

Banxico QR – Modest changes to the macro outlook, maintaining a hawkish tilt

- Banxico published today its 2Q21 *Quarterly Report (QR)*. The release was accompanied by a press conference by Governor Alejandro Díaz de León
- We think the document maintains a hawkish bias. As expected, there were modest revisions to macro forecasts, while those for inflation were unchanged
- Specifically, GDP growth is estimated at 6.2% (+20bps) and 3.0% (unchanged) in 2021 and 2022, respectively
- The balance of risks for inflation remains skewed to the upside. We also note that:
 - (1) The expected convergence of headline inflation to the target remains in 1Q23, as already mentioned [in the last statement](#);
 - (2) Recent changes were mainly on higher core inflation, especially in goods, but also in services; and
 - (3) The Q&A had several questions about the price ceiling to LP gas, but in our view most Board members are not giving a very elevated weight to this when thinking about the inflation outlook
- The trade and current account balances are estimated with a wider deficit this year, while employment affiliated to IMSS is seen stronger. The central bank expects the recovery will continue in the second half of the year, despite COVID-19 risks
- There were seven traditional *grey boxes*. We focus on those related to inflation, including an analysis of the effect of global inflation on domestic CPI and the policy response to different types of inflation shocks
- With no significant new information, we maintain our call that Banxico will raise interest rates by 25bps in each of the remaining three meetings of this year, to 5.25%. Nevertheless, they keep stressing their high data dependence, which is key as the Board remains divided
- Modest effect in local markets, with the curve's pricing reflecting two 25bps rate hikes for this year

Few changes to the outlook, with inflation still in close sight. Banxico published today its *Quarterly Report (QR)* for 2Q21, accompanied with a press conference led by Governor Alejandro Díaz de León. We think the document maintains a hawkish bias. As expected, we had modest revisions to macro forecasts, while those for inflation were unchanged (as they were updated less than a month ago). The mid-point estimate for GDP this year is at 6.2% (+20bps to the previous forecast) and at 3.0% for 2022. Both are exactly in line with our views. On prices, the main highlight were the questions about the possible effect on inflation from the introduction of a price ceiling to LP gas. All in all, and considering that there was no meaningful new information, we maintain our monetary policy call unchanged. Specifically, we expect Banxico to raise interest rates by 25bps in each of the remaining three meetings of this year, to 5.25%. For 2022, we see two 25bps hikes at the beginning of the year and one more at the end, with the rate ending said period at 6.00%.

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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
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA
Director of Economic Research
juan.alderete.magal@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.oroazco.velez@banorte.com

Banxico's 2021 policy decisions

Date	Decision
February 11	-25bps
March 25	0bps
May 13	0bps
June 24	+25bps
August 12	+25bps
September 30	--
November 11	--
December 16	--

Source: Banxico

Document for distribution among the general public

Inflation forecasts unchanged, with expanded commentary about the drivers of recent revisions. Given that forecasts were updated less than a month ago, they were not modified in the horizon (up to 2Q23). The expected moment of convergence to the target also remained in 1Q23. As a result, we focus on expanded comments about the drivers. Among them, they believe some of the upward shocks to prices because of the pandemic have exacerbated, while those to the downside have tended to reverse, with the main driver being adjustments to the core. They included recent shocks –especially in goods, but also in services– as well as the expectation that they will stay affected by some cost pressures. At the non-core, they anticipate a higher path for agricultural goods prices than in the previous report. Risk factors were also very similar to the last decision, adding only to the downside: (1) That slack conditions and hiring conditions do not pressure prices; and (2) if energy prices are below projections.

The effect of a price ceiling to LP gas. Another key focus, especially in the Q&A, was the view about the recent introduction of a price ceiling to LP gas which [reduced inflation in 1H-August](#). In the document, they said that the previous QR incorporated lower prices than actual data for both June and July. Nevertheless, and because of the new policy, estimates are currently similar to actual prices. Hence, forecasts have “caught up” with data and were not a meaningful driver in the revision. This does not rule out that additional changes have a sizeable impact ahead. When asked about this in the press conference, Governor Díaz de León said they would not give an opinion on what could happen to price dynamics in this good. He only mentioned that they keep looking closely at upcoming inflation data. On the other hand, Deputy Governor Heath did not rule out this measure to influence short-term inflation. Nevertheless, he warned that international experience shows that price ceilings tend not to work and create distortions, among them possible scarcity. Therefore, he argued that its impact is not likely to be permanent. Overall, we think most Board members are not giving a very elevated weight to this when thinking about the inflation outlook.

CPI forecasts

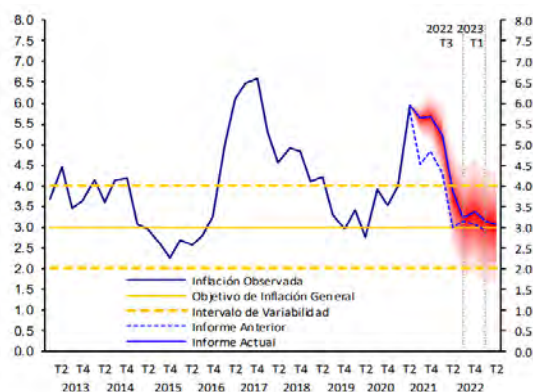
% y/y, quarterly average

	2021	3Q21	4Q21	1Q22	2022	3Q22	4Q22	1Q23	2023
Headline	6.0*	5.6	5.7	5.2	3.9	3.2	3.4	3.1	3.1
Core	4.4*	4.7	5.0	5.1	4.4	3.6	3.3	3.1	3.0

Note: Comparisons to the previous QR are not presented because forecasts will be updated in each policy decision

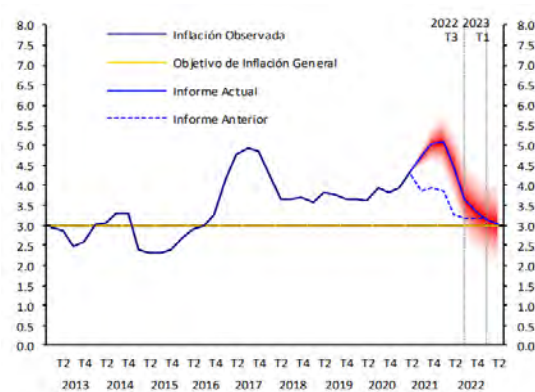
Source: Banco de México. *Observed data

Fan chart: Headline inflation*
% y/y



Source: Extracted directly from Banxico's 2Q21 Quarterly Report, only available in Spanish

Fan chart: Core inflation*
% y/y



Source: Extracted directly from Banxico's 2Q21 Quarterly Report, only available in Spanish

Slight upward revision in GDP growth this year. The central bank made modest adjustments to their forecasts. For this year, their point estimate for GDP stands at 6.2% (range: 5.7% to 6.7%), just 20bps higher than previously. This is exactly equal to our call. This is based on: (1) [Higher-than-anticipated growth in 2Q21](#); and (2) progress in the vaccination campaign in a backdrop of higher mobility and reopening of the economy, mainly helping services. As mentioned in the last statement, they also forecast that the recovery will continue in the second half of the year. In their central scenario, pre-pandemic levels of activity would be reached in 1Q22, one quarter sooner than in the previous *Quarterly Report*. Nevertheless, the output gap will remain negative in the forecast horizon. For 2022, the forecast stayed at 3.0%, also in line with our estimate. The central bank keeps warning about very high uncertainty, flagging global supply bottlenecks and the recent rise of COVID-19 cases. To the upside, they talk about a faster dissipation of the pandemic and a positive impact from global and local stimulus measures that in turn boost confidence, as well as an uptick in investment helped by USMCA, among others. Other forecasts also reflect higher activity, highlighting a higher range for employment affiliated to IMSS, along a wider trade and current account deficit in both years –except for the latter in 2022–. In our view, these changes are positive and suggest an outlook in which domestic demand may recover faster than expected, and even the possibility of remittances maintaining brisk growth next year.

GDP forecasts
% y/y, seasonally adjusted figures



Source: Extracted directly from Banxico's 2Q21 Quarterly Report, only available in Spanish

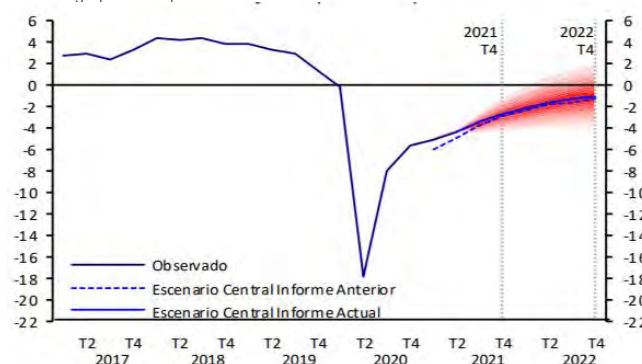
Banxico's Forecasts

Current Report (2Q21)

	2021	2022
GDP (% y/y)		
Central scenario	6.2	3.0
Range	5.7 to 6.7	2.0 to 4.0
Employment (thousands)	640 to 840	500 to 700
Trade Balance (bn)	-8.7 to -3.7 (-0.7% to -0.3% of GDP)	-11.8 to -5.8 (-0.8% to -0.4% of GDP)
Current account (bn)	-6.4 to 1.6 (-0.5% to 0.1% of GDP)	-10.2 to -0.2 (-0.7% to 0.0% of GDP)

Source: Banxico

Output gap
Percentage points of potential GDP



Source: Extracted directly from Banxico's 2Q21 Quarterly Report, only available in Spanish

Banxico's Forecasts

Previous 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

Relevant topics in the traditional grey boxes, focused on inflation. As usual, the central bank included a deep analysis of several important issues. In this occasion, they centered on factors associated to price dynamics, both external and domestic, along activity and central bank operational issues. The seven boxes were: (1) Factors related to recent inflation dynamics in the US; (2) Allocation of the IMF's *Special Drawing Rights*; (3) Estimates on the impact of supply-chain disruptions on auto production and economic activity; (4) Physical currency demand in Mexico during the COVID-19 pandemic; (5) Influence of global price pressures on Mexican inflation; (6) Progress on the central bank's communication strategy; and (7) Inflation shocks, anchoring of expectations and monetary policy. Considering prevailing concerns on inflation, we focused on boxes (5) and (7).

Higher global prices taking a toll on Mexican CPI. Using inflation data from 29 AEs and 9 EMs (including Mexico), the central bank tries to identify a global inflation trend. This is done through a *Principal Components Analysis* (PCA), creating values that capture volatility across the different series. The analysis was applied to both headline inflation as well as the series excluding food prices (both processed and fresh) and energy. The first conclusion is that the current inflation spike is a widespread phenomenon and not explained by a rise in any given country. However, the correlation is higher with the headline index than with the 'core' metric, consistent with the tight relation of international energy and commodity markets. Using results from the PCA, a load factor can be calculated for Mexico, allowing the study of this global component on domestic prices. This metric stands around 0.657, which implies that more than 50% of the variation is explained by this factor. This is more comparable with values obtained for AEs (0.696) than EMs (0.251), suggesting a tighter integration to global markets. As a result, the *box* concludes that inflation during the pandemic has been mostly driven by global factors. Nevertheless, some idiosyncratic pressures have been at play, mostly driving prices higher across this period.

Inflation shocks and the corresponding policy response, along effects on expectations. With a Vector Autoregression model (VAR), the central bank aims to identify the nature of inflation shocks and the corresponding policy response to each one of them. In addition, they also identify the effect of reference rate hikes on inflation expectations. Using activity and price variables, they identify three types of shocks: (1) Demand driven; (2) reversible supply driven; and (3) non-reversible supply driven. They identify them with the interaction between prices and activity levels. The first result is that the central bank responds to both demand and non-reversible supply shocks with some force. Moreover, they also respond to reversible ones, but more modestly. In our view, this might be because of the difficulty in identifying the specific type of shock in real time. Moreover, they mention that the correlation between a rate hike and long-term inflation expectations is negative, with the latter decreasing in the presence of a tighter monetary policy. These results suggest that actions taken by Banxico have bolstered its credibility and that they indeed influence expectations.

Hawkish tone, but highly data dependent. With no significant new information, we maintain our call that Banxico will raise interest rates by 25bps in each of the remaining three meetings of this year, to 5.25%. Nevertheless, they keep stressing their high data dependency, which is key as the Board remains divided. In our view, this was abundantly clear [in the latest minutes](#). Therefore, new developments –especially on inflation– could well tilt the balance in either direction in terms of upcoming policy decisions. In this backdrop, our call rests mainly on the idea that the hawkish wing will stay convinced about the need of further adjustments because of sticky core inflation. Based on our forecasts, the latter will stay above Banxico’s upper bound around the target at least until the end of 2Q22. This is broadly consistent with the central bank’s estimates. On the other hand, it is also relevant that the reference rate is still below the estimated neutral level. Moreover, it is our take that today’s changes to other macro forecasts will not weigh much on this. This is likely even for Deputy Governor Jonathan Heath, who we identify as the current “marginal” voter and that we also think made the argument that the output gap may be miscalculated and in positive territory by now (which in turn, would be hawkish). Nevertheless, we believe he also stated that the new stance could be enough for the time being, increasing the data dependency of future decisions. Hence, in our assessment, he is the one most likely to eventually choose a pause, although this is not our base case, at least for this year. Lastly, for 2022 we expect two 25bps hikes at the beginning of the year and one more at the end, with the rate ending said period at 6.00%.

From our Fixed income and FX strategy team

Modest effect in local markets, with the curve’s pricing reflecting two 25bps rate hikes for this year. The Mexican rates’ market experienced a limited reaction to today’s Quarterly Report, with the Mbonos’ yield curve strengthening by ~3bps in long-term tenors, even when considering a pressured session in other regions led by Europe where inflation figures printed above expectations. Meanwhile, TIEE-28 swaps kept modest pressures of 1bp. As a consequence, the market’s pricing on Banxico’s next moves did not changed materially, currently incorporating implied hikes by 47bps for year-end 2021 and 140bps in a 12-month horizon. This expectation is below our estimate of a reference rate closing this year at 5.25%, reason why we expect the curve to correct as the following economic data for Mexico, especially those related to inflation, result in a repricing of further hikes in the year, despite the current division of the Board exposed in the last communications. Moreover, the long-end of the nominal yield curve has depicted a mostly stable performance in the last weeks, although holding elevated premiums against US Treasuries. We think this reflects an interesting valuation at these maturities; however, we prefer to wait for better entry levels for long directional strategies as, in our view, the local yield curve will pressure from the effect of the Fed’s tapering announcement via higher rates in US Treasuries.

In the FX market, the effect for the Mexican peso was muted with the currency trading close to 20.10 (+0.3 d/d) and stood as one of the least benefited from a strong performance in other EM currencies during the day. Recent price action has depicted resistance to extended with more conviction an appreciation below the 200-day moving average currently at 20.12, while next resistance level stands at 20.00. In a short-term view, this week counts the US employment reports, which in case of supporting the view of recovery conditions robust enough to start the normalization of the Fed's stance, could revert the losses seen since last Friday in the USD. In this sense, we prefer to hold a cautious view for the MXN, bidding USD in dips. Moreover, we considering that beginning of the Fed's tapering will drive a structural strengthening for the USD.

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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, Alik Daniel García Álvarez, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo 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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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
Alik Daniel García Álvarez	Senior Strategist, Equity	alik.garcia.alvarez@banorte.com	(55) 1670 - 2250
Víctor Hugo Cortes Castro	Senior Strategist, Technical	victorh.cortes@banorte.com	(55) 1670 - 1800
Juan Barbier Arizmendi, CFA	Analyst	juan.barbier@banorte.com	(55) 1670 - 1746
Corporate Debt			
Hugo Armando Gómez Solís	Senior Analyst, Corporate Debt	hugo.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.faesil@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
Osvaldo Brondo Menchaca	Head of Specialized Banking Services	osvaldo.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