MEXICO UPDATE

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ROBUST GROWTH CONTINUES; INFLATION PASS-THROUGH FROM U.S. DROUGHT IS A RISK

GDP growth around 4 percent in 2012, twice the U.S. rate

The Mexican economy is expanding nicely. GDP rose 4.1 percent in year-over-year terms in the second quarter, more than double the U.S. pace of expansion. In quarter-over-quarter seasonally adjusted annualized terms, GDP growth moderated slightly, mirroring more sluggish growth north of the border (See Chart 1). But also like the U.S., forward-looking data released in August show the economy strengthening in the second half of the year (See Chart 2). Full year GDP growth will probably be around 4 percent in 2012, likely moderating slightly to 3.25 to 4 percent in 2013. Mexico's strength derives from its favorable trade dynamics and robust domestic demand

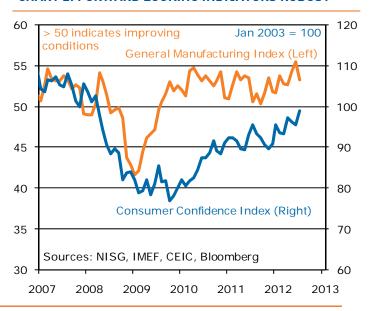
Benefiting from improved competitiveness with China

Unlike most of the rest of the world, international trade will be a major boost to the Mexican economy in 2012-2013. Eighty percent of Mexico's exports are to the United States, shielding it from real economy pass-through of the Euro crisis and Asia's slowdown. Mexican exporters are also benefiting from increased competitiveness against Chinese exporters since the 2009 recession. Although wages have risen in peso terms, a weak exchange rate has held Mexican wage rates steady in U.S. dollar terms; by contrast, Chinese wages have skyrocketed (See Chart 3). At the margin, manufacturers are being encouraged to locate their next plant producing for North American demand in Mexico or the U.S., not China, due to proximity, stable production costs, and the flexibility of trade within the NAFTA zone.

CHART 1: GROWTH MODERATED IN 2ND QUARTER



CHART 2: FORWARD LOOKING INDICATORS ROBUST





Loose monetary policy continues

Expansionary Mexican monetary policy is also boosting domestic demand growth, and contributing to the economy's strength. The Banco de Mexico's overnight rate has been 4.5 percent since July 2009, which given trend Mexican inflation of around 4 percent translates into a real interbank interest rate of less than 1 percent. This is a very low cost of funds for emerging market commercial banks.

Markets expect the central bank to hold the overnight interbank rate unchanged through late 2014, a consensus that is priced into the peso swap curve (which is flat through the two year maturity – See Chart 4). The Banco de Mexico's August inflation report sees limited risks that inflation will exceed its target of 3 percent (+/- 1 percent) in coming quarters, and reveals little sign that the Bank is contemplating a change in rates. Mexican monetary policy will probably mirror the Fed's plan to keep short-term interest rates on hold over the next 24 months.

Inflation risks
may push central
bank to raise
rates, boosting
peso

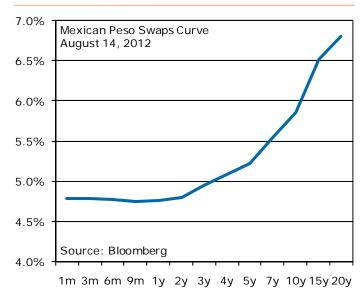
However, a rate hike before the end of 2014 seems more likely than market rates are discounting. The foremost reason why is the strong economy; Banco de Mexico notes that the Mexican output gap probably closed in the second quarter (i.e. the economy was operating at full capacity), making an interest rate hike a possibility in the next 18 months to prevent overheating. External inflationary pressures may also motivate a rate hike. Later this year and into 2013, the severe drought across the U.S. Midwest will destroy one sixth of the U.S. corn crop and keep prices at record highs. The corn supply shock will spread to Mexico, where corn is a staple of the diet. Mexico has already experienced a severe drought in the first half of 2012, inflating commodity prices and pushing up July headline CPI.

A rate hike would drive peso appreciation and lower the price of imported goods, developments which the central bank would welcome. Banco de Mexico Governor Carstens stated in an interview in late July that the peso has "room to appreciate." Whether strong economic growth boosts the value of the peso, or an interest rate hike does, it seems likely that the peso will appreciate against the U.S. dollar over the next 12 months by perhaps 5 percent, to 12.4 pesos per U.S. dollar.

CHART 3: CHINA'S WAGE ADVANTAGE NARROWS



CHART 4: YIELD CURVE SHOWS MARKETS EXPECT RATES TO STAY ON HOLD THROUGH THE END OF 2014



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