

Ahead of the Curve

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Market focus this week will January's inflation report and Banxico's monetary policy announcement

www.banorte.com
www.ixe.com.mx
@analisis_fundam

Alejandro Cervantes

Senior Economist, Mexico
alejandro.cervantes@banorte.com

Francisco Flores

Economist, Mexico
francisco.flores.serrano@banorte.com

- Monthly inflation report (January).** On Thursday, at 9:00am, INEGI will release its bi-weekly inflation report. This report is particularly relevant since it will already consider the impact of several factors on inflation, of which we highlight: (1) The increase in gasoline prices; (2) the rise in the minimum wage; and (3) the higher FX pass-through effect to prices. Considering this, we are forecasting a 1.63% m/m increase in the headline index during the January (consensus: 1.69% m/m). Moreover, for the core index we estimate a 0.48% m/m rise (consensus: 0.52% m/m). With these results, annual inflation is at 4.65% yoy in January from 3.36% in December, while core inflation is at 3.74% from 3.44% yoy.
- Banxico's monetary policy announcement.** On Thursday, Banxico will announce its monetary policy decision at 2:00pm (EST), where we expect a 50bps rate hike. Thus, the new reference rate will stand at 6.25%. We believe that the key variable for Banxico will be the recent upward trend in inflation and the deterioration of inflation expectations. In addition, we believe that the central bank will mention that the balance of risks for inflation has deteriorated in the short and medium run, as a result of: (1) The 16% increase in the still regulated price of gasoline; (2) the higher pass-through effect from the depreciation of the Mexican currency to prices; and (3) the potential impact of the 9.9% increase in the minimum wage to the price dynamics.

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Mexico's weekly calendar

DATE	HOUR (EST)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Mon 6-Feb		Banking holiday: Mexico's Constitution Day					
Tue 7-Feb	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 3y Mbono (Jun' 20); 3y Udibonos (Dec'20)					
Tue 7-Feb	4:30pm	Banamex bi-weekly survey of economic expectations					
Wed 8-Feb	10:00am	International reserves	Feb-3	US\$ bn	--	--	174.8
Thu 9-Feb	9:00am	CPI inflation	January	% m/m	<u>1.63</u>	<u>1.69</u>	0.46
				% yoy	<u>4.65</u>	<u>4.72</u>	3.36
		Core		% m/m	<u>0.48</u>	<u>0.52</u>	0.45
				% yoy	<u>3.74</u>	--	3.44
Thu 9-Feb	2:00pm	Banxico's monetary policy decision	February 9	%	<u>6.25</u>	<u>6.25</u>	5.75
Fri 10-Feb		Wage negotiations	January	%	<u>4.0</u>	--	3.9
Fri 10-Feb	9:00am	Industrial production	December	% yoy	<u>-0.2</u>	<u>-0.4</u>	1.3
		(sa)		% m/m	<u>0.1</u>	<u>-0.1</u>	0.0
		Mining		% yoy	<u>-8.4</u>	--	-9.1
		Utilities		% yoy	<u>3.3</u>	--	2.4
		Construction		% yoy	<u>2.9</u>	--	3.6
		Manufactures		% yoy	<u>1.3</u>	<u>1.5</u>	4.3

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

On Monday, financial markets will remain closed in Mexico. On the logistics side, and before we start with next week’s description, we highlight that next week, Mexico will have a short week with a banking holiday on Monday (February 1), as the country observes the 100th Anniversary of the Mexican Constitution.

Weekly government bond auction. Also on Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent-, will offer 2-year fixed-rate Mbonos (Jun’20), as well as 3-year inflation-linked Udibonos (Dec,20), 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 12:30pm (EDT).

Auction specifics (Tuesday, February 7, 2016)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	9-Mar-17	--	6,000	5.88
3m	11-May-17	--	10,000	6.38
6m	3-Aug-17	--	11,500	6.65
M Bono				
3y	11-Jun-20	8.0	8,500	7.39
Udibonos				
3y	10-Dec-20	2.5	950	2.62

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, growth, and monetary policy forecasts. On Tuesday at 4:30pm (EST) *Citibanamex* will release its bi-weekly survey of economic expectations, where market participants will focus on analysts’ monetary policy assessments given that this will be the last survey published before Banxico’s monetary policy meeting on Thursday.

In addition, analysts will also focus on the inflation forecasts for January (to be published also on Thursday), as well as on CPI estimations for 2017. Moreover, *Citibanamex* will also publish consensus’ growth and FX forecasts for 2016-17, where we expect strong downward revisions to the median growth forecast.

Weekly international reserves report. On Wednesday, at 9:00am (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves increased by US\$96 million amounting to US\$174.8 billion. According to Banxico’s report, this figure comes mainly as a result of a US\$122million change in valuation of the Central Bank’s assets. In this context, the Central Bank’s international reserve have diminished by US\$1.7billion this year (please refer to the table below).

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

	2015	27/Ene/2017	27/Ene/2017	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	176,542	174,791	96	-1,750
(B) Gross international reserve	178,025	176,625	41	-1,400
Pemex	--	--	-54	-127
Federal government	--	--	-245	-114
Market operations	--	--	0	-2,000
Other	--	--	340	841
(C) Short-term government's liabilities	1,483	1,834	-55	350

Source: Banco de México

Inflation in January will be explained by the increase in energy prices. On Thursday, at 9:00am, *INEGI* will release its bi-weekly inflation report. This report is particularly relevant since it will already consider the impact of several factors on inflation, of which we highlight: (1) The increase in gasoline prices; (2) the rise in the minimum wage; and (3) the higher FX pass-through effect to prices. Considering this, we are forecasting a 1.63% m/m increase in the headline index during the January (consensus: 1.69% m/m). Moreover, for the core index we estimate a 0.48% m/m rise (consensus: 0.52% m/m).

Inflation during the period in question will be explained by the 5.15% m/m increase in the non-core sub index, particularly by pressures on energy prices, driven by the 16.8% increase in low-grade gasoline and 21.7% for the high-grade gasoline. In addition, we expect an additional 17.8% increase in LP gas prices.

Moreover, core inflation's 0.48% m/m rise will be explained by greater pressures on "processed foods" and "other services" prices. We believe that these increases stem from the FX depreciation pass-through to prices, as well as the minimum wage increase.

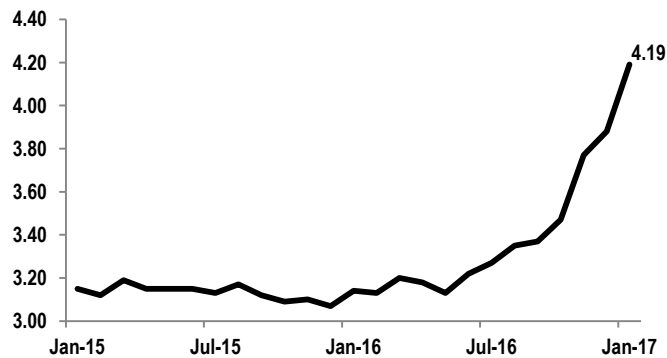
With these results, annual inflation is at 4.65% yoy in January from 3.36% in December, while core inflation is at 3.74% from 3.44% yoy.

We expect a 50bps hike in Banxico's reference rate. On Thursday, Banxico will announce its monetary policy decision at 2:00pm (EST), where we expect a 50bps rate hike. Thus, the new reference rate will stand at 6.25%. We believe that the key variable for Banxico will be the recent upward trend in inflation and the deterioration of inflation expectations. In addition, we believe that the central bank will mention that the balance of risks for inflation has deteriorated in the short and medium run, as a result of: (1) The 16% increase in the still regulated price of gasoline; (2) the higher pass-through effect from the depreciation of the Mexican currency to prices; and (3) the potential impact of the 9.9% increase in the minimum wage to the price dynamics.

On December 27, the Ministry of Finance published the new methodology for determining the maximum prices of gasoline in January. While the MoF's proposal was part of the Federal Government's efforts to foster free markets and impose a second-best scheme before the complete liberalization of the gasoline market, the consumer price index rose 1.51% 2w/2w as a result of this measure. In addition, inflation expectations climbed right after this price adjustment (refer to the charts on the next page). It is our take that the central bank will decide to increase the reference rate by 50bps in order to contain the upward trend in inflation and anchor expectations.

Inflation expectations for 2017

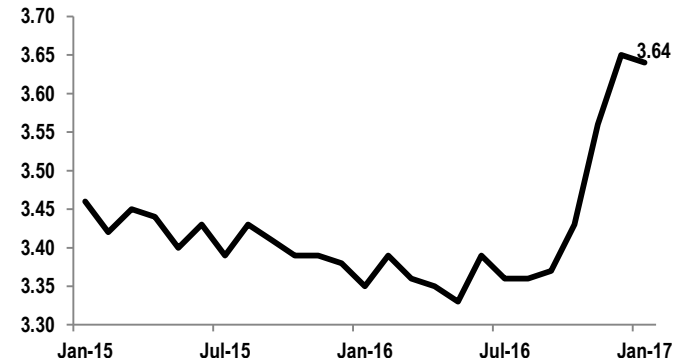
% yoy, mean



Source: Banxico's monthly survey of economic expectations

Inflation expectations in the next four years

% yoy, mean



Source: Banxico's monthly survey of economic expectations

In addition, we believe that Banxico's board will also highlight that the balance of risks for inflation has further deteriorated as a result of the higher pass-through effect from the depreciation of the MXN to prices. In addition, the depreciation of the MXN since Donald Trump's victory has generated additional pressure not only on the consumer price index, but on medium and long-term inflation expectations.

Moreover, we believe that Banxico will also refer to the 9.86% increase in minimum wages for 2017. The central bank did mention in their last monetary policy statement that the upward trend in inflation is also reflecting the increase in the minimum wage, although they will probably emphasize that it will not have an impact on medium and long-term inflation expectations.

While Banxico's central scenario seems to be of lower economic growth, the prospects of a significantly higher inflation in 2017, coupled with a depreciated currency and higher rates in the United States pose a significant risk to inflation expectations in Mexico. Looking ahead, we believe that Banxico will implement an additional 50bps hike in March trying to anchor inflation expectations. In addition, we continue to believe that Banxico will follow the Fed in its monetary tightening cycle. In this context, we expect an additional 50bps hike in June and December (right after the Fed's hikes), with Banxico's reference rate ending at 7.75% in 2017. The minutes of this meeting will be published on the 23th of February.

We expect a 0.2% yoy contraction in December's industrial output. On Friday at 9:00am (EST), *INEGI* will release its monthly industrial production report. We anticipate a 0.2% yoy contraction in total output during December, after the 1.3% expansion in November.

Taking a look at the breakdown, we believe that manufacturing production could post a moderate 1.3% yoy growth, explained by: (1) the 0.3% yoy expansion in the US manufacturing sector (NAICS, original figures); (2) the 8.8% yoy increase in Mexico's vehicle production; and (3) the 4.6% yoy increase in manufacturing exports.

In addition, the 1.2% yoy expansion in industrial output during December will be also explained by the 2.9% yoy increase in construction output as a result of the higher growth in private construction investment projects. By contrast, we expect a 8.4% yoy reduction in mining activity derived from lower oil production and the reduction in the extraction of other minerals.

Industrial production estimates: December 2016

% yoy	Dec-16	Dec-15	2016	2015
Total	-0.2	0.2	0.0	1.0
Mining	-8.4	-4.1	-6.2	-4.6
Utilities	3.3	0.4	3.2	2.3
Construction	2.9	-1.8	2.0	2.5
Manufacturing	1.3	3.1	1.2	2.5

%m/m sa	Dec-16	Nov-16	Difference
Total	0.1	0.0	0.0
Mining	-0.5	-1.0	0.5
Utilities	0.1	0.1	0.0
Construction	0.5	-0.9	1.5
Manufacturing	-0.1	0.7	-0.8

Source: Banorte-Ixe

Wage negotiations will accelerate after the minimum wage increase. Also on Friday, the Ministry of Labor will release the monthly report for contractual wage negotiations. We estimate an annual average increase of 4%, above December's 3.9%. The figure remains relatively low, considering the minimum wage increase as well as the gasoline price hike. Some of the negotiations that took place include increases in the educational sector, particularly *UNAM* (*Aapaunam*) with an increase of 3.1% to its workers, the *Autonomous University of Aguascalientes* with 3.9%, the *Autonomous University of Baja California* (3.1%) and the *Autonomous University of Baja California Sur* (3.1%). We also highlight the salary reviews from *Mexico's Workers Confederation Workers (CTM)*, and in some unions from government entities.

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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
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Juan Carlos García Viejo	Economist, International	juan.garcia.viejo@banorte.com	(55) 1670 - 2252
Francisco José Flores Serrano	Economist, National	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 Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst 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	Equity Research Analyst	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates / Financials/ Mining / Chemistry	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research Analyst – Airlines / Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research Analyst – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250

Corporate Debt

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@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