Ahead of the Curve

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Banxico's minutes to keep signaling prudence despite its recent dovish tilt

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- **Inflation report (June).** We estimate headline inflation at 0.07% m/m and core at 0.30%, both higher than the previous month figures. Dynamics would be benefited by the non-core component, in particular reductions in fresh fruits and vegetables and energy despite both bouncing back in the second fortnight. At the core level, we anticipate some increases in components related to tourism (*i.e.* air fares, tourism services and hotels), along other goods and processed foods. With these results, annual inflation would moderate to 3.95% from 4.28% in May, However, the core component would go to 3.85% from 3.77%

- **Banxico minutes.** On Thursday, Banco de Mexico will publish the minutes of the monetary policy meeting held on June 27th, when the Board left the reference rate unchanged at 8.25%, in a majority decision as one member favored a 25bps rate cut. We believe the document will be quite interesting, with discussions on financial stability risks and the outlook for growth and inflation, among others. In particular, we will look for comments about Pemex's and the sovereign credit rating, uncertainty about USMCA approval, the implications of more dovish central banks in developed-countries (particularly the Fed), and dynamics of inflation expectations and its balance of risks. Overall, we expect the tone to be slightly dovish, with Banxico slowly cooking a 25bps rate cut this year which we expect at the November 14th meeting

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 9-Jul	**7:00am**	**CPI inflation**	June	% m/m	0.07	0.06	-0.29
				% yoy	3.95	3.94	4.28
		Core		% m/m	0.30	0.32	0.16
				% yoy	3.85	--	3.77
Tue 9-Jul	**10:00am**	**International reserves**	Jul-7	US$ bn	--	--	178.9
Tue 9-Jul	**12:30pm**	**Government weekly auction: 1-, 3-, 6-month CETES; 5y Mbono (Sep'24); 10y Udibonos (Nov'28)**					
Wed 10-Jul		**Wage negotiations**	June	%	6.0	--	5.9
Thu 11-Jul	**10:00am**	**Banxico's minutes**					
Fri 12-Jul	**7:00am**	**Industrial production**	May	% yoy	-1.8	--	-2.9
		(sa)		% m/m	-0.6	--	1.5
		Mining		% yoy	-8.0	--	-9.0
		Utilities		% yoy	2.1	--	-3.1
		Construction		% yoy	-0.9	--	-4.2
		Manufacturing		% yoy	-0.7	--	-0.4

Source: Banorte; Bloomberg

Proceeding in chronological order...

Inflation in June would be helped by the non-core component. We estimate headline inflation at 0.07% m/m and core at 0.30%, both higher than the previous month. We expect dynamics to be benefited by the non-core component. In particular, and as seen in the first half of the month, fresh fruits and vegetables had a significant negative contribution, coupled with an additional reduction in energy. Both bounced back in the second fortnight, although not enough to compensate for the reductions in the first half. In particular, we expect a +4bps contribution from fresh fruits and vegetables in this latter period, resulting in a total monthly impact of -11bps. In energy, we expect a 2bps pickup in LP gas, leaving the monthly contribution at -7bps. Adding to the latter -3bps from lower low-grade gasoline, the overall contribution from energy would be -9bps.

At the core level, we anticipate the contrary to the non-core component, with most of the positive variation in the first half of the month. In particular, we believe that some increases in components related to tourism (i.e. air fares, tourism services and hotels) took place before they usually do, making us believe that they will result in lower increases in the second half. In addition, we expect other goods to edge-down 1bp in the fortnight, bringing down the total monthly impact to +3bps. Meanwhile, processed foods would add 7bps, distributed evenly in each sub-period.

With these results, annual inflation would continue to moderate, standing at 3.95% from 4.28% in May, 5bps below the upper bound of Banxico's variability range. However, the core would increase to 3.85% from 3.77%. We still consider that pressures in some categories within core inflation (*i.e.* processed foods and housing) are consistent with some of concerns that the central bank has shown in its latest publications, making their dynamics in the following months particularly relevant.

Weekly international reserves report. Last week, net international reserves increased US$266 million, closing at US$178.9 billion. According to Banxico's report, this figure comes mainly from a positive valuation effect in central bank assets. In this context, the central bank's international reserves have increased US$4.1 billion during 2019 (please refer to the following table).

Banxico's foreign reserve accumulation detail
US$, million

	2018	Jun 28, 2019	Jun 28, 2019	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	174,793	178,868	266	4,075
(B) Gross international reserve	176,384	186,209	127	9,825
Pemex	--	--	-237	6
Federal government	--	--	-41	5,851
Market operations	--	--	0	0
Other	--	--	405	3,967
(C) Short-term government's liabilities	1,592	7,342	-140	5,750

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 5-year fixed-rate Mbonos (Sep'24), 10-year inflation-linked Udibonos (Nov'28), 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, July 9th, 2019)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	08-Aug-19	- -	7,000	8.10
3m	10-Oct-19	- -	11,000	8.13
6m	02-Jan-20	- -	12,500	8.15
Mbonos				
5y	05-Sep-24	8.00	11,500	7.57
Udibonos				
10y	30-Nov-28	4.00	UDIS 950	3.50

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

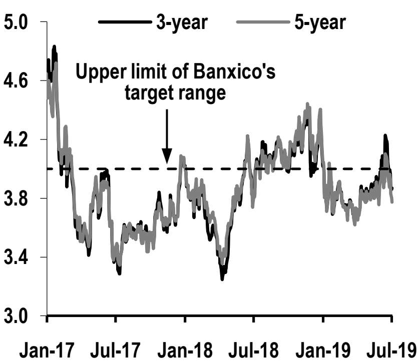
We forecast wage negotiations up 6.0% in June. This would be higher than the 5.9% of the previous month. We believe this increase will be explained by a change in composition within the workers benefited by a revision, tilting more to the private sector relative to the public branch. In this context, year-to-date increases in the former stand at 6.3% while the latter has only managed 3.4%. Going forward and as mentioned in other releases, wage negotiations will likely remain skewed to the upside due to the revision of the minimum wage as well as the lagged impact from high inflation in the previous two years. However, we do not rule out a moderation in the last quarter of the year.

Banxico minutes to discuss financial stability and the balance of risks. Next Thursday, Banxico will publish the minutes of the monetary policy meeting held on June 27th, when the Board left the reference rate unchanged at 8.25%, in line with consensus and our expectations. We believe the document will be very interesting, with discussions on financial stability risks and the outlook for growth and inflation, among others. Overall, we expect the tone to be slightly dovish, with Banxico slowly cooking a 25bps rate cut this year which we expect at the November 14th meeting.

First, we highlight the decision was not unanimous, with one member in favor of a 25bps rate cut. We believe it highly likely that Deputy Governor, Gerardo Esquivel, was the dissenter, as he had already disagreed with the tone of the communique in the past two meetings. If this were the case, we will look closely to his arguments. In our view, he is concerned that monetary policy is too tight given that: (1) Risks for inflation are fairly balanced; (2) current price dynamics have been well-behaved; (3) developed-country central banks have shown a more dovish bias, especially the Fed; and (5) the outlook for economic growth has weakened.

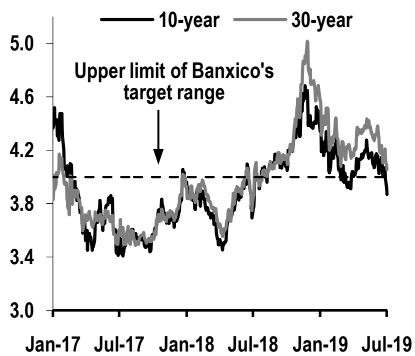
Moreover, he could expand on previous comments that it is not completely unlikely that the increase in inflation expectations and premiums has been affected by central bank communications. In this sense, we think the overall tone of the communique was slightly dovish and significantly less restrictive relative to recent decisions, which should help moderate this concern. Since the meeting on May 16th –when he first stated this argument in the minutes–, market-based inflation expectations have decreased, with 3- to 5-year breakevens virtually unchanged but 10- and 30-year tenors down around 30bps, albeit all above the 3% target. Surveys conducted by the central bank show stable broadly mid- and long-term expectations, although core inflation in the former has increased in recent months (see charts below).

3- and 5-year breakeven rates
%, implicit based on Fisher equation



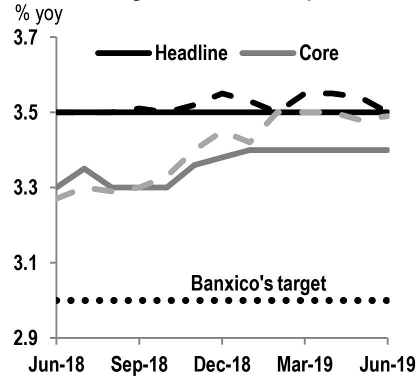
Source: Banorte with data from Valmer

10- and 30-year breakeven rates
%, implicit based on Fisher equation



Source: Banorte with data from Valmer

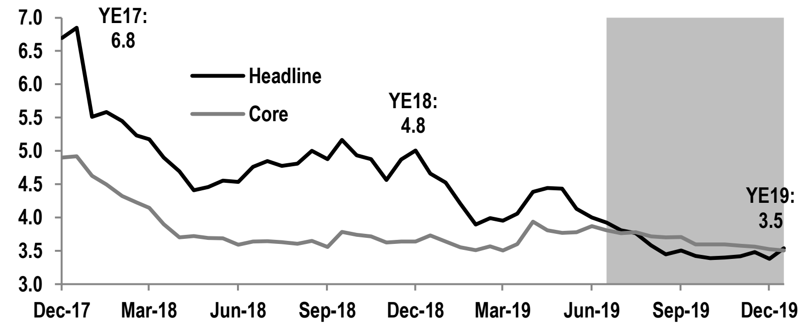
Mid- and long- term inflation expectations
% yoy



Dotted lines refer to mid-tem expectations (1-4 years) and straight lines to long-term (5-8 years(r
Source: Banxico survey, Banorte

Discussions on inflation will be relevant given several changes that in our view pointed to a more comfortable stance. In particular: (1) The balance of risks was no longer characterized as skewed to the upside; and (2) they added a further appreciation of the peso due to central bank dovishness as a downside risk. Moreover, they reiterated that high uncertainty persists, with headline inflation helped to a great extent by non-core prices. Stickiness in the core component is still present, jumping from 3.6% yoy on average in 1Q19 to around 3.9% in 1H-Jun. As of this latest print, the quarterly average for the headline and core stand at 4.2% and 3.8%, respectively, 10bps below the central bank's latest forecast in the former and squarely at the estimate in the latter. In this context, it will be important to gauge where the majority stands, either still concerned by the resistance to the downside of core inflation or less preoccupied as it is virtually a fact that forecasts will be met. In our view, the Board could lean slightly towards the latter, in line with our more benign view on inflation as we forecast it to reach 3.5% by year-end (Banxico forecast: 3.7% on average in 4Q19).

Inflation forecasts
% yoy, bi-weekly frequency



Source: INEGI, Banorte

Considering this, financial stability risks are at the forefront of Banxico's prudent stance. In this respect, it was noteworthy the phrase that: "…*addressing the deterioration of both the sovereign's and Pemex's credit ratings (…) are necessary*…". In our view, rating agencies and market participants are focused in the need to strengthen Pemex's financial situation. *Fitch Ratings* downgraded Pemex's rating to 'BB+' with a negative outlook on June 6th. On the same date, *Moody's* outlook was reduced to 'negative', with the rating just one notch above investment-grade at 'Baa3'. *S&P Global* has the company at 'BBB+' with a 'negative' outlook. In this context, one of the most pressing issues is that another downgrade by a major agency to a rating below investment-grade could trigger forced-selling of securities. In our view, some actions that could help improve this situation are: (1) A favorable business plan, which could already be public by the time of the release of the minutes; and (2) an additional support plan for Pemex, which could include the partial use of assets from the Stabilization Fund (*FEIP*, in Spanish) and/or an explicit guarantee of Pemex liabilities by the Federal Government.

Also in this front, the Board stated that high uncertainty persists over the bilateral relationship between the US and Mexico in the midst of an escalation in trade tensions. The threat of tariffs to all Mexican exports is still present even after that an agreement was reached to avoid them. In this sense, President Trump stated that tariffs are off the table, which moderates this risk. Nevertheless, the approval of USMCA remains complicated given the political environment in the US ahead of the 2020 election. We still expect the deal to be ratified this year, but the timing and evolution of negotiations is very uncertain.

Last but not least, the tone on growth was decisively more dovish, with Banxico stressing that the balance of risks is more uncertain, amplifying further the risk to the downside. Accordingly, recent data is consistent with a difficult outlook for activity, with increasingly warning signs also in services which contracted sequentially for a second month in a row in April according to IGAE. Moreover, PMI's in June fell and added two months in contraction, while growth in employment, banking credit and remittances has decelerated recently.

Industrial production in May to reverse some of April's gain. We estimate a -1.8% yoy contraction, more modest than the -2.9% of the previous month which was affected by the timing of the Holy Week. This would imply the seventh consecutive month in negative territory in the annual comparison. With seasonally-adjusted figures we anticipate a 0.6% m/m decline, partially reversing the +1.5% observed in April.

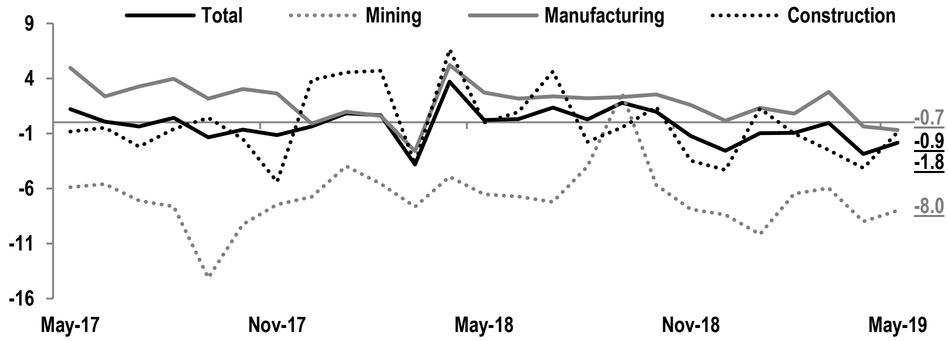
As usual, mining will be a drag, expected to decline 8% yoy from -9% in the previous month. According to Pemex, oil production fell 10%, the second consecutive month falling at a double-digit pace. Nevertheless, gas saw a modest pickup to 0.3%. Regarding the non-oil sector, we anticipate a 3.5% decline. This is consistent with employment dynamics, which keeps slowing down, deepening its decline to -3.4% which is the weakest print since August 2016.

Nevertheless, a more concerning development would be the likely decline in manufacturing, estimated at -0.7% which would be the first in the sector so far this year when excluding April, which as stated above, was distorted by the holiday. First and most importantly, non-oil intermediate goods imports, highly correlated to the sector's supply chain, were barely up 0.4% which is the lowest since the contraction of 6.8% in April 2017. On top that, auto production declined 1.5% after two consecutive months higher. The PMI manufacturing index by IMEF stood below the 50pts threshold after a brief respite in the previous month (using original figures), a situation replicated by the production component, which is the closest one to current conditions.

Last but not least, construction is likely to be subdued as uncertainty keeps affecting the sector. Although we expect a moderation in the rate of decline from -4.2% in April to 0.9%, the monthly comparison would fall as payback to the strong rebound of the previous month. Business confidence indicators remain subdued, particularly in the adequate moment to invest component which reached its lowest since March 2017, just after Trump's inauguration. This is followed by weak indicators about the situation of the enterprise, both current and expectations.

In our view, another limiting factor for industry may be the relative strength of the currency, which despite some volatility at the end of the month due to tariff threats to Mexico by the US, has been quite defensive relative to other EM. With industrial activity still affected globally by trade tensions, we believe the secondary sector remained low at least in 2Q19. Part of this uncertainty could dilute in the second half of the year if more decisive steps are attained in the trade front, particularly between the US and China but also regarding USMCA.

Industrial production
% yoy



Source: INEGI, Banorte

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HOLD	*When the share expected performance is similar to the MEXBOL estimated performance.*
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