

Banxico QR – Higher forecasts suggest less room for rate cuts

- Banxico published today its 4Q20 *Quarterly Report (QR)*. The release was accompanied by a press conference by Governor Alejandro Díaz de León
- We think the document maintains a dovish tone. Nevertheless, we modify our monetary policy call after the release. We now expect only one more 25bps cut in the reference rate, taking it to 3.75%, where it would finish the year
- In line with our view, the central bank adjusted its 2021 inflation path upwards, focusing on the non-core component. The explicit convergence to the 3% inflation target is expected in 2Q22
- The balance of risks for inflation remains uncertain, with little changes in the order, which were mainly on those skewed to the upside. Among them, we highlight:
 - (1) Pressures on core inflation due to the rebalancing of spending, eliminating the reference that persistence remains at elevated levels;
 - (2) A higher relative weight on possible cost pressures due to logistical issues, implementation of sanitary measures or wage increases despite slack; and
 - (3) After the recent increase in energy prices, this factor slid to the bottom place in the order
- GDP estimates in the central scenario rose, to 4.8% from 3.3% for 2021 and to 3.3% from 2.6% in 2022. This is explained by a better starting point from last year's close and expectations of higher growth in US industrial production
- There were seven traditional *grey boxes*. Given recent market dynamics, we focus our attention on those analyzing the evolution of exchange rate volatility and the effects of financial conditions on the economic outlook
- We take profits in long positions in the 6-month TIEE-28 IRS (6x1)

We modify our monetary policy forecast for this year. Banxico published today its *Quarterly Report (QR)* for 4Q20. The release was accompanied by a press conference led by Governor Alejandro Díaz de León. Although we think the document maintains a dovish tone, it seems to be less accommodative at the margin relative to recent publications. In this context, we adjust our call on the reference rate, now expecting only one 25bps cut in March, taking it to 3.75%, where we expect it to remain by year-end (previous: 3.50%). The change is driven by four main factors. The first, upward adjustments on inflation in the short-term, which we believe could make some members uncomfortable of more cuts until they have tangible evidence that the inflation 'hump' will be transitory. The second is the larger-than-expected revision to 2021 GDP to 4.8%, along the perception of more modest downside risks for activity. The third has to do with market conditions and volatility, which could result in additional pressures –especially on the exchange rate and long-term interest rates–, limiting room for cuts.

March 3, 2021

www.banorte.com
@ analisis_fundam

Gabriel Casillas
Chief Economist and Head of Research
gabriel.casillas@banorte.com

Alejandro Padilla
Executive Director of Economic Research and Financial Markets Strategy
alejandropadilla@banorte.com

Juan Carlos Alderete, CFA
Director of Economic Research
juan.alderete.macal@banorte.com

Francisco Flores
Senior Economist, Mexico
francisco.flores.serrano@banorte.com

Fixed income and FX Strategy

Manuel Jiménez
Director of Market Strategy
manuel.jimenez@banorte.com

Santiago Leal Singer
Senior Strategist, Fixed-Income and FX
santiago.leal@banorte.com

Leslie Orozco
Strategist, Fixed Income and FX
leslie.orozco.velez@banorte.com

Banxico's 2021 policy decisions

Date	Decision
February 11	-25bps
March 25	--
May 13	--
June 24	--
August 12	--
September 30	--
November 11	--
December 16	--

Source: Banxico

Document for distribution among the general public

Lastly, the fourth is related to a global backdrop in which the highly accommodative stance of central banks seems to be under scrutiny due to potential inflationary pressures. The latter, on expectations of a very strong global recovery that has pushed commodities' prices higher and has even induced some supply disruptions and bottlenecks that could impact businesses' operating costs. In this backdrop, we believe the decision for a 25bps cut in March will probably not be unanimous, while May's might also be complicated, but favoring to keep the rate unchanged.

Higher inflation due to the increase in energy prices. In line with our expectations, Banxico adjusted their inflation estimates higher throughout the forecast horizon, especially for 2021. Specifically, the average increase for the current year was +20bps, as shown in the table below. Adjustments were mostly on headline inflation, therefore implying revisions mainly at the non-core component. In this sense, they incorporated a higher than foreseen path for energy prices, albeit partly offset by lower pressures in agricultural goods. We also highlight that they: (1) Added some indirect effects from higher energy prices on non-core inflation ('pass-through effect'); (2) assumed a trajectory with a stronger MXN, even after the recent adjustment; and (3) expect a limited effect from the 15% minimum wage increase on prices, given ample levels of economic slack. Broadly speaking, the path is very much in line with our forecasts.

CPI forecasts

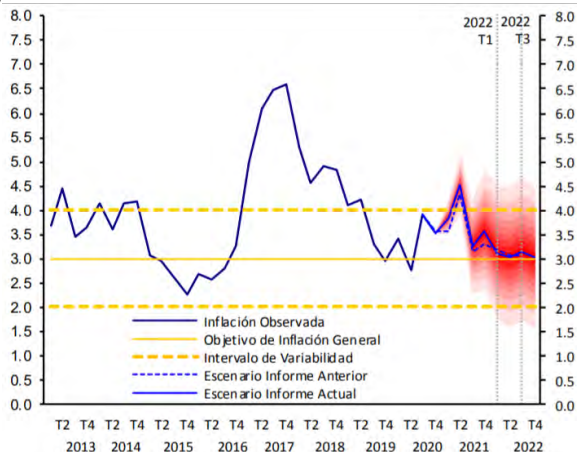
% y/y, quarterly average

	2020				2021				2022				
	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
CPI													
Current	3.5*	3.8	4.5	3.2	3.6	3.1	3.0	3.2	3.0				
Previous	3.6	3.6	4.3	3.1	3.3	3.2	3.1	3.1	--				
Difference (bps)	-10	20	20	10	30	-10	-10	10	--				
Core													
Current	3.8*	3.9	3.6	3.0	3.1	3.0	3.0	3.0	3.0				
Previous	3.8	3.9	3.6	3.0	3.1	2.9	2.9	2.9	--				
Difference (bps)	0	0	0	0	0	10	10	10	--				

Source: Banco de México, 4Q20 QR; *Observed data

Fan chart: Headline inflation*

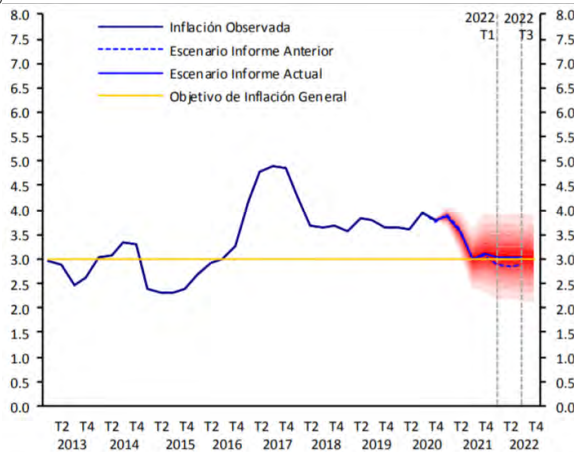
% y/y



Source: Extracted directly from Banxico's 4Q20 Quarterly Report, only available in Spanish

Fan chart: Core inflation*

% y/y

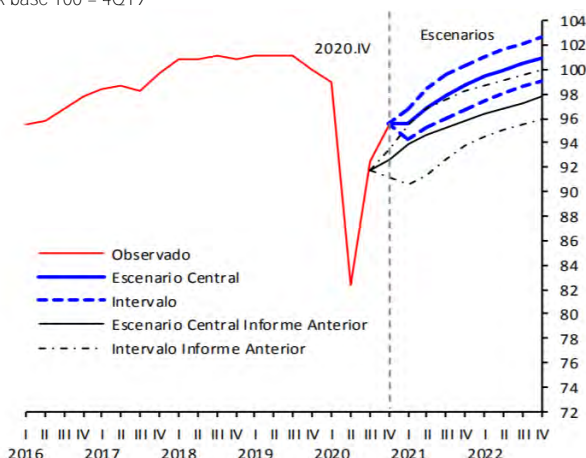


Source: Extracted directly from Banxico's 4Q20 Quarterly Report, only available in Spanish

The balance of risks for prices remains uncertain, with adjustments in the relative order on those to the upside. They explained that a several of the effects on inflation due to the change in assumptions would cancel each other out. Nevertheless, there were some adjustments on those to the upside, with the order also modified. First, they mentioned possible pressures on core inflation due to the rebalancing in spending, eliminating the reference from the last QR that persistence remains at elevated levels. Moreover, in third place they warned about cost pressures from logistics' issues, the implementation of sanitary measures, wage increases or changes in hiring conditions. This was in fifth place in the [3Q20 QR](#), possibly with a higher relative importance after reports about the lack of supplies in some industries and undersupply of containers globally for the shipment of goods, among others. Meanwhile, higher energy prices than expected slid from the fourth to the fifth place. In our view, this could be explained by the fact that they adjusted their expectations in this front today, with this risk already materializing from the last publication. Finally, they recognized the increase on inflation expectations embedded in financial securities, in a context of increased market volatility. They also mentioned the rise in expectations for the end of the year [within the central bank's survey](#). In our opinion, this will remain relevant in the global backdrop. Overall, we consider that adjustments on these estimates will result in additional challenges for the easing cycle, especially among the relatively less dovish members within the Board.

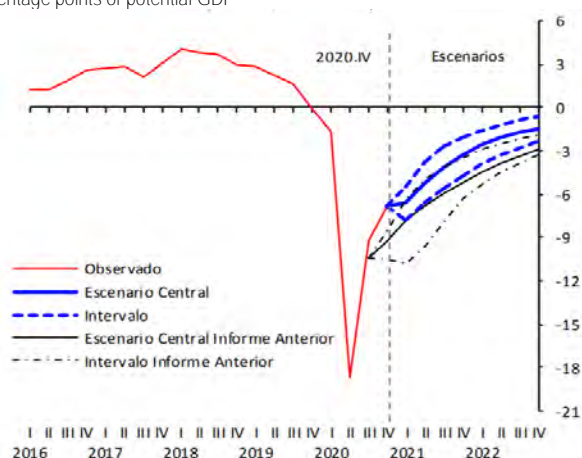
Stronger GDP forecasts. Although we had anticipated upward changes to GDP estimates, the magnitude of the revision was higher than expected. Specifically, for the central scenario they went to a mid-point of 4.8% from 3.3% in 2021, and to 3.3% from 2.6% in 2022 (see table below). The forecast for the current year is above our 4.1% and the median of 3.9% in the latest central bank survey. It is also above the 4.3% and 3.7% of the IMF and World Bank, respectively. They explained that this was driven by a better starting point from last year's close (with Banxico's mid-point for full-year 2020 at -8.9%, [while the actual figure was -8.2%](#)) and expectations of stronger growth in US industrial production. Given that uncertainty remains very high, the monetary authority kept its options open and maintained lower and upper limits around central forecasts. For 2021, the range is between 2.8% and 6.7%; for 2022, between 3.0% and 3.4%. Among the factors that could push growth higher they mentioned a more modest effect from stricter measures to contain the pandemic, a stronger headwind from external demand, and a more accelerated pace of vaccinations both locally and globally. On the contrary, among those that could have a more adverse impact we highlight uncertainty about the continuity of fiscal stimulus. They concluded that slack conditions would remain very ample even if these adjustments meant that the output gap would close faster than previously thought. Hence, 2021 estimates for new jobs affiliated at IMSS, trade balance and current account were increased, with confidence intervals slightly narrower.

GDP forecasts
Index base 100 = 4Q19



Source: Extracted directly from Banxico's 4Q20 Quarterly Report, only available in Spanish

Output gap
Percentage points of potential GDP



Source: Extracted directly from Banxico's 4Q20 Quarterly Report, only available in Spanish

Banxico's Forecasts

Current Report (4Q20)

	2021	2022
GDP (% y/y)		
Central scenario	4.8	3.3
Range	2.8 to 6.7	3.0 to 3.4
Employment (thousands)	250 to 570	390 to 590
Trade Balance (bn)	1.5 to 6.5 (0.1% to 0.5% of GDP)	-6.5 to -1.5 (-0.5% to -0.1% of GDP)
Current account (bn)	-7.1 to 3.5 (-0.5% to 0.3% of GDP)	-13.0 to -2.5 (-0.9% to -0.2% of GDP)

Source: Banxico

Banxico's Forecasts

Previous Report (3Q20)

	2020	2021	2021
GDP (% y/y)			
Central scenario	-8.9	3.3	2.6
Range	-9.3 to -8.7	0.6 to 5.3	2.6 to 3.8
Employment (thousands)	-850 to -700	150 to 500	300 to 500
Trade Balance (bn)	27.1 to 30.3 (2.6% to 2.9% of GDP)	1.0 to 9.2 (0.1% to 0.8% of GDP)	-5.0 to 0.0 (-0.4% to 0.0% of GDP)
Current account (bn)	20.3 to 24.3 (1.9% to 2.3% of GDP)	-9.4 to 1.9 (-0.8% to 0.2% of GDP)	-12.5 to -4.4 (-1.0% to -0.4% of GDP)

Source: Banxico

Several interesting topics in the traditional grey boxes. As usual, the central bank included a deep analysis of several important issues. Once again, they were centered around the impact from COVID-19, especially on economic activity and inflation, as well as other current themes. These included: (1) Currency flows to Mexico and measures to support migrants; (2) Impact of the pandemic on sector-level activity in Mexico and the US; (3) Labor force participation rate in the middle of the COVID-19 shock; (4) Effects of Mexico's pension reform; (5) Effects of 'El Buen Fin' (Mexico's Black Friday) on non-food goods' inflation. They also added a couple of research notes about financial market issues, such as: (6) The evolution of exchange rate volatility; and (7) The effects of financial conditions on the economic outlook. Given the recent dynamics and adjustment in financial markets, along the possibility that these affect the balance of risks for prices and financial stability, we will focus our attention in the latter two.

The evolution of exchange rate volatility. In this box, Banxico analyzed peso volatility with the information provided by the term structure in options' implied volatilities following the pandemic shock in March. Similar to other EM currencies, the MXN showed a pick-up in volatility due to higher uncertainty. Nevertheless, volatilities moderated after the initial impact, albeit with a differentiated performance among them.

Considering this, the central bank used a VAR model to identify the impact of three factors on volatilities: (1) Risk aversion; (2) domestic economic activity; and (3) interest rate spread with the US. The box concludes that the rate differential may have contributed to a larger and faster adjustment lower than in other currency pairs, helping reduce uncertainty about the exchange rate. We believe this analysis is very relevant in the current environment –as well as other bouts of volatility that could surface during the post-pandemic recovery–. In this sense, and considering a prudent stance by the central bank, results seem to point that it would be desirable that the spread remains high relative to other countries, even with the possibility that it is more convenient that the real ex-ante interest rate in our country remains in positive territory.

Financial conditions supported by extraordinary measures deployed by the central bank. In the last box, the central bank studied the behavior of financial conditions during the pandemic, trying to figure out the impact of extraordinary liquidity and credit measures. As part of a vector autoregressive model, they found that a higher amount of the measures helped loosen conditions. By making a dynamic counterfactual scenario against actual data, they obtained that the resulting loosening of financial conditions would have been much more limited. The analysis goes a step further, trying to measure the impact this had on economic activity. Through a quantile regression method with results from the counterfactual, they obtain that the probability distribution under this scenario had a higher negative skew without these extraordinary measures. Considering this, Banxico concludes that their use contributed to more favorable financial conditions, which in turn could have reduced the probability of a more adverse growth scenario. Reiterating the message when these measures were announced, we think that both their implementation, as well as the fact that they were announced, contributed positively to an orderly market. In this manner, we believe the [recent announcement of their extension until September](#) will continue to provide the necessary support for the recovery, without the need of having to implement a much more accommodative monetary policy.

From our Fixed income and FX strategy team

We take profits in long positions in the 6-month TIE-28 IRS (6x1). The local fixed-income market is still experiencing important pressures and volatility associated with the correction observed in global rates, where expectations on a strong economic recovery accompanied by inflationary pressures have been reflected in the interest rates of sovereign bonds. A clear example of this phenomenon has been the levels reached in US Treasuries, where the yield curve has sold-off 30bps in long-term tenors since mid-February. This situation has pushed the 10-year note towards current 1.45%, even temporally trading at 1.60% last week, from 1.07% at the end of January. Consequently, the Mexican yield curve has sold-off around 45bps in mid- and long-term Mbonos since mid-February, taking a monetary breather recently.

Today's Quarterly Report triggered a modest appreciation in local rates; however, they reverted as the session progressed amid weaker risk appetite and relevant pressures in the MXN. In terms of strategy, we recommend taking profits from our trade idea on receiving the 6-month TIIE-28 IRS (6x1) despite acknowledging that Banxico will probably cut its reference rate by 25bps on March 25th. This strategy resulted in a 19bps gain since it was opened on December 17th. We believe current volatility in the market will limit the yield curve to price in with a stronger conviction greater monetary easing. In this sense, the market is currently incorporating implied rate cuts for the 1Q21 of -6bps and of -8bps for the 2Q21. In a short-term horizon, we will wait for attractive entry points for tactical long positions in mid- and long-term Mbonos.

In the FX market, the Mexican peso has been affected by this context and traded back in levels close to 21.00 per dollar since last week. We consider MXN susceptibility to fixed-income adjustments as the main driver behind pressures in the spot, where foreign investors' holdings have declined in the last two weeks according to data released by Banxico and EPFR. We suggest a cautious exposure to this global volatility phase, which is mainly affecting emerging market currencies.

Analyst Certification

We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldivar, Marissa Garza Ostos, Tania Abdul Massih Jacobo, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo, Eridani Ruibal Ortega and Juan Barbier Arizmendi, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V. for the provision of our services.

Relevant statements.

In accordance with current laws and internal procedures manuals, analysts are allowed to hold long or short positions in shares or securities issued by companies that are listed on the Mexican Stock Exchange and may be the subject of this report; nonetheless, equity analysts have to adhere to certain rules that regulate their participation in the market in order to prevent, among other things, the use of private information for their benefit and to avoid conflicts of interest. Analysts shall refrain from investing and holding transactions with securities or derivative instruments directly or through an intermediary person, with Securities subject to research reports, from 30 calendar days prior to the issuance date of the report in question, and up to 10 calendar days after its distribution date.

Compensation of Analysts.

Analysts' compensation is based on activities and services that are aimed at benefiting the investment clients of Casa de Bolsa Banorte and its subsidiaries. Such compensation is determined based on the general profitability of the Brokerage House and the Financial Group and on the individual performance of each analyst. However, investors should note that analysts do not receive direct payment or compensation for any specific transaction in investment banking or in other business areas.

Last-twelve-month activities of the business areas.

Grupo Financiero Banorte S.A.B. de C.V., through its business areas, provides services that include, among others, those corresponding to investment banking and corporate banking, to a large number of companies in Mexico and abroad. It may have provided, is providing or, in the future, will provide a service such as those mentioned to the companies or firms that are the subject of this report. Casa de Bolsa Banorte or its affiliates receive compensation from such corporations in consideration of the aforementioned services.

Over the course of the last twelve months, Grupo Financiero Banorte S.A.B. C.V., has not obtained compensation for services rendered by the investment bank or by any of its other business areas of the following companies or their subsidiaries, some of which could be analyzed within this report.

Activities of the business areas during the next three months.

Casa de Bolsa Banorte, Grupo Financiero Banorte or its subsidiaries expect to receive or intend to obtain revenue from the services provided by investment banking or any other of its business areas, by issuers or their subsidiaries, some of which could be analyzed in this report.

Securities holdings and other disclosures.

As of the end of last quarter, Grupo Financiero Banorte S.A.B. of C.V. has not held investments, directly or indirectly, in securities or derivative financial instruments, whose underlying securities are the subject of recommendations, representing 1% or more of its investment portfolio of outstanding securities or 1 % of the issuance or underlying of the securities issued.

None of the members of the Board of Grupo Financiero Banorte and Casa de Bolsa Banorte, along general managers and executives of an immediately below level, have any charges in the issuers that may be analyzed in this document.

The Analysts of Grupo Financiero Banorte S.A.B. of C.V. do not maintain direct investments or through an intermediary person, in the securities or derivative instruments object of this analysis report.

Guide for investment recommendations.

	Reference
BUY	When the share expected performance is greater than the MEXBOL estimated performance.
HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

Even though this document offers a general criterion of investment, we urge readers to seek advice from their own Consultants or Financial Advisors, in order to consider whether any of the values mentioned in this report are in line with their investment goals, risk and financial position.

Determination of Target Prices

For the calculation of estimated target prices for securities, analysts use a combination of methodologies generally accepted among financial analysts, including, but not limited to, multiples analysis, discounted cash flows, sum-of-the-parts or any other method that could be applicable in each specific case according to the current regulation. No guarantee can be given that the target prices calculated for the securities will be achieved by the analysts of Grupo Financiero Banorte S.A.B. C.V.; since this depends on a large number of various endogenous and exogenous factors that affect the performance of the issuing company, the environment in which it performs, along with the influence of trends of the stock market, in which it is listed. Moreover, the investor must consider that the price of the securities or instruments can fluctuate against their interest and cause the partial and even total loss of the invested capital.

The information contained hereby has been obtained from sources that we consider to be reliable, but we make no representation as to its accuracy or completeness. The information, estimations and recommendations included in this document are valid as of the issue date, but are subject to modifications and changes without prior notice; Grupo Financiero Banorte S.A.B. of C.V. does not commit to communicate the changes and also to keep the content of this document updated. Grupo Financiero Banorte S.A.B. of C.V. takes no responsibility for any loss arising from the use of this report or its content. This document may not be photocopied, quoted, disclosed, used, or reproduced in whole or in part without prior written authorization from Grupo Financiero Banorte S.A.B. of C.V.

GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy			
Gabriel Casillas Olvera	IRO and Chief Economist	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Economic Research and Financial Market Strategy			
Alejandro Padilla Santana	Executive Director of Economic Research and Financial Markets Strategy	alejandro.padilla@banorte.com	(55) 1103 - 4043
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251
Economic Research			
Juan Carlos Alderete Macal, CFA	Director of Economic Research	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Francisco José Flores Serrano	Senior Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Katía Celina Goya Ostos	Senior Economist, Global	katia.goya@banorte.com	(55) 1670 - 1821
Luis Leopoldo López Salinas	Economist, Global	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
Market Strategy			
Manuel Jiménez Zaldivar	Director of Market Strategy	manuel.jimenez@banorte.com	(55) 5268 - 1671
Fixed income and FX Strategy			
Santiago Leal Singer	Senior Strategist, Fixed Income and FX	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Strategist, Fixed Income and FX	leslie.orozco.velez@banorte.com	(55) 5268 - 1698
Equity Strategy			
Marissa Garza Ostos	Director of Equity Strategy	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Senior Strategist, Equity	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Senior Strategist, Equity	valentin.mendoza@banorte.com	(55) 1670 - 2250
Víctor Hugo Cortes Castro	Senior Strategist, Technical	victorh.cortes@banorte.com	(55) 1670 - 1800
Eridani Ruibal Ortega	Analyst	eridani.ruibal.ortega@banorte.com	(55) 1103 - 4000 x 2755
Juan Barbier Arizmendi, CFA	Analyst	juan.barbier@banorte.com	(55) 1670 - 1746
Corporate Debt			
Tania Abdul Massih Jacobo	Director of Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248
Economic Studies			
Delia María Paredes Mier	Executive Director of Economic Studies	delia.paredes@banorte.com	(55) 5268 - 1694
Miguel Alejandro Calvo Domínguez	Senior Analyst, Economic Studies	miguel.calvo@banorte.com	(55) 1670 - 2220
Wholesale Banking			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(81) 8319 - 6895
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.cebillos@banorte.com	(55) 5268 - 9996
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Frigolet Vázquez Vela	Head of Sólida Banorte	alejandro.frigolet.vazquezvela@banorte.com	(55) 5268 - 1656
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Carlos Alberto Arciniega Navarro	Head of Treasury Services	carlos.arciniega@banorte.com	(81) 1103 - 4091
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
Lizza Velarde Torres	Executive Director of Wholesale Banking	lizza.velarde@banorte.com	(55) 4433 - 4676
Oswaldo Brondo Menchaca	Head of Specialized Banking Services	oswaldo.brondo@banorte.com	(55) 5004 - 1423
Raúl Alejandro Arauzo Romero	Head of Transactional Banking	alejandro.arauzo@banorte.com	(55) 5261 - 4910
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Commercial Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454