

# Weekly Watch

Mexico

## Next week...

Second-quarter GDP

August 12, 2011

### Economic Analysis

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After the negative impact on output in the wake of events such as the break in the supply chain caused by the tsunami in Japan, the manufacturing sector improved in April and May (average monthly growth in manufacturing in April and May was 0.7% compared with a fall of 0.2% in the previous two months). The same was not true in June, when manufacturing industry moderated with bad results in a number of sectors, including a slight downturn in automotive production. Manufacturing exports grew at a monthly average of 1.2% in the second quarter, slightly under the 1.4% of the previous quarter. Some indicators more directly linked to domestic demand, such as consumer confidence, recovered over the last two months of the reference period. The improvement was reflected in retail sales and the indicator of aggregate revenues in the service sector; both posted significant growth figures in April, although they moderated in May. The construction industry grew at an average of 0.4% m/m in the second quarter, which compares favorably with the fall of 0.2% in the first quarter. It is worth noting that employment in the private formal sector of the economy continued to grow at a rate of 0.3% m/m throughout the first half of the year. This is key to sustaining domestic demand.

Based on these economic indicators, we estimate that GDP has grown by a quarterly 1% (seasonally adjusted series, 3.4% y/y). This represents an improvement on the 0.5% q/q rate of the previous quarter.

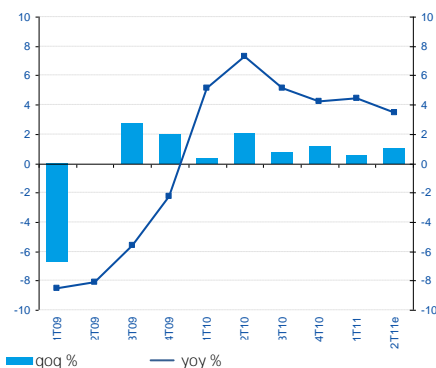
### Market Analysis

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## Strong upturn in global risk aversion directly impacts the asset market in Mexico: volatility will continue

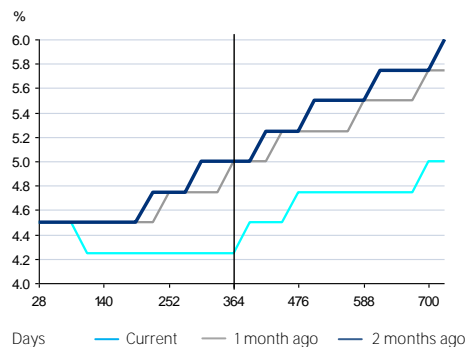
S&P's downgrade of the U.S. triggered a vicious cycle in the markets, with fears of a global recession and fiscal weakness in countries suffering from sovereign risk problems. There was a swift reaction in monetary policy, leading to expectations of low interest rates at least until mid-2013 in the U.S. and prospects of liquidity injections by various central banks around the world. In Mexico, markets are discounting a scenario of a prolonged monetary pause more closely linked to the Fed. Meanwhile, the high level of volatility in the foreign-exchange, capital and corporate bond markets may continue over the week.

Chart 1  
Mexico: GDP (% change y/y and q/q)



Source: BBVA Research with INEGI data

Chart 2  
Implied funding rate on the swap curve (%)



Source: BBVA Research with data from Bloomberg

## Markets

### Market Analysis

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### The U.S. downgrade triggers strong global risk aversion and fears of a recession, with high exposure in Mexico

S&P's downgrade of the U.S. triggered a vicious cycle in the markets, with fears of a global recession and fiscal weakness in countries suffering from sovereign risk problems. Risks of contagion (e.g. France) and systemic risks have increased, so the markets will watch progress in political agreements in the U.S. and EU. Monetary policy reactions were quick off the mark: they included the Fed's statement that interest rates would remain exceptionally low at least until mid-2013 and that other policy tools (e.g. QE3) may be applied; the ECB purchased Italian and Spanish bonds; and there is a chance of more liquidity being injected by the central banks of England, Norway and Australia. The market is still beset by uncertainty, but is beginning to anticipate new liquidity injections in the U.S. (QE3), although their effect on reactivating the economy may be more limited.

As a result, the MXN suffered a strong upturn in its implied volatility, with a broad fluctuation band of between 12.76 and 12.01. It posted the biggest weekly loss among Latin American currencies, closing at 2.6% down for the week at around 12.3 MXN/USD. Over the next few days the broad fluctuation band may continue if there is a clear negative bias in the economic activity indicators to be published in the U.S.

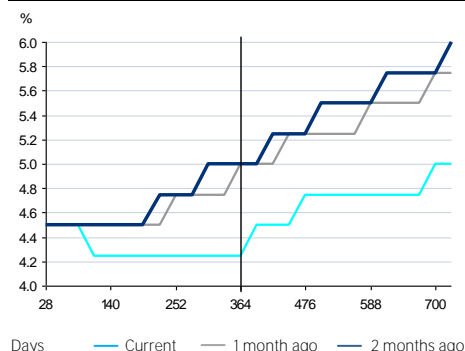
### New global monetary environment with increased liquidity bias

The deterioration in the global balance of economic activity and the moderate improvement in inflation has led to a more dovish monetary scenario for the local market. Banxico is now more likely to delay the tightening of the monetary policy cycle (in line with the Fed's monetary posture). The swap curve also discounts an implied funding rate of 4.25% from November to August of 2012, closing 2012 at 4.50%. This scenario is also suggested by the M bond curve, which has moved more than 10 bps down on average.

### Adjustment in the corporate risk premium and losses on the IPC index due to the level of exposure to the U.S. economy

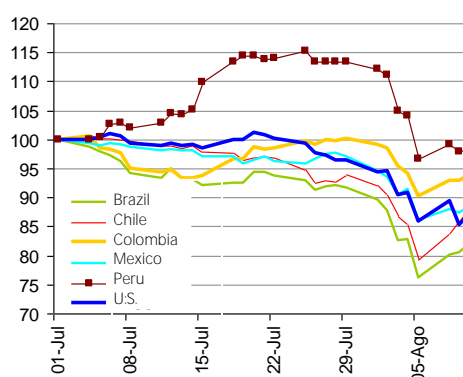
On the corporate front, fears of lower growth have made the movements on the Mexico stock market similar to the Dow Jones in the U.S., while there has been an upturn in the risk premiums of Mexican corporate bonds. Volatility will continue on the capital markets, and there may be profit-taking, given the major adjustments. In corporate bonds, upward adjustments have been more limited in Mexico than in Brazil. The major issue of corporate Brazilian bonds on international markets and lower issue of Mexican corporate bonds have led to investors holding an excess of corporate Latin American paper (except for Mexico).

Chart 5  
Implied funding rate on the swap curve (%)



Source: BBVA Research with data from Bloomberg

Chart 6  
Latin American stock markets (1-Jul-2011=100)



Source: BBVA Research with data from Bloomberg

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## Technical Analysis IPC Stock Market Index



Following a fall of 12% after 29 July, the IPC index began to pull back with a recovery of 6.3% so far. It may find the first zone of resistance at a 10-day moving average of 33,600 points. It is highly probable that before the IPC returns to the 30-day moving average level (35,200 points), this upturn will be used for quick profit-taking and it will revert to levels of close to 33,000 points. We believe that a return of this nature should be used to take up new positions, as the short-term oscillators are still far from the overbuying zones, even with this upturn.

Previous Rec: We believe that these forward conditions in the negative movement should lead to a technical bounce or a pull-back that discounts some of the weekly decline.

Source: BBVA, Bancomer, Bloomberg

## MXN



Strong volatility over the week, which took the dollar to over the resistance levels of MXN 12.00 and MXN 12.20, leading to a very high level of overbuying in the short-term oscillators. With strong resistance at MXN 12.50, we believe that it should return to the MXN 12.20 area or even MXN 12.00 before breaking this resistance.

Previous Rec: Signs of over-buying in the oscillators, combined with the psychological level and 200-day moving average should make it difficult to break through this zone.

Source: BBVA, Bancomer, Bloomberg

## 3Y M BOND

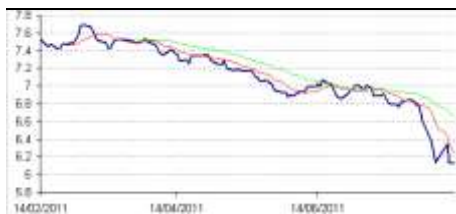


3Y M BOND: (yield): At minimum levels (4.79%) since November 2010. This time it bounced back to 6%. Initial resistance at 4.92% and 5.17%.

Previous Rec.: Support at 4.8% and resistance at 5.07% and 5.26%. Likely to see a short-term bounce.

Source: BBVA, Bancomer, Bloomberg

## 10Y M BOND



10Y M BOND (yield): Can still find levels of 6% that are equivalent to the minimums of the previous year (August and October). A bounce might encounter resistance at 6.3% and 6.5%.

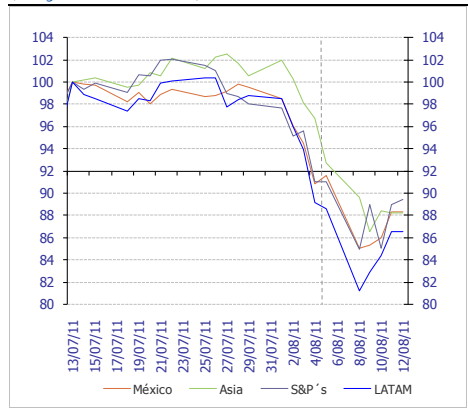
Previous Rec: Bounce towards resistance at 6.5% and 6.77%.

Source: BBVA, Bancomer, Bloomberg

## Markets

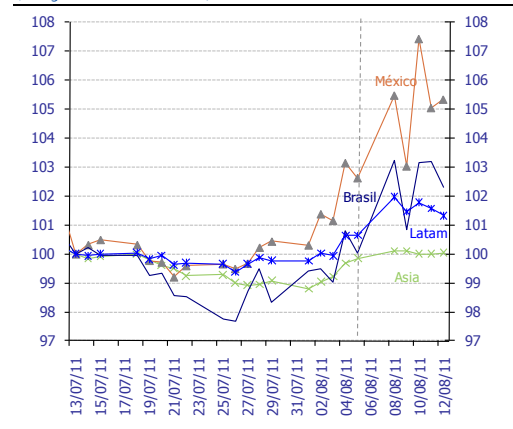
The U.S. downgrade increased uncertainty in an environment of doubts about economic recovery and fiscal problems in Europe. The fall in stock markets and currency depreciation was reversed in part with slightly better than expected retail sales figures in the U.S.

Chart 7  
Stock Markets: MSCI Indices  
(July 13, 2011 = 100)



Source: Bloomberg & BBVA Research

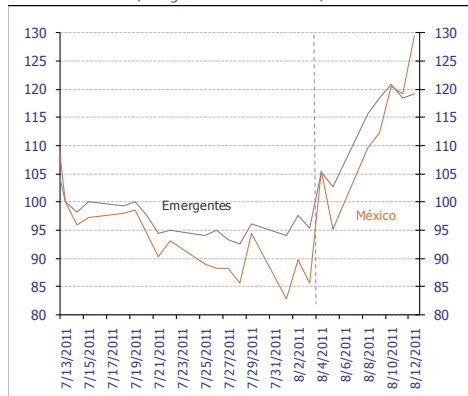
Chart 8  
Foreign exchange: dollar exchange rates  
(July 13, 2011 = 100)



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

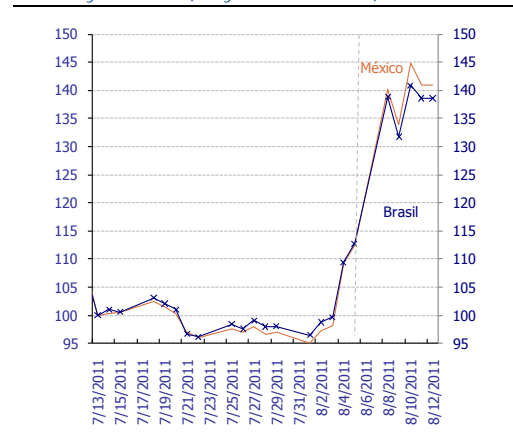
Rise in risk aversion following the downgrade of the U.S. and the lack of definitive solutions to fiscal problems in Europe

Chart 9  
Risk: EMBI+ (July 13, 2011 = 100)



Source: Bloomberg & BBVA Research

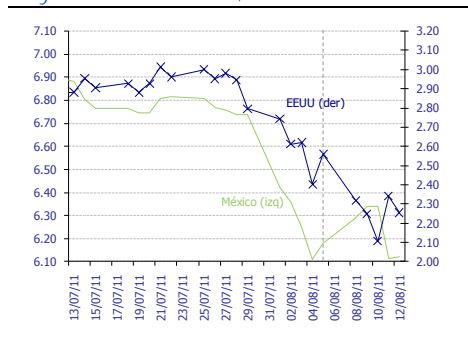
Chart 10  
Risk: 5-year CDS (July 13, 2011 = 100)



Source: Bloomberg & BBVA Research

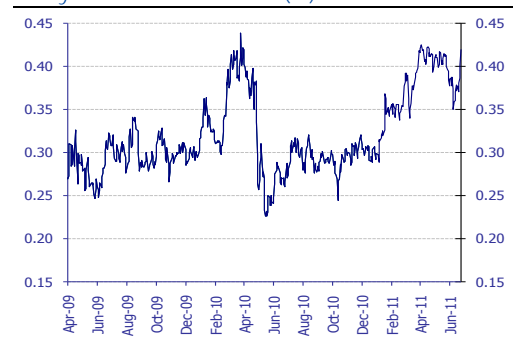
Fall in U.S. rates in the face of demand for safe-haven assets (flight to quality). Rates in Mexico weaken their links with U.S. T-bonds in a volatile environment

Chart 11  
10-year interest rates\*, last month



Source: Bloomberg & BBVA Research

Chart 12  
Carry-trade Mexico index (%)

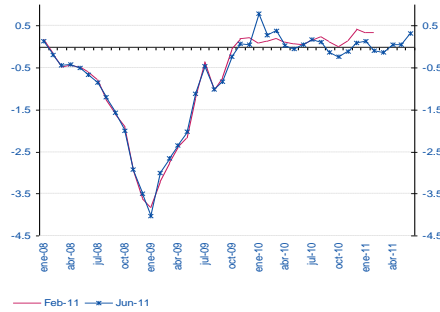


Source: BBVA Research with data from Bloomberg

## Activity, inflation, monetary conditions

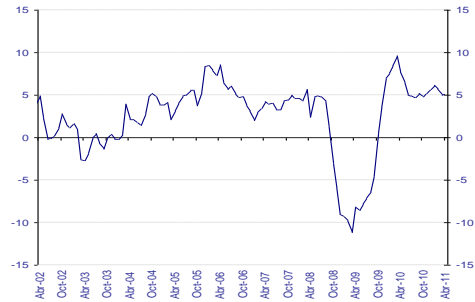
For the time being, recent output data point to moderation in April being temporary and linked to industrial output

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.

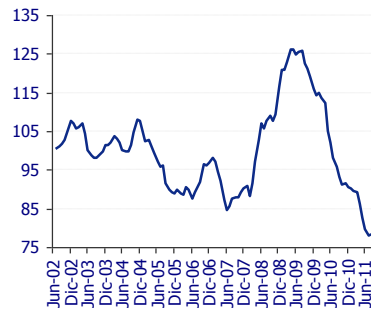
Chart 14  
Advance Indicator of Activity (% change y/y)



Source: INEGI

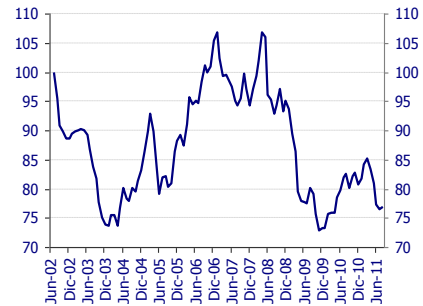
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

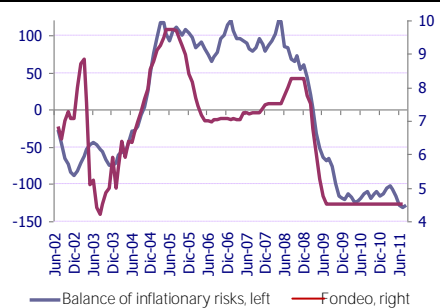
The monetary conditions have not changed and continue to be loose, with this loosening in fact increasing slightly in recent days.

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 likelihood of monetary restriction

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