

Ahead of the Curve

Lower growth and a faster convergence of inflation to target in Banxico's Quarterly Report

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▪ **Banxico's Quarterly Report (QR) and monetary policy minutes.** In the QR, we expect the central bank to reduce its 2019 GDP forecast by 60bps, to 0.2-1.2% yoy (mid-point: 0.7%, Banorte: 0.8%). For 2020 a downgrade is also very likely, estimated to subtract between 40-50bps towards a mid-point of 1.6-1.7% (Banorte: 1.4%). We also see an important decrease in forecasts for formal job creation and the current account deficit. On the other hand, we anticipate Banxico's forecasts for headline inflation in 2019 and 2020 to be lowered, with the estimate for convergence to the 3% target brought forward by one quarter, to 2Q20. In the minutes, it will be important to analyze the discussion about the risks going forward, along the reasons and identity of the Board member who dissented in favor of leaving the reference rate unchanged. In our view, there are still some concerns in two main fronts: (1) The resistance to the downside of core inflation; and (2) financial stability risks and the outlook for public finances. In conclusion, we expect the central bank to reiterate its recent shift to a more dovish stance. Recent developments on growth and inflation provide additional support to our call that Banxico will cut the reference rate two more times this year, each by 25bps, in September and December. As a result, the reference rate would end this year at 7.50%. For 2020, we continue expecting additional cuts between 50 and 75bps, within an easing cycle that we have previously argued could total 125-200bps

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Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 27-Aug	7:00am	Trade balance	July	US\$ mn	-511.9	-466.0	2,561.0
		Total exports		% yoy	4.7	--	1.2
		Oil exports		% yoy	-16.6	--	-20.4
		Non-oil exports		% yoy	6.3	--	2.8
		Total imports		% yoy	-1.6	--	-7.8
Tue 27-Aug	7:00am	Unemployment rate	July	%	3.70	3.68	3.57
		sa		%	3.57	--	3.54
Tue 27-Aug	10:00am	International reserves	Aug-27	US\$ bn	--	--	180.2
Tue 27-Aug	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 30y Mbono (Nov'47); 5y Bondes D					
Wed 28-Aug	1:00pm	Banxico's Quarterly Report					
Thu 29-Aug	10:00am	Banxico's Minutes					
Fri 30-Aug	10:00am	Comercial banking credit	July	% yoy	4.4	--	4.3
		Consumption		% yoy	2.2	--	2.1
		Housing		% yoy	6.3	--	6.4
		Non-banking private firms		% yoy	4.7	--	4.5
Fri 30-Aug	4:00pm	Budget balance	July	MXN bn	--	--	-60.9

Source: Banorte; Bloomberg

Proceeding in chronological order...

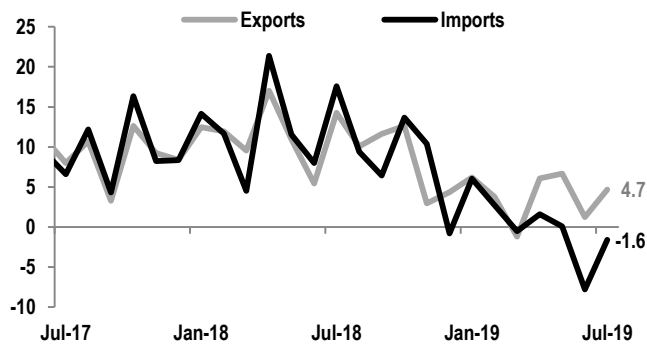
Trade balance will likely show a modest deficit in July. We expect a US\$511.9 million deficit, which would break with five consecutive months with a surplus –with June at a record high of +US\$ 2,561.0 million–. We expect some reversal of the previous month figure, especially in the non-oil balance due to some normalization higher in non-oil intermediate and capital goods imports. The latter would be aided at least to some extent by the relative strength and stability of the Mexican peso.

We expect a US\$ 2,024.9 million deficit in the oil balance, above the –US\$ 1,831.8 million of June. Oil-related exports would contract 16.6% yoy, impacted by a 15.9% decline in crude. This would be a result of a decline of 11.1% in the price of the Mexican oil mix, with an average price of 58.99 US\$/bbl, along a double-digit decline in volumes. In imports, we anticipate a 14.5% yoy contraction. US gasoline prices were higher sequentially but still 9.6% lower than the same month of 2018; meanwhile, available data suggests a steeper fall in volumes due to unusually high imports last year. Intermediate-goods are estimated to fall 14.8%. As a result, the 12-month rolling balance would remain deeply negative at US\$ 23,291.3 million from US\$ 21,373.7 million in the same period of the previous year.

The non-oil balance would fall from a historically-high surplus of +US\$ 4,392.8 million in the previous print, to a more modest +US\$ 1,513.0 million. This would be driven by a 0.2% expansion in imports (previous: -6.3%), which would be the first positive print in two months. We highlight our estimate of +1.3% in intermediate goods, closely linked to manufacturing, with consumption around 4.5%, breaking with four consecutive months in contraction. Capital goods would remain weak at -10.5%, albeit improving significantly relative to the -21.2% observed in June. It should be noted that the “adequate moment to invest” component within business confidence remains pressured, with all sectors declining to new year-to-date lows. More positively, advanced data suggests a better performance in manufacturing exports, expected at 6.6%. This would be supported by the acceleration in US industrial production and higher dynamism in autos, with stronger exports according to AMIA at 9.5% from only 1.7% in the previous month.

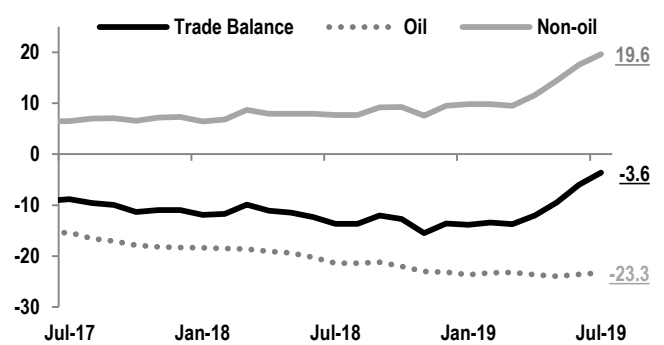
It is our take that a modest deficit, driven by higher non-oil imports, would be a positive sign for activity at the start of 3Q19, more so if accompanied by higher manufacturing exports. On the other hand, capital goods imports will remain limited as confidence has stayed low, with the possibility of improving only gradually by the end of the year as the government increases investment outlays and the outlook for the private sector gets better.

Exports and Imports
% yoy



Source: INEGI, Banorte

Trade balance
US\$ billion, 12-month rolling sum

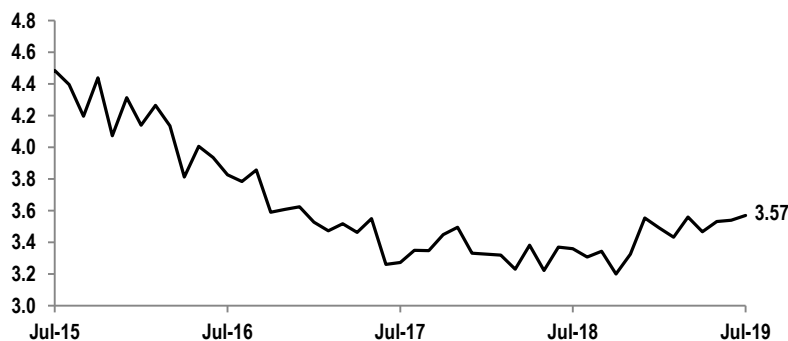


Source: INEGI, Banorte

We expect an additional uptick in the unemployment rate in July. We estimate the unemployment rate at 3.57% sa, slightly above the 3.54% of the previous month. If this is the case, it would be its third consecutive increase. In this context, the annual pace of formal job creation decelerated further, standing at 2.2%, below the 2.4% of the previous two months and a new low since 1Q10. This was a result of a net creation of 16,713 jobs, lowest for July since 2013. Year-to-date, job creation stands at 306,014, while the rolling 12-month sum totals 436,135. On a timelier basis, PMIs for July (which are compiled by *IMEF* in the 2nd half of the reference month) showed employment sub-indices still in contraction, with mixed signals between subsectors as manufacturing worsened while non-manufacturing improved. The Mexican peso gained 1.1% m/m and remained relatively strong in the period, a situation we believe could be having an impact on export-oriented industries. In this respect, business confidence in manufacturing has declined during the last four months, in our view a reflection of low appetite for adding new investment and labor.

Regarding economic activity, June's monthly GDP proxy (IGAE) showed a 0.2% expansion in the monthly comparison, which was not enough to curb the decelerating trend of recent months. Besides, we still believe it is likely that above-average wage increases are impacting formal job creation, inducing a shift to informality. Business confidence was again lower across all sectors, which we expect will continue impacting hiring decisions among businesses.

Unemployment rate
%, sa



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves increased by US\$428 million, closing at US\$180.2 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 US\$5.5 billion during 2019 (please refer to the following table).

Banxico's foreign reserve accumulation detail
US\$, million

	2018	Aug 16, 2019	Aug 16, 2019	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	174,793	180,243	428	5,450
(B) Gross international reserve	176,384	189,026	455	12,642
Pemex	--	--	-270	99
Federal government	--	--	303	7,339
Market operations	--	--	0	0
Other	--	--	421	5,204
(C) Short-term government's liabilities	1,592	8,783	26	7,191

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 30-year fixed-rate Mbonos (Nov'47), 5-year Bondes D, in addition to the 1-, 3-, and 6-month zero-coupon Cetes (see following table). As usual, results will be released at 12:30pm (ET).

Auction specifics (Tuesday, August 27th, 2019)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	26-Sep-19	--	6,000	7.96
3m	28-Nov-19	--	9,000	7.89
6m	27-Feb-20	--	13,000	7.78
Bondes D				
5y	22-Aug-24	--	6,500	0.14
Mbonos				
30y	07-Nov-47	8.00	5,000	8.09

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's Quarterly Report and minutes will reaffirm a dovish bias. The week will be busy for the central bank, with the *Quarterly Report* (QR) for 2Q19 on Wednesday at 1:00pm (ET), accompanied by a press conference led by Governor Diaz de Leon, and the minutes of its latest monetary policy meeting –which took place on August 15th–, on Thursday at 10:00am (ET). We expect both the QR and minutes to reaffirm the dovish bias perceived in the latest communique, which prompted us to expect a lower path for the reference rate by year-end, ending at 7.50%. This would be a result of two additional 25bps cuts, in September and December. Regarding the QR, we will focus on:

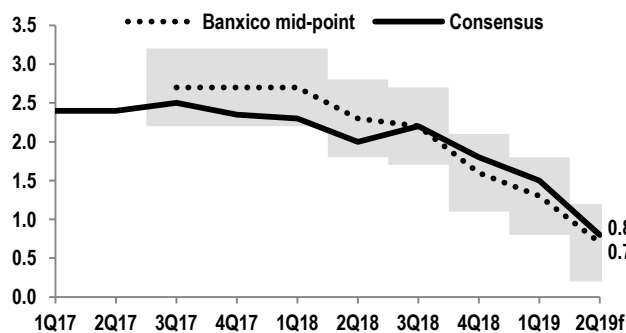
(1) *Lower growth expectations.* We expect the central bank to reduce its 2019 GDP forecast for a fifth consecutive time and significantly, down 60bps to 0.2-1.2% yoy (mid-point: 0.7%), slightly below our estimate and consensus (see chart below, left). For 2020 a downgrade is also very likely, estimated to subtract between 40-50bps towards a mid-point of 1.6-1.7%, slightly above our 1.4%. In this respect, we should mention that the final print of 2Q19 GDP was revised lower both in annual terms (to -0.8% from -0.7% in the preliminary estimate) and relative to the previous quarter (0.0% from 0.1%).

In the 1Q19 QR, Banxico said the revision was mainly due to transitory shocks and industrial production weakness. Some of the risks to the downside included global trade tensions, geopolitical events, high uncertainty impacting investment decisions, and USMCA approval. In our view some of these have materialized, particularly on trade between the US and China, leading to a downward revision in global growth expectations.

We believe the likely reduction in 2019 GDP will be justified by the deceleration in domestic demand –as portrayed by recent private consumption and services figures– and higher-than-usual drag from public spending in the first year of a new administration. In this respect, we expect consumption to slow to 1.4% yoy (from 2.2% in 2018), with government spending contracting 0.4%. This adjustment would also have an impact in terms of: (1) Lower formal job creation, currently at 530-630k (mid-point: 580k); and (2) a more modest current account deficit than Banxico’s US\$ 24.3 billion (1.9% of GDP), driven by a higher trade balance. The latter reached a US\$ 3.1 billion surplus during 1H19 (compared to US\$ 4.5 billion deficit in 1H18), while the latest forecast is of a full-year deficit of US\$ 13.5 billion (1% of GDP). We will also look for comments about the impact of lower growth in terms of a widening output gap, with our estimate at -0.8% of potential GDP using the monthly-proxy IGAE up to June (chart below, right).

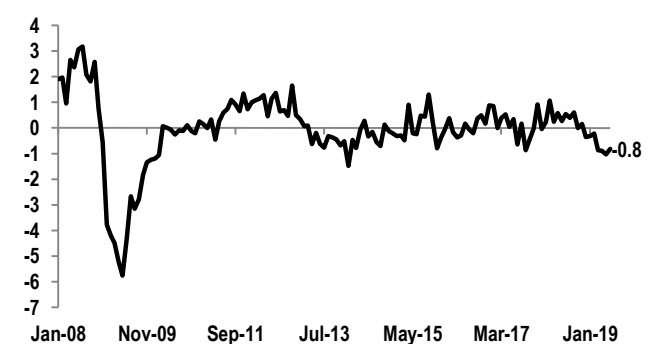
Growth forecasts for 2019

% yoy, nsa



Output gap

% of potential GDP



*Note: Market consensus corresponds to the median in Banxico’s survey at the time of publication of the QR. Shaded area represents Banxico’s forecast range
Source: Banxico

Source: Banorte with data from INEGI

(2) *Faster than expected convergence of inflation to target.* In our view, one of the most relevant pieces of information in the latest communique was that one of the driving forces behind the decision to cut was: “...that headline inflation decreased, as foreseen by Banco de México...”. It is our take that the QR will reaffirm our opinion that the central bank shows a more comfortable stance about inflation. Average headline inflation in 2Q19 was 10bps below the forecast, while core inflation was just in line at 3.8% yoy. Furthermore, the former plunged to 3.3% in the 1st half of August, while the latter remained broadly unchanged. We believe Banxico’s forecasts for headline inflation in 2019 and 2020 will be lowered (see tables below), with the estimate for convergence to the 3% target brought forward by one quarter, to 2Q20 from 3Q20 previously.

Banxico's headline inflation forecasts

% yoy, quarterly average

QR	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21
Nov-17 (3Q17)	4.6	4.1	3.6	3.0	3.1	3.3	3.1	3.0					
Feb-18 (4Q17)	5.5	4.8	4.3	3.8	3.2	3.0	3.1	3.2					
May-18 (1Q18)	5.3	4.6	4.3	3.8	3.3	3.1	3.1	3.1	3.1				
Aug-18 (2Q18)		4.6	4.8	4.2	3.8	3.6	3.2	3.3	3.2	3.1			
Nov-18 (3Q18)			4.9	4.7	4.4	4.4	3.8	3.4	3.3	3.1	3.0		
Feb-19 (4Q18)				4.8	4.1	4.3	3.8	3.4	3.5	3.1	2.8	2.7	
May-19 (1Q19)					4.1	4.3	4.0	3.7	3.8	3.2	3.1	3.0	3.0
Aug-19 (2Q19)						4.2	--	--	--	--	--	--	--

*Note: Shaded numbers indicate actual data

Source: Banxico, INEGI

Banxico's core inflation forecasts

% yoy, quarterly average

QR	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21
Nov-17 (3Q17)	4.2	3.9	3.6	3.6	3.3	3.2	3.1	3.1					
Feb-18 (4Q17)	4.4	4.0	3.8	3.6	3.3	3.2	3.1	3.0					
May-18 (1Q18)	4.3	3.7	3.6	3.4	3.2	3.2	3.1	3.0	3.0				
Aug-18 (2Q18)		3.7	3.6	3.5	3.3	3.2	3.0	2.9	3.0	2.9			
Nov-18 (3Q18)			3.6	3.7	3.6	3.6	3.4	3.1	3.0	2.9	2.7		
Feb-19 (4Q18)				3.7	3.5	3.6	3.4	3.2	3.2	2.9	2.8	2.7	
May-19 (1Q19)					3.6	3.8	3.6	3.4	3.4	3.0	3.0	3.0	3.0
Aug-19 (2Q19)						3.8	--	--	--	--	--	--	--

*Note: Shaded numbers indicate actual data

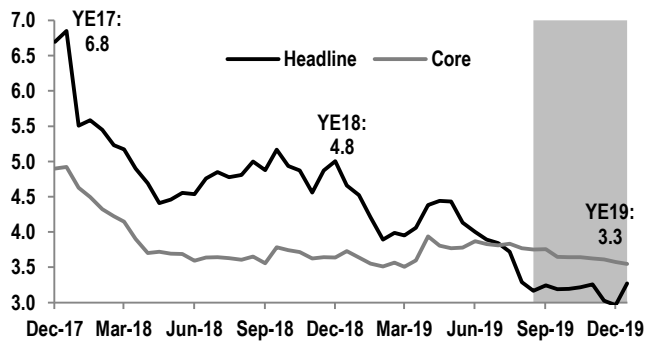
Source: Banxico, INEGI

We expect inflation to inch lower in coming months, supported by the fall in the non-core component. As a result, we now see year-end inflation at 3.3% from 3.5% previously [<pdf>](#), still below consensus at 3.6% (chart below, left). In a speech at *Banorte's Annual Forum*, Governor Alejandro Díaz de León, stressed several mitigating factors for prices, such as the decline in global commodity prices, the effects of the output gap, and the low rate environment worldwide. Moreover, the communique added other factors, such as lower pass-through from energy.

In this respect, we believe fiscal subsidies will continue and the commitment of the federal government of maintaining energy prices constant in real terms will be maintained. This is the key driver behind our more benign outlook for inflation relative to the market, a situation that is materializing even more strongly than we anticipated. Since the start of the new government, low-grade gasoline accumulates a 0.8% decline, while headline inflation has been +1.1%, resulting in a 2% gap so far (see chart below, right). Even if subsidies are gradually reduced –as has been the case in recent weeks– and the Mexican peso depreciates by year-end (as we already anticipate), we expect pressures to remain limited, with low global demand pressures for crude-oil on the back of more modest growth, among other factors.

Inflation forecasts

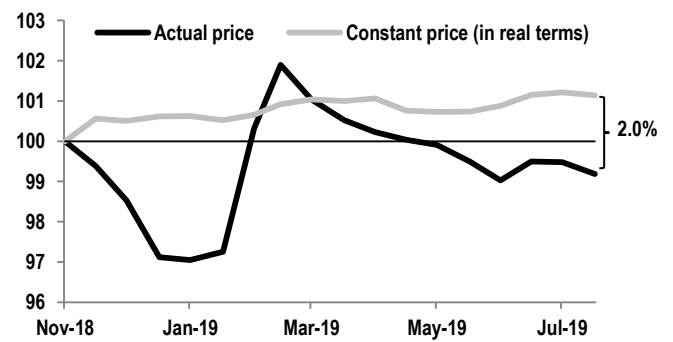
% yoy, bi-weekly frequency



Source: Banorte with data from INEGI

Low-grade gasoline prices

Index 100 = 2H-Nov, 2018



Source: Banorte with data from INEGI

With the release of the QR one day before, the minutes will likely lose some relevance. Nevertheless, it will be important to analyze the discussion about the risks going forward, along the reasons and identity of the Board member who dissented in favor of leaving the reference rate unchanged.

In our view, there are still some concerns in two main fronts. First, we noted that the resistance to the downside of the core component was placed first among the upward risks for inflation, more relevant than the next-to-last place in the previous decision. This will remain a key concern as the pace of wage negotiations so far this year remains elevated, while the minimum wage could be increased again in 2020. Second, it is our take that some members are still concerned about financial stability risks and the outlook for public finances. Banxico reiterated that it is necessary to address the deterioration of both the sovereign's and Pemex's credit rating, and achieving fiscal targets for 2019. In this respect, they made some adjustments to the language, from the risk "...that public finances deteriorate..." to "...weak public finances...", which we believe could be in response to a more difficult environment for tax collection due to lower growth. In particular, they added that: "...It is also important that the Economic Package for 2020 generates confidence...", while Moody's recently stated that there is a higher risk that the Federal Government does not achieve its primary surplus goal for 2019 (1% of GDP). Although these risks have increased, more so as they could impact Pemex's rating to be downgraded below investment grade, it is our base-case that the government will remain committed to sound fiscal accounts, with adjustments along the way in terms of spending in case of lower tax collection.

In conclusion, we expect the central bank to reiterate its recent shift towards a more dovish stance. We think recent developments on growth and inflation provide an additional support to our call that Banxico will cut the reference rate two more times this year, each by 25bps, in September and December, As a result, the reference rate would end this year at 7.50%. For 2020, we continue expecting additional cuts between 50 and 75bps, within an easing cycle that we have previously argued could total 125-200bps.

Banking credit will show a 4.4% yoy increase in July. It is our take that credit to the non-financial sector keeps flowing. We estimate a 4.4% yoy expansion in real terms, higher than the 4.3% growth of the previous month. This would be driven by a 2.0% increase in consumer credit, coupled with a 6.1% and 5.4% expansion in mortgages and corporate credit, in the same order. Part of the pickup would be explained by better inflation dynamics, which help when calculating the year-over-year comparison in annual terms.

MoF's public finance report (July). In this report, attention will center on the public balance as well as on PSBRs, which between January and July accumulated a MXN\$60.9bn deficit. It should be noted that the public deficit at the end of June stood at MXN\$119.9bn, better than the MXN\$258.9bn forecasted deficit. In addition, focus will be on revenues and spending, especially when compared to the MoF's updated *2020 Macroeconomic Forecasts*. Finally, we will also look into public debt, which as of June stands at MXN\$10.6tn, equivalent to 42.5% of GDP (as measured by the HBPSBRs).

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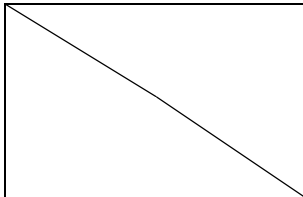
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	Reference
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