

Banxico QR – New estimates match the recent dovish shift

- Banxico published today its 2Q19 *Quarterly Report (QR)*
- The release was accompanied by a press conference by Governor Alejandro Díaz de León
- We highlight that Banxico modified its growth and inflation estimates. Specifically:
 - (1) Growth for 2019 was revised down from a range between 0.8-1.8% (mid-point: 1.3%) to 0.2-0.7% (mid-point: 0.5%), below our expectation of 0.8%
 - (2) The forecast range for 2020 was revised down by 20bps to 1.5-2.5% (mid-point: 2.0%; Banorte: 1.4%)
 - (3) Headline inflation for the next four quarters was lowered sharply, while convergence to the 3% target was brought forward by one quarter to 2Q20
- Among the relevant themes in the ‘grey boxes’, Banxico included: (1) The impact of lower growth and higher wages on formal job creation; (2) the summary of Pemex’s new business plan and recent credit rating actions; and (3) an update on the long term estimate of the real and nominal long-term neutral interest rate
- In our view, the document did not provide meaningful new information about the outlook for monetary policy relative to what we already knew from the latest communique, which showed a dovish tone
- Nevertheless, we believe downward revisions to growth and inflation are consistent with our view of two additional 25bps cuts in the remainder of the year, with the first in September and the second in December
- Banxico’s bias arguing in favor of long positions in long-term Mbonos

We consider that the *Quarterly Inflation* confirmed a dovish tone, in line with the latest policy statement. Banxico published today its *Quarterly Report (QR)* for 2Q19. The release was accompanied by a press conference led by Governor Alejandro Díaz de León. In our opinion, the tone of the QR was dovish and very similar to what we perceived in the monetary policy statement of the August 15th meeting. We believe that revisions on both growth and inflation provide further support to our call of additional easing in 2019, forecasting two 25bps cuts for the remainder of the year, one in September and the other in December.

Significant decline in GDP growth forecasts for this year and 2020. For 2019, the range was cut to 0.2-0.7% yoy (mid-point: 0.5%), from 0.8-1.8% (mid-point: 1.3%), below our expectation of 0.8% and consensus at 0.6%, according to the latest *Citibanamex* survey.

August 28, 2019

www.banorte.com
@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

Juan Carlos Alderete, CFA

Senior Economist, Mexico
juan.alderete.macal@banorte.com

Francisco Flores

Economist, Mexico
francisco.flores.serrano@banorte.com

Fixed income and FX Strategy

Alejandro Padilla

Head Strategist – Fixed-Income and FX
alejandro.padilla@banorte.com

Santiago Leal Singer

Fixed-Income and FX Strategist
santiago.leal@banorte.com

Leslie Orozco

Fixed Income and FX Strategist
leslie.orozco.velez@banorte.com

Document for distribution among public

This was driven by three factors: (1) The downward revision for 2Q19 GDP in the final release published last week, to -0.8% yoy (0.0% q/q). For details, see: “2Q19 GDP stagnated, but avoids a ‘technical recession’”, <pdf>. August 23rd, 2019; (2) more muted expectations about US industrial production growth; and (3) Lower estimates for oil production than previously anticipated, which would be a stronger drag on industry. In the press conference, Governor Díaz de León also noted the loss of dynamism in services and the slowdown in construction. It is worth mentioning that we have already accounted for these two factors in our forecast. For 2020, the range was cut 20bps, to 1.5-2.5% (mid-point: 2.0%), higher than our 1.4%, likely influenced at least partially by a more favorable base-effect given the differences in the estimate for the current year.

In line with our expectations, the central bank also lowered its current account deficit forecast for 2019, from US\$ 24.3 to 15.2 billion or 1.9% to 1.2% of GDP, in the same order. This is mainly due to a more modest trade balance deficit on the back of lower imports. For 2020, the CA deficit was also revised downwards, to US\$ 22.0 billion or 1.6% of GDP. Regarding employment, the range declined by 80k and 60k jobs for this year and next, respectively, to 450-550k and 590-690k, in the same order.

In this respect, we highlight the analysis in one of the ‘grey boxes’ about the factors behind the deceleration in this year’s formal job creation. The main are: (1) The stagnation in activity in recent quarters; and (2) the minimum wage hike that took place in January 2019. The study concludes that for job growth to accelerate, it is necessary to foster higher dynamism with public policies that incentivize private investment and decrease domestic uncertainty. Moreover, they said that it will be important to monitor additional exogenous increases in the minimum wage, as subsequent hikes could have a more sizable impact on formal job creation (depending on their magnitude) given that they affect a higher share of total workers. In our view, the central bank will keep flagging the upside risks for inflation and the price formation process that could result from additional wage increases, particularly if these are not based on higher labor productivity.

As a result and as previewed in the latest communique, estimates for the output gap were decreased meaningfully, estimated near 2% below potential GDP for the full forecast horizon (until year-end 2020), from around -1% previously. In our view, this is one of the most significant dovish developments in recent communications.

Banxico’s Forecasts
Current Report (2Q19)

	2019	2020
GDP (%)	0.2 – 0.7	1.5 – 2.5
Employment (thousands)	450 – 550	590 – 690
Trade Balance (bn)	-7.8 (0.6% of GDP)	-12.1 (0.9% of GDP)
Current account (bn)	-15.2 (1.2% of GDP)	-22.0 (1.6% of GDP)

Source: Banxico

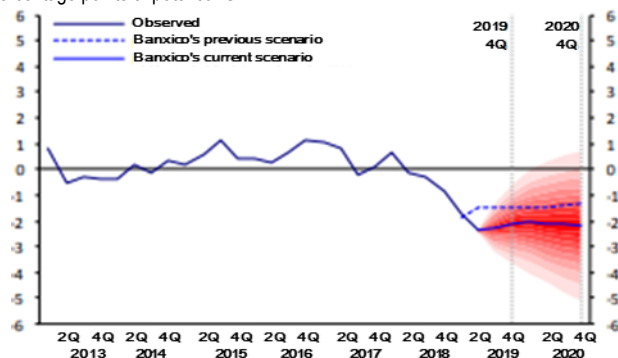
Banxico’s Forecasts
Previous Quarterly Report (1Q19)

	2019	2020
GDP (%)	0.8 – 1.8	1.7 – 2.7
Employment (thousands)	530 – 630	650 – 750
Trade Balance (bn)	-13.5 (1.0% of GDP)	-13.7 (1.0% of GDP)
Current account (bn)	-24.3 (1.9% of GDP)	-25.6 (2.0% of GDP)

Source: Banxico

Output gap

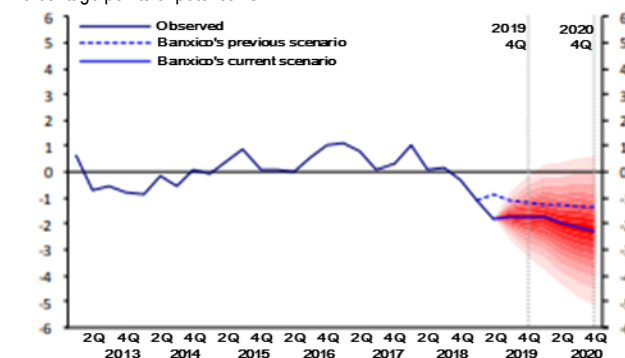
Percentage points of potential GDP



Source: Banco de Mexico; 2Q19 QR

Output gap ex oil production

Percentage points of potential GDP



Source: Banco de Mexico; 2Q19 QR

Lower inflation for the next four quarters, bringing forward the convergence to the target to 2Q20. In particular, average inflation for 3Q19 was lowered 70bps to 3.3% yoy, while the estimate for 4Q19 stood 50bps lower at 3.2%. However, core inflation estimates for these two periods edged-up by 10bps, to 3.7% and 3.5%, in the same order. We believe the latter adjustments reflects recent dynamics in which non-core inflation has decreased considerably, driven by lower agricultural and energy prices. These are also consistent with our latest revision for year-end inflation, which we now estimate at 3.3% (previous: 3.5%), below consensus at 3.6%. Equally important, the estimated timeframe for convergence to the 3% target was brought forward by one quarter, now expecting it at 2Q20 for both the headline and core components, in line with our expectations.

Risks for the inflation outlook were the same as those outlined in the last statement, in our view reflecting a more positive take and comfortable stance despite a context in which uncertainty remains elevated. Considering both the new estimates as well as these risks, we believe Banxico has more than enough room to start an easing cycle, despite the reluctance of Governor Díaz de León to provide additional guidance. Regarding this, he stated during the *Q&A* that the Board was very careful in this respect in the latest communiqué, finding useful to gauge new information as it comes along, to not anticipate future decisions, and the need to maintain a prudent balance going forward.

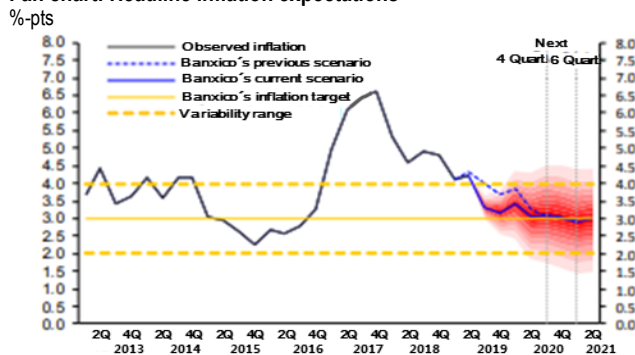
CPI forecasts

% yoy, quarterly average

	2019			2020				2021	
	II	III	IV	I	II	III	IV	I	II
CPI									
Current forecast	4.2*	3.3	3.2	3.4	3.1	3.1	3.0	2.9	3.0
Previous forecast	4.3	4.0	3.7	3.8	3.2	3.1	3.0	3.0	--
Core									
Current forecast	3.8*	3.7	3.5	3.4	3.1	3.0	2.9	2.9	3.0
Previous forecast	3.8	3.6	3.4	3.4	3.0	3.0	3.0	3.0	--

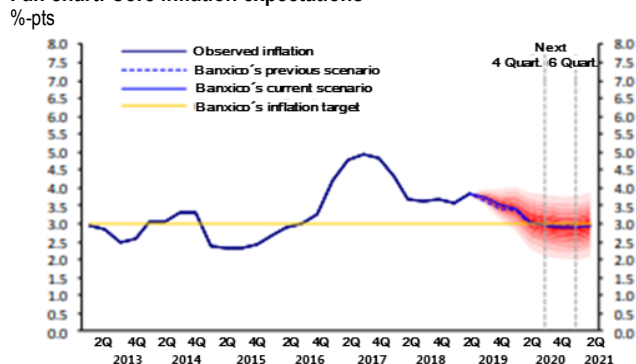
Source: Banco de México, 2Q19 QR; *Observed data

Fan chart: Headline inflation expectations



Source: Banco de Mexico; 2Q19 QR

Fan chart: Core inflation expectations



Source: Banco de Mexico; 2Q19 QR

Several important topics under review in the ‘grey boxes’. In our view, one of the most relevant issues was Pemex’s new business plan. Although Banxico refrained any judgment, we believe it is a concise and useful summary of both the plan and the company’s financial position, especially in the eyes of the rating agencies. In particular, they said some concerns remain among the three main agencies since the plan was presented, although they have not taken any additional action on the outlook or rating.

We think the emphasis on this subject is linked to the predominant role that the company plays in the country’s public finances, along the impact that a rating downgrade could have in the country’s financial conditions and stability. In this respect, the central bank stressed that further fiscal support for the company will entail equivalent adjustments in public finances for 2020 and 2021 to maintain a solid macroeconomic framework. This is also relevant considering that, in the latest communique, they added that “...It is also very important that the Economic Package for 2020 generates confidence...”, which in hindsight is likely related to this financial support along the high likelihood that tax revenues could be below budget because of lower economic growth.

Another important section was the updated estimate of the level of the long-term neutral real interest rate, or as it is known, r^* . The investigation expanded on the work presented in the *3Q16 Quarterly Report*, in which the findings pointed to a neutral value of 2.5% in real terms (range: 1.7-3.2%) and 5.5% in nominal terms (range: 4.7-6.2%). Based on most recent data and using new models, the new estimates stand at 2.6% (range: 1.8-3.4%) and 5.6% (range: 4.8- 6.4%), respectively. In addition, the central bank stated that 87% of the previous range is contained within the new one. As a result, it is our take that the new estimates have relatively marginal implications for the monetary policy framework, which in our view is very relevant considering the most recent changes in terms of overall public policies. We also recognize this as a positive effort of the central bank, providing additional transparency and enhancing communications of its decision-making process.

We maintain our expectation that Banxico will cut the reference rate to 7.50% by year-end. In terms of the tone, we did not see significant changes relative to the dovish bias that we had already perceived in the latest policy statement. Nevertheless, downward revisions in growth and inflation forecasts provide additional support to our view that Banxico will cut the reference rate by 25bps in September 26th, followed by a reduction of the same magnitude in December 19th. As a result, the reference rate would end this year at 7.50%. For 2020, we expect additional cuts between 50 and 75bps, within an easing cycle that we have previously argued could total between 125-200bps. Moreover, the main risk to our call is that the central bank cuts only by an additional 25bps this year, which in our view could materialize if financial stability risks, both external and domestic, increase significantly. Among them, we highlight: (1) Global trade tensions inducing still higher market volatility, impacting capital flows and the exchange rate; (2) additional credit rating downgrades for Pemex and/or the sovereign, remembering that *Moody's* and *S&P Global Ratings* currently assign a negative outlook to both; and (3) risks to the achievement of fiscal goals on the possibility of a deterioration in public finances, although our base-case is that the Federal Government will remain committed to sound fiscal accounts, with adjustments along the way in terms of spending in case of lower tax collection.

From our fixed income and FX strategy team

Banxico's bias arguing in favor of long positions in long-term Mbonos. Global markets have experienced a risk-off mode in August derived from, among other geopolitical factors, an evident deterioration in the trade relation between the U.S. and China which has ended in high tariffs for both countries. This situation has joined heightened fears of a more severe global deceleration. As a consequence, Mexican securities have been impacted in a number of sessions, particularly visible in the case of the Mexican peso. In parallel, local fixed-income performance has been supported by dovish central bank maneuvers in a comprehensive group of peers including the Federal Reserve, the expectation and delivery of a rate cut from Banxico on August 15th, and more favorable local inflation dynamics. In this sense, last Thursday's inflation report depicted an annual headline reading going from 3.72% to 3.29%, closer to Banxico's 3% target, and the lowest since December 2016. It is worth taking into account that, back in April and May, annual inflation was hovering around 4.44%. In this context, and despite some sessions affected by the global backdrop previously described, the Mbonos curve holds a positive balance during the month, averaging a 34bps rally as of yesterday's close. Meanwhile, the local risk premium proxied by the 10-year spread between 10-year Mexican and UST bonds holds contained when compared to more stressed phases during the year, printing 557bps, a level that matches the 12-month mean.

In this context, Banxico's QR preserved a tone that validates the expectation of additional rate cuts. It highlighted a relevant downward revision in its growth and inflation forecasts, now setting its estimate for CPI to convergence to the target in 2Q20. As a result, the Mbonos curve experienced a positive reaction averaging a 4bps rally. The market is currently incorporating a more dovish stance from the central bank for the following months, pricing in -53bps of implied rate cuts for the remainder of the year and -167bps for 2020 close. In this sense we call for two 25bps rate cuts this year, one in September and the other one in December, whereas rate cuts in 2020 could range from 50bps to 75bps. Additionally, market inflation expectations have adjusted towards more comfortable levels for the central bank, hovering around 3.3% in shorter tenors and 3.8% in long-term *breakevens*, nearly 40bps lower from a month ago. This situation suggests a valuation that has improved for real-rate securities; however, we see nominal-rate positioning as more attractive. Hence, we hold our trade recommendation of long positions in Mbonos of larger duration, opened on August 16th 2019, with a more attractive relative valuation in the Nov'38 and Nov'42 tenors.

Regarding the foreign exchange, the low-rate environment worldwide allows Banxico to normalize monetary conditions without affecting, for now, the relative carry gains of the MXN vs. other currencies. This situation joins recent comments from Governor Díaz de León signaling that an orderly adjustment in the real exchange rate would not be a concern for the central bank. As previously discussed, we see the recent peso's performance capturing the complex foreign backdrop which has affected a wide spectrum of currencies, pushing the pair to break the 20.00 psychological level, reaching up to USD/MXN 20.13 on an intraday basis on Monday's session, currently trading at 20.08 (-0.5%), slightly weaker in the aftermath of Banxico's Quarterly Report. The MXN technical structure suggests a floor formation within higher ranges, and we expect the peso to remain in the short-term between 19.60 and 20.15, acknowledging a relevant resistance at 19.80, with its price action conditioned to the global risk appetite. Should the cross extend the current sell-off, the 20.30 handle will work as next support. We hold a negative bias for the currency, reaffirming our year-end forecast at USD/MXN 20.30, which is higher than current consensus at 19.69 in the last survey from Banco de México.

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.

Analyst Certification

We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldivar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Luis Leopoldo López Salinas, Jorge Antonio Izquierdo Lobato and Leslie Thalía Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

Relevant statements.

In accordance with current laws and internal procedures manuals, analysts are allowed to hold long or short positions in shares or securities issued by companies that are listed on the Mexican Stock Exchange and may be the subject of this report; nonetheless, equity analysts have to adhere to certain rules that regulate their participation in the market in order to prevent, among other things, the use of private information for their benefit and to avoid conflicts of interest. Analysts shall refrain from investing and holding transactions with securities or derivative instruments directly or through an intermediary person, with Securities subject to research reports, from 30 calendar days prior to the issuance date of the report in question, and up to 10 calendar days after its distribution date.

Compensation of Analysts.

Analysts' compensation is based on activities and services that are aimed at benefiting the investment clients of Casa de Bolsa Banorte and its subsidiaries. Such compensation is determined based on the general profitability of the Brokerage House and the Financial Group and on the individual performance of each analyst. However, investors should note that analysts do not receive direct payment or compensation for any specific transaction in investment banking or in other business areas.

Last-twelve-month activities of the business areas.

Grupo Financiero Banorte S.A.B. de C.V., through its business areas, provides services that include, among others, those corresponding to investment banking and corporate banking, to a large number of companies in Mexico and abroad. It may have provided, is providing or, in the future, will provide a service such as those mentioned to the companies or firms that are the subject of this report. Casa de Bolsa Banorte or its affiliates receive compensation from such corporations in consideration of the aforementioned services.

Over the course of the last twelve months, Grupo Financiero Banorte S.A.B. C.V., has not obtained compensation for services rendered by the investment bank or by any of its other business areas of the following companies or their subsidiaries, some of which could be analyzed within this report.

Activities of the business areas during the next three months.

Casa de Bolsa Banorte, Grupo Financiero Banorte or its subsidiaries expect to receive or intend to obtain revenue from the services provided by investment banking or any other of its business areas, by issuers or their subsidiaries, some of which could be analyzed in this report.

Securities holdings and other disclosures.

As of the end of last quarter, Grupo Financiero Banorte S.A.B. of C.V. has not held investments, directly or indirectly, in securities or derivative financial instruments, whose underlying securities are the subject of recommendations, representing 1% or more of its investment portfolio of outstanding securities or 1 % of the issuance or underlying of the securities issued.

None of the members of the Board of Grupo Financiero Banorte and Casa de Bolsa Banorte, along general managers and executives of an immediately below level, have any charges in the issuers that may be analyzed in this document.

The Analysts of Grupo Financiero Banorte S.A.B. of C.V. do not maintain direct investments or through an intermediary person, in the securities or derivative instruments object of this analysis report.

Guide for investment recommendations.

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

Even though this document offers a general criterion of investment, we urge readers to seek advice from their own Consultants or Financial Advisors, in order to consider whether any of the values mentioned in this report are in line with their investment goals, risk and financial position.

Determination of Target Prices

For the calculation of estimated target prices for securities, analysts use a combination of methodologies generally accepted among financial analysts, including, but not limited to, multiples analysis, discounted cash flows, sum-of-the-parts or any other method that could be applicable in each specific case according to the current regulation. No guarantee can be given that the target prices calculated for the securities will be achieved by the analysts of Grupo Financiero Banorte S.A.B. C.V, since this depends on a large number of various endogenous and exogenous factors that affect the performance of the issuing company, the environment in which it performs, along with the influence of trends of the stock market, in which it is listed. Moreover, the investor must consider that the price of the securities or instruments can fluctuate against their interest and cause the partial and even total loss of the invested capital.

The information contained hereby has been obtained from sources that we consider to be reliable, but we make no representation as to its accuracy or completeness. The information, estimations and recommendations included in this document are valid as of the issue date, but are subject to modifications and changes without prior notice; Grupo Financiero Banorte S.A.B. of C.V. does not commit to communicate the changes and also to keep the content of this document updated. Grupo Financiero Banorte S.A.B. of C.V. takes no responsibility for any loss arising from the use of this report or its content. This document may not be photocopied, quoted, disclosed, used, or reproduced in whole or in part without prior written authorization from Grupo Financiero Banorte S.A.B. of C.V.

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
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Juan Carlos Alderete Macal, CFA	Senior Economist, Mexico	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Miguel Alejandro Calvo Domínguez	Economist, Regional	miguel.calvo@banorte.com	(55) 1670 - 2220
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Luis Leopoldo López Salinas	Analyst, Global Economist	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
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
Santiago Leal Singer	FX Senior Strategist	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Fixed Income and FX Strategist	leslie.orozco.velez@banorte.com	(55) 5268 - 1698

Equity Strategy

Manuel Jiménez Zaldivar	Director Equity Research – Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Technical Analysis	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Equity Research – Conglomerates / Financials / Mining / Petrochemicals	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research – Airlines / Airports / Cement / Infrastructure / REITs	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research – Auto Parts / Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251

Corporate Debt

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Manager, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248

Wholesale Banking

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.cebillos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Victor Antonio Roldan Ferrer	Head of Commercial Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454