

Quarterly Report – Banxico remains *hawkish* amid a highly uncertain backdrop

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- Banxico published today its *Quarterly Report (QR)* for 1Q18
- 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 statement which was published on May 17
- We highlight two of the main sources of uncertainty and risk that might impact Banxico’s scenario in the short-term:
 - (1) The uncertainty associated with the renegotiation of NAFTA and the electoral process; and
 - (2) Episodes of high volatility in global financial markets
- In this context, with respect to growth prospects, Banxico did not modify its forecasts for 2018 (2% -3%) and also kept them unchanged between 2.2% and 3.2% for 2019
- These estimates assume that Mexico’s macroeconomic framework will remain solid, accompanied by sustainable public finances and policies that encourage investment and productivity
- Along with short-term risks, the monetary authority added three risks that could impact the scenario in the medium and long term, as well as potential growth:
 - (1) An unfavorable NAFTA renegotiation or even the treaty’s cancelation;
 - (2) Protectionist measures impacting global value chains; and
 - (3) The impact of the US fiscal reform and public insecurity in Mexico on our country’s competitiveness levels

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Document for distribution among public

Banxico’s Forecast
Recent

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

Source: Banxico

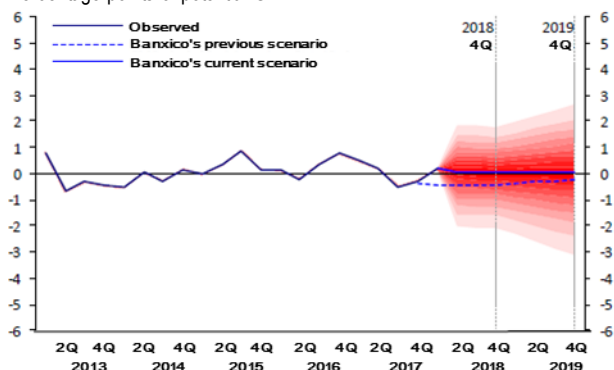
Banxico’s Forecast
Previous Quarterly Report

	2018	2019
GDP (%)	2.0 – 3.0	2.2 – 3.2
Employment (thousands)	680 –780	690 - 790
Trade Balance (bn)	-13.7 (1.1% of GDP)	-15.0 (1.2% of GDP)
Current account (bn)	-25.9 (2.1% of GDP)	-30.5 (2.3% of GDP)

Source: Banxico

Output gap

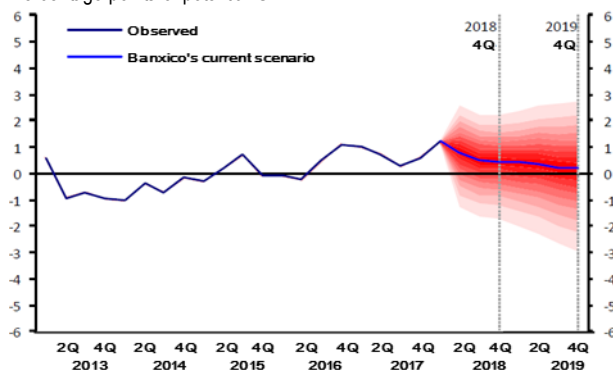
Percentage points of potential GDP



Source: Banco de Mexico; 1Q18 QIR

Output gap ex oil production

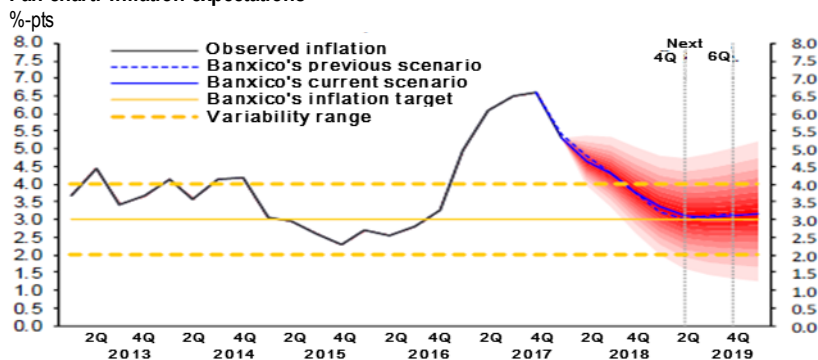
Percentage points of potential GDP



Source: Banco de Mexico; 1Q18 QIR

- **Inflation forecasts were not modified either (see tables below). Nevertheless, there were some changes within the estimates lowering core inflation levels, which would be offset by higher levels than previously expected in non-core inflation, on the back of higher energy prices**
- **Banxico's inflation outlook assumes an orderly behavior of the exchange rate, the absence of pressures from the labor market and a favorable behavior of non-core inflation**
- **However, the balance of risks continues to have a negative bias given possible:**
 - (1) **Pressures on the exchange rate;**
 - (2) **Unexpected shocks on agricultural prices;**
 - (3) **The evolution of the unit labor costs; and**
 - (4) **On the positive side, a possible appreciation of the currency in case of a favorable NAFTA renegotiation**

Fan chart: Inflation expectations



Source: Banco de Mexico; 1Q18 QIR

CPI forecasts

% y.o.y on the quarterly average

	2018				2019				2020
	I	II	III	IV	I	II	III	IV	I
CPI									
Current forecast	5.3*	4.6	4.3	3.8	3.3	3.1	3.1	3.1	3.1
Previous forecast	5.5	4.8	4.3	3.8	3.2	3.0	3.1	3.2	
Core									
Current forecast	4.3*	3.7	3.6	3.4	3.2	3.2	3.1	3.0	3.0
Previous forecast	4.4	4.0	3.8	3.6	3.3	3.2	3.1	3.0	

Source: Banco de México, 1Q18 QR; *Observed data

- The document concludes that the resilience shown by the Mexican economy in the face of recent shocks is explained by its monetary policy stance along with a solid fiscal policy
- Looking ahead, the monetary authority recommends that the structural situation of public finances should be strengthened further, along with the implementation of reforms and other actions that improve public security levels, strengthen the rule of law and foster competitiveness
- In the traditional research boxes, they included the following issues:
 - (1) The Phillips curve in a global environment;
 - (2) The recent behavior of GFI in Mexico;
 - (3) The effect of international prices on the volume of agricultural exports;
 - (4) Measurements of work sub-utilization;
 - (5) The Interbanking Electronic Payments System (SPEI);
 - (6) Information about the cyber-attacks on users of SPEI;
 - (7) Recent evolution of financial markets in Mexico; and
 - (8) Improvements in the communication of the central bank
- In this sense, the first grey box regarding SPEI explains its role as a payment system as well as key data from the platform. Moreover, the second one focuses on the attacks on market participants that use the system. In particular, the attack affected five financial institutions, with the latest attack happening on May 8
- Regarding the central bank's communications, we previously published a research note detailing the benefits of it [*"Banxico makes significant improvements to its communication strategy"* <[pdf](#)>]
- We maintain our view that Banxico will hike the reference rate by 25bps at its June meeting amid the high levels of uncertainty that prevail, particularly related to the factors mentioned by the monetary authority: the renegotiation of NAFTA, the electoral process and the geopolitical factors that maintain a high degree of volatility in global financial markets
- We also maintain our expectation that the reference rate will end the year at 7.25%

From our fixed income and FX strategy team

- Local markets depicted a modest reaction to Banxico's Quarterly Report with Mexican rates holding a 6-7bps sell-off, following the MXN which limited a 0.20% rally before the release. The latter is currently trading fairly unchanged to yesterday's close at 19.80 per dollar (-0.10%)
- In our view, the central bank remains cautious ahead of several risks that could result in higher volatility in the Mexican peso, with consequences for inflation in terms of the pass-through effect. Following today's QIR, the market is pricing-in a 16bps cumulative implicit hike for 2Q18, 28bps for 3Q18 and 32bps for 4Q18

- **As Banxico’s current assessment is consistent with our defensive strategies, we hold our trade idea of long positions in floating-rate securities with positive carry (e.g. Bondes D), while waiting for better market conditions to enter once again in Mbonos**
- **Regarding the MXN we have a similar view expecting a more volatile path for the peso in coming weeks, favoring long USD as a short-term tactical strategy. More details in our “*Fixed-Income and FX Weekly*” [<pdf>](#), published last Monday**

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