

Banxico's QIR – Inflation will converge towards the target in late 2018

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- Banxico published today its *Quarterly Report (QIR)* for 3Q17
- We highlight the following issues:
 - (1) The central bank made a marginal upward revision to its inflation forecasts for 2017;
 - (2) However, in their traditional fan charts, the monetary authority is expecting inflation to converge to its 3% target by YE18;
 - (3) The economic outlook for this year for Mexico became slightly more negative due to a larger than expected deceleration in 3Q17 on the back of the impact of the recent earthquakes, prompting Banxico to revise down its GDP growth forecast to a range of 1.8%-2.3% (previous range: 2%- 2.5%); and
 - (4) Considering the change in the base year for GDP, the output gap turned slightly positive in the period from 2015 to the first half of 2017, however it returned to negative territory during the last quarter
- In the traditional “grey boxes”, Banxico’s researchers tackle the following topics:
 - (1) The manufacturing trade balance with the US in terms of value added;
 - (2) The impact of uncertainty related to trade policy on foreign investment; and
 - (3) The effect of monetary policy decisions on inflation since 2015
- We believe Banxico will remain on hold at least until the second half of 2018, when they could start an easing cycle
- Banxico maintains a prudent stance, providing a favorable scenario for relative value strategies in the TIEE-IRS curve

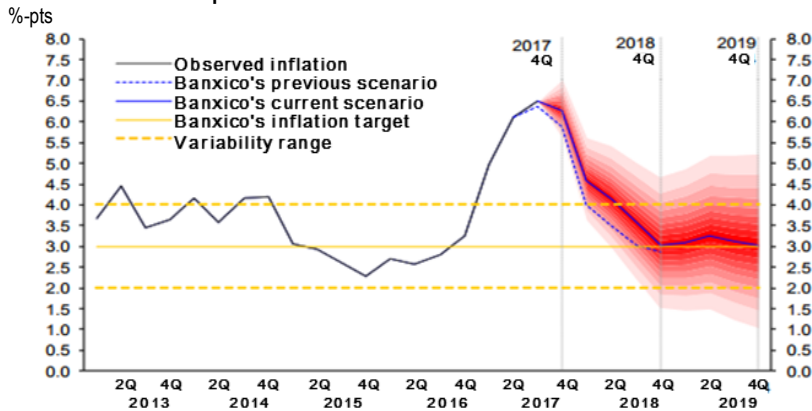
Lower inflation and growth. The monetary authority released its *Quarterly Inflation Report (QIR)* for 3Q17. The release was accompanied by the last press conference led by Governor Carstens as head of the institution. We highlight the following issues discussed in the document: (1) The central bank made a marginal upward revision to its inflation forecasts for 2017; (2) however, in their traditional fan charts, the monetary authority is expecting inflation in line with its 3% target by YE18; (3) the economic outlook for Mexico became slightly more negative due to a larger than expected deceleration in 3Q17 on the back of the impact of recent earthquakes, prompting Banxico to revise down its GDP growth forecast to a 1.8%-2.3% range (previous: 2%- 2.5%); and (4) considering the change in the base year for GDP, the output gap turned slightly positive in the period from 2015 to the first half of 2017, however it returned to negative territory during the last quarter. Additionally, the central bank acknowledged again the positive effect of structural reforms. However, it also warned about the need for solid fundamentals in an environment of insecurity and lack of full force of the rule of law.

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Inflation around 6.3% in 2017, but around 3% in 2018. The monetary authority argued that the balance of risks for inflation has deteriorated, mainly due to shocks in agricultural and energy prices. In this context, the forecast for YE17 inflation was revised marginally from around 6% to approximately 6.3% (refer to the following graph). The recent increase in the minimum wage is expected to have a marginal impact on 2017 inflation without affecting the convergence to the target range next year which, according to the fan chart presented in the document, will materialize as soon as 2Q18.

Among the upside risks for inflation, the central bank highlighted: (1) An additional depreciation of the Mexican peso; (2) an increase in agricultural prices, although this would be transitory; (3) upward pressures on energy prices; and (4) inflationary pressures stemming from the upward trend in unit labor costs.

Fan chart: Inflation expectations



Source: Banco de Mexico; 3Q17 QIR

Lower economic growth forecast for 2017, but unchanged for 2018. The report highlighted that the growth outlook has deteriorated as a result of a larger than expected slowdown during the third quarter of 2017. While stressing that the fall was due to September's earthquakes as well as the decrease in oil production, the consequences of natural disasters are not expected to have a substantial impact on growth going forward. Considering this, the forecast for 2017 was revised down to a range between 1.8% and 2.3% (previous: 2% to 2.5%, Banorte: 2.1%), while the estimate for 2018 remained unchanged between 2% and 3% (refer to the tables on the next page). Additionally, the estimated range for 2019 was included, which stands between 2.2% and 3.2%.

Regarding the output gap, and considering *INEGI's* change in the base year of the GDP series, it was in positive territory practically from 2015 until the first half of 2017. However, it became negative after the economic slowdown in 3Q17. Additionally, although 2018 estimates remained unchanged, the gap would stay in negative territory during 2018 and 2019, as shown on the graph below.

Banxico's Forecast
Recent

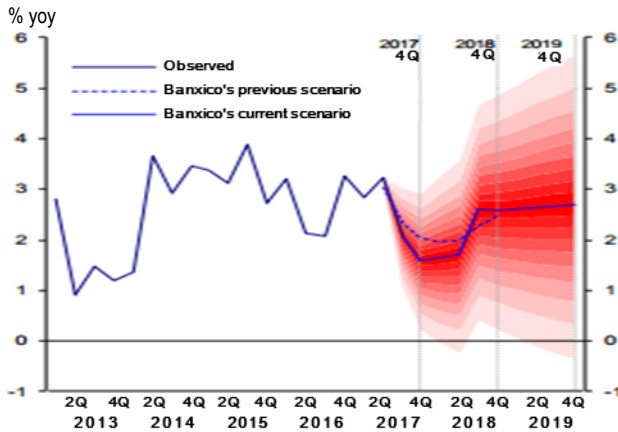
	2017	2018	2019
GDP (%)	1.8 – 2.3	2.0 – 3.0	2.2 – 3.2
Employment (thousands)	720 – 790	680 – 780	690 - 790
Trade Balance (bn)	-11.0 (0.9% of GDP)	-13.1 (1% of GDP)	-14.5 (1.1% of GDP)
Current account (bn)	-19.4 (1.7% of GDP)	-25.9 (2.1% of GDP)	-30.6 (2.3% of GDP)
Inflation			
Headline	Continues with a downward trend	Convergence to the 3% target	Around 3%
Core	Above 4% but below headline	Moderately above 3%	Around 3%

Source: Banxico

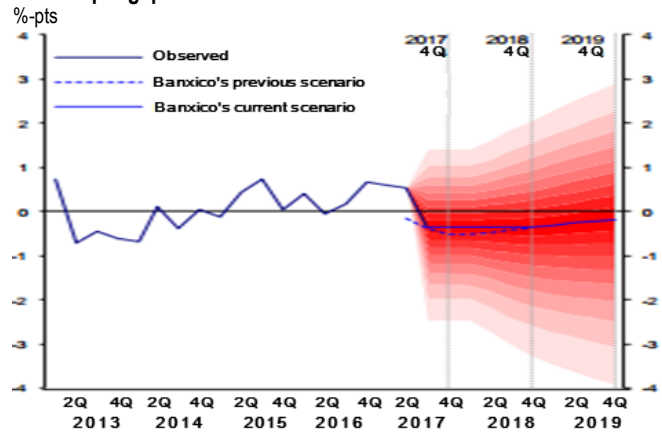
Banxico's Forecast
Previous Quarterly Report

	2017	2018
GDP (%)	2.0 – 2.5	2.0 – 3.0
Employment (thousands)	660 – 760	670 – 770
Trade Balance (bn)	-13.2 (1.2% of GDP)	-12.5 (1% of GDP)
Current account (bn)	-25.0 (2.2% of GDP)	-27.1 (2.2% of GDP)
Inflation		
Headline	Will start a downward trend	Convergence to the 3% target
Core	Above 4%, but below headline inflation	Close to 3%

Source: Banxico

GDP forecast


Source: Banco de Mexico; 3Q17 QIR

GDP output gap


Source: Banco de Mexico; 3Q17 QIR

The added value analysis regarding trade with the United States is positive.

In the first *grey box*, an analysis is presented on the value chains in the trade relationship between Mexico and the US, which seeks to study the balance between the two countries in terms of added value instead of only looking at the deficit. The results of the study show that in 2014, despite the fact that the US had a gross trade deficit with Mexico, in terms of added-value it obtained a surplus. This occurred since US exports to Mexico have a greater American added-value than what imports have. In this sense, the application of NAFTA results in gains for the United States despite of a gross trade deficit.

Uncertainty about future trade policy has had a negative impact on FDI.

The second research box shows the relationship between foreign direct investment (FDI) and the perception of trade policy uncertainty. The research was conducted using an index of uncertainty using the results of a search engine with words related to NAFTA. Such index shows a negative correlation between FDI and the degree of uncertainty. In this sense, although the levels of FDI in 1H17 have not been low compared to the previous year, they could have been higher in the absence of uncertainty.

Monetary policy adjustments have translated into lower inflation. The last *grey box* analyzes the impact of monetary restriction on the trajectory of inflation in the face of two shocks, one in the 2014-2016 period and another in 2016-2017. The results suggest that if the monetary restriction by Banxico had not been carried out, inflation would have reached a ceiling of 9.4% at the end of 2017.

Banxico published its calendar of monetary policy meetings for 2018. In our opinion, Banco de Mexico is still highly aware of the Fed's decision-making process given that all of its monetary policy meetings will be held days after the FOMC meetings (refer to the following table).

Monetary policy meetings: Banxico & Fed

Month	Banxico	Fed
January	--	31
February	8	--
March	--	21
April	12	--
May	17	2
June	21	13
July	--	--
August	2	1
September	--	26
October	4	--
November	15	8
December	20	19

Source: Banorte-ixe with data from the Federal Reserve and Banxico

On hold at least until 2H18. Although we recognize that the probability of a rate hike in December has increased, we believe that Banxico will maintain its monetary stance unchanged at least until the second half of 2018, when the monetary authority could cut interest rates by 50bps (two 25bps cuts), as we expect inflation to start converging to the 3% target.

From our fixed income and FX strategy team

Banxico maintains a prudent stance, providing a favorable scenario for relative value strategies in the TIEE-IRS curve. Banxico's QIR kept emphasizing the need of maintaining a prudent monetary stance in the face of a difficult backdrop for the Mexican economy that could result in additional bouts of volatility. In our view, this release does not exhibit significant changes when compared to the more hawkish bias seen in the latest monetary policy decision, held back on November 9th. In particular, we highlight the view that the balance of risks for inflation has deteriorated. Notwithstanding the latter, it is our take that the bias of the Board's majority is that the necessary adjustments have already been made for inflation to reach its target next year as well as leaving behind its inflection point. In this respect, we reiterate our expectation that Banxico will maintain its reference rate unchanged and could reduce it by 50bps in the second half of 2018.

The Mexican fixed-income market registered a moderate reaction, holding gains accumulated before the release and also watchful of the Fed's minutes, which supported an extension of today's rally. Particularly, the Mbonos curve consolidated a 1-4bps appreciation, with the 10-year benchmark Jun'27 at 7.18% (-4pb). TIEE-IRS upheld a positive performance, rallying 1-5bps mainly in the long-end, while real-rate Udibonos appreciated between 1-6bps. Broadly speaking, we hold a less-optimistic view in longer-term securities on the possibility of an additional upward adjustment in term and risk premiums due to a number of headwinds faced by the Mexican economy and local markets (*e.g.* NAFTA's negotiation process). We still recommend defensive, relative-value strategies with 2/5 and 2/10 steepeners in the TIEE-IRS curve. Likewise, the MXN was stable after the publication, although appreciating slightly following the Fed's minutes, closing 0.6% stronger on the day at 18.66 per dollar. In spite of the peso's rally in recent days and the break below the USD/MXN 19.00 psychological level, we believe the current level is attractive for dollar longs for short-term trading purposes. In our view, the room for strong currency gains from here is limited due to very relevant risks still lingering around, both in the local and external fronts.

Disclaimer

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