

## Banxico QR – Higher short-term inflation, but convergence to the target unchanged

- Banxico published today its 1Q21 *Quarterly Report (QR)*. The release was accompanied by a press conference by Governor Alejandro Díaz de León
- We think the document maintains a hawkish tone. In line with our expectations, there were strong upward revisions in growth and inflation estimates, especially for this year
- In our opinion, this confirms that the next adjustment to the reference rate will probably be a hike. We maintain our call of two 25bps increases each this year, taking place in November and December
- The balance of risks for inflation is skewed to the upside, despite considering that current pressures are transitory. We also highlight that:
  - (1) Core inflation does not reach the 3% target in the forecast horizon, with a minimum of 3.2% starting on 3Q22 onwards;
  - (2) The expectation that headline inflation will reach the target in 2Q22 was unchanged relative to the previous QR; and
  - (3) To the upside, they expanded over the possibility that the drought in several regions of the country could pressure some agricultural prices
- On GDP, they estimate an expansion of 6.0% (range: 5.0% to 7.0%) this year and 3.0% in 2022 (range: 2.0% to 4.0%). This is explained by a better performance than expected in 1Q21, external demand strength, and progress in the vaccination process
- There were seven traditional *grey boxes*. Given recent price dynamics, we focused our attention on these, including an analysis of the impact of base effects on annual figures and the influence of fruits and vegetables' exports to the US
- The short end of the yield curve is consistent with our expectation of rate hikes by year-end

**Higher growth and inflation suggest rate hikes this year.** Banxico published today its *Quarterly Report (QR)* for 1Q21. This was accompanied by a press conference led by Governor Alejandro Díaz de León. As in [recent central bank communications](#), we think the document has a hawkish tone, broadly in line with our expectations. Specifically, the mid-point for GDP growth this year was revised to 6.0% (Banorte: 5.9%), while inflation is seen closing 4Q21 at an average of 4.8% (Banorte: 5.2%; year-end: 5.5%), below our call. In addition, we highlight that the estimated convergence to the 3% target remained in 2Q22, with no changes relative to the previous QR. However, we highlight that the core does not reach said level in the forecast horizon. In our opinion, this suggests that Banxico sees most current pressures as temporary. Overall, we consider that the adjustments confirm that the next move will probably be a rate hike. In this context, we reiterate our expectations of two 25bps hikes this year, taking place in the November 11<sup>th</sup> and December 16<sup>th</sup> meetings, with the reference rate closing 2021 at 4.50%.

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### Banxico's 2021 policy decisions

Date	Decision
<a href="#">February 11</a>	-25bps
<a href="#">March 25</a>	0bps
<a href="#">May 13</a>	0bps
June 24	--
August 12	--
September 30	--
November 11	--
December 16	--

Source: Banxico

Document for distribution among the  
general public

**More complex inflation outlook in the short-term...** In line with expectations, inflation estimates were mostly revised higher throughout the forecast horizon (see table below). The largest changes were from 2Q22 to the first quarter of 2023. Banxico explains that this responds to inflation being skewed by supply shocks, a gradual reduction of ample slack conditions (given higher GDP growth) and greater-than-expected inflation in the first quarter of the year and the early part of the second. For the core, they expect larger pressures on goods and services, with the latter higher on reduced restrictions to economic activity (due to lower cases and deaths from COVID-19 and progress on the vaccination process). Meanwhile, they warned that the central scenario incorporates shocks that have already impacted prices but does not account additional pressures that could surface, which in turn would represent a more adverse scenario. This is important because of current supply chain issues (which could take even longer to be resolved, impacting further price dynamics for goods) and even the possibility of the discussion and approval of a fiscal reform for next year, among other factors.

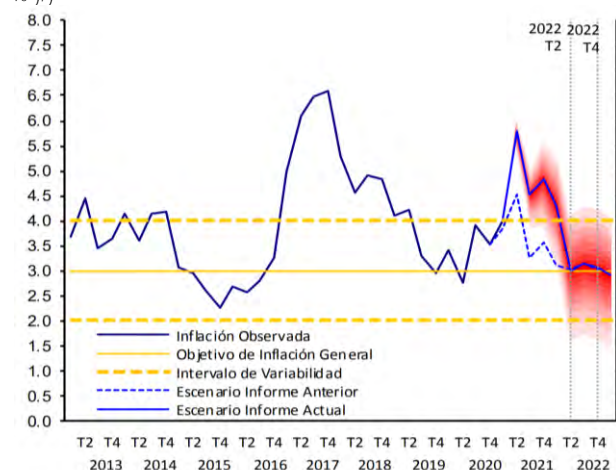
**...but the timing for convergence to the target was unchanged.** Specifically, headline inflation would reach the 3% target in 2Q22, as in the previous QR. This suggests that Banxico sees recent price pressures as transitory. Specifically, upward inflation surprises already observed are behind most of the forecast adjustments, so they would fade away in a twelve-month period. In addition, estimate changes are influenced importantly, but not exclusively, by base effects (for details, see section below). On the other hand, we highlight also that core inflation would not reach the 3% target in the horizon, with a minimum expected at 3.2% on average from 3Q22 onwards. In contrast, the previous QR had this metric oscillating around 3.0% since the third quarter of 2021. In our view this is an important hawkish development, supporting our call that the next monetary policy move will be a rate hike, most likely this year. The balance of risks remains to the upside, such as in the last statement. In the section where they expand about the factors that could affect it, among those to the upside they added the drought that is affecting several regions of the country, which could in turn pressure prices of some agricultural goods. To the downside, they were practically unchanged.

CPI forecasts  
% y/y, quarterly average

	2021				2022				2023
	I	II	III	IV	I	II	III	IV	I
CPI									
Current	4.0*	5.8	4.5	4.8	4.3	3.0	3.1	3.1	2.9
Previous	3.8	4.5	3.2	3.6	3.1	3.0	3.2	3.0	--
Difference (bps)	20	130	130	120	120	0	-10	10	--
Core									
Current	3.9*	4.3	3.9	3.9	3.9	3.3	3.2	3.2	3.2
Previous	3.9	3.6	3.0	3.1	3.0	3.0	3.0	3.0	--
Difference (bps)	0	70	90	80	90	30	20	20	--

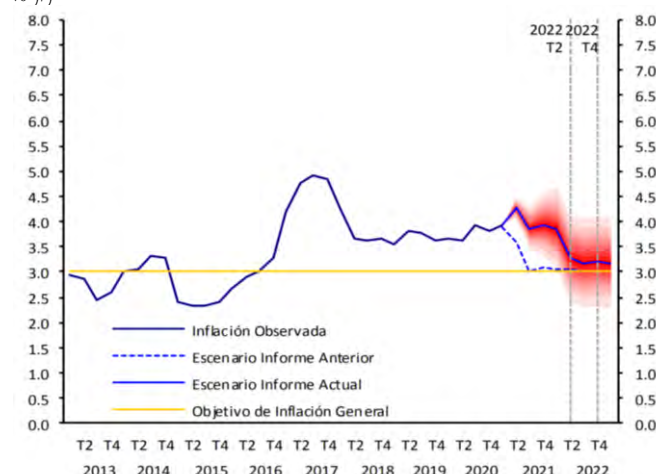
Source: Banco de México, 1Q21 QR; \*Observed data

Fan chart: Headline inflation\*  
% y/y



Source: Extracted directly from Banxico's 1Q21 Quarterly Report, only available in Spanish

Fan chart: Core inflation\*  
% y/y

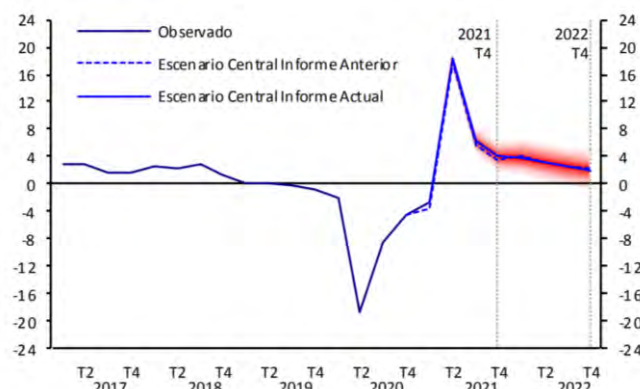


Source: Extracted directly from Banxico's 1Q21 Quarterly Report, only available in Spanish

**Higher GDP growth, reaching pre-pandemic levels by 2022.** The central bank also modified strongly its view on growth. For this year, their point estimate is 6.0% (range: 5.0% to 7.0%), significantly above 4.8% previously. This forecast is practically equal to our 5.9%. They also stopped presenting specific assumptions in terms of “Optimistic” and “Pessimistic” scenarios, as they were doing since the start of the pandemic. This suggests that uncertainty has moderated. The main factors behind the revision included: (1) A better-than-expected economic performance in 1Q21 and expectations of an acceleration in the second quarter and beyond; (2) external demand strength, mainly on sizable fiscal stimulus in the US; and (3) a reactivation of domestic demand on progress in vaccination campaigns and the gradual elimination of mobility restrictions. For 2022, they see growth of 3.0% (range: 2.0% to 4.0%), higher than our 2.5%. In this case, they anticipate growth to converge towards inertial GDP. In turn, these changes would mean higher job creation and a tendency towards a higher trade balance deficit (see charts below). The latter is likely because of more imports due to the reactivation of domestic demand. Despite of this, the current account would be less negative this year, probably considering higher income from remittances and tourism –because of a higher influx of foreigners– given the economic reactivation and inoculations.

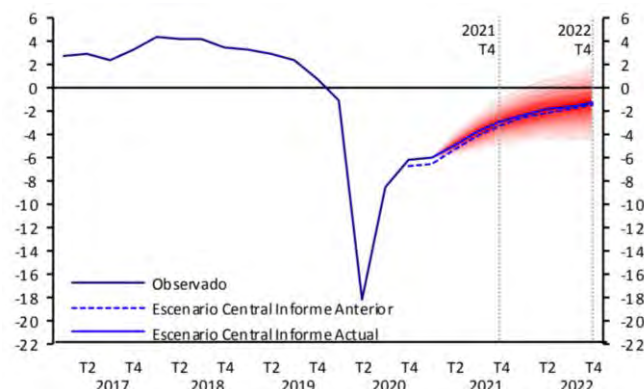
Lastly, in the base case scenario the economy would return to pre-pandemic levels (4Q19) by the second quarter of 2022. Nevertheless, the output gap should stay negative in all the forecast horizon as there is still room left to reach the trend seen before the COVID-19 shock. If growth reaches the upper end of estimates, this level would be reached by the fourth quarter of this year. On the contrary, if activity is near the lower bound, it would be delayed until the beginning of 2023.

GDP forecasts  
% y/y, seasonally adjusted figures



Source: Extracted directly from Banxico's 1Q21 Quarterly Report, only available in Spanish

Output gap  
Percentage points of potential GDP



Source: Extracted directly from Banxico's 1Q21 Quarterly Report, only available in Spanish

### Banxico's Forecasts

Current Report (1Q21)

	2021	2022
GDP (% y/y)		
Central scenario	6.0	3.0
Range	5.0 to 7.0	2.0 to 4.0
Employment (thousands)	370 to 570	390 to 590
Trade Balance (bn)	-3.7 to 1.3 (-0.3% to 0.1% of GDP)	-10.9 to -4.9 (-0.8% to -0.4% of GDP)
Current account (bn)	-4.8 to 3.2 (-0.4% to 0.2% of GDP)	-13.4 to -3.4 (-1.0% to -0.2% of GDP)

Source: Banxico

### Banxico's Forecasts

Previous 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

**Timely topics in the traditional grey boxes.** As usual, the central bank included a deep analysis of several important issues. In this occasion, they centered on factors associated to the recovery in activity as well as the effects on prices of recent dynamics. The seven boxes were: (1) Progress on vaccination processes and the global economic recovery; (2) Impact of fiscal stimulus in the US; (3) Sectoral contributions to aggregate slack; (4) Supply and demand drivers of the evolution of banking credit to corporates; (5) Contribution from base effects to headline inflation; (6) Influence of Mexican fruits and vegetables exports to the US on domestic prices; and (7) The correlation between domestic sovereign risk and the slope of the US yield curve. Considering strong adjustments on inflation estimates, we focused on boxes (5) and (6).

**Pressures on annual inflation partly due to base effects, albeit also due to an unfavorable performance at the start of the year.** Based on a decomposition analysis, the central bank analyzes price dynamics so far in the year, trying to identify two relevant components: (1) The accumulated impact on annual inflation due to variations in base effects; and (2) the accumulated component of other increases or declines. This is very relevant considering current conditions, with annual inflation at 5.80% in the 1<sup>st</sup> half of May –considerably above target, but very distorted by the first driver. Specifically, the study focuses on gasolines –given that these showed the largest decline in 2020–, but also considering the remaining components.

From this analysis, they estimate that the 265bps difference between annual inflation in 1H-May relative to December 2020 (5.80% vs. 3.15%, respectively) can be roughly separated into +50bps from base effects (both gasolines and other components) and +215bps on other influences. In our opinion, these are related to several factors, including: (1) Rising commodities prices on a more vigorous recovery; (2) cost pressures on the lack of key raw materials and higher transportation costs; and (3) focalized factors impacting some goods (*e.g.* corn tortillas). In addition, they do a similar analysis for the US, finding similar results. Considering the performance of inflation last year, Banxico estimates that the impact from base effects in upcoming fortnights will be negative, which is consistent with the forecast path outlined in the report.

**Substantial effect from agricultural demand in the US on domestic prices.**

Using instrumental variables, the institution tried to determine the relationship between exports of fruits and vegetables to the US and domestic price dynamics of this component. The analysis was made on eight relevant items, finding more significative results on two goods. Coincidentally, these two –tomatoes and avocados– are the ones that have a bigger export share. They conclude that a 1% increase in exports can generate an increase of 1.4% in the price of the first good and 0.4% in the second. This is very relevant in the current backdrop, as droughts are impacting not only our country but also other regions of the world, resulting in higher demand from the US from our country's products. Hence, we think the analysis: (1) Helps explain increases already observed year-to-date, especially on avocados, which are up 48.9%; and (2) suggests that trade dynamics of agricultural goods are an important factor behind the volatility of non-core inflation.

*From our Fixed income and FX strategy team*

**The short end of the yield curve is consistent with our expectation of rate hikes by year-end.** Despite the relevant adjustments in the central bank's forecasts, and especially in those regarding CPI, local rates' reaction to the Quarterly Report was relatively modest suggesting a market that is already factoring in a complex inflation scenario given the current backdrop. In this sense, Mbonos and TIE-28 swaps added pressures mainly in short-term rates of ~2bps following Banxico's release.

Since mid-May the Mbonos' yield curve has experienced a relevant flattening bias, with the long-end outperforming as the pause in the pressures in US Treasuries has allowed for a further breather in fixed-income securities but also supported risk assets, including those from emerging market regions. This rates' adjustment has permeated favorably shortest-term tenors. As a result, the pricing for future Banxico's movements has corrected towards more feasible levels considering the available space for rate hikes. Currently, the yield curve is incorporating implied rate hikes for +47bps in December, matching our expectation of a reference rate closing 2021 at 4.50%. In terms of strategy, we hold our [trade recommendation in Mbono Mar'26](#).

In the FX market, the Mexican peso held remarkably stable with the currency near to levels of 19.90 and a modest appreciation of ~0.3% with respect to yesterday's close. The consolidation dynamics experienced recently in the MXN respecting levels around 19.70 and 20.30 has occurred under a scene of a widespread USD weakening and broad compression in volatility gauges. We prefer to hold a cautious view given the current market backdrop and suggest buying USD in dips for trading purposes.



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We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldivar, Marissa Garza Ostos, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, 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.

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