

Ahead of the Curve

We expect Banxico to reaffirm its prudent stance in the Quarterly Report and minutes of the last decision

- Banxico's Quarterly Report (1Q19).** In our view, the tone of the document will remain hawkish, as perceived in the latest communique. We anticipate that the central bank will maintain its growth forecasts for 2019 and 2020 unchanged, although we recognize that risks are skewed to the downside. On the other hand, we expect an upward revision in short-term forecasts of core inflation. In this front, we will focus on any additional comments about cost-pressures and recent wage revisions as upside risks to the expected path for prices. Any evaluation about the potential impact of recent developments in trade (*i.e.* an escalation in tensions between the US and China and the removal of tariffs of Mexican steel and aluminum exports), Pemex's financial situation, and financial volatility, will also be relevant. We keep expecting that the growth and inflation outlook (reiterating our better-than-consensus year-end forecast of 3.5% yoy in the latter) will provide enough reasons for the central bank to start an easing cycle, anticipating a reference rate cut of 25bps to 8.00% in November

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Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 28-May	9:00am	Unemployment rate	April	%	<u>3.63</u>	--	3.25
		sa		%	<u>3.64</u>	--	3.56
Tue 28-May	10:00am	International reserves	May-24	US\$ bn	--	--	177.1
Tue 28-May	12:30pm	Government weekly auction: 1-, 3-, and 6-months Cetes; 3y MBono (Dic'21); 3y Udibono (Jun'22)					
Wed 29-May	1:30pm	Banxico's Quarterly Report	1Q19				
Thu 30-May	10:00am	Banxico's minutes					
Thu 30-May	15:30pm	Budget balance	April	MXN bn	--	--	-17.8
Fri 31-May	10:00am	Comercial banking credit	April	% yoy	<u>6.5</u>	--	7.0
		Consumption		% yoy	<u>1.9</u>	--	2.0
		Housing		% yoy	<u>5.6</u>	--	6.1
		Non-banking private firms		% yoy	<u>7.7</u>	--	8.7

Source: Banorte; Bloomberg

Proceeding in chronological order...

We expect the unemployment rate to keep increasing on cyclical conditions.

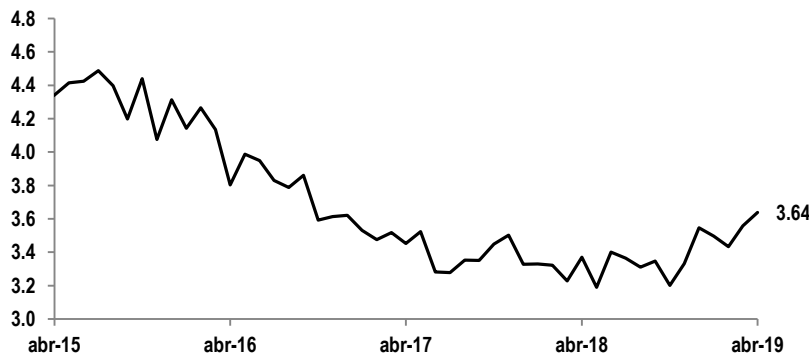
We estimate the unemployment rate at 3.63% sa in April, higher than the 3.56% of the previous month, and which is actually the highest since December 2016. In this respect, it should be noted that the deceleration in the annual pace of formal job creation has been persistent for the last nine consecutive months, reaching 2.5% in April and at its lowest since March 2010. In absolute terms, this equated to 30,419 new formal jobs, less than the 87,109 observed in the same period of 2018.

Other figures were more mixed. In particular, the USD/MXN exchange rate, with peso weakness historically associated with a lower unemployment rate, actually declined from 19.24 to 18.98 per dollar during the month. In our view, these could help explain more limited growth in manufacturing activity as local companies lose competitiveness at the margin, adding to headwinds stemming from less global dynamism.

Moreover, the most recent available data on activity points to protracted weakness, with the IGAE in March at -0.6% m/m, its first contraction so far in 2019. Nevertheless and on the other hand, employment components in PMI indices for the month were stronger, with manufacturing going from 47.6 to 48.9pts while services stayed broadly stable and in expansion territory at 50.2pts.

Unemployment rate

%, sa



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves increased US\$167 million, closing at US\$177.1 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\$2.3 billion during 2019 (please refer to the following table).

Banxico's foreign reserve accumulation detail

US\$, million

	2018	May 17, 2019	May 17, 2019	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	174,793	177,091	167	2,298
(B) Gross international reserve	176,384	184,459	-95	8,074
Pemex	--	--	-151	47
Federal government	--	--	-94	6,034
Market operations	--	--	0	0
Other	--	--	149	1,993
(C) Short-term government's liabilities	1,592	7,368	-262	5,776

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 3-year fixed-rate Mbonos (Dec'21), 3-year inflation-linked Udibonos (Jun'22), 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, May 28th, 2019)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	27-Jun-19	--	7,000	8.03
3m	29-Aug-19	--	10,000	8.24
6m	21-Nov-19	--	12,000	8.27
Mbonos				
3y	09-Dec-21	7.25	9,700	7.98
Udibonos				
3y	09-Jun-22	2.00	UDIS 950	4.00

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

Busy agenda for Banxico with the *Quarterly Report* and minutes. Banco de Mexico will publish its *Quarterly Report* (QR) for 1Q19 on Wednesday around 1:30pm (ET), accompanied by a press conference led by Governor Diaz de Leon. On Thursday at 10:00am (ET), the central bank will release the minutes of its latest monetary policy meeting, which took place on May 16th. We expect both the QR and the minutes to confirm the more hawkish bias we perceived in the last communiqué. Moreover, we will focus on:

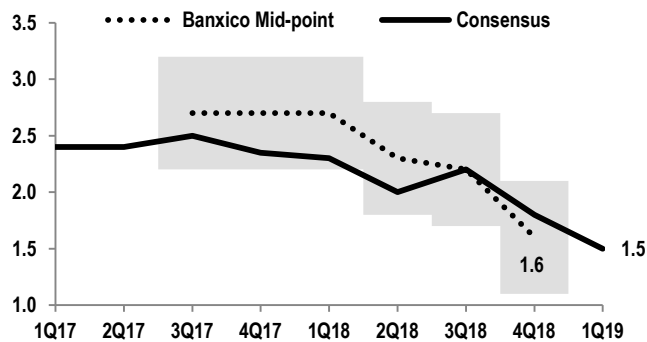
(1) *An unchanged growth outlook, with risks tilted to the downside.* We expect the central bank to maintain its current 2019 GDP forecast range unchanged at 1.1-2.1% yoy (mid-point: 1.6%), an inch above our estimate of 1.5%. It is worth noting that the central bank's forecast for the current year has been reduced on three consecutive times, from a mid-point of 2.7% at the beginning of 2018 (chart below on the left). For 2020, we also expect an unchanged range at 1.7-2.7% (mid-point: 2.2%), also 10bps above our forecast.

We believe the tone on growth will stay dovish. In the external front, the central bank will consider most recent developments, particularly on global trade and the escalation of tensions between the US and China). Locally, activity in March according to the *Global Economic Activity Indicator* (IGAE) was weak, contracting 0.6% m/m after advancing in the first two months of the year (see chart below on the right). As a result, GDP in 1Q19 decreased 0.2% q/q.

It should be noted that in the latest communique, the central bank said that weakness since 4Q18 has intensified, consistent with these figures. On the other hand, the trade balance in April showed a rebound in exports, lessening the concern of a stronger decline in manufacturing. However, dynamism has indeed moderated, consistent with their comments that one of the drivers behind the deceleration was weaker external demand, which in our view could extend in coming months. Another factor that could be weighing, and which had also been flagged, is the slowdown in government spending and the impact of transitory shocks in the first quarter. All in all, it is our take that recent data is consistent with the central bank's expectations of a deceleration, which to a great extent we believe it is already embedded in their forecasts. Nevertheless, we also think risks are tilted slightly towards an additional downgrade, especially for this year.

Growth forecasts for 2019

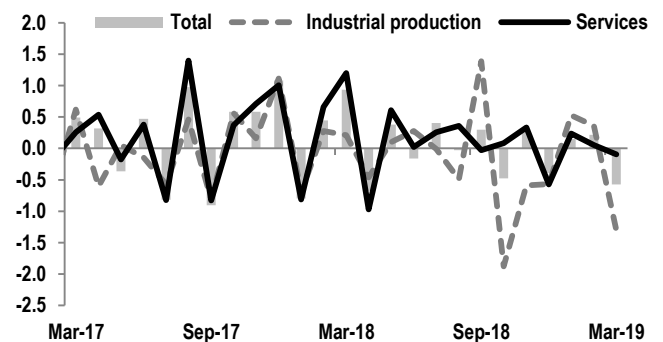
% yoy, nsa



*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

IGAE

% m/m, sa



Source: INEGI

(2) *Upward revisions in short-term core inflation forecasts.* In our view, recent dynamics and persistent concerns on core inflation could lead the central bank to make an upward adjustment in its inflation path, particularly at the core level. It is our take that the timing of the Easter holiday and methodological changes in the index last year played a part in the recent increase. However, even when taking this into account there seems to be other pressures which could be of a more structural nature, as evidenced by the persistence of higher-than-average increases in relatively stable components, such as housing.

In the latest monetary policy statement, Banxico added for the first time in recent memory to its forward-looking guidance the possible impact of cost-related pressures, along with previously outlined risks such as second-round effects from FX to prices, the relative monetary policy stance vs. the US and slack conditions. We believe the new factor is closely related to comments about upside risks and resistance to the downside of core inflation due to wage revisions exceeding productivity gains in some sectors. In this respect, the main takeaway was the warning that greater economic slack could not translate into lesser price pressures, as suggested by the behavior of some components at the core level. We expect these to be explained further within the minutes and even with more exhaustive analysis in one of the “grey boxes” in the QR.

On forecasts, headline and core inflation in 1Q19 averaged 4.1% and 3.6% yoy, respectively (see table below). The central bank's estimates were exactly in line in the former but were underestimated 10bps in the latter. For 2Q19, the average inflation forecast is currently at 4.3% and is tracking 4.4% so far (including April and the 1st half of May). Our expectation is for this to come down slightly in the following fortnights, so we believe that the headline will likely remain unchanged. However, core inflation is at 3.8%, 20bps above Banxico's 3.6% estimate. Based on our inflation trajectory, we believe a revision higher between 10-20bps for 2Q19 is probable, a situation that could also lead to modest adjustments in the same direction for the following quarters.

Banxico's headline inflation forecasts

% yoy, quarterly average

QR	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
Nov-17 (3Q17)	4.6	4.1	3.6	3	3.1	3.3	3.1	3				
Feb-18 (4Q17)	5.5	4.8	4.3	3.8	3.2	3	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	
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	--	--	--	--	--	--	--

*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
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	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	--	--	--	--	--	--	--

*Note: Shaded numbers indicate actual data
Source: Banxico, INEGI

(3) *Others risks to the outlook, highlighting Pemex.* News on this front have been mixed in recent weeks. On the external front, the US lifted tariffs on imports of Mexican steel and aluminum, which should help relieve some of the downside risks associated to mounting trade tensions. However, these could be more than compensated by the escalation on the US-China front and its impact on global growth, implying the possibility of a bleaker outlook for Mexican exports in spite of the positive effect from substitution. Moreover, the Board highlighted higher Mexican peso volatility while mentioning the potential of some investment portfolio changes due to global uncertainty, which we interpret as potential outflows in a move to safer assets.

On the domestic side, we believe attention will remain on Pemex's financial position due to its potential implications on both its own credit outlook as well as the sovereign. In this context, recent comments by President López-Obrador about not using resources from the *Stabilization Fund for Budget Revenues* (FEIP, in Spanish) to pay down debt, a strategy that had been already suggested by some members at the Ministry of Finance, inserted additional uncertainty.

However, the Federal Government is preparing more financial support for the company, while we expect the business plan to be presented to the Board of Directors soon. In our view, these measures will be positive and will alleviate some of the main concerns among investors, paving the way to remove some of the risks to the short-term outlook.

In conclusion, we expect the central bank to maintain or increase slightly its dovish stance on growth. Nevertheless, the overall tone should reiterate prudence given risks for inflation and financial stability in a more volatile environment. Considering this, we maintain our view that Banxico could find enough room to cut the reference rate in November, by 25bps to 8.00%. We continue believing that the outlook on growth and inflation (reiterating our better-than-consensus forecast of 3.5% yoy by year-end 2019) will provide enough reasons for the central bank to start an easing cycle soon. Moreover, we do not rule out that this happens even earlier than we currently expect, particularly if the scenario about Pemex and its related influence on the sovereign credit outlook becomes clearer and more favorable.

MoF's public finance report (April). In this report, attention will center on the public balance as well as on the PSBRs. It should be noted that the public deficit as of the end of March stood at MXN\$24.5bn, better than the MXN\$67.7bn forecasted deficit. In addition, attention will focus on revenue and spending, especially when compared to the update in the *2020 Macroeconomic Forecasts* from the Ministry of Finance. Finally, we will also look into public debt, which as of March stands at MXN\$10.5tn, equivalent to 42.3% of GDP (as measured by the HBPSBRs).

Banking credit will show a 6.5% yoy increase in April. It is our take that credit to the non-financial sector continued flowing in the fourth month of 2019. In particular, we estimate a 6.5% yoy expansion in real terms as a result of a 1.9% increase in consumer credit, coupled with a 5.6% and 7.7% expansion in mortgages and corporate credit, in the same order.

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HOLD	<i>When the share expected performance is similar to the MEXBOL estimated performance.</i>
SELL	<i>When the share expected performance is lower than the MEXBOL estimated performance.</i>

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