

## Quarterly Report – Banxico updates economic forecasts reflecting a complex environment

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www.banorte.com  
@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

### 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 Senior Strategist  
juan.alderete.magal@banorte.com

### Santiago Leal

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

- Banxico published today its *Quarterly Report (QR)* for 2Q18
- The release was accompanied by a press conference by Governor Alejandro Díaz de León
- In our opinion, the tone of the QR is very similar to the one we observed in the last monetary policy minutes which were published on August 16<sup>th</sup>
- We highlight that Banxico modified its growth and inflation estimates in a highly uncertain environment, in particular:
  - (1) Growth estimates for 2018 were revised to a range between 2%-2.6% from 2%-3%, while 2019's went from 2.2%-3.2% to 1.8%-2.8%; and
  - (2) Convergence of inflation towards the target was postponed from 2Q19 to 2Q20
- In terms of the traditional *grey boxes*, we highlight:
  - (1) The discussion about the advantages of the *Inflation Forecast Targeting* regime; and
  - (2) The analysis of long-term inflation trends with a wavelet approach
- Considering this, we maintain our view that, while the monetary authority is still open to further rate hikes, Banxico will not pull the trigger as we believe that risks are contained

**Quarterly Inflation in line with last monetary policy minutes.** Banxico published today its *Quarterly Report (QR)* for 2Q18. The release was accompanied by a press conference by Governor Alejandro Díaz de León. In our opinion, the tone of the QR is very similar to the one we observed in the last monetary policy minutes which were published on August 16<sup>th</sup>, in which the central bank maintained a *hawkish* bias amid a scenario that continues to entail high levels of uncertainty.

**We highlight Banxico's revisions to its growth and inflation estimates amid a highly risky environment.** GDP contraction in 2Q18 revealed a larger than expected weakness in the economy. In this context, the central bank expects the country to continue facing a difficult backdrop with trade tensions, a more restrictive rate environment globally, a stronger U.S. dollar, and turmoil in some emerging economies. In terms of the domestic economy, uncertainty surrounding the change in government prevails while oil production has failed to recover as expected. This could eventually further delay investment plans. On the upside, Banxico recognizes that this week's agreement on NAFTA reduces uncertainty, while dynamism in the U.S. could favorably affect Mexico's manufacturing performance. Moreover, higher than expected levels of public spending could have a positive effect on growth. All in all, growth forecasts were reduced from 2%-3% in the last QR to 2%-2.6% for 2018, and from 2.2%-3.2% to 1.8%-2.8% for 2019, as shown in the tables below.

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**Banxico's Forecast**  
 Recent Report (2Q18)

	2018	2019
<b>GDP (%)</b>	2.0 – 2.6	1.8 – 2.8
<b>Employment (thousands)</b>	670 – 770	670 - 770
<b>Trade Balance (bn)</b>	-13.4 (1.1% of GDP)	-14.1 (1.1% of GDP)
<b>Current account (bn)</b>	-23.7 (1.9% of GDP)	-27.9 (2.1% of GDP)

Source: Banxico

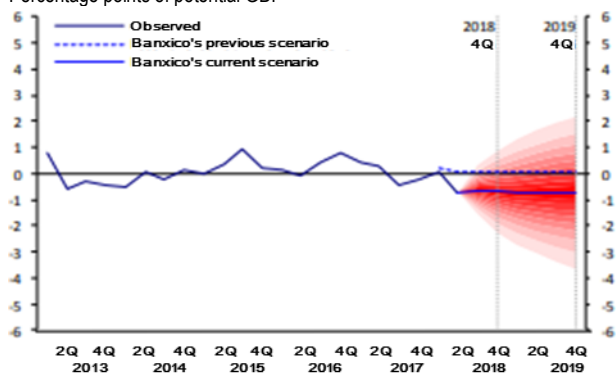
**Banxico's Forecast**  
 Previous Quarterly Report (1Q18)

	2018	2019
<b>GDP (%)</b>	2.0 – 3.0	2.2 – 3.2
<b>Employment (thousands)</b>	680 – 780	690 - 790
<b>Trade Balance (bn)</b>	-14.0 (1.1% of GDP)	-15.0 (1.1% of GDP)
<b>Current account (bn)</b>	-25.2 (2.1% of GDP)	-30.5 (2.3% of GDP)

Source: Banxico

**Output gap**

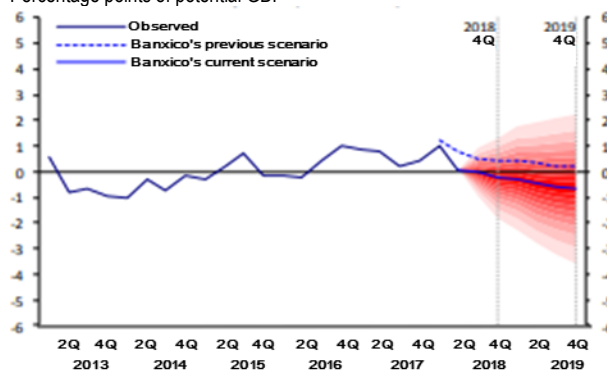
Percentage points of potential GDP



Source: Banco de Mexico; 2Q18 QR

**Output gap ex oil production**

Percentage points of potential GDP



Source: Banco de Mexico; 2Q18 QR

**Convergence to the inflation target was delayed from 2Q19 to 2Q20.**

According to the report, Year-to-date, inflation has been affected by higher than expected energy prices, offset by lower contribution of merchandise and agricultural prices. In this context, non-core inflation has been persistently higher than expected, delaying the process of convergence to the target. Nevertheless, core inflation, which according to Banxico, better reflects the monetary policy stance, shows a descending trend and it is expected to converge to target in 3Q19, while total inflation will do so in 1H20. The balance of risks continues to be balance to the upside with the QR naming the exchange rate as one of the main factors that could affect inflation, while there is also the risk of seeing more pressures on energy prices and that trade tensions in general derived in pressures. Moreover, there is a risk that wage negotiations do not reflect changes in productivity levels, while a higher level of public spending could prevent core inflation from falling at current rates.

**CPI forecasts**

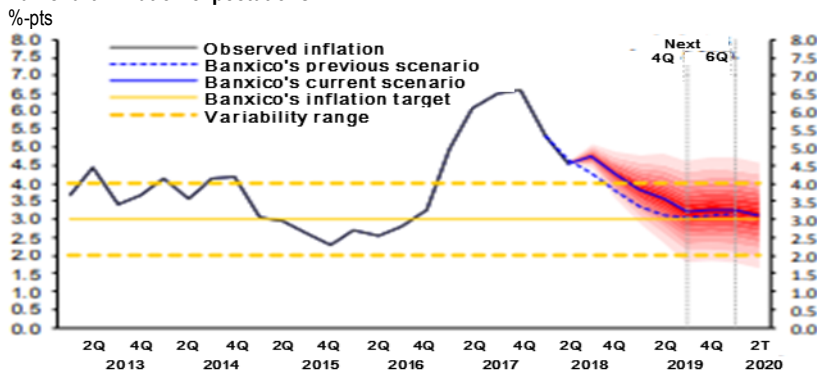
% yoy, quarterly average

	2018			2019				2020	
	II	III	IV	I	II	III	IV	I	II
<b>CPI</b>									
Current forecast	4.6*	4.8	4.2	3.8	3.6	3.2	3.3	3.2	3.1

Previous forecast	4.6	4.3	3.8	3.3	3.1	3.1	3.1	3.1	3.1
<b>Core</b>									
Current forecast	3.7*	3.6	3.5	3.3	3.2	3.0	2.9	3.0	2.9
Previous forecast	3.7	3.6	3.4	3.2	3.2	3.1	3.0	3.0	

Source: Banco de México, 2Q18 QR; \*Observed data

**Fan chart: Inflation expectations**



Source: Banco de Mexico; 2Q18 QR

**In the traditional grey boxes, Banxico details the advantages of Inflation Forecast Targeting...**

The central bank expanded on the implications of releasing inflation forecasts, which it began publishing in the 4Q17 Quarterly Report. They emphasize that forecasts can be thought of as an “*intermediate target*”, as they “*are not an end in itself, but in taking the actions necessary to reach the forecasted level of inflation, the goal is to achieve the central bank’s target*”. Banxico argues that this helps understand the central bank’s strategy and reaction function, increases the predictability of its actions and contributes to greater transparency, credibility and accountability. Furthermore, it strengthens the transmission mechanism of monetary policy via two channels: (1) Increases public confidence in central bank actions to reach its inflation target; and (2) has an influence in inflation expectations and monetary policy going forward. On the other hand, they mention that in a sample of 28 developed and emerging economies that follow an inflation-targeting regime, all of them forecast inflation both for taking into account in their own decisions and providing regular information to the public. In this sense, the central bank has been advancing decisively in its communication strategy, which apart from benefiting the effective transmission of monetary policy through rules-based measures as opposed to discretion; it is also in the forefront in terms of best global practices.

**...and analyzes long-term trends of inflation the main inflation sub-indices.**

Banxico provides the results of an analysis of inflation using “wavelets”, a statistical technique that decomposes time-series data into deterministic functions. Under this method, monthly headline, core and non-core measures are decomposed in frequencies ranging from 2 to 8 months (high-frequency), 8 to 16 months (seasonal), 16 to 32 months (mid-term) and higher than 32 months (long-term trend). Results suggest that recent shocks to inflation have had only a transitory impact, without evidence of second-round effects in the price-formation process and with the mid- and long-term components both in headline

and core inflation exhibiting a downward trend towards the bank's inflation target. The latter is consistent with Banxico's expectation of a gradual fall in inflation. Nevertheless, the analysis also suggests that the long-term trend of non-core inflation has been persistently above the target, with the increase in gasoline and gas prices after the liberalization of these markets possibly having repercussions on a longer-term horizon.

In this sense, the central bank warns that this trend could pose a greater challenge for the fulfillment of its inflation mandate. In our view, this also suggests the possibility of a more hawkish stance in the future, particularly in the case that non-core inflation stays consistently above the target, as Banxico's goal is on the headline and not the core index.

**We maintain our view that, while the monetary authority is still open to rate hikes Banxico will not pull the trigger as we believe that the risks are contained.** We expect the reference rate to end the year at current 7.75% as we believe that inflation will converge to our 4.3% forecast by year end from current levels of 4.8%. Moreover, we still see well-behaved exchange rate amidst a highly volatile environment, with our forecast still at USD/MXN 18.60 for year-end. Nonetheless, we could not rule out another hike before year-end as we consider there are still some risks to the scenario: (1) There is a risk that Banxico will not be able to decouple from the US Fed, which maintains a hawkish bias and is expected to hike the Fed funds rate twice more in 2018, with the next one taking place at its meeting on September 26<sup>th</sup>; (2) additional negative inflation surprises, which could continue to impact short-term inflation expectations; and (3) renewed currency pressures on the back of heightened geopolitical risks, among them protectionist measures of Trump's administration.

*From our fixed income and FX strategy team*

**Mexican assets pricing in a modest hawkish tilt from Banxico.** Local rates and the peso depicted a modest reaction to Banxico's quarterly report. Investors have acknowledged two opposing forces within the central bank's assessment of current conditions: a hawkish tilt in terms of inflation compensated by a dovish bias with respect to economic growth. The yield curve is currently pricing in +18bps of implied hikes in the reference rate by year-end and only +11bps in a 12-month horizon, as Banxico will remain vigilant of the following drivers for its monetary policy (in order of importance): (1) The performance of the Mexican currency the pass-through effect on prices; (2) the relative stance of its monetary policy *vis-à-vis* the Federal Reserve; and (3) the evolution of the effect of slack of the Mexican economy. The current spread between ex-ante short-term real rates in Mexico and the U.S. suggests that Banxico has a 75bps buffer that could reduce the need to react to further rate hikes from the Federal Reserve, suggesting that the upside risks for the repo rate is limited. Taking into account this conditions in addition to the inflation dynamics for the remainder of the year (additional analysis in our note "*Fixed-Income and FX Weekly*" [pdf](#)),

released August 27<sup>th</sup>, 2018) we hold our trade idea of long positions in the CPI-linked Udibono Jun'22.

In the FX market, recent sessions have been mainly driven by trade developments in the region. The MXN is still the only EM currency with a positive balance YTD, partially supported by a carry which has compensated other risk factors in the global scene. Particularly, the peso holds a 3.7% appreciation in 2018, which compares favorably to the 11.8% sell-off of an EM currency basket within the same period. In our view, the space of MXN further appreciation is moderated, considering the recent risk premium compression as a result of trade optimism and the potential erosion of the currency's carry with a market which is still somewhat pricing a hike from Banxico, as previously discussed. In this sense, we see the USD/MXN 18.50 technical as a main short-term support, suggesting gradual USD purchases in or below this level with a valuation that is also becoming expensive when approaching these levels. Moreover, we reiterate our year-end forecast at 18.60 per dollar.

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	Reference
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<b>HOLD</b>	When the share expected performance is similar to the MEXBOL estimated performance.
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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
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional	miguel.calvo@banorte.com	(55) 1670 - 2220
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@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 Senior Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Strategist 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	Technical Analysis	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Equity Research – Conglomerates / Financials/ Mining / Petrochemicals	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research – Airlines / Airports / Cement / Infrastructure / REITs	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Francisco Duarte Alcocer	Analyst	francisco.duarte.alcocer@banorte.com	(55) 1670 - 2707
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@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	Senior, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@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