

Ahead of the Curve

December 11, 2015

Market focus this week will on Banxico's monetary policy decision

- Banxico's monetary policy decision next Thursday: 25bps rate hike after a 18-month pause.** This week, Banxico will hold its final monetary policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (December 17) at 2:00pm (EST). We believe that board members will decide to increase by 25bps the reference rate, as it is widely expected. Thus, the new reference rate will stand at 3.25% from 3%. We highlight that the last time that Banxico raised the reference rate was in August 2008, and the last downward movement was in June 2014. This implies that the reference rate has stood at 3% for 18 months consecutive months. In addition, Banxico's rate hike will take place a day after the Fed starts normalizing rates in the United States. We believe that the Board will justify the increase, given the importance of Mexico's relative monetary conditions, particularly with the U.S., despite the absence of inflationary pressures and moderate economic growth. Given Mexico's slow economic growth, the absence of inflationary pressures and the Fed's current monetary policy, common sense would dictate that Banxico should not raise the reference rate, until the Fed begins its hiking cycle. Inflation is at historically low levels, and even though Mexico's economic growth has been higher in 2015, growth expectations have been continuously revised downwards. Similarly, Mexico's economic outlook is not encouraging in 2016. The current situation of low crude oil prices given Mexico's heavy dependence on oil revenue (~25%), the government's commitment to reduce the fiscal deficit to 0.5% of GDP in 2016, and the new fiscal regulations that will affect the accounts of Mexico's federal entities and municipalities, will translate into a lower public spending, hindering 2016 GDP's growth below 3%

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Mexico weekly calendar

DATE	HOURL (EST)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Tue 15-Dec	10:00am	International reserves	11-Dec	US\$ mn	--	--	172.0
Tue 15-Dec	12:30pm	Government weekly auction: 1-, 3-, and 6-month Cetes; 3y MBono (Dec'18); 3y Udibono (Jun'19);					
Thu 17-Dec	2:00pm	Banxico's monetary policy decision	December	%	<u>3.25</u>	<u>3.25</u>	3.00
Fri 18-Dec	9:00am	Aggregate Demand	3Q15	% yoy	<u>3.5</u>	--	3.0
		Private consumption		% yoy	<u>3.4</u>	--	3.0
		Government consumption		% yoy	<u>2.2</u>	--	2.6
		Gross-fixed investment		% yoy	<u>4.1</u>	--	5.5
Fri 18-Dec	10:00am	Banxico's survey of economic expectations	December				
Fri 18-Dec	4:30pm	Banamex bi-weekly survey of economic expectations					

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

Weekly international reserves report. On Tuesday, at 10:00am (EST), Banco de Mexico will release its weekly balance report. Last week, net international reserves increased by US\$73mn amounting to US \$172bn on December 4. According to Banxico's report, this figure comes mainly as a result of: (1) Dollar sales by the Central Bank to the Federal Government for US\$31mn; along with a (2) US\$104mn increase due to changes in the valuation of the Central Bank's assets. It is worth noting that Pemex is currently the only significant source of reserve accumulation. In this context, the central bank has an accumulated reduction of US\$21,284mn international reserves this year (please refer to the table below).

Banxico's foreign reserve accumulation details
US\$, million

	2014	4/Dec/2015	4/Dec/2015	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	193,239	171,954	73	-21,284
(B) Gross international reserve	195,682	172,744	261	-22,938
Pemex	--	--	225	2,913
Federal govt	--	--	-71	-1,549
Market operations	--	--	0	-23,405
Other	--	--	106	-897
(C) Short-term government's liabilities	2,443	790	188	-1,653

Source: Banco de México

Weekly government bond auction. On Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent-, will offer 3-year fixed-rate Mbonos (Dec'18) as well as 3-year inflation-linked Udibonos (Jun'19), 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 (EST).

Auction specifics (Tuesday, December 15, 2015)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	14-Jan-16	--	5,500	3.20
3m	17-Mar-16	--	9,500	3.33
6m	09-Jun-16	--	11,000	3.55
Mbono				
3y	13-Dec-18	8.50	9,000	4.83
Udibono				
3y	13-Jun-19	4.00	850	1.94

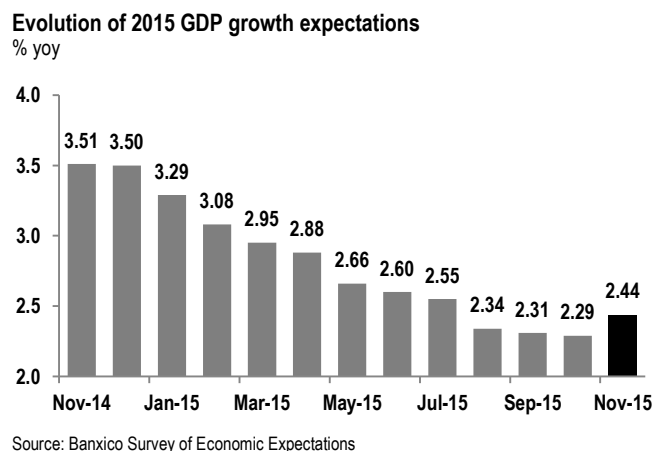
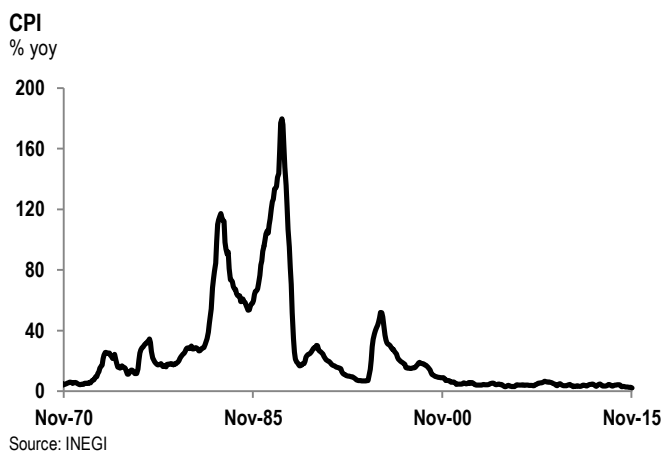
Source: Banorte-ixe with data from Banco de México

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

Monetary policy decision on Thursday: 25bps rate hike after a 18-month pause. This week, Banxico will hold its final monetary policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (December 17) at 2:00pm (EST). We believe that board members will decide to increase by 25bps the reference rate, as it is widely expected. Thus, the new reference rate will stand at 3.25% from 3%.

We highlight that the last time that Banxico raised the reference rate was in August 2008, and the last downward movement was in June 2014. This implies that the reference rate has stood at 3% for 18 months consecutive months. In addition, Banxico’s rate hike will take place a day after the Fed starts normalizing rates in the United States. We believe that the Board will justify the increase, given the importance of Mexico’s relative monetary conditions, particularly with the U.S., despite the absence of inflationary pressures and moderate economic growth.

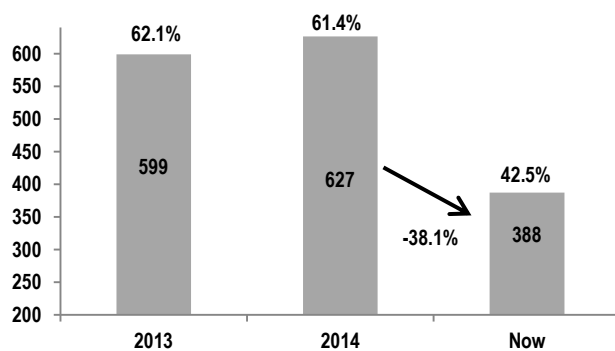
Given Mexico’s slow economic growth, the absence of inflationary pressures and the Fed’s current monetary policy, common sense would dictate that Banxico should not raise the reference rate, until the Fed begins its hiking cycle. Inflation is at historically low levels (refer to the chart on the left), and even though Mexico’s economic growth has been higher in 2015, growth expectations have been continuously revised downwards (refer to chart on the right). Similarly, Mexico’s economic outlook is not encouraging in 2016. The current situation of low crude oil prices given Mexico’s heavy dependence on oil revenue (~25%), the government’s commitment to reduce the fiscal deficit to 0.5% of GDP in 2016, and the new fiscal regulations that will affect the accounts of Mexico’s federal entities and municipalities, will translate into a lower public spending, hindering 2016 GDP’s growth below 3%.



Despite moderate economic growth and low inflation, we believe that an increase in the U.S. reference rate is a sufficient condition to trigger a rate hike in Mexico –despite the fact that economic activity has been sluggish and that inflation could converge to the 3% target this year-, given that the holdings of foreign investors in the short-end of the curve is elevated (refer to the following chart on the left), making even more relevant the spread between Mexico’s reference rate and the *Fed funds* rate, as shown in the chart on the right.

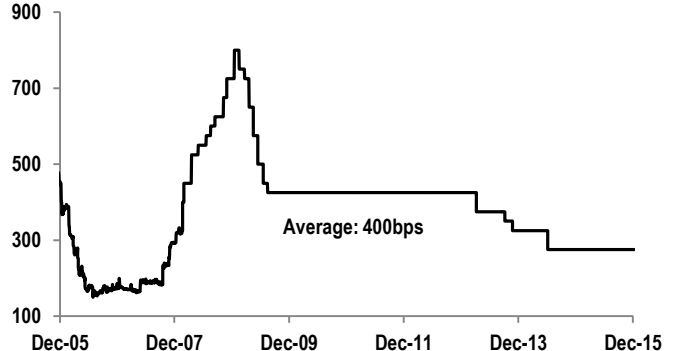
In this regard, given that Mexico continues to be a small and open economy, Banxico does not manage the reference rate in absolute terms but, given the global influence of the U.S. monetary policy, it only sets the spread between Mexico's rate and the U.S. *Fed funds* rate. Thus, if the U.S. Fed decides to hike its rate in December, almost independently of Mexico's economic cycle and inflation, Banco de Mexico "*will have to maintain*" the differential between the interest rates in both countries. Particularly given that not doing it could trigger a significant and erratic depreciation of the Mexican peso against the dollar.

Holdings of foreign investors in the short-end of the curve
MXN billions, %



Source: Banorte-Ixe, Banco de Mexico

Spread between Fed and Banxico reference rates
bps



Source: Banorte-Ixe with data from Bloomberg

While Banxico's central scenario seems to be of economic activity weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given this, we believe that Banxico will start its hiking cycle when the Fed begins its own normalization of monetary policy next Wednesday. Looking ahead, we believe that Banxico will follow the Fed in its monetary tightening cycle, but Banxico's monetary stance could diverge from the Fed's if the business cycles between both countries show major differences.

We estimate a 3.5% yoy expansion in aggregate demand (AD) during 3Q15.

On Friday, *INEGI* will publish its aggregate supply and demand report for 3Q15, where we believe aggregate demand increased 3.5% yoy, vs. the 3% yoy expansion observed in 2Q15. Taking a look at the breakdown, we expect a 3.4% yoy increase in private consumption, while we estimate a significant 4.1% yoy expansion for gross fixed investment. However, we believe that government spending will likely show a moderate 2.2% yoy growth.

Banxico's survey of economic expectations.

Also on Friday, at 10:00am (EST), Banco de Mexico will publish its monthly survey of economic expectations. In our view, market participants' focus will be on three issues: (1) 2015 inflation expectations that currently are at 2.4% (Banorte-Ixe: 2.5%); (2) mid-term inflation expectations—quite important for the central bank's board—that are currently at 3.39% (Banorte-Ixe: 3%); and (3) the analysts' assessments of GDP growth for 2015 given the recent upward revisions made by several economists (currently at 2.44%; Banorte-Ixe: 2.5%).

***Banamex* Survey: Market participants will focus on analysts' monetary policy assessments.** On Friday at 4:30pm (EST) *Banamex* will release its bi-weekly survey of economic expectations, where market participants will focus on analysts' monetary policy assessments after Banxico's monetary policy announcement. Furthermore, analysts will also focus on December's first half inflation forecast (to be published on Wednesday December 23), as well as on CPI estimations for 2015 and 2016. Moreover, we expect moderate upward revisions to the economic growth estimates for 2015 and 2016.

Disclaimer

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