The world after November 8th – Revising our macroeconomic framework for 2017-2018

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- **Trump's victory led us rethink our macroeconomic scenario both for the United States and for Mexico**
- **Our new backdrop incorporates greater uncertainty surrounding the new Trump administration**
- **In this context, we consider that Trump's government may not be as radical as foreseen by the campaign rhetoric**
- **In our view, the short-term impact will come through a deterioration of expectations both for consumers and businesses**
- **We expect growth in the United States in the area of 1.5% vs our previous estimate of 2%**
- **In Mexico, we now see a deceleration of economic activity to 1.1% (vs our previous estimate of 2.3%)**
- **In the medium-term, forecasts will rely upon the signals sent by Trump in the coming months**
- **In the meantime, we expect growth in the United States in the area of 2%, while in Mexico, the economy could recover expansion levels of 2.5%**
- **Regarding inflation, we believe that CPI will converge faster to the 2% target in the US**
- **For Mexico, consumer prices would resent higher levels of exchange rate pass-through, which could drive inflation to levels around 4%**
- **We continue to expect a Fed's rate hike in December**
- **Moreover, we expect Banxico hike another 150bps before year-end**
- **Despite these changes to our 2017-2018 scenario, we continue to believe that the government will reach a primary surplus in 2017, and will curb the debt-to-GDP upward trend**
- **The Mexican peso is conveying a new political reality in the U.S.**

Uncertainty surrounding a Trump administration. With 279 electoral votes, Donald Trump will become the forty-fifth president of the United States. The most feared scenario materialized and this led us to rethink our macroeconomic scenario for the next two years. Trump's victory is especially sensitive to our scenario for the Mexican economy, given the anti-immigration and anti-international trade rhetoric during the campaign. Moreover, markets also put a question mark on what a Trump administration will entail. Our main assumption –acknowledging that there are still many issues in the air-, is that a Trump administration will not be as radical as we might have thought during the election campaign. In fact, Trump's acceptance speech was more conciliatory than the demagoguery shown during the campaign, although it is true that the behavior of Trump is usually quite erratic.

In our opinion, in addition to the signals that he could send in the coming weeks regarding his government objectives, it will be interesting to follow the conformation of his cabinet, especially his chief of staff, the Secretary of Defense, the head of the National Security Agency (NSA), the Secretary of State, the Secretary of Commerce, the Attorney General and the Secretary of the Treasury. For the latter, there is speculation about the appointment of Steve Mnuchin, a former Goldman Sachs executive; Lawrence Kudlow, former chief economist at Bear Stearns, or Steve Moore, economist at the Heritage Foundation, who helped design the fiscal plans for Trump's campaign. The former mayor of New York, Rudolph Giuliani, who actively participated in the campaign, could occupy the post of Attorney General or the Secretary of Commerce.

US base case scenario: expansionary fiscal policy with lower taxes and more infrastructure expenditure. One of the strongest promises of Mr. Trump's campaign is a large overhaul of the tax system for both individuals and corporations (35% to 15%). There is also the possibility for a reduction in the rate imposed on the repatriation of capital to the United States, which currently encourages companies to reinvest their profits abroad. These tax cuts could possibly lead to an acceleration of spending, for both households and businesses, although we think that this effect will start to take place in 2018, because it requires approval by Congress. On the expenditure side, Trump talks about increasing defense and infrastructure spending, this coupled with lower tax rates tallies up to an expansionary fiscal policy, with effects on growth in the medium term (probably 2018). However, Trump has not made it clear in his campaign speeches how he intends to fund such policies so we believe the impact on growth could eventually be limited. Additionally, we think that the uncertainty regarding the decisions of a Trump administration, particularly on issues such as international trade, will make companies delay their investment and expansion plans. In this context, we expect a 1.5% annual growth of the US economy during 2017, which means a reduction of 0.5%pts from our base scenario in which Hillary Clinton won. For 2018, growth would pick up to 2%.

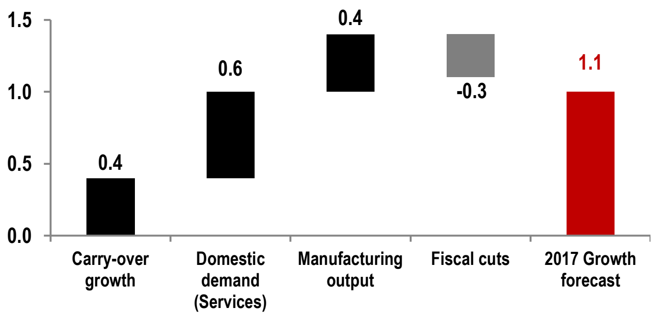
Inflation could accelerate in the medium term. While we believe that inflation is gradually converging to the 2% target, we estimate that inflation dynamics would be slightly higher than in the Clinton scenario, as higher disposable income levels would allow for stronger consumption outlays along with higher spending from the government. In addition, certain anti-trade measures could imply higher import prices. Therefore, we expect an increase of 2.1% yoy during 2017. The CPI price index will be 0.2pp above what we had predicted in case of a victory of the former Secretary of State.

We continue to expect a rate hike in December, although we recognize that the probability has been reduced. The initial market reaction has been limited, at the time financial conditions remain almost unchanged since the last FOMC meeting, in which the Fed seemed prepared to act in December. If this remains the case, we maintain our expectation of a hike at the Fed's last meeting of the year, which takes place on December 14th. After this, the pace of normalization will depend on the evolution of fiscal policy and economic conditions in general. For the time being we expect another 50bps rate hikes in 2017. However, we cannot rule out a scenario in which financial conditions could present a moderate decline globally in the coming days. In addition, concerns about slower growth resulting from the drop in confidence and its impact on the labor market recovery could weigh on the Fed's reaction function.

The Fed and the Trump administration. Another target of the now President-elect during his campaign was the Federal Reserve System (Fed), whom he accused of acting "politically" to favor his opponents. This jeopardizes the independence and credibility of the Fed in two ways: (1) The possible reaction of the president in the case where the Fed will be forced to increase rates more rapidly in the context of a more expansionary fiscal policy, which would generate inflationary pressures, removing the potential positive effect on growth of Trump policies; and (2) the tenure of the current president, Janet Yellen, and Vice President Fischer ends in 2018 (February and June, respectively). At this point, Trump would have to ratify the current participants or elect new officials.

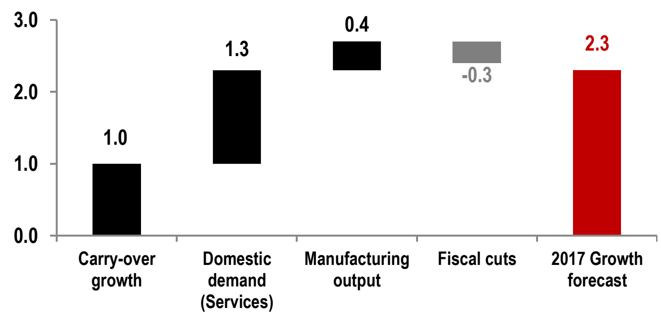
For the Mexican economy, we now expect 1.1% growth in 2017. We believe that the election of Donald Trump will imply lower economic growth for next year in the face of uncertainty generated in the bilateral relationship with Mexico. In this context, we modify our previous growth forecast for the Mexican economy during 2017 to 1.1% from 2.3%, where the greatest impact will be reflected in a lower contribution of both inertial growth and domestic demand (refer to the following charts).

2017 GDP growth forecast: Actual forecast
%-pts.



Source: Banorte Ixe with data from INEGI

2017 GDP growth forecast: Previous forecast
%-pts.



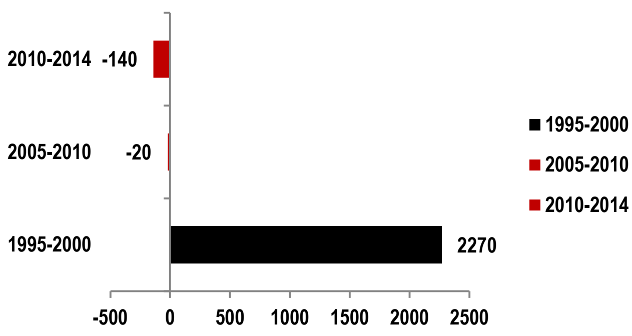
Source: Banorte Ixe with data from INEGI

The immediate impact will be on consumer confidence and business climate with a gradual recovery towards the end of 2017. We believe that the first impact on growth will most likely come in the first half of 2017, with the transmission channel being a strong deterioration of consumer confidence and business climate, leading to a significant deceleration in economic activity. However, it is likely that the negative perception of a Donald Trump presidency will gradually fade and confidence levels will begin to recover towards the second half of the year. In this context, we expect a 0.5% yoy growth during the first half of the year, and a 1.6% yoy growth in the second half. For 2018, we believe that the recovery of the Mexican economy will continue and will grow around 2.5% given the fiscal expenditure as a result of the election process.

Limited impact on the Mexican labor market and remittances. Net migration rates between Mexico and the Unites States has been close to zero in the recent years (as seen in the first chart below). Moreover, the participation rate of Mexican migrants without a citizenship is significantly higher than for the entire American population (62.8% for the American population vs 68% for Mexican migrants, as seen in the second chart below), which, as seen from an operational standpoint, means that the deportation of more than 7.8 million workers is nearly impossible.

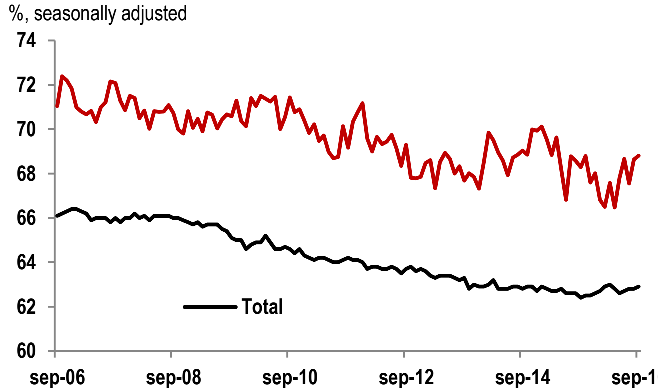
Similarly, the deportation of all Mexicans that live in the US without a citizenship would have two direct consequences: (1) The absence would leave many job openings –one of the labor market's problems has been that to create employment there is the needed to create more jobs than vacancies–, which would have to be filled in a "reasonable" period of time, probably at a higher cost, reducing businesses' margins or making goods and services more expensive; and (2) the massive deportation would leave a huge gap in the economy's growth in the US, both due to the lack of workers –from the supply viewpoint–, and to private consumption –on the demand side. For these reasons, we consider that the proposals from the Republican candidate –which include slowing down the migration from Mexicans to the US and the deportation of Mexican "illegal aliens"– would have a limited impact on Mexico's workforce. Regarding remittances, and assuming a negative scenario, Trump could levy a tax on the remittances –possibly around 10% to 15%–, which would impact household income that rely on this income. On a more positive scenario, it is more likely that the Trump administration would not limit the remittance flow.

Net migration to the US from Mexico
Miles de personas



Source: Pew Hispanic Center

Participation rate: US total population and Mexican migrant workers without citizenship
%, seasonally adjusted



Source: Banorte-Ixe and US Census Bureau's Data Ferret

Limited impact from protectionist measures. We believe that in the most likely scenario, and referring to the comments made by several of Donald Trump's economic advisers, a renegotiation of NAFTA could be carried out. This renegotiation would only imply imposing stricter rules of origin. In this scenario, Mexican manufacturing output would not be affected by a Trump administration. It should also be mentioned that negotiations would take time to implement. In a pessimistic scenario, Donald Trump could try to dismantle NAFTA, which would lead the US to give Mexico the *most-favored-nation* treatment under WTO rules. In this scenario, Mexican exporters would have to pay average tariffs of about 9.2% on manufacturing products.

Inflation above target and deceleration of private consumption. Another immediate effect of Trump's victory is the depreciation of the MXN, which would imply a higher pass-through to prices. In this context, we estimate inflation to be in the area of 4% in 2017. In this case, it is highly likely that the growth trend we had witnessed in household consumption during the year would be affected by the upward trend of inflation, diminishing growth possibilities for the economy.

150bps hike in Banxico's reference rate. As we have already mentioned, the market reaction so far has been limited. However, we cannot rule out any further deterioration in financial conditions, particularly considering that Trump's policies may specifically affect Mexico and that would be reflected via the exchange rate. In this context, we are still expecting a rate hike at November 17 meeting. In addition, we maintain our expectation of an additional 150bps increase before the year ends, although we recognize that it could be less in case the market adjustment does not require higher monetary restriction. In 2017, we expect Banxico to hike in tandem with the US Fed (50bps).

Solid fiscal framework. In our view, revisions to our macroeconomic framework do not imply a change in our outlook for fiscal policy. We continue to anticipate that the government will continue with the fiscal consolidation effort and will meet the goals of generating a primary surplus in 2017, while curbing the debt-to-GDP ratio upward trend. In this context, from the revenue side, the government recently hedged oil revenues, while the budget approved for 2017 does not take into consideration the possible operation surplus generated by the fact that international reserves in Banxico were valued at USD/MXN17.24 at the end of last year while exchange rate will be higher than that at the end of 2016. On the expenditure side, we believe that the government has still room for further cuts if required.

The Mexican peso is conveying a new political reality in the U.S. The local currency depreciated 8.3% today to USD/MXN 19.84 in the aftermath of the victory of President-elected Donald Trump. We acknowledge a new political paradigm coming from the U.S. electoral results, with the Trump tail risk materializing on Tuesday. This situation suggests that the FX dynamics in Mexico will continue to be highly sensitive to geopolitical risks ahead, immerse in a complex scenario where fundamentals could be undermined by difficult conditions (*e.g.* lower crude production and a limited relief rally in oil prices). It is our take that the MXN will remain as an important proxy hedge for risky assets, mainly in emerging markets (more details in our research note "*Mexican Peso: Catching up to a crude reality*" <pdf>, published on August 29th, 2016). Taking into account the results of the U.S. elections on Tuesday and the balance of risks for the currency for next year, we have decided to modify our 2016-end forecast from USD/MXN 18.50 to 21.50 and the 2017-end estimate from USD/MXN 19.80 to 23.50.

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