

Mexico Weekly Flash

Next week...

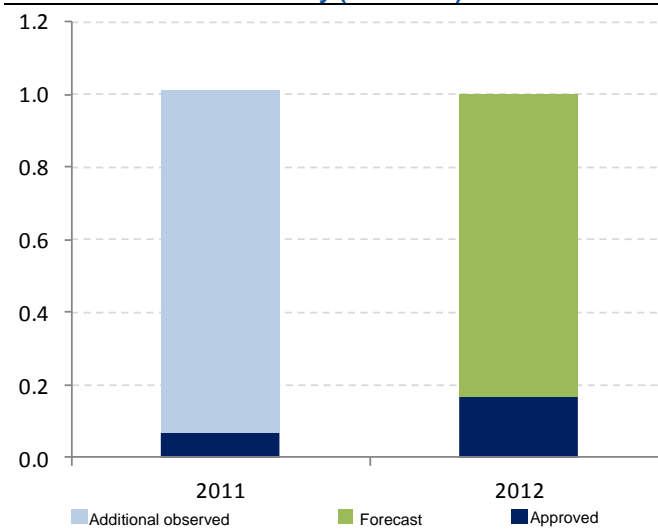
- **Public Finances: revenue, expenses and IEPS on gasoline and diesel performance**

The state of public finances in May will be published next week. The performance in receipts and public spending will be important to see since, among other reasons, it contributes to weighing up the recent performance in output for the period and shows the level of compliance with the approved budget deficit for the year (-2.4% of GDP). The information will include the IEPS tax on gasoline and diesel, i.e. the subsidy the public sector provides for these products. In April, the subsidy sat at 70.188 billion pesos, i.e. around 0.45% of GDP, much higher than the 0.17% budgeted for the whole year. Taking into account an average oil price of 110 dollars per barrel in the year to date and a slip in fuel prices in what remains of the year as seen to date, we expect the subsidy for this year will be around 1.0% of GDP. This level is in line with the subsidy in 2011, 1% of GDP, a much higher level than budgeted that year at 0.07% of GDP.

- **High volatility in the MXN and domestic interest rates at all-time lows**

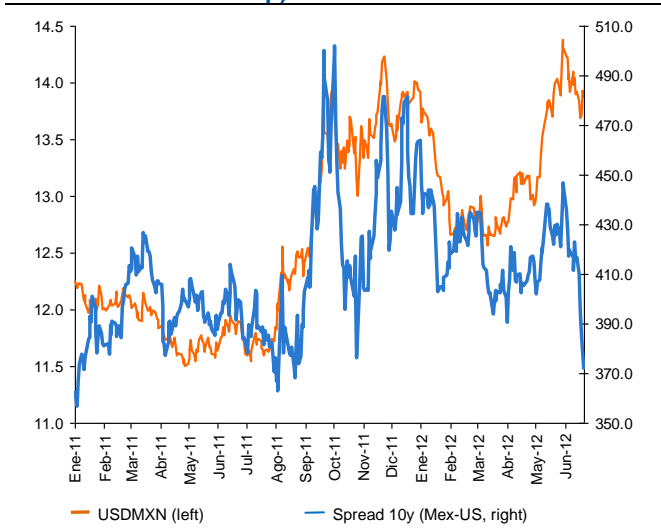
The exchange rate saw high volatility due to international news (particularly monetary expectations at the Fed) meaning the MXN traded in a range between 13.63 and 13.96 with a slightly stronger close. The most important aspect was the currency's decorrelation with fixed income instruments in Mexico and, especially, the low reaction to the major foreign inflows to domestic assets seen since the start of May. This should correct itself via the exchange rate (appreciation) if the global liquidity effects dominate those for sovereign risks and, in turn, via a higher interest rate. Interest rates are at record lows and outside all proportion for domestic investors (negative carry in many instances or almost null). At this time we do not see Banxico cutting the bank lending rate and we therefore believe it to be too risky to be in nominal curves at present.

Chart 1
Gasoline and diesel subsidy (% of GDP)



Source: SHCP and BBVA Research.

Chart 2
Mexico: MXN and 10-year sovereign spread (ppd and 10Y Mbonds less 10Y TN bp)



Source: Bloomberg and BBVA Research

Calendar: Indicators

April IGAE (June 26)

Forecast: -0.2% m/m, 4.6% y/y Consensus: N.A. Previous: 2.0% m/m, 4.1% y/y

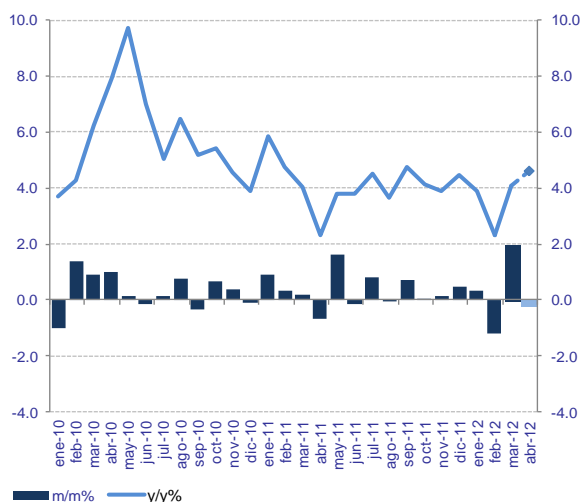
IGAE activity index performance in April to be released this week will be important as it adds to current available information with "hard" data on economic performance in the second quarter of the year. To date, information on industrial output, automotive output, employment and consumer and producer confidence indicators has been available. Nonetheless, statistical factors such as the leap year and the comparison base effect linked to the decline in output due to the tsunami in Japan last April are elements to be taken into account in the analysis. In this way, the correction of the leap year base effect is linked to the -1.2% m/m decline in the IGAE in February and the later 2% m/m upswing in March, hard-to-repeat growth for April. In all, it will be especially important to see the performance in services in the fourth month of the year. It should be stated that the real time estimate for GDP growth in the current quarter, MICA BBVA Research, points to somewhat higher growth than in the first quarter of the year. In all, both the recent slowdown in the US cycle and the scant growth in domestic variables such as real wages in the formal private sector should be taken as moderation and cautionary elements.

Trade Balance in May (June 25)

Forecast: 536 md Consensus: 245 md Previous: 560 md

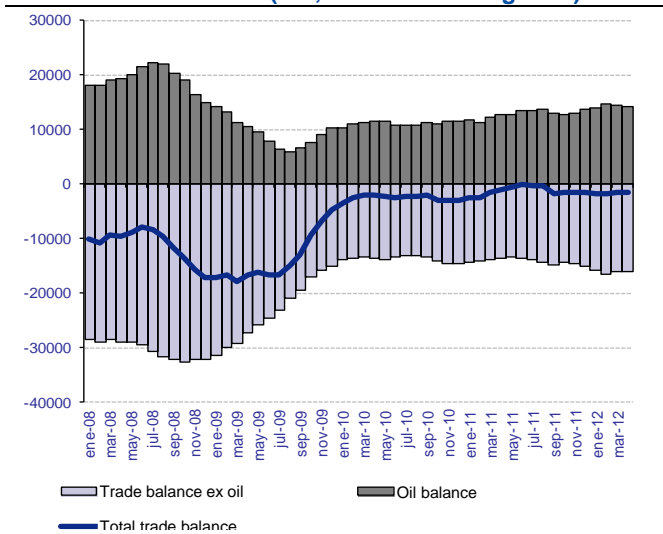
Next week sees the release of the trade balance in May which we believe will return to surplus by around 536 md. The trade balance will remain close to balanced as long as the exchange rate remains low, the oil price remains high and domestic consumption continues to recovery moderately. Although at a yearly rate both exports and imports continue to see growth, they will do so at a lower rate, especially after the statistical effect favoring both indicators since April (partly due to the tsunami in Japan in March 2011) finally dissipates. In short, as long as US output manages to see reasonable growth, foreign trade in Mexico is likely to expand, especially in a context where Mexican products are relatively cheaper thanks to the weaker peso.

Chart 3
IGAE (% change, y/y and m/m)



Source: BBVA Research with INEGI data

Chart 3
Trade Balance Mexico (MD, 12-month rolling total)



- **The MXN strengthened around 0.6% on Friday after having traded in a wide range.**

It again saw high volatility over the week, strengthening in the first few days due to expectations of more stimulus measures at the Fed and, once the extended "Operation Twist" was announced, profit-taking being seen. Beyond this high sensitivity to news, an important aspect was the currency's decorrelation with fixed income instruments in Mexico and, especially, the low reaction to the major foreign inflows to domestic assets seen since the start of May.

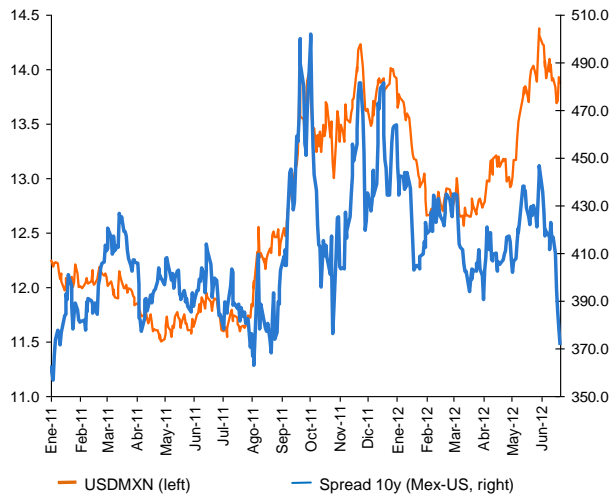
The reaction of the MXN to portfolio flows is not typically direct and immediate. Many trades are carried out "OTC" and the daily volume in the last 20 days was around USD42bn. Nevertheless, we believe the size of flows should, at some time, be reflected in the exchange rate. In the coming two weeks, the calendar of domestic and global events reduces the chances of this happening. After the European meetings however, with global data at the start of the month and the presidential elections in Mexico we cannot rule out a new rally to the 13.55 level.

- **Domestic interest rates continued to fall in the week, coming in at all-time lows**

Beyond the strength of foreign inflows being behind this major *rally* in the month, the last two days saw some appetite at Afores due partly to coupon payments. Both short and medium tranches of the curve are outside all proportion for domestic investors - the *carry* is negative in many instances or almost zero. At this time we do not see Banxico cutting the bank lending rate and we therefore believe it to be too risky to be in nominal curves at present.

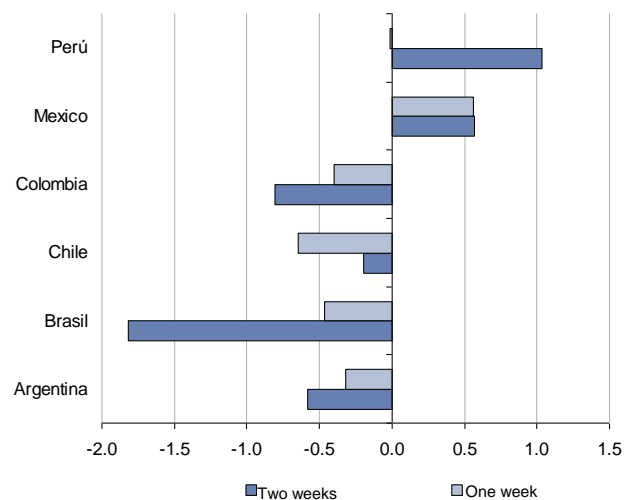
Nonetheless, even if Banxico planned to cut its target rate in coming months, we should take into account the following: Banxico would cut if economic output pointed to a plunge (in the US and Mexico) which would imply higher global risk premiums. In turn, this would be accompanied by lower commodities prices (see chart for oil). In addition, it would mean higher pressure on the MXN in a scenario where *spreads* against US rates have already come down a lot. This would involve a lower tolerance margin for changes in monetary policy, i.e. FDI would tend to slow. Inflation forecasts could increase slightly, with medium maturities practically monopolized by foreigners, which would increase demand for short terms and/or, where applicable, a disproportionate sell-off by foreigners in the *belly* of the curve if they are looking to re-balance their portfolios. All this would lead to a sudden steep climb in the curve. We believe that the conditions to remain long in the curve, especially in the medium and short tranches, have been exhausted.

Chart 5
Mexico: MXN and 10-year sovereign spread (ppd and 10Y Mbonds less 10Y TN bp)



Source: Bloomberg and BBVA Research

Chart 6
LatAm: exchange rate change (% vs. one and two weeks)

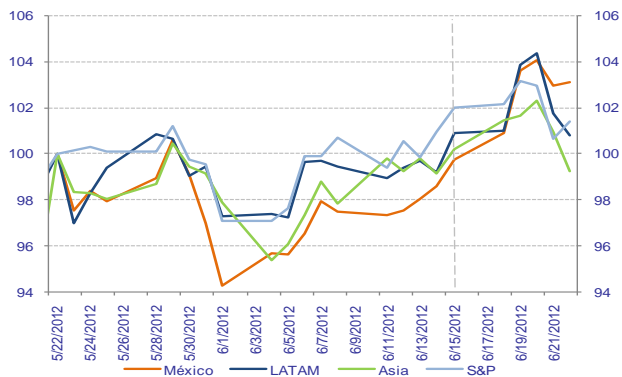


Source: Bloomberg

Markets

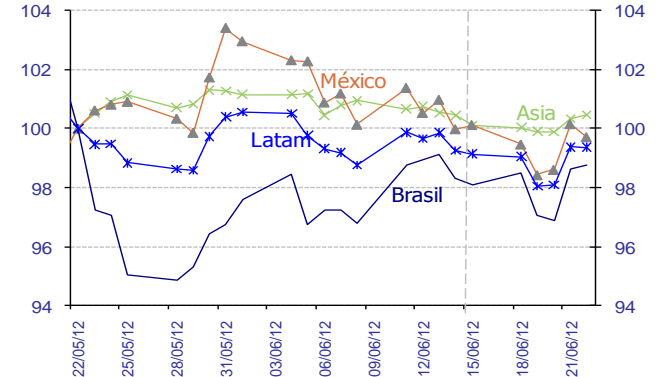
- The peso lost its strength from the start of the week after the Federal Reserve failed to announce a new round of asset purchases as the market expected. Stock markets moved up at the end of the week after a lower-than-expected credit rating cut by Moody's of 15 banks.

Chart 7
Stock Markets: MSCI Indices
 (May 22, 2012 index = 100)



Source: Bloomberg & BBVA Research

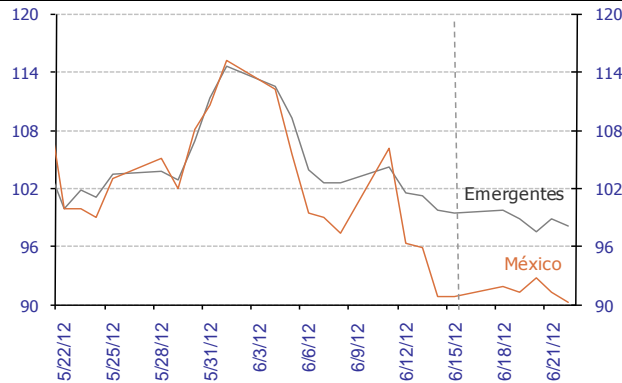
Chart 8
Foreign exchange: dollar exchange rates
 (May 22, 2012 index = 100)



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

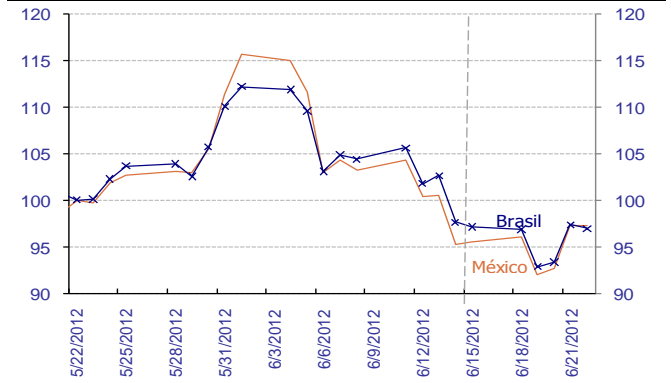
- Slight rise in risk aversion after the Federal Reserve failed to implement a new round of asset purchases.

Chart 9
Risk: EMBI+ (May 22, 2012 index = 100)



Source: Bloomberg & BBVA Research

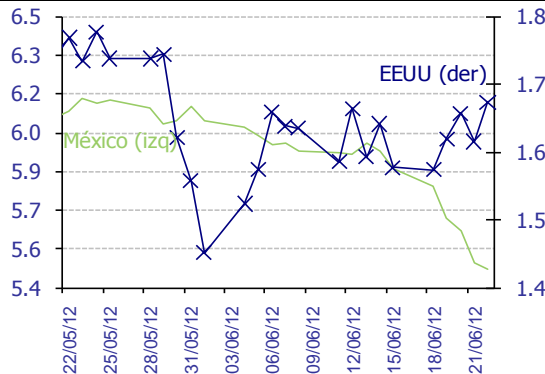
Chart 10
Risk: 5 year CDS (May 22, 2012 index=100)



Source: Bloomberg & BBVA Research

- The yield differential in Mexico linked to perception of macro-economic stability led to a fall in long-term rates. US rates closed slightly higher after seeing volatility over the week

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

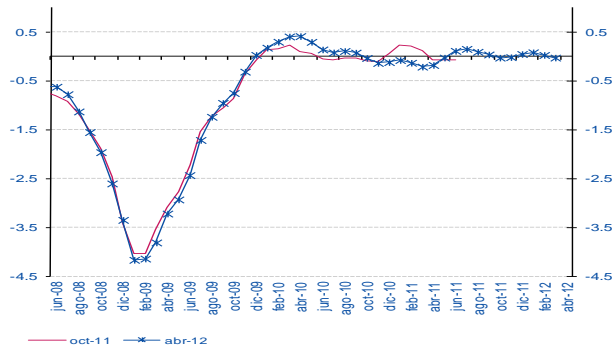


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

- Output holds positive performance, situation indicators point to 2Q12 with quarterly rates around 0.7%.

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.

- Inflation ceases downward surprises while output moved up.

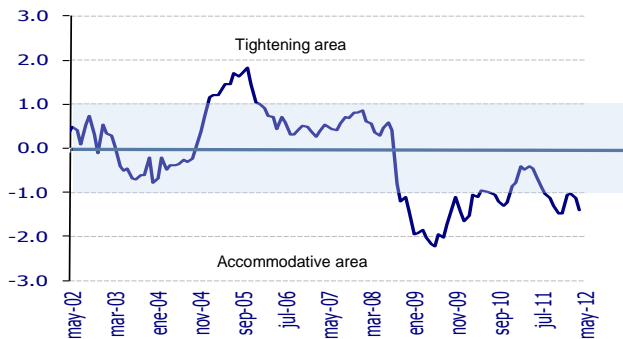
Chart 15
Inflation Surprise Index (July 2002=100)



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

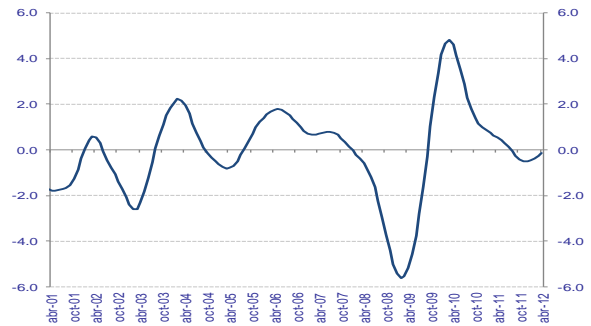
- Monetary Conditions ease due to exchange rate depreciation in May and June

Chart 17
Monetary Conditions Index



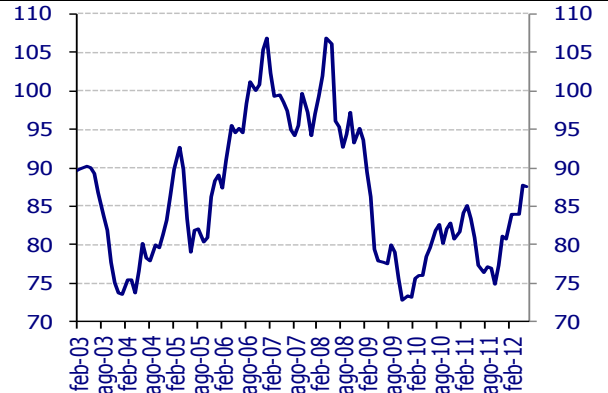
Source: BBVA Research

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



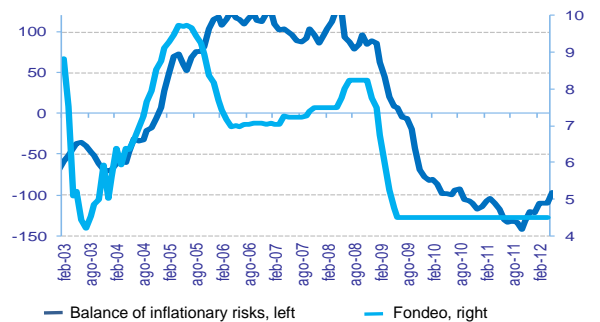
Source: INEGI

Chart 16
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 18
Balance of Inflationary Risks* and Lending Rate (standardized and %; monthly averages)



Source: BBVA Research. * Standardized and weighted index (of inflation and economic growth) based on economic indicators of economic 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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