Mexico

MXN Overview

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Market Analysis
FX

Global Interest Rates

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Differentiation drives greater recovery in the short term

- **Technical factors and fundamentals**
  favor positive bias for the peso in the short-medium term.

- **In our view,**
  a likely recovery of foreign inflows and technical factors should drive appreciation in the short term.

- **Additionally,**
  liquidity factors in the domestic market have begun to align in the peso's favor.

- **All of these factors coming in conjunction with current market positioning and the forward curve profile**
  should drive the peso toward the vicinity of USDMXN12.60 in the short term

Table 1
Short and medium term outlook

	Spot	1M	3M	6M	12M	Revision of medium term forecast
USD/MXN	12.77	12.61	12.30	12.00	12.10	=

*Spot rate as 9 of July
Source: BBVA Research

USD/MXN

Negative differentiation favors stronger short-term recovery

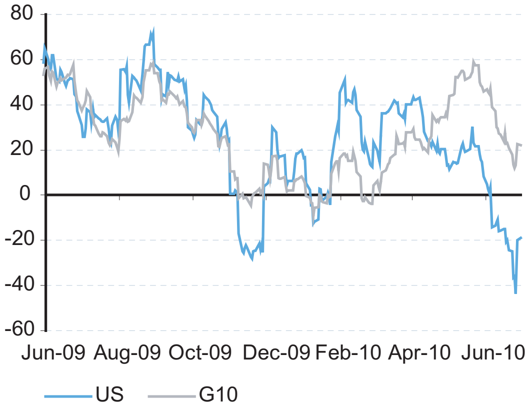
- The peso has endured negative differentiation since the end of June due to ongoing uncertainty with regard to the US cycle and the high exposure of the Mexican economy to this factor.
- Nonetheless, we believe levels will normalize in the short term based on the likely recovery of technical factors and foreign inflows (portfolio and trade investments, as well as remittances).
- Thus, in our view the current positioning of the market, liquidity factors and the forward curve profile favor a movement toward the vicinity of USDMXN12.80 in the short term.

Short-term outlook

For the last two months, the market has focused on the fiscal woes of countries in the Europe's periphery and the trend in credit risk premiums. Now, heading in to the year's second half, these doubts have migrated toward matters of the global economy although this does not necessarily mean an easing of sovereign European risk premiums, which could bounce back on any news from this front in the short term. The market has now priced in a scenario of slower growth in Europe and is especially concerned with the flow of economic news from regions that could serve as a global growth driver: China, the US, and Latin America. So, since the first spate of economic reports has resulted in a moderation of the positive outlook (particularly in the US where, as seen in the economic surprise index, the data have been consistently disappointing since mid-June), the phenomenon of risk aversion has returned (rates on 10Y US Treasuries are back at 13-month lows).

Chart 1

Economic surprise index



Source: Bloomberg and BBVA Research

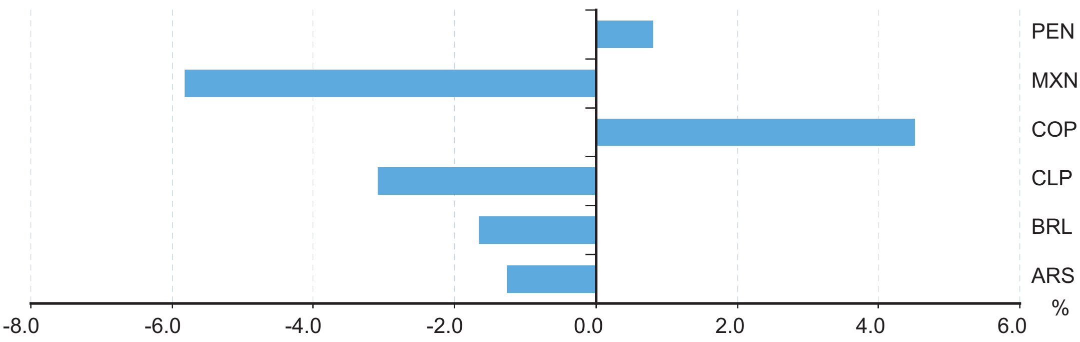
Chart 2

US bond rates

Source: Bloomberg and BBVA Research

This means the global climate is beginning to show a differentiation: first, a clear preference for risk-free assets (the Japanese yen has appreciated more than 6% in the last two months, while equity indices have tumbled around 5% in the same period), and second, a premium on regions with stronger growth prospects (Latin America, for example). In this context, the peso has been weakened by the resulting flight to quality, as well as the prospect of slower US economic growth impacting directly the Mexican economy. This led the peso to reverse all of the gains it racked up in the first quarter of the year, and it has now lost more ground this year than any currency in the region: 5.8%, vs. an average of 1.35%.

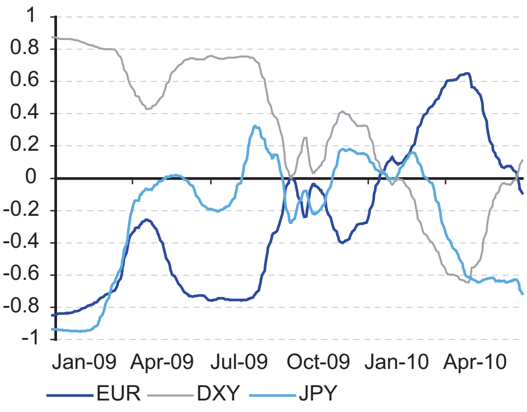
Chart 3
Change in LatAm currencies (May-present)



Source: Bloomberg and BBVA Research

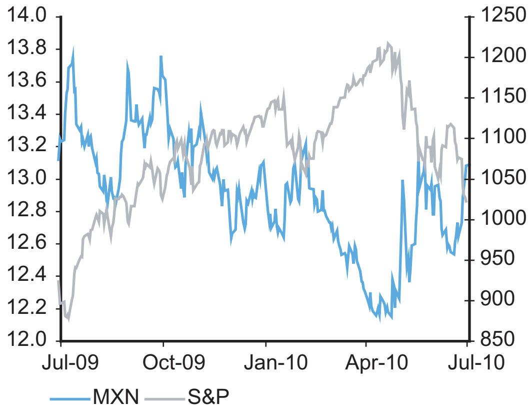
The peso's performance has also begun to diverge from the euro and the DXY Index, with which it usually bears a close correlation, although it remains highly sensitive to changes in commodity prices and stock indices –factors that ceased to affect other Latin American currencies because they were more sensitive to domestic elements. Because the local newsflow has also contributed nothing that would spur an outperformance by domestic assets over other emerging markets (which is not expected to happen in the short term), the basic drivers for the peso remain, in the short term, external. Specifically, we believe the market will be closely watching the forthcoming batch of quarterly reports in the US and Mexico starting in mid-July, and the resulting trend in equity indices.

Chart 4
Correlation MXN-other currencies (6M)



Source: Bloomberg and BBVA Research

Chart 5
MXN vs. S&P



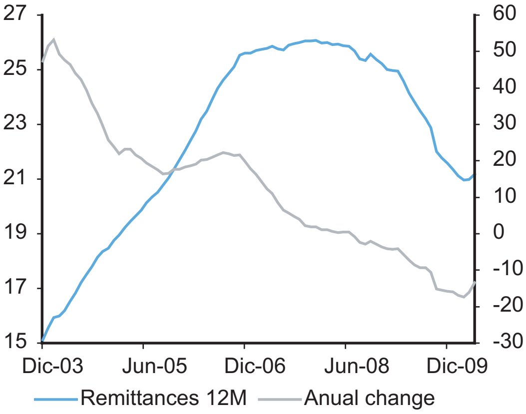
Source: Bloomberg and BBVA Research

Four other factors support a normalization of the peso in the short term:

1. Foreign flows

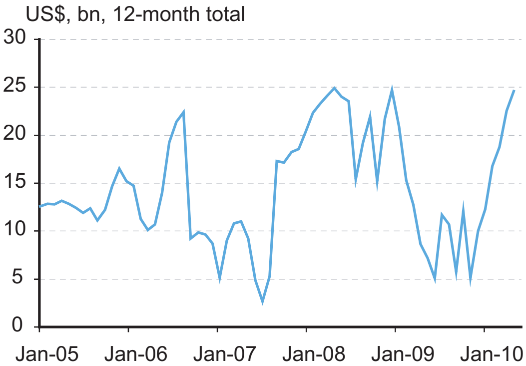
After an uninterrupted 23-month slide, the YoY growth rate in remittances picked up in the last two months, rising by 12% in of May. This was despite a scenario of more modest recovery in the US job market. Additionally, trade flows have been strengthening this year. Our proxy for these flows (change in reserves - trade balance, 12M) is close to where it stood at the end of 2008. These factors, still not priced in, could contribute to a stabilization of the peso in the short and medium term.

Chart 6
Remittances, level and % change (12M)



Source: Banco de México and BBVA Research

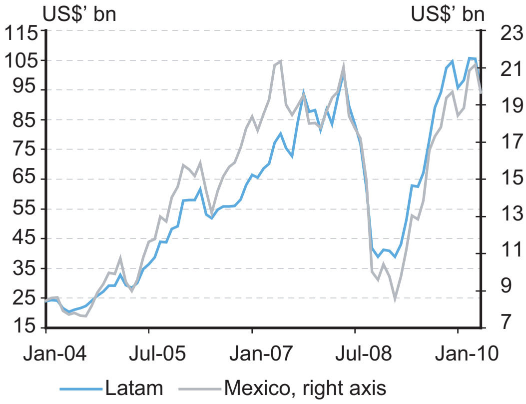
Chart 7
Trade flows proxy



Source: Banco de México and BBVA Research

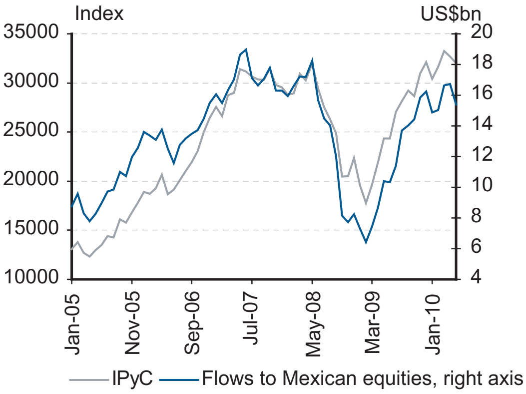
Financial flows, on the other hand, have corrected down in recent months, responding to the above-mentioned risk version. In fact, flows into fixed-income instruments have seen a marginal decline compared to allocation in equities. This has been reflected in the IPC, so given our positive outlook on the index, we can also expect to see a pickup in these flows heading into the second half of the year. And given that the correlation of the peso with these flows has been -0.68 in the past two years, the Mexican currency should benefit from a possible reversal of the decline.

Chart 8
Mutual fund investment in Latam and Mexico



Source: EPFR and BBVA Research

Chart 9
Mutual fund investment in equities vs. IPC



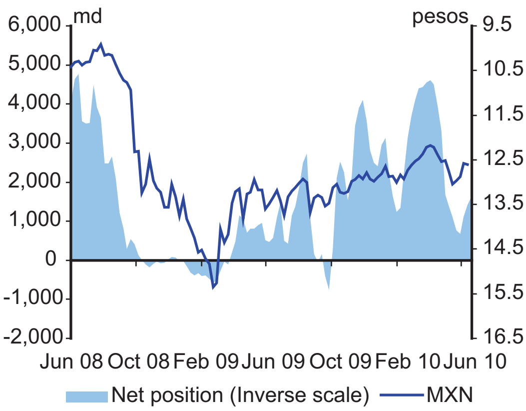
Source: Bloomberg, EPFR and BBVA Research

2. Market positioning

After having fallen to US$676mn (lowest point since October 2009), speculative long positions on the peso in the CME began to turn around in mid-June, which does not reflect the negative differentiation of the MXN in the first week in July. Although we may see a closure of positions heading into the second half of the month, we think it will be light. Risk reversals, on the other hand, remain closely correlated with the MXN and have risen, although less than in the last phase of peso depreciation. Meanwhile, the peso's implied 1M volatility is far from its mid-May highs of 20%: it is currently at 14.7%, and we still see room for a downward shift.

Chart 10

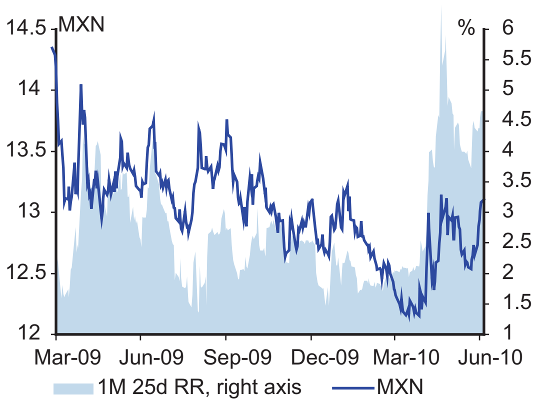
Long position on the MXN in CME



Source: Bloomberg and BBVA Research

Chart 11

MXN vs. 3M 25d RR



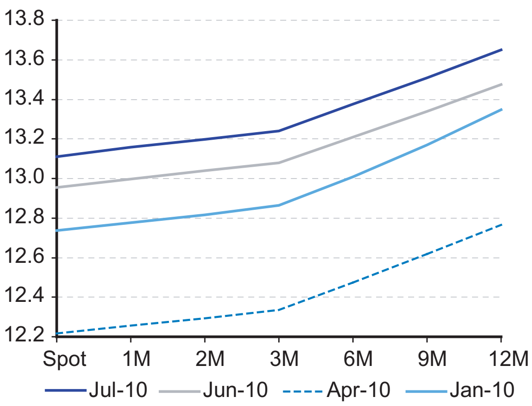
Source: Bloomberg and BBVA Research

3. Forward curve

The forward curve prices in implicit rates below those of shorter terms on the Cetes curve (2-3 months). We do not think this situation is sustainable for much longer, and it also reflects a slightly exaggerated movement in the spot and 1M rates. Thus, we would expect a correction in the short term.

Chart 12

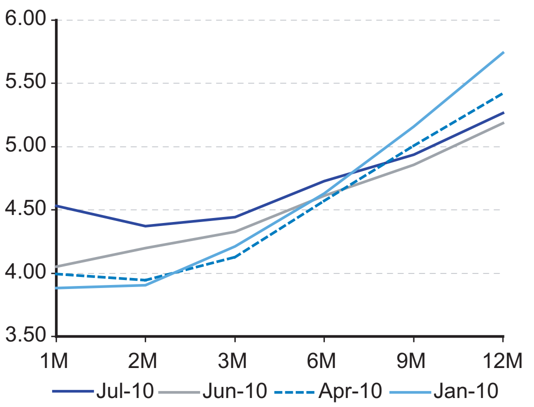
MXN forward curve



Source: Bloomberg and BBVA Research

Chart 13

Implied rate in the MXN forward curve

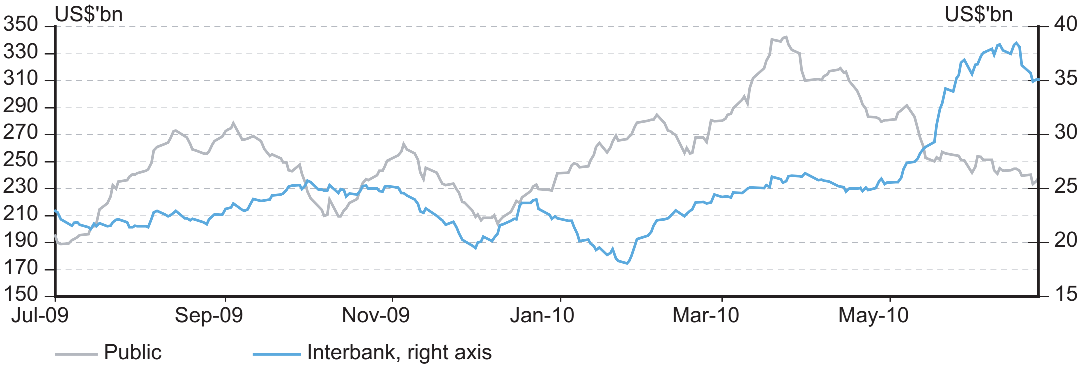


Source: Bloomberg and BBVA Research

4. Liquidity

Another factor we think contributed to the size of the recent movement was the level of liquidity in the domestic FX market. In the second half of June, trading volume with the public ebbed by 8%, and on the interbank market, 7.8%. We therefore believe the upturn was more the product of technical factors than position closures, so it should correct in the short term.

Chart 14
FX market trading volume, cumulative monthly

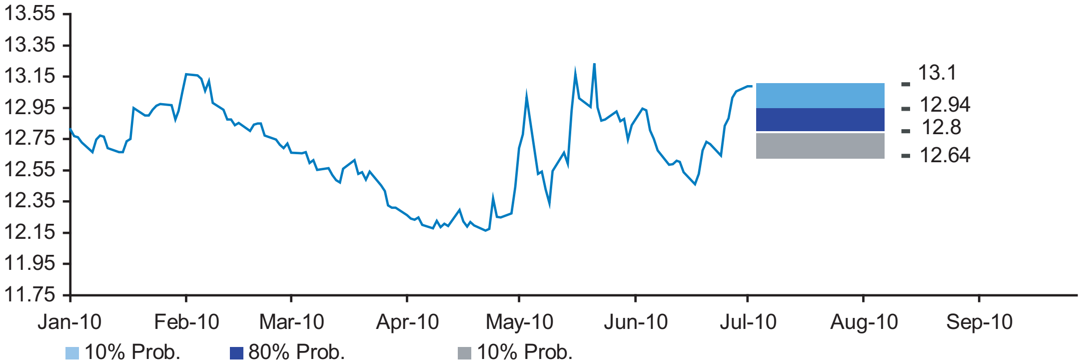


Source: Banco de México and BBVA Research

Conclusion

Based on these elements, we believe that in the short term the peso should consolidate in the vicinity of USDMXN12.60.

Chart 15
USD/MXN: 1M forward forecast



Source: Datastream and BBVA Research

Medium-term outlook

From a medium- and long-term perspective, we continue to think that the combination of positive factors on the domestic front (although the outlook on the economy has dimmed, it remains positive; inflation is under control and the monetary cycle is expected to turn restrictive in the second quarter of next year; fiscal and external accounts are strong, with positive prospects for foreign direct investment flows) and a strong appetite for risk on the external front, where commodity prices will continue to rise, will support a return to 12.0-11.75 per dollar for the peso. In fact, although we are not considering this a determining factor in its short- and medium-term performance, the peso is the only currency in the region that is undervalued in terms of purchasing power parity (PPP), by -6.3%, which should favor a decompression over the long term.

Table 2

Short and medium term view

	Spot*	3Q10	4Q10	1Q11	2Q11	Forecast reviewed in the medium term
USD/MXN	12.82	12.30	12.00	11.75	12.00	=

*Spot as at July 8
Source: BBVA Research

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