MEXICO OUTLOOK 2010

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Mexico's challenges and opportunities for 2010

Mexico SWOT analysis[1]

Strengths	Weaknesses
• Public spending boosted by gubernatorial elections	• Higher taxes and administered prices
• Responsible fiscal stance	• Lack of meaningful structural reforms
• Oil hedge	• Uncompetitive market structure
• Pemex contracts	• Inflexible labor market
• Infrastructure projects	• Violence related to the war on drugs
• Skilled labor force (manufacturing)	
Opportunities	**Threats**
• Depreciated peso	• Fiscal and monetary "exit strategies" abroad
• High energy costs	• Better investment opportunities in other emerging economies
• Revaluation of Asian currencies	

Source: J.P.Morgan

1. SWOT analysis is a strategic planning method used to evaluate the Strengths, Weaknesses, Opportunities, and Threats involved in a project or in a business venture is credited to Humphrey, Albert (1970).

Manufacturing activity will lead the recovery, while inflation will be the most important challenge

We divided the most important general things in strengths and weaknesses on the internal side, and opportunities and threats on the external side

- (1) **Strengths**: Mexico's growth could benefit in year 2010 by public spending at the state level usually spurred by gubernatorial elections that will take place in ten states. Moreover, we believe that two other strengths on the fiscal side are the oil hedge that the Government implemented during this year, as well as the possible implementation of the Pemex's incentive contracts

- (2) **Opportunities:** The Mexican skilled labor, particularly in the manufacturing sector. The 21% depreciation of the peso vis-à-vis the US dollar that took place during 2009, and the consistently high energy costs combined with Mexico's strategic geographic location and the skilled labor force, all have provided incentives for automakers to relocate part of their production to Mexico. The large fiscal deficits abroad could be an opportunity for Mexico as a better investment destination, particularly as it is one of the very few countries that have recently adopted a more stringent fiscal stance

- (3) **Threats:** One of these "threats" is the "exit strategies" of countries that have implemented large stimulus packages will probably have to adopt soon. This could become a global growth cap in the short term. Another threat to Mexico's growth could be the deviation of foreign direct investment towards economies that could be more attractive than Mexico due to upcoming structural reforms or because of easier and more flexible ways to invest in key sectors such as oil or telecom industries

- (4) **Weaknesses:** These "threats" unfortunately lie on top some important "weaknesses" that will probably be relevant not only in year 2010, but in the medium term as well. Here we refer to the lack of meaningful structural reforms that are not fostering more competitive markets as well as a more flexible job market in Mexico. These, in addition to the increased violence that the war against local drug lords has unleashed are important factors that will continue in the minds of investors and market participants in their decision-making processes to assign a weight in their global portfolios

- And last, but not least, **one of the consequences of the recently-approved fiscal reform will be higher inflation**. Furthermore, the fiscal pressures that the government has experienced in 2009 will probably also spur a series of administered price hikes, particularly gasoline prices

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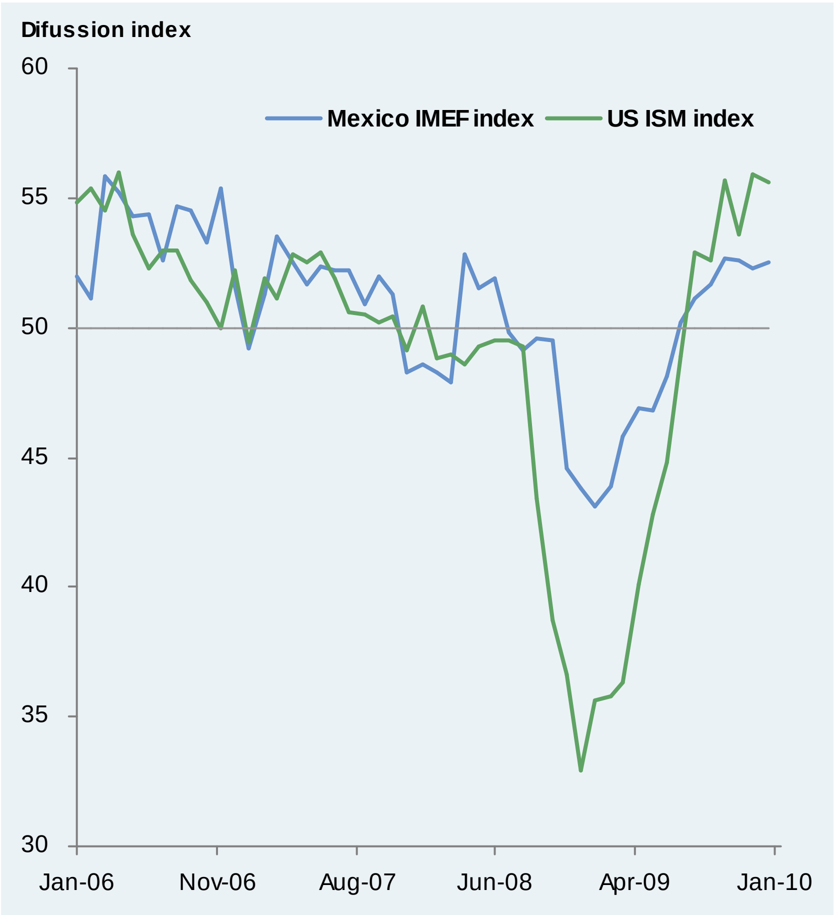
Economic activity is back on track with manufacturing driving the recovery

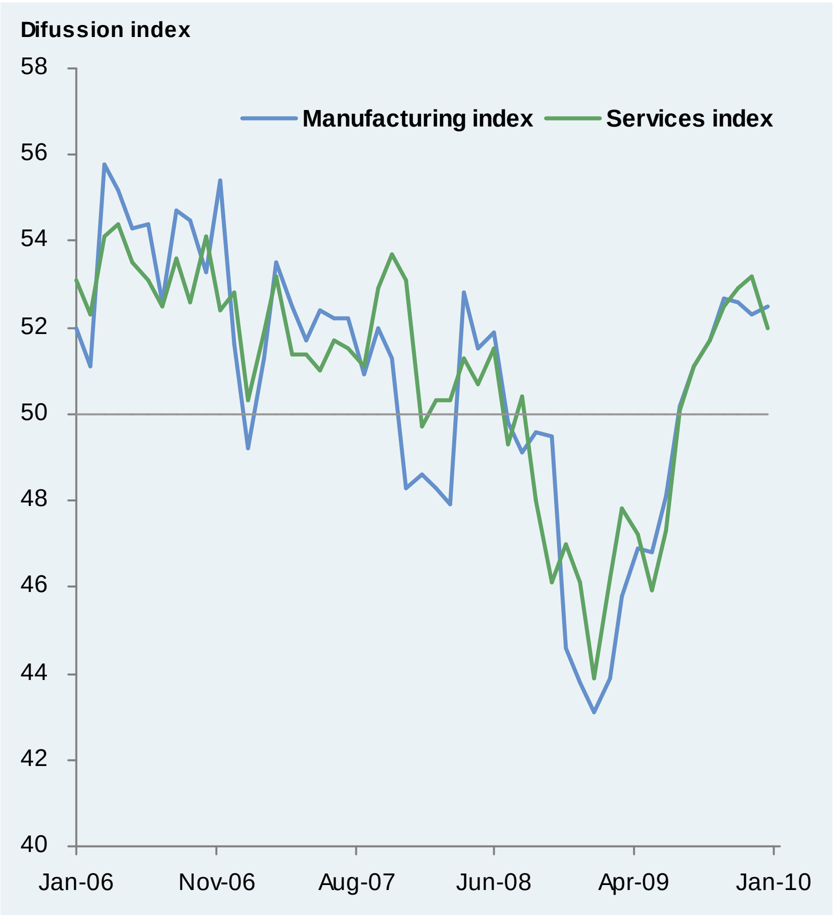
Furthermore, latest data points towards a more balanced rebound…

Mexico and US manufacturing PMIs



Source: IMEF and ISM

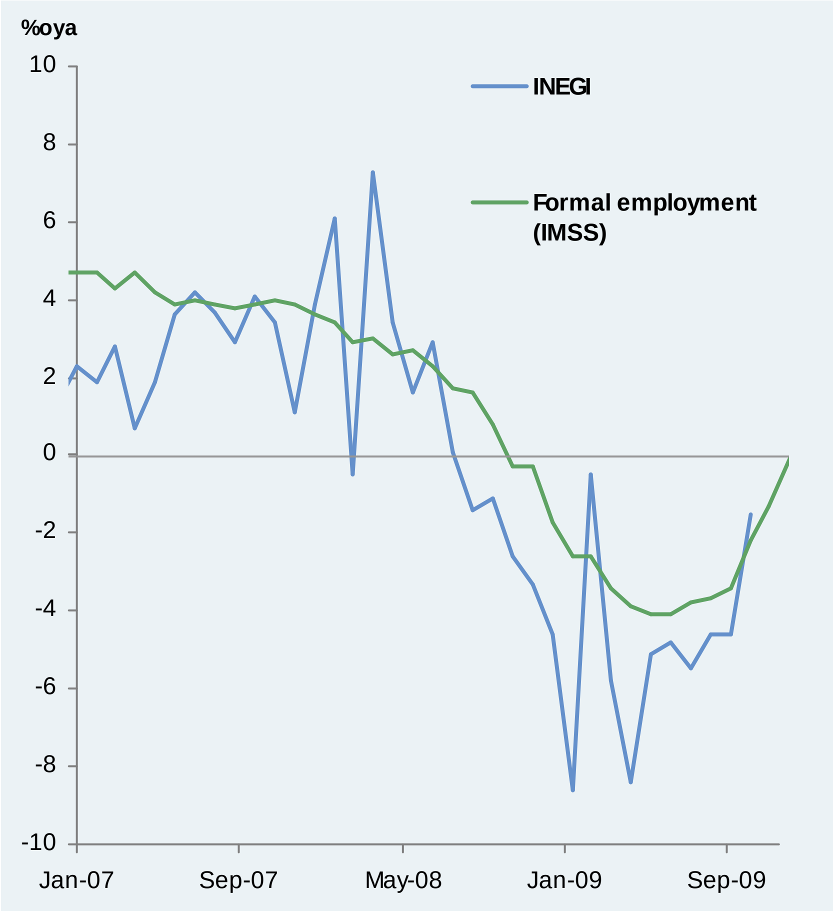
IMEF manufacturing and services PMIs



Source: IMEF

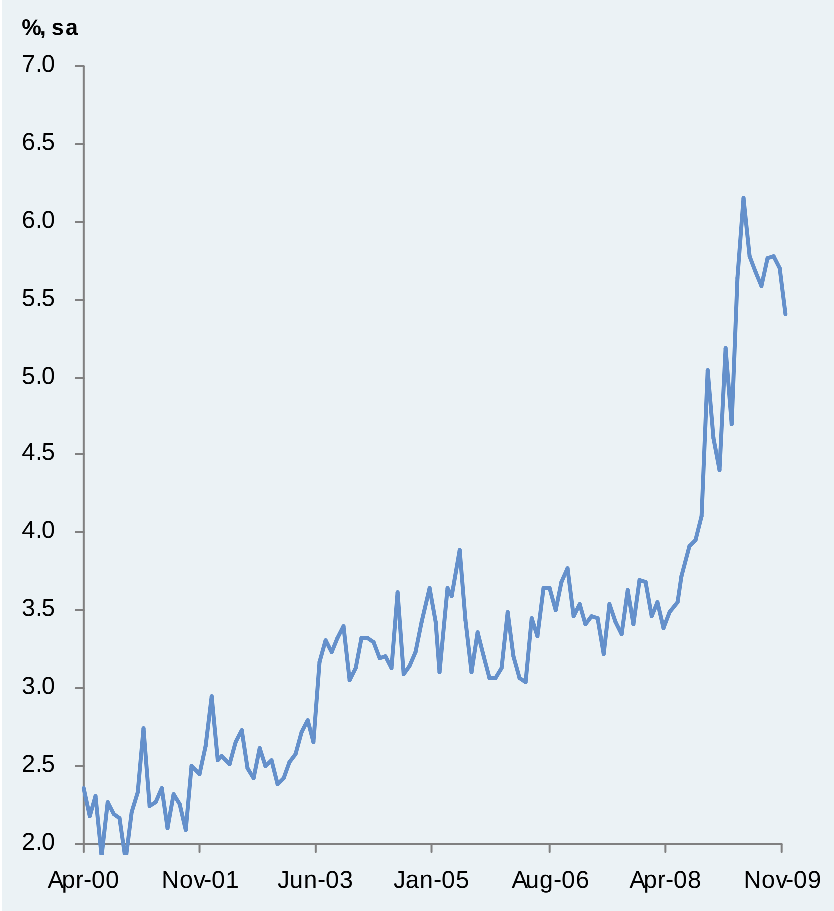
Labor market stress has eased, employment should support the rebound in 2010

Employment outlook



Source: INEGI and IMSS

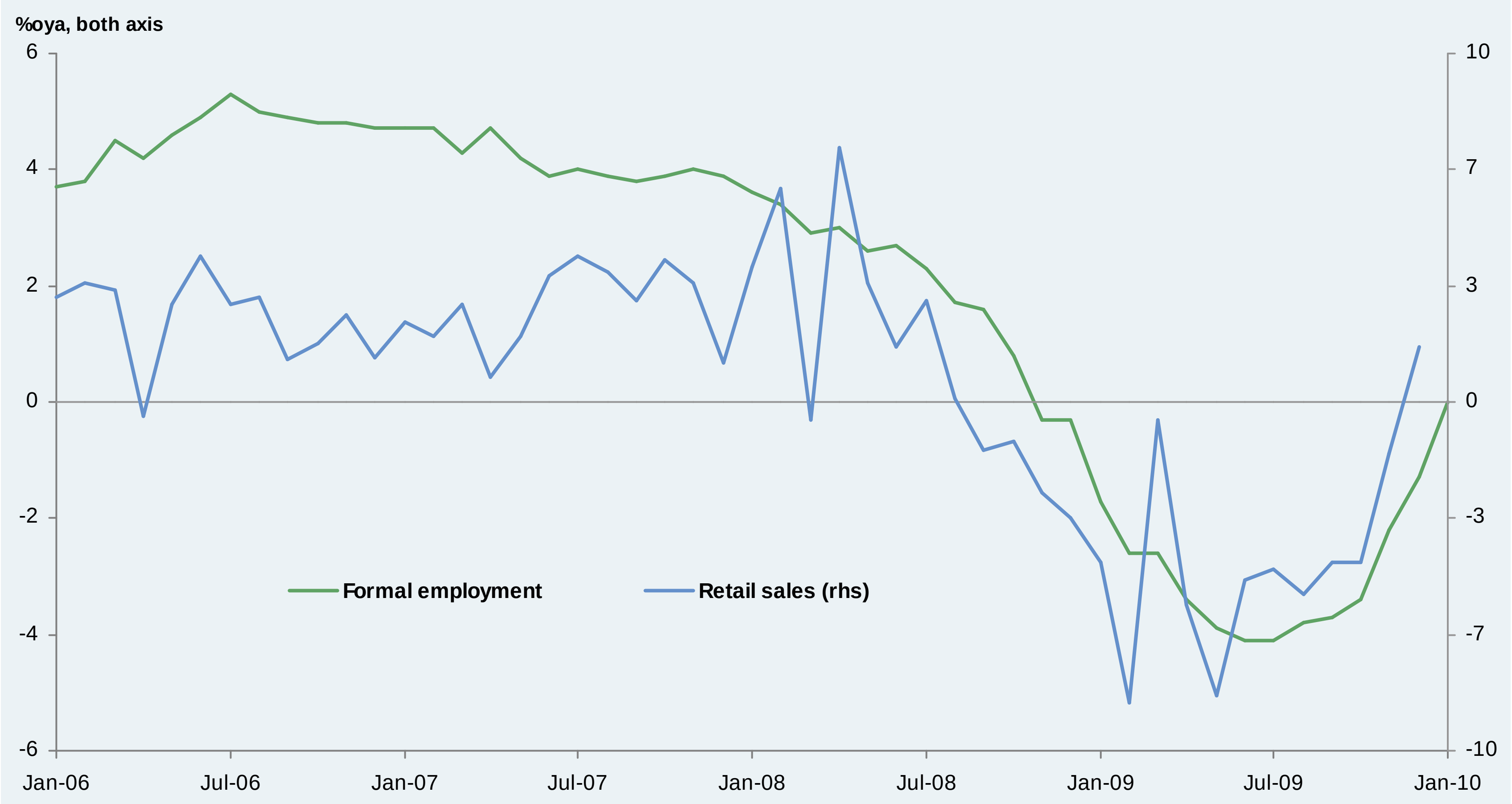
Unemployment rate



Source: INEGI

Domestic demand indicators suggest a moderate internal rebound is on its way…

Retail sales and formal employment



Source: INEGI and Banxico

We expect a stronger rebound in 2010

We recently revised our GDP estimations mainly because of three reasons:

- A stronger-than-expected manufacturing rebound
- A perception of sustain competitiveness. This comes mainly after comments from the Central Bank Governor and the Ministry of Finance that they will probably implement a foreign reserve accumulation program, even purchasing US dollars directly from the market. Here, even though we believe it is not going to be extremely substantial, we do believe that this will at least decelerate the still likely peso strengthening, at least once this sell off ends
- We have now observed that manufacturing improvement that has permeated into better employment conditions is now starting having also a positive effect on domestic demand

GDP forecasts (%oya)

	2009	2010	
	Actual	Current	Previous
GDP	**-6.5**	**4.5**	**3.5**
Supply side[1]			
Agricultural	1.8	1.5	3.3
Industrial	-7.3	4.5	4.0
Services	-6.6	3.5	3.4
Demand side			
Consumption	-5.1	3.5	2.9
Private	-6.3	3.8	3.2
Public	2.6	1.8	1.0
Gross fixed investment	-10.9	2.2	6.1
Net exports	-64.7	14.6	4.0
Exports	-15.8	14.5	15.0
Imports	-21.3	14.5	14.0

Source: J.P.Morgan.
1. Supply side figures for 2009 are actual values.

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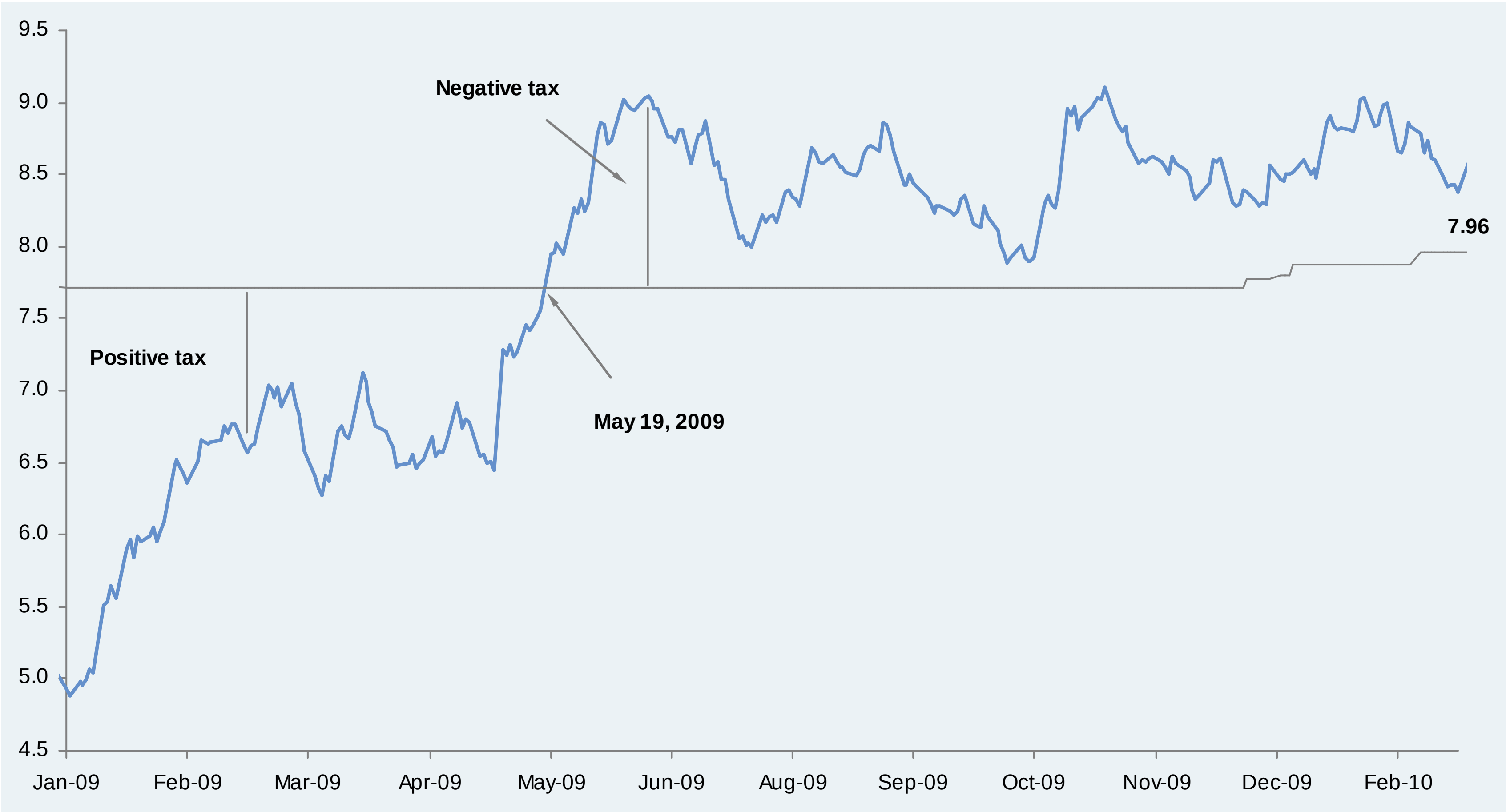
We anticipate inflationary pressures in 2010 on the back of new taxes and gasoline price hikes

- **We are forecasting 12-month inflation to end year 2010 at 5.4%**
- We estimate that the 1% increase in VAT and additional excise taxes (on beer, cigarettes, etc.), could contribute with 53bps to 12-month inflation, while we forecast an incidence of 66bps from our projected administered price hikes, and 40bps coming from second-round effects
- These are all 'once-and-for-all' supply-sided inflationary pressures
- However, even though the Mexican economy still observes a large output gap and medium-term inflation expectations remain well-anchored, manufacturing activity, domestic demand, and labor market conditions have improved
- This, in turn, could enhance Mexican workers' bargaining power and could increase the firms' pricing power, probably having an effect on expectations towards the second quarter of the year
- As a result, **we anticipate Banco de México will hike interest rates in June 2010** (Consensus: +25 bps on July 2010).

Gasoline prices started increasing since the second half of December

Low grade gasoline prices (MXN per liter)



Source: Pemex, Mexico's Consumer Protection Agency (Profeco), Bloomberg, and J.P. Morgan

We estimate a contribution of 169 bps to 12-month inflation in 2010, along the same lines as Banxico

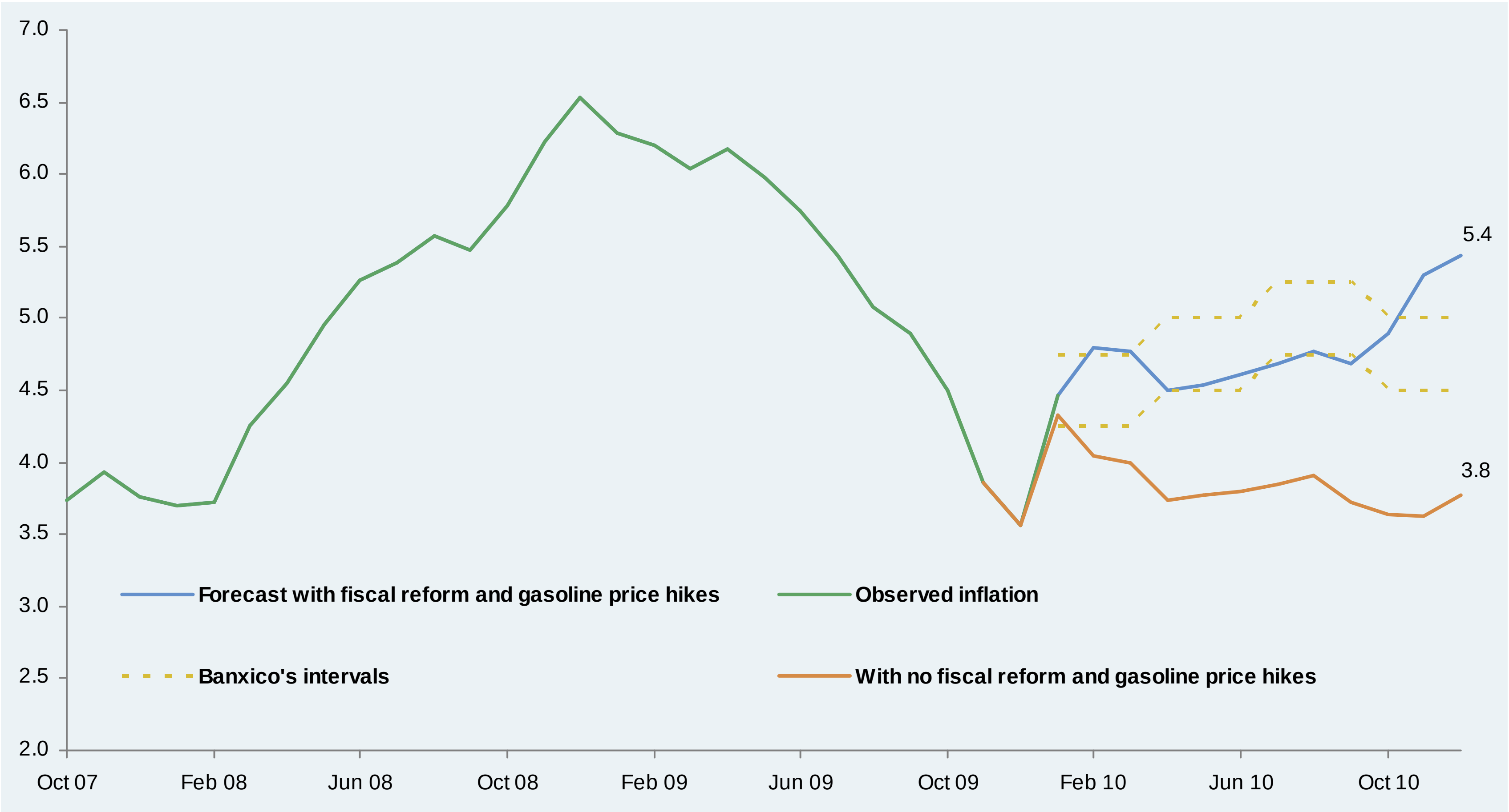
Estimations of the recently approved tax modifications as well as the administered price hikes to headline CPI inflation

	Banxico	J.P.Morgan
Total contribution (bp)	**169**	**169**
1. Tax modifications	**50**	**53**
a. 1% VAT increase	35	43
b. Excise taxes	10	10
Beer	2	--
Alcoholic beverages (above 20°GL)	1	--
Tobacco products	3	--
Telecom	5	--
c. Corporate income tax increase	5	--
2. Administered prices	**76**	**96**
a. Direct effects	62	46
Gasoline	32	36
Heating Gas	12	5
Electricity Tariffs	18	5
b. Second-round effects	14	50
3. Administered prices and taxes at the state level	**44**	**20**

Source: Banxico and J.P.Morgan
1. Total sum might not add up exactly due to rounding

We expect inflation to break above Banxico's upper-end inflation interval by year-end 2010

CPI inflation



Source: J.P. Morgan with data from Banco de México

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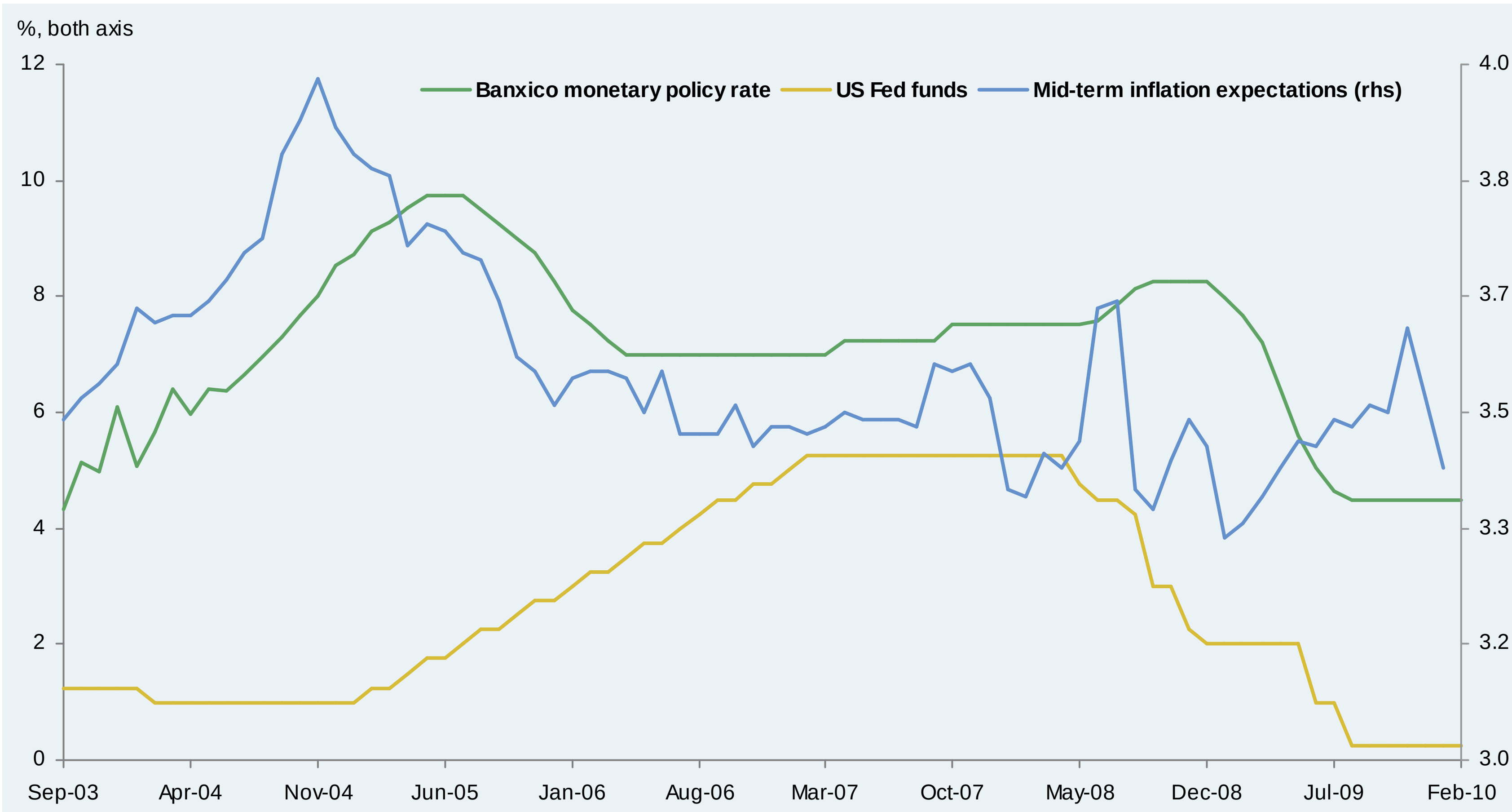
Banxico's reaction function

Banxico's monetary policy rate, US Fed funds, and mid-term inflation expectations



Source: J.P.Morgan with data from the US Fed and Banxico

Wage negotiations could trigger Banxico's first hike. We expect them to remain subdued during in 1H10

Banco de Mexico's monetary policy reaction function

Months ahead	US Fed funds rate	Output gap[2]	Wage negotiations	Medium-term inflation expectations
1	5.1	6.5	58.1	30.3
3	3.4	4.2	31.8	60.6
6	2.4	3.7	30.4	63.5
9	7.7	3.9	34.0	54.4
12	10.9	5.4	32.4	51.2
18	13.6	5.8	36.3	44.3
24	13.1	5.9	36.4	44.6
36	16.6	5.7	35.2	42.4
Avg	9.1	5.1	36.8	48.9

Source: J.P.Morgan with data from the US Fed, INEGI, the Ministry of Labor and Banxico

1. Forecast-error variance decomposition using an estimated Vector Autoregression (VAR) with Cholesky ordering US Fed funds rate - output gap - nominal wage negotiations - inflation expectations (6 month lags, first differences, 66 observations 2003-2009). Own variable (Banxico's rate) was excluded from the table to focus on the other variables.
2. Built upon the log differences between the seasonally-adjusted IGAE and its Hodrick-Prescott filtered index

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USD/MXN outlook

- **We see an upside risk for the peso ahead** coming from Mexico's economic recovery, likely US dollar weakness, potential CNY appreciation (given the competition between China and Mexican exports in US markets), and light investor positioning

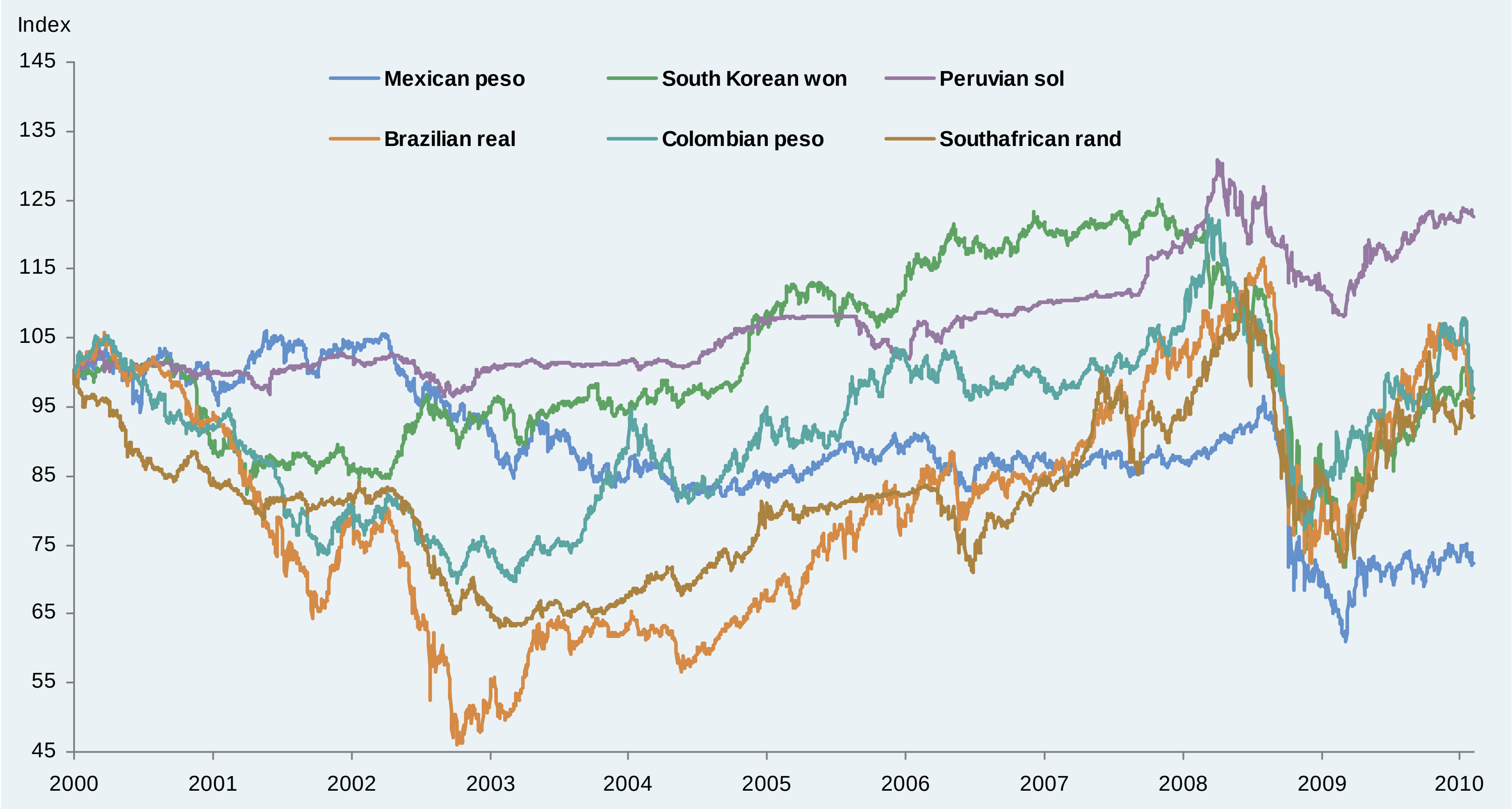
- **The peso continues to be underowned by investors** as multiple doubts on corporate rollover needs, oil revenues drop, downgrade threats, as well as uncertainties about the approval of the fiscal reform and the economic impact of the US recession led it to underperformed this year

- T**he major sources of uncertainty have been clearing up**, particularly the 1-notch sovereign rating downgrades by S&P and Fitch Ratings, and market participants are not expecting any rating action from Moody's

- Even though we do not expect USD/MXN to catch up as much as other emerging currencies that have rallied up to the pre-crisis levels, **projected balance of payments' flows in Mexico look quite healthy and we are now even anticipating a foreign reserve accumulation of more than US$ 5 billion under quite conservative scenarios**

The peso has been the laggard compared to other EM currencies

Major emerging currencies index



Source: Bloomberg

USD/MXN and Banxico's US Dollar put options mechanism

- Banco de México will auction USD Put options to domestic financial institutions every last working day of the month starting next Friday
- The monthly amount will be US$ 600 million
- This mechanism will be exactly the same as the one used back in the 1996-2001 period to accumulate reserves
- The owners of the options will have the right to sell US dollars to the Central Bank (in exchange for pesos) at the previous day's 'fix' rate, whenever the 'fix' rate is below or at the 20-day moving average 'fix' rate
- We highlight that the 'minimum price' auction in which Banxico sells US$ 250 million to market participants whenever the peso depreciates 2% vis-à-vis the US dollar with respect to the previous 'fix' rate will remain unchanged
- In fact, we continue forecasting USD/MXN to average 12.80 in 1Q10, 12.50 in 2Q10, 12.80 in 3Q10, and 13 in 4Q10
- All in all, we believe that with this new measure Banxico will accumulate reserves on a gradual basis without putting pressure on the FX market, and will probably reduce USD/MXN volatility

USD/MXN 'Fix' Rate and 20 days moving average

Source: J.P.Morgan with data from Banxico