

Mexico

Weekly Observatory

March 11, 2011

Next week...

Economic Analysis

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... Economic progress at the start of 2011

The earliest indicators on economic activity for the first few months of the year show that the manufacturing sector and especially growth in sectors such as the motor vehicle sector will play a key role. In the first month of the year, average growth in terms of produced units stood around 3.2% compared to the previous month, representing an acceleration in the average monthly variation for 4Q10. Other indicators related to manufacturing producer perception are mostly in line with expectations of a recovery, which seems to have continued into the start of this year. Indicators related to domestic demand still remain at low levels and mostly showed slower growth in the last quarter than in the third. As well as the level of employment recovery, the ability for real wages to recover growth lost since 2008 will also be important. The January industrial output result, to be announced on Monday, will give more detailed information on whether the recovery of the motor vehicle industry will be more widespread among other branches, as well as the level of late recovery in construction.

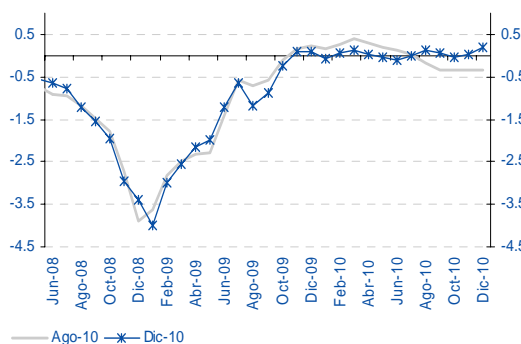
Market Analysis

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Positive week for debt markets and MXN

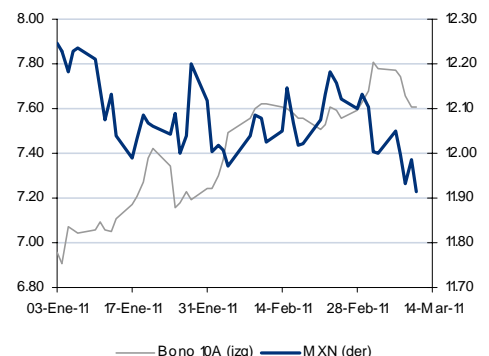
In spite of geopolitical tensions prevailing in the Middle East, oil prices have pulled back slightly from their highs, but continue to fluctuate above \$110 a barrel. This has strengthened treasury bonds as a safe-haven asset and reduced the appetite for the stock market. Due to this aversion, local bonds have moved into correlation with the US downtrend and the MXN has broken the 12.00 zone, to 11.90ppd. We think that there are three factors driving this trend: 1) High oil prices, which start to weigh on forecasts of cyclical growth; 2) in spite of the current oil price level, this has stopped rising, and even pulled back slightly from its maximum levels, lessening noise and uncertainty regarding the short-term level that it could reach; 3) tension on sovereign debt markets in peripheral European countries, which has favored other emerging markets as far as flows are concerned. These three factors have resulted in a positive correlation between local bonds and the MXN. The relative value of bonds has risen due to the lack of determinants which will push treasury bonds up in the short term, and the peso is acting as a commodity currency, widening its correlation with the Canadian dollar. There is a lot of economic information in the US for next week, but the unfolding of events in the Middle East will determine inflows.

Chart 1
Mexico, synthetic activity indicator (standardized)



Source: BBVA Research

Chart 2
10-year bond and Mexican Peso



Source: BBVA Research

Economic Analysis

Calendar: Indicators

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Industrial Output

Monday March 14

5.8% NSA (4.9% previous, 5.3% consensus so far). In SA: -0.2% mom, 4.3% yoy (4.5% yoy previous)

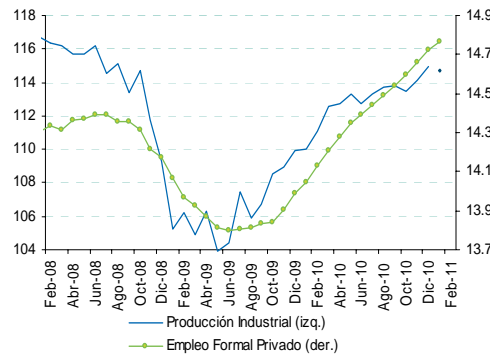
The information available so far suggests that in January the industrial output manufacturing component has recorded a strong trend in keeping with US manufacturing output. The construction component posted an unwelcome surprise with falls in two of the last three months. This sector has still not recovered from the economic crisis in 2008. It is worth remembering that in December growth in the Mexican manufacturing sector continued on the back of the US sector (0.6% up in the last month of the year). The volume of imports of intermediate goods (a pointer towards domestic activity) performed better towards the end of the year than in 3Q (1% October-November vs. 0.2% 3Q). In the coming months we expect to see a moderate recovery in components with a significant weight in manufacturing with domestic demand. This will help improve the industry's profile.

Banxico minutes

Friday March 11

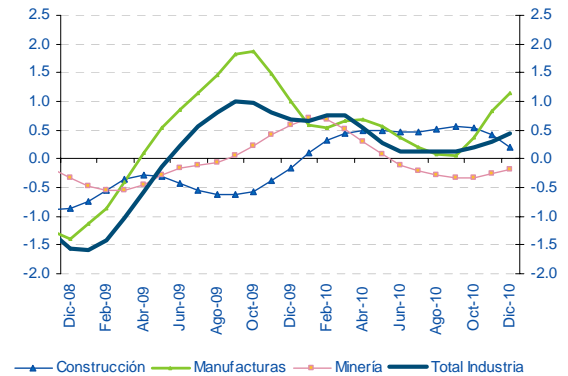
After the more cautious tone that Banxico adopted in its latest statement, we must pay attention to the Board members' opinions regarding losses on the inflation balance sheet, which represented the most significant change. The minutes should give an idea about the balance of expansive and restrictive positions which will give us more information to analyze the monetary policy stance in view of more risks to come.

Table 1
**Industrial Output and Employment
(Index 2003=100 and million people)**



Source: BBVA Research and Banxico

Chart 3
Industrial Output (mom %, trend)



Market Analysis

Markets

The curve flattened out in the week due to falls in yields in the US and a halt in oil prices.

In spite of geopolitical tensions prevailing in the Middle East, oil prices have pulled back slightly from their highs, but continue to fluctuate above \$110 a barrel. This has strengthened treasury bonds as a safe-haven assets and reduced the appetite for the stock market. Due to this aversion, local bonds have moved back into correlation with the fall in yields in the US. We think that there are three factors driving this trend: 2) high oil prices, which start to cause doubts about a positive negative effect on economic recovery; 3) in spite of the current oil price level, this has stopped rising, and even pulled back slightly from its maximum levels, lessening noise and uncertainty regarding the short-term level that it could reach; 3) tension on sovereign debt markets in peripheral European countries..

Overall, these three factors have resulted in a positive correlation between local bonds and the MXN. The relative value of bonds has risen due to the lack of determinants which will push treasury bonds up in the short term, and the peso is acting as a commodity currency, widening its correlation with the Canadian dollar. Against this background, the 10-year bond recorded a 17pb rally during the week and, as we expected, the bond curve flattened out (measured by the 10/3 year slope) 10pb.

The MXN ended the week with gains, in line with domestic equity instruments, but diverged from stock market index trends.

Last week the MXN moved into the 11.91-12.08 range due to the aforementioned volatility on global markets. On the one hand, the currency appreciated in response to a greater inflow towards local equity instruments and better speculative positioning (the long/net MXN positioning in the CFTC recorded a USD700mn increase, which could spread if we take into account that it does not include the breakthrough into the 11.91 range). On the other hand, the loss of correlation with the stock market indexes in the US and with the EUR is noteworthy, which reacted more sensitively to uncertainty related to geopolitical tension and the sovereign debt situation in the EU. Therefore, we still cannot see any clarity regarding directional positions. This week the news flow in the US is considerable, and if the results are positive we could see an increase in gains.

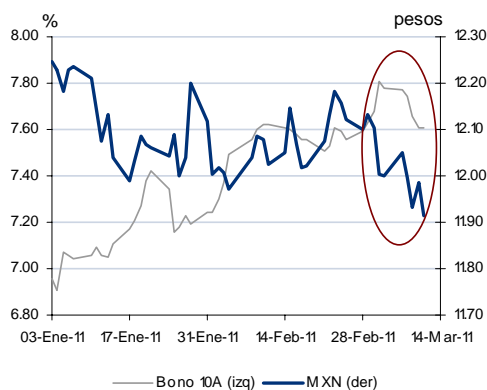
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Chart 5
10-year bond rates and MXN (% , pesos)



Source: BBVA Research with Banxico data

Chart 6
VIX vs. MXN



Source: BBVA Research with data from Bloomberg

Mexico City, March 11, 2011

Market Analysis
Equities

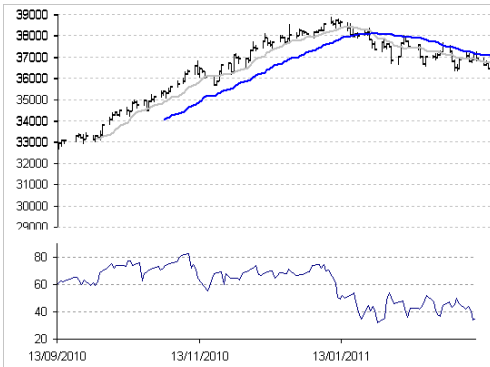
Technical Analysis

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Technical Analysis

CPI Stock Market Index

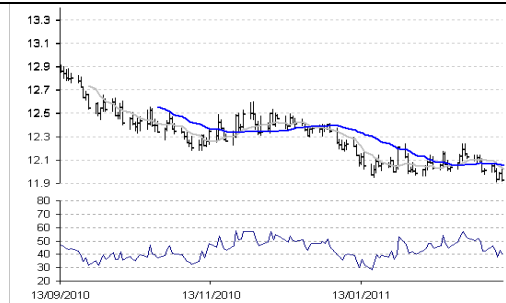


Source: BBVA, Bancomer, Bloomberg

CPI: The CPI has gone back to the lower limit of the negative range in which it has been since the year began. The 35,800pts level represents 61.8% in the Fibonacci model. The small upturn in the last session of the week shows that we could start to see some interested buyers at these levels. We can assume an upturn in the CPI from these levels, possibly to 36,800/36,900pts, although we have to ensure that the US market does not give out signs of a change in trend. Below 35,600pts the CPI's next lower limits are at 34,800pts (200-day rolling average) and 34,200pts.

Previous Rec.: 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.

MXN

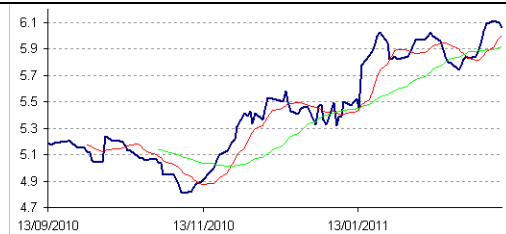


Source: BBVA, Bancomer, Bloomberg

MXN: After unsuccessfully trying to break through the ceiling of the 30-day rolling average, the dollar started to move below the P\$11.95 limit in the last sessions of the week. A breakthrough below this level would make P\$11.80 the target, P\$0.20 below the base level, which corresponds to the limits within which it moved in the lateral range.

Previous Rec.: The oscillating indices show momentum in the overselling zone and we may expect a new upturn from the lower limit.

3Y M BOND

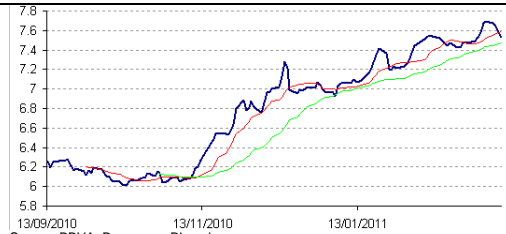


Source: BBVA, Bancomer, Bloomberg

10Y M BOND (yield): Upturn during the week, breaking the previous maximum of 6.02%. This means the next sticking point is at 6.2% and base levels at 6% and 5.91%. The uptrend is still in force.

Previous Rec.: There is overbuying in the short-term oscillating indicators, so we think there will be an adjustment in the middle part of the range at 5.9%.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

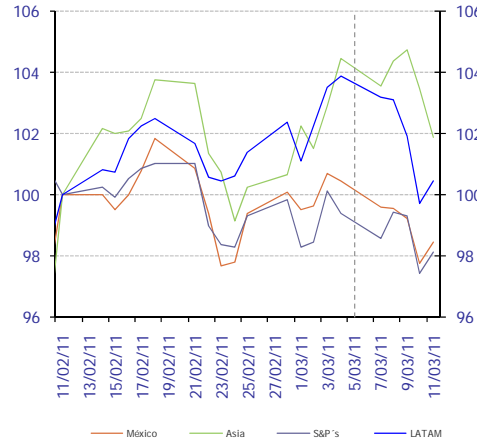
10Y M BOND (yield): The upturn continues during the week, reaching a new maximum for the year of 7.7%. Overbuying in the oscillating indicators continues, but as long as it does not break down through the 30-day rolling average, 7.45%, the uptrend could continue, with the next target at 7.8%.

Previous Rec.: The limited opening of averages suggests that the upturn may be maintained.

Markets

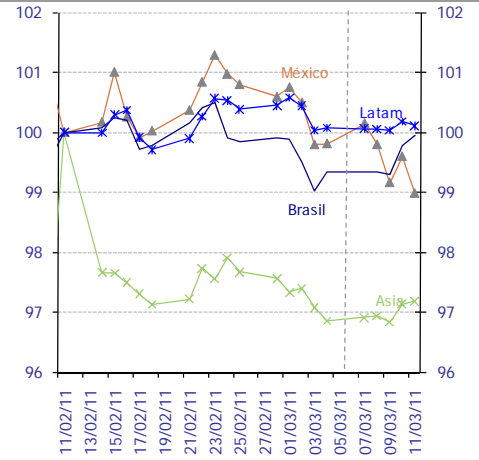
Chart 5
Stock Market: MSCI indices (Feb 4, 2011 index = 100)

Rises on stock markets at the end of the week due to better-than-expected results in the US. These do not, however, offset the fall related to increase risk caused by the downgrading of Spain's rating. The peso appreciated, influenced by the domestic inflation result and retail sale results in the US.



Source: Bloomberg & BBVA Research

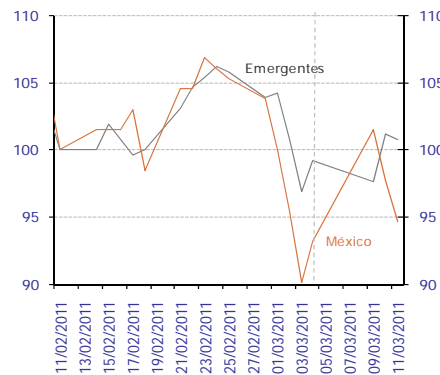
Chart 6
Foreign currencies: dollar exchange rates (Feb 4, 2011 index = 100)



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.

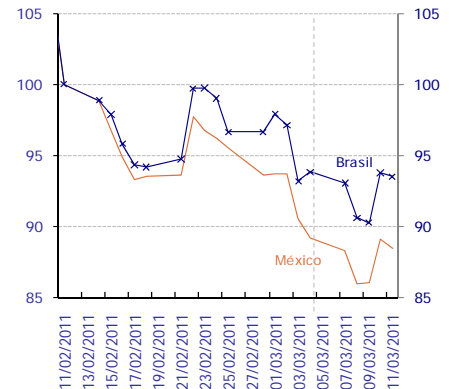
Chart 7
Risk: EMBI+ (Feb 11, 2011 index = 100)

Slight weekly upturn in risk aversion related to uncertainty in the Middle East and North Africa and the European debt crisis.



Source: Bloomberg and BBVA Research.

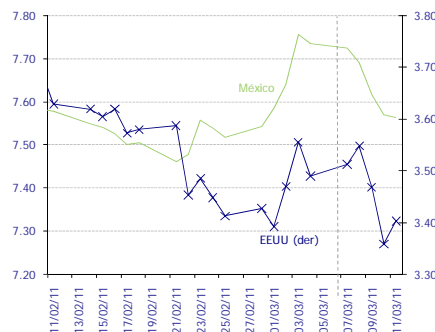
Chart 8
Risk: 5-year CDS (Feb 11, 2011 index = 100)



Source: Bloomberg and BBVA Research.

Chart 9
10-year interest rates*, last month

Rise in US rates on Friday in light of expectations that insurers in Japan will reduce their positions to meet their obligations. Weekly fall in Mexico related to better-than-expected inflation result.



Source: Bloomberg and BBVA Research

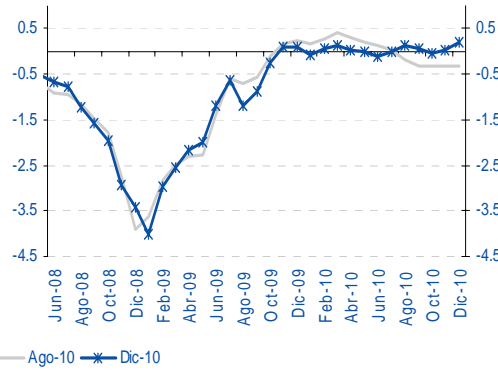
Chart 10
Carry-trade Mexico index (%)



Source: Bloomberg and BBVA Research

Activity, inflation, monetary conditions

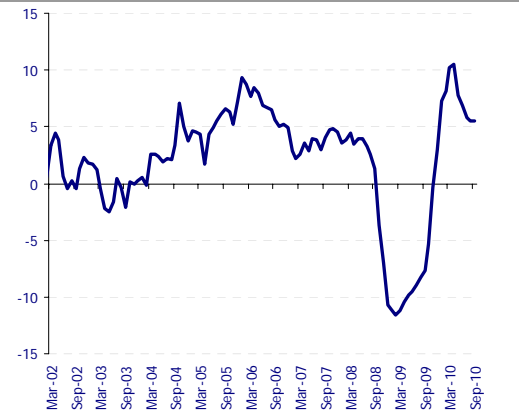
Chart 11
BBVA Synthetic Activity Indicator for the Mexican economy



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

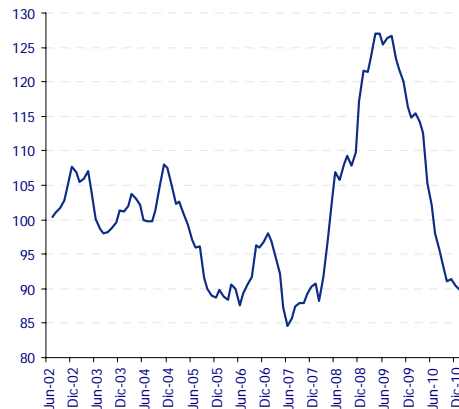
Economic activity in Mexico has improved, but the speed of recovery appears to have moderated

Chart 12
Early Activity Indicator (% y/y change)



Source: INEGI

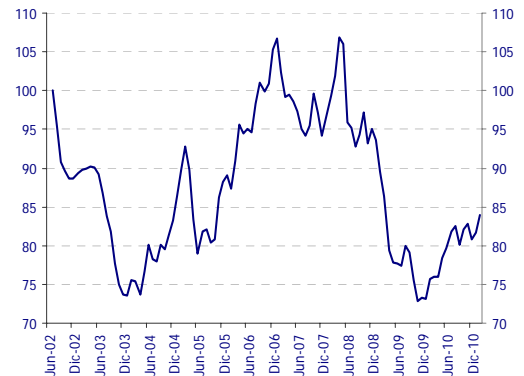
Chart 13
Inflation Surprise Index (July 2002=100)



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.

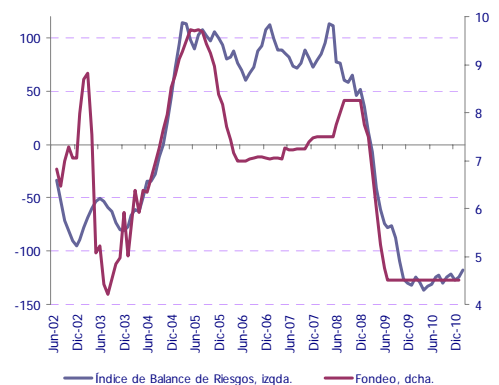
Chart 15
Monetary Conditions Index



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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