

Mexico

Fixed Income Overview

Mexico D.F., 20 July 2010

Market Analysis Interest Rates

Fixed Income

FX LatAm

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Fixed Income Mexico

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Monetary conditions remain lax

- **The market continues to move back the expected start of rate hikes as well as the extent of the normalization**
The analysts' consensus has also changed its estimate on the start of the restrictive cycle, in line with the market, for March 2011.
- **This scenario is bolstered by surprisingly low inflation in recent months**
coupled with prospects of slower global growth in a climate of higher risk.
- **A scenario of greater liquidity**
prompts investors to seek out longer duration in Bonos.

Table 1

Fixed-income forecast*

%	Current	2009	3Q10	4Q10	1Q11	2Q11
1M Cetes	4.59	4.51	4.57	4.66	5.05	5.63
3M Cetes	4.64	4.61	4.68	4.83	5.27	5.83
1Y Cetes	4.74	5.07	5.05	5.55	6.02	6.37
1Y-1M slope (bp)	15	56	48	88	97	74
3Y Bono	5.40	6.72	5.52	6.14	6.70	7.01
10Y Bono	6.65	7.97	6.77	7.22	7.74	7.97
20Y Bono	7.24	8.57	7.37	7.83	8.30	8.41
10Y-3Y slope (bp)	125	125	126	108	103	95
65X1 IRS	6.24	7.51	6.26	7.07	7.97	8.25
130X1 IRS	6.99	8.32	7.22	7.87	8.46	8.57
260X1 IRS	7.47	8.87	7.85	8.50	9.01	9.01
3Y Udibono	1.22	1.46	1.82	2.08	2.40	2.53
10Y Udibono	2.68	3.42	2.81	3.11	3.53	3.73

*All data end of period, updated July 16th, 2010
Source: BBVA Research

PLEASE SEE ANALYST CERTIFICATION AND OTHER IMPORTANT DISCLOSURES STARTING ON PAGE 11

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Money market

Prolonged monetary pause

- The fondeo rate implied in the swap curve shows that the market has moved back the expected date of rate hikes, as well as the size of those movements.
- Surprisingly low inflation in recent months, along with expectations of slower global growth in a climate of higher risk all contribute to an outlook of prolonged monetary pause.

Short-term view

In recent months, the market has changed its outlook on monetary policy. In early December, the date of the previous high, the swap curve priced in a 300bp hike (accrued) in the next two years, while today the expected size of the tightening is only 175b. This means the market has delayed the expected start of the rate hike cycle to the first quarter of 2011 (compared to the market's bet since the report we released at the start of 3Q10), as well as the size of the increase (to 5.50% now, vs. 7% in the previous period). The consensus of analyst forecasts also shows a later expected start to the restrictive cycle, similar to what the market is evidencing, for March 2011. Most of the correction (see Table 2) is found starting in the second half of April.

Table 2

Ciclo de normalización monetaria descontado en la curva swap

Change (bp) for next:	High 07-Dec-09	Pre-Greece 29-Jan-10	Pre-Crisis 1HApr	Current
6 months	75	50	25	5.25
12 months	75	50	75	0
18 months	75	100	75	0
24 months	75	75	75	5
Accrued	300	275	250	0
Final fondeo rate (%)	7.50	7.25	7.00	4.50

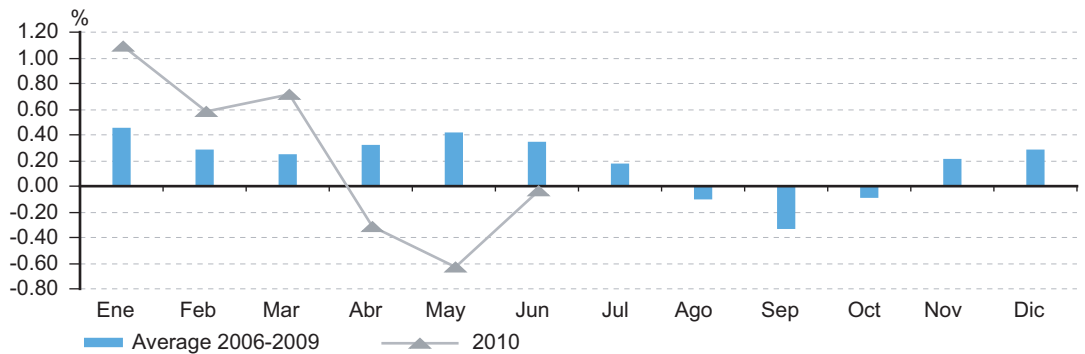
Source: BBVA Research

This scenario of a prolonged monetary pause is backed up by three elements. The first is the trend in inflation, which eased substantially in the second quarter of the year, closing at 3.69% YoY vs. 4.97% to March, and falling below Banco de México's target range for the quarter (average between 4.5% and 5.0%). The decline is attributed to: (i) a swift dilution of tax increases, which were absorbed in the first quarter of the year; (ii) a surprising drop in volatile agricultural product prices, which account for 72% of the inflationary decline in the quarter; (iii) persistently high output gaps because of the sluggish recovery of domestic demand; and (iv) a decline in imported inflation.

Although inflation is likely to hover below Banxico's target for the third quarter as well, it may turn up again by the end of the year (estimated close of 5.2%) then fall back into line with the central bank's target range. The rise in late 2010 will be the product of a modest base of comparison in 2009 (freeze on public energy prices and abnormal declines in agricultural product prices) and a possible return to record highs in the prices of more volatile products.

Chart 1

Headline inflation, current vs. historic

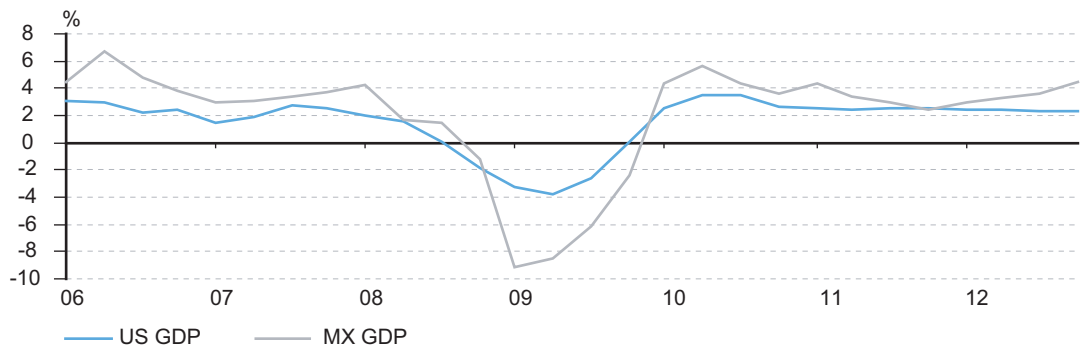


Source: Banco de México y BBVA Research

The second element is the economic recovery. The Mexican economy could grow by between 4.5% and 5.0% in 2010. This expansion would be grounded in rising external demand, which would provide 60% of the growth. But the reactivation of domestic demand, especially private consumption, will remain weak because of a limited growth in individual labor income. In the second half of the year, the pace of economic growth could slow as projected international economic growth also loses speed.

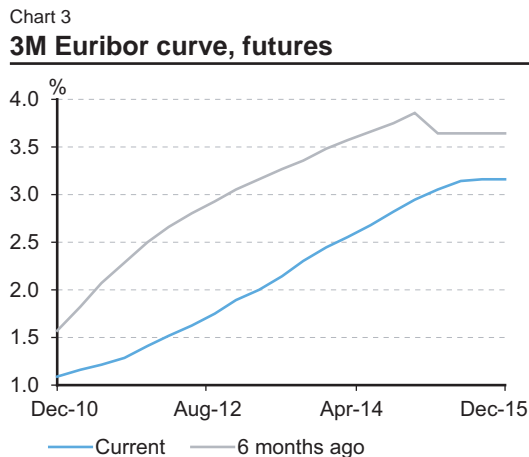
Chart 2

Economic growth, realized and forecast

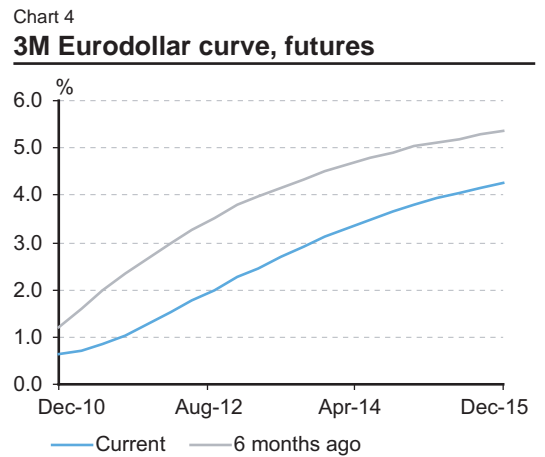


Source: Bloomberg and BBVA Research

The third and final element supporting expectations of a prolonged monetary pause is the global market climate, where risk premiums have risen in the wake of the Eurozone sovereign risk crisis and its impact on slower global economic growth (the US growth estimate dropped to 3% and, for Europe, the forecast is 0.7%). This has prompted central banks to keep their rates low for longer periods of time –a situation clearly seen in the 3M Euribor and Eurodollar futures curves, where rates on the September 2011 contracts are at 1.29% and 1.05%, down from 2.29% and 2.34% at the start of the year, respectively.

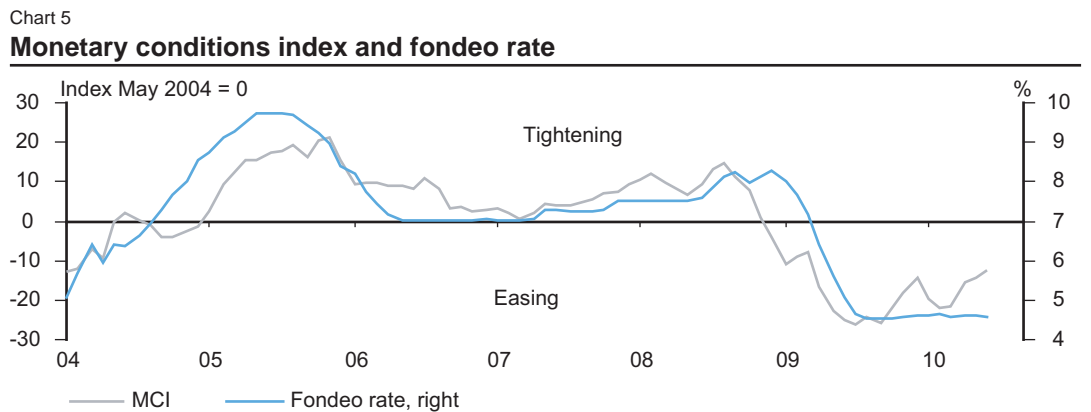


Source: Bloomberg and BBVA Research



Source: Bloomberg and BBVA Research

Ongoing monetary conditions are lax, as seen in our monetary conditions index (MCI), indicating that current conditions remain in an accommodative range. Although the degree of laxness has diminished since February, it remains slightly below the previous maximum easing (early 2004). The movement since February is due to the peso's appreciation in real terms, and adding to this, in the past three months, an increase in real rates (6M Cetes) due to lower 12M inflation as discussed above and, to a lesser extent, the rise in sovereign risk as gauged by the 5Y CDS spread).

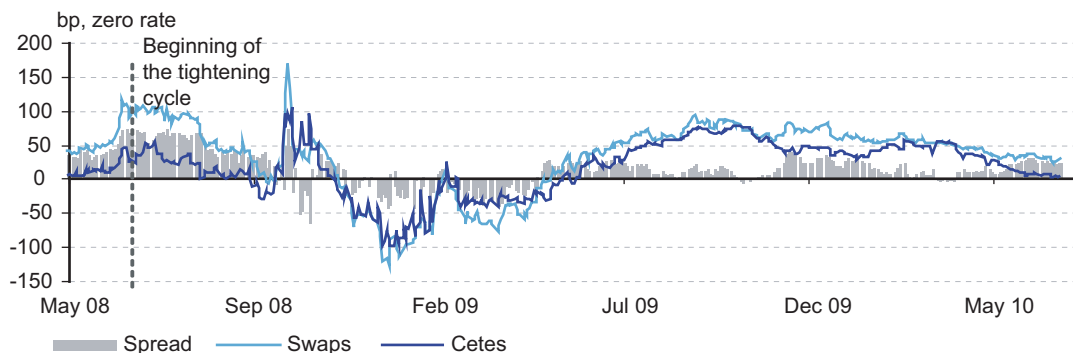


Source: BBVA Research

The scenario of a more prolonged monetary pause can be seen in the slope of the Cetes and swap curves, where 1Y-1M spreads are less than 8bp and 30bp, respectively. Spreads have not been this narrow since June 2009, and they remain 22bp and 60bp lower, respectively, than their average at the start of the restrictive cycle (June 2008).

Chart 6

Monetary curve slopes (1Y-1M)



Source: Bloomberg and BBVA Research

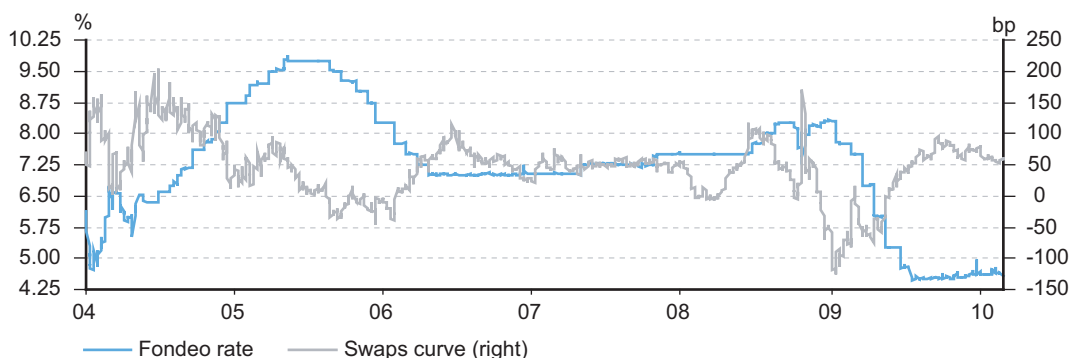
These elements justify Banxico's decision to delay altering its lax monetary policy stance. We now expect it to raise rates in April 2011, applying successive 25bp hikes to reach 6% by September of that year.

Medium- and long-term view

From a medium and long-term perspective, we see conditions for a selloff at the middle and long end of the Cetes and swaps curves. This would occur as the curves price in higher inflation premiums, and it may happen more quickly if rates are normalized sooner. This said, we expect a flattening toward the first quarter of 2011.

Chart 7

Central bank bias and swap curve (1Y-1M)



Source: Bloomberg and BBVA Research

Table 3

Medium- and long-term forecast, monetary market

%	Current	2009	3Q10	4Q10	1Q11	2Q11
1M Cetes	4.59	4.51	4.57	4.66	5.05	5.63
3M Cetes	4.64	4.61	4.68	4.83	5.27	5.83
1Y Cetes	4.74	5.07	5.05	5.55	6.02	6.37
1Y-1M slope (bp)	15	56	48	88	97	74

Data at close period. Update 16-07-2010

Source: BBVA Global Markets Research, S.A.

Debt markets

Additional room for curves to rally

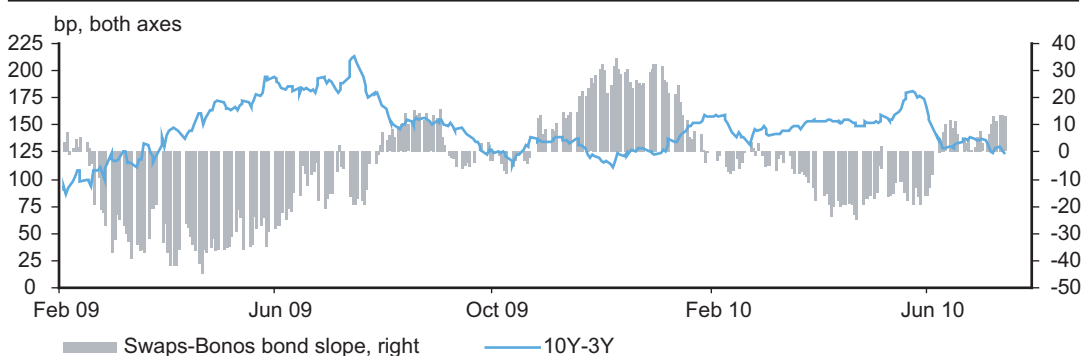
- Amid a global search for attractive yields and a selective preference for less vulnerable assets, Mexican debt instruments have fared well.
- Appetite is stronger for longer durations in Bonos, justified by an expected rise in inflows.
- Expectations of a prolonged monetary pause fuel appetite at the long end of the bond curve.

Short-term view:

The rally in the Bonos market in the first quarter of the year was concentrated in lower-term instruments (84bp and 68bp in the 3- and 5-year paper, respectively), while in the second quarter the rally was stronger at the middle and long end (100bp and 89bp in the 7- and 10-year bonds, respectively). Thus, in recent weeks, increased demand for longer durations reflects prospects of lower inflation and expectations of a more extensive monetary pause (see Monetary market section). This is seen in the 48bp flattening of the curve (10Y-3Y spread) over the past six weeks. The swap market also saw a stronger rally at the long end (58bp) and a 14bp flattening in the last 6 week. We think there is still value in this segment of the curve, and it is justified by three elements.

Chart 8

10Y-3Y Bonos slope and spread vs. IRA



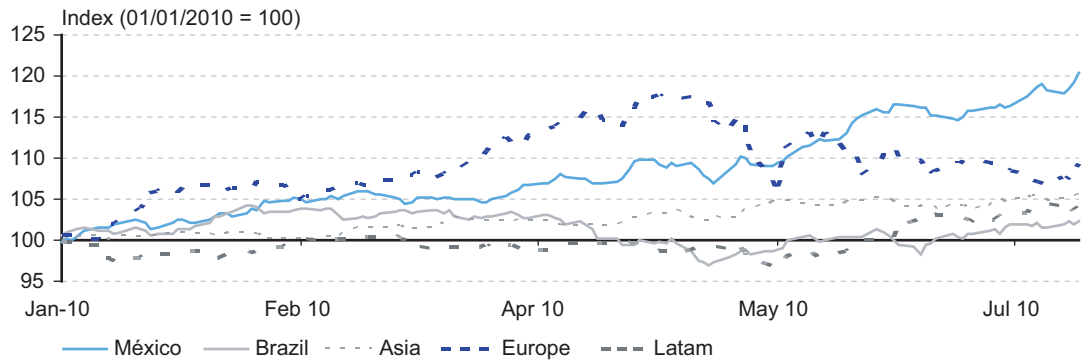
Source: Bloomberg and BBVA Research

1. Relative value

Mexican bonds have been doing well since the start of the year, outperforming other countries (see Figure 9). To date, the rally in Mexico in the year to date, measured by the 10Y GBI, has been 17% stronger than Brazil's and 15% greater than Latam's. This indicates selectivity based on relative vulnerability indicators.

Chart 9

Bonos trend (10Y GBI) on the global market



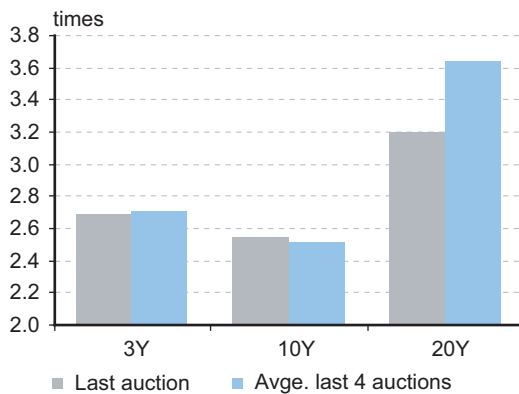
Source: Bloomberg and BBVA Research

2. Greater liquidity

Our valuation of the long end of the curve is justified by greater market liquidity, which has translated into an increased appetite for longer durations. Thus, the bid-to-cover ratio in primary auctions has been markedly high at the long end of the curve. Furthermore, this heightened liquidity is evident in the rising inflow of foreign and institutional investment (mutual funds and Afores) (see Figure 10) which, according to early July figures, show that foreign investors had Bono holdings of MXN370bn and institutional investors MXN400bn, both showing higher Bono holdings after portfolio reshuffling (see Figure 11). Naturally, Mexico's inclusion in the WGBI is one reason for the rally in bond prices, and we think there are more flows still to come, which should continue to feed appetite in coming weeks.

Chart 10

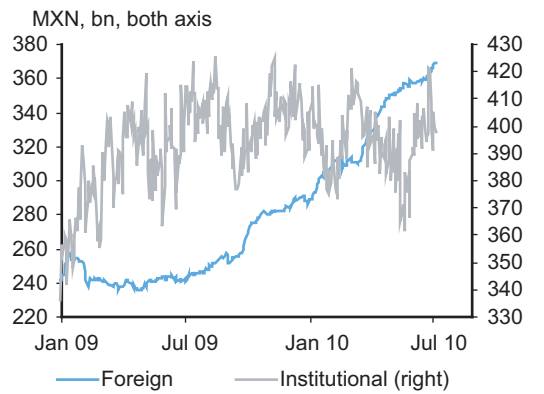
Bid to cover (Bonos)



Source: Banco de México and BBVA Research

Chart 11

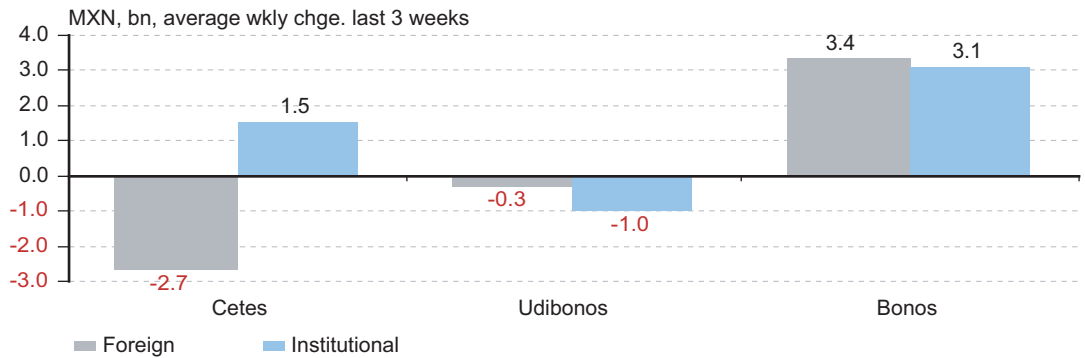
Bono holdings among investors



Source: Banco de México and BBVA Research

Chart 12

Weekly change in Bono holdings



Source: Banco de México and BBVA Research

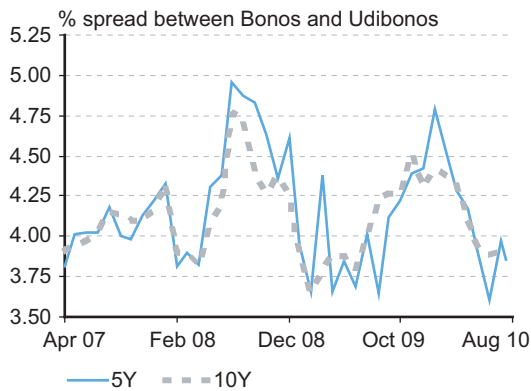
3. Monetary cycle outlook

The flattening of the bond curve is justified by expectations of a prolonged monetary pause (see details in Monetary market section).

In this climate, it is important to analyze the value of Bonos and Udibonos. To this end, we estimated the real spread on the former using the estimated 4-year inflation). Our estimator indicates that at currently expected inflation levels, long-term bonds offer a higher yield in real terms than Udibonos. Short- and medium-term Udibonos, however, offer higher yield than bonds, so we recommend opening long positions in these terms.

Chart 13

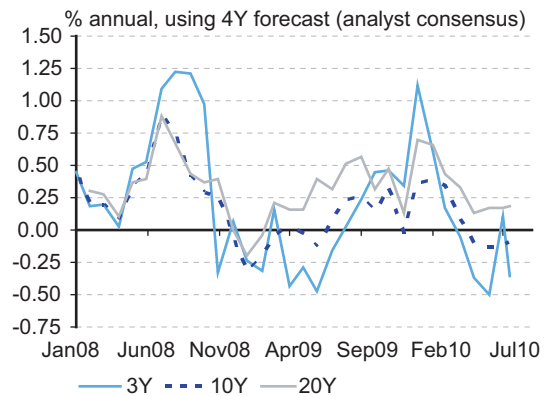
Implied inflation in the Bono curve



Source: BBVA Research

Chart 14

Real spread: Bonos vs. Udibonos



Source: BBVA Research

In the short term, these elements may continue to drive a flattening trend in bond curves, with strong appetite for longer durations. Additionally, indexed instruments show value at short and medium terms.

Medium-term view

We see a curve flattening toward year-end based on a scenario of rising inflows toward longer-term fixed-income assets, as well as our expectations (discussed above) of a prolonged monetary pause. Once the inflation premium is priced in, we see the curve steepening toward the first quarter of next year.

Table 4

Debt markets medium and long-term forecast

%	Current	2009	3Q10	4Q10	1Q11	2Q11
3Y Bond	5.40	6.72	5.52	6.14	6.70	7.01
10Y Bond	6.65	7.97	6.77	7.22	7.74	7.97
20Y Bond	7.24	8.57	7.37	7.83	8.30	8.41
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* All data end of period, updated 16-July-2010

Source: BBVA Research

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