Ahead of the Curve

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Market focus this week will be on June's bi-weekly inflation report and Banxico's monetary policy decision

- **Bi-weekly inflation report (1H-Jun).** On Thursday, at 9:00am, *INEGI* will release its bi-weekly inflation report for the first half of June. We are forecasting a 0.10% 2w/2w increase in the headline index (consensus: 0.12% 2w/2w), while we expect the core index to rise 0.18% 2w/2w (consensus 0.16% 2w/2w). Inflation during the period in question will be explained by increases in the prices of goods, both processed foods and other goods. Moreover, we also expect to see an increase in the prices of other services.
- **Monetary policy decision.** On Thursday, Banxico will announce its monetary policy decision at 3:00pm (EDT), where we expect a 25bps rate hike. Thus, the new reference rate will stand at 7%. We believe that the key variables for Banxico will be: (1) The Fed's 25bps hike; (2) the recent upward trend in inflation, as a result of the increase of gasoline prices and the pass-through effect of the depreciation of the Mexican currency to prices; and (3) the absence of slack in the labor market and the lower probability of a tail-risk event to materialize in the Mexican economy.

Mexico weekly calendar

DATE	TIME (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Tue 20-Jun	9:00am	**Aggregate Demand**	1Q17	% yoy	2.2	2.6	1.9
		Private consumption		% yoy	3.0	--	2.8
		Government consumption		% yoy	-0.8	--	1.6
		Gross-fixed investment		% yoy	0.0	--	1.0
Tue 20-Jun	10:00am	**International reserves**	16-Jun	US$ bn	--	--	174.6
Tue 20-Jun	12:30pm	**Government weekly auction: 1-, 3-, 6-, 12-month CETES; 30y Mbono (Nov'47); 30y Udibonos (Nov'46); 5y Bondes D**					
Tue 20-Jun	3:30pm	**Citibanamex bi-weekly survey of economic expectations**					
Thu 22-Jun	9:00am	**CPI inflation**	1Q Jun	% 2w/2w	0.10	0.12	0.17
				% yoy	6.25	6.25	6.16
		Core		% 2w/2w	0.18	0.16	0.17
				% yoy	4.83	--	4.78
Thu 22-Jun	2:00pm	**Banxico's monetary policy decision**	June	%	7.00	7.00	6.75
Fri 23-Jun	9:00am	**Retail sales**	April	% yoy	1.5	2.0	6.1
		sa		% m/m	0.8	--	-1.3

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

We estimate a 2.2% yoy expansion in aggregate demand during 1Q17. On Tuesday at 10:00am (EDT), *INEGI* will publish its aggregate supply and demand report, where we believe aggregate demand increased 2.2% yoy in the first quarter of the year vs. the 1.9% yoy expansion observed in the previous quarter. Taking a look at the breakdown, we expect a 3% yoy increase in private consumption, while we estimate a null expansion for gross fixed investment. Moreover, we believe that government spending will likely show a 0.8% yoy contraction, given the fiscal cuts implemented by the federal government.

Weekly international reserves report. On Tuesday, at 10:00am (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves decreased by US$117 million amounting to US$174.6 billion. According to Banxico's report, this figure comes mainly as a result of: (1) US$63 million dollar sales from Banxico to the Federal Government; and (2) a negative revalorization in central bank assets amounting to US$54 million. In this context, the Central Bank's international reserves have diminished by US$2 billion this year (please refer to the table below).

Banxico's foreign reserve accumulation detail
US$, million

	2016	Jun 9, 2017	Jun 9, 2017	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	176,542	174,577	-117	-1,965
(B) Gross international reserve	178,025	175,806	-269	-2,219
Pemex	--	--	-23	-734
Federal government	--	--	-376	-1,268
Market operations	--	--	0	-2,000
Other	--	--	130	1,783
(C) Short-term government's liabilities	1,483	1,229	-152	-254

Source: Banco de México

Weekly government bond auction. On Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent-, will offer 30-year fixed-rate Mbonos (Nov'47), 30-year inflation linked Udibonos (Nov'46), 5-year Bondes D, in addition to the "more traditional" 1-, 3-, 6-, and 12-month zero-coupon Cetes (please refer to the table below). As usual, the results will be released at 12:30pm (EDT).

Auction specifics (Tuesday, May 30, 2017)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	20-Jul-17	- -	7,000	6.79
3m	21-Sep-17	- -	11,000	7.06
6m	21-Dec-17	- -	11,500	7.21
12m	21-Jun-17	- -	12,500	7.23
Bondes D				
5y	12-May-22	- -	4,500	0.20
M Bono				
30y	07-Nov-47	8.00	3,000	7.61
Udibonos				
30y	08-Nov-46	4.00	400	3.78

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

***Citibanamex* Survey: Market participants will focus on inflation and monetary policy forecasts.** Also on Tuesday around 3:30pm (EDT) *Citibanamex* will release its bi-weekly survey of economic expectations, where market participants will focus on analysts' monetary policy assessments given Banxico's monetary policy meeting on Thrusday. In this regard, we believe that the central bank will increase the reference rate by 75bps within three meetings throughout the remainder of the year (25bps hike in each of the meetings). Of these, the next 25bps hike will take place in Thursday's monetary policy meeting. In this regard, in the last *Citbanamex* survey all but two analysts were also discounting a 25bps hike in June.

Furthermore, analysts will also focus on the inflation forecasts for the first half of June (to be published also on Thursday), as well as on CPI estimations for 2017. In addition, *Citibanamex* will also publish consensus' growth and FX forecasts for 2017. In the first case, we do not expect strong revisions to the median GDP forecast. In the second case, we expect stronger downward revisions to the FX estimates for 2017.

Inflation during the first half of June will be explained by increases in goods prices. On Thursday, at 9:00am, *INEGI* will release its bi-weekly inflation report for the first half of June. We are forecasting a 0.10% 2w/2w increase in the headline index (consensus: 0.12% 2w/2w), while we expect the core index to rise 0.18% 2w/2w (consensus 0.16% 2w/2w).

Inflation during the period in question will be explained by increases in the prices of goods, both processed foods and other goods. Moreover, we also anticipate seeing an increase in the prices of other services.

We forecast inflation to be 8bp higher than the observed in same period last year, derived from: (1) 6.2bp from a higher contribution of meat and egg prices (1.5bp vs. -4.3bp in 2016); (2) 5.4bp derived from a higher contribution of fresh fruits and vegetables prices (-4bp vs. -9.4bp in 2016); (3) 6.3bp stemming from a lower contribution of energy prices (-2.2bp vs. 4.1bp in 2016); (4) 0.8bp coming from a higher impact of other government tariffs (1bp vs. 0.2bp in 2016); and (5) 0.8bp derived from a higher contribution of services prices (6.1bp vs. 5.2bp in 2016), as shown in the table below.

With these results, annual inflation will stand at 6.24% in the first half of June, (previous: 6.16% yoy), while core inflation will be at 4.83% (previous: 4.78% yoy). Moving forward, we will be attentive to the evolution of energy prices and the behavior of the exchange rate, as well as the impact they might have on the price formation dynamic.

1H-June inflation by components
% bi-weekly incidence

	2017 F	2016	Difference
Headline	0.10	0.02	0.08
Core	0.14	0.12	0.01
Goods	0.08	0.07	0.00
Processed foods	0.04	0.04	0.00
Other goods	0.04	0.04	0.00
Services	0.06	0.05	0.01
Housing	0.02	0.02	0.00
Education	0.00	0.00	0.00
Other services	0.04	0.03	0.01
Non-core	-0.04	-0.10	0.06
Agricultural	-0.03	-0.14	0.12
Fresh fruits and vegetables	-0.04	-0.09	0.05
Meat and egg	0.02	-0.05	0.06
Energy and government regulated	-0.01	0.04	-0.06
Energy	-0.02	0.04	-0.06
Government regulated	0.01	0.00	0.01

Source: Banorte-Ixe, INEGI

We expect a 25bps hike in Banxico's reference rate. On Thursday, Banxico will announce its monetary policy decision at 3:00pm (EDT), where we expect a 25bps rate hike. Thus, the new reference rate will stand at 7%. We believe that the key variables for Banxico will be: (1) The Fed's 25bps hike; (2) the recent upward trend in inflation as a result of the increase of gasoline prices and the pass-through effect of the depreciation of the Mexican currency; and (3) the absence of slack in the labor market and the lower probability of a tail-risk event to materialize in the Mexican economy.

In the first case, we believe that an increase in the U.S. reference rate is a sufficient condition to trigger a rate hike in Mexico, given that the holdings of foreign investors in the short-end of the curve are elevated. In this regard, given that Mexico continues to be a small and open economy, Banxico does not manage the reference rate in absolute terms, but -given the global influence of the U.S. monetary policy- it only sets the spread between Mexico's rate and the U.S. *Fed funds* rate. Thus, after the Fed's 25bps hike, almost independently of Mexico's economic cycle and inflation, Banco de Mexico "*will have to maintain*" the differential between the interest rates in both countries.

In the second case, Banxico will also justify the 25bps hike in order to limit the inflationary impact as a result of the simultaneity and magnitude of the temporary shocks that inflation has been experiencing generated by the increase in gasoline prices and the changes in relative prices of goods with respect to services, as a result of the pass-through effect of the depreciation of the Mexican currency. Nevertheless, the Board of Governors will emphasize that the medium and long term inflation expectations have remained relatively stable, although they will acknowledge that during 2017 inflation will be considerably above the upper limit of the range of variation of the Bank of Mexico. They will also highlight that it is anticipated that in 2018 inflation will resume a path of convergence towards the 3% target.

Banxico's Board will highlight that the Mexican economy has continued to grow, although they will acknowledge the contraction of private investment. In addition, Banxico will also mention that there seems to be no slack in the labor market, which could foster addition inflationary pressures. Moreover, the central bank will probably state that although the risk balance for the Mexican economy has remained unchanged, there is a perception that the probability of tail risks materializing has diminished.

Regarding financial conditions, it is likely, that the central bank will mention that domestic markets improved, highlighting the significant appreciation of the Mexican currency in the face of a reduction in volatility. Regarding the spread of rates between Mexico and the US, the monetary authority commented that it remained relatively stable. However, the central bank will also highlight that uncertainty in the external environment prevails and they cannot rule out additional depreciations and/or increases in the volatility of the Mexican currency.

The Mexican currency has experienced a significant appreciation in recent months as a result of the following factors: (1) The generalized depreciation of the dollar, given the impossibility of Trump's administration to pass the set of reforms proposed during his electoral campaign; (2) the moderate increase of the oil price; and (3) the outcome of the elections that took place in the State of Mexico. However, we believe that the risk of higher volatility in the Mexican currency persists, so we can't rule out abrupt movements of the MXN as a result of unanticipated events, particularly with regard to geopolitical issues, both external and domestic. In addition, we expect the Fed to raise the Fed funds range by at least 25bp in the remainder of 2017. As a result, after June's meeting we continue to expect further increases in the reference rate by 50bps throughout the remainder of the year to finalize in 7.5%.

Retail sales will post a 1.5% yoy expansion in April. On Friday at 9:00am (EDT), *INEGI* will publish its retail sales report for April, where we anticipate a scant 1.5% yoy expansion, below the 6.1% observed in April.

We believe that the moderate growth in retail sales growth will be explained by the 3.3% contraction in vehicle sales during April, and the 7.2% reduction in non-oil consumption goods. However, the 3.2% yoy growth in *ANTAD* total store sales will overcompensate for the fall in vehicle sales.

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