

Banxico's QIR – Slow growth and lower inflation will not stop a rate hike

August 12, 2015

www.banorte.com
www.ixe.com.mx
@ analisis_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

- Banxico published today its *Quarterly Inflation Report (QIR)* for 2Q15
- We highlight the following issues:
 - (1) The downward revision to its estimated growth range in 2015; and
 - (2) Banxico's confidence that inflation will stand below the 3% target this year, despite the significant depreciation of the Mexican peso
- In our opinion, the report maintained the tone we 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
- No relevant reaction following Banxico's *QIR* as markets continue to price-in at the beginning of the US Fed's rates liftoff in September

Tied to the US Fed's actions. The monetary authority released its *Quarterly Inflation Report (QIR)* for 2Q15. The release was accompanied by a press conference by Governor Carstens. We highlight the following issues discussed in the document: (1) The downward revision of the forecasted range of growth for 2015; and (2) Banxico's confidence that inflation will stand below the 3% target this year, despite the significant depreciation of the Mexican currency. In our opinion, Banxico's *QIR* maintained the tone we have already discussed previously, in the sense that an adverse external backdrop is being key for the prospects of the Mexican economy in 2015. In particular, Banxico emphasized the U.S. Fed normalization process, which has been an important source of uncertainty in international markets.

Short-term pessimism... Banxico's *QIR* highlights that the performance of the Mexican economy has been slower than initially anticipated by the central bank. In particular, Banxico mentioned that Mexico's industrial production continued to show a weak growth generated by the deceleration in the US manufacturing sector, which had a negative impact on Mexico's manufacturing exports. Moreover, the monetary authority also referred to the lower growth dynamics in residential construction, the stagnation of the non-residential construction output, the weak recovery in consumer confidence, and the moderate growth in private consumption. In this context, the central bank revised down its estimated GDP growth range in 2015 from 2%-3%, to 1.7%-2.5% (please refer to the following tables).

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

Document for distribution among public

Banxico's Forecast (Actual)

	2015	2016
GDP (%)	1.7 - 2.5	2.5 - 3.5
Employment (thousands)	560 - 660	600 - 700
Trade balance (bn)	-6.0	-6.3
Current account (bn)	-30.6	-31.8
Inflation		
Headline	under 3%	around 3%
Core	under 3%	around 3%

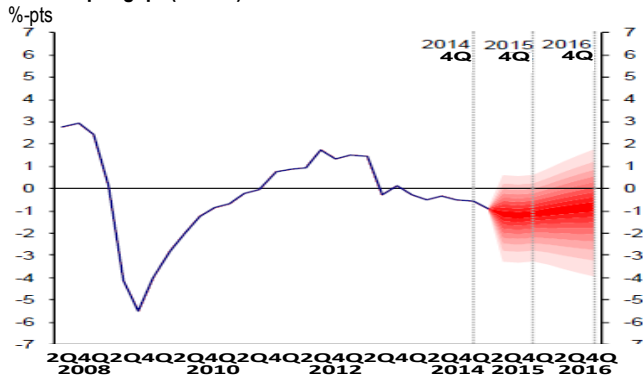
Source: Banco de México 2Q15 QIR

Banxico's Forecast (Previous)

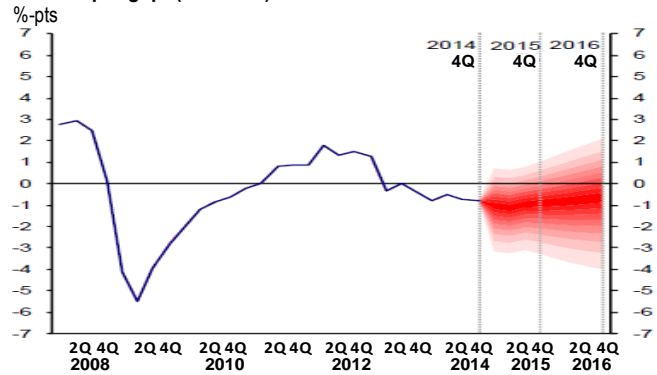
	2015	2016
GDP (%)	2.0 - 3.0	2.5 - 3.5
Employment (thousands)	580 - 680	600 - 700
Trade balance (bn)	-5.2	-6.9
Current account (bn)	-27.7	-29.7
Inflation		
Headline	under 3%	around 3%
Core	under 3%	around 3%

Source: Banco de México 1Q15 QIR

...but more optimistic in the medium term. Banxico maintained its growth forecast for 2016, within the 2.5%-3.5% range. In this context, in the traditional output gap chart, Banxico clearly shows that it will remain open until the end of 2016, but Governor Carstens highlighted that it will be closing gradually. Among the factors that could affect the economic growth in Mexico, the central bank highlights: (1) Mexico's manufacturing exports could show a sluggish performance if the U.S. industrial sector maintains a weak recovery; (2) a deterioration in the investors' outlook given the inefficient implementation of the energy reform, and a further weakening of the perception of the rule of law; (3) a further decline in the oil production platform; and (4) new episodes of volatility in financial markets. On the positive side, Mexico's economy could improve amid a stronger external demand, and Mexico's economic outlook could also improve as a result of a favorable outcome in the early stages of implementation of the structural reforms.

GDP output gap: (Actual)


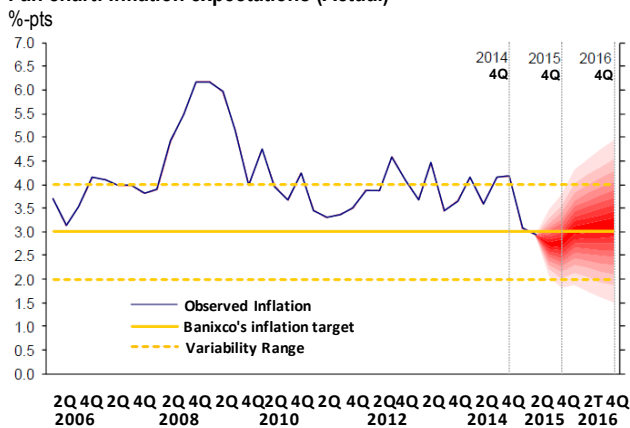
Source: Banco de México 2Q15 QIR

GDP output gap: (Previous)


Source: Banco de México 1Q15 QIR

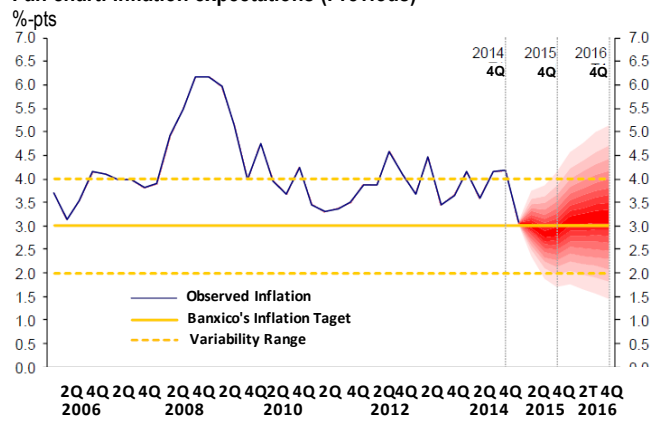
Inflation below 3% in 2015. The central bank remains confident that inflation will stand below the 3% target, given the favorable base effect of the absence of a fiscal reform, and the implied benefits of the telecommunications reform on inflation. Similarly, the central bank explained that the pass-through effect of the sharp depreciation in the Mexican currency to inflation has been very limited, and it has been reflected in a spike in durable goods prices, which account for less than 6% of the consumer price index. However, Governor Carstens highlighted that the depreciation of the Mexican peso is a significant risk to the inflation outlook, while given the expected reduction in the output gap, new changes in relative prices could also be a factor that could contaminate inflation expectations.

Fan chart: Inflation expectations (Actual)



Source: Banco de México 2Q15 QIR

Fan chart: Inflation expectations (Previous)



Source: Banco de México 1Q15 QIR

“Grey boxes” on manufacturing production and upward asymmetry in the pass-through effect from the PPI index to the CPI index. As it is now a tradition, Banxico included two pieces of research (a.k.a. “grey boxes”) in its *QIR*. The first relates to the synchronization of the Mexican manufacturing sector with that in the United States. While this box includes only an update to the previous work done by the central bank in 1Q14, Banxico’s modified the conclusions of the previous essay, highlighting that with the new base year in the U.S. production figures, the long-term relationship between Mexico’s manufacturing sector and the U.S. strengthened even more and that the economic cycles of these sectors became more synchronized. In the second box, Banxico made a very detailed analysis of the upward asymmetry in the pass-through effect from the PPI index to the CPI index. Banxico concludes that: (1) In the absence of the upward asymmetry, annual inflation would have been 13bp lower on average in the last 8 years; (2) the effects on food consumption would have been potentially higher for urban households with the lowest incomes; (3) the average household income in the first quintile would have been 1.6% yoy higher in terms of the purchasing power of their total annual income; (4) the monthly cost of the basic food basket would have been 5.1% lower; and (5) the lower cost of the basic food basket would have involved approximately 1.7 million less people in food poverty condition.

We maintain our view that the central bank's next move will be a hike, immediately after the Fed. 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.

From our fixed income and strategy team

No relevant reaction following Banxico's QIR as markets continue pricing in the beginning of rates liftoff in September. Dynamics in the Mexican fixed-income and FX markets have been steered today by global concerns on China, with limited reaction following Banxico's QIR this afternoon, despite adjustments on growth and inflation forecasts for this year. The local yield curve continues flattening portraying the combination of a sell-off in short-term securities and a rally in the long-end. Shorter tenors have been affected by the uncertainty regarding the Federal Reserve and Banxico's reaction to current FX conditions. Rates are pricing in slightly more than 50bps of cumulative hikes by year-end in Mexico, higher from a month ago and trending towards a more aggressive scenario (strong likelihood of higher implied hikes). On the other hand, longer tenors continue rallying on the back of a better valuation in Mexico vis-à-vis other EM, especially if investors take into consideration the slope of the Mbonos curve (2y10y @ 173bps), the spread vs U.S. Treasuries (10Y @ 387bps) and the 5y5y forward rate (7.5%). In this regard, we acknowledge that current dynamics support our view that the yield curve will continue flattening in coming weeks, despite a valuation that is getting expensive.

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 - 1821
Rey Saúl Torres Olivares	Analyst, Mexico	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) 5004 - 1275
Víctor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 5004 - 1231
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry	marissa.garza@banorte.com	(55) 5004 - 1179
Marisol Huerta Mondragón	Equity Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 5004 - 1227
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 5004 - 1266
Valentín III Mendoza Balderas	Equity Research Analyst	valentin.mendoza@banorte.com	(55) 5268 - 9000 x 1267
María de la Paz Orozco García	Analyst	maripaz.orozco@banorte.com	(55) 5004 - 5262

Corporate Debt

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5004 - 1405
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 5004 - 1340
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 5004 - 1437

Wholesale Banking

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Managing Director – Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Jorge de la Vega Grajales	Managing Director – Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Managing Director – Private Banking	lpietrini@ixe.com.mx	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Managing Director – Asset Management	pimentelr@ixe.com.mx	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Managing Director – International Banking	rvelazquez@ixe.com.mx	(55) 5268 - 9879
Víctor Antonio Roldan Ferrer	Managing Director – Transactional Banking	vroldan@ixe.com.mx	(55) 5004 - 1454