

Global Research

**Mexico: Macroeconomic
outlook for 2010**

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The world's local bank

Mexico: Outlook for 2010

Mediocre economic recovery and volatile politics; nonetheless, stable macroeconomic framework

Background:

- Drastic recession, which started in Q1 2008 and ended officially in 3Q 2009
- At present, we have a trajectory of economic recovery

Short-term and medium-term real GDP forecast:

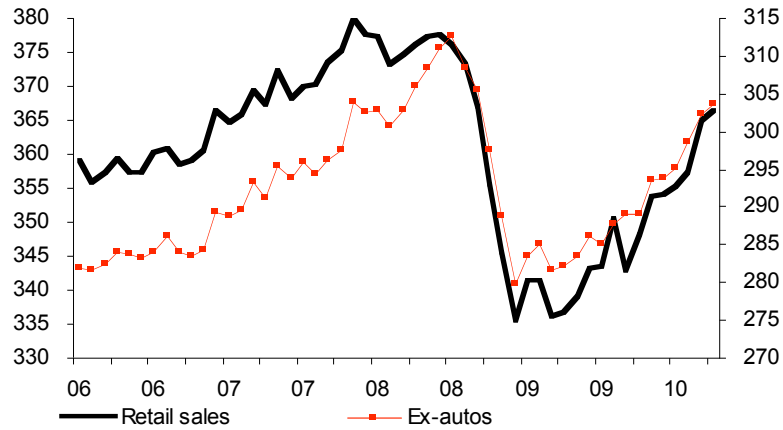
- Real GDP growth rate at 3.6% in 2010
- However, recovery is unequal for manufacturing and non-manufacturing
- A difficult crisis, but less strenuous than in the past
- Mexico will not reach 2008 GDP level until end-2011, we believe

Macroeconomic framework in 2010:

- Slightly higher inflation, strong exchange rate, and low interests rates
- A relatively benign external sector with higher current account deficit, but adequate capital inflows that will allow substantial international reserve accumulation
- A positive fiscal impulse, and some tightening in monetary policy
- Credit to the private sector may improve

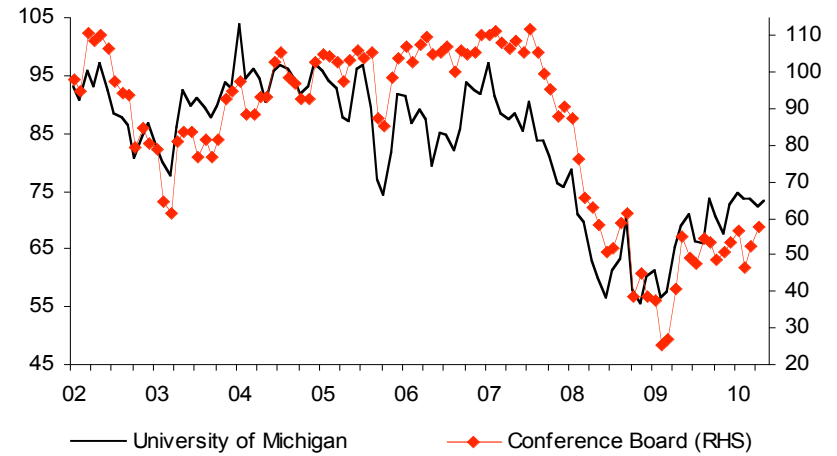
US: Economic overview

Retail sales



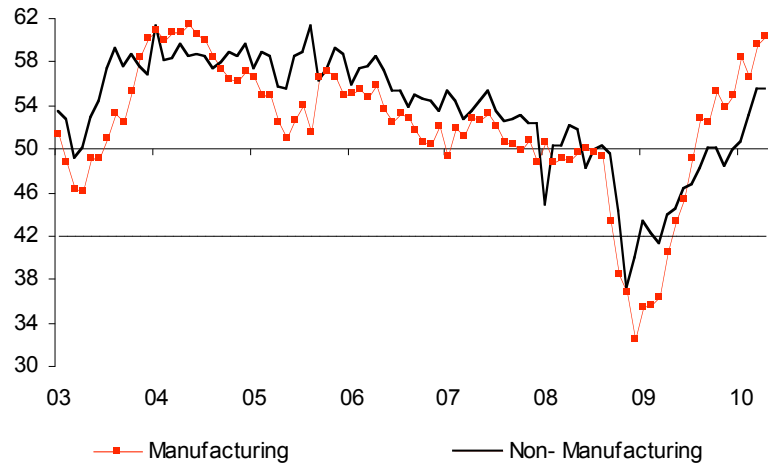
Source: Bloomberg

Consumer confidence



Source: Bloomberg

ISM manufacturing and non-manufacturing



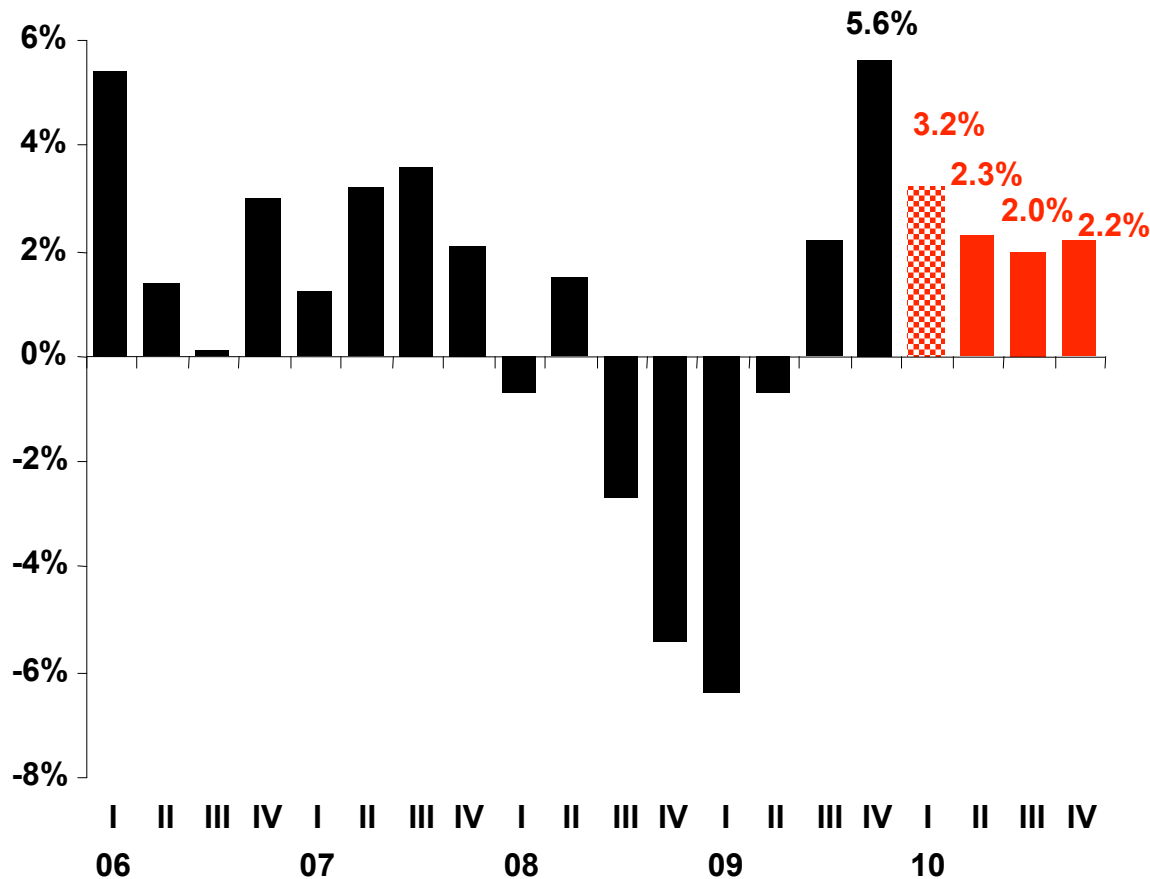
Source: ISM

Housing sector: Sales and prices



Source: Bloomberg

US: Real gross domestic product



▶ **Recent trend:** According to the advance estimate, GDP grew 3.2% (q-o-q, saar) in 1Q10. This increase reflected positive contributions from personal consumption expenditures (PCE) (3.6%), private inventory investment, exports (5.8%), and non-residential fixed investment (4.1%). These were partly offset by an increase in imports and decreases in state and local government spending (-3.8%) and in residential fixed investment.

▶ **Short-term expectation:** The contribution from inventories in 1Q10 was perhaps a little stronger than expected, but the ability of this category to support growth further during the remainder of 2010 now appears limited. It is the rate of change in inventories across quarters that determines their impact upon GDP. Thus, even an additional rebuilding of inventories will provide much less support to the GDP figure, leaving growth to be determined by the real fundamentals of the economy. A clearer picture of the post-crisis US economy is now emerging, and there is seemingly little on the horizon that will force policymakers to steer a substantially different course any time soon.

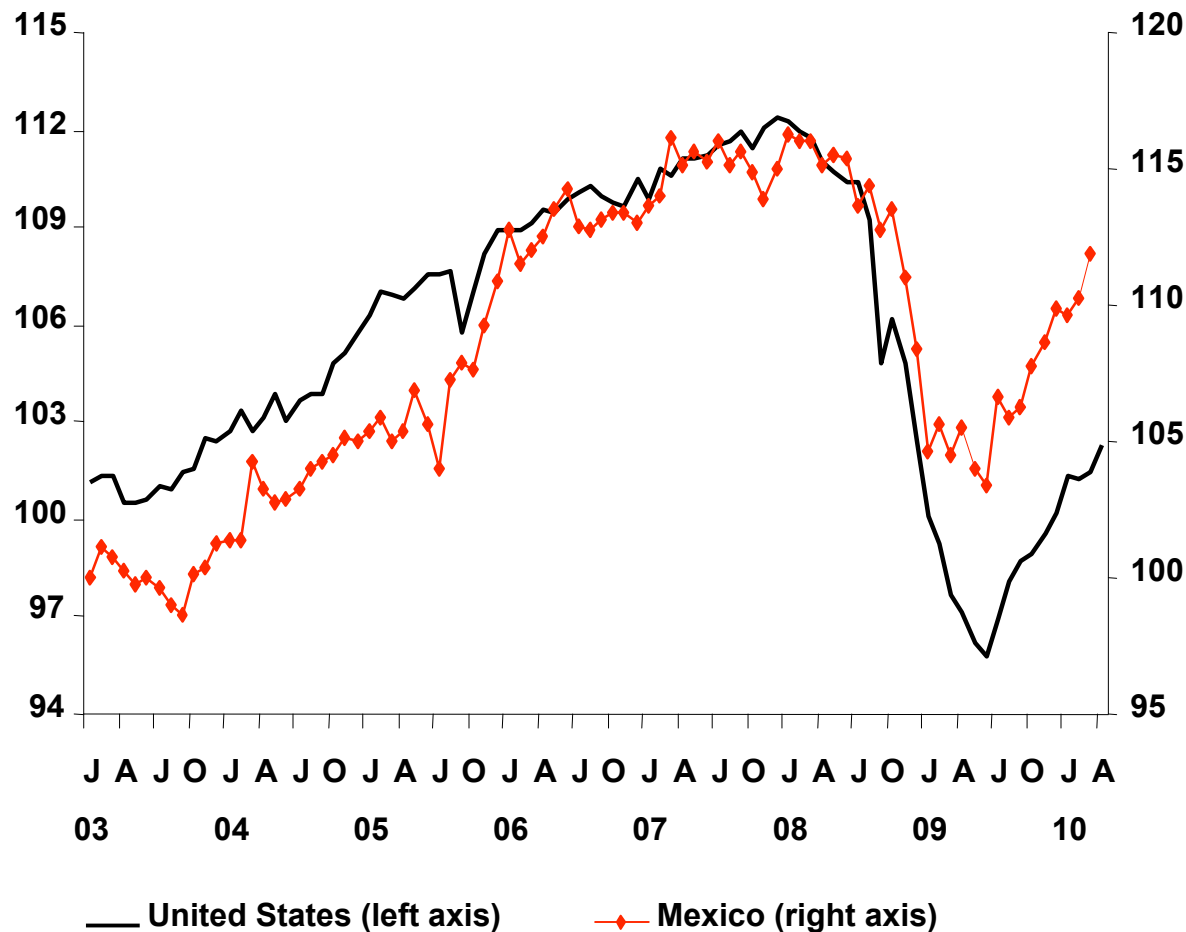
▶ **Forecast 2010:** 2.7%

▶ **Forecast 2011:** 2.5%

Source: BEA

Industrial production: US and Mexico

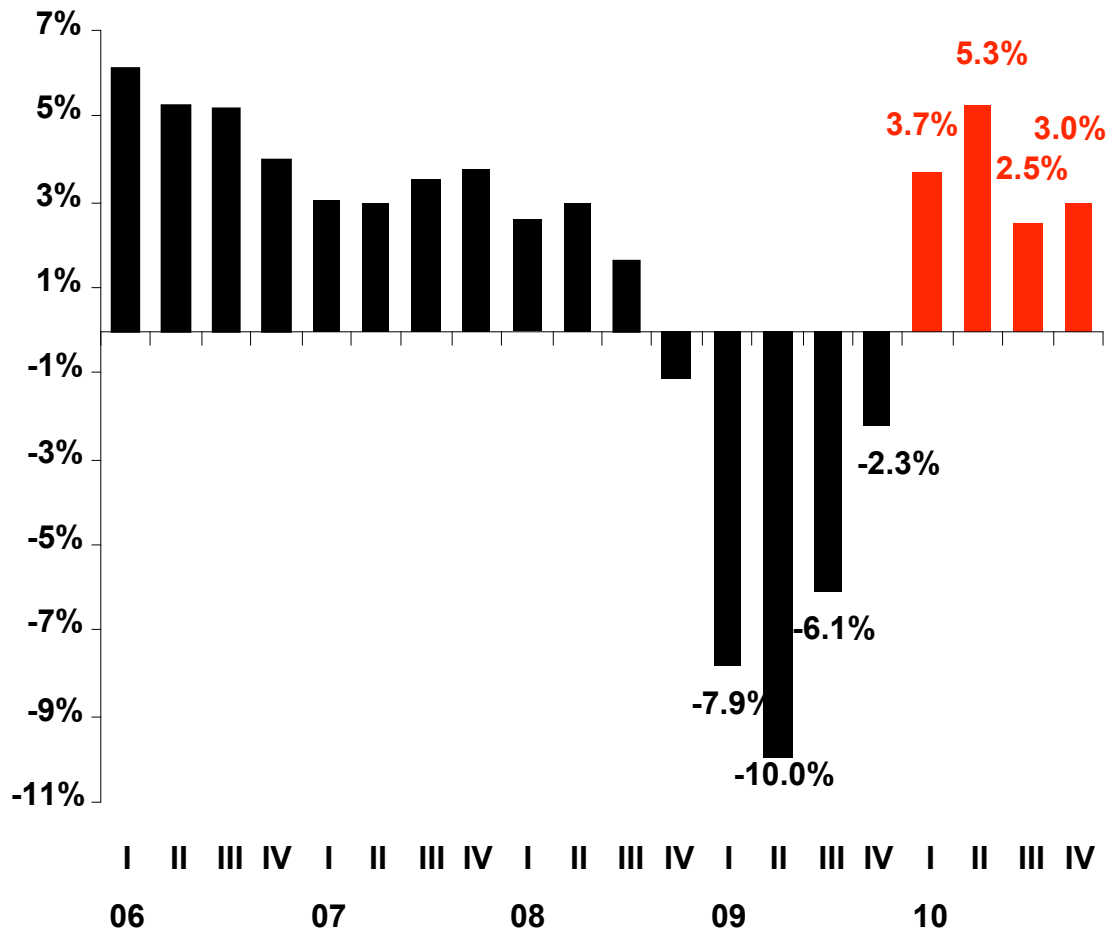
(seasonally adjusted series)



- ▶ **Recent trend:** April industrial production came in slightly above expectations, rising by 0.8% (consensus 0.7%). Manufacturing output not only climbed 1.0% in April for a second consecutive month and was 6.0, but manufacturing improvements continued to be broadly based across industries. Outside of manufacturing, the output of mines rose 1.4%, and the output of utilities decreased 1.3%.
- ▶ In Mexico, in March, industrial production came in above market expectations, increasing 7.4% in annual terms and 0.9% in seasonally adjusted terms. Although the annual reading was helped by a low statistical base, the expansion in seasonally adjusted terms reflects the view that this sector continues to improve at the margin. In effect, the positive monthly result reflects a broad-based improvement, with manufacturing leading the way.
- ▶ **Main driver:** US industrial production is the main source of non-oil exports, which, in turn, determine industrial production in Mexico.

Mexico: Real GDP growth

(year over year, base year 2003)



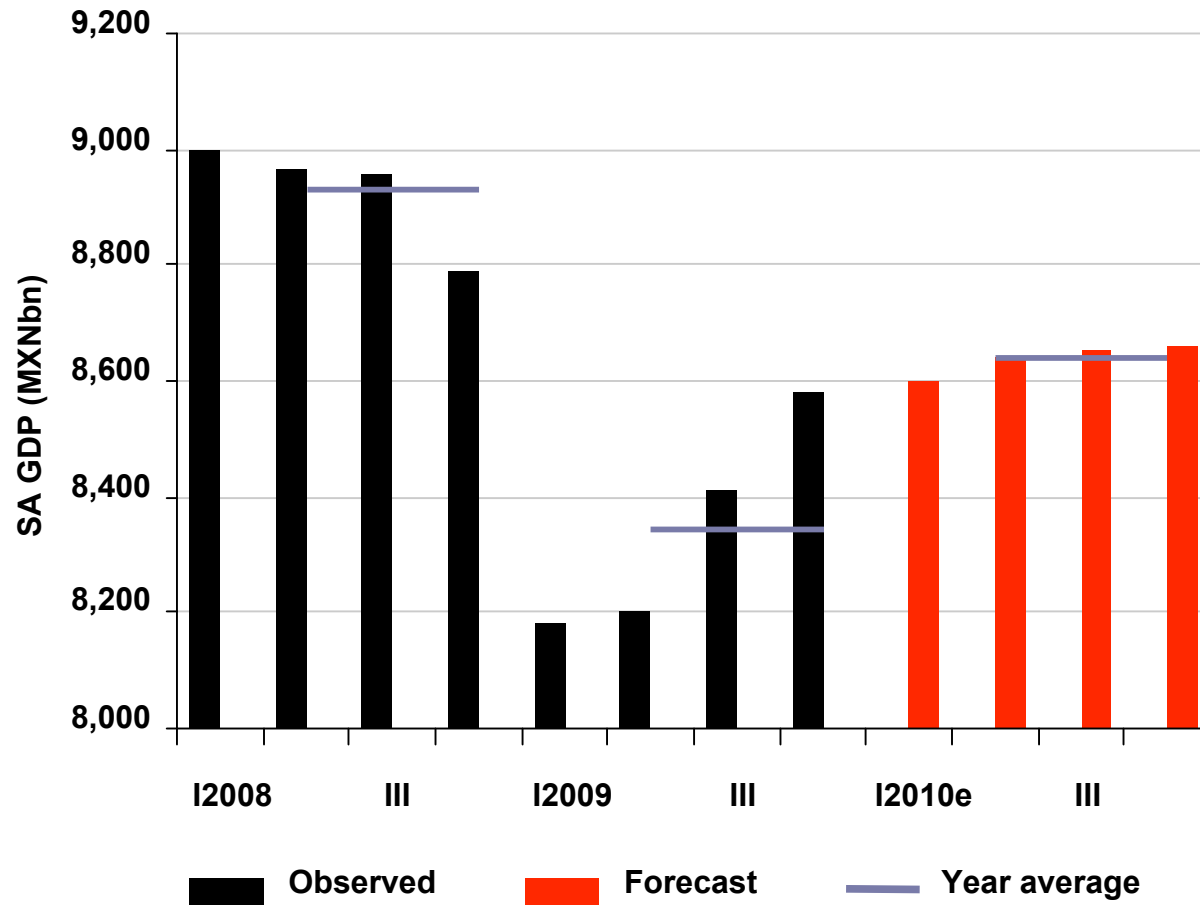
▶ **Recent trend:** Real GDP growth for 4Q09 was above expectations coming in at -2.3% y-o-y. As a result, GDP annual contraction for 2009 was better than expected, coming in at -6.5% y-o-y. (consensus: -6.9%; HSBC: -6.6%). The main driver in 4Q10 was the recovery observed in the secondary sector with a growth rate at 3.1% (q-o-q); playing along, the primary activities and tertiary activities were also positive at 0.9% and 1.0% (q-o-q), respectively. This pattern supports the trend towards recovery shown by several indicators, such as PMI.

▶ **Short-term expectation:** Currently there is an optimistic view on economic recovery among market analysts: some estimate that GDP growth could be as high as 5.5%. Authorities, including the IMF, are more cautious at 4.0% and consensus remains at 4.1%. This significant gain is mostly based on the 2009 low statistical base and the global economic recovery, particularly from the US. While we concur with this optimistic view, we maintain our GDP growth rate projection at 3.6% until harder data indicate more clearly the strength of the recovery.

▶ **Forecast 2010:** 3.6%

▶ **Forecast 2011:** 3.4%

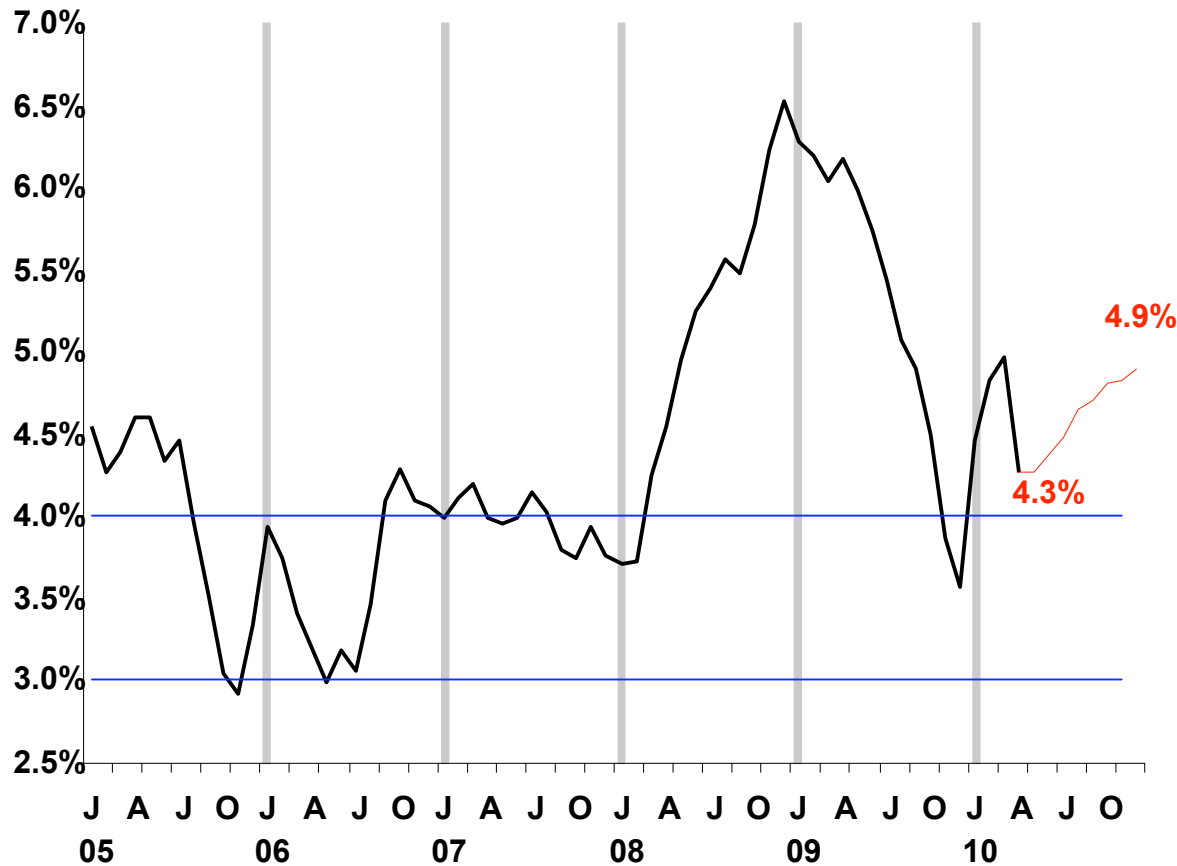
Mexico: Seasonally adjusted GDP (base year 2003)



- ▶ **Q-o-Q seasonally adjusted GDP:** The quarterly dynamics show an interesting pattern: we see that in Q209, we reached bottom, in Q309, the recession ended, and in Q409, the recovery continued.
- ▶ **Short-term expectation:** On a quarter-over-quarter basis, we expect the economy to keep posting positive results in 2010, albeit at a more moderate pace.

Source: INEGI

Mexico: CPI annual inflation rate



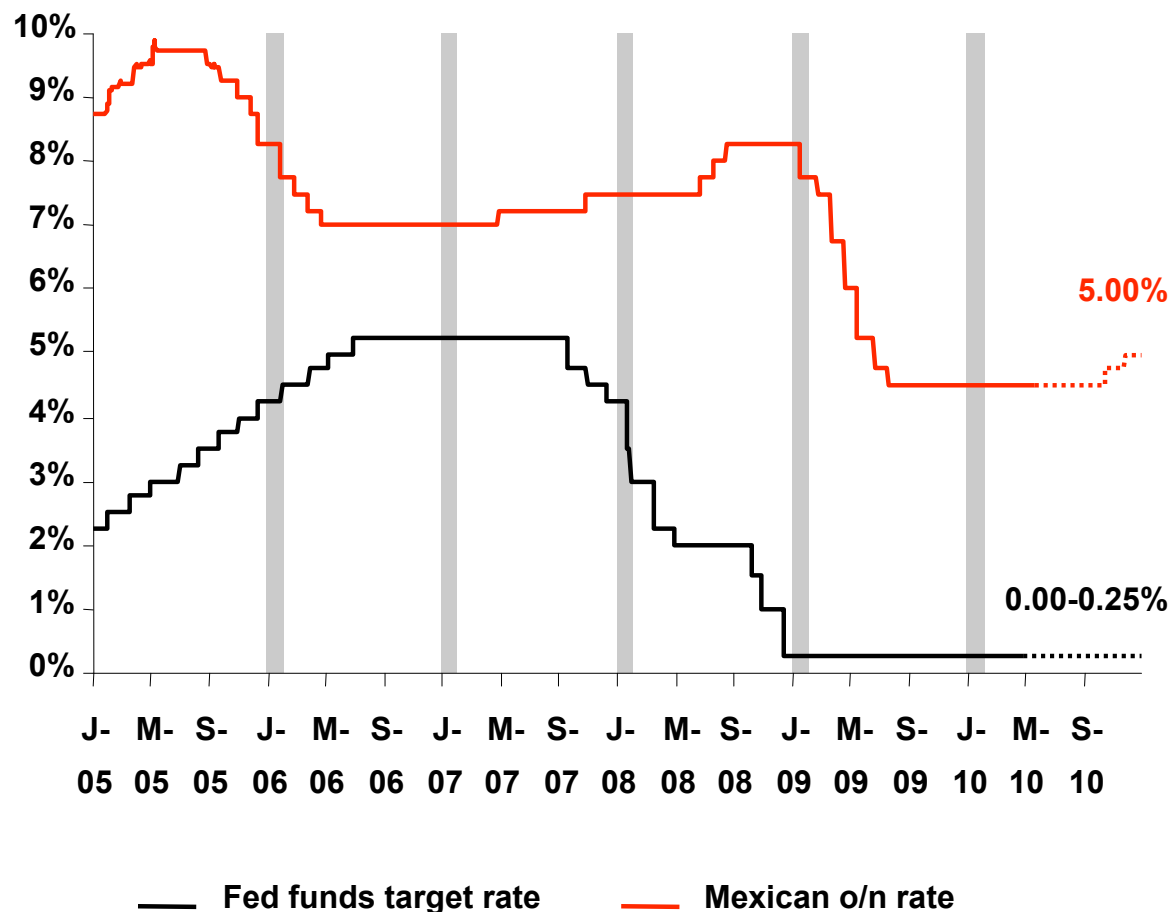
▶ **Recent results:** In April, headline inflation came in at -0.32%, below expectations (HSBC: -0.18%; consensus: -0.16%). Annual headline inflation declined to 4.27% from 4.97%. Core inflation was also lower than expected, reporting a monthly increase of 0.11%, and its annual reading declined to 4.11% from 4.40%. These positive results were a nice surprise, even when the strong decline in inflation in 1H April (0.3%) is taken into account. We believe that this result is mainly the product of a seasonal pattern caused by the reduction in electricity tariffs in the hottest parts of the country. However, also playing an important role in the overall reduction was the lower-than-expected reading of the "fruits and vegetables" item. In effect, fruits and vegetables declined 5.0% in the month, explaining 0.2% of the reduction in the monthly inflation.

▶ **Short-term expectation:** Headline inflation is expected to decrease 0.3% in May, leaving the annual rate at 4.3%.

▶ **Year-end 2010:** 4.9%

▶ **Year-end 2011:** 3.4%

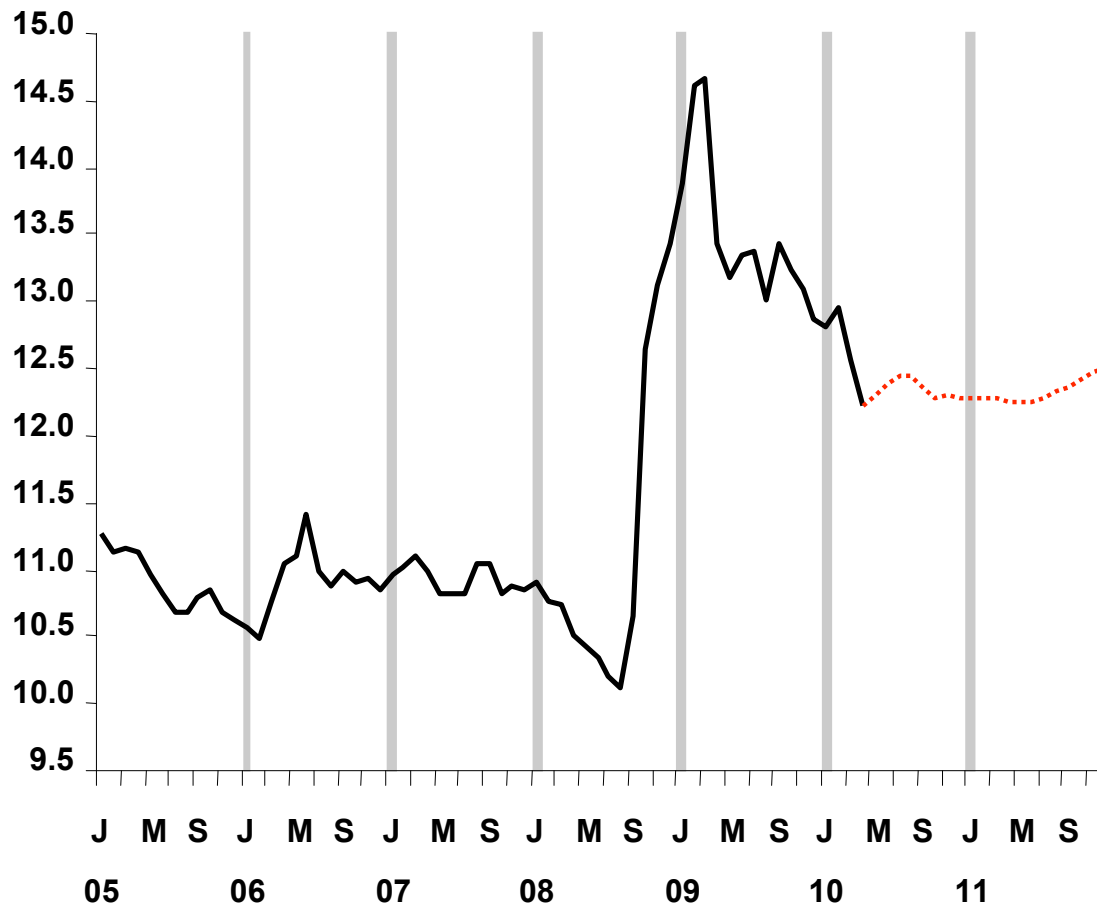
Monetary policy: Overnight rates for Bank of Mexico and Federal Reserve System



- ▶ **FOMC policy decision 28 April:** As expected, the Fed decided to keep the interest rate range unchanged. This month's FOMC statement was not expected to be a thriller, with very few changes emerging from last month's communiqué, save for a minor upgrade to the assessment of current economic conditions.
- ▶ **Banxico policy decision 16 April:** As expected, the central bank kept unchanged the monetary policy at 4.50%. The Board also maintained a dovish tone. It pointed out that economic activity is still below potential GDP. However, the central bank also emphasized that it would watch closely the speed at which the negative output gap closes. We see no change in the policy or tone until 4Q10, when we expect 25bp hikes in October and November to bring the monetary policy rate to 5% at end-2010.
- ▶ **Forecast:** We expect the FOMC to keep the target range (0.0-0.25%) in 2010. We expect Banxico to continue to hold the interest rate in 4.50% until 4Q10.

Source: Banxico

Mexico: Exchange rate



- ▶ **Main drivers:** MXN-USD has returned to the 13.30 level as the risk aversion of last week has eased. The technical position has improved, so the vulnerability of the currency has diminished. MXN will remain subject to volatility, in our view, but given the solid fundamentals, MXN should return to around 12.20.
- ▶ Upcoming IPOs should give some support to MXN in coming weeks.
- ▶ The main risk we see for the peso is the situation in Greece over the coming weeks.
- ▶ **Year-end 2010 forecast:** 12.25
- ▶ **Year-end 2011 forecast:** 12.50

Source: Banxico

Handicaps and advances

Key handicaps:

- Low productivity
- Low human capital development
- Low-quality physical infrastructure
- Labor market inflexibility
- Monopolistic structure
- Dominance of unions in key sectors
- Fiscal dependence on oil revenues
- Fiscal evasion
- High poverty level
- Dysfunctional political system

Advances:

- Trade opening
- Solid fiscal and monetary policies
- Fiscal responsibility law
- Public sector debt reduction
- Anti-monopoly Federal Commission

Mexico: Main projections

	2008	2009	2010e	2011e	2012e	2013e	2014e
Gross domestic product (% y-o-y)	1.5	-6.5	3.6	3.4	4.5	3.0	3.0
GDP (USD bn)	1,087.5	874.9	1,042.5	1,136.1	1,225.2	1,303.1	1,385.6
Unemployment rate (average %)	4.9	6.7	6.0	5.5	3.7	3.7	3.7
Consumer price inflation (eop)	6.5	3.6	4.9	3.4	3.4	3.4	3.4
Total fiscal balance (% GDP)	-0.1	-2.3	-2.8	-2.3	-2.0	-2.0	-2.0
Current account balance (% GDP)	-1.5	-0.6	-1.0	-1.6	-2.2	-2.4	-2.8
Monetary policy rate	8.3	4.5	5.0	6.0	6.5	6.5	6.5
Foreign currency reserves	85.4	90.8	103.8	115.6	127.6	140.6	153.3
Local Currency/USD (year-end)	13.8	13.1	12.3	12.5	12.6	12.8	12.9

Source: HSBC

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