

Ahead of the Curve

September 20, 2019

Banxico to cut 25bps and maintain a dovish tone

- Banxico's monetary policy decision (September 26th).** We expect the central bank to cut the reference rate by 25bps, to 7.75%, maintaining a dovish tone. In our view, the most important driver would be that growth expectations have persistently declined while annual inflation stands close to the 3% target, providing additional room for a lower rate. Another issue that will likely be factored-in by the central bank is that the window of opportunity for easing remains open, especially because of the Fed, which cut this week by 25bps. Moreover, it is our take that domestic developments have reduced some of the uncertainty about the most acute risks to financial stability, highlighting the *2020 Budget* proposal and recent announcements on Pemex. In our view, comments by Board members suggest an easing bias to achieve the inflation target in the most cost-efficient way for activity
- Global Economic Activity Indicator (July).** We expect a 0.2% yoy advance, still dragged by industry despite a stronger but limited performance in services. Using seasonally-adjusted figures, we anticipate a 0.2% m/m contraction, worse than the +0.2% observed in June. As already published, industrial production fell -1.7% yoy, affected by construction (-8.4%) and mining (-7.5%), with manufacturing strong at 3.0%. On the other hand, we estimate services at 1% yoy, higher than the -0.1% observed in the previous month. If the forecast materializes, performance would point to an economy that remains stagnated, with the brunt of the impact coming from sectors less externally-exposed, both in industry and services

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Document for distribution among the general public

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS	
Mon 23-Sep	7:00am	Retail sales	July	% yoy	<u>1.6</u>	1.4	1.0	
				sa	% m/m	<u>-0.3</u>	-0.3	-0.5
Tue 24-Sep	7:00am	CPI inflation	1H Sep	% 2w/2w	<u>0.20</u>	0.23	0.05	
				% yoy	<u>3.02</u>	3.06	3.04	
				Core	% 2w/2w	<u>0.25</u>	0.22	0.10
				% yoy	<u>3.85</u>	--	3.78	
Tue 24-Sep	10:00am	International reserves	Sep-20	US\$ bn	--	--	179.7	
Tue 24-Sep	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 20y Mbono (Nov'38); 5y Bondes D						
Wed 25-Sep	7:00am	Unemployment rate	August	%	<u>3.71</u>	3.82	3.71	
				sa	%	<u>3.56</u>	3.63	3.58
Thu 26-Sep	7:00am	Global economic indicator	July	% yoy	<u>0.2</u>	0.5	-0.9	
				sa	% m/m	<u>-0.2</u>	-0.03	0.2
				Primary activities	% yoy	<u>1.9</u>	--	2.5
				Industrial production	% yoy	<u>-1.7</u>	--	-2.9
				Services	% yoy	<u>1.0</u>	--	-0.1
Thu 26-Sep	2:00pm	Banxico's monetary policy decision	October	%	<u>7.75</u>	7.75	8.00	
Fri 27-Sep	7:00am	Trade balance	August	US\$ mn	<u>-952.3</u>	-952.3	-1,116.8	
				Total exports	% yoy	<u>0.5</u>	--	7.0
				Oil exports	% yoy	<u>-23.3</u>	--	-14.1
				Non-oil exports	% yoy	<u>2.3</u>	--	8.6
				Total imports	% yoy	<u>-3.4</u>	--	2.0

Source: Banorte; Bloomberg

Proceeding in chronological order...

Mixed signals for July retail sales. We anticipate a 1.6% yoy increase, higher than the 1% advance of the previous month. We should mention that the *FIFA World Cup 2018* was still being played during the first half, although Mexico was not in competition anymore. This leads us to believe that the base effect will not be as harsh as in June, further helped by was one more labor day in the annual comparison. Nevertheless, with seasonally-adjusted data we estimate a 0.3% m/m decline, extending the -0.5% observed in June. Broadly speaking, known data for local sales remains weak, albeit imports showed a more positive performance after a weak print in the previous month.

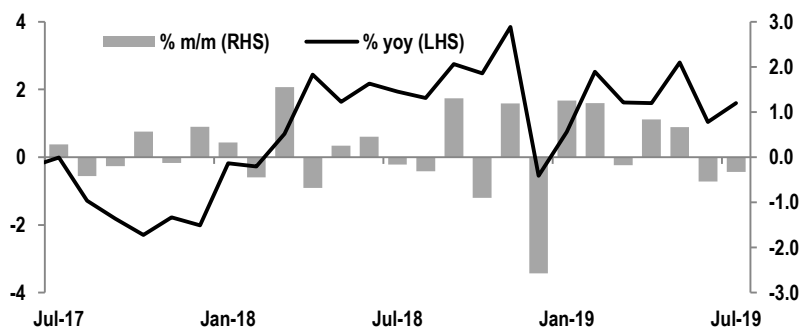
Regarding the former, same-store sales at Walmart and ANTAD during the period fell 1.5% and 2.5%, respectively. Meanwhile, auto sales were also down by 7.9%, improving relative to the -11.4% in the previous month but adding half a year in contraction. Formal job creation kept slowing down, with the annual rate at 2.2% from 2.4% previously. Consumer confidence decreased 1.6% m/m, with a generalized decline among its components, with the strongest adjustment in the “durable goods” component, which in our view is broadly consistent with the performance observed in auto sales.

On a more positive note, two factors suggest that underlying fundamentals keep supporting the sector, with remittances surging 14.4% yoy, reaching a monthly flow of US\$ 3,270.3 million. On the other hand, inflation declined further, helped by the non-core component. As a result, the pace of advance in real wages picked up to 2.6%, which remains high relative to its recent history. Moreover, non-oil consumption goods imports rebounded significantly, reaching 9.3% from -5.7% in the previous print. In our view, this latter result was positive and may have been helped by the relative strength of the peso following some recent bouts of volatility, with the USD/MXN averaging 19.05 per dollar.

We still believe that consumption could improve the rest of the year, helped by lower inflation, Federal Government social transfers programs, and relatively resilient levels of the exchange rate despite the significant pressures observed in August. Nevertheless, this should be modest as austerity measures remain in place despite the recent announcement of a relative acceleration in government spending for the rest of the year, while overall growth has stayed modest.

Retail sales

% yoy (nsa), % m/m (sa)



Source: INEGI, Banorte

Annual inflation in 1H-Sep to continue declining. We estimate headline inflation at +0.20% 2w/2w, with the core at +0.25%. We expect that, similar to previous fortnights, the core component will lead the contribution, adding 19bps to the headline index. On the other hand, non-core would only add 1bp (+0.06% 2w/2w).

In particular, we expect a relevant contribution from education (+7.5bps), remembering that most of the tuition increases for kindergarten, elementary and middle school are accounted for in this fortnight. Within other services, we forecast that they will only add 1bp, with some pressures in air fares and tourism services due to the September 16th holiday. Nevertheless, we anticipate that these will be partially mitigated by decreases in other categories within this component. Moreover, we also expect important increases in core goods, with 5.5bps corresponding to other goods, while another 3bps correspond to processed foods.

For the non-core component, we forecast a moderate contribution of 3bps from fresh fruits and vegetables. In this regard, our price monitoring showed a mixed performance, with some pressures in chilies, which were partially offset by lower onion prices. In addition, we expect meat and egg (-2bps) to extend their recent falls, supported by the downward trend in chicken prices. Going to energy, we consider that LP gas could rise again, although in a modest manner (+0.07bps). However, this would be completely offset by a reduction in electricity tariffs. On gasoline, the subsidy to excise tax for low-grade fuel increased relative to the previous period, this despite better dynamics of both the exchange rate and the international reference price. Nevertheless, this move could be showing some lag, taking into account that there were greater pressures at the end of August. In this context, we expect that the price of this good to remain on average, unchanged.

With these results, annual inflation would continue to decline, standing at 3.02% from 3.16% in August, its best level since September 2016. In this sense, the non-core component would fall to 0.50%, its lowest level in history (with the series available in a bi-weekly frequency since January 1989). Inside, agricultural goods would stand at 2.53% (from 5.44% in Dec-2H, 2018), while energy could come at -3.16% (from 11.17% at the end of last year). Considering this behavior, on top of the Federal Government's policy on the prices of the latter goods, we believe will continue to support low levels of inflation. On the other hand, core inflation would rise to 3.85% from 3.78%, reaching a new high since last June. Nevertheless, we expect that this increase could fade away in coming months, pushed down in part by the deceleration of economic activity.

Weekly international reserves report. Last week, net international reserves decreased by US\$709 million, closing at US\$179.7 billion. According to Banxico's report, this figure comes mainly from a negative valuation effect in central bank assets. In this context, the central bank's international reserves have increased US\$5.0 billion during 2019 (please refer to the following table).

Banxico's foreign reserve accumulation detail

US\$, million

	2018	Sep 13, 2019	Sep 13, 2019	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	174,793	179,747	-709	4,955
(B) Gross international reserve	176,384	187,488	-925	11,104
Pemex	--	--	13	113
Federal government	--	--	-249	6,158
Market operations	--	--	0	0
Other	--	--	-689	4,833
(C) Short-term government's liabilities	1,592	7,741	-216	6,149

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 20-year fixed-rate Mbonos (Nov'38), and 5-year Bondes D, 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).

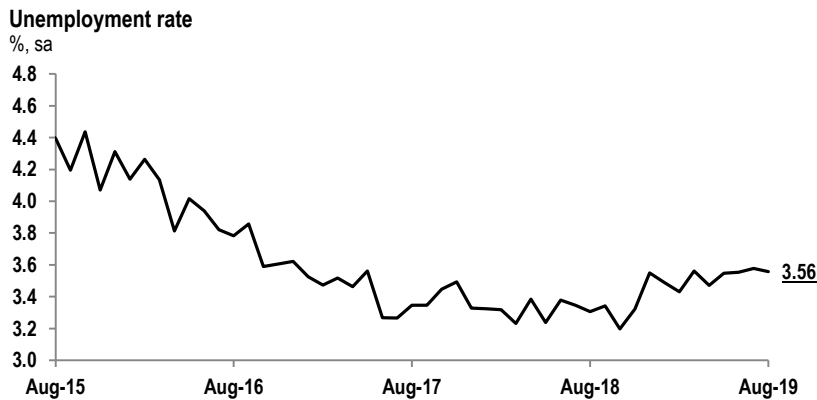
Auction specifics (Tuesday, September 24th, 2019)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	24-Oct-19	--	6,000	7.72
3m	26-Dec-19	--	11,000	7.67
6m	26-Mar-20	--	13,000	7.65
Bondes D				
5y	22-Aug-24	--	6,500	0.15
M Bono				
20y	18-Nov-38	8.50	3,700	7.57

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 expect a slight reduction in the unemployment rate in August. We estimate the unemployment rate at 3.56% sa, slightly below the 3.58% of the previous month. If this is the case, it would cut with three consecutive increases. In this context, formal job creation during the month stood at 36,631 new jobs, improving from +16,713 in the previous month. However, the annual pace of formal job creation decelerated further to 1.8%, lowest since early 2010. Year-to-date, job creation stands at 342.6 thousand, while the rolling 12-month sum totals 358.6 thousand. On the positive side, August PMIs showed employment sub-indices still in contraction but with some positive signals, improving in manufacturing but with non-manufacturing unchanged to the previous month.

Regarding activity, June's monthly GDP proxy (IGAE) showed a 0.2% monthly expansion. Nevertheless, more recent data for industrial production (-0.4% m/m in July) signal that some lingering weakness prevails in the sector. On a timelier manner, business confidence for three out of the four sectors covered kept declining, albeit at a slower pace. In this sense, the only one that improved was manufacturing, increasing 0.3pts vs. the previous month. This could signal at least some stabilization of the outlook for business investment, which in turn could result in better hiring conditions going forward.



Source: INEGI, Banorte

IGAE to stay muted in July. We estimate the *Economic Activity Indicator* (IGAE) at 0.2% yoy, still dragged by industry despite a stronger but still limited performance in services. Using seasonally-adjusted figures, we anticipate a 0.2% contraction, worse than the +0.2% of the previous month. It should be noted the latter would be explained to some extent by the fact that the month had three more labor days when compared to June, which impacts the monthly comparison to the downside.

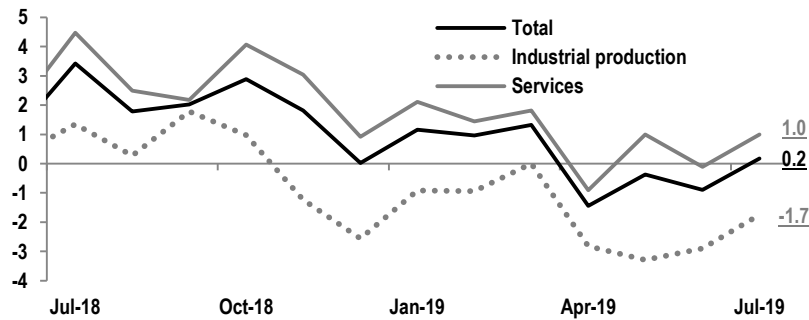
As already known, industrial production stood at -1.7% yoy, impacted by construction (-8.4%) and mining (-7.5%). Manufacturing was strong at 3.0%, but not enough to compensate for the former two. For details, see: “*Industrial production – Slight contraction in July despite resilient manufacturing*”, [pdf](#), September 11th, 2019. Although signs coming from external demand have been more positive, such as the +0.6% m/m advance in US industrial production in August, we believe the sector is not out of the woods yet as suggested by softness in Mexico’s PMI indices and the US ISM manufacturing.

On the other hand, we estimate a 1% yoy expansion in services, higher than the -0.1% observed in June. The annual rate would be benefitted by an additional labor day relative to the same period of the previous year, although limited by a more difficult base effect (given that 4.5% of July 2018). As mentioned above, retail sales will likely be stronger in annual terms, albeit dampened by indicators for the local economy that remain weak. In this respect, the production subcomponent within the IMEF non-manufacturing index fell again relative to June, signaling still modest overall performance. The pace of annual job creation was broadly unchanged at 2.8% yoy, suggesting some stabilization. Nevertheless, only 8,612 net jobs were created, which could be a result of seasonal weakness due to the holidays. Hints of better performance include a strong inflow of remittances and low inflation pressures, with the latter mainly driven by the non-core component.

If the forecast materializes, performance would point to an economy that remains stagnated, with the brunt of the impact coming from sectors less externally exposed, both in industry and services. Activity in July looks to have remained limited, with better signals observed in August. In this respect, we maintain our view of a gradual recovery in activity in 2H19, likely stronger in the third quarter but in our view much better only later in the year.

IGAE

% yoy (nsa)



Source: INEGI, Banorte

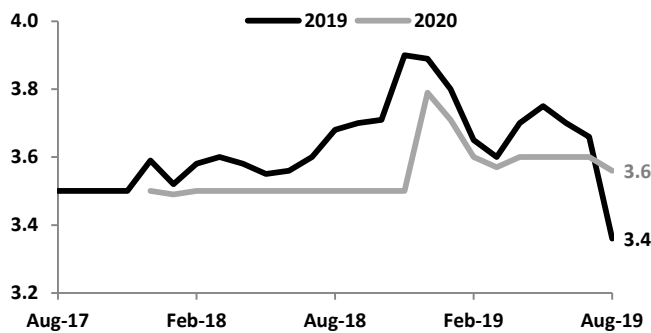
Banxico to cut 25bps, maintaining a dovish tone. Next Thursday, Banxico will hold its sixth meeting of 2019, in which we expect a 25bps cut, leaving the reference rate at 7.75%, in line with consensus. This would be the second cut in the year, supporting our view that the central bank started an easing cycle in August 15th, which we estimate could be between 125-200bps. In the latest minutes we noted that a relevant discussion was held whether this was the case, with mixed opinions on the matter. For details, see: “*The easing cycle has begun, with some lingering risks*”, <[pdf](#)>, August 29th, 2019. We believe the central bank will maintain a dovish tone, likely signaling additional cuts. We maintain our view that the reference rate will be lowered again in December to end the year at 7.50%. However, we recognize that risks are skewed for an additional two 25bps, one in November and another one in December, which would result in a year-end level of 7.25%.

In our view, the most important driver for a cut and keeping a dovish tone is that the growth-inflation mix provides additional room for lower rates. In terms of prices, annual inflation fell to 3.16% at the end of August from 3.78% in the latest decision, now standing very close to the 3% target and at a minimum since early October 2016. Banxico had already acknowledged that inflation would fall faster than anticipated in the 2Q19 *Quarterly Report* (QR) <[pdf](#)>, forecasting average annual inflation in the third quarter at 3.3%. As things stand, during the first two months the average was 3.5%. According to our forecasts, favorable base-effects and limited pressures at the non-core component make it very likely that this estimate will be reached.

Meanwhile, core inflation is projected at 3.7%, lower than the current average of 3.8%. For the forecast to materialize, September’s annual inflation would have to fall at least 12.5bps to round-down to the forecast. In this sense, the resistance to the downside of core inflation was one of the main reasons behind the dissenting vote of Deputy Governor Javier Guzmán in August. Nevertheless, the majority of the Board signaled a more comfortable stance with the inflation outlook, due to the energy pricing policy of the federal government (both because of its direct and indirect effects) and the expectation that higher slack will result in limited demand-side price pressures for this component in coming months.

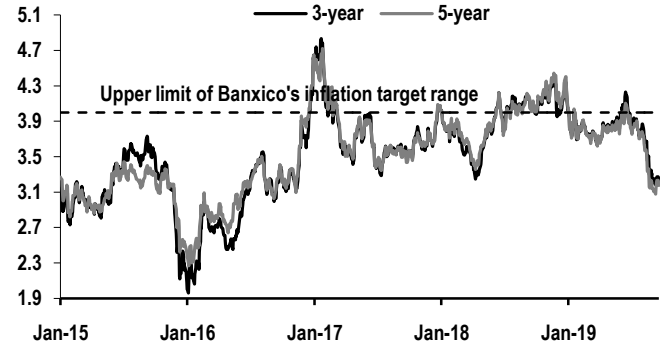
On inflation expectations, the central bank’s survey showed a strong adjustment in analysts’ year-end forecast, to 3.4% from 3.7%, with the core unchanged at 3.7% (see chart below, left). *Citibanamex’s* survey, which is more frequently updated, has the estimates for the end of the year slightly lower, with the headline at 3.3% (in line with our forecast) and the core at 3.6%. For the mid- and long-term, though, forecasts have been broadly unchanged for some time now, hovering around 3.5%. Market-implied inflation has also shown a significant decline, with three- and five-year *breakevens* at levels not observed since the gasoline price hike in early 2017 (see chart below, right). In a similar fashion, 10- and 30-year tenors have also diminished, albeit to a lesser extent, in the same order, within the upper half of Banxico’s variability range. Overall, we think recent inflation dynamics support our call of a dovish tone despite doubts likely remaining among some members.

Private analysts’ year-end inflation forecast
% yoy



Source: Banorte with data from Banxico

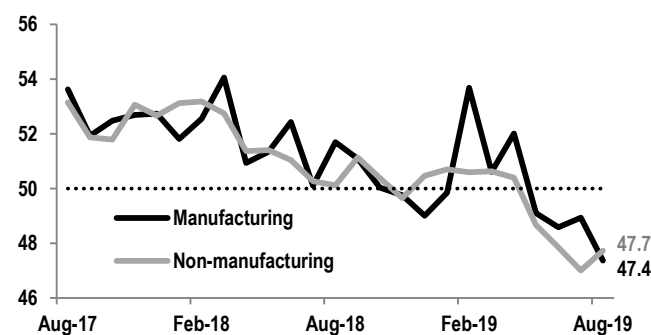
3- and 5-year inflation breakevens
% yoy, implied market inflation using Fisher's equation



Source: Banorte with data from Valmer

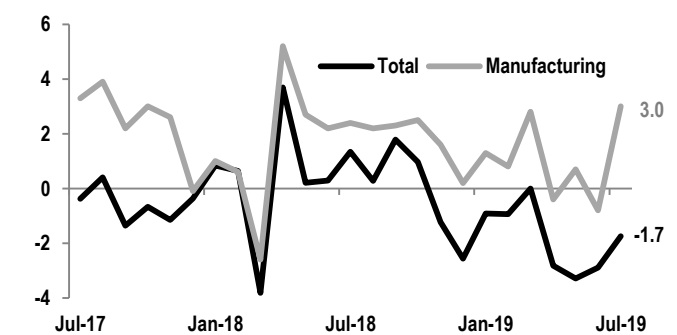
GDP expectations for 2019 and 2020 have declined in a persistent manner, at 0.5% and 1.4%, respectively (Banorte: 0.8% and 1.4%, in the same order). PMI indices have stayed in contraction four months up to August, while July’s industrial production had its ninth negative print in a row in the annual comparison despite some resiliency in manufacturing (see charts below). Given the latest data, international developments –such as higher tariffs between the US and China–, and other geopolitical tensions, it is our take that the central bank will maintain that the balance of risks for growth remains skewed to the downside. The latter, even considering that they did not explicitly stated in the latest communique that the balance had further deteriorated for the domestic economy, despite characterizing it that way in terms of the global backdrop.

IMEF indices
Pts, diffusion index



Source: Banorte with data from IMEF

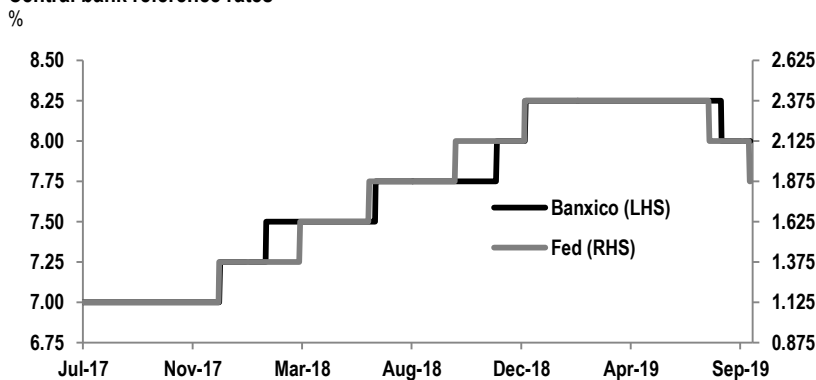
Industrial Production
% yoy



Source: INEGI

An additional factor that will likely be factored-in is that the window of opportunity for easing remains open at least in part thanks to other central banks. Specifically, this week the Fed cut the *fed funds* range by 25bps. Despite the *dot plot* showing a median that implies no more cuts this year, we expect an additional cut in December. To a great extent, we have reiterated our call for Banxico to cut to 7.50% by end-2019 as we expect the Fed to do so in the same magnitude (see chart below). In this sense, the minutes showed members noted the previous 25bps cut by the Fed as one of the main arguments to ease. Moreover, the ECB announced a set of easing measure that included even more negative interest rates and the restart of QE with the aim of lifting inflation and its expectations. Other central banks have also stepped up stimulus, which should help Banxico at the margin given the importance of the interest rate spread, not only against the US but also to other emerging markets. With global central banks maintaining this bias, global conditions remain supportive despite the Board seemingly split between those who see this backdrop as a reason to start and easing cycle and those who did not, suggesting that the central bank is more in a ‘*data and events dependency*’ mode.

Central bank reference rates



Source: Bloomberg

In our view, domestic developments have reduced some of the uncertainty about the most acute risks to financial stability. First, the *2020 Budget* proposal confirmed the government’s commitment with healthy public finances while being more realistic as it recognized a more challenging backdrop (for details, see: “*Fiscal responsibility continues in 2020, with some optimism in underlying assumptions*”, <[pdf](#)>, September 9th, 2019). Second, last weekend’s attacks on Saudi Arabia’s oil infrastructure have heightened geopolitical tensions, which is not positive for financial stability. As a result, oil prices have increased, which is potentially beneficial for the country’s finances given two factors: (1) Outright higher oil revenues; and (2) greater room to maneuver on the oil hedge, with public officials saying they are looking to implement this strategy again for 2020, but with the related transactions not yet completed. In our view, this provides an opportunity of locking-in better strike prices and/or a lower cost for put options. However, it could also potentially imply higher tax subsidies to gasoline. Even if the benefits are limited or non-existent, we believe the US\$/bbl 49 price estimate for the Mexican oil mix in the budget is relatively conservative.

Last but not least, the government unveiled an additional capital contribution of US\$ 5 billion for Pemex, with the company's financial situation remaining as one of the most pressing concerns among market participants. These resources will not affect the level of net government debt as they will be used to buyback outstanding bonds in the short-end. This announcement was coupled with a successful bond offering of US\$ 7.5 billion in 7-, 10- and 30-year notes for the refinancing of short-term liabilities and an exchange offer to improve the company's maturity profile.

After these transactions, *Fitch Ratings* said they remain cautious as the equity contribution is "modest" and will not resolve the company's challenges, but it is important as it improves its short-term liquidity position. On the other hand, *Moody's* –which rates Pemex's only one notch above investment-grade– considered it helps the company avoid higher short-term debt while being in line with their expectations about additional support. Nevertheless, it does not substantially change the credit outlook for the sovereign and/or the company. In this respect, it is our take that although financial stability risks persist from Pemex's situation, these transactions help alleviate some of the most immediate concerns, an additional factor that we believe could help the central bank to continue reducing the reference rate in the short term.

All these considerations are being assessed by members of the Board, as portrayed by their recent comments. Banxico Governor, Alejandro Díaz de León, said that "*...to the degree that some of the scenarios that contribute to inflation slowing in a more decisive manner materialize, we could also take corresponding monetary policy decisions...*", signaling that they could lower rates. Nevertheless, he also stated that they are careful not to forecast future decisions and that the MXN has gotten riskier to hold, with Banxico maintaining its attractiveness in part by increasing the appeal of fixed income assets, suggesting some lingering doubts over financial stability. In fact, dissenter Javier Guzman argued that Pemex continues to be a major source of concern, with the recent plan not dissipating distress about its outlook and with unease still present about the potential implications for public finances. Deputy Governor Jonathan Heath recently stated that there is an opportunity to lower the interest rate further as inflation is closer to the target and the economy has stagnated. He was careful to note that this would not necessarily mean that the central bank will adopt an outright accommodative stance, but only turning less restrictive.

In this sense, the central bank updated in the latest QR its estimate of the neutral interest rate, to 2.6% in real terms (range: 1.8-3.4%) and 5.6% in nominal terms (range: 4.8-6.4%). Given the current level of 8.0% we believe there is plenty of room for rate cuts, with our estimate of the upper bound of an easing cycle at 200bps, resulting in a terminal rate close to 6.25%, within Banxico's new range estimate and slightly higher than neutral.

All in all, we believe Banxico will cut the reference rate by 25bps and maintain a dovish tone, staying vigilant due to the challenging global and local backdrop but taking advantage of the window of opportunity to reduce rates. This, based on the continuous central bank assessment of the above-mentioned factors, within a context of a relatively strong behavior of the MXN (at around 19.40 per dollar, broadly unchanged when compared to the latest decision and below recent highs of 20.20) and local yield curves, along recent comments by Board members that suggest a bias in favor of easing to achieve the inflation target in the most cost-efficient way for overall economic activity.

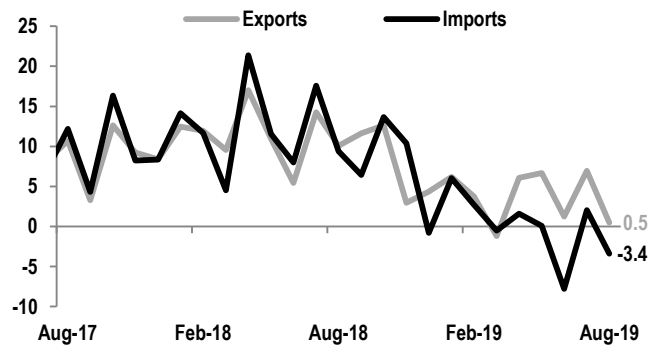
Trade balance deficit expected again. We estimate a US\$952.3 million deficit mainly driven by a moderation in exports, while imports would return to contraction on an annual basis due to persistent weakness in capital goods, affected to some extent by the depreciation of the MXN. We also see an adverse calendar effect, as the month had one less working day relative to both the previous month and the same period of 2018. In particular, we anticipate total exports at 0.5% yoy from 7.0% in July, with imports estimated to contract 3.4% after rebounding 2.0% previously.

In the oil balance, we anticipate a US\$ 2,025.2 million deficit. Exports would contract 23.3% yoy, with a 24.4% decline in crude. Related to the latter, available data shows that despite a sequential pickup in volumes, the base-effect is more challenging. More importantly though, the Mexican oil mix price fell as renewed trade tensions had an additional impact on growth prospects, with the average at US\$/bbl 50.18 from 58.99 in July, resulting in a 21.3% yoy decline. In imports, we estimate a 16.6% contraction. In consumption, we see a more modest but still quite high decline of -14.3%, influenced by the 18.4% fall in US gasoline, as it also reacted to pressures in crude. We continue anticipating a slowly deteriorating balance, remaining with a deficit of at least US 23 billion on a 12-month rolling basis since November 2018.

The non-oil balance would pick-up from a quite low surplus of US\$ 729.1 million in July to +US\$ 1,072.5 million. We anticipate a deceleration of exports to 2.3% from 8.6%. The main highlight would be a slowdown in autos, which we expect at 3.3% after surging 12.6% in the previous month. In the US, this sector inched higher by 0.3%, with a more sizable effect according to AMIA, which showed exports at -12.7%, first fall since February and partially because of a quite difficult base effect. On the other hand, other manufacturing exports would moderate to 1.1%. Regarding imports, we see a 1.7% decline, impacted the most by our expectation of protracted weakness in capital goods (-18.6% from -16.5% in July), mostly as we believe this category is among the most sensitive to peso depreciation –which went from 19.05 to 19.68 per dollar on average (+4.4% yoy), reaching close to 20.15 by the end of the month–, while intermediate-goods would also moderate given their high correlation with the manufacturing sector.

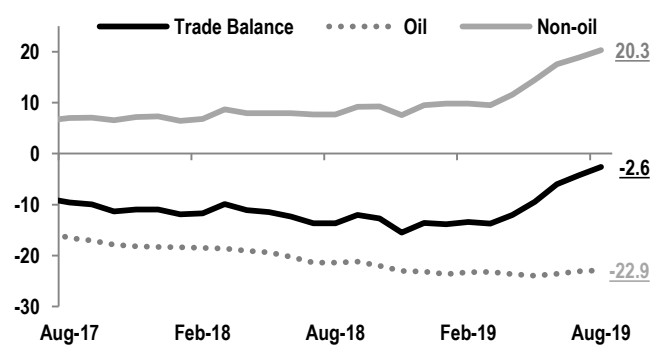
Overall, we expect results to show that manufacturing remains positive despite slowing down, mostly as payback from the previous month, while non-oil consumption-goods imports would also suggest a better performance in 3Q19. In contrast, the weak spot would remain in capital goods, which would add three consecutive prints falling at a high double-digit pace, affected to some extent by FX but, more structurally, by low investment appetite by domestic companies.

Exports and Imports
% yoy



Source: INEGI, Banorte

Trade balance
US\$ billion, 12-month rolling sum



Source: INEGI, Banorte

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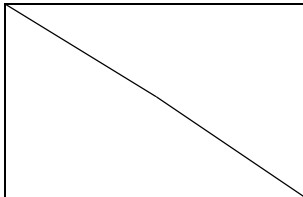
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Guide for investment recommendations.

	Reference
BUY HOLD SELL	When the share expected performance is greater than the MEXBOL estimated performance. When the share expected performance is similar to the MEXBOL estimated performance. When the share expected performance is lower than the MEXBOL estimated performance.

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