

# Ahead of the Curve

December 18, 2015

Market focus this week will on INEGI's bi-weekly inflation report

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- Bi-weekly inflation report.** On Wednesday, at 9:00am, *INEGI* will release its bi-weekly inflation report. We are forecasting a 0.21% 2w/2w increase in the first half of December. In the core index, we expect an increase of 0.27% 2w/2w. Inflation during the period in question will be explained by pressures on services prices along with higher merchandise prices. With these results, annual inflation is at 2% yoy in the first half of December from 2.21%, while core inflation is at 2.39% from 2.34% yoy

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**Mexico weekly calendar**

DATE	HOURL (EST)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Mon 21-Dec	9:00am	Retail sales	October	% yoy	<u>5.8</u>	<u>5.7</u>	4.9
Tue 22-Dec	10:00am	International reserves	18-Dec	US\$ bn	--	--	172.3
Tue 22-Dec	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 30y Mbono (Nov'42); 5y Bondes D					
Wed 23-Dec	9:00am	Global economic indicator	October	% yoy	<u>2.0</u>	<u>2.0</u>	3.1
		(sa)		% m/m	<u>-0.5</u>	--	-0.2
		Primary activities		% yoy	<u>8.1</u>	--	9.6
		Industrial production		% yoy	<u>0.5</u>	--	1.7
		Services		% yoy	<u>2.6</u>	--	3.7
Wed 23-Dec	9:00am	CPI inflation	1Q Dec	% 2w/2w	<u>0.21</u>	<u>0.25</u>	-0.06
				% yoy	<u>2.00</u>	<u>2.04</u>	2.16
		Core		% 2w/2w	<u>0.27</u>	<u>0.24</u>	-0.02
				% yoy	<u>2.39</u>	--	2.34
Thu 24-Dec	9:00am	Trade balance	November	US\$ mn	<u>-2,700.3</u>	<u>-2,152</u>	-1,443.9
		Total exports		% yoy	<u>-4.5</u>	--	-7.4
		Oil exports		% yoy	<u>-52.4</u>	--	-41.5
		Non-oil exports		% yoy	<u>0.7</u>	--	-4.1
		Total imports		% yoy	<u>0.6</u>	--	-3.6
Thu 24-Dec	9:00am	Unemployment rate	November	%	<u>4.3</u>	<u>4.3</u>	4.55
Fri 25-Dec		Banking holiday: Christmas					
Tue 29-Dec	10:00am	International reserves	25-Dec	US\$ bn	--	--	--
Tue 29-Dec	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 5y Mbono (Jun'21); 10y Udibonos (Dec'25)					
Wed 30-Dec	3:30pm	Budget balance (year to date)	November	MXN bn	--	--	-490.5
Thu 31-Dec	10:00am	Comercial banking credit	November	% yoy	<u>10.3</u>	--	10.6
		Consumption		% yoy	<u>6.9</u>	--	6.5
		Housing		% yoy	<u>9.8</u>	--	10.5
		Firms		% yoy	<u>13.9</u>	--	13.5
Thu 31-Dec	10:00am	Banxico's minutes of December 17 meeting					
Fri 1-Jan		Banking holiday: New year					

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

**Banking holiday on Friday December 25<sup>th</sup> and January 1<sup>st</sup>.** On the logistics side, and before we start with our estimates description, we highlight that financial institutions will be closed given Christmas and New Year's holidays.

**Retail sales will post a 5.8% yoy expansion in October.** On Monday (December 21) at 9:00am (EST), *INEGI* will publish its retail sales report for October 2015. We anticipate a 5.8% yoy expansion explained by the 18.8% yoy growth in vehicle sales (*AMIA*), which will have a positive impact on the overall growth rate. Moreover, *ANTAD* total store sales increased 10.4% yoy in real terms during the period in question. However, consumption goods imports -which have a strong correlation with retail sales- posted a scant 0.5% yoy expansion, which could limit October's growth rate.

Looking ahead, we believe that retail sales performance will show a visible recovery in the last quarter of the year. In particular, private consumption in Mexico will show better growth prospects derived from: (1) An improvement in consumer's expectations regarding economic growth; (2) the recent downward trend in inflation; and (3) the stronger growth dynamics in the Mexican labor market.

**Weekly international reserves report.** On Tuesday, at 10:00am (EST), Banco de Mexico will release its weekly balance report. Last week, net international reserves increased by US\$370mn amounting to US \$172.3bn on December 11. According to Banxico's report, this figure comes mainly as a result of: (1) Dollar sales by the Federal Government to the Central Bank for US\$1,447mn, partially derived from the oil coverage revenues that the federal government received on December; (2) US\$600mn decrease explained by the introduction of Banxico's USD ordinary auction with minimum price and US\$400mn by the supplementary auction also with minimum price; along with a (3) US\$77mn decrease due to changes in the valuation of the Central Bank's assets. It is worth noting that Pemex is currently the only significant source of reserve accumulation. In this context, the central bank has an accumulated reduction of US\$20,914mn international reserves this year (please refer to the table below).

**Banxico's foreign reserve accumulation details**

US\$, million

	2014	11/Dec/2015	11/Dec/2015	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	193,239	172,325	370	-20,914
(B) Gross international reserve	195,682	179,279	6,534	-16,403
Pemex	--	--	674	3,588
Federal govt	--	--	6,335	4,787
Market operations	--	--	-400	-23,805
Other	--	--	-75	-973
(C) Short-term government's liabilities	2,443	6,954	6,164	4,511

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 1:30pm (EST).

**Auction specifics (Tuesday, December 22, 2015)**

	Maturity	Coupon rate, %	To be auctioned <sup>1</sup>	Previous yield <sup>2</sup>
<b>Cetes</b>				
1m	21-Jan-16	--	5,500	3.20
3m	23-Mar-16	--	9,500	3.28
6m	23-Jun-16	--	11,000	3.50
<b>Mbono</b>				
30y	13-Nov-42	7.75	2,500	6.89
<b>Bondes D</b>				
5y	26-Nov-20	--	5,000	0.24

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

**We expect a 2% yoy expansion in October’s IGAE.** On Wednesday, at 9:00am (EST), *INEGI* will release its monthly global economic indicator for October (GDP monthly proxy), where we expect a 2% yoy expansion. We believe that IGAE’s growth during the tenth month of 2015 was driven by the performance of the service sector, which we forecast at 2.6% yoy. Similarly, we highlight that industrial production increased a scant 0.5% yoy.

As we had mentioned in our last IP report, the 0.5% yoy expansion in industrial production during October was explained in part by the 1.2% yoy growth in manufacturing output. In this regard, despite the meager growth in manufacturing output during October, we believe that the recovery of this industry is on the way, and will strengthen in the first quarter of 2016 given that the significant depreciation of the Mexican currency could trigger a higher growth in Mexico’s manufacturing exports. In this regard, we believe that the recovery of both manufacturing and construction industries will continue in 1Q16. However, IP’s headline figure was also affected by the current recession in the mining industry –derived from the significant contraction in Mexico’s oil production–.

We also believe that the 2.6% yoy estimated expansion in services will be explained by the recovery in private consumption. In this regard, *ANTAD*’s retail sales report showed that consumers’ spending is gaining momentum, whereas formal job creation has observed a significant recovery in the last 5 months.

**Inflation in the first half of December will be explained by pressures on the price of services along with higher prices of goods.** On Wednesday, at 9:00am, *INEGI* will release its bi-weekly inflation report. We are forecasting a 0.21% 2w/2w increase in the first half of December. In the core index, we expect an increase of 0.27% 2w/2w. Inflation during the period in question will be explained by pressures on services prices along with higher merchandise prices.

Nevertheless, we expect this figure to be 20.9bps lower than the observed in same period last year, derived from: (1) 2.3bps stemming from a higher contribution of merchandise prices (9.2bps vs. 6.9 in 2014); (2) 2bps stemming from a higher contribution of services prices (10.8bps vs. 8.7 in 2014). By contrast, we expect (3) a lower contribution agriculture prices (5.5bps vs. 22.4 in 2014) and (4) -8.7bps stemming from a lower contribution of energy prices (-5.6bps vs. 3.1 in 2014), as shown in the table below.

With these results, annual inflation is at 2% yoy in the first half of December from 2.21%, while core inflation is at 2.39% from 2.34% yoy.

#### 1H-December inflation by components

% bi-weekly incidence

	Banorte-Ixe	2014	Difference
Total	0.21	0.41	-0.21
Core	0.20	0.16	0.04
Goods	0.09	0.07	0.02
Processed foods	0.05	0.03	0.03
Other goods	0.04	0.04	0.00
Services	0.11	0.09	0.02
Housing	0.02	0.02	0.00
Education	0.00	0.00	0.00
Other services	0.09	0.07	0.02
Non-core	0.01	0.26	-0.26
Agricultural	0.06	0.22	-0.17
Fresh fruits and vegetables	0.02	0.19	-0.17
Meat and egg	0.04	0.04	0.00
Energy and government regulated	-0.05	0.03	-0.08
Energy	-0.06	0.03	-0.09
Government regulated	-0.02	0.01	-0.02

Source: Banorte-Ixe with data from INEGI and Banco de México.

Note: Contributions might not add due to the number of decimals allowed in the table. Previous to year 2011, contributions might not add because of the change in CPI-calculation methodology

**Car and oil exports will falter in November.** On Thursday (December 24), at 10:00am (EST), *INEGI* will make available its trade report for November, where we expect to see a US\$2,700 million deficit. On the exports side, we will probably see a 52.4% yoy contraction of oil exports given the significant fall in oil prices during the period in question. Moreover, non-oil exports could have expanded 0.7% yoy, on the back of a 0.4% expansion in manufacturing exports.

On the imports side, we estimate a 0.6% yoy expansion in total imports. Taking a look at the breakdown, we estimate that imports of consumption goods decreased 11.3% yoy, while imports of intermediate goods could have grown 2.9% yoy. Finally, we estimate a 2.5% expansion in capital goods imports.

**Unemployment rate in November will stand at 4.3%.** Next Thursday, *INEGI* will publish its employment report for the eleventh month of 2015, in which we estimate an unemployment rate of 4.3% nsa, below the 4.55% observed in October. In seasonally-adjusted terms, we believe that the unemployment rate could stand at 4.3%, which implies a monthly fall of 0.07%-pts.

It is likely that the job creation in November was positively affected by better growth dynamics of the economy. In this regard, we believe that the Mexican labor market will continue to recover given the recent upward trend in the Mexican economy, which will eventually reduce the level of unemployed workers.

Looking ahead, we are still positive on the outlook regarding the recovery Mexico's economic activity, which will have a positive impact on firms' expectations about domestic demand, resulting in a more dynamic labor market.

**Weekly government bond auction.** On Tuesday December 29, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent-, will offer 5-year fixed-rate Mbonos (Jun'21) as well as 10-year inflation-linked Udibonos (Dec'25), in addition to the “more traditional” 1-, 3-, and 6- month zero-coupon Cetes. As usual, the results will be released at 12:30pm (EST).

**The MoF's quarterly report.** On the 30<sup>th</sup> of December, the Ministry of Finance (MoF) will make its finance report available for the first eleven months of 2015. On the revenue side, we will be looking at non-oil tax collection as it provides additional information about domestic demand dynamics. Moreover, we will focus on spending dynamics. Finally, it will be important to evaluate the evolution of public sector debt, which currently represents about 42% of Mexico's GDP.

**Banking credit will show a 10.3% yoy increase in November.** Banco de Mexico will make available its banking credit report on Thursday December 31 at 10:00am (EST). It is our take that banking credit continued flowing in November given the significant spike in credit supply from the banking sector. In particular, we estimate an 10.3% yoy expansion in banking credit (in real terms) as a result of increases in the area of 6.9%, 9.8%, and 13.9% yoy in consumer, housing and business credit, respectively.

**Banxico's minutes.** On Thursday, December 31<sup>st</sup> (10:00am, EST), Banco de Mexico will publish the minutes of its monetary policy meeting held back on December 17, in which the board decided to increase the reference rate 25bps leaving it 3.25%, as it was widely expected. In our view, discussions during the meeting were focused on two issues: (1) The relative monetary conditions, particularly vs. those in the United States and exchange rate; and (2) the assessment of the balance of risks for growth and inflation. Moreover, we believe that the decision was unanimous.

In our opinion, the tone of December's *communiqué* regarding Mexico's economic growth was more positive than in October's statement. In particular, the central bank considered that consumer spending is gaining momentum supported by higher employment and low inflation levels.

However, exports stalled given the weakness of the manufacturing sector in the U.S. and the fall in oil prices. Taking all these factors into account, the board considered that: *“...the slack in Mexico’s economy and the labor market has diminished, but it will not translate into demand-side pressures on prices yet. The board now considers that the balance of risks for growth has improved compared to the previous monetary policy decision...”*.

Banxico also mentioned that inflation has continued to show a downward trend, reaching historic lows as a result of the negative output gap, the positive effects of the structural reforms on prices of energy and telecommunications services. The monetary authority also commented on the moderate impact of the pass-through effect of the depreciation of the Mexican currency to prices. In response, the Board considered that: *“... the balance of risks for inflation has improved in the short term...”*.

The monetary authority concluded its monetary announcement that despite that the recent behavior of inflation is consistent with medium and long-run target, the Board decided to increase the reference rate by 25bps. In particular, the statement shows that: *“...[Banxico’s Board] acted in response to the 25bps increase in the fed funds rate, given that the absence of an adjustment in our reference rate could generate an additional and disorderly depreciation of the Mexican currency, affecting both inflation expectations and inflation itself...”*. However, the central bank also left the window open to adjust its monetary policy to Mexico’s cyclical conditions given that *“...the Board will continue to monitor the evolution of all inflation determinants [...]. In order to be able to take additional and flexible measures required to consolidate the efficient convergence of inflation to the target of 3 percent...”*. We believe that another clear example that Banxico will also consider Mexico’s economic cycle to adjust its monetary stance is the divergence between the scheduled monetary policy meetings between the central bank and the Fed.

In sum, while Banxico’s central scenario seems to be of moderate economic growth and inflation below target in 2016, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Looking ahead, we believe that Banxico will follow the Fed in its monetary tightening cycle, but Banxico’s monetary stance could diverge from the Fed’s if the business cycles between both countries show major differences. In this context, we expect the Fed to hike 75bps in 2016, while Banxico will do only 50bps, with the reference rate ending next year at 3.75%.

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