



Banxico's monetary policy decision

On hold but a hike still looms for 2018

October 4, 2018

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

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

Leslie Orozco

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

- Banxico's board announced today its decision to hold the reference rate at 7.75%
- It is worth noting that there was one dissenter, who voted for a 25bps hike
- In our opinion, the statement signals that the monetary authority will likely hike the reference rate by 25bps to 8.00% before year-end
- Our view is based on the expectation that inflation will continue to overshoot the central bank's forecasts, ending the year at 4.8%, while the FX will remain highly volatile amid a highly uncertain backdrop
- The linguistic analysis of the statement shows the improvement in the scenario for growth, reducing the relative weight of the word "risks" and "uncertainty" vs. the previous statement, while the words "Canada" and "agreement" appear as a reference to the end of the NAFTA renegotiation. Nevertheless, the relative weight of "inflation" also increased in the overall word count
- Negative market reaction to Banxico's hawkish hold, with conditions in favor of our trade ideas of long positions in the CPI-linked Udibono Jun'22 and buying USD in dips

October 2, 2018 Statement Word Cloud



Source Banorte

August 2, 2018 Statement Word Cloud



Source Banorte



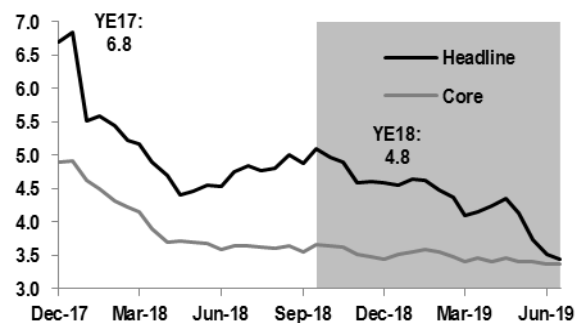
As expected, Banxico remained on hold, but with a split decision. The central bank just announced its decision to maintain the reference rate at 7.75%, in line with both our expectations and the market. As already mentioned throughout our publications, we considered this decision was a tough one for the central bank, which is reflected by the fact that one member voted in favor of a rate hike. Moreover, we now believe that Banxico is ready to hike again before year-end, leaving the rate at 8%, to then remain on hold in 1H19.

A more hawkish tone on inflation and a highly uncertain external backdrop. We perceived a hawkish tone in the communiqué as the monetary authority is worried about a highly uncertain global outlook, with a negative balance of risks for inflation despite the fact that the NAFTA (now USMCA) negotiation ended, thus reducing uncertainty on FX and growth prospects. Banxico considers that the balance of risks for inflation maintains an upward bias on the back of “...additional upward pressures on energy prices, as indicated by the futures prices of some of these products; escalating protectionist measures worldwide that could affect inflation negatively; and, greater-than-anticipated levels of public expenditure...”. Moreover, it mentions the risk that wage negotiations could impact inflation if not consistent with productivity gains, while concerned about potential pass-through to other prices in the economy from the so considered “temporal” pressures on energy prices.

Our inflation view argues in favor of a rate hike before year-end. We recently revised up our YE18 estimate from 4.3% to 4.8%, above the consensus of 4.5% according to this week’s central bank survey. This was driven by an upward revision of our expectations for energy prices, while our FX forecasts include the possibility of short-term pressures that could eventually delay the convergence of inflation towards the target. In this respect, we would expect a rate hike of 25bps, taking the rate to 8.00% before year-end, bearing in mind that our forecasts overshoot those of the central bank, as presented in its latest *Quarterly Report*, as shown in the table below.

Inflation trajectory

% yoy, biweekly frequency



Source INEGI, Banorte

Quarterly inflation forecasts

% yoy, quarterly average

	2018		2019	
	III	IV	I	II
Headline				
Banxico	4.8	4.2	3.8	3.6
Banorte	4.9	4.7	4.4	3.9
Core				
Banxico	3.6	3.5	3.3	3.2
Banorte	3.6	3.5	3.5	3.4

Source Banorte, Banxico

Banxico did not decouple from the US Fed. In fact, in the communiqué they talk about the possibility of inflation pressures in the U.S. stemming from reduced slack, in line with our view that the Fed will hike 25bps for the fourth time this year in December, to then continue hiking in 2019. It is worth noting that this is the first time that the Mexican monetary authority did not respond to a Fed hike since the normalization process started at the end of 2015. Nevertheless, it maintained the relative monetary stance as the second most important factor to consider when making decisions. In our view, Banxico cannot fully decouple from the Fed in the midst of a highly uncertain and volatile scenario for emerging markets. In this context, the rout in *Treasuries* over the last couple of days induced pressures in the Mexican peso and other EM currencies, with the former adjusting from around USD/MXN18.80 to 19.12, while the 10y Mbono rate was pushed higher by 9bps.



On the other hand, growth seems to be rebounding. In their last meeting, the Board seemed more worried about activity levels after the slight contraction in GDP in 2Q18. In our view, they now seem a bit more upbeat about growth, considering that the end of NAFTA negotiations will substantially reduce uncertainty. Moreover, recent reports have provided tentative signs of an improvement. In particular, the monthly GDP proxy (IGAE) for July posted a 3.3% yoy increase from +1.2% in the previous month. This improved outlook is backed up by stronger performance in construction and retail sales, among others. In addition, trade balance figures for August seem to validate this trend, given a better performance of manufacturing exports and stronger consumption-goods imports. In addition, the recovery in IMEF's PMIs, particularly in the new orders and employment components, round-up our view of a stronger activity in 3Q18. However, we expect growth in 2019 to be impacted by a slowdown in government spending, both due to a base-effect, as well as bureaucratic bottlenecks commonly experienced during the first year of a new administration. In this sense, we expect a 1.8% yoy growth in 2019, vs. 2.1% for 2018.

All in all, a more hawkish communiqué suggests the monetary authority is not done hiking rates yet. The scenario going forward is still highly uncertain, more so on the external front where upcoming mid-term elections in the U.S. could have an unknown impact on financial markets. Moreover, trade tensions (particularly between the US and China) could extend further, while the Fed is determined to continue with its normalization process. On the domestic front, the new administration is due to present its budget plans for 2019, which we expect to prove their commitment to fiscal responsibility. Nevertheless, we expect pressures on energy prices to keep building in the short term, likely pushing inflation to our year-end forecast of 4.8%. In this complicated context, and assuming the exchange rate stays volatile, we expect Banxico to hike the reference rate 25bps to 8.00% before the end of 2018, to then remain on hold during the first half of 2019 in an uncertain environment with lower growth.

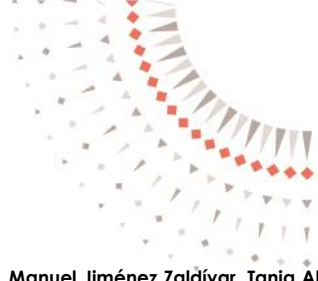
From our fixed-income and FX strategy team

Negative market reaction to Banxico's hawkish hold, with conditions in favor of our trade ideas of long positions in the CPI-linked Udibono Jun'22 and buying USD in dips

In line with our most recent call, Banxico decided to stay put today, leaving its reference rate unchanged at 7.75%, with a split decision (4-1) and a balance of risks for the economy and inflation that the market has interpreted, among other things, as a more hawkish tilt from the central authority. Board members held their strong concerns about inflation dynamics, a complex external backdrop (especially for EM) and a more restrictive language from the Federal Reserve, which has increased market's implied probability of a rate hike in the last quarter of this year from 32% to 56%. In the aftermath of today's policy decision the Mexican yield curve registered a 9bps sell-off, while the peso continue trading with a negative performance in tandem with the rest of EM. In terms of strategy, we hold our trade idea of long positions in the CPI-linked Udibono Jun'22 and continue recommending buying USD in dips. More details in our "Fixed-Income and FX Weekly" <[pdf](#)>, published on October 1st, 2018.

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 Zaldívar, 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, Francisco Duarte Alcocer 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 Ixe 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.

Research and Strategy

Gabriel Casillas Olvera	Chief Economist and Head of	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
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) 1670 - 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
Francisco Duarte Alcocer	Analyst	francisco.duarte.alcocer@banorte.com	(55) 1670 - 2707
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	Analyst, 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.cebaldos@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 Asset Management	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Corporate Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454