Ahead of the Curve

February 17, 2017

Market focus this week will be on 4Q16's GDP and Banxico's minutes

- **Gross Domestic Product (4Q16).** On Wednesday, INEGI will publish its GDP report for the fourth quarter of 2016, where we expect a 2.3% yoy expansion, marginally above the 2.2% preliminary figure reported by INEGI. As a result, we believe that the Mexican economy probably grew 2.3% in 2016. In seasonally adjusted terms, we expect a 0.7% q/q expansion during 4Q16. Taking a look at the breakdown, we believe that services will continue to show a favorable performance (3.4% yoy), by contrast, we expect a 0.1% yoy contraction in the industrial sector.
- **Banxico's Minutes.** On Thursday at 10:00am (EST), Banco de Mexico will publish the minutes of its monetary policy meeting held back on February 9, in which the board decided to increase the reference rate by 50bps. We believe that the decision to hike rates was unanimous. In addition, we expect discussions during the meeting to have focused on three issues: (1) The transitory effect of the liberalization of gasoline prices to inflation; (2) the adjustment in relative prices as a result of the depreciation of the MXN; and (3) the upward trend in short-term inflation expectations as a result of the above-mentioned factors. Looking ahead, the upward trajectory that will maintain inflation during the year is likely to justify an additional increase of 150bp in the remainder of the 2017.

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Mexico's weekly calendar

DATE	HOUR (EST)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Tue 21-Feb	**10:00am**	**International reserves**	17-Feb	US$ bn	--	--	174.9
Tue 21-Feb	**12:30pm**	**Government weekly auction: 1-, 3-, 6-month CETES; 5y Mbono (Jun'22); 10y Udibonos (Dec'25)**					
Tue 21-Feb	**4:30pm**	**Citibanamex bi-weekly survey of economic expectations**					
Wed 22-Feb	**9:00am**	**GDP**	4Q16	% yoy	2.3	--	2.2
		(sa)		% q/q	0.7	--	0.6
		Primary activities		% yoy	6.1	--	6.2
		Industrial production		% yoy	-0.1	--	-0.2
		Services		% yoy	3.4	--	3.2
Wed 22-Feb	**9:00am**	**Global economic indicator**	December	% yoy	1.7	--	3.7
		Primary activities		% yoy	3.4	--	12.0
		Industrial production		% yoy	-0.6	--	1.3
		Services		% yoy	3.0	--	4.5
Thu 23-Feb	**9:00am**	**CPI inflation**	1Q Feb	% 2w/2w	0.13	0.35	0.24
				% yoy	4.49	4.72	4.66
		Core		% 2w/2w	0.24	0.25	0.37
				% yoy	3.96	--	3.95
Thu 23-Feb	**10:00am**	**Banxico's minutes**	January				
Fri 24-Feb	**9:00am**	**Retail sales**	December	% yoy	8.6	--	11.2
Fri 24-Feb	**10:00am**	**Current Account Balance**	4Q16	US$ mn	-5.3	--	-7.6

Source: Banorte-IXE with data from Bloomberg

Proceeding in chronological order...

Weekly international reserves report. On Tuesday, at 9:00am (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves decreased by US$5 million amounting to US$174.9 billion. According to Banxico's report, this figure comes mainly as a result of: (1) USD sale to the Federal Government amounting to US$47 million; and (2) a US$42million increase due to the change in valuation of the Central Bank's assets. In this context, the Central Bank's international reserves have diminished by US$1.6billion this year (please refer to the table below).

Banxico's foreign reserve accumulation detail
US$, million

	2016	Feb 10, 2017	Feb 10, 2017	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	176,542	174,948	-5	-1,594
(B) Gross international reserve	178,025	176,587	340	-1,438
Pemex	--	--	346	-401
Federal government	--	--	110	-70
Market operations	--	--	0	-2,000
Other	--	--	-116	1,033
(C) Short-term government's liabilities	1,483	1,639	346	155

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 5-year fixed-rate Mbonos (Jun'22), as well as 10-year inflation-linked Udibonos (Dec'25), 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 21, 2016)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	23-Mar-17	- -	7,000	5.90
3m	25-May-17	- -	11,000	6.29
6m	17-Aug-17	- -	11,500	6.58
M Bono				
5y	9-Jun-22	6.5	8,500	7.36
Udibonos				
10y	4-Dec-25	4.5	700	3.02

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 first survey published after Banxico's 50bps rate hike in February's meeting.

In addition, analysts will also focus on the inflation forecasts for the first half of February (to be published on Thursday), as well as on CPI estimations for 2017. Moreover, *Citibanamex* will also publish consensus' growth and FX forecasts for 2017-18, where we expect strong downward revisions to the median growth forecast for this year.

Mexico's GDP will stand at 2.3% yoy in 4Q16. On Wednesday, *INEGI* will publish its GDP report for the fourth quarter of 2016, where we expect a 2.3% yoy expansion, marginally above the 2.2% preliminary figure reported by *INEGI*. As a result, we believe that the Mexican economy probably grew 2.3% in 2016. In seasonally adjusted terms, we expect a 0.7% q/q expansion during 4Q16.

Taking a look at the breakdown, we believe that services will continue to show a favorable performance (3.4% yoy) driven by the strong growth of banking credit (12.3% yoy in real terms over the same period), and the higher growth of the Mexican labor market (4% yoy).

By contrast, we expect a 0.1% yoy contraction in the industrial sector during 4Q16 derived from the sharp deceleration in the manufacturing industry, coupled with the recession in the mining sector, and the marginal increase in construction output given the contraction in public investment projects.

We expect a 1.7% yoy expansion in December's IGAE. On Wednesday, and in addition to the GDP report, *INEGI* will also release its monthly global economic indicator for December (GDP monthly proxy), where we expect a 1.7% yoy expansion. We believe that Mexico's economic growth will be explained by a 0.6% contraction in industrial production, coupled with a 3% yoy increase in services output.

As we had mentioned in our last report, IP's contraction in December was partially explained by the 10.5% yoy reduction in mining activity, as a result of the significant contraction in Mexico's oil production, and the lower investment in Mexico's drilling projects. By contrast, construction output posted a 1.8% growth, despite the 12.4% reduction of public civil engineering construction projects given the fiscal cuts implemented by the Federal Government. Moreover, manufacturing output grew 1.8% yoy.

In addition, we believe that the 3% yoy estimated expansion in services will be explained by the still positive trend in private consumption during December. However, we believe that all the services that hold a strong correlation with manufacturing activity, such as trade and transportation, will decelerate.

Inflation in the first half of February will be explained by pressures on the price of goods along with higher prices of services. On Thursday, at 9:00am, INEGI will release its bi-weekly inflation report. We are forecasting a 0.13% 2w/2w increase in the first half of February. In the core index, we expect an increase of 0.24% 2w/2w. Inflation during the period in question will be explained by pressures on goods prices along with higher services prices, but will experience downward pressures due to the decreases in fresh fruits and vegetables prices.

Considering this, we expect this figure to be 15.9bps lower than the observed in same period last year, derived from: (1) -21.3bps from a lower contribution agriculture prices (-8bps vs. 13.3 in 2016); (2) -4.4bps stemming from a lower contribution of goods (9bps vs. 13.4 in 2016); (3) 4.8bps stemming from a higher contribution of services (8.4bps vs. 3.6 in 2016); and (4) 4.6bps stemming from a higher contribution of energy prices (1.8bps vs. -2.8 in 2016), as shown in the table below.

With these results, annual inflation is at 4.49% yoy in the first half of February from previous 4.72% while core inflation is at 3.96% from 3.84%yoy.

1H-February inflation by components
% bi-weekly incidence

	Banorte-Ixe	2016	Difference
Total	0.13	0.29	-0.16
Core	0.17	0.17	0.00
Goods	0.09	0.13	-0.04
Processed foods	0.04	0.03	0.01
Other goods	0.05	0.11	-0.06
Services	0.08	0.04	0.05
Housing	0.02	0.02	0.00
Education	0.01	0.00	0.00
Other services	0.06	0.01	0.04
Non-core	-0.05	0.12	-0.17
Agriculture	-0.08	0.13	-0.21
Fruits & vegetables	-0.09	0.08	-0.17
Meat & eggs	0.01	0.06	-0.05
Energy & government tariffs	0.03	-0.02	0.05
Energy	0.02	-0.03	0.05
Government tariffs	0.02	0.01	0.01

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

Banxico's minutes – Hawkish tone justifying the 50bps hike. Next Thursday at 10:00am (EST), Banco de Mexico will publish the minutes of its monetary policy meeting held back on February 9, in which the board decided to increase by 50bps the reference rate. We believe that the decision to hike rates was unanimous. In addition, we expect discussions during the meeting to have focused on three issues: (1) The transitory effect of the liberalization of gasoline prices to inflation; (2) the adjustment in relative prices as a result of the depreciation of the MXN; and (3) the upward trend in short-term inflation expectations as a result of the above-mentioned factors.

In the first case, the central bank explained that the upward trend in inflation during the last month was exacerbated by adjustments in energy prices, particularly by the rise in gasoline prices. In addition, the central bank also explained that the increase in inflation expectations in the short term has been explained by this factor. While the increase in energy prices will have a temporary impact on inflation, we believe that the discussions on this issue will also revolve around the second-round effects that the increase in gasoline prices will have in the price formation dynamics.

In addition, the Central Bank expressed concern about the volatility of the exchange rate generated by various economic and geopolitical events. In particular, Banxico highlighted that among the main upside risks to inflation, is the upward trend in inflation expectations arising from an additional depreciation of the Mexican currency given of the uncertainty prevailing in the external environment.

On the other hand, the central bank also showed caution about the impact of the aforementioned effects on the price formation dynamics. In particular, Banxico mentioned that: *"Given the simultaneity of the adverse environment and the temporary shocks in relative prices, the main challenge facing the Board is to minimize the second-round effects, in order to anchor medium and long-term inflation expectations. This, considering both the transitory nature of inflationary shocks and the horizon in which the transmission channels of monetary policy operate, in view of the adjustments made during 2016 and those deemed convenient for this year."*

We expect the central bank to increase the reference rate by 50bp as early as in the next meeting (March 30), as a result of the seasonal increase in the price of gasoline during the second fortnight of the month. In addition, it is likely that Banxico will decide to increase the reference rate by an additional 100bps for the remainder of the year. In this regard, we believe that the Central Bank's *Quarterly Inflation Report* (to be issued on March 1st) will provide additional information regarding Banxico's monetary stance.

Retail sales will post an 8.6% yoy expansion in December. On Friday at 9:00am (EST), *INEGI* will publish its retail sales report for December, where we anticipate an 8.6% yoy expansion. Retail sales' growth will be explained by the favorable performance of durable goods sales. In particular, vehicles sales increased by 19.9% yoy according to *AMIA's* report. In addition, *ANTAD* total store sales posted a 5% yoy growth in real terms during the period in question. However, retail sales growth will be bounded by the 12.7% yoy contraction in non-oil consumption goods imports.

The current account deficit will narrow to US$5.3 billion in the fourth quarter of 2016. Finally on Friday, Banxico will publish its balance of payments report for the fourth quarter of last year, for which we expect a US$5.3 billion deficit. According to already reported trade balance figures, trade deficit amounted to US$671million, while net transfers increased on the back of a more dynamic flow of remittances up 12.4%yoy. In our opinion, external accounts remain solid with current account deficit fully financed by long term investment flows. In addition, we expect positive portfolio investment as local markets remain appealing to foreign investors.

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