Ahead of the Curve

Banxico to cut by 25bps in a split decision, with a slightly less dovish statement

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- **Banxico monetary policy decision (February 13th).** We expect a 25bps cut to leave the reference rate at 7.00%, in line with consensus. We believe the most likely scenario is a 4-1 vote for a 25bps cut, with Deputy Governor Esquivel still favoring a 50bps reduction. However, we do not rule an unanimous decision. In our view, the tone of the communique will stay dovish on the back of low economic growth, the widening of the output gap, and downside risks to the outlook. Nevertheless, it will be relevant to gauge any potential shift regarding prices, as annual inflation started to pick up again in the 2nd half of December and is currently above target. In this respect, we think the latest minutes were comparably less dovish, with the debate skewing more decisively towards the need of a conservative, prudent stance going forward

- **Industrial production (December).** We anticipate a 0.1% y/y expansion, its first positive print since October 2018 and which would be favorable. This result would benefit from an additional working day. With seasonally-adjusted figures activity would increase 0.2% m/m, on top of the 0.8% of the previous month. We expect mining to keep growing, while construction and manufacturing would recover at the margin.

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 10-Feb		**Wage negotiations**	January	%	5.7	--	5.9
Mon 10-Feb	**7:00am**	**Gross fixed investment**	Noviembre	% y/y	-4.8	-4.3	-8.6
		sa		%m/m	0.3	--	-1.5
		Machinery and equipment		% y/y	-7.1	--	-9.3
		Domestic		% y/y	-1.8	--	-5.7
		Imported		% y/y	-10.3	--	-11.6
		Construction		% y/y	-3.0	--	-8.0
Tue 11-Feb	**7:00am**	**Industrial production**	December	% y/y	0.1	-0.5	-2.1
		sa		% m/m	0.2	0.1	0.8
		Mining		% y/y	1.1	--	0.9
		Utilities		% y/y	3.1	--	3.2
		Construction		% y/y	-0.8	--	-3.4
		Manufacturing		% y/y	-0.2	-1.9	-3.0
Tue 11-Feb	**10:00am**	**International reserves**	Feb-7	US$ bn	--	--	182.8
Tue 11-Feb	**12:30pm**	**Government weekly auction: 1-, 3-, 6-month CETES; 30y MBono (Nov'47); 5y Bondes D**					
Thu 13-Feb	**2:00pm**	**Banxico's monetary policy decision**	Feb-13	%	7.00	7.00	7.25

Source: Banorte; Bloomberg

Proceeding in chronological order…

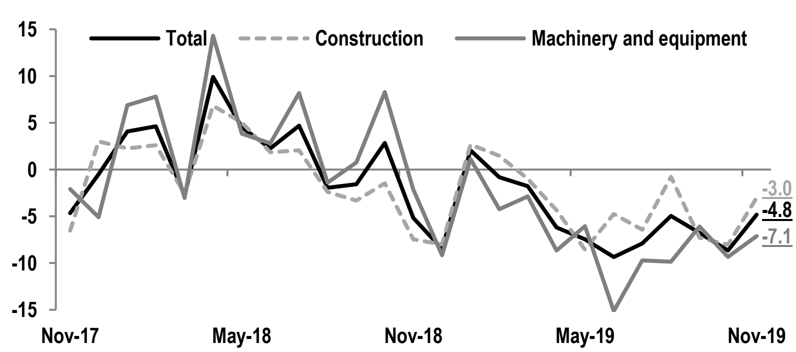
Wage negotiations to climb 5.7% in January. We expect a significant hike in wages at the start of the year, above the 5.2% observed in the same month of 2019. We believe the main driver behind this acceleration will be the 20% increase to the minimum wage (MW), which took effect on January 1st. Even though this would be lower than in recent months, it would be due to a larger amount of negotiations in the public sector, which are typically below those in the private sector. We expect the former to increase close to 3.6% and the latter near 6.5%. We consider this report will be particularly relevant in order to assess part of the impact of the MW on the wage distribution, providing us with more information about its potential behavior during the rest of the year.

Gross fixed investment to improve on the back of favorable base effects. We anticipate GFI at -4.8% y/y in November, above the -8.6% observed in the previous month. Nevertheless, most of the relative improvement would be due to a positive base effect in construction and domestic machinery and equipment, remembering that persistent weakness throughout 2019 began at the end of 2018. Year-to-date, GFI would be at -5.2%. Despite of the decline in annual terms, we anticipate 0.3% m/m increase with seasonally-adjusted figures, breaking with two consecutive months in contraction.

In particular, we expect construction at -3.0% y/y. In this sense, the IP report showed a 3.4% contraction in the sector, with edification back to positive but civil engineering extending its weakness. Related to the latter, federal spending in physical investment plunged 20.8%, lowest since June. Moreover, business confidence fell further, nearing June 2018 lows, although with the 'adequate moment to invest' component showing some resiliency. Nevertheless, looking into December's figures, these last two indicators seem to have shown a stronger performance, making us believe there could be a modest recovery in the month.

Regarding machinery and equipment (M&Eq), we estimate a 7.1% decline, higher than -9.3% in October. Weakness would prevail in the imported component, falling 10.3%, broadly in line with the capital goods imports within the trade balance (-11.3%). Specifically, this sector would not yet be benefited by the base effect, given that the marked slowdown in this component began until December. Finally, the domestic component would pick up to -1.8%, improving after the strong decline in the previous month.

GFI
% yoy



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves increased US$394 million, closing at US$182.8 billion. According to Banxico's report, this comes mainly from a positive valuation effect in central bank assets. In this context, the central bank's international reserves have increased US$1.9 billion during 2020 (please refer to the following table).

Banxico's foreign reserve accumulation detail
US$, million

	2019	Jan 31, 2020	Jan 31, 2020	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	180,877	182,796	394	1,919
(B) Gross international reserve	183,028	189,158	344	6,130
Pemex	--	--	96	977
Federal government	--	--	-161	4,271
Market operations	--	--	0	0
Other	--	--	409	881
(C) Short-term government's liabilities	2,151	6,361	-50	4,211

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 30-year fixed-rate Mbonos (Nov'47), 5-year Bondes D, in addition to 1-, 3-, and 6-month zero-coupon Cetes (see following table). As usual, results will be released at 12:30pm (ET).

Auction specifics (Tuesday, February 11th, 2020)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	12-Mar-20	- -	5,000	6.99
3m	14-May-20	- -	5,000	7.00
6m	13-Aug-20	- -	11,500	6.93
Bondes D				
5y	19-Dec-24	- -	6,500	0.13
M Bono				
30y	07-Nov-47	8.00	4,200	7.19

Source: Banorte with data from Banco de México 1. Except for Udibonos, which are expressed in UDI million, everything else is expressed in MXN million. 2. Yield-to-maturity reported for Cetes, Mbonos and Udibonos

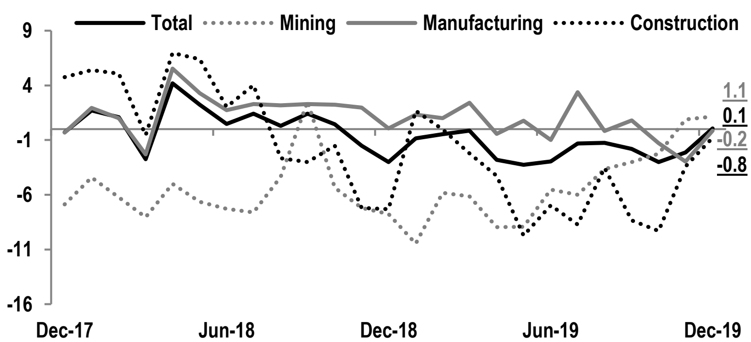
Industrial production to return to positive territory in annual terms. We anticipate a 0.1% y/y expansion, first positive print since October 2018 and which we would consider as favorable. This figure is poised to benefit from an additional working day in the annual comparison. Nonetheless, with seasonally-adjusted figures activity would climb 0.2% m/m, on top of the 0.8% of the previous month. We expect mining to keep growing, while construction and manufacturing would recover at the margin.

We estimate mining at +1.1% y/y, best since January 2013 (excluding Sep-18, distorted to the upside by a base effect given natural disasters in the same month of 2017). Pemex's crude oil production edged-up 0.2%, while gas output grew 2.9%. While these represent a slight moderation relative to last month's data, non-oil mining and services would improve. In construction, we anticipate a 0.8% contraction, benefiting from higher business confidence, which rebounded strongly for this sector in the month. In addition, data for physical investment for the Federal Government points to greater dynamism, expanding 13.9% y/y in real terms, much better than the -20.8% of the previous month.

In manufacturing, we estimate a 0.2% contraction. Although the additional working day should have the most impact in this sector, there are several mixed signals about activity in this category. On the negative side, auto production fell 12.5%, practically in line with the figure from the previous month. Manufacturing output in the US decelerated, falling 1.1%, while employment in our country also showed an additional reduction. On the contrary, IMEF's PMI improved on the margin, particularly production. Finally, non-oil intermediate goods imports, which are highly related to this sector, increased 0.6%, its best since September.

We should remember that in this occasion we have additional information about performance, considering that the preliminary GDP for 4Q19 has already been released. In this sense, our forecast implies a relative improvement in the quarter, which puts it close to 0.0% y/y. If our forecast materializes, 4Q19 could be revised to -1.7% from -1.8%, although this would not be enough to change the full-year result.

Industrial production
% yoy



Source: INEGI, Banorte

Banxico will keep cutting the reference rate. Next Thursday, the central bank will hold its first meeting of this year, where we expect a 25bps cut to leave the reference rate at 7.00%. This is in line with consensus, with all except one analyst in the latest *Citibanamex* survey anticipating the same. In our view, the tone of the communique will stay dovish on the back of low economic growth, a widening output gap, and downside risks to the outlook. Nevertheless, it will be relevant to gauge any potential shift, as annual inflation started to pick up again in the 2nd half of December and is currently above target. In this respect, we think the latest minutes (released on January 2nd) were comparably less dovish, with the debate skewing more decisively towards the need of a conservative, prudent stance going forward.

We believe the most likely scenario is a 4-1 vote for a 25bps cut, with Deputy Governor Esquivel possibly still favoring a 50bps reduction. Nevertheless, we cannot discard a unanimous decision, which has not happened since May 16th, 2019 (see table below). In this respect, he stated in the latest minutes that "*…the economic juncture in which the decision was taken was probably one of the last favorable opportunities of this cycle to make a more decisive monetary policy adjustment…*".

Although this is a clear hint that he could shift his stance soon, at least three reasons might prevent him to do so, yet: (1) Inflation surprising analysts to the downside by year-end 2019 (at 2.83% y/y); (2) his public comments stressing weak growth, limiting demand-side pressures to prices; (3) the affirmation that monetary policy has been very restrictive for a prolonged period, impacting consumption and investment decisions. To the latter, we add that the exchange rate is today close to 18.77 per dollar, depicting a 0.9% gain in a YTD basis, and below the level observed at the latest decision, around 18.90. This last point is important as he said this was one additional factor that by that time justified opting for a more decisive policy action (*e.g.* -50bps).

Latest Banxico's monetary policy decisions

Date	Decision	In favor	Against	Dissenters
May 16, 2019	Unchanged	5	0	--
Jun 27, 2019	Unchanged	4	1	G. Esquivel
Aug 15, 2019	-25bps	4	1	G. Esquivel
Sep 26, 2019	-25bps	3	2	G. Esquivel & J. Heath
Nov 14, 2019	-25bps	3	2	G. Esquivel & J. Heath
Dec 19, 2019	-25bps	4	1	G. Esquivel

Source: Banxico

We expect the tone about growth to remain dovish, with risks still tilted to the downside. In our view, most developments since the last decision have been negative in this front, resulting in heightened risks to the outlook. Among them, we anticipate an acknowledgment of the uncertain, but unfavorable, impact that the coronavirus outbreak might have –mostly concentrated in 1Q20–. They will also likely mention that full-year 2019 GDP, based on INEGI's preliminary estimate, stood at –0.1% y/y, an inch below Banxico's latest median of 0.0% within their -0.2 to 0.2% forecast range. Despite some signs of improvement at the turn of the year, the output gap in 4Q19 kept widening, in line with the central bank's view. We do not discard that the central bank could provide a hint of a possible reduction in their GDP forecast range for 2020, currently at 0.8-1.8%, with their 1.3% median significantly above our 0.8% and consensus of 1.0%.

On inflation, we have perceived more cautiousness, particularly after the 20% minimum wage hike. At the December decision, this factor stood as the second most important place in terms of upside risks to watch. In this respect, we saw in the minutes a greater chance of categorizing risks in this front as skewed to the upside, so far avoided based on high uncertainty about dynamics among its drivers. Nonetheless, we identified two members in favor of this scenario, one relatively neutral, and only one seeing to the downside. With headline and core inflation in January back above target, to 3.24% and 3.73% y/y, respectively, we think this added cautiousness is granted. In particular, we also believe members will emphasize that inflation expectations by year-end 2020 are still above target despite the slack in the economy.

It is important to say that our expectation of a cut despite these price dynamics is supported by the fact that higher annual inflation was already expected by the central bank (see table below). Although we are not able to explicitly pinpoint the degree of the central bank's surprise in the bi-weekly prints released so far for 2020, our forecast path is still consistent with average inflation in the whole quarter in line with Banxico's forecast of 3.5%.

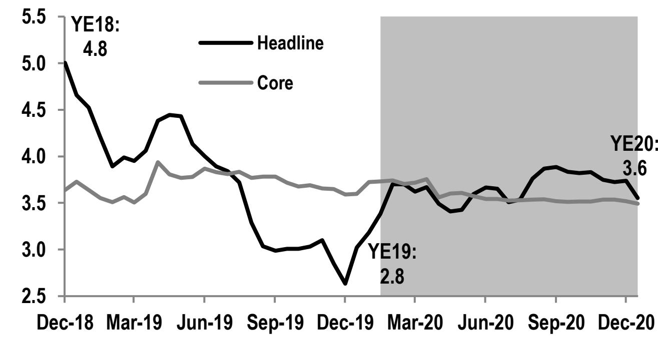
In this respect, Governor Alejandro Díaz de León reiterated recently that what matters most are deviations in actual data relative to forecasts. Given that the central bank has been dovish so far and inflation forecasts have been met, we believe most Board members will continue supporting the prudent and cautious approach that has been followed since the start of this easing cycle. Moreover, with markets discounting the possibility of another round of some central bank easing as global inflation has stayed low and growth will likely decelerate, the relative stance against other economies (after decoupling from the Fed in November 2019) also provides some room to keep cutting the reference rate.

Inflation forecasts
% y/y, quarterly average

	1Q20	2Q20	3Q20	4Q20
Banorte				
Headline	3.5	3.5	3.7	3.7
Core	3.7	3.6	3.5	3.6
Banxico				
Headline	3.5	3.1	3.1	3.0
Core	3.6	3.2	3.1	2.9

Source: Banxico, Banorte

2020 Inflation forecasts
% y/y, bi-weekly frequency



Source: INEGI, Banorte

All in all, we reiterate our view that Banxico will find the global and domestic backdrop as consistent with continuing the easing cycle, at least for now. Apart from next week's decision, we maintain our expectation of two additional rate cuts, each of 25bps, in March and May, to 6.50%, staying at that level until year-end. We will be focused on potential changes to the outlook as the central bank keeps reducing the rate in a prudent manner. This relative cautiousness is mainly based on two factors. First, it is our take that inflation could keep trending gradually higher at least until late 2Q20 or the start of the third quarter (see chart above, right), contrary to the reversal seen by the central bank. Second, we also think market volatility could increase as we approach the US election (November 3rd). Governor Díaz de León recently stated that, in Mexico, this monetary policy channel could be even more important that the one acting through credit and economic activity. In his context, we believe that both considerations are relevant to continue managing the easing cycle in a cautious manner, given that if this is not the case the latter could translate into risks for inflation and its expectations.

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