

Banxico QR – Slower growth, convergent inflation, but FX risks

- Banxico published today its 1Q19 *Quarterly Report (QR)*
- The release was accompanied by a press conference by Governor Alejandro Díaz de León
- In our view, the tone was similar to the latest communique, with a more hawkish bias in terms of the inflation outlook
- Considering this, we maintain our expectation of a 25bps reference rate cut in November. Nevertheless, in case of a further deterioration in growth, better inflation dynamics or lower local uncertainty, we do not discard that a cut could materialize earlier
- We highlight that Banxico modified both its growth and inflation estimates. Specifically:
 - (1) Growth for 2019 was revised down from a range between 1.1-2.1% to 0.8-1.8%, while the forecast for 2020 stood at 1.7-2.7%
 - (2) Headline inflation for 2Q19 remained at 4.3% yoy, while the rest of the trajectory for this year and 2020, including the core component, was revised upwards between 10 to 30bps
- Among the most relevant themes in the “grey boxes” Banxico included the impact on Mexico from the US-China trade war, the impact of wage revisions on inflation, and the main factors that hinder local economic growth, among others
- Today’s QR suggested that board members continue discussing a complex trilemma

We consider that the *Quarterly Inflation* shows a relatively hawkish tone, in line with the latest policy statement. Banxico published today its *Quarterly Report (QR)* for 1Q19. The release was accompanied by a press conference led by Governor Alejandro Díaz de León. In our opinion, the tone of the QR was slightly hawkish, very similar with what we perceived in the monetary policy statement of the May 16th meeting. Although we consider that the tone regarding growth has been more dovish, concerns on inflation have more than compensated for this sentiment.

Downward adjustment in 2019 GDP forecasts for the fourth consecutive time. The forecast range for GDP this year was downgraded from 1.1-2.1% yoy to 0.8-1.8% (see table below). As a result, the mid-point was cut by 30bps and from 1.6% to 1.3%, slightly below our forecast of 1.5%. For next year, the forecast range was left unchanged at 1.7-2.7%. In the press conference, Governor Díaz de León highlighted two main factors behind the reduction: (1) That 1Q19 GDP at 1.2% yoy (-0.2% q/q) was weaker than originally estimated by the central bank, affected in part by transitory shocks; and (2) the relative weakness in industrial production, as portrayed by the 0.6% q/q decline in 1Q19, its second consecutive quarter in contraction.

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Considering this, the downgrade is consistent with the more dovish tone about growth that we had already perceived in the latest communique.

On a more positive note, it is worth mentioning that the central bank expects that the economy will return to positive growth in coming quarters due to both internal and external demand, which is also consistent with our forecast path for GDP during the rest of the year. However, the latter could decelerate further given the dynamics of the global economy and the US, in particular. It is our take that this comment is primarily driven by the risks stemming from the recent escalation in trade tensions between the US and China.

In this respect, the “grey box” analyzing the impact of US tariffs to China on Mexico’s market share in US imports concludes that recent gains have been driven by several factors. Among them, tariffs have indeed supported Mexican exports of certain goods but they do not explain the full gains in market share, with the accumulated depreciation of the real exchange rate also behind them. The central bank’s study affirms that some sectors could benefit from this dispute, particularly if the USMCA is ratified and regional integration deepens. Nevertheless, the net effect is uncertain and could well be negative as trade tensions could generate financial volatility and increase doubts over the maintenance of global supply chains, impacting the productivity and competitiveness of Mexico’s export sector.

Banxico’s Forecast
Current Report (1Q19)

| | 2019 | 2020 |
|-------------------------------|------------------------|------------------------|
| GDP (%) | 0.8 – 1.8 | 1.7 – 2.7 |
| Employment (thousands) | 530 – 630 | 650 - 750 |
| Trade Balance (bn) | -13.5 (1.0% of GDP) | -13.7 (1.0% of GDP) |
| Current account (bn) | -24.3 (1.9% of GDP) | -25.6 (2.0% of GDP) |

Source: Banxico

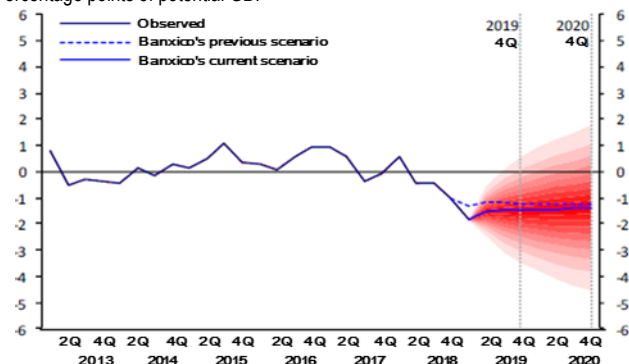
Banxico’s Forecast
Previous Quarterly Report (4Q18)

| | 2019 | 2020 |
|-------------------------------|------------------------|------------------------|
| GDP (%) | 1.1 – 2.1 | 1.7 – 2.7 |
| Employment (thousands) | 620 - 720 | 650 - 750 |
| Trade Balance (bn) | -11.8 (0.9% of GDP) | -14.0 (1.0% of GDP) |
| Current account (bn) | -25.2 (2.0% of GDP) | -28.0 (2.0% of GDP) |

Source: Banxico

Output gap

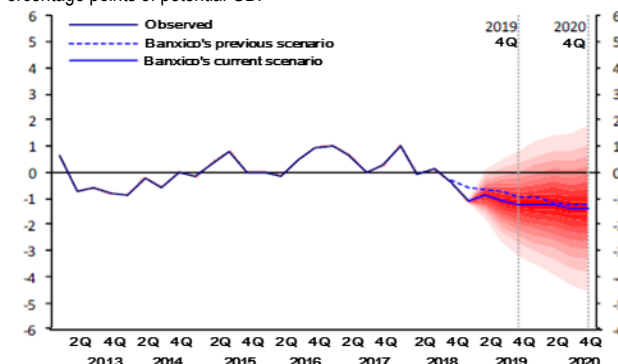
Percentage points of potential GDP



Source: Banco de Mexico; 1Q19 QR

Output gap ex oil production

Percentage points of potential GDP



Source: Banco de Mexico; 1Q19 QR

Upward revisions in CPI forecasts. Although the estimate for headline inflation in 2Q19 was unchanged at 4.3% yoy, the rest of the trajectory was revised upward by 10-30bps, with the highest revision in 4Q19 and 1Q20. With this, and based on quarterly averages, convergence to the 3% target was delayed from 3Q to 4Q20.

Moreover, revisions in the core component for the next four quarters were updated by +20bps in each case, with more mixed upward adjustments starting on 2Q20.

Banxico mentioned that changes in the forecasts for the headline are explained by revisions in the core component –quoting recent dynamics in processed foods and several services– on top of the expectation of higher energy prices going forward. Regarding upside risks, they reiterated those described in the last policy statement, highlighting the possible impact of recent wage increases which have already surpassed productivity gains in some sectors, contributing to elevated core inflation. In this context, Banxico used one of its “grey boxes” to analyze these dynamics. The analysis consisted on the correlation between services within CPI with unit labor costs in this sector, concluding that it is positive. In addition, when restricting the sample to 1Q19, the monetary authority found the correlation to be positive and statistically-significant. This leads the central bank to conclude that services’ prices have been influenced by a great extent by recent wage dynamics, as well as by accumulated pressures in energy prices during the last few years.

In our opinion, adjustments to the inflation forecast, as well as outlined risks, are consistent with the tone of a more prudent stance by the monetary authority that we perceived in the last monetary policy statement. Although now the year-end forecast from the central bank stands above ours, according to the central bank the revisions affected short-term estimates the most, leaving estimates for 2Q and 3Q largely in line with ours. Taking into account our year-end forecast of 3.5% and our expected inflation path, we consider that the magnitude of the adjustments is not enough to close the door on possible rate cuts during the year.

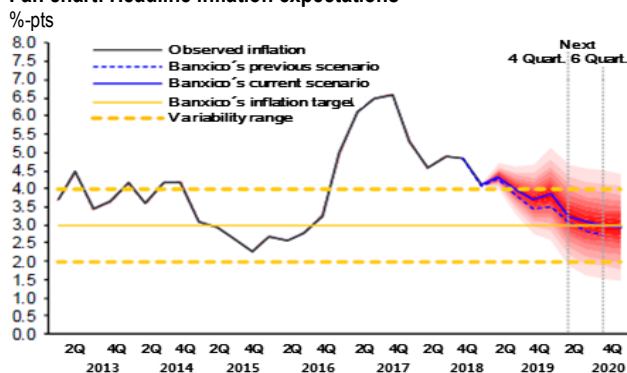
CPI forecasts

% yoy, quarterly average

| | 2019 | | | | 2020 | | | | 2021 |
|-------------------|------|-----|-----|-----|------|-----|-----|-----|------|
| | I | II | III | IV | I | II | III | IV | I |
| CPI | | | | | | | | | |
| Current forecast | 4.1* | 4.3 | 4.0 | 3.7 | 3.8 | 3.2 | 3.1 | 3.0 | 3.0 |
| Previous forecast | 4.1 | 4.3 | 3.8 | 3.4 | 3.5 | 3.1 | 2.8 | 2.7 | --- |
| Core | | | | | | | | | |
| Current forecast | 3.6* | 3.8 | 3.6 | 3.4 | 3.4 | 3.0 | 3.0 | 3.0 | 3.0 |
| Previous forecast | 3.5 | 3.6 | 3.4 | 3.2 | 3.2 | 2.9 | 2.8 | 2.7 | -- |

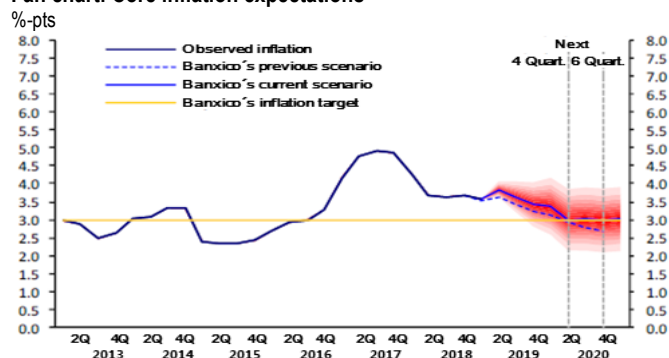
Source: Banco de México, 1Q19 QR; *Observed data

Fan chart: Headline inflation expectations



Source: Banco de Mexico; 4Q18 QR

Fan chart: Core inflation expectations



Source: Banco de Mexico; 4Q18 QR

The importance of governance factors for economic growth. In our view, one of the most interesting ‘grey boxes’ analyzed answers of both economic analysts and companies about the three most important factors that, in their opinion, could weigh on GDP growth during the next six months. These are separated in five categories, including: (1) Governance; (2) inflation and monetary policy; (3) domestic economic conditions; (4) external conditions; and (5) public finance. As of March 2019, both groups coincided that the top factor is related to governance (which includes insecurity, political uncertainty, corruption and impunity, and rule of law, among others). In particular, this was the top-answer for 28.6% of companies and 40.5% of analysts.

Within this, both also said that the most important is public security, followed by domestic political uncertainty. Moreover and on a longer-term basis, this category has been gaining relative weight. In second place, and in a different tone between groups, analysts placed domestic economic conditions (mostly related to the decline in the oil production platform) while companies pointed to higher prices in commodities and cost of goods sold within “inflation and monetary policy”. In this respect, the central bank argued that strengthening the enforcement of the rule of law, advancing in terms of legal certainty and contract compliance, and combating corruption, impunity and insecurity, would help in the development of a more certain and trustworthy environment for economic growth that will benefit the overall population.

We maintain our expectation that Banxico will cut the reference rate by 25bps in November 14th. In our view, the tone of the document and the press conference, along forecast updates, did not deviate much from the information already published in the latest communications of the central bank. In this sense, the QR is consistent with a more dovish outlook in terms of growth but a prudent stance given the risks to the outlook for inflation, with a special focus on dynamics at the core component. Considering the information provided today, we maintain our expectation of a 25bps reference rate cut in November 14th. Moreover, we also think that a cut could materialize earlier than we currently expect. Specific conditions that would increase the probability of the latter scenario include: (1) A further deterioration of economic activity; (2) better inflation dynamics than those currently estimated by the central bank, a situation we believe could materialize by 4Q19;, and/or (3) a reduction in local uncertainty, particularly regarding the financial situation of Pemex including its potential effect on both its own and the sovereign credit rating.

From our fixed income and FX strategy team

Today's QR suggested that board members continue discussing a complex trilemma. Market participants are aware of the difficult conundrum faced by the central bank. First, the economy is showing clear signs of deceleration, with significant headwinds coming from the external backdrop (*i.e.* global economic downturn), combined with some short-lived local shocks (more details in “*1Q19 GDP revised down to 1.2% yoy, dragged by industry and services*”, [pdf](#)), published on May 24th, 2019). As a result, the balance of risks for the Mexican economy remains tilted to the downside, portraying a relevant dovish argument. Second, inflation has been recently affected by negative externalities, steering inflation expectations higher inside analysts' surveys and market-traded breakevens. Mid- and long-term inflation expectations are approximately 60bps above the central bank's target of 3%, while inflation breakevens are trading nearly 18bps higher than the levels observed last quarter with longer tenors even locating above 4%. It is important to bear in mind that in its recent policy communiqué, Banxico included the strong likelihood of higher costs pressures in the economy in the near term. Overall, Banxico's assessment on inflation is biased towards the hawkish spectrum. The third part of this complex situation is coming from the risk premium embedded in local assets, mainly the Mexican peso. The currency is depicting a defensive performance this year benefited by an attractive carry. Short-term ex ante real rate is showing a 440bps spread against the U.S. real rate, which Banxico has to strategically manage in the next quarters and years.

Taking into account these three factors Banxico is likely to have a prudent approaching towards an easing cycle. Local rates are trading with pressures of 2bps on average mainly concentrated in short- and mid-term securities while U.S. Treasuries extend the recent rally (-3pbs). However the recent flattening of the yield curve is consistent with this cautious stance. In terms of the market's pricing, expectations about Banxico's future policy path have recently adjusted, discounting only -30bps of rate cuts this year vs. -49bps observed only a month ago. Although we acknowledge that the Mexican yield curve could benefit from the dovish inertia from several central banks combined with an attractive carry, we hold a cautious stance for long directional trade ideas. We continue observing a more attractive relative valuation in Mbonos Nov'36 and Nov'38, nevertheless we suggest waiting for better market conditions and entry levels for new long positions.

Regarding the FX market, the Mexican peso reacted with a slightly positive tone to Banxico's Quarterly Report, trading close to 19.15 per dollar, equivalent to a 0.25% appreciation with respect to yesterday's close. The currency's performance throughout the last sessions has remained under a narrow range, defined by USD/MXN 18.90 in its strongest point and 19.20 as the main support. This has taken place despite a USD which remains sustained by weaker risk appetite conditions on the back of prevailing geopolitical tensions, coupling to a monetary and economic position which is more favorable to the U.S. relative to other developed regions.

In this sense, we have argued that the main support for the MXN is still its implied carry, which is high when considering other comparable EMs. In our opinion, and taking into account the central bank's view offered today, this anchoring element will remain as a relevant factor for the following months. In terms of strategy, we still see a defensive peso in the short-term, reason why we suggest waiting for more attractive levels below 19.00 for directional recommendations on USD longs, reaffirming our view about a more challenging 2H19. For greater detail in our FX views please consult: "*Fixed-Income, FX, and Commodities - 2Q19 Outlook*", <[pdf](#)>, published on April 10th, 2019.

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|------------------|--|
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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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