

2015 IMF/WB Annual meetings – What keeps markets awake at night?

October 12, 2015

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

Katia Goya

Senior Global Economist
katia.goya@banorte.com

Alejandro Padilla

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

- This weekend took place the Annual Meetings of the International Monetary Fund (IMF) and the World Bank (WB) in Lima, Peru
- Our main takeaways are:
 - (1) It is not clear whether the world is in a “secular stagnation” or “this time is different” mode;
 - (2) The majority believes –and we share this view-, that the Fed will hike rates in December, particularly because this is what several FOMC members have signaled;
 - (3) There is no doubt China is decelerating. The question is how successful it could be in its transit from an export and investment-driven economy to a country based on private consumption, and the potential policy mistakes that could occur;
 - (4) Concerns in the EM world have turn to corporate debt; and
 - (5) Mexico continues to be the best emerging economy due to its strong macro fundamentals, as well as the recently-approved structural reform agenda, which will also benefit from the continuous US rebound

Relevance of IMF/World Bank Annual Meetings. A delegation of Banorte-Ixe attended the Annual Meetings of the International Monetary Fund (IMF) and the World Bank (WB), which was held this weekend in Lima, Peru. Note that this is the first time in 48 years that the meeting takes place in a Latin American country. In our opinion, being present at these meetings allows us to be in touch with the most important issues being discussed globally.

We are currently experiencing one of the most important moments in modern history. Seven years have passed since the global financial crisis began and it is still not clear if the world is “out of the woods” or if the so-called “new normal” is just slower growth –needing lower interest rates for a long period of time-, or even worse, the world is about to begin another downturn. We are at a time in which several contrasting theories converge, but we do not really know which one is right, and which are the right policy prescriptions, which could lead to quite divergent outcomes. Are we in Rogoff and Reinhart’s “*This time is different*” world, in which it takes longer for an economy to get out of a crisis whenever economic and financial crises occur at the same time, as it happened back in 2008? or Are we in Summers and Gordon’s “*secular stagnation*” world in which the current demographic situation and the productivity framework will not allow developed economies to grow at the rates they used to observe in the past few years? or Are we in a combination of both and the world is entering into another slowdown, in which there is no much space for stimulus? This is the world in which we are living these days and why it is so important to attend these meetings and try to assess where we are, what we should do next, and what to expect.

Document for distribution among public

The two main issues in hand. After the more philosophical intro, we now turn to the two main issues in hand: (1) The potential beginning of the US Fed normalization process; and (2) China structural transition. As some of the speakers here set it up, the apparently upcoming US Fed rate hike is having an impact in the country's capital account, while the structural transition in China - which is already slowing its economy down-, is having an impact on the economies' current account. Both issues are having particular effects via three channels of transmission: (1) US dollar strength; (2) higher interest rates; and (3) lower commodity prices. While this seems to be a quite toxic combination of factors for EM's, fortunately, there is a generalized perception that sovereign debt in these markets are being able to face the aforementioned risks. This is mainly due to the modifications EM governments have undertaken since the several crises in the nineties. More flexible exchange rates, lower fiscal dominance, less external debt, and high level of foreign reserves have made a difference. However, the focus on the balance of risks has now tilted towards corporate debt, particularly from companies that do not obtain foreign currency flows from their core businesses, as well as the unhedged ones.

Main takeaways. All in all, our main conclusions are that: (1) It is not clear whether the world is in a "secular stagnation" or "this time is different" mode. However, given Mexico's experience with a twin crisis (economic and financial) back in 1994, we continue to believe that the economy in which the crisis began -the US-, is getting out of the crisis; (2) the majority believes that the US Fed should have already began its normalization process, and given what has happened, it seems that FOMC members will always be able to find a reason not to hike. However, the majority -and we share this view-, still believes that the Fed will hike rates in December, particularly because this is what several FOMC members have signaled; (3) there is no doubt China is decelerating. The questions are whether it could face a quicker and deeper deceleration, how successful it could be in its transit from an export and investment-driven economy to a country based on private consumption, and the potential policy mistakes that could occur; (4) concerns in the EM world have turn to corporate debt; and (5) Mexico continues to be the best emerging economy due to its strong macro fundamentals, as well as the recently-approved structural reform agenda, which will also benefit from the continuous US rebound.

The meetings in detail...

A slow but continued recovery of the global economy. Prior to the official meetings, the IMF published its *World Economic Outlook* (or WEO), in which it revised down its global growth forecasts both for 2015 (from 3.3% to 3.1%) and for next year (from 3.8% to 3.6%). According to the IMF, advanced economies will experience a slight recovery this year vs. 2014, due to a modest expansion in the Eurozone and in Japan, where growth has returned to positive territory, supported by the decline in oil prices, accommodative monetary policy and the improvement in financial conditions. Regarding emerging economies, the IMF emphasized the difference among countries, but explained that the prospects for this year are generally weak, with a slowdown rates of expansion of 4% vs. previous 4.6% in 2014. The factors behind the lower growth are: (1) Slower dynamics in oil and other commodity exporters; (2) the slowdown in China; (3) adjustments after investment and credit booms; and (4) geopolitical tensions. They explained that external conditions have become more difficult for emerging economies. Finally, the improvement expected for these economies in 2016 reflects not a widespread recovery, but a milder recession.

Relevant topics. In our opinion, the most important issues discussed during the meetings were threefold (1) Uncertainty about the structural change in China, affecting the growth outlook in other emerging economies; (2) US monetary policy normalization and its effect on the capital account of the rest of the world, particularly in emerging economies; and (3) the need of additional monetary stimulus by the ECB and the BoJ. In addition, topics of a more structural nature: (1) The impact on growth of new financial regulatory standards; and (2) the role of disruptive technologies in the financial system.

Uncertainty on structural change in China. Discussions on the risks that entail structural changes in China occupied most of the time in the discussions. Doubts among investors and analysts were not about the slowdown of economic activity –with consensus agreeing on a soft landing, with expansion rates stabilizing between 6%-7%yoy-, but about the duration of such deceleration in the context of structural change. It is worth noting that, so far, the Chinese government has followed the objectives set at the *Third Plenum* of the Chinese Communist Party, which took place back in 2013. In this context, investors’ fears are related to two issues: (1) Uncertainty about the lack of transparency in the decision making process of the Chinese government –especially taking into account that the change from an investment-based economy to one based on consumption takes time; and (2) the probability of a policy mistake, particularly in terms of exchange rate policy.

Fed liftoff in December. While we see a consensus among investors that the Fed will hike in December, there is no conviction that this date will necessarily be the right one. Against this backdrop, it is worth noting that the performance of the US economy is still acceptable, given the substantial recovery observed in the labor market. However, the risk that inflation could remain below the 2% target longer than originally planned is still high.

Not a promising future for commodities. Investors expressed strong concerns about the dynamics for commodities. Overall, the sentiment remains negative, at least for twelve months ahead. The pessimistic view includes oil and oil-related goods, metals, and food. Three main drivers for commodities' prices have been identified since mid-2014 and will likely remain at least until 2016/2017. First, the backdrop steered by the effect of slack in the global economy, mainly coming from the slowdown in China. This will result in a lower demand for this type of assets, mainly oil and industry-related metals. Second, an adverse supply effect. Several OPEC members are increasing their production despite recent announcements of the organization deciding to leave the group's quota unchanged. This situation in tandem with oil production in the U.S. that has not decreased in an important fashion in the last months intensifies the concerns on lower prices for longer. Inventories and rig counts which are important leading indicators of production haven't changes significantly. In addition, new cost-efficient processes have resulted in cost curves that continue depressing, diminishing the rate of adjustment of the oil supply. Third, commodities (especially oil) are facing a relevant structural change. Since 2012, commodities-consuming countries have turned also into important producers (e.g. U.S.A., Canada and Brazil). This is why we have not observed evidence of a windfall of importing economies compensating the drop in exporting economies, resulting in a lower equilibrium price. Additionally, an environment of low interest rates worldwide has induced firms to explore into new commodity-related projects that have increased the overall supply.

In addition to those key drivers, there are other short-term conditions that are worth mentioning and took attention from most of the investors attending the IMF/WB meetings. Geopolitical factors in Iran and Libya could result in an increase of global production of 1-2 million barrels a day by 2016-end. Another topic (related to food prices) is the effects of "El Niño" in several regions (mainly central and east-central equatorial Pacific). All in all, the topics discussed regarding commodities suggests a downside risk for prices of 10% to 15% (oil, oil-related assets and metals) for the next 12 months.

Double risks for emerging markets. We believe that the main risk to next year's outlook have to do with the challenges facing emerging economies, amid the uncertainties just mentioned. In this context, having a grasp on the extent of the slowdown in China is key to determining the growth outlook in other emerging economies, where the current account is impacted either because they are exports to China, or indirectly, they are commodity exporters, in general. With respect to the Fed, the general opinion is that the lack of action by the U.S. monetary authority has been a source of uncertainty, particularly in terms of capital outflows. In the case of China in particular, the feedback channel between the fears of a slowdown in economic activity and the delay in the US normalization process has to do with the fact that, in recent years, commercial banks have been channeling funds to China. Such funding was predominantly short-term, encouraged by rates arbitrage. However, the factors favoring these funds are no longer present, largely explaining the recent adjustment to Chinese financial market.

But not in a crisis mode. While the main source of global concern is the performance of emerging economies, it was also recognized that these economies are better prepared to face the challenges already mentioned, particularly Latin American economies. Basically there are four positive factors: (1) Capital flows have slowed but are still positive in Latin America; (2) there are shock absorbers such as flexible exchange rate regimes, (3) high levels of international reserves; and (4) although there has been a significant increase in the levels of corporate leverage, the duration of the debt is longer than in other episodes, with no particular stress coming from the derivatives markets. Nevertheless, there is still a lot of room for structural reforms. In this context, it was highlighted the progress made so far in Mexico and in India.

Additionally monetary stimulus in Eurozone and Japan. Amid a scenario with persistently low commodity prices, it was highlighted the need –and the willingness-, of central banks such as the one in the Eurozone and in Japan to increase monetary stimulus if needed. In the case of the ECB, even though it was the last central bank to implement a full-fledged QE program, it has few additional instruments of monetary policy if necessary. Not only short-term rates are already at zero-bound levels –including deposit rates in negative territory-, but long-term rates are also near their lower range. In addition, the asset purchase program has done little to change inflation expectations. In this context, interventions of the different members of the ECB (*open mouth operation*) have been more successful to change the market dynamics, so we would expect more active participation of ECB-speakers, led by Mario Draghi, in the coming months. In the case of the BoJ, inflation has not been able to increase as a result of low energy prices, while the output gap is closing very slowly. In this context, BoJ governor, Haruhiko Kuroda, said that they will not hesitate to act if necessary, especially amid a difficult fiscal situation, in which the government plans an increase, once again, the tax on sales in 2017, which could reverse the incipient recovery in private consumption.

Mexico, the favorite among emerging markets, but with monetary policy challenges. The most relevant issues to highlight about Mexico are three: (1) Mexico continues to be the best emerging market, with clear-cut macroeconomic stability and recently-approved structural reforms; (2) nobody is paying attention to Mexico's slow growth because it turns out that it is growing at the same or even higher rates than other EM (please see table below on the left); and the major focus is on (3) what will Banxico do if the US Fed decides to postpone (indefinitely?) the beginning of its normalization process? The question seems irrelevant if you only think in the inflation-output gap framework, with inflation at its lowest level ever and growth has not picked up significantly in the past few years. Nevertheless, there continue to be two issues in hand: (a) On the one hand, Governor Carstens has repeatedly mentioned that Mexico, like any small and open economy, is an interest rate taker, and does not control the reference interest rate in full, but the spread between the hegemonic country (the US) and Mexico, which we believe is a good assessment, particularly if you do not want to face the risk of major outflows, mainly in the short-end of the curve; and...

... (b) on the other hand, the more the Fed delays the lift-off -keeping markets thinking that it could be sooner rather than later-, the more time they keep world financial markets in a highly volatile episode. As a result, there will be the need to continue helping the currency not to face a disorderly depreciation process. So far, the Foreign Exchange Commission (FEC) has done it via pre-announced minimum-price and no-matter-what daily US dollar auctions, but these have made a dent on reserves and Pemex' dollars -the only source of FX reserves accumulation-, seems to be over (please see table below on the right). This situation, in our view, foster Governor Carstens' comments during the IMF/WB annual meetings that there might be a case in which Banxico might prefer to hike interest rates vis-à-vis continue to drain reserves. All in all, it is our take that the FEC will change the US dollar auctions, decreasing the amount of the no-matter-what auctions, and increasing the minimum price auctions. If USD/MXN dynamics behave "well", then Banxico will be able to wait for the Fed hike. If not, Banxico will have to hike ahead of the Fed. We believe that Banxico will be able to wait for the Fed.

IMF Growth forecast

% yoy

Forecasts	Oct'15		Jul'15	
	2015	2016	2015	2016
Emerging & developing	4.0	4.5	4.2	4.7
Russia	-3.8	-0.6	-3.4	0.2
China	6.8	6.3	6.8	6.3
Colombia	2.5	2.8	3.4	3.7
Chile	2.3	2.5	2.7	3.3
Peru	2.4	3.3	3.8	4.9
Brazil	-3.0	-1.0	-1.5	0.3
Mexico	2.3	2.8	2.4	3.0

Source: IMF

Banco de Mexico US dollar auctions and Pemex' sales to Banxico

Type of auction	US\$ million (YTD)	% of total
Total	17,205	100
Minimum-price auctions	2,109	12.3
1.5% (throughout the year)	400	2.3
1.0% (since July 31, 2015)	1,709	9.9
No minimum-price auctions	15,096	87.7
US\$ 52 mn (since March 2015)	5,096	29.6
US\$ 200 mn. (since July 31, 2015)	10,000	58.1
Pemex US\$ sales to Banco de Mexico	3,614	

Source: Banxico

Structural Issues

Trans-Pacific Partnership (TPP). Given the recent agreement among countries negotiating TPP, the main Latin American economies stressed that success in the negotiations was possible due to a previous strengthening of the macroeconomic framework in each country, including fiscal discipline and inflation targets. In addition, in the case of Latin America, the agreement comes at a time when there is already some integration of financial markets, as it is the case of the *Integrated Latin American Markets (MILA)*, which currently allows trading of companies listed in Chile, Colombia, Peru and Mexico, with settlement in the respective local markets of each of these countries. This agreement aims to soon be extended to fixed-income instruments, while it will seek to continue converging towards a common tax code for investors as well as the approval of the deal to institutional investors.

The impact on growth of new standards of financial regulation globally. One of the issues present in many of the discussions on growth during the conferences is the room that exists in terms of expanding infrastructure as a way of boosting growth, in a context in which monetary policy is beginning to have a limited effect, and there is little effort from government to undertake structural reforms. In these discussions, a constant by the representatives of the financial system, was that new financial regulation (*Basel III*, in particular) has undermined the ability of commercial banks in particular to participate in the funding of infrastructure projects. They stressed the need of guarantees from development banks to support project financing as, under current regulation, it is very difficult for commercial banks to have the required capital returns on infrastructure projects. In this context, one of the main challenges facing regulation in 2016 is the inconsistency that still exists among regulations in different countries.

Disruptive technologies and their role in the financial system. Finally, a major theme in the meetings was the role of disruptive technologies in the financial system. In particular, the sector faces major challenges as a result of the new technologies such as: (1) Mobility; (2) crypto-currencies; (3) artificial intelligence; (4) biometrics; and (5) the cloud. In this context, the digital transformation of the banks is taking place in a context in which there is not a pre-set route or a pre-defined goal while rules have not been yet written.

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.

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, Mexico	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) 1103 - 2368
Equity Strategy			
Manuel Jiménez Zaldivar	Director Equity Research Analyst - Telecommunications / Media	manuel.jimenezza@banorte.com	(55) 5268 - 1671
Víctor 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	Senior Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 1670 - 1227
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
María de la Paz Orozco García	Analyst	maripaz.orozco@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	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	Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Jorge de la Vega Grajales	Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Private Banking	lpietrini@ixe.com.mx	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Asset Management	pimentelr@ixe.com.mx	(55) 5268 - 9004
Ricardo Velazquez Rodríguez	International Banking	rvelazquez@ixe.com.mx	(55) 5268 - 9879
Victor Antonio Roldan Ferrer	Transactional Banking	vrolدان@ixe.com.mx	(55) 5004 - 1454