

Mexico Weekly Flash

Next week...

- ... first clues about the possible impact of the slowdown in the US cycle on Mexico

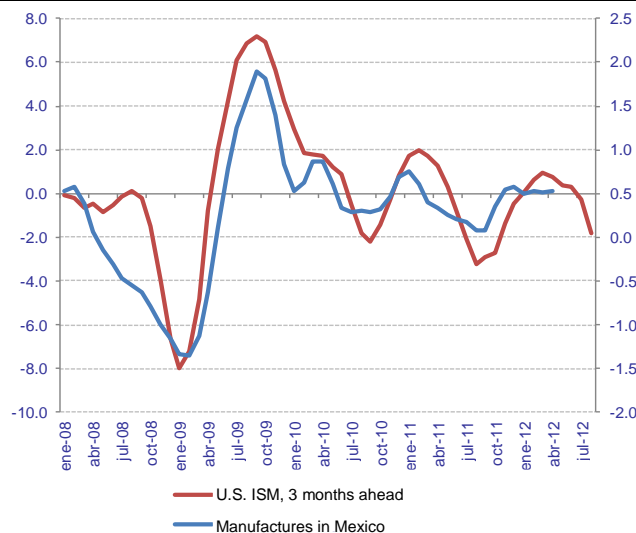
The most recent US expectation, activity and employment indicators point to a slowdown in the second half of 2012. Expectations of US procurement managers in June, manufacturing activity in May and June non-farm payroll figures have weakened. Given the close relationship between the USA and Mexico, this suggests there will be a slowdown in our country, although this is not yet reflected in the figures. The question is therefore whether there is a delay because of a lag in the relationship between the two economies (not just slower publication of Mexican data) or whether other elements are limiting contagion: improved competitiveness offsetting the impact of slower growth in US demand and domestic support from very favorable finance conditions and increased employment. In the coming week **the May industrial production index**, particularly for manufacturing, and **automotive production figures for June** will give us some clues about the degree of contagion from the slowdown in the USA, if domestic supports continue and the external slowdown does not accelerate. We should bear in mind that, as shown in the accompanying chart, **US manufacturing is an advance indicator for Mexico**; whatever happens there today impacts here three months later.

Finally, **June inflation** figures are published on Monday, July 9. We expect the increase in the first half of the month to be confirmed, with the annual rate remaining constant at 4.3%. Our forecasts suggest that this figure should be the ceiling for the year; however, we will have to watch some foodstuffs carefully, as these were affected in the first half of July by health problems restricting supply of poultry products.

- Mexico fixed income as a “safe-haven asset”, but continuing sensitivity of the MXN

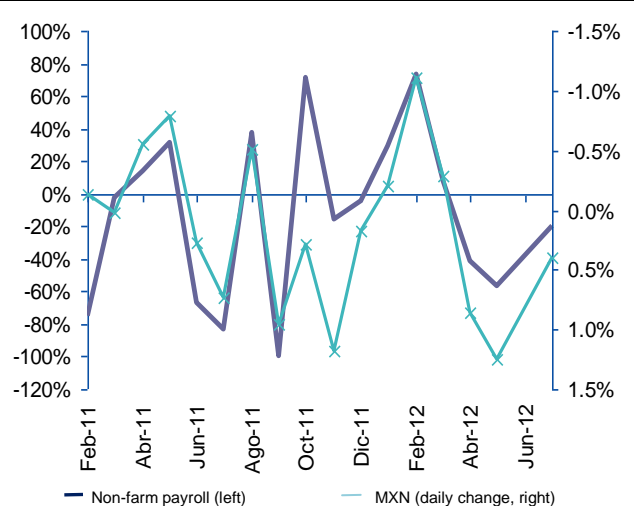
Foreign flows into fixed-income instruments remained strong last week (MXN11,707 mn to 5 July) resulting in a continuance of the rally in Mexico's yield curve, with average reductions of 25 bp. This fall in domestic yields is not exclusive to our country, and is also being seen in other emerging markets. The MXN depreciated by 0.4% with June non-farm payroll figures for the USA being weaker than expected. The sensitivity of the MXN to the US cycle could be increased after the EMU meeting on Monday, July 9.

Chart 1
Manufacturing activity in Mexico and Manufacturing expectations in the USA



Source: BBVA Research and Bloomberg

Chart 2
Surprises in US non-farm payroll figures (observed minus expected, %) and daily change in MXN (%)



Source: BBVA Research with STPS data

Calendar: Indicators

Industrial output (July 12)

Forecast: -0.2% m/m, 3.1% y/y

Consensus: N.A.

Previous: 0.7% m/m, 4.2% y/y

Some important figures for the diagnosis of economic activity in the second quarter are published this week, including automotive production figures for June (reported by the AMIA, the Mexican Automotive Industry Association) and the May Industrial Output figures published by INEGI.

There were slight falls on the previous month in manufacturing output in the United States (-0.3%) and automotive production in Mexico (-1.6%). The performance of the automotive industry will be particularly relevant, as in April, despite a 7.2% monthly fall, in annual terms, output increased by 35%; this was due to a contraction of 54 thousand units in April 2011 caused by the supply chain being interrupted by Japan's March 2011 tsunami. In addition to the slight fall in US manufacturing output, the US's annual ISM indicator fell below 50 points for the first time since July 2009, indicating a contraction in manufacturing activity in the country. As an advance indicator of the trend in economic activity over coming months, this points to a slowdown in industrial activity in Mexico appearing around the third quarter of the year.

June inflation (July 9)

Forecast: 0.43% m/m, 4.32% y/y

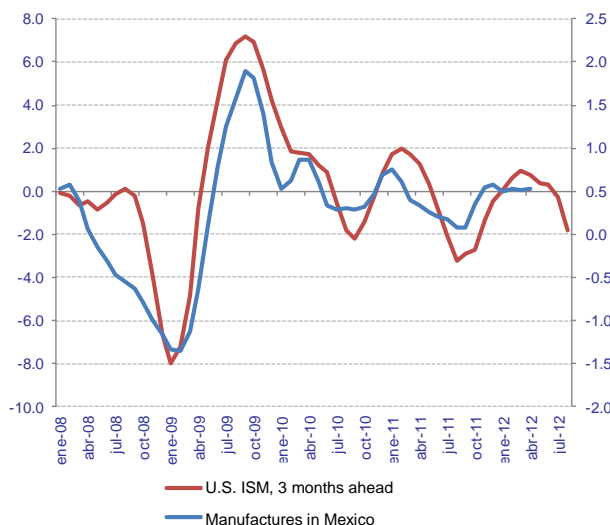
Consensus: 0.42%

Previous: -0.32% m/m, 3.86% y/y

Next Monday inflation figures for June will be published. We expect this to come in at 0.43% m/m, implying a bounce in the annual rate to 4.3% y/y from 3.9% in May. This increase in inflation is mainly due to the annual comparison effect with June 2011. Although inflation will come in above the high-end of the central bank's target range, we believe performance to date to be in line with an end-year rate of under 4% y/y. Nevertheless, we need to watch the performance of inflation carefully over the coming months, as this could accelerate significantly in July due to price increases for poultry products following the outbreak of bird flu in the state of Jalisco. Poultry products contributed to reducing inflation in the first half of June (-0.48% q/q); however, this could be diluted or even reversed in the first half of July. Inflation could be favored over coming months, if international energy resource and grain prices continue to moderate. We forecast core inflation of 0.21% m/m, putting the annual rate at around 3.5%. We expect slight price pressure on non-food goods. Despite the recent increase in inflation and expectations in excess of 4% for the coming months, we expect inflation to remain contained due to the absence of demand pressures, a very slight impact on prices of exchange rate changes, and transitory increases in the price of fruit and vegetables and, at present, eggs.

Chart 3

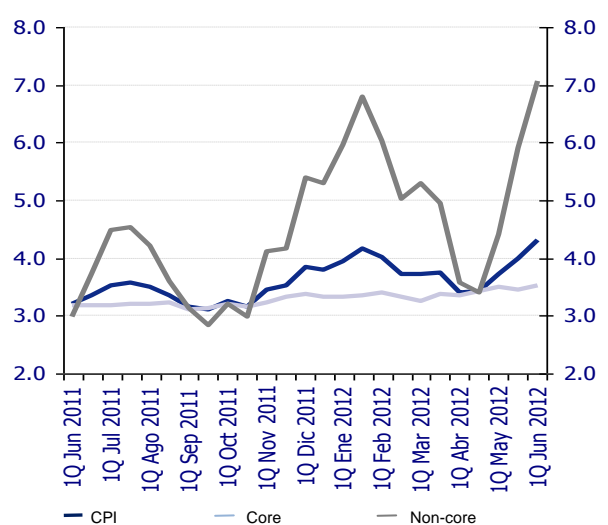
Manufacturing activity in Mexico and Manufacturing expectations in the USA



Source: BBVA Research with INEGI and Bloomberg data

Chart 4

Inflation and components (y/y % change, fortnightly series)



Source: BBVA Research with INEGI data

- **Fixed-income assets in Mexico continue acting as a "safe haven"...**

The rally in Mexico's yield curve continued during the week with the stability of the record low in US treasury bills (UST) and ongoing foreign investment inflows. Yields on the curve fell by an average of 25 bp. The biggest beneficiaries were long-term M Bonds, which fell by over 35 bp in the week (20 and 30 year). Gains were less aggressive over the mid-section of the curve, with a decrease of around 20 bp in yields.

Fixed-income assets are continuing to act as "safe havens", particularly in comparison to those of developed countries with continuing latent risks, such as the EMU countries. Foreign investment flows continue to be strong. To Thursday, July 5, net foreign inflows were a significant MXN11,707 mn. The largest flows were for maturities from 2013 to 2017, in particular 2015 (December), which accounted for 38% of total net purchases during the week.

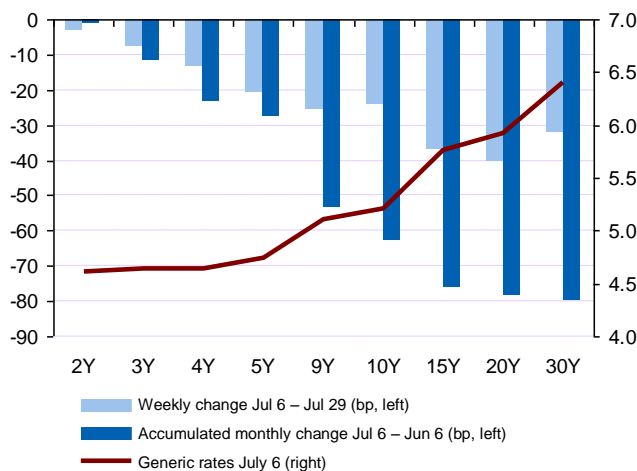
Curve flattening strategies continue to be favored, particularly by local investors. We should note that the fall in domestic yields is not exclusive to our country, as we are also seeing vigorous performance by local currency bonds in other areas (mainly emerging markets).

- **... however, the MXN depreciated by around 0.4% at the end of the week on the back of US data**

Non-farm payroll figures were weaker than expected, but did not raise expectations of more quantitative easing sufficiently to offset losses on risk assets globally. We should once again highlight that the sensitivity of the MXN to the US cycle could increase at the end of the EMU meeting, if there is progress on measures for the region. Although relatively favorable events have occurred in Europe, overall the US indicators published in the week poured a bucket of cold water on market euphoria, leading the MXN to lose some of the ground gained over the last week.

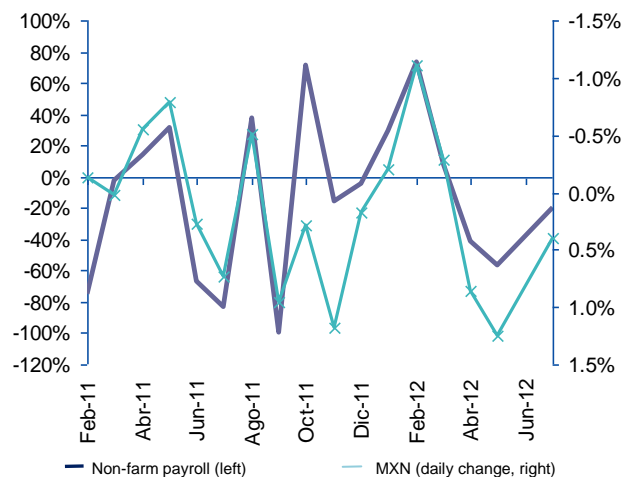
This lower optimism did not impact on local fixed-income assets, and this could boost the MXN, if inflows remain as strong as they have been over recent months. Given that there is still a disparity in key factors, we consider that the currency will consolidate at current levels (13.3-13.5) in the run up to Ecofin.

Chart 5
Mexico: M Bond yield curve (% and bp)



Source: Bloomberg and BBVA Research

Chart 6
Surprises in US non-farm payroll figures (observed minus expected, %) and daily change in MXN (%)



Source: Bloomberg and BBVA Research

Technical Analysis

IPC



Source: BBVA, Bancomer, Bloomberg

The return to 40,000pts can be read in two ways. A pull-back after testing the recent breakthrough of the support level or the start of profit taking. We have been highlighting the over-purchasing of the IPC and various issuers. This, together with the widening between 10 and 30 day rolling averages of almost 1,500 pts, inclines us to consider this to be profit taking. The change to IPC could find a first support in the 10-day rolling average at 39,800 pts. However, a fall to this level would not be sufficient to take the oscillating indicators to levels closer to the over-selling. Therefore, we consider that it should return to a second floor at 38,500 pts, the 30-day rolling average. A fall to this level would involve an adjustment of around -3.5%.

Previous Rec. (2/7/12). We continue to consider 40,000 pts to be a significant resistance point for short-term movement. Therefore, we have been reducing our short-term position in the expectation of a possible adjustment to the IPC.

MXN



Source: BBVA, Bancomer, Bloomberg

The currency moved laterally at the start of the week, picking up during the last two sessions to finish once again above the 200-day rolling average. The oscillating indicators suggest that this bounce could continue towards the next targets at MXN13.50 and MXN13.80.

Previous Rec. (2/7/12). We believe that it could at the most hit MXN13.25 before a bounce due to over-selling in the oscillating indicators.

3Y M BOND



Source: BBVA, Bancomer, Bloomberg

3-YEAR M BOND: (yield): Hitting resistance at 4.75% and starting a new downward adjustment. Although it is close to very advance levels of over-selling, we do not see a strong support until 4.55%.

Previous Rec. (2/7/12). This may continue, initially, toward MXN4.75% and, if the 30-day rolling average is breached, we could see a return to 4.9%.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

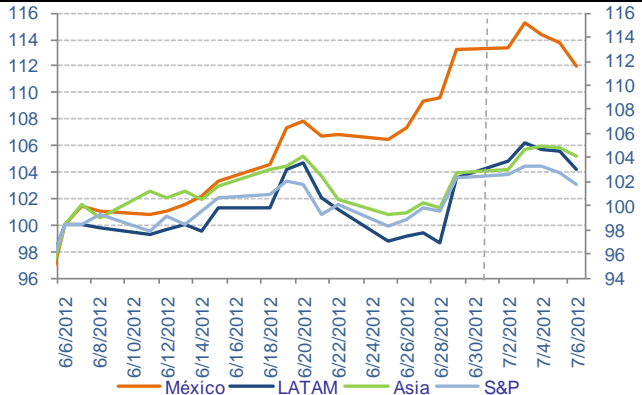
10-YEAR M BOND (yield): Extreme over-selling reading, as the bond is in the 2nd standard deviation of the 60 week regression. This could give technical rebounds to 5.4% and subsequently 5.6%.

Previous Rec. (2/7/12). The opening of short-term rolling averages suggests a return to 5.8%.

Markets

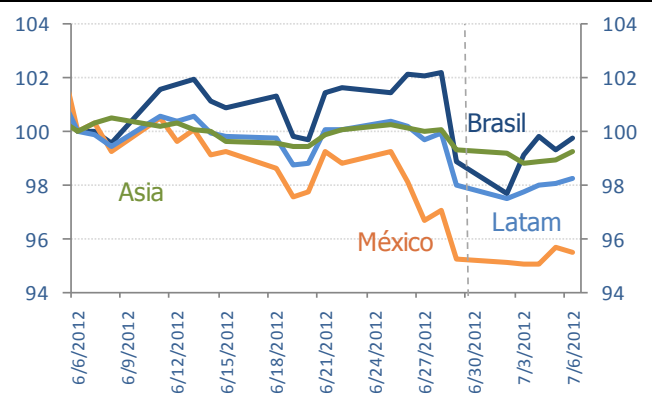
- Weaker than expected US job creation data influenced the fall in stock markets and depreciation of the currency during the week. This followed the expansionary actions of monetary authorities in Europe, the UK and China not managing to boost confidence in the markets.

Chart 7
Stock Markets: MSCI Indices
 (June 6, 2012 index=100)



Source: Bloomberg & BBVA Research

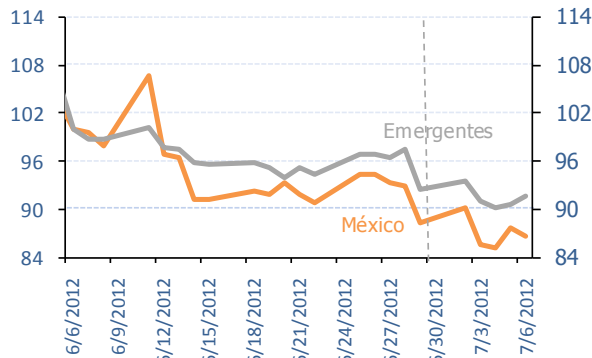
Chart 8
Foreign exchange: dollar exchange rates
 (June 6, 2012 index=100)



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

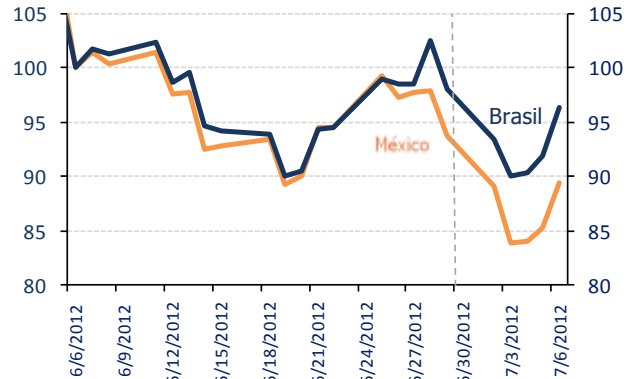
- Increase in risk aversion at the end of the week after US employment figures increased concerns about the fragility of the recovery in the face of risk events in Europe.

Chart 9
Risk: EMBI+ (June 6, 2012 index=100)



Source: Bloomberg & BBVA Research

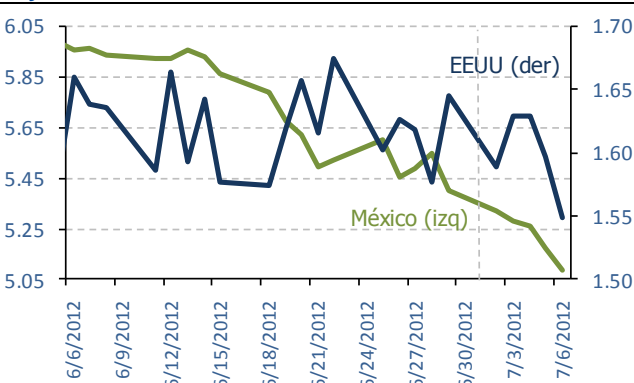
Chart 10
Risk: 5-year CDS (June 6, 2012 index=100)



Source: Bloomberg & BBVA Research

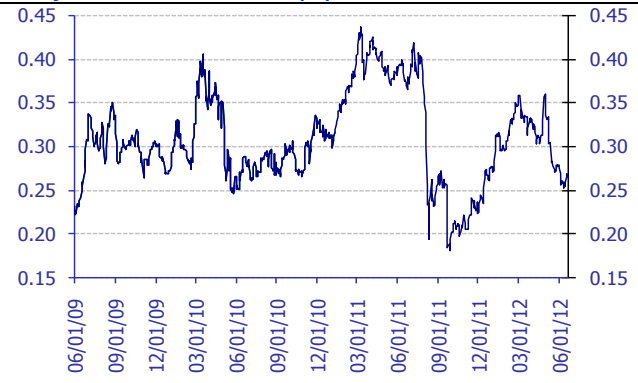
- Fall in US rates at the end of the week. Rates in Mexico continue falling, influenced by the performance of Treasury bonds and foreign investment inflows.

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

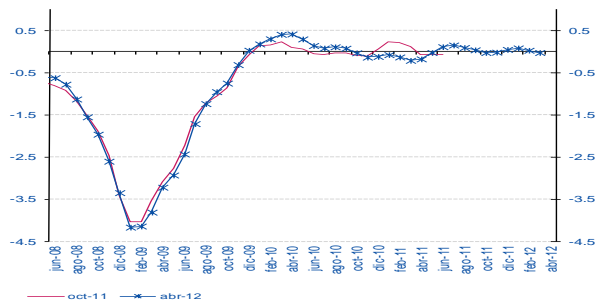


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

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

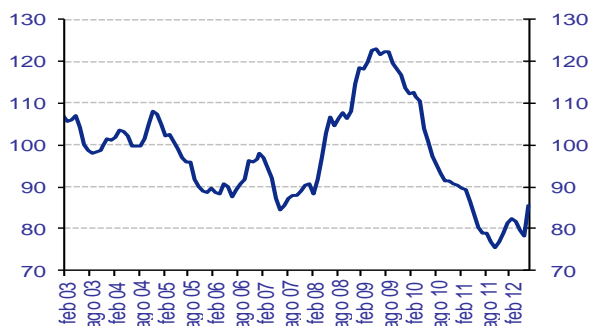
Chart 13
BBVA Research Synthetic Activity Indicator for the Mexican economy



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.

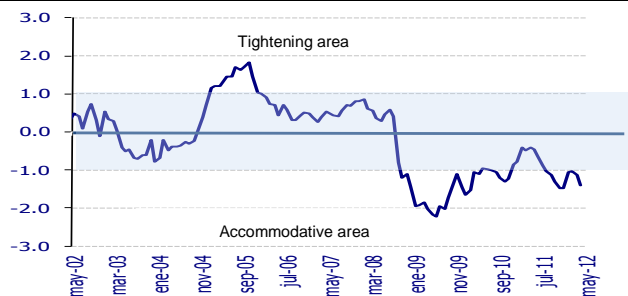
Chart 15
Inflation Surprise Index (July 2002=100)



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

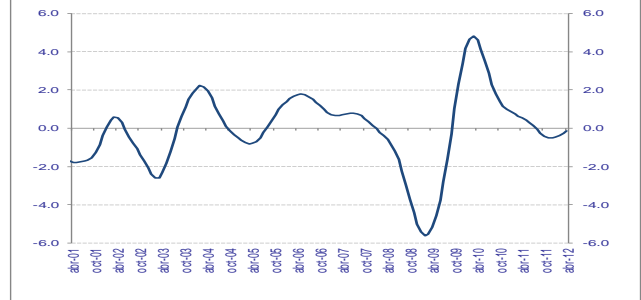
- Monetary Conditions ease due to exchange rate depreciation in May and June

Chart 17
Monetary Conditions Index



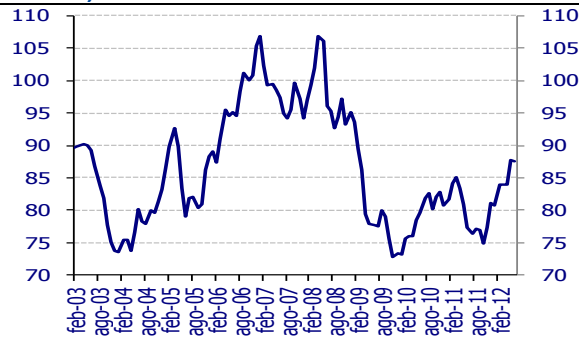
Source: BBVA Research

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



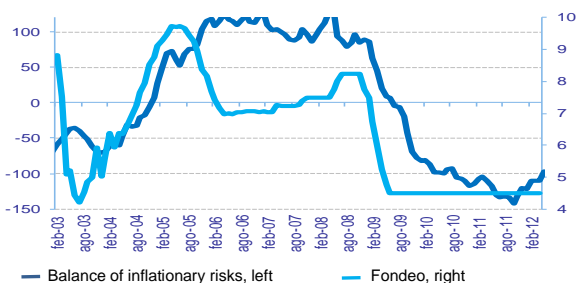
Source: INEGI

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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