

Banxico's QR – February's hike anticipated the Fed's potential hike in March

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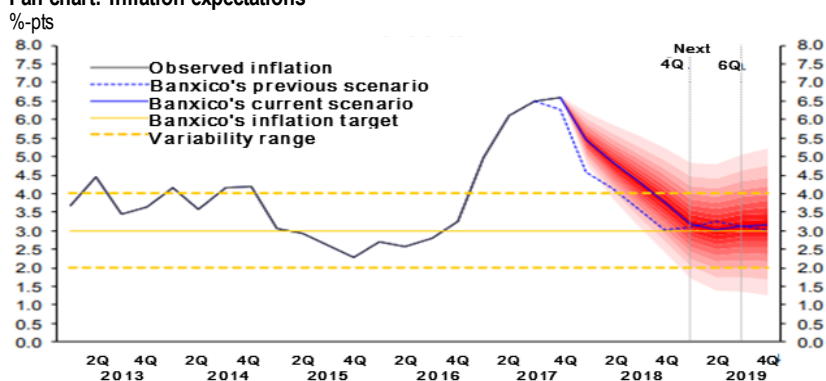
- Banxico published today its *Quarterly Report (QR)* for 4Q17
- This was the first Quarterly Report of Alejandro Diaz de Leon as Banxico's Governor
- We highlight the following issues:
 - (1) Alejandro Diaz de Leon commented that February's rate hike "*took into account more restrictive monetary conditions expected in the US*", which signaled that the central bank will not necessarily have to increase the reference rate in April, right after the Fed's hike in March;
 - (2) For the first time, Banxico published quarterly inflation estimates for 2018 and 2019, in an effort to improve the central bank's communication (refer to the first table on the following page);
 - (3) In addition, they also published a series of indicators measuring the slack in the Mexican economy –in addition to the traditional output gap– in order to improve the measurement of inflationary pressures (refer to the graphs on the following page);
 - (4) Moreover, growth and employment forecasts remained unchanged for 2018 and 2019 (refer to the second table on the following page)
 - (5) Banxico's inflation fan chart reflects the lower expected speed of convergence towards the target, as mentioned in the last monetary policy *communiqué*
- In the traditional "*grey boxes*", Banxico's researchers tackled the following topics:
 - (1) Descriptive considerations of the tax reform in the US;
 - (2) The recent evolution of Mexico's vehicle and auto-parts exports;
 - (3) Considerations on the new methodology of measuring monetary aggregates in Mexico
 - (4) The above mentioned slack indicators, where we highlight the GDP output gap excluding oil;
 - (5) The concept of fundamental core inflation; and
 - (6) Banxico's regime of inflation targeting and the role of forecasts
- In this context, we now believe that the central bank will hike the reference rate by 25bp at some point during the second quarter, given the Fed's more restrictive monetary stance, coupled with the higher MXN volatility (previous: 25bp hike in April)
- Looking ahead, and as volatility due to the electoral process in our country and the uncertainty regarding NAFTA renegotiations dissipates, it is likely that the Central Bank will cut rates by 50bp in the second half of the year
- Local rates rallied after Banxico released its QR, as it suggested that the tightening cycle is very close to an end in the 2Q18
- The fixed-income market registered gains of nearly 3bps, mainly in the short- and mid-ends. On the other hand, the peso observed an initial

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positive performance, most likely conveying the better outlook in terms of the inflationary premia embedded in local assets

- However, the peso finished slightly weaker at USD/MXN 18.85 following the sell-off in oil prices and a less hawkish rhetoric
- Overall the slightly hawkish tilt prevailed at today's communication by Banco de Mexico, granting appropriate conditions for our trade idea of long positions in 5-year floating-rate Bonds D
- Regarding the Mexican peso, there are several risky events in the short-term that could spur volatility, highlighting the 7th round of NAFTA talks currently taking place and the next policy meeting from the Federal Reserve on March 21st

Fan chart: Inflation expectations



Source: Banco de Mexico; 4Q17 QIR

CPI forecasts

% yoy on the quarterly average

	2018				2019			
	I	II	III	IV	I	II	III	IV
CPI								
Current forecast	5.5	4.8	4.3	3.8	3.2	3.0	3.1	3.2
Previous forecast	4.6	4.1	3.6	3.0	3.1	3.3	3.1	3.0
Core								
Current forecast	4.4	4.0	3.8	3.6	3.3	3.2	3.1	3.0
Previous forecast	4.2	3.9	3.6	3.5	3.3	3.2	3.1	3.1

Source: Banco de México, 4Q17 QIR

Banxico's Forecast
Recent

	2018	2019
GDP (%)	2.0 – 3.0	2.2 – 3.2
Employment (thousands)	680 – 780	690 – 790
Trade Balance (bn)	-13.7 (1.1% of GDP)	-15.0 (1.2% of GDP)
Current account (bn)	-25.9 (2.1% of GDP)	-30.5 (2.3% of GDP)

Source: Banxico

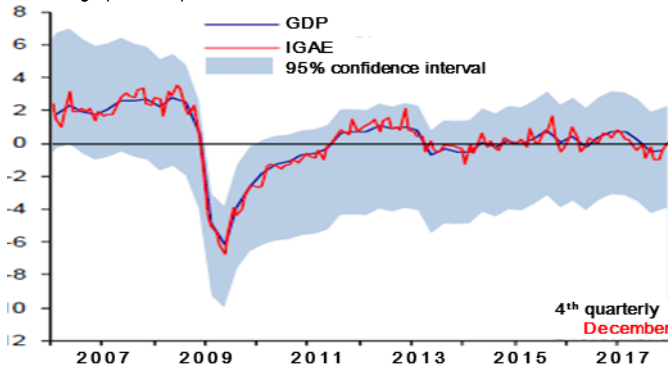
Banxico's Forecast
Previous Quarterly Report

	2018	2019
GDP (%)	2.0 – 3.0	2.2 – 3.2
Employment (thousands)	680 – 780	690 – 790
Trade Balance (bn)	-13.1 (1% of GDP)	-14.5 (1.1% of GDP)
Current account (bn)	-25.9 (2.1% of GDP)	-30.6 (2.3% of GDP)

Source: Banxico

Output gap

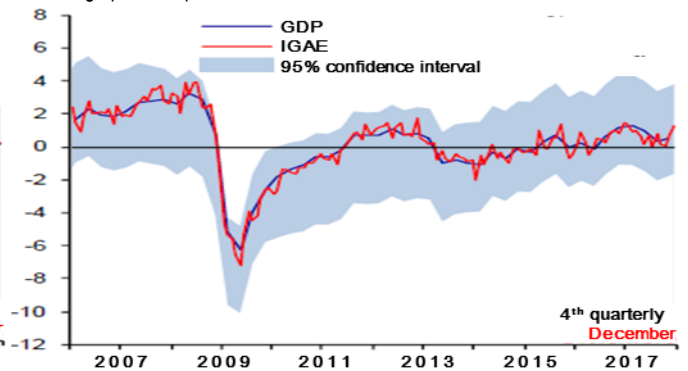
Percentage points of potential GDP



Source: Banco de Mexico; 4Q17 QIR

Output gap ex oil production

Percentage points of potential GDP



Source: Banco de Mexico; 4Q17 QIR

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