

Mexico Weekly Flash

Next week...

- **Inflation above 4% but the risk balance shows a downward bias for global activity**

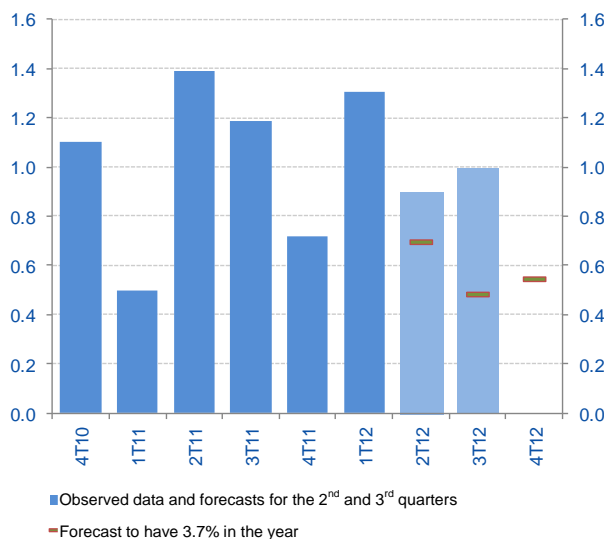
The week ended with Banxico's monetary decision to maintain the lending rate at 4.5%, as expected, although there was a more uncertain tone regarding global activity risk balance which the Central Bank believes also means a downward bias for the medium-term domestic inflation outlook. This will not avoid short-term upward pressure due to supply problems with some food products maintaining price growth above 4%, as shall be seen with inflation from the 1st two weeks of July (Tuesday 24: 4.29% annual). In any case, the central bank's tone will avoid this hitting domestic yield rates if a somewhat higher result is seen.

In terms of output, the impact already seen on manufacturing due to the current slowdown in the US will be clear in the IGAE for May (Wednesday 25: -0.5% monthly). In short, domestic support elements and upward surprises recorded in different output indicators in the first part of the year point to a growth forecast for Mexico of 3.7% in 2012 being more reasonable given the second half is likely to see less dynamism. As seen in the attached chart, forecast growth in the second and third quarter of the year in line with recent information is more than enough to hit 3.7% in 2012.

- **Foreign capital inflows and global risk balance set the standard for fixed income assets and the MXN**

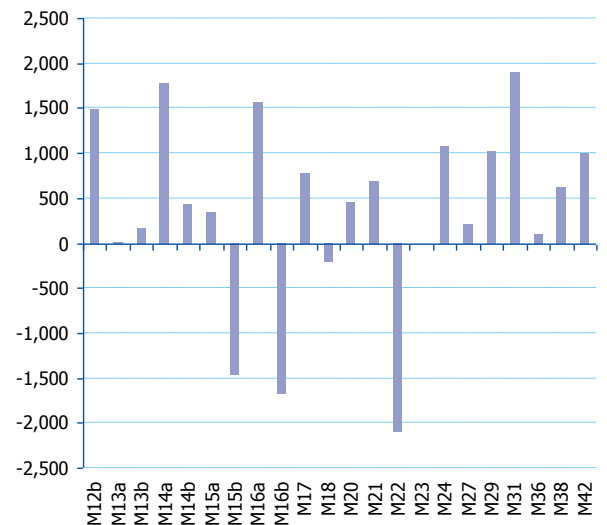
Overseas appetite for domestic curves continues. This higher demand, in a monetary scenario confirming an expansive monetary posture for a longer time continues to support the long sections on nominal curves. In turn, the upswing in inflation in the short-term leaves the door open for short-term Udibonos. The MXN should remain in ranges in the face of higher cyclical risks and appetite for domestic curves.

Chart 1
Mexico, quarterly GDP growth, %



Source: BBVA Research

Chart 2
Net foreign inflows to Mbond over the week of July 16-19 (millions of MXN)



Source: BBVA Research, Banxico, Indeval

Calendar: Indicators

Economic Activity Index (IGAE) May (July 25)

Forecast: -0.5% m/m, 3.1% y/y	Consensus: N.A.	Previous: 0.3% m/m, 5.3% y/y
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With figures for industrial output in May already released on July 12, the services sector should also have recorded a slight contraction in the Month. We estimate the decline to have been around (-)0.3% which contrasts with the 0.7% growth in the previous month. Nonetheless, this is in line with recent figures for retail sales (-0.2%) and the even bigger fall in the service sector revenue indicator (-1.2%), making for the biggest decline since October 2010. It should also be stated that industrial output in May fell (-)0.9% vs. the (-)0.2% expected - mainly a result of the decline in manufacturing of (-)1.4%. The branches mainly linked to foreign demand such as transport equipment, furniture manufacturing, non-metal minerals saw slight declines in May compared to the previous month.

In this way, we expect a slight contraction in the IGAE for May, in line with slightly lower growth in the second quarter compared to the first and the expected mid-year slowdown. We forecast GDP growth in 2Q12 of around 0.7% (q/q).

Inflation in the first two weeks of July (July 24)

Forecast: 0.24% bi-weekly, 4.29% y/y	Consensus: 0.29% bi-weekly	Previous: 0.46% m/m, 4.34% y/y
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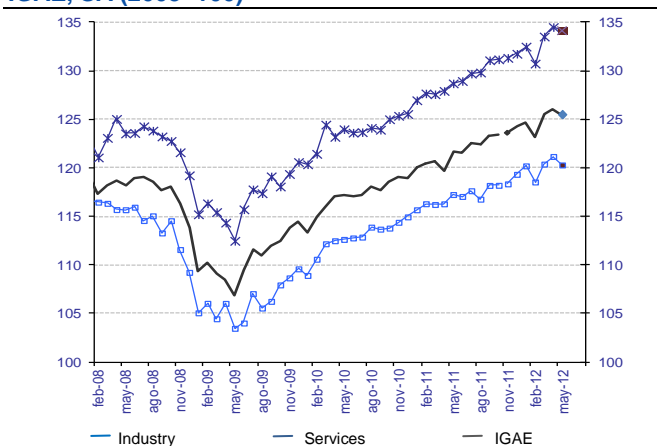
Inflation for the first half of July will be released next Tuesday, set to remain around 4.3% y/y. Inflation came in above 4% thanks to shock on grain and oil markets, as well as the recent increase in fruit and vegetable prices. Linked to these factors, inflation in July will be affected by the higher egg prices due to the outbreak of bird flu in Jalisco. Core inflation will continue around 3.5% thanks to the absence of supply pressures seen in low services inflation levels is enough to contain goods price pressures caused by high maize prices and lower peso. We maintain that the recent increase in inflation will last a few months and come in below 4% in December.

Trade balance in June (July 29)

Forecast: 338.9 md	Consensus: -100 md	Previous: 362 md
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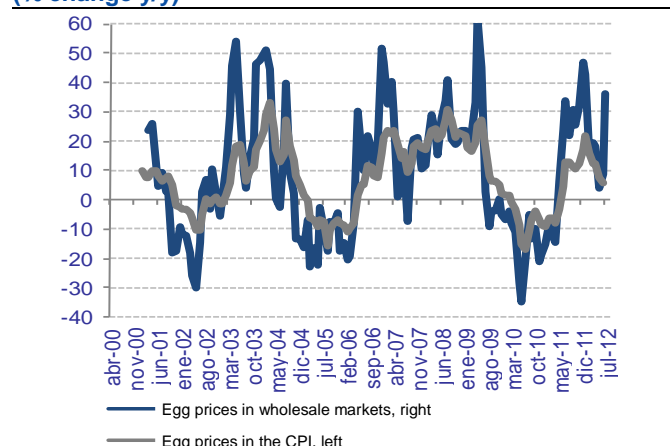
The trade balance in June is released next week, although we believe it will continue to be near balanced. It is important to see the performance of manufacturing exports and imports of intermediate goods in the country - both indicators being closely linked to US output. This year's average nominal monthly growth rates are 1.27% and 0.6% respectively which, although positive, do show high volatility in the year to date. The trade balance will again remain near balanced at the end of the year, although it will be the first to be affected if a new global recession hits.

Chart 3
IGAE, SA (2003=100)



Source: BBVA Research with INEGI and Bloomberg data

Chart 4
Egg prices in the CPI and wholesale markets (% change y/y)



Source: BBVA Research with data from INEGI and SNIIM

There is still a margin for long positions in the long part of the curve

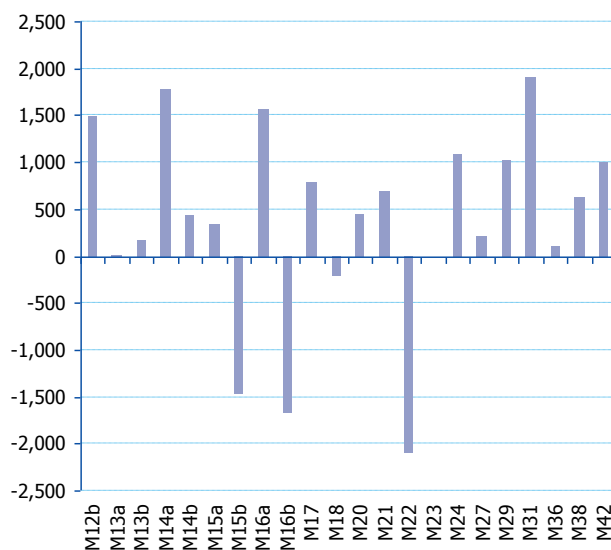
Economic risks will not dissipate in coming months and the current rate of the economy, despite the slowdown, will not see a quick marked change. Since we do not expect Banxico to cut the rate this year, we believe the short section of the curve will not offer relative value. Nevertheless, as we stated in our note "Surfing on the MX rocketed curves", the current risk/profit analysis suggests holding long positions in the 3Y zone since, in the short-term, the appetite for the short section of the curve will not reduce. In addition, it is clear that the low international yields are here to stay. If we also consider the curve being fairly flat in the medium section, it offers negative carry for domestic investors in the short part and includes minimal or zero risk premiums once monetary policy expectations are taken into account (not the mention the domestic constructive scenario, expected economic reforms and persistent foreign capital inflows). It is more than likely that domestic curves remain anchored and foreign inflows maintain their dynamism. All this means that the long part of the curve will continue to dominate due to the convex effect at these levels and the risk premiums will continue low due to the domestic constructive outlook.

Based on this, we recommended a strategy of extremes (butterfly) with a neutral effect and duration: go long in the extremes (3Y and 30Y) and short in the medium. It avoids the lack of curvature in the medium section of the curve and provides protection against any steep climb due to an unexpected rate cut. It also takes advantage of the domestic constructive vision and the convex effect in the long section. We expect the gap between the 10Y and 30Y to close at 80-85bp and that the section between the 3Y and 10Y climbs around 100bp in the next 6 months. In this way, the butterfly would go from -0.72pp currently to 0.0-0.1pp. In turn, we maintain our long position open in the 3Y Udibono. Since May, the rally here has been over 117bp although we believe it will maintain its safe-haven asset quality since we expect inflation to increase above expectations at the end of the year. Our real target rate is zero.

Insignificant impact on the USDMXN - set to remain in ranges

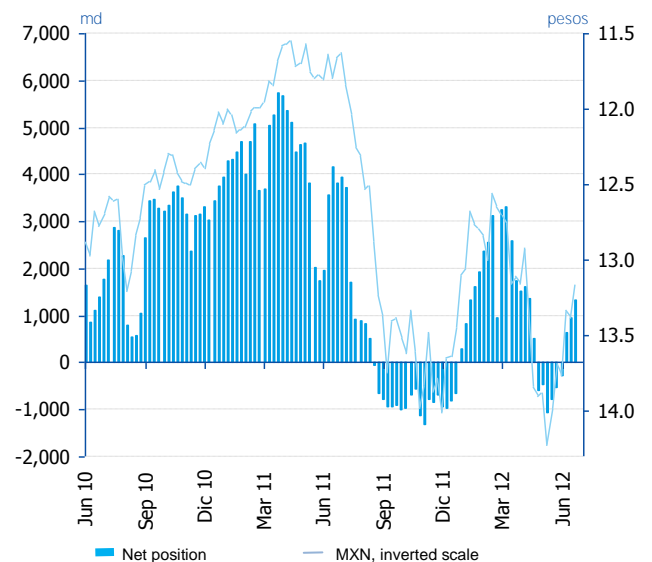
Banxico restated that, if financial market uncertainty fell back, the MXN will continue to fluctuate in line with fundamentals, as seen in recent weeks. The outlook of a stronger MXN has been the basic forecast for most analysts for some time, including ourselves. Despite the fact that we maintain this positive outlook, we believe the USDMXN rate will remain in ranges for the time being and respond to technical levels since the determining factors in coming months will remain mixed. On the one hand, foreign capital inflows and quantitative easing expectations will likely continue to support most risk assets. On the other, pessimistic news on the EMU, high concern over the cycle and key political events in the US will add more volatility to global markets. If Banxico adopts a looser stance, the low differential between interest rates will weigh the currency down. Since this seem impossible right now, we do not believe the MXN will react to monetary policy expectations in the short-term.

Chart 5
Net foreign inflows to Mbond over the week of July 16-19
 (millions of MXN)



Source: BBVA Research, Banxico, Indeval

Chart 6
Share Indices: changes (%)



Source: BBVA Research and Bloomberg

Technical Analysis

IPC



Source: BBVA, Bancomer, Bloomberg

The week saw a new all-time high for the IPC (41,273pts), maintaining the short-term upward trend. Despite the break on the market from mid-week, the 10-day rolling average saw no trend change. This technical level, at 40,400pts, is our 1st support reference for the short-term. A downward break through this level would mean a return to the 39,500pts zone where the 30 day rolling average sits. In turn, the upward move marks resistance levels at 42,000 and then 43,000pts. Due to the over-buying we may see at this 2nd resistance, we believe an appropriate level for profit-taking sits at 42,000pts.

Previous Rec. (16/7/12). With the weekly close at a new all-time high above 40,500pts, we can consider targets at 41,000 and 41,500pts

MXN

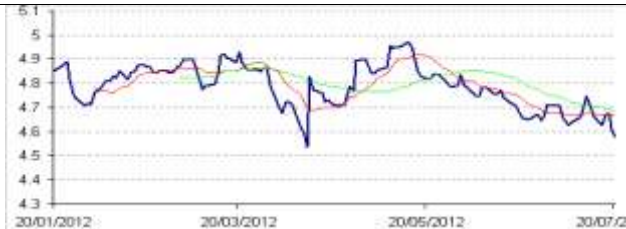


Source: BBVA, Bancomer, Bloomberg

The dollar had a volatile week, starting with a downward move to a minimum of MXN13.09 (very near the important MXN13.00 floor) from where it started an upswing. Now above MXN13.25 (previous floor), it could maintain an upswing to MXN13.50.

Previous Rec. (July 16, 2012). With the return to levels below MXN13.40, the door is open for a new return to the MXN13.25 level. We believe it may again respect this floor.

3Y M BOND



Source: BBVA, Bancomer, Bloomberg

3-YEAR M BOND (yield): It again attempted a bounce over the week but was unable to hit above 10- and 30-day rolling averages while, on the contrary, breaking the previous minimum. Next floor up to 4.55%.

Previous Rec. (16/7/12). We believe it has marked a good floor at 4.65%.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

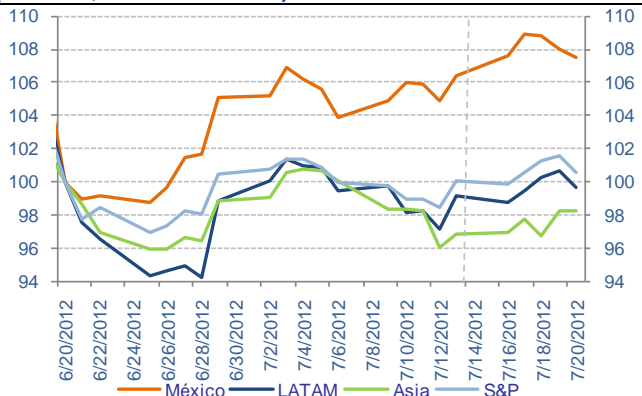
10-YEAR M BOND (yield): Unable to go above the 10-day rolling average, the bond hit a new all-time low. Next floor at the psychological level of 5% and, if broken, up to 4.8%.

Previous Rec. (16/7/12). In order to be validated, any upswing attempt has to place it above the 10-day rolling average (5.3%).

Markets

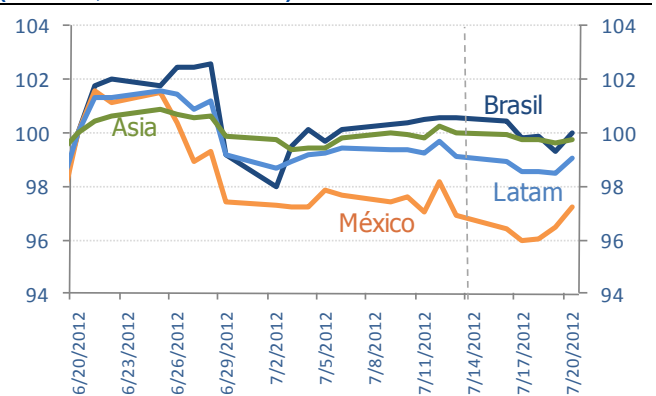
- Gains on stock markets over the week after the Fed chairman clearly stated before the US Senate banking committee that, if needed, they were ready to take action. The peso fell toward the end of the week after the release of lower-than-expected figures for US manufacturing output and house sales.

Chart 7
Stock Markets: MSCI Indices
(June 20, 2012 index=100)



Source: Bloomberg & BBVA Research

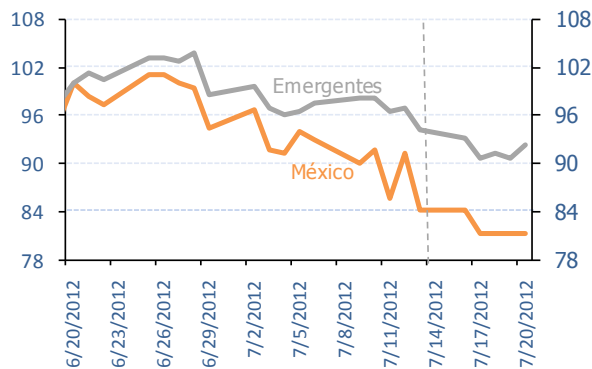
Chart 8
Foreign exchange: dollar exchange rates
(June 20, 2012 index=100)



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

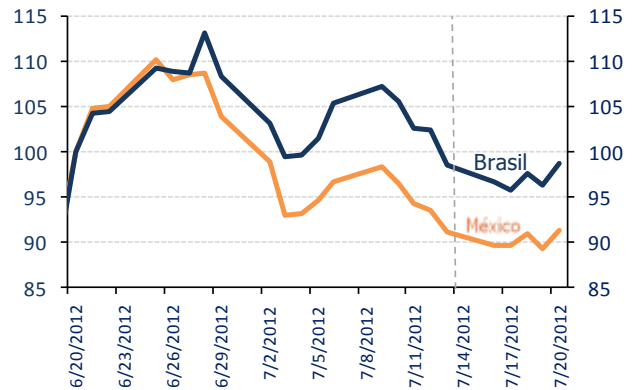
- Slight upswing in risk aversion over the week after the signing of a Memorandum of understanding on the bailout package for the Spanish banking system was delayed, as well as continuing doubts on markets on how it will work.

Chart 9
Risk: EMBI+ (June 20, 2012 index=100)



Source: Bloomberg & BBVA Research

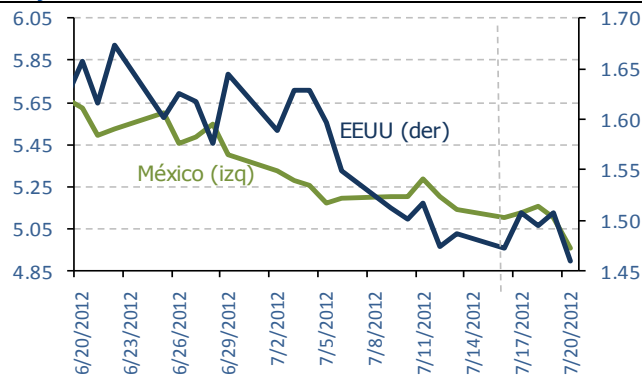
Chart 10
Risk: 5-year CDS (June 20, 2012 index=100)



Source: Bloomberg & BBVA Research

- US rates fall over the week. Rates in Mexico fell, 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 (%)

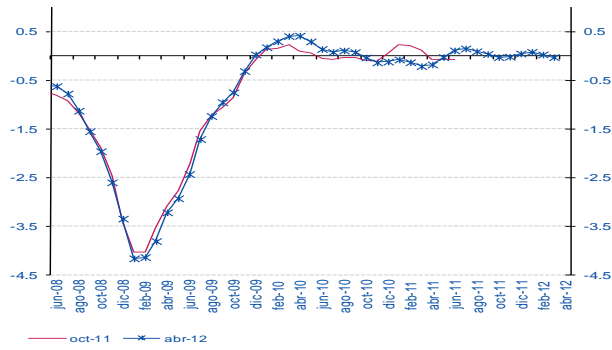


Source: BBVA Research with data from Bloomberg

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.

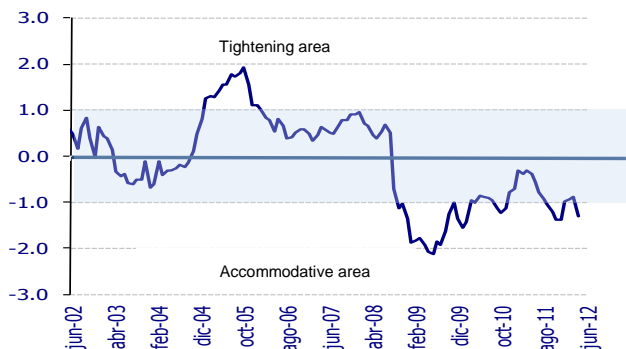
Chart 15
Inflation Surprise Index (July 2002=100)



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

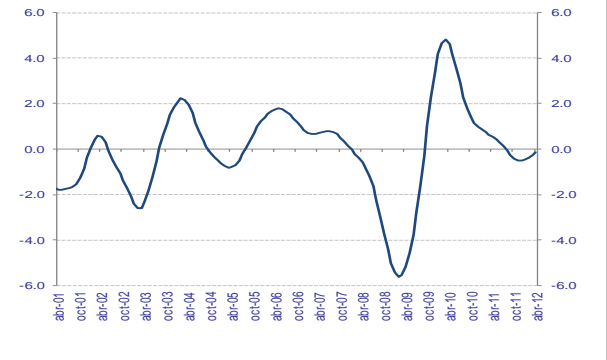
- Monetary Conditions relax after higher inflation in June.

Chart 17
Monetary Conditions Index



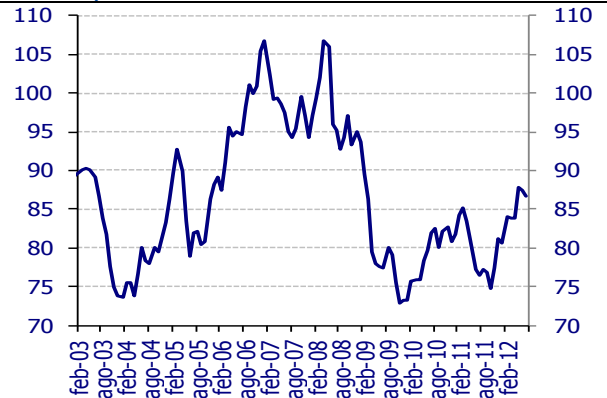
Source: BBVA Research

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



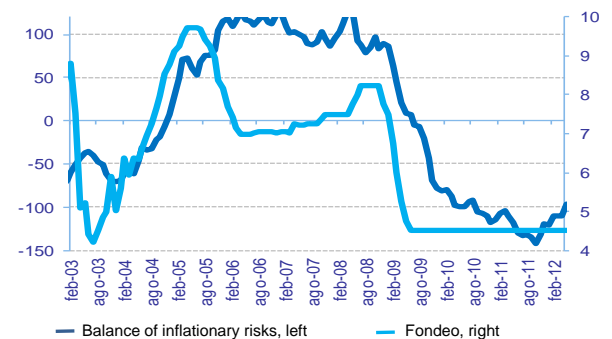
Source: INEGI

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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