

## Banxico's QIR – A momentary lapse of inflation

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www.banorte.com  
www.ixc.com.mx  
@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

### Alejandro Cervantes

Senior Economist, Mexico  
alejandro.cervantes@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

### Juan Carlos Alderete, CFA

FX Strategist  
juan.alderete.magal@banorte.com

### Santiago Leal

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

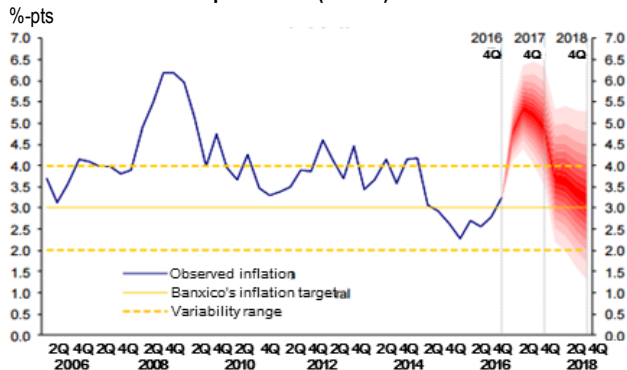
- Banxico published today its *Quarterly Inflation Report (QIR)* for 4Q16
- We highlight the following issues:
  - (1) Inflation in 2017 will hover around 5% target throughout the year, although it will converge to Banxico's 3% target in 2018;
  - (2) The economic outlook for Mexico has become more complex, as a result of the uncertainty around the trade relationship with the US;
  - (3) As a result, the balance of risks for the Mexican economy has deteriorated, which prompted a downward revision to Banxico's 2017 growth forecast range, which now stands between 1.3% and 2.3% (previous range: 1.5%-2.5%); and
  - (4) The output gap will remain in negative territory until 2018;
- In the traditional "grey boxes" Banxico's researchers tackle the following topics:
  - (1) The effects of increases in energy prices on price formation have not occurred in a disorderly manner and have behaved as anticipated;
  - (2) The importance of the global value chains for the Mexican and the US economy; and
  - (3) The slack in the Mexican labor market
- We maintain our view that Banxico will increase the reference rate by an additional 100bps throughout the year

**Higher inflation ahead but lower growth.** The monetary authority released its *Quarterly Inflation Report (QIR)* for 4Q16. The release was accompanied by a press conference led by Governor Carstens. We highlight the following issues discussed in the document: (1) Inflation in 2017 will hover around 5% target throughout the year, although it will converge to Banxico's 3% target in 2018; (2) the economic outlook for Mexico has become more complex, as a result of the uncertainty around the trade relationship with the US; (3) as a result, the balance of risks for the Mexican economy has deteriorated, which prompted a downward revision to Banxico's 2017 growth forecast range, which now stands between 1.3% and 2.3% (previous range: 1.5%-2.5%); and (4) the output gap will remain in negative territory until 2018.

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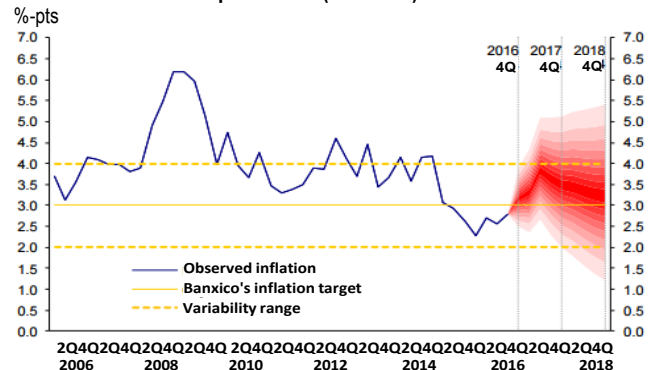
**Inflation temporarily around 5% in 2017.** The monetary authority stated that the balance of risks of inflation has deteriorated and that the recent upward trajectory of inflation has been explained by: (1) Changes in relative prices derived from the depreciation of the real exchange rate; and (2) the transitory impact of the liberalization of gasoline prices. Analyzing the fan charts, the central bank expects inflation to be above 5% during the year, but will converge to its goal by year-end 2018. Among the upside risks, the central bank highlighted as the main ones being that the frequency of the above-mentioned shocks increases the probability of second-round effect on inflation, and an additional deterioration in inflation expectations stemming from future depreciations of the Mexican currency as a result of the uncertainty regarding the external environment.

**Fan chart: Inflation expectations (Actual)**



Source: Banco de México, 3Q16 QIR

**Fan chart: Inflation expectations (Previous)**



Source: Banco de México, 2Q16 QIR

**Lower economic projections.** The report highlights the lower growth of the Mexican economy during the fourth quarter of 2016, as a result of the deceleration of investment flows, despite the upward trend in private consumption and the recovery of external demand. The central bank also mentioned that: *“...although uncertainty still prevails around the concrete measures that the actual US administration will undertake, the latest comments made already point to a deterioration in the trade relationship between the two countries.”* As a result, the central bank revised down its estimated growth range for this year between 1.3% and 2.3% (previous: 1.5% and 2.5%). Moreover, the central bank also revised its growth estimates for 2018, which now stand between 1.7% and 2.7% (previous: 2.2% and 3.2%; refer to the table on the next page). In addition, Banxico’s output gap also stands at negative territory throughout the year.

**Banxico's Forecast**  
Recent

	2017	2018
<b>GDP (%)</b>	1.3 – 2.3	1.7 – 2.7
<b>Employment (thousands)</b>	580 – 680	620 – 720
<b>Trade Balance (bn)</b>	-10.1 (1% of GDP)	-9.0 (0.9% of GDO)
<b>Current account (bn)</b>	-26.5 (2.7% del GDP)	-27.8 (2.7% of GDP)
<b>Inflation</b>		
<b>Headline</b>	Above the upper bound of the inflation target	Close to 3%
<b>Core</b>	Above the permanent inflation target	Close to 3%

Source: Banxico

**Banxico's Forecast**  
Previous Quarterly Report

	2017	2018
<b>GDP (%)</b>	1.5 – 2.5	2.2 – 3.2
<b>Employment (thousands)</b>	600 – 700	650 – 750
<b>Trade Balance (bn)</b>	-12.6 (1.2% of GDP)	-12.3 (1.1% of GDP)
<b>Current account (bn)</b>	-30.9 (3.0% of GDP)	-33.9 (3.0% of GDP)
<b>Inflation</b>		
<b>Headline</b>	Above the permanent inflation target	Close to 3%
<b>Core</b>	Above the permanent inflation target	Close to 3%

Source: Banxico

**The increase in energy prices has not caused serious distortions in the price formation process.** The “*grey box*” analyzes the impact of the increase in gasoline and LP gas prices on the economy. The result of the research shows that the adjustment in prices has so far been in an orderly fashion, since the observed indirect effects have not had a greater-than-expected effect on the prices of goods and services that use this commodities as inputs, thus signaling that second-round effects have not been involved in the price formation process.

**The importance of the global value chains for the Mexican and the US economy.** In the second “*grey box*”, the central bank conducted an analysis of the importance of global value chains between Mexico and the United States. The research note concludes that a country's restrictions on international trade affect both the country of origin of the goods and the recipient country, given that it loses competitiveness resulting from a higher cost of its productive inputs. On the other hand, this also has a negative impact on the production process, while distorting consumption and trade patterns.

**The Mexican labor market, considering the informal conditions it presents, is close to the unemployment rate consistent with a stable inflation environment.** The last “*grey box*” analyzes the NAIRU (Non-accelerating rate of inflation) in the Mexican labor market and its level of slack. The result of the research suggests that incorporating the particular conditions of the Mexican labor market, in which informal employment act as a buffer against aggregate shocks, the unemployment rate is at its long-term level, so it is not expected to generate inflationary pressures stemming from the demand side.

**We expect a 100bps hike in the reference throughout the year.** Looking ahead, we consider that the central bank will increase the reference rate by another 100bps in 2017. Given the FEC's announcement, the central bank now has more room to execute monetary policy due to fewer inflationary pressures derived from the reduced volatility of the exchange rate coupled with lower energy prices. In addition, the implementation of the exchange rate hedge program is also likely to lead to lower short-term inflation expectations. As a result, we now believe that Banxico has larger margin not to hike by 50bps as a response to a 25bps Fed hike.

*From our fixed income and FX strategy team*

***We maintain our rates and FX recommendations after the central bank confirms the possibility of a difficult outlook ahead.*** Local rates are paring losses and even rallying in the long-end of the curve after rumors that Banxico has leeway to implement additional mechanisms to tackle adverse conditions for local markets going forward (e.g. a swap line with the Fed and/or TIE-IRS as reported by *Bloomberg*). Nevertheless, we highlight that Governor Carstens said the central bank is not currently in the process of seeking any credit lines with the Fed, inducing some reversal of the reaction due to the press report.

Shorter-term rates are still performing on the negative spectrum today, as the *Quarterly Inflation Report* (QIR) confirmed the central bank's concerns about a complex situation for inflation in coming months, and a stronger likelihood of additional rate hikes in 2017, in spite of the downward revision in economic growth forecasts for this year and 2018. The yield curve is pricing-in +76bps in rate hikes (Banorte-Ixe +100bps) for the rest of the year. Inflation-adjusted bonds (Udibonos) are already discounting this scenario, even trading with an excessive inflation premia for longer tenors, as short-term breakevens are currently standing at 4.07% and long-term securities at 3.93%. All in all, we hold our trade idea opened on February 15<sup>th</sup>, 2017 of a 5y10y steepener in TIE-IRS (long/receive 5y TIE-IRS (65x1) and short/pay 10y TIE-IRS (130x1)) with an entry level of 28bps, target of 43bps, stop-loss of 18bps, currently trading at 29bps. More details in our research note "*Trade Idea: 5y10y TIE-IRS steepener*" <[pdf](#)>.

In FX, the Mexican peso is gaining 1.3% at 19.85 per dollar, the best in EM today. Similar to rates, the strongest move was before the QIR, albeit going from 19.73 to 19.90 following Carstens's comments on the swap with the Fed. We continue favoring peso longs for trading purposes, without discarding a move towards the 19.50-19.55 zone which we see as adequate to take profits. On the other hand, we would suggest cutting exposure on a move to 20.10, although worth mentioning that we have had this trading bias a little more than two weeks ago, when the cross was trading around 20.35 per dollar.

#### **Disclaimer**

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**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
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Juan Carlos García Viejo	Economist, International	juan.garcia.viejo@banorte.com	(55) 1670 - 2252
Rey Saúl Torres Olivares	Analyst	saul.torres@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
Juan Carlos Alderete Macal, CFA	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

**Equity Strategy**

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry	marissa.garza@banorte.com	(55) 1670 - 1719
Marisol Huerta Mondragón	Equity Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 1670 - 1746
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research Analyst – Auto parts	valentin.mendoza@banorte.com	(55) 1670 - 2250

**Corporate Debt**

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@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 Asset Management	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 Corporate Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454