Banxico's QIR – U.S. political & economic situation poses risks to Mexico's outlook

August 31, 2016

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- **Banxico published today its *Quarterly Inflation Report* (QIR) for 2Q16**
- **We highlight the following issues:**
  - **(1) The measures taken during the quarter, which included the rate hike June 30, were taken by the monetary authority in a flexible manner;**
  - **(2) Growth estimates ranges for 2016 and 2017 were revised down;**
  - **(3) The output gap will remain in negative territory until the end of 2017;**
  - **(4) Inflation in the coming months will increase gradually to 3%, although at the end of the year will close slightly below this level; and**
  - **(5) Given the nature of the shocks that have caused the increase in the current account deficit, it seems more efficient that its containment is carried out through fiscal policy**
- **In the traditional *grey* boxes the following issues were addressed:**
  - **(1) The relationship between the producer's price index and consumer's;**
  - **(2) The importance of the performance of US export sector as a determinant of non-car manufacturing exports from Mexico to the United States; and**
  - **(3) Recent developments in Mexico's current account**
- **We maintain our expectation that the central bank will hike rates in 50bps in September, and by the same magnitude again in December**
- **Losses in Udibonos on a marginally less hawkish tone**

Lower growth ahead but inflation under control. The monetary authority released its *Quarterly Inflation Report* (*QIR*) for 2Q16. The release was accompanied by a press conference led by Governor Carstens. We highlight the following issues discussed in the document: (1) The measures taken during the quarter, which included the rate hike June 30, were taken by the monetary authority in a flexible manner; (2) growth estimates ranges for 2016 and 2017 were revised down; (3) the output gap will remain in negative territory until the end of 2017; (4) inflation in the coming months will increase gradually to 3%, although at the end of the year will close slightly below this level; and (5) given the nature of the shocks that have caused the increase in the current account deficit, it seems more efficient that its containment is carried out through fiscal policy. In our opinion, Banxico's *QIR* suggests that the central bank´s next movement is a rate hike as soon as September (50bps) and then again in December.

Economic activity contracted in 2Q16 vs. previous quarter. The report notes that the performance of the Mexican economy during the second quarter of 2016 was less favorable, since the industrial sector continued to show persistent stagnation amid the recession in the mining-sector, while services activity stopped its expansion. Meanwhile, some indicators suggest that private consumption decreased its rate of expansion. Finally, gross fixed investment continues to show a downward trend. This means that slack in the economy has remained and Banxico expects the output gap remains negative until the end of 2017.

Banxico revised down its growth estimate for 2016 and 2017. Given that the slowdown in 2Q16 was larger than expected, the monetary authority considered it necessary to revise downward its growth range forecast for 2016 to 1.7%-2.5% from 2%-3%. Meanwhile, for 2017 they changed the range to 2%-3% from 2.3%-3.3%. Banxico considers that structural reforms will contribute to the recovery of domestic spending and create an environment more favorable growth (refer to the tables below).

Banxico´s Forecast
Recent

	2016	2017
GDP (%)	1.7 – 2.5	2.0 - 3.0
Employment (thousands)	590 - 690	610 - 710
Trade balance (bn)	-16.0 (1.5% del PIB)	-16.0 (1.4% del PIB)
Current account (bn)	-32.4 (3.1% del PIB)	-35.6 (3.2% del PIB)
Inflation		
Headline	Close to 3%	Around the permanent inflation target
Core	Near 3%	Around the permanent inflation target

Source: Banxico

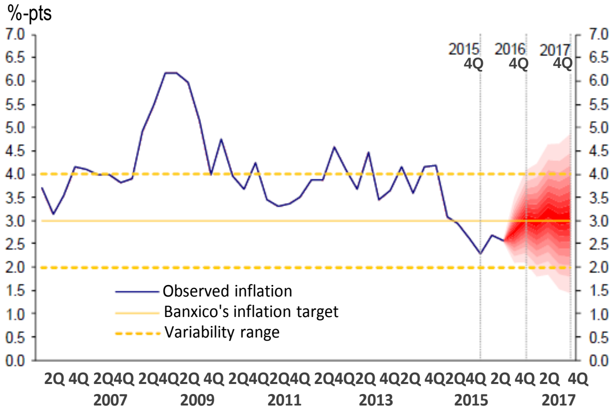
Banxico´s Forecast
Previous Quarterly Report

	2016	2017
GDP (%)	2.0 - 3.0	2.3 - 3.3
Employment (thousands)	590 - 690	630 - 730
Trade balance (bn)	-15.4 (1.4, %PIB)	-15.1 (1.3, %PIB)
Current account (bn)	-34.4 (3.1, %PIB)	-36.7 (3.1, %PIB)
Inflation		
Headline	Near 3%	Around the permanent inflation target
Core	Near 3%	Around the permanent inflation target

Source: Banxico

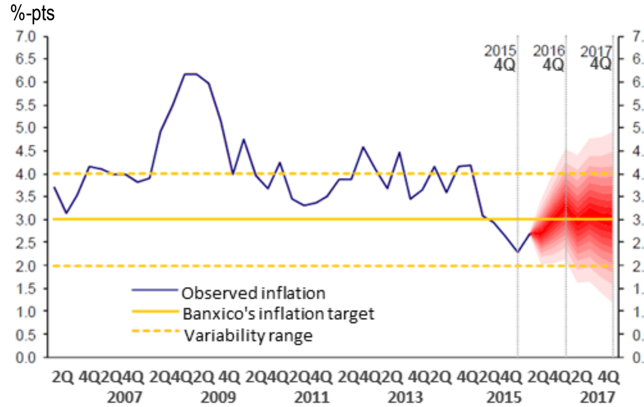
Banxico considers that inflation will be arount 3% this year. The central bank said headline inflation will increase gradually to levels near the target, closing the year slightly below this level (3%). Meanwhile, core inflation will increase gradually ending the year around 3%. By 2017, the central bank expects inflation levels will remain around the target. Regarding the risks balance, the monetary authority considers that structural reforms will continue to decrease prices of telecommunication services while the dynamism of economic activity could be lower than anticipated. In contrast, it is possible that the Mexican peso will continue depreciating derived from the uncertainty associated with the outcome of the electoral process in the United States and its implications, the possibility of weaker oil prices, a deterioration of the current account deficit, and the normalization of monetary policy of the U.S. Fed.

Fan chart: Inflation expectations (Actual)



Source: Banco de México, 2Q16 QIR

Fan chart: Inflation expectations (Previous)



Source: Banco de México, 1Q16 QIR

There is no evidence of inflationary pressures on consumer prices from the PPI. The first *grey box* analyzes the predictive power of the different PPI merchandise sub-index vs. the ones in the core index in the CPI. The result shows that there is a long-term relationship between the prices of merchandise both in the producer and consumer price index, being the latter the one adjusting to the different shocks. In this context, the performance of the merchandise sub-index has remained slightly above its long-term equilibrium ratio vs. the PPI, suggesting that there are no inflationary pressures on consumer prices of goods coming from producer prices.

The weakness of economic activity in countries other than the United States has had adverse effects on the Mexican export sector. This effect is both direct and indirect, through the impact on US exports and the purchase of intermediate goods from other countries. Another channel that has a negative impact on US exports is the appreciation of the US dollar since low growth in countries other than US has resulted in lower exports of Mexico addressed to those economies. In addition, it also implies a slowdown in Mexican exports to the United States. The fact that weak global economic activity impacts directly or indirectly to Mexican exports, has meant that the adjustment of real exchange rate has had to be larger than if its impact had limited only to direct effect from lower domestic demand in the United States.

In terms of GDP, the current account has gradually increased. This issue is relevant because we can analyze the magnitude of foreign financing vs. domestic income. In this context, the depreciation of the exchange rate has adversely affected Mexico's GDP in dollar terms, contributing to the deterioration of current account levels as a percentage of GDP. In addition, the increase in the current account is also explained by the deterioration in the oil trade balance while other components have been lower than those observed in previous years. This could lead to some concerns because it does not seem that the phenomenon of deteriorating oil terms of trade is transitory. Moreover, the composition of domestic income seems to be biased towards increased consumer spending relative to investment. Finally, external financing conditions have become more stringent and are expected to continue making more difficult. These considerations suggest the need for an adjustment to take place in domestic income, particularly from the side of fiscal policy, which is considered to be more efficient monetary policy.

We continue to expect a 50bps hike at September's meeting. We believe that the QIR confirms our perception that the monetary authority will hike the benchmark rate 50bps in September and December. In particularly, it is worth considering that the September meeting is the last before the election in the United States, an event that could be particularly volatile for the Mexican exchange market.

Losses in Udibonos on a marginally less hawkish tone. In our view, Banxico's tone was marginally less hawkish when compared to the latest communique and minutes, particularly given the reduction in GDP growth estimates and a slight improvement in the outlook for inflation this year. Most local assets did not react to the report. Mbonos have been trading with moderate gains around 1-2bps today along the curve, with the securities maturing in Dec'24 and Mar'26 at 5.74% and 5.83%, respectively, both 2bps stronger when compared to yesterday's close. In contrast, real-rate instruments are pressured up to 10bps in the short-end, with more modest losses in the long-end. Even after these changes, we continue seeing risks of further corrections in the extremes of the Mbonos and TIIE curves. Specifically, we consider that short-end could be pressured as implied rate hikes for the rest of the year (35bps) and by the end of 1H17 (72bps) have recently adjusted down. In Udibonos, we see valuations as more attractive in the 5- to 10-year maturities. Lastly, we are waiting for better market conditions to re-enter the market with new, directional trade ideas. In FX, the currency lost around 0.2% to 18.85 per dollar, broadly unchanged before and after the release. We highlight the analysis of the current account deficit (CAD), arguing that the most efficient adjustment mechanism is through fiscal as opposed to monetary policy. In spite of recent efforts to decrease the fiscal deficit, we believe that risks to the CAD could keep the currency pressured at least until the rest of the year and until 2017, as detailed in our note: "*Mexican Peso: Catching up to a crude reality*", August 29, 2016, <pdf>. On a shorter-term basis, we continue recommending USD/MXN longs on dips, believing that the cross could break above 19.00 if our economist's payrolls forecast of 205,000 new jobs materializes. In case of reaching or breaking that level, we would suggest taking profit in dollar longs.

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