

Banxico's QIR – Modest growth and inflation under control for another couple of years

November 4, 2015

- Banxico published today its *Quarterly Inflation Report (QIR)* for 3Q15
- We highlight the following issues:
 - (1) Banxico published its growth and inflation forecast for 2017. In the first case Banxico expects GDP growth between 3% and 4%; in the second case, the central bank estimates that year-end inflation will close near its 3% target;
 - (2) The output gap will remain open until the end of 2017; and
 - (3) Banxico is confident that inflation will remain below the 3% target this year, although it will pick up marginally in 2016-17
- In our opinion, the tone of the document is the same we had already perceived in the last monetary policy *communiqué*, in the sense that Banxico is tied to the U.S. Fed actions
- We maintain our view that Banxico will hike interest rates *in tandem* with the U.S. Fed
- Local assets remained under pressure despite dovish rhetoric in terms of growth but reacting to Yellen's comments

www.banorte.com
www.ixe.com.mx
@analis_fundam

Gabriel Casillas

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

Delia Paredes

Executive Director of Economic Analysis
delia.paredes@banorte.com

Alejandro Cervantes

Senior Economist, Mexico
alejandro.cervantes@banorte.com

Fixed income and FX strategy

Alejandro Padilla

Head Strategist - Fixed-Income and FX
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA

FX Strategist
juan.alderete.macal@banorte.com

Higher growth and inflation in 2016. The monetary authority released its *Quarterly Inflation Report (QIR)* for 3Q15. The release was accompanied by a press conference by Governor Carstens. We highlight the following issues discussed in the document: (1) Banxico published its growth and inflation forecast for 2017. In the first case Banxico expects GDP growth between 3% and 4%; in the second case, the central bank estimates that year-end inflation will close near its 3% target; (2) the output gap will remain open until the end of 2017; and (3) Banxico is confident that inflation will stay below the 3% target this year, although they believe it will pick up in 2016-17. In our opinion, Banxico's *QIR* maintained the tone we have already discussed previously, in the sense that Banxico is tied to the U.S. Fed actions.

Short-term economic outlook without significant changes... The document highlights, among other things, that the Mexican economy maintained a moderate growth. In particular, Banxico mentioned that Mexico's industrial production continued to show signs of weakness derived from the slowdown in the U.S. manufacturing industry, which had an adverse impact on Mexican manufacturing exports and the downward trend of Mexico's exports to Asia and Europe. However, the central bank also made reference to the recovery in private consumption derived from the better growth dynamics of the labor market trends, low inflation, and the recent growth in remittances inflows. In this context, the central bank modified its growth forecast for 2015 to a range between 1.9% and 2.4% from a range between 1.7% and 2.5% (refer to the chart below).

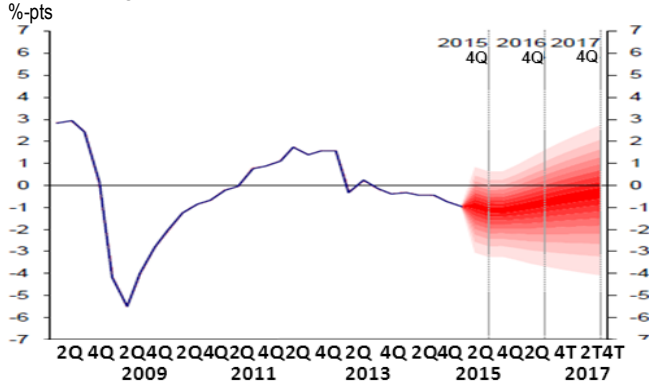
| Banxico's Forecast (Current) | | | | Banxico's Forecast (Previous) | | |
|-------------------------------|-------------------|-------------------|---------------------------------------|-------------------------------|-----------|-----------|
| | 2015 | 2016 | 2017 | | 2015 | 2016 |
| GDP (%) | 1.9 - 2.4 | 2.5 - 3.5 | 3.0 - 4.0 | GDP (%) | 1.7 - 2.5 | 2.5 - 3.5 |
| Employment (thousands) | 640 - 710 | 630 - 730 | 660 - 760 | Employment (thousands) | 560 - 660 | 600 - 700 |
| Trade balance (bn) | -9.4 (0.8, %GDP) | -6.6 (0.6, %GDP) | -9.4 (0.7, %GDP) | Trade balance (bn) | -6.0 | -6.3 |
| Current account (bn) | -30.3 (2.6, %GDP) | -29.8 (2.5, %GDP) | -34.9 (2.7, %GDP) | Current account (bn) | -30.6 | -31.8 |
| Inflation | | | | Inflation | | |
| Headline | under 3% | around 3% | Moderate downward trend, closer to 3% | Headline | under 3% | around 3% |
| Core | under 3% | around 3% | Moderate downward trend, closer to 3% | Core | under 3% | around 3% |

Source: Banco de México 3Q15 QIR

Source: Banco de México 2Q15 QIR

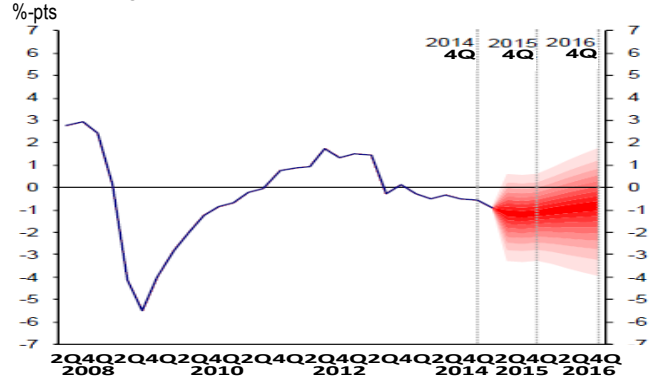
...but more optimistic in the medium term. Banxico maintained its growth forecast for 2016, within the 2.5%-3.5% range. The central bank believes that Mexico's growth in 2016 will be explained by the recovery in the U.S. industrial sector, the positive impact of external demand in domestic demand, and the better growth dynamics derived from the implementation of the structural reforms. Moreover, the central bank released today its growth forecasts for 2017, which stand between 3 and 4%. In its traditional output gap chart, Banxico clearly shows that it will remain open until the end of 2017. Among the factors that could affect the economic growth in Mexico, the central bank highlights: (1) A delay in the recovery of the U.S. industrial sector; (2) a further decline in Mexico's oil production and/or international oil prices; (3) new episodes of volatility in financial markets; and (4) a further deterioration in confidence given the persistence of a weak economy and the lack of progress in strengthening the rule of law. Among the factors that could explain a higher growth, Banxico highlights the possibility of better growth dynamics derived from a higher than expected recovery in external demand, and significant progress in implementing structural reforms and strengthening the rule of law.

GDP output gap: (Actual)



Source: Banco de México 3Q15 QIR

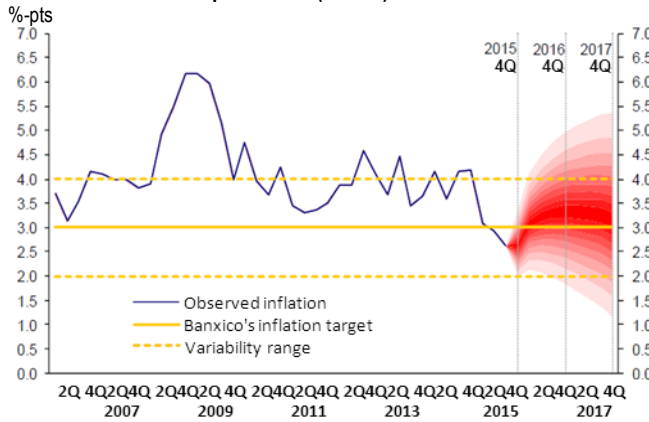
GDP output gap: (Previous)



Source: Banco de México 2Q15 QIR

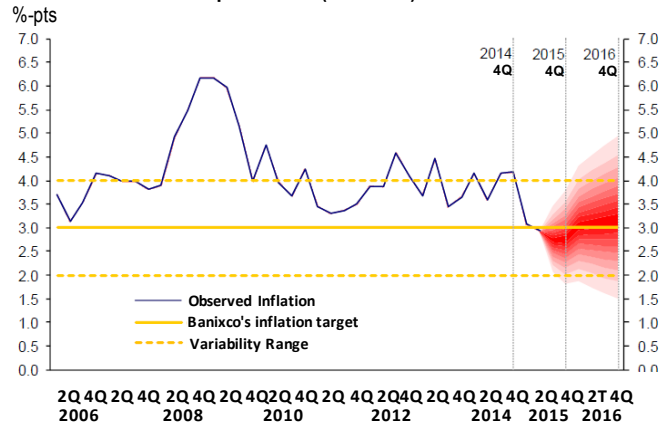
Inflation below 3% in 2015. The central bank remains confident that inflation will stand below the 3% target, given the negative output gap and the absence of demand side pressures. For 2016, the central bank estimates that headline and core inflation will be higher than the 3% target given the pass-through effect of the FX depreciation to prices and the fading positive effect of supply shocks. For 2017, the central bank anticipates that these effects will fade and headline and core inflation will maintain a downward trend, and will end the year close to the 3% target.

Fan chart: Inflation expectations (Actual)



Source: Banco de México 3Q15 QIR

Fan chart: Inflation expectations (Previous)



Source: Banco de México 2Q15 QIR

“Grey box” on the pass-through effect of the FX depreciation to prices within LATAM countries. As it is now a tradition, Banxico included a research note (a.k.a. “grey box”) on the *pass-through* effect of the FX depreciation to prices within LATAM countries, in particular Brazil, Mexico Colombia, Chile, and Peru. The study builds on the fact that even though the currencies of these countries observed a significant depreciation, inflation has increased in most of these countries, although Mexico’s inflation now stands at historical lows. Using a VAR model (vector autoregressive model) for each country, Banxico estimated the impact of a 1% depreciation of the currency on inflation. The study concludes that in the case of Mexico, the 12-month accumulated effect of the MXN depreciation of 1% on inflation is equivalent to 3.8bps, while for other countries, the impact is significantly higher (refer to table below). Among the factors that explain this limited *pass-through* effect in Mexico, Banxico highlighted: (1) The reduction in the persistency, volatility and inflation levels; (2) Mexico’s process of price formation behaves in the manner in which prices are determined in advanced economies with a long history of price stability; (3) anchored inflation expectations; and (4) a gradual reduction in the compensation for inflation and its risk premium.

12-month accumulated effect of the MXN depreciation of 1% on inflation

Basis points

| Country | Impact |
|----------|--------|
| Brazil | 26.8 |
| Chile | 17.5 |
| Peru | 9.4 |
| Colombia | 4.6 |
| Mexico | 3.8 |

Source: Banxico

We maintain our view that the central bank's next move will be a hike, immediately after the Fed in December. 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 December 15-16. This implies that the central bank could be raising rates at its next regular meeting on December 17. However, the central bank’s more dovish stance relative to the Fed suggests that Banxico will adequate its monetary policy to Mexico’s business cycle, and will not necessarily follow the Fed in 2016.

From our fixed income and strategy team

Local assets remained under pressure despite dovish rhetoric in terms of growth but reacting to Yellen's comments. Local rates and the MXN are heading towards the end of the session with a weaker tone despite Banxico's reiteration of an effect of slack in the economy and a dovish bias in terms of growth. The central bank's QIR depicted a similar tone as the policy communiqué released a week ago. Mexican bonds extended the losses from previous sessions, especially in the short-end of the curve, as a reaction of a hawkish rhetoric by Yellen and other Fed speakers this Wednesday. In the aftermath of these events, the short-end is observing a 3-4bps sell-off this day, with the belly and the long-end portraying a more defensive stance (between null movements and modest 1bp losses). Despite the recent correction in the fixed-income market (driven by an upward adjustment in U.S. rates), we hold a positive view for the Mexican market. In this regard, we acknowledge a better relative valuation in Mbonos Dec'19 to Dec'24. Moreover, Mexican linkers (Udibonos) from Jun'19 to Jun'22 also depict a good investment opportunity. Nonetheless, we suggest being cautious ahead of NFP report, which could result in better entry levels for long positions.

In the FX market, the peso had marginal changes on scant new developments, trading 0.9% weaker on the day at 16.54 per dollar. We continue seeing the dovish tone on growth as signaling a low probability of stronger support from a potential widening of Mexico's interest rate differential with the US in the short term, still tied to the Fed. Moreover, countries in the region such as Colombia, Peru and Chile have begun raising rates, which could strip some attractiveness to our currency at least on the margin, particularly in episodes of high volatility. The next relevant local event for this market will be the decision on dollar auctions by the Foreign Exchange Commission, no later than November 30. We reiterate our recommendation to buy USD/MXN below 16.50, with renewed focus on US figures given the Fed's increased data-dependency for its December decision and with cautiousness given light positioning in peso futures and low short-term implied volatilities.

Disclaimer

The information contained in this document is illustrative and informative so it should not be considered as an advice and/or recommendation of any kind. BANORTE is not part of any party or political trend.

GRUPO FINANCIERO BANORTE S.A.B. de C.V.
Research and Strategy

| | | | |
|-------------------------|--------------------------------------|------------------------------|------------------|
| Gabriel Casillas Olvera | Chief Economist and Head of Research | gabriel.casillas@banorte.com | (55) 4433 - 4695 |
| Raquel Vázquez Godínez | Assistant | raquel.vazquez@banorte.com | (55) 1670 - 2967 |

Economic Analysis

| | | | |
|----------------------------------|---|---------------------------------|-------------------------|
| Delia María Paredes Mier | Executive Director of Economic Analysis | delia.paredes@banorte.com | (55) 5268 - 1694 |
| Alejandro Cervantes Llamas | Senior Economist, Mexico | alejandro.cervantes@banorte.com | (55) 1670 - 2972 |
| Katia Celina Goya Ostos | Senior Global Economist | katia.goya@banorte.com | (55) 1670 - 1821 |
| Miguel Alejandro Calvo Domínguez | Economist, Regional & Sectorial | miguel.calvo@banorte.com | (55) 1670 - 2220 |
| Juan Carlos García Viejo | Economist, International | juan.garcia.viejo@banorte.com | (55) 1670 - 2252 |
| Rey Saúl Torres Olivares | Analyst | saul.torres@banorte.com | (55) 1670 - 2957 |
| Lourdes Calvo Fernández | Analyst (Edition) | lourdes.calvo@banorte.com | (55) 1103 - 4000 x 2611 |

Fixed income and FX Strategy

| | | | |
|---------------------------------|---------------------------------------|---------------------------------|------------------|
| Alejandro Padilla Santana | Head Strategist – Fixed income and FX | alejandro.padilla@banorte.com | (55) 1103 - 4043 |
| Juan Carlos Alderete Macal, CFA | FX Strategist | juan.alderete.macal@banorte.com | (55) 1103 - 4046 |
| Santiago Leal Singer | Analyst Fixed income and FX | santiago.leal@banorte.com | (55) 1670 - 2144 |

Equity Strategy

| | | | |
|--------------------------------|--|--------------------------------------|------------------|
| Manuel Jiménez Zaldivar | Director Equity Research — Telecommunications / Media | manuel.jimenez@banorte.com | (55) 5268 - 1671 |
| Victor Hugo Cortes Castro | Equity Research Analyst | victorh.cortes@banorte.com | (55) 1670 - 1800 |
| Marissa Garza Ostos | Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry | marissa.garza@banorte.com | (55) 1670 - 1719 |
| Marisol Huerta Mondragón | Equity Research Analyst – Food/Beverages | marisol.huerta.mondragon@banorte.com | (55) 1670 - 1746 |
| José Itzamna Espitia Hernández | Equity Research Analyst – Airports / Cement / Infrastructure / Fibras | jose.espitia@banorte.com | (55) 1670 - 2249 |
| Valentín III Mendoza Balderas | Equity Research Analyst – Auto parts | valentin.mendoza@banorte.com | (55) 1670 - 2250 |
| María de la Paz Orozco García | Analyst | maripaz.orozco@banorte.com | (55) 1670 - 2251 |

Corporate Debt

| | | | |
|-----------------------------|-------------------------|-----------------------------|------------------|
| Tania Abdul Massih Jacobo | Director Corporate Debt | tania.abdul@banorte.com | (55) 5268 - 1672 |
| Hugo Armando Gómez Solís | Analyst, Corporate Debt | hugo.gomez@banorte.com | (55) 1670 - 2247 |
| Idalia Yanira Céspedes Jaén | Analyst, Corporate Debt | idalia.cespedes@banorte.com | (55) 1670 - 2248 |

Wholesale Banking

| | | | |
|--------------------------------|--|--|------------------|
| Armando Rodal Espinosa | Head of Wholesale Banking | armando.rodal@banorte.com | (55) 1670 - 1889 |
| Alejandro Eric Faesi Puente | Head of Global Markets and Institutional Sales | alejandro.faesi@banorte.com | (55) 5268 - 1640 |
| Alejandro Aguilar Ceballos | Head of Asset Management | alejandro.aguilar.cebillos@banorte.com | (55) 5268 - 9996 |
| Arturo Monroy Ballesteros | Head of Investment Banking and Structured Finance | arturo.monroy.ballesteros@banorte.com | (55) 5004 - 1002 |
| 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 |
| René Gerardo Pimentel Ibarrola | Head of Asset Management | pimentelr@banorte.com | (55) 5268 - 9004 |
| Ricardo Velázquez Rodríguez | Head of International Banking | ricardo.velazquez@banorte.com | (55) 5268 - 9879 |
| Víctor Antonio Roldan Ferrer | Head of Corporate Banking | victor.rolan.ferrer@banorte.com | (55) 5004 - 1454 |