

Banxico's QIR – Difficult external backdrop defines outlook in 2015

May 19, 2015

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- Banxico just published its *Quarterly Inflation Report (QIR)* for 1Q15
- In our opinion, we highlight the following issues:
 - (1) The downward revision of the forecasted range of growth for 2015 and 2016;
 - (2) Banxico's confidence in inflation reaching the 3% target this year; and
 - (3) The comprehensive macroeconomic strategy to mitigate the impact of a complex adverse external backdrop
- In our opinion, the report maintained the tone we already perceived both in the last monetary policy *communiqué* and in the minutes published last week, in the sense that Banxico is tied to the U.S. Fed actions
- We maintain our view that Banxico will hike interest rates *in tandem* with the U.S. Fed
- Banxico will keep waiting for US economic performance and the Fed, warning about the possibility of additional market volatility

Fixed income and FX strategy

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Tied to the Fed's actions. The monetary authority released its *Quarterly Inflation Report (QIR)* for 1Q15. The release was accompanied by a press conference by Governor Carstens. We highlight the following issues discussed in the document: (1) The downward revision of the forecasted range of growth for 2015 and 2016; (2) Banxico's confidence in inflation reaching the 3% target this year; and (3) the comprehensive macroeconomic strategy to mitigate the impact of a complex adverse external backdrop. In our opinion, Banxico's *QIR* maintained the tone we have already discussed previously, in the sense that an adverse external backdrop is being key for the prospects of the Mexican economy in 2015. In particular, Banxico emphasized the U.S. Fed normalization process, which has been an important source of uncertainty in international markets.

Short-term pessimism... Banxico's *QIR* highlights the weak performance of the U.S. economy. In Mexico, activity has also moderated on the back of an adverse external backdrop, as we have already mentioned, and particularly given the reduction of oil output, where there is still the risk of seeing further decline in the production platform. In addition, domestic spending has been recovering very slowly, but with no sign that it might be an acceleration in the coming months. In this context, the central bank revised down its estimated GDP growth range in 2015 from 2.5% -3.5%, to 2% -3% below our expectations (refer to the following tables).

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Banxico's Forecast (recent)

| | 2015 | 2016 |
|-------------------------------|-----------|-----------|
| GDP (%) | 2.0 - 3.0 | 2.5 - 3.5 |
| Employment (thousands) | 580 - 680 | 600 - 700 |
| Trade balance (bn) | -5.2 | -6.9 |
| Current account (bn) | -27.7 | -29.7 |
| Inflation | | |
| Headline | under 3% | around 3% |
| Core | under 3% | around 3% |

Source: Banxico

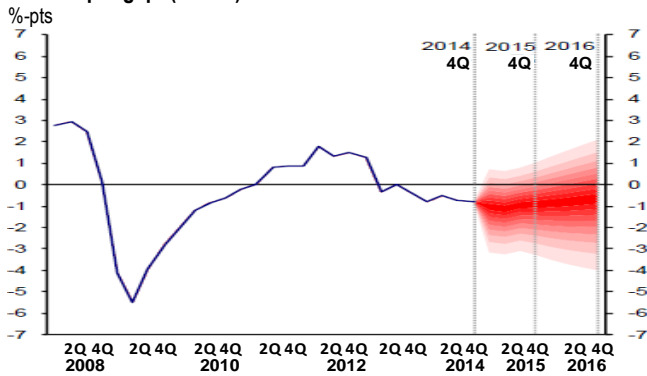
Banxico's Forecast (previous)

| | 2015 | 2016 |
|-------------------------------|-----------|-----------|
| GDP (%) | 2.5 - 3.5 | 2.9 - 3.9 |
| Employment (thousands) | 600 - 700 | 620 - 720 |
| Trade balance (bn) | -6 | -8.8 |
| Current account (bn) | -28.7 | -31.6 |
| Inflation | | |
| Headline | under 3% | around 3% |
| Core | under 3% | around 3% |

Source: Banxico

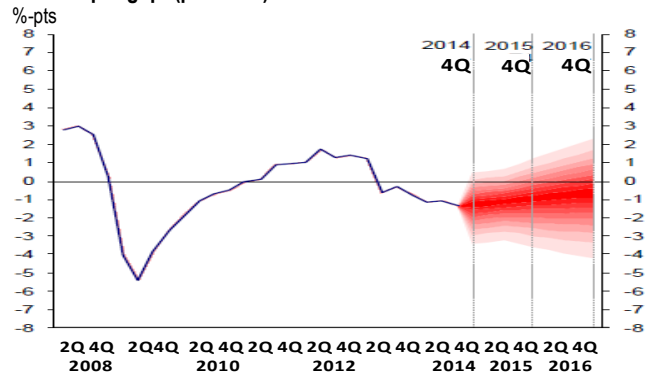
...As well as in the medium term. Banxico also revised down its growth range for 2016, from 2.9%-3.9% to 2.5%-3.5%. In this context, in the traditional output gap chart, Banxico clearly shows that it will remain open until the end of 2016. Among the factors that could affect the economic dynamism of Mexico, the central bank highlights: (1) A further weakening of the U.S. economy; (2) new episodes of volatility in financial markets; (3) a further decline in the oil production platform; and (4) weak consumer and business confidence levels. On the positive side, the U.S. economy could improve amid low costs of energy while the outlook could also improve as a result of a favorable outcome in the early stages of implementation of the energy reform.

GDP output gap: (recent)



Source: Banxico

GDP output gap: (previous)



Source: Banorte-Ixe

Banxico is relatively confident that inflation will converge to its 3% target in 2015. Banxico continues to believe that inflation will converge to the 3% target of 3% this year on the back of three factors: (1) A favorable base of comparison; (2) the absence of changes in the fiscal framework; and (3) the benefits already observed derived from the telecommunications reform. Similarly, the monetary authority explained that despite the sharp depreciation of the Mexican peso, there has been a limited pass-through to inflation. Nevertheless, the depreciation of Mexican peso continues to be a significant risk for the inflation backdrop.

A comprehensive macroeconomic strategy. While Banxico considers that there has been a limited *pass-through* from FX depreciation, it highlights that U.S. Fed monetary policy normalization process, the uncertainty associated with it, along with lower oil prices, have the potential of impacting both the exchange rate and inflation expectations. In this context, the central bank noted that the monetary stance is part of a "*comprehensive macroeconomic strategy*" that aims to mitigate the impact of an adverse external backdrop. Such strategy is built on three pillars: (1) The monetary stance focused on price stability; (2) the intervention mechanisms of the Exchange Commission –minimum price dollar auctions and auctions without minimum price-, and (3) government's fiscal consolidation process.

"Grey boxes" on medium-term inflation and use of the monetary base. As it is a tradition, Banxico included two pieces of research (a.k.a. "*grey boxes*") in its *QIR*. The first relates to the measurement of the medium-term trend of inflation using the trimmed mean, while the second is about the recent evolution of the monetary base. In the first case, monetary authority concludes that the trimmed mean is a good approximation for the medium-term inflation dynamics, as it allows differentiating between transitory effects from those who could have a more permanent impact on inflation. In the case of the monetary base, Banxico confirmed that during 2014 the monetary base increased its rate of expansion, not because of the macroeconomic environment but as a result of the changes in both the fiscal and regulatory framework.

We maintain our view that the Banxico's next move will be a rate hike. We consider that this movement will take place immediately after the U.S. Fed hikes its own rate in June this year (Banxico's meeting will take place in July 2015). In addition, we expect a 100bps hiking cycle this year so that the reference rate could finish the year at 4%. Beyond 2015, there is a high degree of uncertainty about whether the Fed will hold only a process of "*normalization*" and not monetary "*restriction*", so it is difficult to predict what Banxico could do in this period. Nevertheless, we consider that the long-term monetary policy reference rate in Mexico, incorporating the impact of structural reforms, stands at 7%.

From our fixed income and strategy team

Banxico will keep waiting for US economic performance and the Fed, warning about the possibility of additional market volatility.

Banxico's Quarterly Inflation Report released earlier today confirmed expectations of being cautious and to wait and see the development of US economic activity in coming months, as well as the Fed's future actions. The statement regarding the balance of risks for local activity and inflation was broadly unchanged from the last communiqué, minutes and Board member interventions. In this sense, it is likely that the market will continue pricing-in a rate hike in tandem with the Fed on 2H15. The Mexican bond market observed a positive reaction as the profit taking seen throughout the day was cut by around 2pbs, reversing the trend of the day by setting on flat levels compared to yesterday's close.

We hold a neutral stance on local rates, suggesting to wait for better market conditions to open long directional positions. The Fed's minutes to be published this week will depict discussions around the U.S. economic situation in the light of the slowdown observed in 1Q15 and the possibility that part of the latter could permeate into coming quarters. Prior to this event, the market priced the Fed's liftoff in 4Q15 and a scenario where Banxico could begin its monetary conditions normalization somewhere between 3Q15 and 4Q15 with strong implied probabilities. In the aftermath, cumulative hikes by year-end are standing at 19bps for the Fed and 49bps for Banxico. This suggests that there is muted value in the short-end of the curve, although investors are likely to continue avoiding higher duration as a defensive strategy on the back of high global market volatility.

In terms of longer term securities, investors are aware of the prevailing risks at the global level that are likely to generate an additional sell-off in sovereign bonds worldwide (European bonds' adjustments, uncertainty about the Fed, and Greek's credit *impasse*). In our view, there is an attractive valuation in the Mexican yield curve, mainly in 20-year Mbonos such as May'31 and Nov'34. However, we acquiesce in the strong likelihood that the sell-off registered in the last days could endure given the uncertainty surrounding the Fed's future actions, waiting for more definition in the economic front. In this sense, we believe patience should keep paying off, waiting for better entry levels for long directional strategies. It is likely that this situation continues despite an attractive Mbonos curve slope and a spread between US rates and local bonds that does not reflect Mexico's fundamentals. Specifically, the 10-year spread is currently trading at 366bps, higher than the mid-term equilibrium of 360bps and the 12-month mean at 354bps.

In the FX market, the peso did not react much to the release as new developments from recent communications were scarce, trading 0.5% weaker at 15.19 per dollar. We highlight that, in line with our expectations, Governor Carstens did not rule out additional measures by the Foreign Exchange Commission in case of higher volatility or a disorderly depreciation due to the beginning of the Fed's normalization process, say on a fast depreciation to above 16.00 per dollar. Nevertheless, it was clear that the current policy of rule-based measures would be preferred in order to avoid signaling the defense of a particular level for the currency. The MXN should remain as a very relevant variable for Banxico's monetary policy decisions based on potential risks to financial stability (due to high holdings of securities by foreigners) and pass-through effects to inflation, although likely exhausting other measures before forcing the bank's hand to raise rates prematurely.

On the other hand, we believe that the reduction in GDP growth estimates for 2015 and 2016 signals higher risks to the upside for our year-end USD/MXN forecasts, currently at 14.90 and 14.50 per dollar, respectively. In our view, these risks should be closely monitored in order to assess the currency's potential to be able to differentiate itself from other EM in a still difficult external environment. Carstens also suggested that it is unlikely to see a scenario to justify rate cuts in Mexico and should follow the Fed, resulting in low and stable carry at least in the months ahead. In our view, the latter could also limit the peso, at least for the time being. In terms of strategy, we maintain a cautious stance on the MXN and avoid chasing the rally observed in recent weeks (even after the correction since last Friday). We recommend to trade the ranges as we expect them to remain wide given the persistence of high volatility in global markets and the lack of local catalysts. In our view, the peso's higher correlation with US rates will limit a stronger appreciation past 15.00 per dollar as a relevant technical support, in which we could continue seeing higher appetite for long USD positions. On the contrary, interest in peso longs could increase above 15.40 per dollar, particularly if risk premiums in Mexican bonds to US rates in the long-end are high.

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