

Banxico QR – We now expect Banxico to begin an easing cycle as soon as June

- Banxico published today its 4Q18 *Quarterly Report* (QR)
- The release was accompanied by a press conference by Governor Alejandro Díaz de León
- In our opinion, the tone of the QR was *dovish* enough to forecast the beginning of the easing cycle in June (-25bps)
- In this context, we believe that Banxico could cut the reference rate by an accumulated 50-75bps during 2019
- We highlight that Banxico strongly modified its growth estimates, while adjusting moderately its inflation path. Specifically:
 - (1) Growth estimates for 2019 were revised down from a range between 1.7-2.7% to 1.1-2.1%, while the forecast for 2020 stood at 1.7-2.7% from 2.0-3.0%
 - (2) The estimated path for short-term inflation was revised marginally to the downside due to recent surprises in agricultural prices
- In the traditional *grey boxes*, six relevant themes to the scenario were touched upon, highlighting a study on the impact of the problems in fuel distribution on inflation and an analysis of the persistence of high core inflation
- Current valuation in local assets is consistent with Banxico's dovish tone

We consider that the *Quarterly Inflation* shows a dovish tone on concerns for growth. Banxico published today its *Quarterly Report* (QR) for 4Q18. The release was accompanied by a press conference led by Governor Alejandro Díaz de León. In our opinion, the tone of the QR was dovish as a result of higher concerns over growth and its balance of risks, and even more than observed in the last monetary policy decision on February 7th and the associated minutes.

Significant downward revision in GDP forecasts, particularly for 2019. The forecast range for GDP this year was downgraded from 1.7-2.7% yoy to 1.1-2.1% (see table below). As a result, the mid-point was cut by 60pbs, from 2.2% to 1.6%. This is still marginally higher than our forecast of 1.5%, but the reduction was above our expectations (-30bps, to 1.9%) while also standing below the median forecast of 1.8% according to the latest central bank's analyst survey. The next release of this survey will be this Friday, in which we think another cut is very likely, which would result in the market's and Banxico's mid-point getting closer at the margin.

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The majority of the drivers behind the downgrade were already known, including: (1) Lower global economic and trade activity; (2) a stronger-than-expected deceleration in domestic growth in 2H18, particularly at the end of the year, resulting in a negative base effect for 2019; (3) the expectation that transitory shocks (railway blockades, delays in fuel distribution and strikes in Matamoros) will impact activity at the beginning of 2019 –although with not enough information yet to estimate its impact, according to one of Banxico’s traditional *grey boxes*–; and (4) the revision lower in the estimate for the oil production platform, taking into account the most recent information available, along protracted weakness in investment. For 2020, the forecast range was lowered from 2.0-3.0% to 1.7-2.7%. Given these changes, the central bank expects slack conditions to be more relaxed when compared to the previous *Quarterly Report*.

Banxico’s Forecast

Current Report (4Q18)

	2019	2020
GDP (%)	1.1 – 2.1	1.7 – 2.7
Employment (thousands)	620 - 720	650 - 750
Trade Balance (bn)	-11.8 (0.9% of GDP)	-14.0 (1.0% of GDP)
Current account (bn)	-25.2 (2.0% of GDP)	-28.0 (2.0% of GDP)

Source: Banxico

Banxico’s Forecast

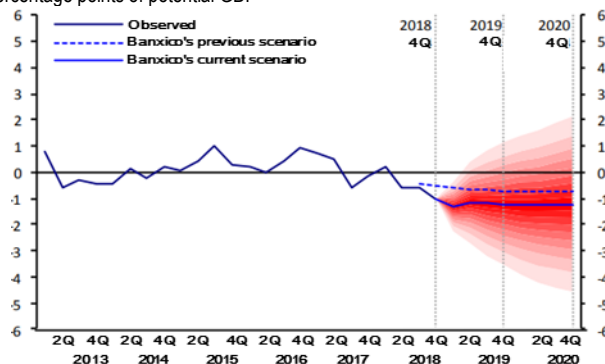
Previous Quarterly Report (3Q18)

	2018	2019	2020
GDP (%)	2.0 – 2.4	1.7 – 2.7	2.0 – 3.0
Employment (thousands)	670 – 740	670 – 770	690 - 790
Trade Balance (bn)	-13.5 (1.1% of GDP)	-14.1 (1.1% of GDP)	-15.1 (1.1% of GDP)
Current account (bn)	-22.6 (1.9% of GDP)	-28.8 (2.3% of GDP)	-31.5 (2.3% of GDP)

Source: Banxico

Output gap

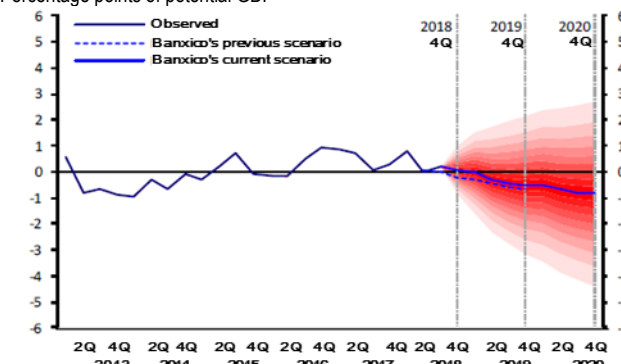
Percentage points of potential GDP



Source: Banco de Mexico; 4Q18 QR

Output gap ex oil production

Percentage points of potential GDP



Source: Banco de Mexico; 4Q18 QR

Marginal revisions in CPI forecasts. Banxico revised slightly its short-term inflation estimates due to the recent downside surprises in agricultural goods. As seen in the table below, as well as in the fan charts, this was reflected in adjustments for the first half of the year, while 1Q20 was probably revised up only due to a more challenging base-effect. For the core component, revisions were more moderate, even adding a marginal increase starting in 4Q19, probably reflecting comments from the central bank’s Board regarding the persistence to the upside of core inflation (also analyzed in a *grey box*, see below).

Regarding risks, we did not see meaningful changes vs. recent documents, considering that the balance remains tilted to the upside in a highly uncertain environment. Among the main risks, they highlighted pressures on the exchange rate as well as in non-core goods, an increase in protectionist measures, deterioration of public finances, direct and indirect effects stemming from the above-average minimum wage increase and finally, persistently high core inflation. On the contrary, to the downside they highlighted two: (1) Lower variations in non-core goods; and (2) slack conditions widening more than expected. It should be noted that they eliminated the section on structural risks, which featured prominently in the previous report.

It is our take that Banxico's inflation forecasts, as well as the risks associated to it, still show a cautious tone, being prudent considering the highly uncertain scenario for the Mexican economy as well as medium- and long-term inflation expectations, which still stand above the central bank's 3% target. Banxico also elaborated on this subject in one of the grey boxes, described later in the document.

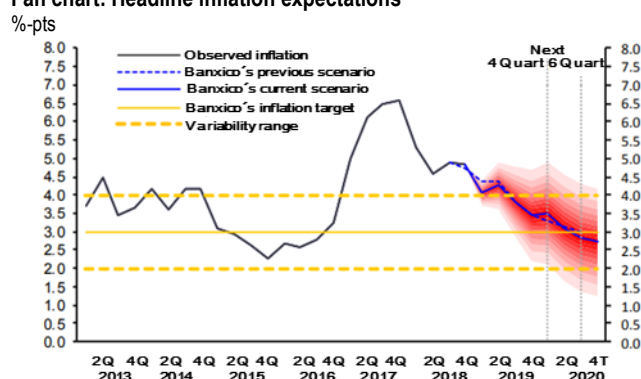
CPI forecasts

% yoy, quarterly average

% yoy, quarterly average									
	2018		2019				2020		
	IV	I	II	III	IV	I	II	III	IV
CPI									
Current forecast	4.8*	4.1	4.3	3.8	3.4	3.5	3.1	2.8	2.7
Previous forecast	4.7	4.4	4.4	3.8	3.4	3.3	3.1	3.0	
Core									
Current forecast	3.7*	3.5	3.6	3.4	3.2	3.2	2.9	2.8	2.7
Previous forecast	3.7	3.6	3.6	3.4	3.1	3.0	2.9	2.7	

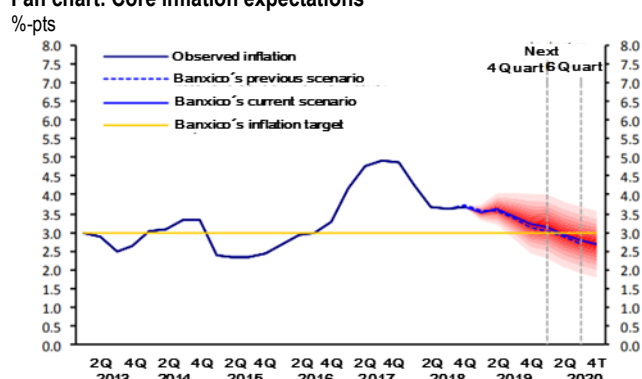
Source: Banco de México, 4Q18 QR; *Observed data

Fan chart: Headline inflation expectations



Source: Banco de México, 4Q18 QR

Fan chart: Core inflation expectations



Source: Banco de México, 4Q18 QR

Grey boxes tackle relevant themes for the scenario. In the traditional 'grey boxes', there are six relevant topics, in our opinion, for the monetary authority's evaluation of the outlook: (1) The relationship between the Fed's monetary policy and global financial markets; (2) the effect of the escalation of trade tensions on the global economy; (3) the measures announced by Banxico and the Ministry of Finance to boost the financial sector; (4) the effect of fuel distribution problems on inflation; (5) an analysis of the persistently high core inflation; and (6) the evolution of long-term inflation expectations.

In the first case, Banxico concludes that the maturity of the US economic cycle and its extended expansion have increased uncertainty about monetary policy. Nevertheless, despite a more cautious Fed, the central bank does not rule out new episodes of volatility in the face of surprises that could lead to more restrictive financial conditions. Regarding the second issue, Banxico concludes that trade tensions have had a limited effect on global growth for the time being, although if they persist and/or escalate, they could have a more significant negative impact on the global economy, in particular in the U.S. and China.

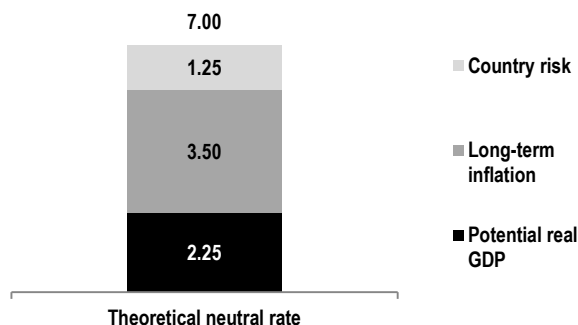
We highlight Banxico's findings on the impact of fuel distribution problems and the persistence of high core inflation. In the first case, Banxico concludes that the effect of the recent episode of problems with the distribution of fuels had a limited impact on inflation and that the effect was probably greater - although there is still not enough data to have a more precise assessment-, in terms of growth, in line with our expectation (for details, see; "*Limited impact on GDP from fuel shortage*", <[pdf](#)>, January 25th, 2019). However, they don't rule out that, if these problems persist in coming months, the impact could be higher. In this context, they consider that the fight against fuel theft is positive in terms of reinforcing the rule of law, although it is important that it does not lead to more distribution problems.

Regarding the persistence of high core inflation, Banxico concludes that this index (in its annual comparison) has suffered the effects of a series of simultaneous shocks of a considerable magnitude, both domestic and external, and when core inflation was already at high levels. According to the analysis, this has resulted in a higher resistance to the downside, particularly in a context in which cyclical conditions were relatively tight (modest slack in terms of the output gap) despite the fact that these shocks have been gradually fading away.

We expect Banxico to start an easing cycle in June. After a higher-than-expected downward revision to its growth forecasts, as well as our expectation that economic activity will keep deteriorating in 1Q19, we modify our monetary policy forecasts for the rest of the year. In particular, we now expect Banxico to cut the reference rate by 25bps (to 8.00%) in its June 27th meeting. In addition, we now believe that the central bank could cut the reference rate by a total of 50-75bps throughout 2019, in an easing cycle which according to our estimates provides room for accumulated cuts between 125-200bps.

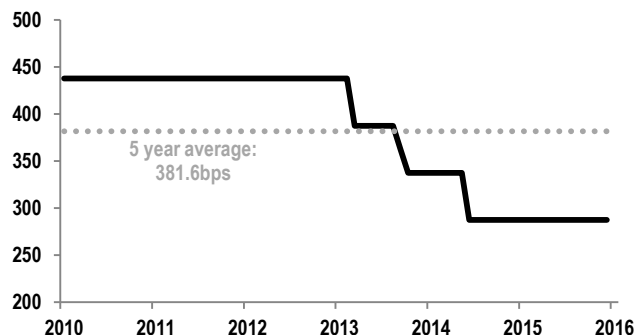
We used two methodologies for this calculation. The first is through a simple approximation by adding our estimates of Mexico's potential GDP (2.25%), long term inflation expectations (3.50%), and country risk premium (125bps), as seen in the chart below on the left. This is consistent with a neutral nominal rate of 7.00%, 125bps below its current level. The second method uses the historical average spread between Mexican and US reference rates, in nominal terms. We take into account the period of a relatively stable spread between 2010 and 2015 of around 375bps. Subtracting the latter to the current differential of 587.5bps suggests that the room for cuts should be around 200bps (see chart below, right).

Theoretical “neutral” reference rate %



Source: Banorte

Spread between the mid-point of the Fed funds rate and Banxico's reference rate Bps



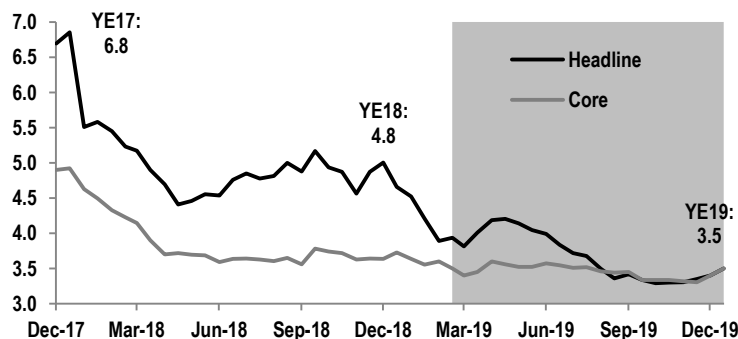
Source: Federal Reserve, Banco de México

Other factors that support our call include:

(1) *A better inflation path expected for this year.* We maintain our 2019 year-end inflation forecast at 3.5% yoy, below consensus at 3.8%. More importantly, our quarterly inflation trajectory, in particular for headline inflation (see chart below), stands below the one projected by the central bank. Specifically, our estimate for annual inflation in 2Q19 is at 4.1% (Banxico: 4.3%) and for 3Q19 at 3.5% (Banxico: 3.8%). Regarding the core, our estimates do not differ strongly from those of the monetary authority. In this context, we believe that as soon as June, inflation conditions coupled with the known information about growth will be enough to convince the Board to start its easing cycle.

Inflation forecasts

% yoy, bi-weekly frequency



Source: INEGI, Banorte

(2) *A solid macroeconomic framework.* We believe that the new Federal administration will deliver on its commitment to maintain healthy public finances. In our view, if risks arise that comprise the fulfillment of the fiscal targets, the government will act accordingly. In this sense, we foresee Mexico's credit rating standing at BBB+ or its equivalent this year. Despite of the latter, we believe that uncertainty on this subject constitutes the most important risk for our monetary policy call.

(3) *Additional downside risks for growth.* We reiterate our GDP forecast for 2019 at 1.5% yoy, marginally below Banxico's mid-point of 1.6%. Moreover, we recognize that risks remain skewed to the downside. In this context, we believe that at the time of the June 27th meeting, the Board will have enough information for a cut. Domestically, the agenda includes (see timeline below), among others, the preliminary GDP print for 1Q19, inflation for the 1H-Jun, and the Quarterly Report for 1Q19.

Incoming relevant releases in Mexico



Source: INEGI, Banxico

All in all, we believe that the reduction in growth estimates, along with our expectation of an inflation forecast below the central bank's expectations, and a solid macroeconomic framework are more than enough to anticipate the start of an easing cycle in the reference rate as soon as June. In this context, we believe that information that will be published will be consistent with this expectation, adding reasons for the Board to cut rates.

From our fixed income and FX strategy team

Current valuation in local assets consistent with Banxico's dovish tone.

Banxico released this afternoon its 4Q18 Quarterly Report, stressing out the effect of slack in the Mexican economy combined by a better performance in annual inflation. The most recent assessment in terms of the balance of risks for these two variables (tilted to the downside for growth and biased upwards for the CPI) suggests a cautious stance from the central bank going forward. Nevertheless, we acknowledge that current conditions will pressure Banxico to adopt a more dovish rhetoric throughout 2019.

Overall this is supportive for the current pricing of the yield curve, discounting a repo rate 33bps lower by year-end. On the other hand, analysts' surveys still anticipate the reference rate to remain unchanged this year at 8.25%. Local rates reaction to this release was of an initial appreciation of 1-2bps, later returned to trade again under a 2-4bps sell-off. Overall we think that the current backdrop could result in stable rates and risk premium in a short-term horizon, with limited scope for an additional significant rally, especially taking into account several asymmetric risks. As a result, we suggest waiting for better entry levels for new directional long positions in the belly of the Mbonos curve.

In the FX market, the Mexican peso has witnessed a trading range in the last weeks defined in the upper-end by a strong support at the USD/MXN 19.45, with the main resistance at the 19.00 area. In this sense, according to our REER model, the Mexican peso is as of today printing a fair value at USD/MXN 19.01, which suggests that the current valuation will keep the 19.00 reference as a strong short-term floor. In our view, the space for additional appreciation should the pair cross 19.00 is limited. Consequently, we are waiting for levels below USD/MXN 19.00 where we would evaluate new USD longs. Additionally, taking into account Banxico's stance, we highlight the possibility of witnessing an erosion in the peso's high carry going forward, a factor from which the currency has remarkably benefited.

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