

Ahead of the Curve

September 23, 2016

Market focus this week will on Banxico's monetary policy announcement

- Banxico's monetary policy announcement.** This week, Banxico will hold its seventh policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (September 29) at 2:00pm (EDT). We believe that board members will increase the reference rate by 50bps, leaving it at 4.75%. In particular, we have observed a higher pass-through effect of the significant depreciation of the Mexican currency to prices during the last two months. In addition, the higher volatility in the MXN could induce a deterioration of inflation expectations.
- July's economic activity.** On Monday, at 9:00am (EDT), *INEGI* will release its monthly global economic indicator for July (GDP monthly proxy), where we expect a 1.2% yoy expansion. We believe that Mexico's economic growth in July will be explained by a 1% reduction in industrial production, a 2.3% yoy increase in services output, and a 6.3% expansion in agricultural production.

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Mexico weekly calendar

DATE	HOUR (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS	
Mon 26-Sep	9:00am	Global economic indicator	July	% yoy	<u>1.2</u>	1.9	2.2	
		(sa)		% m/m	<u>-0.6</u>	--	0.6	
		Primary activities		% yoy	<u>6.3</u>	--	14.8	
		Industrial production		% yoy	<u>-1.0</u>	--	0.6	
		Services		% yoy	<u>2.3</u>	--	2.5	
Tue 27-Sep	9:00am	Trade balance	August	US\$ mn	<u>-367.0</u>	-2,257	-1,827	
		Total exports		% yoy	<u>1.4</u>	--	-8.9	
		Oil exports		% yoy	<u>-7.1</u>	--	-22.3	
		Non-oil exports		% yoy	<u>2.0</u>	--	-8.0	
		Total imports		% yoy	<u>-5.9</u>	--	-9.9	
Tue 27-Sep	10:00am	International reserves	Sep 23	US\$ bn	--	--	177.3	
Tue 27-Sep	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 20y Mbono (Nov'34); 5y Bondes D						
Wed 28-Sep	9:00am	Unemployment rate	August	%	<u>4.10</u>	4.00	4.01	
		sa		%	<u>3.80</u>	3.80	3.75	
Thu 29-Sep	2:00pm	Banxico's monetary policy decision		%	<u>4.75</u>	4.25	4.25	
Fri 30-Sep	10:00am	Comercial banking credit	August	% yoy	<u>13.2</u>	--	14.2	
		Consumption		% yoy	<u>10.3</u>	--	10.7	
		Housing		% yoy	<u>8.5</u>	--	8.5	
		Non-banking private firms		% yoy	<u>16.5</u>	--	17.7	
Fri 30-Sep	3:30pm	Budget balance	August	MXN bn	--	--	-157.2	

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

We expect a 1.2% yoy expansion in July's IGAE. On Monday, at 9:00am (EDT), *INEGI* will release its monthly global economic indicator for July (GDP monthly proxy), where we expect a 1.2% yoy expansion. We believe that Mexico's economic growth in July will be explained by a 1% reduction in industrial production, a 2.3% yoy increase in services output, and a 6.3% expansion in agricultural production.

As we had mentioned in our last IP report, the 1% yoy contraction in industrial production during July was explained in part by the contraction in manufacturing output (-0.2% yoy). Moreover, construction output fell 0.1%, as a result of the 3.3% growth in private building projects, whereas public civil engineering construction projects declined 16.6% yoy, given the fiscal cuts implemented by the Federal Government. On the other hand, mining activity fell 6.3% as a result of the significant contraction in Mexico's oil production.

Moreover, the 2.3% yoy estimated expansion in services will be explained by the recovery in private consumption. In particular consumers' spending is gaining momentum, whereas formal job creation has observed a significant recovery in the first seven months of the year.

Exports will show a marginal increase. On Tuesday, at 10:00am (EDT), *INEGI* will make available its trade report for August, where we expect to see a US\$367 million deficit. On the exports side, we will probably see a 7.1% yoy contraction of oil exports given the fall in oil exports and prices during the period in question. However, non-oil exports could have increased 2% yoy, on the back of a 1.8% increase in manufacturing exports.

On the imports side, we estimate a 5.9% yoy contraction in total imports. Taking a look at the breakdown, we believe that imports consumption goods decreased 8.6% yoy, while imports of intermediate goods could have fallen 5.3% yoy. Finally, we estimate a 6.2% reduction in capital goods imports.

Weekly international reserves report. On Tuesday, at 10:00am (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves fell by US\$433 million amounting to US \$175.9 billion on September 15. According to Banxico's report, this figure comes mainly as a result of: (1) Dollar sales by Banxico to the Federal Government for US\$355 million; along with a (2) US\$78 million reduction due to changes in the valuation of the Central Bank's assets. In this context, the Central Bank's international reserves have diminished by US\$866 million this year (please refer to the table below).

Banxico's foreign reserve accumulation details

US\$, million

	2015	15/Sep/2016	15/Sep/2016	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	176,735	175,869	-433	-866
(B) Gross international reserve	177,597	177,162	-1,735	-434
Pemex	--	--	-119	2,378
Federal government	--	--	-1,738	142
Market operations	--	--	0	-5,562
Other	--	--	122	2,606
(C) Short-term government's liabilities	861	1,293	-1,302	432

Source: Banco de México

Weekly government bond auction. Also on Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent-, will offer 30-year fixed-rate Mbonos (Nov'42) as well as 5-year Bondes D, in addition to the “more traditional” 1-, 3-, and 6- month zero-coupon Cetes (please refer to the table below). As usual, the results will be released at 12:30pm (EDT).

Auction specifics (Tuesday, September 27)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	27-Oct-16	--	5,500	4.27
3m	29-Dec-16	--	9,500	4.50
6m	3-Mar-17	--	11,000	4.74
Mbono				
20y	23-Nov-34	7.75	2,500	6.25
Bondes D				
5y	15-Sep-21	--	3,000	0.21

Source: Banorte-Ixe 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

Unemployment rate in August will stand at 4.1%. On Wednesday, *INEGI* will publish its employment report for the eighth month of 2016, in which we estimate an unemployment rate of 4.1% nsa, above the 4.01% observed in July, but below the 4.68% observed in August¹⁵. In seasonally-adjusted terms, we believe that the unemployment rate could stand at 3.8%, which implies a 0.05%-pts increase.

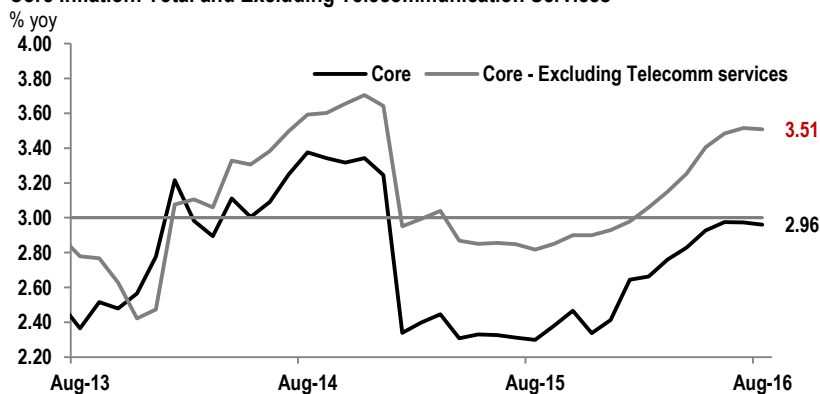
It is likely that August's labor market report will reflect the lower growth dynamics of the Mexican economy. In particular, the downward trend in public spending has translated in a higher number of unemployed workers, and has already affected private investment projects. We believe that these collateral effects will also have a negative impact in the Mexican labor market. Looking ahead, we believe that the labor market will continue to grow, but at a slower pace given the fiscal cuts that the Federal Government will continue to implement throughout the second half of the year.

We expect a 50bps hike in Banxico’s reference rate. This week, Banxico will hold its seventh policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (September 29) at 2:00pm (EDT). We believe that board members will increase the reference rate by 50bps, leaving it at 4.75%. In particular, we have observed a higher pass-through effect of significant depreciation of the Mexican currency to prices during the last two months. In addition, the higher volatility in the MXN could induce a deterioration of inflation expectations.

Within the communiqué, the central bank will probably emphasize on the following issues: (1) The balance of risks for inflation in the horizon, in which monetary policy operates, has continued to deteriorate, highlighting an upward trend in core inflation given the higher pass-through effect of the depreciation of the MXN to prices; (2) a higher probability of financial volatility on the back of geopolitical risks, including the US elections; and (3) the necessity to adapt Banxico’s monetary policy in order to prevent that the depreciation of the Mexican currency and the adjustment in relative prices translate into a deterioration of inflation expectations.

Even though Mexico’s headline CPI index has remained below Banxico’s 3% target, we believe that the balance of risks for inflation has deteriorated. In particular, core inflation has maintained an upward trend, where we highlight the recent acceleration in core index excluding telecommunications services (refer to the chart below). In fact, most of the Board members expressed this concern in the last monetary policy minutes. In this context, we believe this week’s monetary policy statement will incorporate Banxico’s view that there is a possibility that the depreciation of the Mexican currency will exacerbate the growing trend of core inflation, and could affect the trajectory of the non-core sub-index, through energy tariffs, particularly through gasoline prices.

Core Inflation: Total and Excluding Telecommunication Services



Source: Banorte-Ixe; INEGI

Moreover, Banxico has strongly highlighted the importance of keeping inflation expectations firmly anchored in line with its 3% target. In fact, most of the board members agreed that the 50bps rate hike in June was justified by the significant depreciation of the Mexican currency, and its potential negative impact on inflation expectations. In addition, in the minutes of their last monetary policy meeting, several board members agreed that Banxico's monetary policy tightening in June helped to stabilize inflation expectations, which was reflected in the flattening of the yield curve

Banking credit will show a 13.2% yoy increase in August. Banco de Mexico will make available its banking credit report on Friday at 10:00am (EDT). It is our take that banking credit continued flowing in August. In particular, we estimate a 13.2% yoy expansion in banking credit (in real terms), as a result of increases in the area of 10.3%, 8.5%, and 16.5% yoy in consumer, housing and business credit, respectively.

The MoF's monthly report. On Friday, the Ministry of Finance (MoF) will make its monthly finance report available for August. On the revenue side, we will be looking at non-oil tax collection as it provides additional information about domestic demand dynamics. Moreover, markets will focus on the spending side of the report, in order to assess the execution of the fiscal cuts announced by the *MoF*. Finally, it will be important to evaluate the evolution of public sector debt, which currently represents about 48% of Mexico's GDP.

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