

Mexico Weekly Flash

Next week...

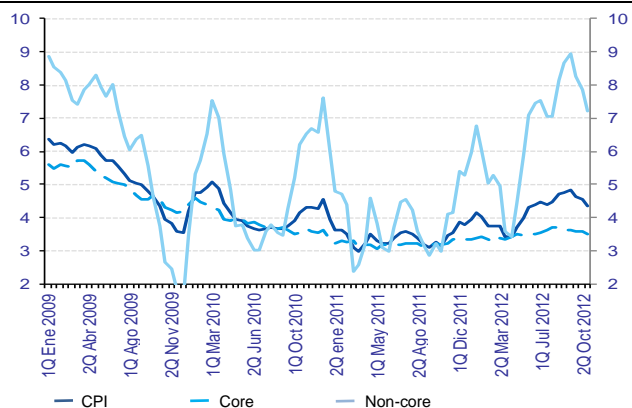
- **Banxico will release its last monetary policy decision of the year.**

Next week we will hear the last monetary policy decision released by the governing board of Banxico. We expect the lending rate to remain the same, given that inflation has begun to fall (as the central bank expected). However, we also expect the statement to maintain the tone of warning against inflation, because even though inflation has fallen, the most important risks mentioned by the Central Bank remain: further supply shocks affecting basic products, higher than expected increases in public prices, a distortion in the wage fixing process or a higher devaluation of the peso. In terms of output, we believe that the main factors will be external weakness and the potential risks implied for Mexico and the world, and uncertainties in economic policy prevailing in both the US and Europe. Consequently, we believe that the monetary pause will continue for a certain length of time, although there could be new supply shocks which could again put inflation off course, or if there is a knock-on effect from the most volatile prices to those most linked to activity performance, Banxico might take a tougher line and even begin to withdraw the monetary stimulus.

- **Local markets shaped by MXN in ranges and heavy inflows of foreign investment.**

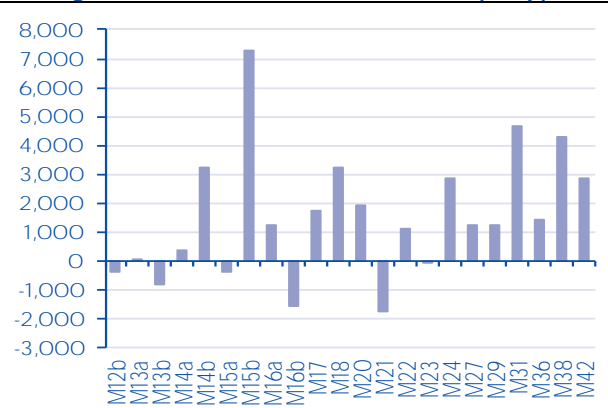
A week of higher appetite for global risk leads to 1.26% rise in MXN, increases of around 2.7% in the IPC and a slight increase in the level of the Mbono curve (10bp); although the medium part has been hit hardest (see flow comment below). This behavior was focused on the last two days, with very little liquidity due to the markets being closed in the US on Thursday (and partly open on Friday, and also that markets in Japan did not open that day either). The impulse stems from signs suggesting that an agreement to provide Eur44bn is to be reached, and also from the good business confidence figure in Germany. Although budget negotiations in the European Union have fallen through, markets still have a constructive outlook compared to the "fiscal cliff" in the US, and have omitted any news from Europe which does not offer a realistic or favorable financial outlook.

Chart 1
Inflation breakdown



Source: BBVA Research with INEGI data

Chart 3
Net foreign inflows to MBONO in November (bn. p)



Source: BBVA Research, Banxico, Indeval

Calendar: Indicators

October Trade Balance

Forecast: -755 md

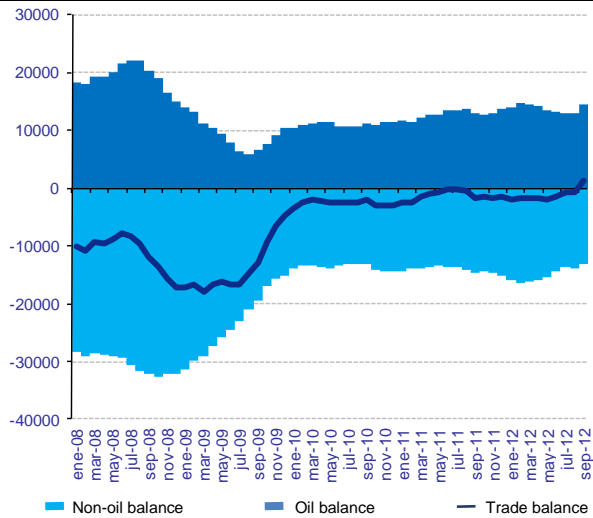
Consensus: -555 md

Previous: 233 md

We will be informed next week of the trade balance for October, which, according to our estimates, will present a 755 md deficit, typical bearing in mind the seasonal nature of this indicator in the last quarter of the year. The trade balance should once again - as in September - show the slowdown in output both outside and inside Mexico, so that in our opinion there is a possibility that the year end trade balance could be close to zero or might even show a slight surplus. Mexico's foreign trade balance shows a surplus of 1363 md up to 3Q12, although traditionally the 4Q12 balance is the most deficit prone, so that at year end we believe the figure will be equally balanced.

Chart 2

Trade balance and components (MD, 12-month rolling total)



Source: BBVA Research with INEGI data

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On the domestic front, the inflation figure for the first fortnight revealed a continuing downward trend, though it had little impact on the markets. Inflation for the first fortnight of November was published on Thursday, and was slightly above market consensus (0.79% vs. 0.72%); although the downward trend in the annual rate continued (to 4.36% from 4.60%). According to the BBVA Research Economics team (see Flash Inflation Mexico), supply shocks continued to dilute, while core inflation continued its downward trend. There were two important aspects of core inflation: 1) in goods, foods were better than expected, while the figure was somewhat worse for the rest of goods, but very much in line in the aggregate figure; 2) other services, again much lower than expected, due to higher competition in the telecommunications market. In non-core inflation, electricity was higher than expected, though the downward trend continued; and agricultural components continued to fall (although there might be pressures in coming months).

Regardless of yesterday's figure, which confirms slowing in the annual inflation rate, we expect that Banxico will bear in mind the inflation breakdown a few months ago — particularly of the main components affected by wage negotiations and second round effects on the recent supply shocks seen — before defining a different monetary policy. In 2013, there will be more details of these risk elements, plus new ones if the new government implements a change in its energy subsidy policy and/or a change in the Income Act (taxes). We thus do not expect changes in the lending rate in 2013 and in any case the first few months of the year will have to pass before Banxico has enough information to implement a change in its position. Generally speaking, before having new catalysts, we expect that assets in both MXN and local curves, will continue to respond to range strategies.

Mexico's construction story, plus the global interest rate scenario, continues to be materialized in foreign flows to the Mbono curve. According to estimates, up to November 22, there is an accumulated inflow of USD 2.5bn in foreign investments. In contrast to October, foreign investors have exploited the fly, with heavy buys from 2031 to 2042, and December 2015. Our current open recommendation in the Mbono curve is to be long in this bond of 2015, in the Mbono 2042 and short on the 10-year bond. The Siefos meanwhile continue selling the nominal curve. In the same period, they have sold USD 1.2bn. As we predicted, this means that the inflow of funds during the year will be very similar to 2011, in fact it might even be higher. The trigger for adjustment in foreign investors' portfolios will not be a catalyst such as the "fiscal cliff" and/or greater aversion stemming from events in Europe, but when the Fed changes its monetary policy and the market considers a clear cycle of increases in interest rates.

This Monday, PEMEX will issue MXN 25.0bn in issues of fixed-rate, inflation-indexed and floating rate Bonds. On Tuesday the 1-year Mbono will be auctioned. After the PEMEX issue, with the interest payments close at hand, and further details of global risks ("fiscal cliff" and Europe), locals can take advantage of these levels to return to the market.

Technical Analysis

IPC (headline)



Source: BBVA, Bancomer, Bloomberg

The weekly rise in the IPC was not strong enough to take the market back above 41,500pts and 30-day rolling averages. With these resistances broken upward, the market would not have a short term ceiling until the zone between 42,500 and 42,700pts. The RSI, at 58pts and without yet reaching an overselling zone, suggests that the rebound movement may be maintained in the following sessions. The notch of 41,500pts becomes a new base in the short-term. The lack of correlation between IPC and Amx has been evident in recent weeks. The short term oscillating indicators of the issuer have begun to rebound from very high oversell levels; and still have a lot of upside potential.

Previous Recommendation (12/11/12). The doji candlestick with which the IPC ended the week suggests a major bounce. Nonetheless, it has to combine with a positive candlestick to complete the upswing pattern

MXN



Source: BBVA, Bancomer, Bloomberg

The dollar ended the week slightly below the level of MXN13.00. Although it attempted a rebound from this level midweek, it was unable to consolidate it and there is still risk of a downward break of this floor to place targets of between MXN12.90 and MXN12.70. Any upturn would be limited to between MXN13.15 and MXN13.20.

Previous Recommendation (12/11/2012): Once above MXN13.10, expectations are maintained to seek out the MXN13.30/13.40 zone. MXN13.00 continues to be our major support.

3Y M BOND



Source: BBVA, Bancomer, Bloomberg

3Y M BOND (yield): The bond adjusts towards 30-day rolling average from which to begin a new rebound. The 4.95% zone is a good support, where 10- and 30-day rolling averages sit. We think it might try the 5.1% range in the short term.

Previous Rec. (12/11/12). The 4.85% level should provide support to attempt an upswing.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

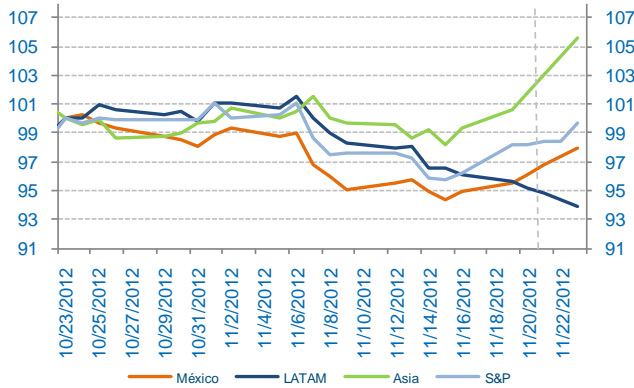
10Y M BOND (yield): The bond has operated in a lateral range of between 5.2% and 5.6% since August. Close to the high part of this channel, we recommend waiting for an upward break to consider a move toward 6%.

Previous Rec. (12/11/12). The bond came in below the 30-day rolling average opening the door back to the previous minimum at 5.25% levels.

Markets

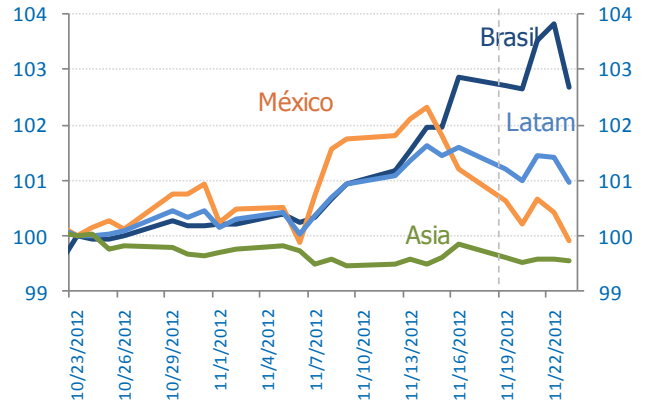
- A week of optimism on the markets after President Obama said he was hopeful of reaching an agreement with Congress, and due to positive figures in China and Germany.

Chart 7
Stock Markets: MSCI Indices
 (October 16, 2012 index=100)



Source: Bloomberg & BBVA Research

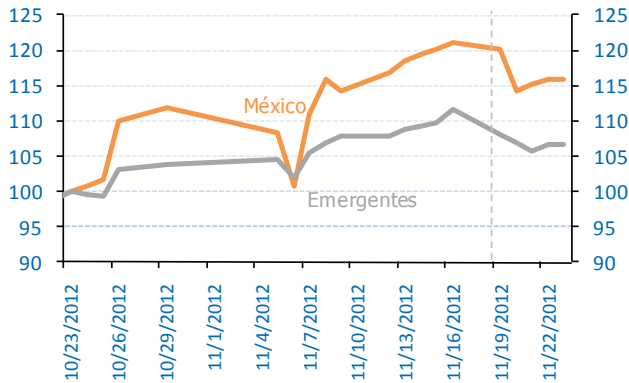
Chart 8
Foreign exchange: dollar exchange rates
 (October 16, 2012 index=100)



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

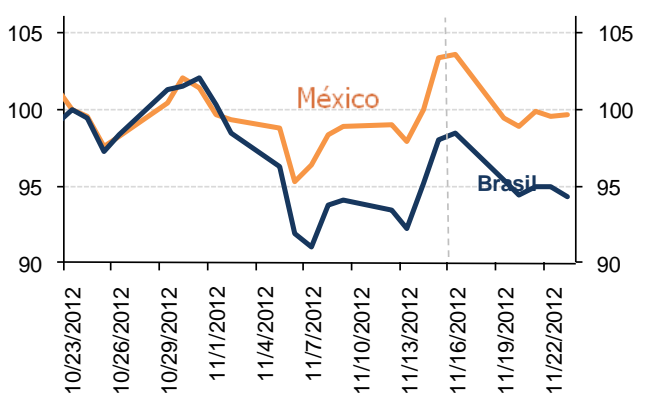
- Given the above, generally speaking risk aversion slowed slightly this week.

Chart 9
Risk: EMBI+ (October 16, 2012 index=100)



Source: Bloomberg & BBVA Research

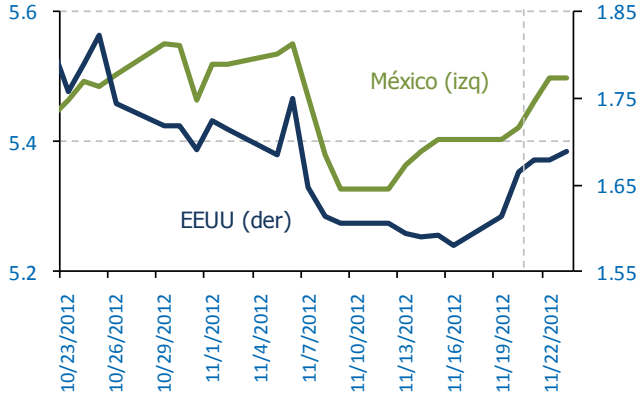
Chart 10
Risk: 5-year CDS (October 16, 2012 index=100)



Source: Bloomberg & BBVA Research

- The positive correlation between interest rates in Mexico and the US continues.

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

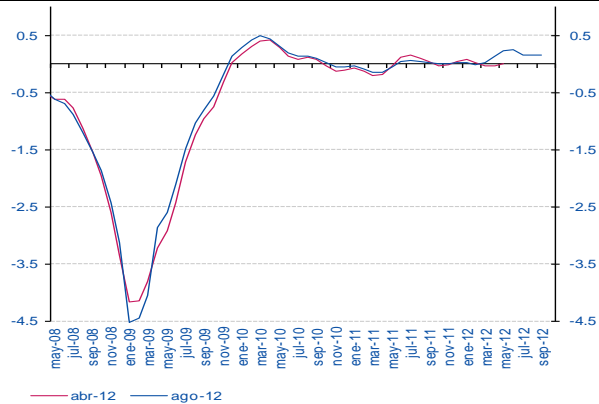


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

- Output slowed in the third quarter, indicators from the third quarter point to this continuing to see a soft slowdown

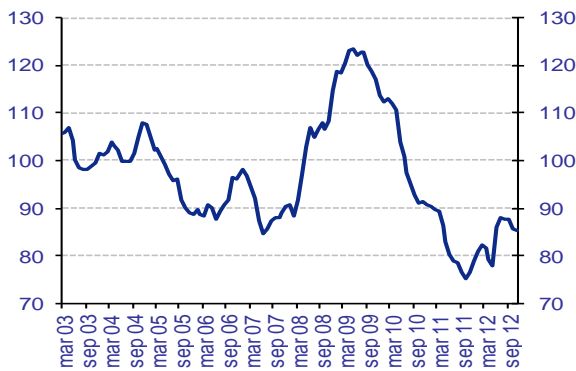
Chart 13
BBVA Research Synthetic Activity Indicator for the Mexican economy



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 upward surprises while output slowed.

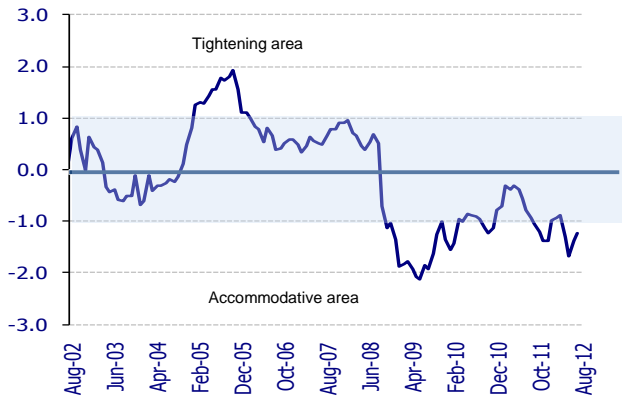
Chart 15
Inflation Surprise Index (July 2002=100)



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

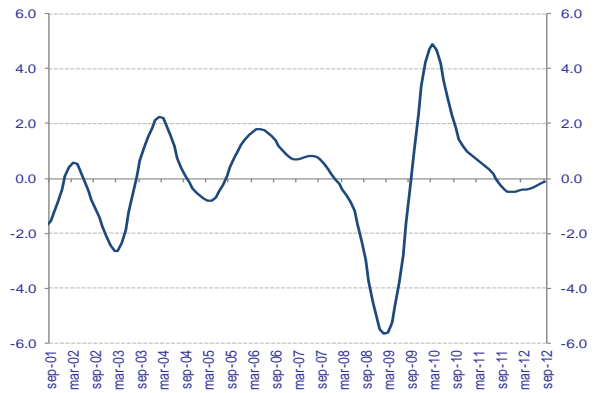
- Monetary conditions slightly reduced their looseness after currency appreciation.

Chart 17
Monetary Conditions Index



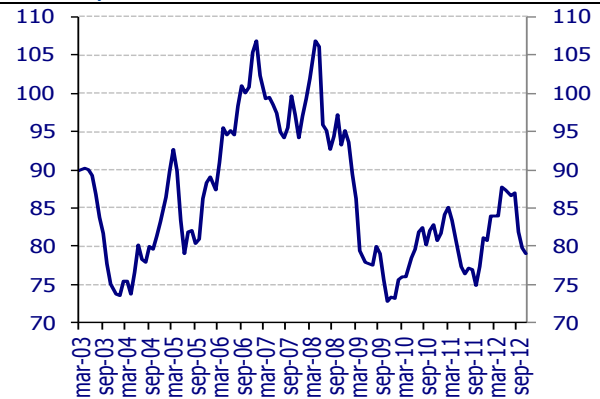
Source: BBVA Research

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



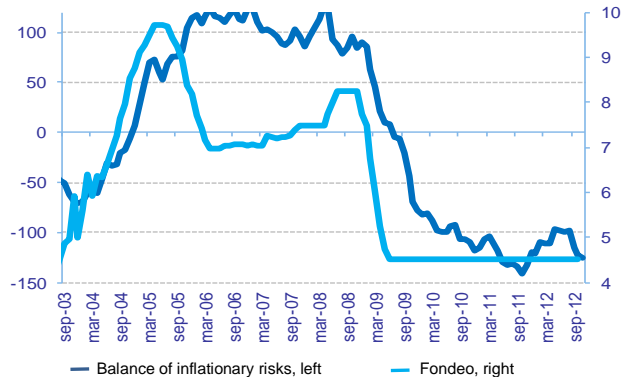
Source: INEGI

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 IBR signals greater weight of inflationary risks over those of growth and, therefore, more likelihood of monetary restriction

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