

Banxico's QIR – Lower growth and higher inflation in 2016

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- Banxico published today its *Quarterly Inflation Report (QIR)* for 4Q15
- We highlight the following issues:
 - (1) The 50bps hike in the reference rate during Banxico's extraordinary meeting held back in February 17 should not be taken as a sign of a tightening cycle; looking ahead, Banxico's monetary policy will be subject to both external and internal factors;
 - (2) Banxico revised down its growth forecast for 2016 and 2017. In the first case, the central bank now expects GDP growth between 2% and 3% from 2.5% and 3.5%; in the second case, the central bank estimates that GDP growth will be between 2.5% and 3.5% (3% and 4% in their previous report);
 - (3) The output gap will remain open until 4Q17; and
 - (4) Banxico believes that inflation will remain above the 3% target in 2Q and 3Q16, but will close around 3% in 4Q16
- We maintain our view that Banxico will hike the interest rates after the U.S. Fed in June

Lower growth and higher inflation in 2016. The monetary authority released its *Quarterly Inflation Report (QIR)* for 4Q15. The release was accompanied by a press conference led by Governor Carstens. We highlight the following issues discussed in the document: (1) The 50bps hike in the reference rate during Banxico's extraordinary meeting held back in February 17 should not be taken as a sign of a tightening cycle; looking ahead, Banxico's monetary policy will be subject to both external and internal factors; (2) Banxico revised down its growth forecast for 2016 and 2017. In the first case, the central bank now expects GDP growth between 2% and 3% from 2.5% and 3.5%; in the second case, the central bank estimates that GDP growth will be between 2.5% and 3.5% (3% and 4% in their previous report); (3) the output gap will remain open until the end of 2017; and (4) Banxico believes that inflation will remain above the 3% target in 2Q and 3Q, but will close around 3% in 4Q16. In our opinion, Banxico's *QIR* maintained the tone we have already discussed previously, in the sense that after Banxico's 50bps rate hike, the central bank is tied to the U.S. Fed actions.

Economic growth was higher than Banxico's estimates in 4Q15...The document highlights, among other things, that the Mexican economy maintained a higher-than-expected growth during the last quarter of 2015. In particular, Banxico mentioned that Mexico's economic growth was supported by the upward trend in private consumption. In particular, the central bank explained that the recovery in consumption was explained by the better growth dynamics of the labor market trends, low inflation, higher banking credit, and the recent growth in remittances inflows. However, manufacturing exports continued to show signs of weakness derived from the slowdown in the U.S. manufacturing industry, and the downward trend of Mexico's exports to other countries.

...but lower growth for 2016 and 2017. Banxico revised down its growth forecast for 2016 and 2017. In the first case, the central bank now expects GDP growth between 2% and 3% from 2.5% and 3.5%. In the second case, the central bank estimates that GDP growth will be between 2.5% and 3.5% (3% and 4% in their previous report). 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 international oil prices which could lead to an additional fiscal cut; (3) new episodes of volatility in financial markets derived from China's economic growth and the uncertainty regarding the Fed's next hike. In this regard, the central bank highlighted that the increase in market volatility could lead to a disorderly adjustment in the exchange rate, which in turn would cause a deterioration in confidence levels, and therefore also in spending decisions of consumers and firms. 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 the structural reforms. Finally, in its traditional output gap chart, the central bank clearly shows that the output gap will remain open until 4Q17 (refer to the charts below).

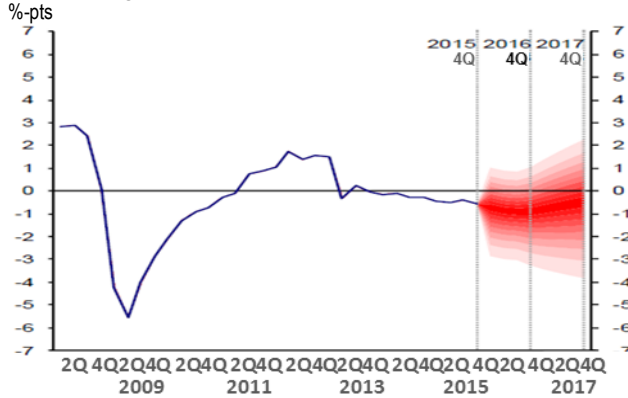
Banxico's Forecast Recent		
	2016	2017
GDP (%)	2.0 - 3.0	2.5 - 3.5
Employment (thousands)	610 - 710	650 - 750
Trade balance (bn)	-12 (1.2, %GDP)	-13.1 (1.2, %GDP)
Current account (bn)	-30.3 (2.9, %GDP)	-33.5 (2.9, %GDP)
Inflation		
Headline	Near 3%	Around the permanent inflation target
Core	Near 3%	Around the permanent inflation target

Source: Banxico

Banxico's Forecast Previous Quarterly Report		
	2016	2017
GDP (%)	2.5 - 3.5	3.0 - 4.0
Employment (thousands)	630 - 730	660 - 760
Trade balance (bn)	-6.6 (0.6, %GDP)	-9.4 (0.7, %GDP)
Current account (bn)	-29.8 (2.5, %GDP)	-34.9 (2.7, %GDP)
Inflation		
Headline	Around 3%	Moderate downward trend, closer to 3%
Core	Around 3%	Moderate downward trend, closer to 3%

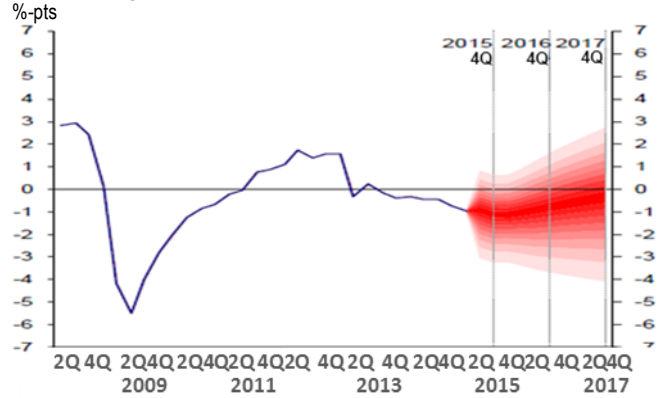
Source: Banxico

GDP output gap (Banxico's 4Q-report)



Source: Banco de México, 4Q15 QIR

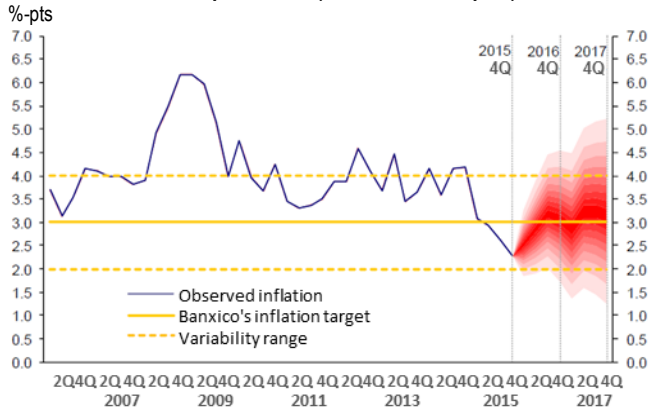
GDP output gap (Banxico's 3Q-report)



Source: Banco de México, 3Q15 QIR

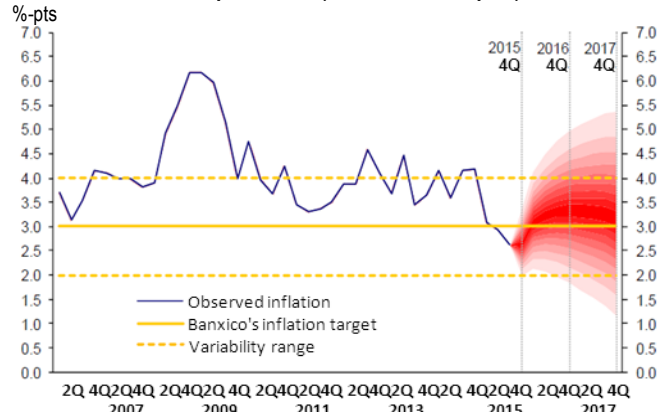
Year-end-inflation will close around 3% in 2016. Banxico mentioned that headline inflation will increase this year given the following factors: (1) The fading of favorable supply shocks that took place in 2015; (2) price adjustments given the depreciation of the Mexican currency; (3) the change in the MoF's policy of the determination of gasoline prices, which implies higher prices during the second and third quarters, but lower during the first and fourth quarters. In this regard, Banxico estimates that inflation will be above 3% during the second and third quarter, but will end 2016 near its 3% target. By 2017, the central bank anticipates that these effects will fade and the central bank expects a downward trajectory in which the headline and core inflation will end the year close to 3%.

Fan chart: Inflation expectations (Banxico's 4Q-report)



Source: Banco de México, 4Q15 QIR

Fan chart: Inflation expectations (Banxico's 3Q-report)



Source: Banco de México, 3Q15 QIR

“Grey boxes” on the deceleration of Mexican exports and Mexico’s oil trade balance. As it is now a tradition, Banxico included two research notes (a.k.a. “grey boxes”). The first relates to the impact of the deceleration of external demand in Mexican exports and how this effect over-compensated the positive exchange rate depreciation effect on exports flow. The second box analyzed the behavior of the international oil market and the reduction in oil prices as a result of factors of both supply and demand. In the case of Mexico, the grey box shows that the terms of trade in the oil market deteriorated significantly, and this led to the deficit in Mexico’s oil trade balance. Moreover, the study concluded that the 2015 deficit was also explained by higher oil import volumes.

We maintain our view that the central bank's next move will be a 25bps rate hike, immediately after the Fed in June. In our opinion, Banxico’s QIR maintained the tone we have already discussed previously, in the sense that after Banxico’s 50bps rate hike, the central bank is tied to the U.S. Fed actions. In this regard, we believe that Banxico’s next move will be a rate hike, immediately after the Fed continues its normalization of monetary policy in June 15. This implies that the central bank could be raising rates at its next regular meeting on June 30.

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