We now expect a 25bp hike in June

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www.banorte.com
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@analisis_fundam

Gabriel Casillas
Chief Economist and Head of Research
gabriel.casillas@banorte.com

Delia Paredes
Executive Director of Economic Analysis
delia.paredes@banorte.com

Alejandro Cervantes
Senior Economist, Mexico
alejandro.cervantes@banorte.com

Francisco Flores
Economist, Mexico
francisco.flores.serrano@banorte.com

- **Following the favorable labor market report in the U.S., our international economic analysis team now expects that the FOMC will hike the Fed funds range in 25bps at its next meeting on June 14**
- **Consequently, we anticipate that Banxico will follow the Fed and raise its reference rate by 25bps at its meeting on June 22**
- **The Board Members have stated in the past that the three main factors they will evaluate in deciding whether to increase the reference rate are:**
  (1) The relative monetary stance between Mexico and the United States;
  (2) The evolution of inflation; and
  (3) The evolution of the output gap
- **In an environment where 12-month inflation is likely to continue to rise and where it is practically a fact that the Fed will raise rates in June, we find it very difficult for Banxico to be able to disassociate itself from the Fed's moves**

Following the positive US labor market report, our international economic analysis team now expects the FOMC to raise the Fed funds rate by 25bps at its next meeting on June 14. Consequently, we anticipate that Banxico will follow the Fed and raise its reference rate by 25bps at its meeting on June 22. The Board Member have stated in the past that the three main factors they will evaluate in deciding whether to increase the reference rate are: (1) The relative monetary stance between Mexico and the United States; (2) the evolution of all inflation determinants and its medium- and long-term expectations, in particular the potential pass-through effect of the depreciation of the exchange rate changes and increase in gasoline prices to other prices; and (3) the evolution of the output gap.

(1) Relative monetary stance vs. US Fed. The FOMC kept the *Fed funds* range unchanged at 0.75-1% at its last meeting on Wednesday. The US monetary authority stated that the deceleraton in 1Q17 is temporary and that the labor market has strengthened despite the slowdown. Moreover, the tone of the recent interventions by different *Fedspeakers* led our international economic analysis team to believe that the Fed will still hike two more times this year, 25bps in June and another 25bps in September. This view is in line with market expectations, which discount a June hike with 100% of probability (as implied by *Fed funds* rate futures). As a result, we believe that Banxico will skip the hike in May, but will follow the Fed in June by hiking the reference rate by 25bps.

(2) Inflation, FX and expectations. Since the last monetary policy meeting that took place on March 30, annual inflation has increased from 5.35% in March to 5.62% in the first half of April. Moreover, next Tuesday, *INEGI* will release April's inflation numbers, where we expect to see annual inflation climb to 5.79%, slightly above our forecast for year-end. Against this backdrop, in terms of the exchange rate and inflation expectations, the outlook is more favorable. Although the peso has depreciated 1.1% since the last monetary policy meeting, it has appreciated 15.3% from the high reached on January 19, from 21.90 to 19 pesos per dollar (taking May 4th,"fix" exchange rate) . In addition, although inflation expectations for year-end, according to the latest Banxico's survey, have increased from 4.6% in March to 4.7% in April, medium and long-term expectations have not shown any additional deterioration standing at 3.5% and 3.4%, respectively.

(3) Negative output gap. Analyzing Banxico's methodology to estimate the output gap –where GDP is calculated using a Hodrick-Prescott filter with tail correction–, we have seen several quarters with a negative gap, although it has considerably tightened towards the long term trend. Considering this, we believe that we are close to seeing demand-side pressures on inflation.

We expect a 25bps increase in Banxico's reference rate at the June 22 meeting. In an environment where annual inflation is likely to continue to rise – even though it will only reflect the increase in energy prices in January, and some pass-through effects of the exchange rate-, and expecting a US Fed rate hike in June, we find it very difficult for Banxico to be able to disassociate from the US Fed, particularly now that much of the uncertainty related to Trump's potential policies has dissipated, which could accelerate economic growth in the coming quarters.

GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

Economic Analysis

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Juan Carlos García Viejo	Economist, International	juan.garcia.viejo@banorte.com	(55) 1670 - 2252
Francisco José Flores Serrano	Economist, National	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

Fixed income and FX Strategy

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal, CFA	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

Equity Strategy

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates / Financials/ Mining / Chemistry	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research Analyst – Airlines / Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research Analyst – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251

Corporate Debt

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247

Wholesale Banking

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Asset Management	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Corporate Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454