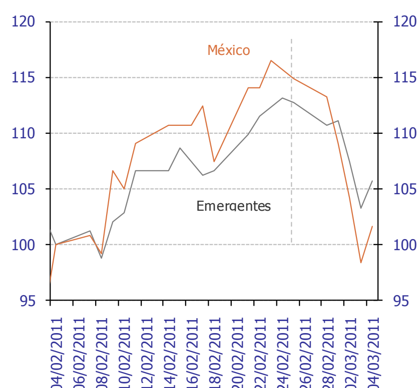
Chart 6
Foreign currencies: dollar exchange rates (Feb 4, 2011 index = 100)



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.

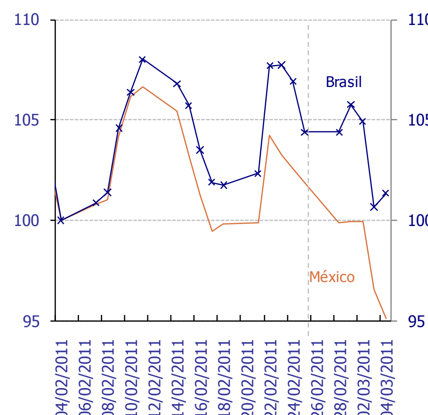
Increase in risk aversion towards the end of the week with new rises in oil prices and wage figures below expectations in the U.S.

Chart 7
Risk: EMBI+ (Feb 4, 2011 index = 100)



Source: Bloomberg and BBVA Research.

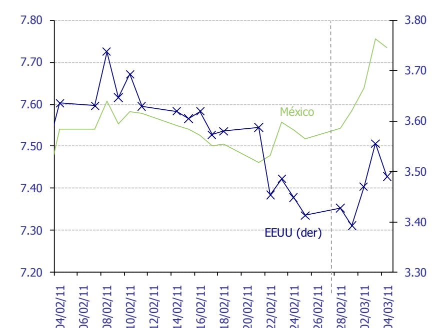
Chart 8
Risk: 5-year CDS (Feb 4, 2011 index =100)



Source: Bloomberg and BBVA Research.

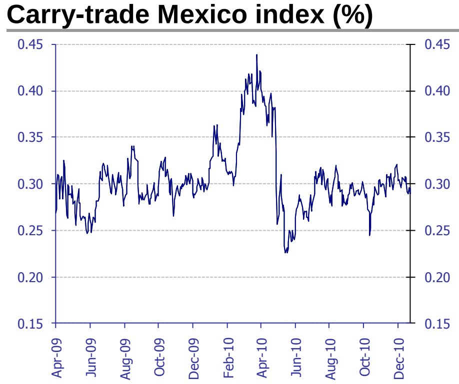
Fall in U.S. rates towards the end of the week in search of safe-haven assets. The rates in Mexico have registered a slight fall

Chart 9
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

Chart 10
Carry-trade Mexico index (%)

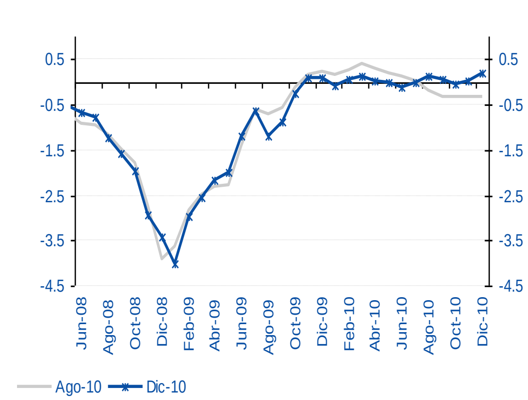


Source: Bloomberg and BBVA Research

Activity, inflation, monetary conditions

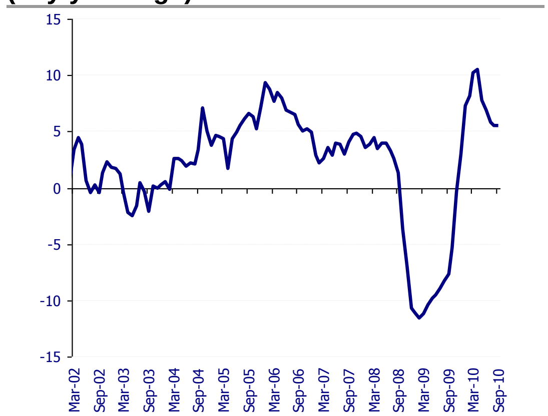
Economic activity in Mexico has improved, but the speed of recovery appears to have moderated

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 indicators of activity, expenditure and expectation, based on trend series.

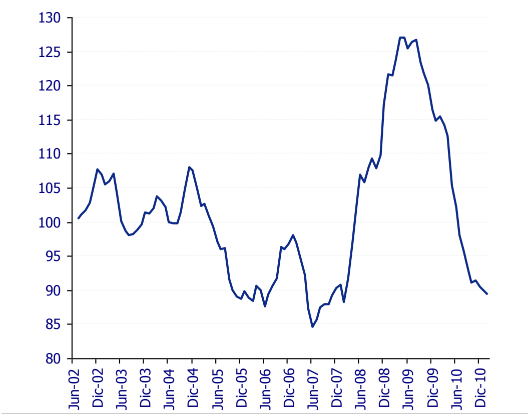
Chart 12
Advance Indicator of Activity (% y/y change)



Source: INEGI

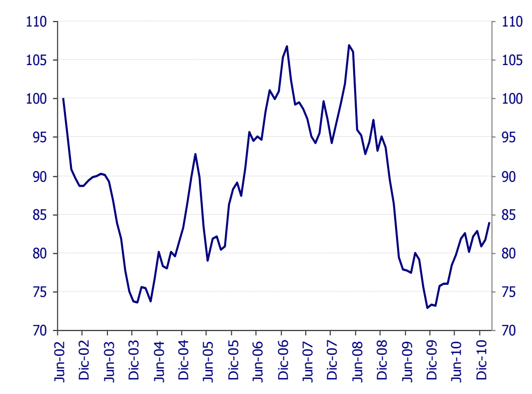
Inflation surprises fell throughout most of 2010, while activity surprises were moderate.

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.

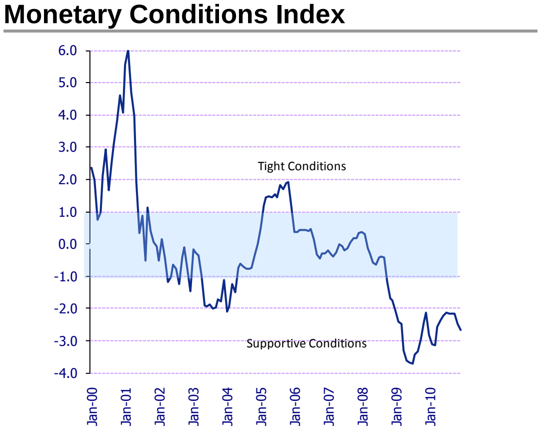
Chart 14
Activity Surprise Index
(2002=100)



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.

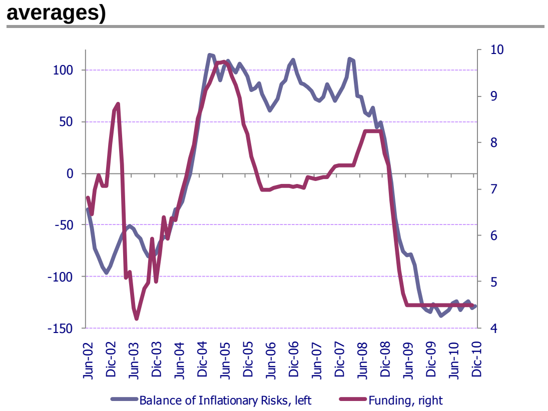
The monetary conditions in which the economy is moving are accommodative. No upward movements to the reference rate are therefore expected in the short term

Chart 15
Monetary Conditions Index



Source: BBVA Research

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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