

Ahead of the Curve

August 7, 2015

Market focus this week will on Banxico's Quarterly Inflation Report

- Banxico's QIR (2Q15).** Banco de México will publish its Quarterly Inflation Report (QIR) for 2Q15 on Wednesday around 1:30pm (EDT). The release will be accompanied by a press conference led by Governor Carstens. In our view, market participants will focus on three issues: (1) A downward revision to the central bank's inflation forecast that will be reflected in Banxico's traditional fan chart; (2) Banxico's output gap projection; and (3) U.S. Fed's monetary policy normalization
- Banxico's minutes.** Next week (Thursday, August 13), Banco de Mexico will publish the minutes of its monetary policy meeting held back on July 30, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view, the tone of Banxico's minutes will be quite similar to the last communiqué, mainly focused on three issues: (1) The balance of risks for economic growth continues to be relatively weak; (2) the balance of risks for inflation has improved; and (3) their attention is focused on the timing at which the U.S. Fed will begin its hiking cycle, given that any actions from the U.S. Fed could have repercussions on the Mexican exchange rate and inflation expectations

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Mexico weekly calendar

DATE	HOUR (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Mon 10-Aug		Wage negotiations	July	%	<u>4.5</u>	--	4.4
Tue 11-Aug	9:00am	Industrial production	June	% yoy	<u>0.6</u>	1.2	-0.9
		(sa)		% m/m	<u>0.3</u>	--	-0.4
		Mining		% yoy	<u>-8.1</u>	--	-8.0
		Utilities		% yoy	<u>2.4</u>	--	1.2
		Construction		% yoy	<u>3.0</u>	--	1.6
		Manufactures		% yoy	<u>3.1</u>	3.2	0.8
Tue 11-Aug	10:00am	International reserves	7-Aug	US\$ bn	--	--	190.8
Tue 11-Aug	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 5y Mbono (Jun'21); 10y Udibono (Dec'25)					
Wed 12-Aug	1:00pm	Central bank inflation report	2Q15				
Thu 13-Aug	10:00am	Banxico's minutes of July 30 meeting	July				

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

July's wage negotiations. On Monday, the Ministry of Labor (STPS) will make its contractual wage negotiations monthly data available. We anticipate workers to have negotiated an annual average wage increase of 4.5% in July. This would be slightly above the average observed year-to-date (4.3%). In this regard, we believe that July's figure was mainly driven by the increase in wage negotiations in the government sector, such as labor unions at the service of municipalities and states; as well as wages revisions by labor unions of the private sector.

We expect a 0.6% yoy expansion in June's industrial output. On Tuesday, at 9:00am (EDT), *INEGI* will release its monthly industrial production report. We anticipate a 0.6% yoy expansion in total output during the sixth month of the year. Taking a look at the breakdown, we believe that construction output could have expanded 3% yoy. In this regard, construction has consolidated its recovery given the better growth dynamics in households' durable goods expenditure. Moreover, formal employment generated within this sector has shown a significant recovery in the past year, which supports our view of a more positive perspective regarding the recovery of this sector. This would imply that construction could reach its twelve positive growth rate after adding 17 consecutive months in contraction.

Moreover, we believe that manufacturing production could post a 3.1% yoy expansion, explained by a 6.5% yoy increase in manufacturing exports, a 6.7% yoy growth in June's vehicle production, and a 2% yoy expansion in U.S. manufacturing output, which has a strong correlation with Mexico's manufacturing sector. We believe that in the next months the Mexican manufacturing sector will show better growth prospects, derived from: (1) A stronger external demand, particularly coming from the U.S.; (2) the recent depreciation of the Mexican currency; and (3) the recovery of private consumption in Mexico, which will eventually translate into a higher domestic demand for manufacturing products.

Finally, we believe that the moderate growth in industrial output during June will be mainly explained by the poor performance of mining activity. In this regard, we expect an 8.1% yoy contraction derived from lower oil production and the reduction in the extraction of other minerals.

Weekly international reserves report. On Tuesday, at 10:00am (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves increased by US \$49mn amounting to US \$190.8bn on July 31. According to Banxico's report, this figure comes mainly as a result of: (1) Dollar sales by the Central Bank to the Federal Government for US \$309mn; (2) US \$408mn decrease explained by the introduction of Banxico's USD daily auction without minimum price and US \$200mn with minimum price; along with a (3) US \$965mn increase due to changes in the valuation of the Central Bank's assets and other operations.

It is worth noting that Pemex is currently the only significant source of reserve accumulation, given that on November 2011, the FEC (Federal Exchange Commission) decided to shut down the options scheme that Banxico also used to accumulate reserves. In this context, the central bank has an accumulated reduction of US \$2,480mn international reserves this year (please refer to the table below).

Banxico's foreign reserve accumulation details

US\$, million

	2014	31/Jul/2015	31/Jul/2015	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	193,239	190,759	48	-2,480
(B) Gross international reserve	195,682	193,336	1,555	-2,345
Pemex	--	--	782	3,656
Federal govt	--	--	-30	-395
Market operations	--	--	-260	-5,244
Other	--	--	-1064	-363
(C) Short-term government's liabilities	2,443	2,577	1507	134

Source: Banco de México

Weekly government bond auction. Also on Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent-, will offer 5-year fixed-rate Mbonos (Jun’21) as well as 10-year inflation-linked Udibonos (Dec’25), in addition to the “more traditional” 1-, 3-, and 6- month zero-coupon Cetes (please refer to the table below). As usual, the results will be released at 12:30pm (EDT).

Auction specifics (Tuesday, August 11, 2015)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	10-Sep-15	--	5,500	3.02
3m	12-Nov-15	--	9,500	3.24
6m	04-Feb-16	--	11,000	3.32
Mbono				
5y	10-Jun-21	6.50	8,500	5.46
Udibono				
10y	04-Dec-25	4.50	750	2.91

Source: Banorte-Ixe with data from Banco de México

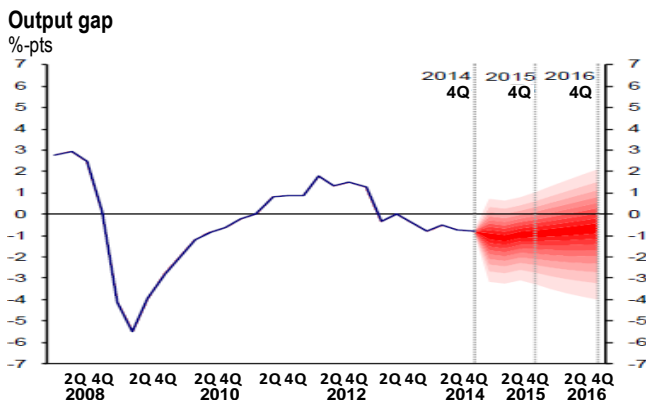
1. Except for Udibonos, which are expressed in UDI million, everything else is expressed in MXN million. 2. Yield-to-maturity reported for Cetes, Mbonos and Udibonos

Banxico’s QIR – Lower inflation projections. Banco de México will publish its Quarterly Inflation Report (QIR) for 2Q15 on Wednesday around 1:30pm (EDT). The release will be accompanied by a press conference led by Governor Carstens. In our view, market participants will focus on three issues: (1) A downward revision to the central bank’s inflation forecast that will be reflected in Banxico’s traditional *fan chart*; (2) Banxico’s output gap projection; and (3) U.S. Fed’s monetary policy normalization.

In the first case, we believe that the central bank could make a downward revision to its inflation forecast, which could be motivated by the downward trend in inflation since Banxico’s last quarterly report. In this context, we highlight that the annual change in prices during July hit a new record low at 2.74%.

Moreover, in the last monetary policy announcement, Banxico mentioned that: *“...the pass-through effect of the depreciation of the Mexican currency to prices has been relatively low, reflected mainly in the prices of durable goods, without any second-order effects. Moreover, the reduction in the prices of inputs widely used -such as energy, raw materials and telecommunications services- have also contributed to inflation’s favorable performance. Reflecting the above-mentioned factors, expectations for headline and core inflation at year-end 2015 and 2016 have decreased below 3 percent...”*

On the other hand, the central bank has repeatedly highlighted the lower growth dynamics of the Mexican economy. In this context, market participants will examine the timing in which Banxico’s Board believe that the output gap will close. In their last QIR, the central bank clearly showed in their traditional output gap chart, that it will remain open until the end of 2016. Among the factors that could affect Mexico’s economic dynamism, the central bank highlighted: (1) A further weakening of the U.S. economy; (2) new episodes of volatility in financial markets; (3) a further decline in the oil production platform; and (4) weak consumer and business confidence levels. On the positive side, the U.S. economy could improve amid low costs of energy while the outlook could also improve as a result of a favorable outcome in the early stages of implementation of the energy reform.



Source: Banco de Mexico

Regarding to Banxico’s monetary policy, the board members have been very clear in highlighting that they will be paying close attention to the Fed’s monetary policy normalization. In its last monetary policy statement, the monetary authority warned that: *“...the Fed’s actions could have additional repercussions on the exchange rate and inflation expectations...”*. In this context, Banxico’s board of governors will pay particular attention to *“... the evolution of the exchange rate, the relative monetary conditions between Mexico and the United States, and the evolution of the slack in the economy...”*

In conclusion, while Banxico’s central scenario seems to be of economic activity weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given this, we believe that Banxico’s next move will be a rate hike, immediately after the Fed starts its normalization of monetary policy in September 16-17. This implies that the central bank could be raising rates at its next regular meeting on September 21.

Recent measures taken by the *Foreign Exchange Commission* give Banxico some leeway to wait for the Fed to hike rates, instead of increasing Mexico's own reference rate ahead of the decision, as it has been the case in some other emerging economies (*e.g.* Brazil).

Banxico's minutes – Banxico's monetary policy bounded to the Fed's normalization process. Next week (Thursday, August 13), Banco de Mexico will publish the minutes of its monetary policy meeting held back on July 30, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view, the tone of Banxico's minutes will be quite similar to the last *communiqué*, mainly focused on three issues: (1) The balance of risks for economic growth continues to be relatively weak; (2) the balance of risks for inflation has improved; and (3) their attention is focused on the timing at which the U.S. Fed will begin its hiking cycle, given that any actions from the U.S. Fed could have repercussions on the Mexican exchange rate and inflation expectations.

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