

Ahead of the Curve

November 23, 2018

Focus on Banxico's Quarterly Report forecast updates in a backdrop of high uncertainty

- **Banxico's Quarterly Report (3Q18).** Banco de Mexico will publish its Quarterly Report (QR) for 3Q18 on Wednesday around 1:30pm (ET). In our view, market participants will focus on: (1) The likely increase in inflation forecasts, in our view both for 4Q18 and next year's trajectory, with high uncertainty over the degree of the adjustment due to the possibility of a new policy for gasoline prices, price controls on agricultural products, and a higher minimum wage, among others; (2) GDP growth estimates, in our view unchanged for both 2018 and 2019, but with risks tilted to the downside on the latter; and (3) the calendar for next year's policy meetings (particularly in relation to the Fed), along minutes and Quarterly Reports
- **Trade balance (October).** We expect a US\$1,740.2 million deficit in October. Although export data remains strong, the overall deficit would be higher than the previous month as a result of a seasonally negative effect in terms of non-oil consumption imports, driven by companies replenishing their inventory levels ahead of the holiday season that starts in November ("El Buen Fin", Mexico's Black Friday). We estimate a 9.7% yoy increase in exports and 7.9% higher imports

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Document for distribution among the general public

Mexico weekly calendar

DATE	TIME (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 26-Nov	9:00am	Retail sales	September	%yoy	<u>4.0</u>	--	3.9
		sa		% m/m	<u>0.0</u>	--	-0.3
Tue 27-Nov	9:00am	Trade balance	October	US\$ mn	<u>-1,740.2</u>	--	-193.9
		Total exports		% yoy	<u>11.9</u>	--	9.7
		Oil exports		% yoy	<u>24.3</u>	--	43.8
		Non-oil exports		% yoy	<u>8.8</u>	--	10.0
		Total imports		% yoy	<u>7.8</u>	--	6.4
Tue 27-Nov	9:00am	Unemployment rate	October	%	<u>3.44</u>	--	3.60
		sa		%	<u>3.35</u>	--	3.33
Tue 27-Nov	10:00am	International reserves	25-Nov	US\$ bn	--	--	173.9
Tue 27-Nov	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 5y Mbono (Dec'23); 10y Udibonos (Nov'28)					
Wed 28-Nov	1:30pm	Banxico's Quarterly Report					
			3Q18				
Thu 29-Nov	10:00am	Banxico's minutes					
			November				
Fri 30-Nov	10:00am	Comercial banking credit	October	% yoy	<u>5.7</u>	--	5.9
		Consumption		% yoy	<u>1.7</u>	--	1.5
		Housing		% yoy	<u>3.9</u>	--	4.0
		Non-banking private firms		% yoy	<u>9.2</u>	--	9.4
Fri 30-Nov		Budget balance	October	MXN bn	--	--	-311.0

Source: Banorte; Bloomberg

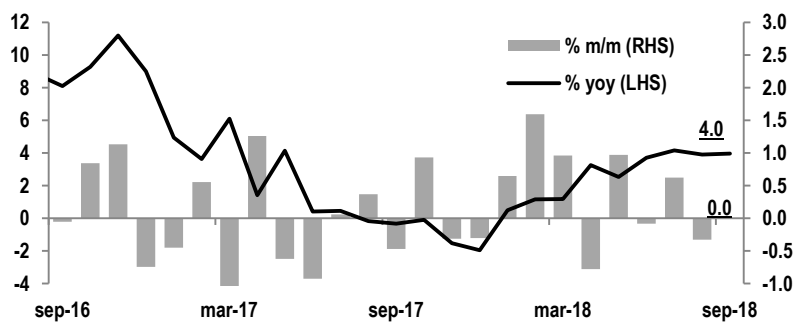
Proceeding in chronological order...

September retail sales could remain at a relatively high annual growth rate despite some signs of moderation. We estimate a 4.0% yoy increase, slightly above the 3.9% expansion of the previous month and which would be the second highest year to date. Nevertheless, in the monthly comparison (using seasonally adjusted figures), this would result in a flat reading, slightly higher than the 0.3% contraction observed in August. In this respect, retail data known so far remain quite robust, in particular same-store department sales (*ANTAD*) which say a 1.0% yoy increase from 0.1% in the previous month. Meanwhile, *AMIA* vehicle sales moderated their fall in terms of their yearly comparison, going from -5.3% in August to -1.5% in September. Other indicators related to domestic demand, such as remittances, have kept with a strong dynamics as they increased 16% when measured in MXN. In spite of the latter, it is worth mentioning that the Mexican peso depreciated only by 1.5% in real, effective exchange terms when compared to the previous year.

On the contrary, non-oil consumption good imports decelerated meaningfully during the month, falling 3.3% yoy, after a relatively strong performance in the two previous months. Last but not least, households' current conditions according to the consumer confidence index fell from 103.6 to 101.pts during the month (original figures), despite a still quite high overall performance in these indicators.

Retail sales

% yoy (nsa), % m/m (sa)



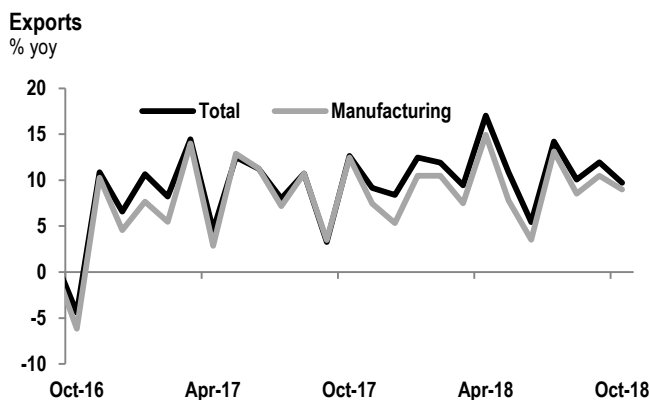
Source: INEGI, Banorte

Trade balance deficit to widen after a surprisingly strong report in September. We expect a US\$1,740.2 million deficit in October. Although export data remains strong, the overall deficit would be higher than the previous month as a result of a seasonally negative effect in terms of non-oil consumption imports, driven by companies replenishing their inventory levels ahead of the holiday season that starts in November (*“El Buen Fin”*, Mexico’s Black Friday).

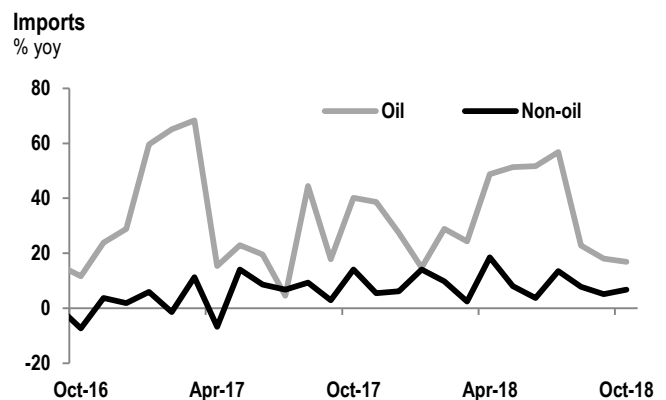
Inside the report, we estimate a 9.7% yoy increase in total exports. By components, oil is forecasted to grow 24.3%, decelerating meaningfully with respect to the previous month (43.8%), mostly due to a negative base effect as export volume returned to more normal levels in Oct’17 after dipping in the previous month due to natural disasters. Nevertheless, crude-oil prices stayed relatively high despite starting to decline more meaningfully by the end of the month. The Mexican crude-oil basket averaged US\$/bbl 74.09, 51.2% yoy.

On the other hand, we expect manufacturing exports at 9% yoy, still supported by auto sector exports (according to data already released by AMIA), albeit with a more modest rate of expansion when compared to the previous month (+10.5%). Additionally, we expect a 6.1% increase in the rest of manufacturing exports, supported by a still healthy performance of US industrial activity.

Going to imports, we forecast a 7.9% yoy increase, above the 6.4% expansion in September. Looking into the details, we expect non-oil consumption goods at 1%, which in spite of being a seasonally high month in absolute terms, the effect is dampened in the annual comparison. Last but not least, we expect intermediate goods imports to recover slightly to advance 7.5% from 5.8% in the previous month.



Source: INEGI, Banorte

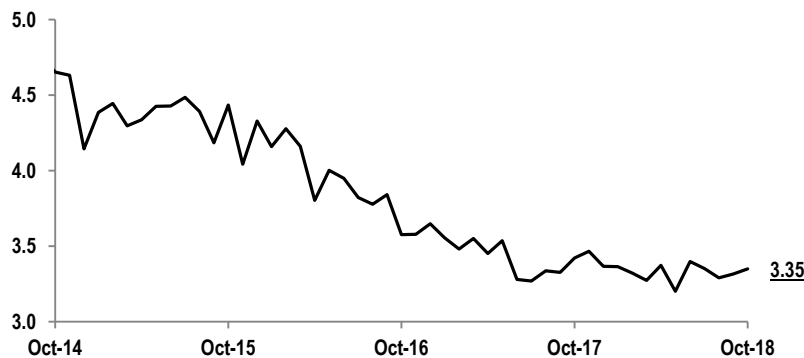


Source: INEGI, Banorte

Unemployment in October may increase modestly. We estimate an unemployment rate of 3.44% nsa, slightly below the 3.60% print observed in the previous month. Nevertheless, when using seasonally adjusted figures, we expect an increase to 3.35% from 3.32% in September. In this respect, it is worth noting that most signs suggest that employment may have decelerated. In particular, the year-ago rate of increase in formal employment stood at 3.7% yoy (non-seasonally adjusted), decelerating for a second consecutive month and at its lowest since July 2017. Moreover, in spite of an historical inverse relationship between the FX and unemployment (which may be due to higher competitiveness in the manufacturing sector due to lower unit labor costs), it is our take that the positive effect of the peso's depreciation during the month may have been more muted as October was characterized by a high degree of local uncertainty. Even with business confidence mostly stable, we believe that the slight reduction in present condition indexes (except for construction) is likely to weigh slightly in the unemployment rate during the month.

Unemployment rate

%, sa



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves expanded by US\$291 million, amounting to US\$173.9 billion. According to Banxico’s report, this figure comes mainly from a positive valuation effect in central bank assets. In this context, the central bank’s international reserves have increased by US\$1,050 million during 2018 (please refer to the following table).

Banxico's foreign reserve accumulation detail

US\$, million

	2017	Nov 16, 2018	Nov 16, 2018	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	172,802	173,851	291	1,050
(B) Gross international reserve	175,450	176,655	650	1,205
Pemex	--	--	154	-654
Federal government	--	--	-44	391
Market operations	--	--	0	0
Other	--	--	540	1,468
(C) Short-term government's liabilities	2,648	2,803	359	155

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent–, will offer 5-year fixed-rate Mbonos (Dec’23), 10-year inflation-linked Udibonos (Nov’28), in addition to the “more traditional” 1-, 3-, and 6-month zero-coupon Cetes (please refer to the following table). As usual, results will be released at 12:30pm (ET).

Auction specifics (Tuesday, November 27th, 2018)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	27-Dec-18	--	7,000	7.94
3m	28-Feb-19	--	11,000	8.23
6m	23-May-19	--	11,000	8.40
M Bono				
5y	07-Dec-23	8.00	9,000	8.57
Udibono				
10y	30-Nov-28	4.00	UDIS 600	4.15

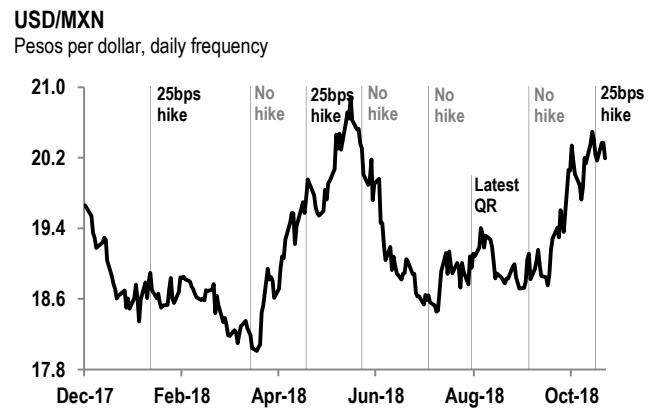
Source: Banorte with data from Banco de México 1. Except for Udibonos, which are expressed in UDI million, everything else is expressed in MXN million. 2. Yield-to-maturity reported for Cetes, Mbonos and Udibonos

Banxico will likely raise its inflation forecasts in the 3Q18 Quarterly Report. Banco de Mexico will publish its *Quarterly Report (QR)* for 3Q18 on Wednesday around 1:30pm (ET). The release will be accompanied by a press conference led by Governor Diaz de Leon. In our view, market participants will focus on:

(1) *Likely increase in inflation forecasts.* In the latest QR, the central bank estimated an average annual inflation rate in 4Q18 of 4.2%. In our view, both this forecast and next year’s trajectory will be revised higher (see table below). In this respect, in the November 15th decision the Governing Board mentioned that: “...inflation faces significant risks related to the possible adoption of policies that could structurally affect the economy’s price formation process...”, reflecting both internal and external factors. In this context and after the 25bps hike, they said: “...the balance of risks to the forecasted trajectory of inflation has deteriorated and exhibits a significant upward bias, in an environment of high uncertainty...”. Additionally in the minutes of the October 4th decision, every member coincided that shocks to inflation have been temporary in nature but have delayed the convergence of the headline to its target. Moreover, most stated that core inflation remains in line with forecasts and is expected to continue its downward trend towards 3%, although some pointed out that it is anticipated to decrease at a slower rate. In this respect and following the peso’s 7% accumulated depreciation since the latest update (see chart below), we expect an upward adjustment in both headline and core inflation.

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

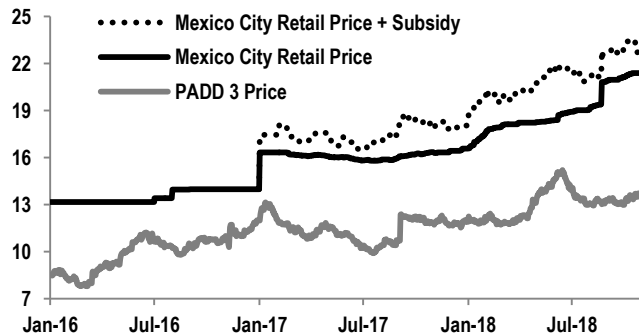


Source: Banorte, Bloomberg

In spite of the likely upward adjustment, there is high uncertainty about its magnitude. In our view, at least three factors could influence the forecasts:

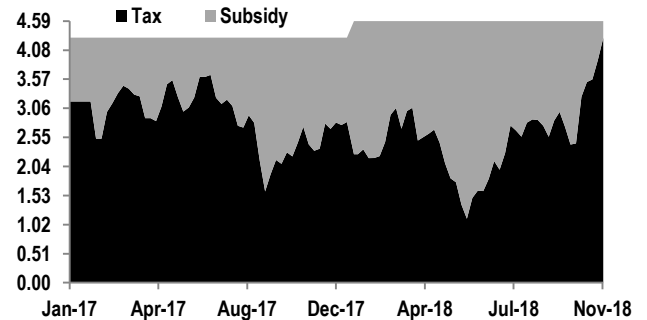
(a) *Gasoline prices.* The pricing policy of the incoming administration for gasoline (in particular, regarding excise taxes) has not been detailed in full, and will likely be unveiled in the 2019 Budget to be released by December 15th at the latest. Related to the latter, international crude-oil prices have fallen strongly in recent days, although this could be compensated to some degree with the peso’s recent depreciation.

Low-grade gasoline price
Pesos per liter



Source: Banorte with data from CRE, DoF

Excise tax on low-grade gasoline
Pesos per liter, total tax in 2018 = 4.59 pesos per liter



Source: Banorte with data from DoF

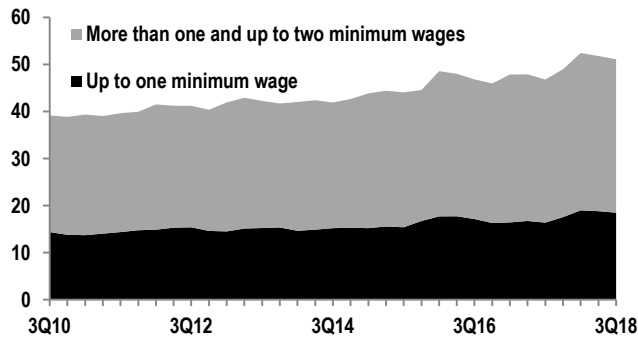
(b) *Price floor for some agricultural products.* On October 27th, President-elect Andres Manuel López-Obrador detailed price floors to be implemented for five products: milk, wheat, corn, rice, and beans. The weight of these generics in CPI, considering only those that include at least one of these five words (a total of 10, except soy milk) is practically at 4.85%. Nevertheless, the final effect is uncertain considering a wide range of goods that use these as their main input, apart from the scope of the program. In our view, the impact on CPI will not be highly significant, assuming that the program will be focused only on small producers.

(c) *Minimum wage hike.* We believe it is highly likely that an agreement will be reached before year-end, to be applied on the first day of 2019. According to several reports, the planned increase to the minimum wage (MW) would be around 10-15%. In 2018, the official MW was 88.36 pesos per day, so the increase implies that it could practically reach 102 pesos (see chart below). In this context, we have estimated that a 10% MW hike would increase twelve-month inflation around 30bps. For details, see: “*Abnormal increase in minimum wage will have a marginal effect on inflation*”, <pdf>, November 21st, 2017. It is worth mentioning that further increases in the MW (in absolute levels) could have a greater effect in terms of the total number of people in the labor force for which the change applies. According to the *National Employment Survey* (“*Encuesta Nacional de Ocupación y Empleo*”, ENOE, in Spanish), as of 3Q18 around 18.5% of the labor force (excluding those not reporting their income) earned up to one MW, while those earning up to 2 MW surge to 51.1% (chart below). In spite of the latter, the figure of those effectively impacted could even be below the lower limit, because: (1) The increment is likely to be around 10%, not 100%; and (2) the survey includes both formal and informal employees, with most of the latter possibly not benefitted by the increase.

Banxico proposed an econometric model to estimate the direct- and indirect-effects of an increase in the MW on the “*Basic Formal Wage*” (“*Salario Básico de Cotización*”, in Spanish) to estimate the latter’s impact on inflation. For details, see: “*Salario Mínimo e Inflación*”, <pdf>, June 2016 (only in Spanish). The central bank estimated that a 10% increase in the MW would have a direct impact of around 150bps. This contrasts significantly with our own estimate, which implies a much lower effect, reminding us of the high level of uncertainty about the final impact that this measure could eventually have.

Employees by income level

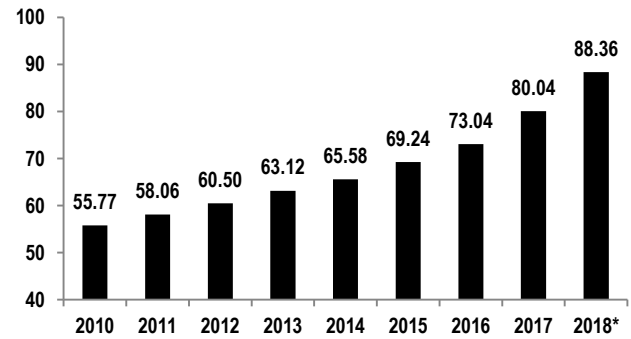
% of total employees*



*Note: excluding those that do not report their income level
Source: Banorte with data from INEGI

Average minimum wage by year

Pesos per day



*Note: For 2018 the average is calculated until the day of this publication
Source: Banorte with data from INEGI

(2) *Unchanged growth forecasts, but risks skewed to the downside.* The central bank's current annual GDP growth estimated range for 2018 stands at 2.0-2.6% (midpoint: 2.3%), while our forecast is 2.1%. Coincidentally, the YTD growth up to 3Q18 stands at 2.1%. Considering this, we do not expect significant changes to this year's growth forecast.

For 2019, the estimated range is at 1.8%-2.8% (midpoint: 2.3%), while our forecast stands exactly at the lower bound of Banxico's range. In our view, it is too early for the central bank to modify its forecasts as they still lack very relevant information about fiscal policy, although we see risks skewed to the downside. In particular, in the latest communique the central bank stated that: "...*Forecasts for world economic growth for 2018 and 2019 have been revised slightly downwards due to the intensification of international trade disputes and to a further tightening of financial conditions, while considerable risks in the short and medium run have increased...*". Moreover, they reaffirmed that the balance of risks for local growth in a cyclical perspective continues biased to the downside and has deteriorated at the margin, "...*due mainly to both the complex external environment faced by the Mexican economy and the abovementioned domestic uncertainty factors...*". Lastly, we will pay attention to growth forecasts for 2020, to be released for the first time.

(3) *2019 Calendar.* As usual, this report will include the calendar for policy meetings, minutes and Quarterly Reports for next year. In this respect, we only highlight that, starting in 2019, every meeting of the Federal Reserve will be followed by a conference press led by the Chairman, in contrast with the current quarterly frequency. Taking this into account, coupled with the fact that Banxico has reiterated that the relative monetary stance with the US remains as one of the main factors to watch closely, it will be important to see how near the meetings of Banxico will be with respect to those of the Fed.

We maintain our view that Banxico will keep the reference rate at 8.00% by the end of the year. Moreover, we believe that the reference rate will remain unchanged at least during the first half of 2019, albeit recognizing risks of further hikes. Although we consider that the document will reiterate the hawkish bias, our view is supported by: (1) The expectation of a responsible budget in 2019, which could help reduce local market volatility; (2) healthy macro fundamentals, supporting conditions for no additional rate hikes at least for now; and (3) a real, ex-ante interest rate already in restrictive territory, hovering around 4%. For further details, please see: “*Banxico’s monetary policy decision – Ready to hike, but with no real willingness to do it*”, [pdf](#), November 15th, 2018.

Banxico’s monetary policy minutes (November). Next Thursday at 10:00am (ET), Banxico will publish the minutes of its November 15th meeting, in which the Board hiked the reference rate 25bps to 8.00%, maintaining a hawkish bias. Moreover, it is worth remembering that one member voted in favor of a 50bps increase. Despite the possibility that the minutes’ relevance diminishes given that the central bank will release its Quarterly Report on the previous day, investors will focus on several discussions, particularly those about mid- and long-term risks, the price formation process, and the country risk premium. In our view, markets will look for details about these as they could have longer-term implications for the monetary policy outlook and the equilibrium real interest rate, among others.

The statement referred to medium run risks to global growth, noting that risks from the intensification of trade disputes and tighter financial conditions have increased, mostly driven by the US-China dispute, the Fed and US fiscal policy. Going into idiosyncratic factors, the Board said: “...*the peso exchange rate was also affected by the announcement about the intention of cancelling the New Mexico City International Airport project and, in general, by markets’ concerns regarding both the incoming administration’s policies and some legislative initiatives...*”. Moreover, the statement argued that the downgrade to Mexico’s sovereign risk outlook and higher sovereign risk premium were also responsible for the sizable increase in medium- and long-term interest rates. As a result; “...*this environment entails significant medium and long term risks that could affect the country’s macroeconomic conditions, its growth potential and the economy’s price formation process...*”. I

Regarding prices, the focus was on the resistance of core inflation to decline, attributed mostly to the indirect effect on production costs of higher energy prices. Nevertheless, they said that: “*inflation faces significant risks related to the possible adoption of policies that could structurally affect the economy’s price formation process*”. The most important is that the exchange rate may continue to be subject to pressures, with the risk of second-round effects affecting it. Moreover, they reaffirmed that uncertainty is very high because of both external (trade disputes, interest rates) and local (public finances, wage negotiations) factors. Last but not least, we will watch the interpretation about the fundamental drivers behind the significant re-pricing higher in market-based measures of inflation expectations in short-, mid- and long-term tenors.

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Banking credit will show a 5.7% yoy increase in October. It is our take that credit to the non-financial sector continued flowing in October. In particular, we estimate a 5.7% yoy expansion in banking credit (in real terms), as a result of a 1.7% increase in consumer credit, coupled with a 3.9% and 9.2% expansion in mortgage and credit to firms, in the same order.

MoF's October's public finance report. In it, we will focus on income and spending dynamics of the Federal Government. On the revenue side, we will be looking at non-oil tax collection, as it will provide additional information about domestic demand. Moreover, data regarding collection of fuel-excite tax (IEPS) will be relevant given the moderation in the policy to smooth gasoline price variations in recent months. In addition, markets will focus on the spending side of the report, in particular vs. 2017, both on the discretionary side as well as debt servicing costs. Finally, we will evaluate the evolution of public sector debt (as measured by the Historical Balance of Public Sector Borrowing Requirements), which currently represents close to 43.4% of Mexico's GDP.

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HOLD	<i>When the share expected performance is similar to the MEXBOL estimated performance.</i>
SELL	<i>When the share expected performance is lower than the MEXBOL estimated performance.</i>

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