

# Ahead of the Curve

## We expect a close-call cut of 25bps by Banxico

- Monetary policy decision (November 14<sup>th</sup>).** We expect a 25bps cut, which would leave the reference rate at 7.50%. In our view, the decision will be split and with a more dovish tone than in the previous communique, signaling that the central bank sees fit to continue with the easing cycle that started in August. Nevertheless, we expect Banxico to remain relatively cautious, at least for now, given that: (1) Core inflation remains above target despite the widening of the output gap; (2) more definition about the policy framework and global backdrop in 2020 is needed. In our view, some of the most relevant short-term risks that will likely see important developments soon include the magnitude of the minimum wage increase for 2020, the approval and details of the Budget for 2020, USMCA ratification in the US, trade tensions between the US and China, and the general election in the UK in the midst of the *Brexit* process; and (3) the Fed's pause on easing monetary policy further. Despite these, we acknowledge other factors have helped the case of accelerating the pace of easing. Among them, we highlight that headline inflation is virtually at the central bank's target while the economy remains weak, the recent capitalization of Pemex that we believe has lowered the probability of a rating downgrade of the company and the sovereign in the short term, and a stronger-than-expected performance of the Mexican peso
- Industrial production (September).** We estimate activity at -1.5% yoy from -1.3% in August. By sector, we expect mining at -3.6%, manufacturing at 0.4% and construction at -4.1%. If our forecast materializes, industry in 3Q19 would have contracted 1.5%. It is our take that the impact during the month from GM's strike on the auto sector was mainly in exports, seeing a less pronounced effect in production as companies were able to draw down inventories, although likely to be more adverse in October. With seasonally-adjusted figures we anticipate a 0.2% m/m rebound, which would be the second consecutive print in positive territory

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### Mexico weekly calendar

| DATE       | TIME (ET) | EVENT                                                                                        | PERIOD    | UNIT    | BANORTE | CONSENSUS | PREVIOUS |
|------------|-----------|----------------------------------------------------------------------------------------------|-----------|---------|---------|-----------|----------|
| Fri 9-Nov  | 7:00am    | Industrial production                                                                        | September | % yoy   | -1.5    | --        | -1.3     |
|            |           | sa                                                                                           |           | % m/m   | 0.2     | --        | 0.8      |
|            |           | Mining                                                                                       |           | % yoy   | -3.6    | --        | -3.2     |
|            |           | Utilities                                                                                    |           | % yoy   | -1.4    | --        | 2.7      |
|            |           | Construction                                                                                 |           | % yoy   | -4.1    | --        | -2.9     |
|            |           | Manufacturing                                                                                |           | % yoy   | 0.4     | --        | -0.5     |
| Tue 13-Nov | 10:00am   | International reserves                                                                       | Nov-8     | US\$ bn | --      | --        | 180.7    |
| Tue 13-Nov | 12:30pm   | Government weekly auction: 1-, 3-, and 6-month Cetes; 3y MBono (Mar'23); 3y Udibono (Jun'22) |           |         |         |           |          |
| Thu 15-Nov | 2:00pm    | Banxico's monetary policy decision                                                           | Nov-14    | %       | 7.50    | 7.50      | 7.75     |

Source: Banorte; Bloomberg

## Proceeding in chronological order...

### **Industry in September to advance modestly, still in a challenging backdrop.**

We estimate industrial production at -1.5% yoy from -1.3% in August. Nevertheless, with seasonally- adjusted figures we anticipate a 0.2% m/m rebound, which would be the second consecutive print in positive territory. If this is the case we would judge the result as relatively positive, although it should be taken into account that October is likely to be weak once again on the back of an impact in auto manufacturing due to GM's strike in the US.

By sector, we forecast mining at -3.6% yoy. Although this would be below August's -3.2%, the pace of decline would be more modest than in the first half of the year, mainly on signs of a better performance in oil. Pemex's crude oil production fell 5.3%yoy to 1.73mbpd, which despite still in contraction was its fifth consecutive month with a sequential advance. Gas production was also stronger, at 2.1% from 0.8% in August. On the contrary, we expect some weakness in services, which are typically very volatile. In this respect, recent efforts by Pemex to stabilize production seem to be starting to have a clearer impact, at least in terms of being a more modest drag to the sector.

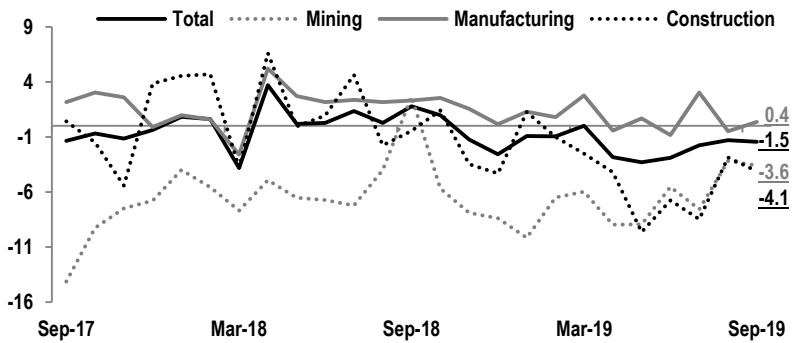
In manufacturing, we expect a modest advance of 0.4%. It is our take that the impact during the month from GM's strike on autos was mainly in exports (as already portrayed in trade balance data). We see a less pronounced effect in terms of production as companies were able to draw down inventories, with a more adverse effect likely until October. According to AMIA, production fell only 0.4% yoy, above the -9.6% of the previous month. Meanwhile, total intermediate-goods imports, closely related to the sector, actually increased 1.7%.

Last but not least, we estimate construction at -4.1%, with some payback after August's relatively strong performance while also affected by a more challenging base effect. Despite of the latter, there have been some signs about an improvement in the sector, highlighting: (1) Higher business confidence, with the index climbing to a three-month high of 49.2pts, and particularly in the 'adequate moment to invest' component; and (2) reports that activity in Mexico City started to reactivate more meaningfully from this month forward on the back of efforts by the local government to speed-up activity. Nevertheless, business confidence in October failed to gather strength and financing costs remain elevated, a situation that makes us a little skeptic about the underlying fundamentals.

As a result, industry in 3Q19 would have contracted 1.5% yoy, still negative albeit stronger than in the previous quarter (-3.0%), which was distorted downwards by the effect of the Holy Week. Unfortunately, October will likely be weaker due to the temporary shock from the abovementioned strike. In this backdrop, we will be focused in manufacturing, which so far has been resilient despite trade tensions and has been among the few supports to GDP as domestic demand has slowed down meaningfully.

## Industrial production

% yoy



Source: INEGI, Banorte

**Weekly international reserves report.** Last week, net international reserves increased US\$295 million, closing at US\$180.7 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\$5.9 billion during 2019 (please refer to the following table).

### Banxico's foreign reserve accumulation detail

US\$, million

|                                         | 2018    | Nov 1, 2019 | Nov 1, 2019 | Year-to-date |
|-----------------------------------------|---------|-------------|-------------|--------------|
|                                         | Balance |             | Flows       |              |
| International reserves (B)-(C)          | 174,793 | 180,728     | 295         | 5,935        |
| (B) Gross international reserve         | 176,384 | 183,646     | 332         | 7,262        |
| Pemex                                   | --      | --          | -140        | -5           |
| Federal government                      | --      | --          | 301         | 1,488        |
| Market operations                       | --      | --          | 0           | 0            |
| Other                                   | --      | --          | 170         | 5,777        |
| (C) Short-term government's liabilities | 1,592   | 2,918       | 37          | 1,327        |

Source: Banco de México

**Weekly government bond auction.** The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 3-year fixed-rate Mbonos (Mar'23), 30-year inflation-linked Udibonos (Jun'22), in addition to the 1-, 3-, and 6-month zero-coupon Cetes (see following table). As usual, results will be released at 12:30pm (ET).

### Auction specifics (Tuesday, November 12<sup>th</sup>, 2019)

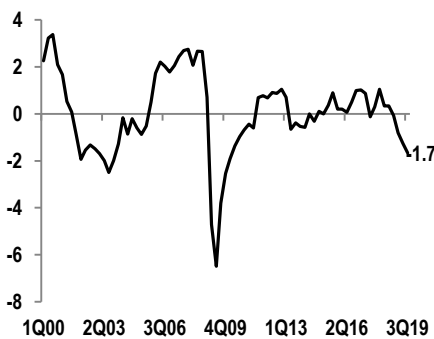
|                 | Maturity  | Coupon rate, % | To be auctioned <sup>1</sup> | Previous yield <sup>2</sup> |
|-----------------|-----------|----------------|------------------------------|-----------------------------|
| <b>Cetes</b>    |           |                |                              |                             |
| 1m              | 11-Dec-19 | --             | 6,000                        | 7.55                        |
| 3m              | 13-Feb-20 | --             | 13,000                       | 7.52                        |
| 6m              | 07-May-20 | --             | 14,500                       | 7.40                        |
| <b>M Bono</b>   |           |                |                              |                             |
| 3y              | 09-Mar-23 | 6.75           | 10,500                       | 6.68                        |
| <b>Udibonos</b> |           |                |                              |                             |
| 3y              | 09-Jun-22 | 2.00           | UDIS 875                     | 3.40                        |

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

**Banxico to continue the easing cycle with a 25bps rate cut.** Next Thursday, Banxico will hold its next-to-last meeting of 2019, in which we expect a 25bps cut to leave the reference rate at 7.50%. According to the latest *Citibanamex* survey, all analysts expect a reduction, with our view shared by other 17 out of 23 participants while 5 anticipate a 50bps cut, a scenario for which we assign a non-negligible probability, as two members in the last decision (Deputy Governors Heath and Esquivel) favored this call. In our view, the decision will be split and with a more dovish tone than in the previous communique, signaling that the central bank sees fit to continue the easing cycle that started in August. We expect the central bank to opt for a 25bps rate cut, based on:

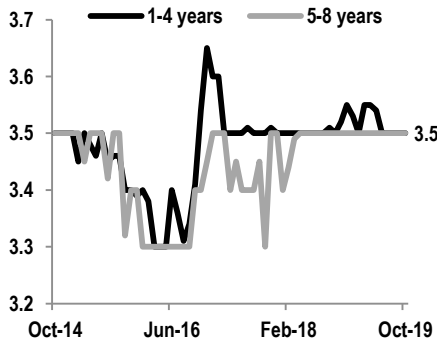
(1) *Core inflation remaining above target despite the widening of the output gap.* In this respect, the minutes of the meeting held on September 26<sup>th</sup> showed most members remain concerned about core inflation staying above the 3% target, reaching 3.68% yoy at the end of October and falling only gradually from its recent high of 3.87% in April. We see the magnitude of the decline as modest given the steep fall of headline inflation and amid greater economic slack, a concern shared by the Board. As of 3Q19 (using preliminary data) we estimate the output gap at -1.7% of GDP, widening from +0.3% in 3Q18 and at a new low since early 2010, when the economy was recovering from the financial crisis (see chart below, left). Mid- and long-term inflation expectations have stayed close to 3.5% for quite some time (chart below, middle), also above target despite the deceleration of the economy since 4Q18 (chart below, right). In our view, the most recent downward drift in core inflation makes it likely that Banxico will show a more dovish bias. Nevertheless, we believe details about inflation dynamics so far, in which the main driver behind reaching the 3% target has been the fall of the non-core component, suggest that the central bank will not change its relatively cautious and prudent approach, at least for now.

**Output gap**  
% of potential GDP



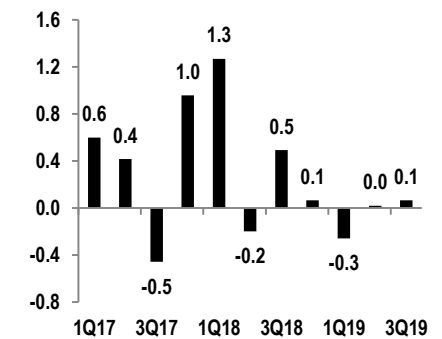
Source: Banorte with data from INEGI

**Mid- and long-term inflation expectations**  
%, yoy



Source: Banxico survey

**GDP growth**  
%, q/q sa



Source: INEGI

(2) *The need for more definition about the policy framework and global backdrop in 2020.* In our view, the central bank can purchase a “cheap option” by waiting to have more definition on several fronts, with those we deem most relevant highlighted in the table below. In our view, Banxico is likely on watch for the decision about the magnitude of the minimum wage (MW) increase for 2020, as they have repeatedly stated that one of the most relevant upside risks for inflation is that strong wage increases could lead to cost pressures if they are not coupled with productivity gains.

Moreover, some members believe the resistance to the downside of this component is related precisely to this year's above-average increase (for details about the latest announcement, see: "*The National Commission for Minimum Wages agreed on a 16.2% increase for 2019*", <[pdf](#)>, December 17<sup>th</sup>, 2018). In our view, next year's increase could be between 10-15%, with comments from the president and cabinet members biased in favor of relatively significant hikes. Last month, business chamber COPARMEX recommended a MW of 127.76 pesos per day, 24.4% higher compared to this year. Inflation dynamics so far in 2019 makes us think that the effect of a higher MW on prices might be relatively modest –particularly considering the level of the output gap–, although uncertainty about the impact is very high due to the possibility of a higher pass-through effect driven by the “lighthouse effect”. In this respect, we will keep an eye on this decision, which is typically known between the end of November and the first weeks of December.

In the fiscal front, we believe Banxico will also be tracking closely the estimates from the Ministry of Finance about this year's use of the *Stabilization Fund*, with the latest forecast at around MXN 150 billion (53.6% of the fund's size as of December 2018, given that some resources have already been spent). In the latest minutes, one member argued that “...*the use of more resources from the Oil Revenues Stabilization Fund (...) may lead to future pressures on public finances, given that part of the reserves to face future shocks would be depleted...*”. Regarding the *2020 Budget*, the Senate approved the Revenue Law on November 5<sup>th</sup>, increasing expected income by almost MXN\$7 billion. In this regard, some central bank members warned that several analysts think some of the assumptions are optimistic, resulting in prevailing risks for fiscal policy. Considering this, the final spending budget should be approved by the Lower Chamber no later than November 15<sup>th</sup>, in which it will also be important to see how these additional resources will be spent as well as any reshuffling that might be agreed upon.

Externally, the ratification of USMCA by the US Congress has also been in the mind of Board members. Prospects of a favorable outcome seem to have increased. Nancy Pelosi, the Speaker of the House, said that negotiations with the White House have been positive and that she would be ready to put the agreement for a vote as soon as it is ready, although without discarding that it can be delayed until early 2020. Regarding trade tensions, the US and China seem closer to the signature of an agreement before year-end. Nevertheless, after the cancelation of the APEC meeting in Chile which was scheduled for mid-November, a definite date has not been settled and details about its possible scope are still missing. Finally, a general election in the UK will be held on December 12<sup>th</sup>, with the results important for the Brexit process. Although economic ties with Mexico are limited, the potential impact of the result on market volatility, especially on the Mexican peso, is also relevant in terms of the central bank's assessment of financial stability risks.

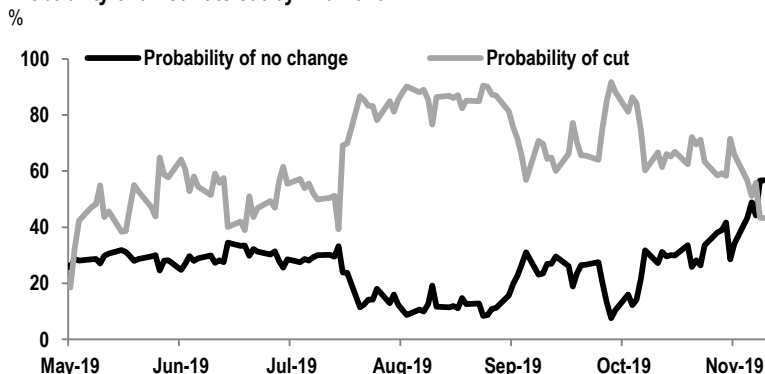
### Risk events in the short-term

| Concept                                                         | Possible outcome                                                                                                           | Comments                                                                                                                                                                                                                                                                         |
|-----------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Use of the Stabilization Fund / Approval of the Spending Budget | The amount used will be similar to the one announced by the MoF, while the budget will be approved in a timely manner      | While the use of resources from the Stabilization Fund could pressure public finances, we believe fiscal prudence will prevail. Meanwhile, the approved increase in revenues could be used for higher social spending, considering the administration's priorities on this front |
| Revision of Mexico's 3Q19 GDP                                   | Revised figures will be published on November 25 <sup>th</sup>                                                             | There is a possibility that seasonally-adjusted data show significant revisions, particularly since they are very close to zero                                                                                                                                                  |
| Minimum wage increase                                           | A similar increase relative to the 16.2% raise at the beginning of the year is approved for 2020, estimated between 10-15% | We expect the announcement towards the end of November or beginning of December. Recently, business chambers have argued in favor of a significant increase, which could represent upward risks for inflation                                                                    |
| Ratification of USMCA in the US                                 | USMCA is approved in the short-term, either by late 2019 or early 2020                                                     | Nancy Pelosi commented that important advances have been made in the discussions between both parties. However, the process could be delayed given the start of the impeachment process against President Trump                                                                  |
| US-China trade war                                              | A "phase one" agreement is signed before year-end                                                                          | Considering recent progress, including the possible and gradual reduction of tariffs, the probability of further escalation has decreased considerably. This could help drive some recovery of global economic activity                                                          |
| Brexit                                                          | The Conservative party wins Parliamentary elections                                                                        | If the Conservative Party obtains more seats in Parliament, Boris Johnson's plan seeking to leave the EU on Jan 31, 2020 could strengthen                                                                                                                                        |

Source: Bloomberg, WSJ, national newspapers

(3) *The Fed has paused on easing monetary policy.* As widely expected, the Fed cut the range the *fed funds* rate by 25bps to 1.50-1.75% on October 30<sup>th</sup>. The decision was not unanimous, while in our view the tone of the communique was less dovish. In this respect and more importantly, chairman Powell said that “...*the current policy is likely to remain appropriate...*” as long as the economy expands moderately, and the labor market stays strong. We believe this signals that the bar for additional rate cuts is quite high and that the Fed will pause on cutting rates for an extended period. This interpretation was also observed in the adjustment lower priced-in by the market in terms of the implied probability of at least one more rate cut by mid-2020 (see chart below). Given that the relative monetary stance between Mexico and the US has been key for Banxico's monetary policy decisions, we think the latest Fed decision reduces the possibility of a steeper path lower for the reference rate given the importance of the short-term interest rate spread for the relative attractiveness of Mexican assets. Although we believe Banxico has room to gradually reduce the spread with the US, it is our take the central bank will remain cautious at least as uncertainty about some relevant domestic and external risks remains high, as mentioned above.

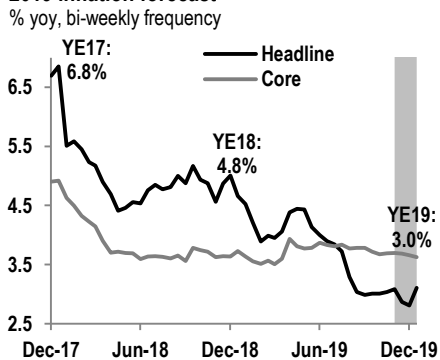
#### Probability of a Fed rate cut by mid-2020



Source: Bloomberg

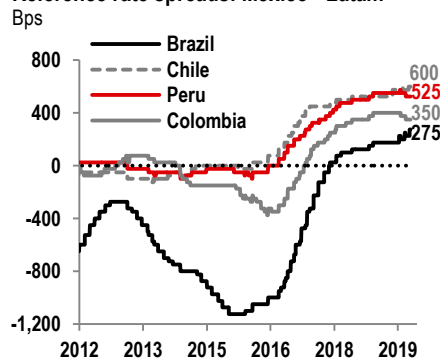
Despite these factors, we acknowledge that recent developments have helped the case of accelerating the pace of easing. First, headline inflation is virtually at the central bank’s target, a situation we expect to prevail in the short term. (see chart below, left). For details, see: “*We revise our year-end inflation forecast to 3.0% from 3.3%*” <[pdf](#)>. Activity has been limited, as already mentioned, with the weakest link for aggregate demand being investment spending. We believe reducing financing costs would help, in a context with room to cut relative to other EMs that compete for financial flows in the region (with reference rate spreads at highs, as shown in the chart below on the middle) also providing flexibility for easier financial conditions. Moreover, other financial stability risks have waned, highlighting: (1) The recent capitalization of Pemex –with the Federal Government injecting US\$5 billion of fresh resources– coupled with a series of financial transactions that have diminished short-term liquidity risks. In our view, this has lowered the probability of a rating downgrade of the company and the sovereign, helping moderate financing costs and risk premiums (chart below, right); and (2) a stronger-than-expected performance of the Mexican peso, currently near 19.10 per dollar, in a risk-on environment characterized by, among other factors, a weaker USD globally on optimism of a resolution of global trade tensions, helping to reduce some of the concerns about its pass-through effect to inflation.

**2019 inflation forecast**



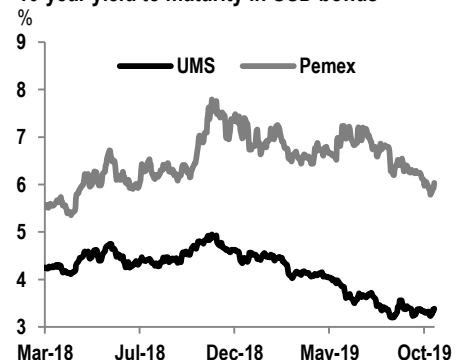
Source: Banorte with data from INEGI

**Reference rate spreads: Mexico - Latam**



Source: Banorte with data from Bloomberg

**10-year yield to maturity in USD bonds**



Source: Bloomberg

Overall, we expect a split decision in favor of a 25bps rate cut, with a more dovish tone relative to the previous communique, helping to reaffirm that the central bank is in the midst of an easing cycle. Moreover, we reiterate our view that Banxico will keep cutting the interest rate, with our year-end forecast at 7.25% and continuing in 2020, with our estimate for a terminal rate of 6.00% Nevertheless, we recognize that the outlook on inflation, weak GDP growth and the widening of the output gap, and the easing bias of global monetary policy may help the central bank to increase the pace of rate cuts. In this regard, we believe that the speed and magnitude of future adjustments will largely depend on the resolution of some of the most immediate risks in the horizon, both domestic and external. We believe the central bank will maintain a relatively cautious approach in next week’s decision, particularly as Board members are well aware that high levels of uncertainty, coupled with an accelerated pace of rate cuts, could increase financial stability risks going forward.

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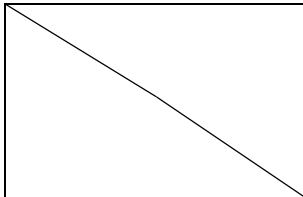
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|                                                                                     |                                                                                                                                                                                                                                                                     |
|-------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  | <b>Reference</b>                                                                                                                                                                                                                                                    |
| <b>BUY</b><br><b>HOLD</b><br><b>SELL</b>                                            | When the share expected performance is greater than the MEXBOL estimated performance.<br>When the share expected performance is similar to the MEXBOL estimated performance.<br>When the share expected performance is lower than the MEXBOL estimated performance. |

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