Ahead of the Curve

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Market focus this week will be on Banxico's monetary policy announcement and October's industrial production

- **Banxico's monetary policy announcement (December).** On Thursday, Banxico will announce its monetary policy decision at 2:00pm (ET), where we expect a 25bps hike in the reference rate, which will stand at 7.25%. We believe that the central bank's main concern will be the actual trend in inflation, given that with Nov-2H report, this was the 15th time in the past 22 bi-weekly readings that inflation beat consensus estimates. Moreover, consensus is now calling for a 25bp rate hike and TIIE futures market had already discounted a 25bp rate hike with a 64% probability. In addition, the recent quick depreciation of the peso vis-à-vis the US dollar and Thursday's inflation number, adds to the more hawkish tone we have perceived from new central bank Governor Díaz de León

- **Industrial production (October).** On Tuesday at 9:00am (ET), *INEGI* will release its monthly industrial production report. We anticipate a null annual growth in total output during October, after the 1.2% contraction in the previous month. Taking a look at the breakdown, manufacturing production could post a 4.2% yoy expansion. In addition, we forecast a marginal 0.1% yoy expansion in construction output, while the poor performance of mining activity will continue, where we estimate a 11.9% yoy contraction

Mexico weekly calendar

DATE	TIME (ET)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Mon 11-Dec	**12:30pm**	**Government weekly auction: 1-, 3-, and 6-month Cetes; 3y MBono (Jun'20); 3y Udibono (Dec'20)**					
Tue 12-Dec	**9:00am**	**Industrial production**	October	% yoy	0.0	0.5	-1.2
		(sa)		% m/m	0.7	0.6	-0.4
		Mining		% yoy	-11.9	--	-15.1
		Utilities		% yoy	-0.5	--	1.4
		Construction		% yoy	0.1	--	0.1
		Manufactures		% yoy	4.2	3.8	2.8
Wed 13-Dec	**10:00am**	**International reserves**	9-Dec	US$ bn	--	--	172.6
Thu 14-Dec	**2:00pm**	**Banxico's monetary policy decision**		%	7.25	7.25	7.00
Fri 15-Dec	**10:00am**	**Banxico's survey of economic expectations**	December				

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

Weekly government bond auction. On Monday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent–, will offer 3-year fixed rate Mbonos (Jun'20) and 3-year inflation-linked Udibonos (Dec'20), 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 (ET).

Auction specifics (Monday, December 11, 2017)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	11-Jan-18	- -	7,000	7.02
3m	15-Mar-18	- -	11,000	7.23
6m	07-Jun-18	- -	11,500	7.32
M Bono				
3y	11-Jun-20	8.00	8,000	7.05
Udibonos				
3y	10-Dec-20	2.50	UDIS 750	3.36

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

We expect a null annual growth in October's industrial output. On Tuesday at 9:00am (ET), *INEGI* will release its monthly industrial production report. We anticipate a null annual growth in total output during October, after the 1.2% contraction in the previous month. Taking a look at the breakdown, manufacturing production could post a 4.2% yoy expansion, as a result of the significant 11.2% increase in vehicle production.

In addition, industrial output during October will be also explained by: (1) The marginal 0.1% yoy expansion in construction output, as a result of the lower growth in private construction investment projects, coupled with the contraction in public investment projects given the Federal Government's austerity program; and (2) the poor performance of mining activity, where we estimate a 11.9% yoy contraction.

Industrial production estimate: October 2017
% yoy nsa; % m/m sa

% yoy	Oct-17	Oct-16	Jan-Oct, '17	Jan-Oct, '16
Total	0.0	-1.3	-0.5	0.3
Mining	-11.9	-5.8	-10.3	-3.4
Utilities	-0.5	-1.1	-0.3	0.2
Construction	0.1	2.4	-1.0	2.0
Manufacturing	4.2	-1.3	3.4	1.0

%m/m sa	Oct-17	Sep-17	Difference
Total	0.7	-0.4	1.1
Mining	3.4	-6.2	9.6
Utilities	-1.5	1.8	-3.3
Construction	0.7	0.8	-0.1
Manufacturing	0.5	-0.1	0.6

Source: Banorte-Ixe

Weekly international reserves report. On Wednesday, at 10:00am (ET), Banco de Mexico will release its weekly balance report. Last week, net international reserves decreased by US$168 million amounting to US$172.6 billion. According to Banxico's report, this figure comes mainly as a result of: (1) US dollar sales from the Central Bank to the Federal Government totaling US$19 million; (2) the payment to the IMF of the renovation of the Flexible Credit Line amounting to US$148 million; and (3) a negative valuation effect in central bank assets of around US$1 million. In this context, the Central Bank's international reserves have diminished by US$4 billion this year (please refer to the table below).

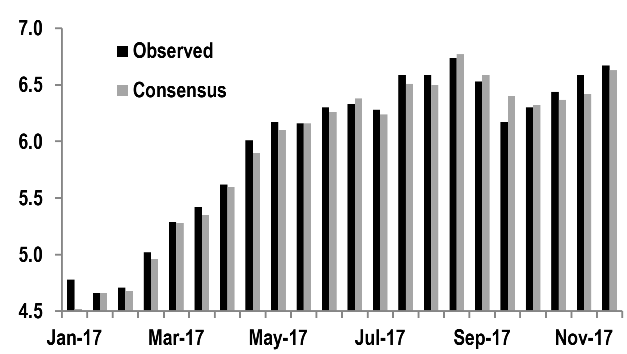
Banxico's foreign reserve accumulation detail
US$, million

	2016	Dec 1, 2017	Dec 1, 2017	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	176,542	172,581	-168	-3,961
(B) Gross international reserve	178,025	174,131	-590	-3,894
Pemex	--	--	103	-563
Federal government	--	--	-71	-4,329
Market operations	--	--	0	-2,000
Other	--	--	-622	2,998
(C) Short-term government's liabilities	1,483	1,550	-422	67

Source: Banco de México

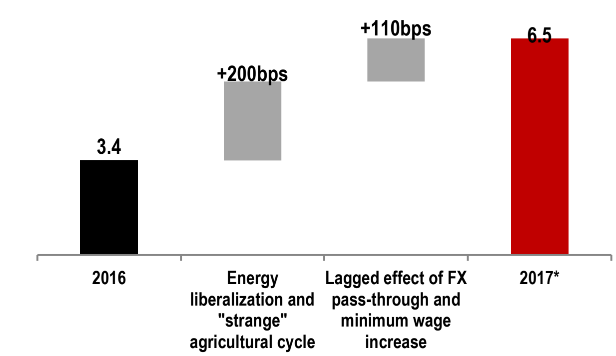
Banxico's monetary policy announcement – We expect an additional 25bps hike. On Thursday, Banxico will announce its monetary policy decision at 2:00pm (ET), where we expect a 25bps hike in the reference rate, which will stand at 7.25%. We believe that the central bank's main concern will be the actual trend in inflation, given that with Nov-2H report this was the 15th time in the past 22 bi-weekly readings that inflation beat consensus estimates (please see the chart/table below on the left). It is clear for us that currently high inflation is mainly explained by supply-side factors. Nearly two thirds of this year's increase in 12-month inflation is due to the gasoline and LP gas price liberalization, as well as an adverse agricultural cycle. The rest reflects lagged effects of the significant depreciation of the peso vis-à-vis the US dollar since year 2014, which seems to have decided to show "*its ugly face*" recently (please refer to the flying-brick chart below on the right).

Bi-weekly inflation vs. consensus forecast
% yoy, bi-weekly frequency



Source: INEGI and Bloomberg

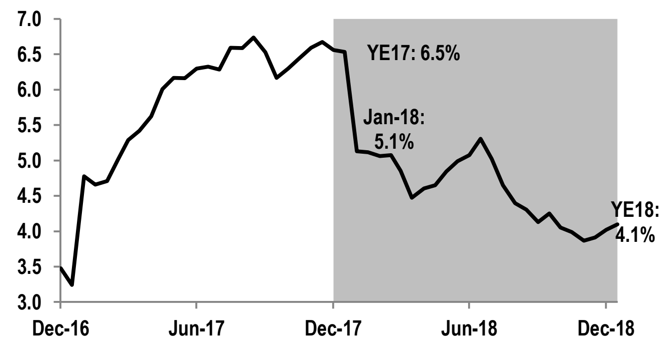
Contributions to 2017's inflation
% yoy, contribution in bps



Source: Banorte

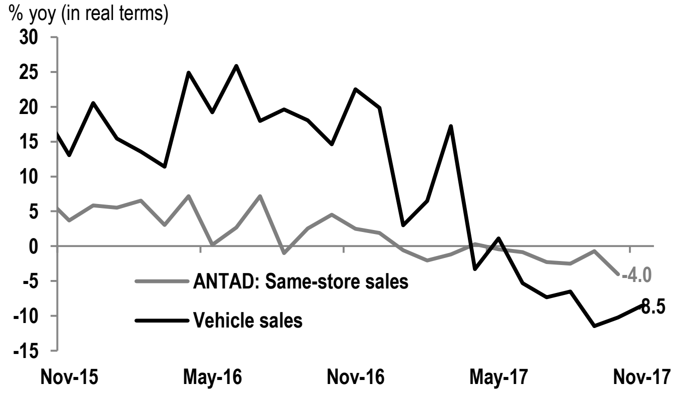
Moreover, recall that Banxico has already hiked 400bps since December 2015. What is more, we are quite sure that in the absence of extreme shocks, 12-month inflation will be between 130 and 160 bps lower in less than two months, as it is shown in the chart below in the left. As a result, we believe Banxico should not hike. More so given the recent weakness in growth, private consumption, and investment (please see the chart below on the extreme right). In this contrast, even though the third quarter weakness might have reflected the aftermath of the severe earthquakes the Mexico City and surrounding states faced back in September, the recent *"Buen Fin"* consumer figures (Mexico's *Black Friday*), could support more structural underlying reasons for the observed deceleration in economic activity.

Inflation forecast
% yoy



Source: INEGI and Bloomberg

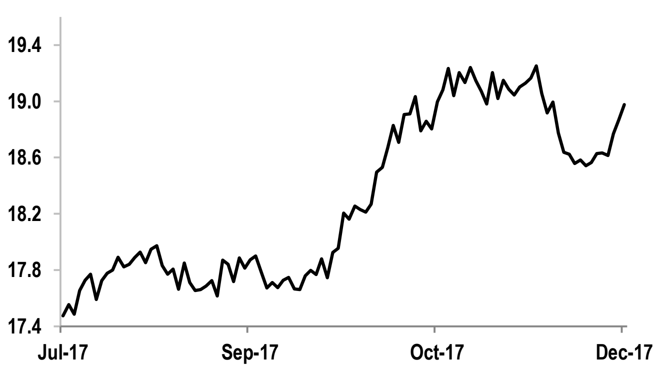
Auto sales and ANTAD same-store sales
% yoy (in real terms)



Source: Banorte

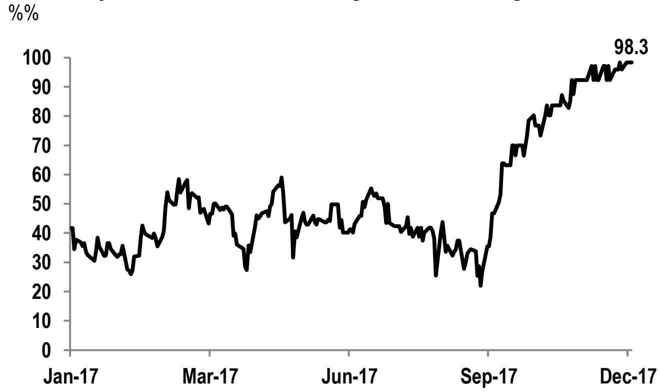
However, consensus is now calling for a 25bp rate hike and TIIE futures market had already discounted a 25bp rate hike with a 64% probability. In addition, the recent quick depreciation of the peso vis-à-vis the US dollar (please see chart below on the left), and Thursday's inflation number, adds to the more hawkish tone we have perceived from new central bank Governor Díaz de León, as well as the fact that the US Fed has also been perceived more hawkish (please see chart below on the right). As a result, we change our call to a 25bp rate hike next week, from having expected the Central Bank to remain on hold. Looking ahead, we continue to expect Banxico's next move to be a rate cut in the second half of year 2018.

Mexican peso
USD/MXN



Source: Bloomberg

Probability of Fed funds rate reaching 1.25%-1.5% range in December
%%



Source: Bloomberg

Banxico's survey of economic expectations. Finally, on Friday, at 10:00am (ET), Banco de Mexico will publish its monthly survey of economic expectations. Market focus will be on inflation forecasts for both 2017 and 2018, which as of last survey stand at 6.5% (Banorte: 6.5%), as well as inflation expectations for the medium and long term. Moreover, attention will also be on monetary policy forecasts, where we don't expect to have changed from last survey's results. Additionally, we will be looking into 2017 and 2018's GDP forecasts, which we expect at 2.1% and 2.5% respectively. Furthermore, we expect marginal upward revisions to FX forecasts, which we continue to forecast at USD/MXN18.10 by YE17.

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