

Weekly Watch

Mexico

3 June 2011

Economic Analysis

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Market Analysis

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Next week...

Awaiting May inflation data and the Banxico minutes to see how far inflation risks have eased

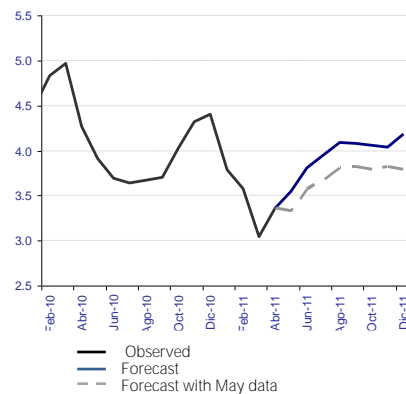
This coming Friday 10 sees the release of the minutes from the monetary policy decision on May 27. It will be important to see Banxico's take on the level for movement in the economy, specifically in the face of signs of recent more moderate output levels and the transfer of recent inflation surprises to the outlook for each component in core and headline inflation. This should confirm that the central bank sees no demand pressures for prices over the rest of the year. Since inflation forecasts saw major falls between April and May, from 3.87 to 3.67% for December 2011 according to the Banxico survey, we expect the debate on its duration to ease. It is also important to follow the uncertainty level the Bank of Mexico assigns to the strength of the US recovery.

Inflation data in May comes out on June 9 and if low inflation for the month is confirmed (around -0.66%), we would expect inflation to close the year in December at around 3.8%. *Continued on next page.*

Concerns about the strength of the global cycle increase risk aversion and lead to asset volatility

Fears about the cycle in the U.S., particularly in employment and manufacturing, increased risk aversion over the week and led to greater asset volatility in the region. Thus, the MXN saw falls and sensitivity to economic cycle news. In turn, the local Mbond curve again increases its correlation with Treasuries, where negative US economic data supported this week's rally. As uncertainty on the level and duration for a US slowdown continues, the rally space will not close.

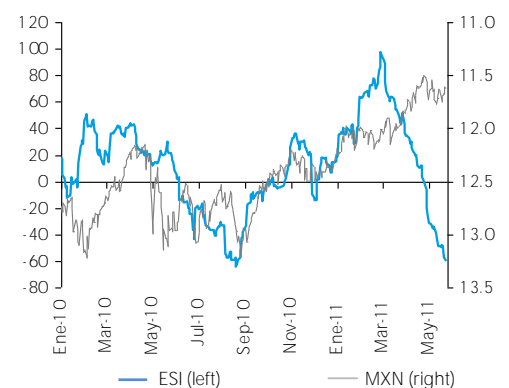
Chart 1
Annual inflation: forecast and adjusted forecast with May data (%)



Source: BBVA Research

The adjusted forecast with the May data includes the same expectations for monthly inflation from our scenario as of June, but for the May figure it considers the observation of the first half of the month that was recently released.

Chart 2
Economic surprise index for the US and MXN (ppd)



Source: BBVA Research and Bloomberg

Calendar: Indicators

Inflation May 2011

Forecast: -0.66% (3.33% y/y) Consensus: -0.63% Previous: -0.01% (3.36% y/y)

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Inflation usually contracts in monthly terms in May due to the general application of the lower warm season electricity rates which, this year, have reduced even more than expected. Further, the contraction may be higher this year with agricultural prices seeing a larger fall. In turn, core inflation which we expect to see a 0.12% m/m increase will continue to show price pressures for processed food, although the remaining components (non-food goods and services) should maintain a downward trend due to different factors as a higher exchange rate and the lack of demand pressures. The latter situation is clear in the still-negative product gap, real growth in salaries being highly curtailed and a still-high jobless rate. With this, the inflation outlook for 2011 has improved.

Employment IMSS May 2011

Forecast: 0.28% (4.1% y/y) Consensus: N.A. Previous: 0.20% (4.4% y/y)

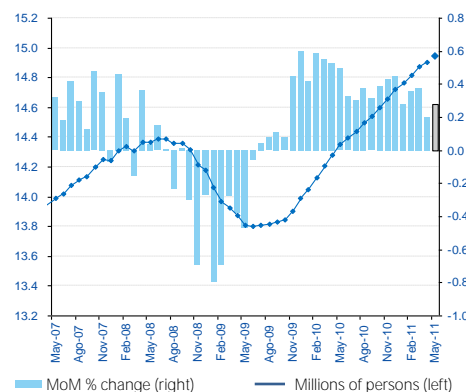
Formal employment in the private sector for May will be released this week. We estimate a slight recovery in comparison to the moderation seen in April. This will have been influenced by the negative effects on manufacturers and some services due to the tsunami in Japan, in a scenario of lower foreign demand. Available consumer and producer confidence indicators in May point to improved outlooks over the month although not breaking the moderate output profile for the second quarter of the year. The increase in the likely purchase of a durable good indicator among the confidence sub-indices should be highlighted. This favors an outlook for a slight recovery in employment data.

Chart 3
Inflation forecast for May (% y/y and m/m change)

	Peso (%)	Monthly change (%)			Annual change (%)			
		2003-2009	Mar-11	Abr-11	May-11	Mar-11	Abr-11	May-11
CPH-Mx	100.0	-0.31	0.19	-0.01	-0.66	3.04	3.36	3.33
Core-Mx	74.8	0.24	0.30	0.08	0.12	3.21	3.18	3.06
Goods	37.0	0.33	0.48	0.35	0.23	3.97	4.07	4.07
Food products	14.7	0.48	0.90	0.58	0.55	5.55	5.98	6.28
Other Goods	22.4	0.22	0.17	0.17	0.00	2.75	2.60	2.37
Services	37.7	0.16	0.15	-0.15	0.03	2.57	2.44	2.24
Rent	17.9	0.28	0.21	0.20	0.17	2.10	2.19	2.11
Education	5.2	0.10	0.04	0.07	0.03	4.46	4.47	4.41
Other serv.	14.7	0.07	0.11	-0.56	-0.11	2.34	1.93	1.56
Non Core-Mx	25.2	-2.18	-0.16	-0.28	-3.26	2.46	3.90	4.03
Farm products	8.1	-0.48	-1.25	3.06	-2.25	-1.69	3.70	4.99
Fruits/Vegetables	3.3	-1.21	-3.05	7.22	-6.00	-6.36	5.71	8.43
Meat/Eggs	4.8	0.02	0.05	0.16	0.60	1.86	2.33	2.97
Public managed	17.2	-3.21	0.44	-2.11	-3.84	4.96	4.04	3.50
Energy	7.8	-5.20	0.76	-3.25	-6.20	5.96	5.00	4.27
Controlled prices	9.4	0.10	-0.15	-0.03	0.32	3.27	2.62	2.81

Source: BBVA Research with Banxico data

Chart 4
Formal private-sector employment (% change y/y and m/m)



Source: BBVA Research and INEGI.

Markets

MXN sees high volatility due to greater risk aversion, but with a strengthening bias if no bad news accumulated in the US

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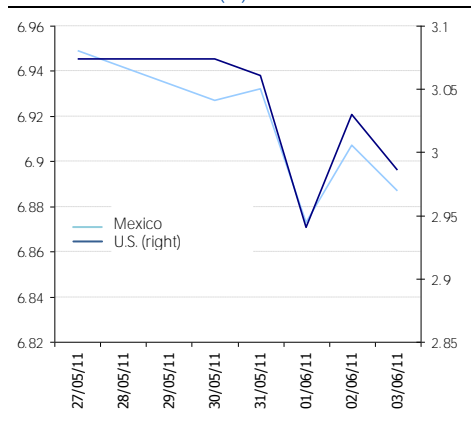
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The start of the week saw strengthening moves in the MXN (to 11.55 levels) in the face of a likely rescue package for Greece from Ecofin/IMF (sovereign risk) but as the days passed, the higher slowdown risk in the US (ADP employment survey) led to falls to levels near 11.70. In this context, MXN performance will continue to be sensitive to sovereign risk in the Eurozone and, mainly, to global cycle news. If news from the US gets no worse, the MXN is likely to see an appreciation bias in the 11.55 to 11.75 range.

The local Mbond curve again increased its correlation with Treasuries. Negative US economic data supported the rally this week.

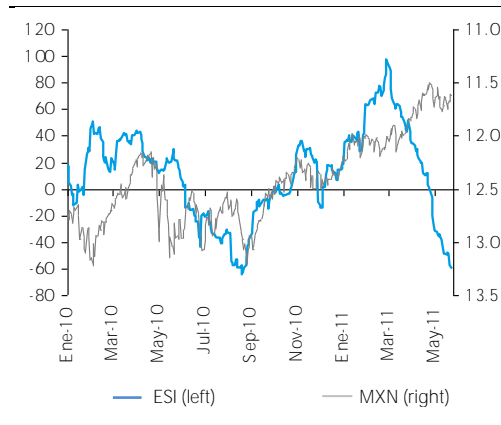
Job indicators released the previous week, alongside past adjustments for manufacturers, suggest that the slowdown in the economic cycle is more noticeable than expected. Markets could start to speculate as to the possibility that the fiscal and monetary policy drive is disappearing in the US, increasing the risks of a more noticeable pause being seen. What is certain is that the uncertainty over the level and duration of the slowdown has increased and will be difficult to correct in the short-term. In this way, we believe the rally space is not closed, more so in a local scenario of lower inflationary risks and the soft stance of the Bank of Mexico.

Chart 5
10Y Bonds Mexico- US (%)



Source: BBVA Research with data from Bloomberg

Chart 6
Economic surprise index for the US and MXN (ppd)



Source: BBVA Research with data from Bloomberg

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Technical Analysis

IPC Stock Market Index



IPC: The IPC was not able to realize its first attempt to break the 36,000pts barrier, opening up the possibility of a new return to the 35,000 / 34,800pts zone - a level which in previous market stress was effectively a support zone. After the major fall mid-week, the last two sessions saw the CPI recover from negative openings when this floor was close, although the short-term outlook should continue to place pressure as long as the 30-day rolling average (35,690pts) and the 200-day rolling average (36,000pts) are not broken through.

Previous rec.: Although the IPC could stop the bounce right at this level, especially if we take into account the US public holiday at the start of the week, we believe the market has a good chance of restarting the upward bounce in the coming week and trying to come in above this resistance level.

Source: BBVA, Bancomer, Bloomberg

MXN

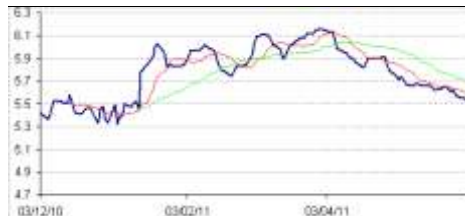


The dollar is now at 24 sessions trading between P\$11.55 and P\$11.80. Oscillating indicators point to a new return to the high part of this range. Above this resistance comes in at P\$11.90 and below the support at P\$11.50.

Previous rec.: We believe that it should remain in this trading range in coming session with chances of moving downward and hitting P\$11.50.

Source: BBVA, Bancomer, Bloomberg

3Y M BOND

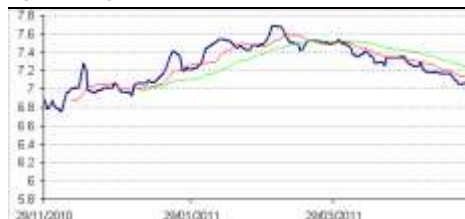


3Y M BOND (yield): Reaches 5.5% support and maintains its downward trend in the short-term. The 200-day rolling average comes in at 5.54% from where we could see a bounce. Resistance at 5.59% and 5.7%. Trend change until it breaks the second.

Previous Rec.: Support maintained at 5.5%. A close above 5.75% would mean a change to an upward trend.

Source: BBVA, Bancomer, Bloomberg

10Y M BOND



10Y M BOND (yield): Hits 200-day rolling average at 6.88%. We could expect a bounce with resistance at 6.97% and 7.15%. Breaking the second level marks a trend change.

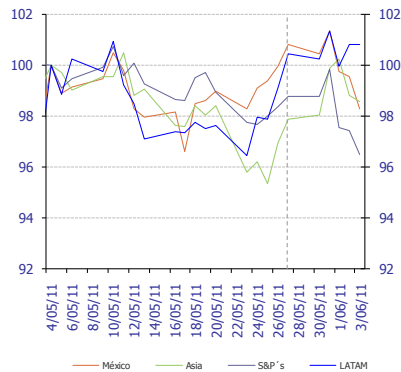
Previous rec.: Accentuated downward move over the week, hitting the support level at 6.9%.

Source: BBVA, Bancomer, Bloomberg

Markets

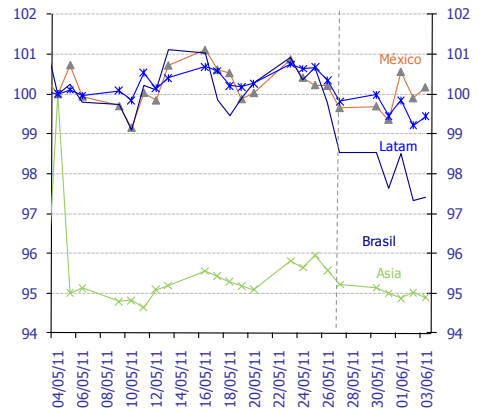
Lower-than-expected US job and manufacturing data lead to falls on stock markets. The peso falls in a week marked by high volatility.

Chart 7
Stock Markets: MSCI Indices
(May 4, 2011 index = 100)



Source: Bloomberg & BBVA Research

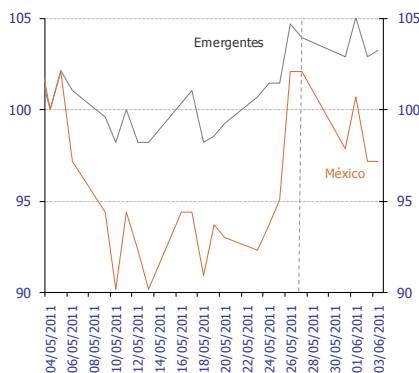
Chart 8
Foreign exchange: dollar exchange rates
(May 4, 2011 index = 100)



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

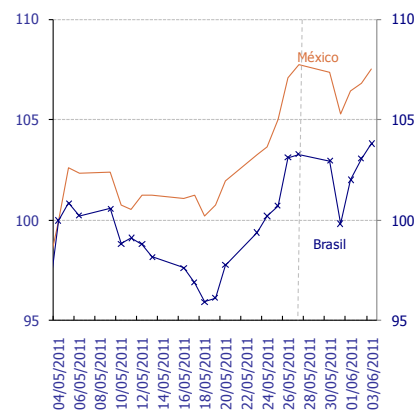
Slight rise in risk aversion with data supporting slower recovery rate for US economy

Chart 9
Risk: EMBI+ (May 4, 2011 index = 100)



Source: Bloomberg & BBVA Research

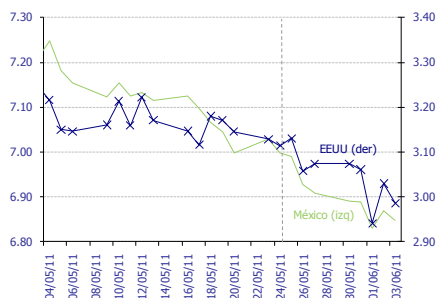
Chart 10
Risk: 5 year CDS (May 4, 2011 index=100)



Source: Bloomberg & BBVA Research

US interest rates fall due to lower growth forecasts. Mexican rates recover high correlation with US rates and move down

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

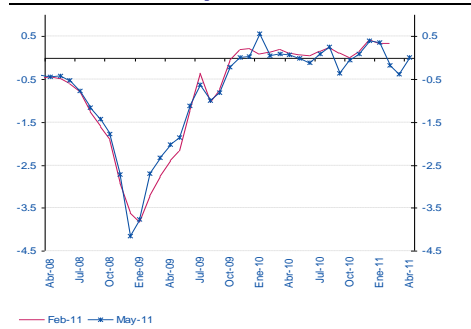


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

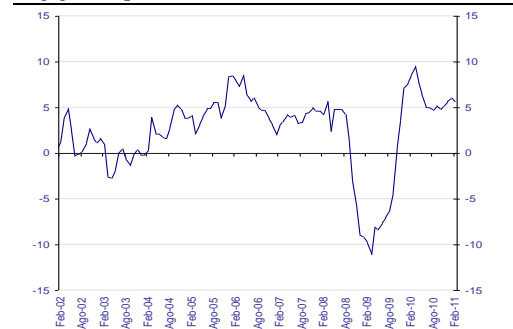
Output showed a moderation trend since the end of the 1Q11 linked to the negative effects of the tsunami in Japan and moderate foreign demand

Chart 13
BBVA Research Synthetic Activity Indicator for the Mexican economy



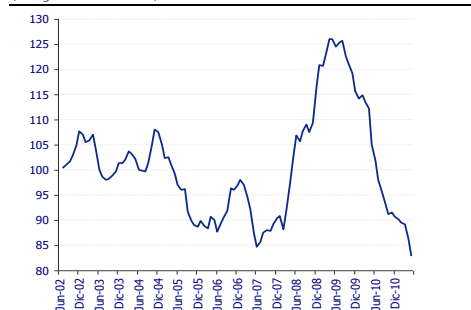
Source: BBVA Research with data from INEGI, AMIA and BEA
Weighted sum of 21 different indicators of activity, expenditure and expectation, based on trend series.

Chart 14
Advance Indicator of Activity (% y/y change)



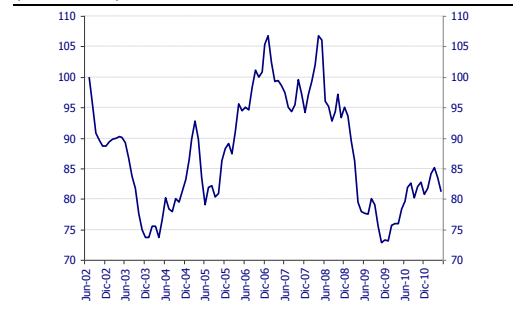
Source: INEGI

Chart 15
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.

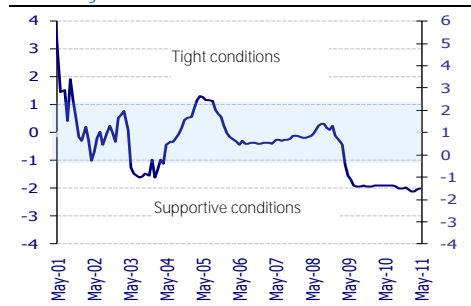
Chart 16
Activity Surprise Index (2002=100)



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

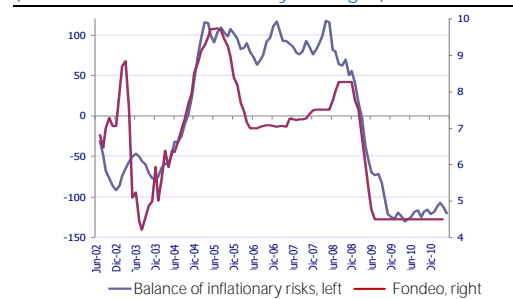
The monetary conditions have not changed and continue to be loose, with this loosening in fact increasing slightly in recent days.

Chart 17
Monetary Conditions Index



Source: BBVA Research

Chart 18
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 index points to a greater weight of inflationary risks over growth risks and thus a greater possibility of monetary restriction

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