

Banxico's QIR – Explaining the recent and temporary spike in inflation

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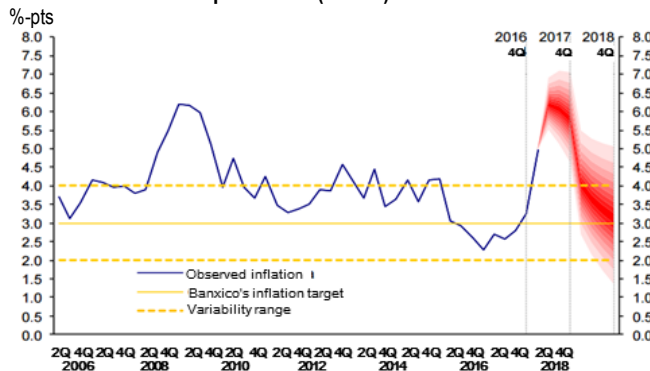
- Banxico published today its *Quarterly Inflation Report (QIR)* for 1Q17
- We highlight the following issues:
 - (1) The central bank made a strong upward revision to its inflation forecasts depicted in their traditional fan charts, where now inflation is expected to hover around 5.7% throughout the year, although it will converge to Banxico's 3% target in 2018;
 - (2) The economic outlook for Mexico became slightly more positive, which prompted an upward revision to Banxico's 2017 growth forecast range, which now stands between 1.5% and 2.5% (previous range: 1.3%-2.3%); and
 - (3) The output gap will remain in negative territory until 2018
- In the traditional "grey boxes" Banxico's researchers tackle the following topics:
 - (1) The recent behavior of the prices of liquefied gas has begun to marginally reflect the variations observed at the international level; and
 - (2) The uncertainty surrounding the future of US-Mexico trade relationship has induced lower private investment
- We maintain our view that Banxico will increase the reference rate by an additional 75bps throughout the year

Higher inflation ahead but lower growth. The monetary authority released its *Quarterly Inflation Report (QIR)* for 1Q17. The release was accompanied by a press conference led by Governor Carstens. We highlight the following issues discussed in the document: (1) The central bank made a strong upward revision to its inflation forecasts depicted in their traditional fan charts, where now inflation is expected to hover around 5.7% throughout the year, although it will converge to Banxico's 3% target in 2018; (2) the economic outlook for Mexico became slightly more positive, which prompted an upward revision to Banxico's 2017 growth forecast range, which now stands between 1.5% and 2.5% (previous range: 1.3%-2.3%); and (3) the output gap will remain in negative territory until 2018.

Inflation around 5.7% in 2017. The Central Bank asserted that the balance of risks of inflation has deteriorated and that the recent upward trend of inflation has been explained by the changes in relative prices of goods given the depreciation of the real exchange rate as well as the transitory impact of the liberalization of gasoline prices. Considering this, the central bank emphasized that: “... [inflation] is significantly above the upper limit of the range of variation of the Bank of Mexico, although it is anticipated that during the last months of 2017 and during 2018 it starts to trend towards the 3 percent target and reach that level at the end of the forecast horizon ...”.

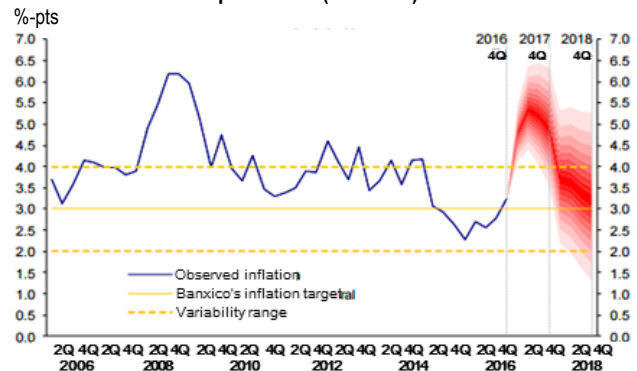
In this context, Banxico stated that despite the immediate impact of the adjustment of relative prices on inflation and on short-term expectations, medium- and long-term inflation expectations have remained stable given the actions taken by the monetary authority. Among the upside risks for inflation, the central bank highlighted: (1) The probability of increases in second order effects due to an increase in the number and magnitude of observed shocks; (2) an increase in inflation expectations as a result of their behavior or of additional depreciations or abrupt movements of the Mexican currency; and (3) inflationary pressures stemming from the upward trend in unit labor costs.

Fan chart: Inflation expectations (Actual)



Source: Banco de México, 3Q16 QIR

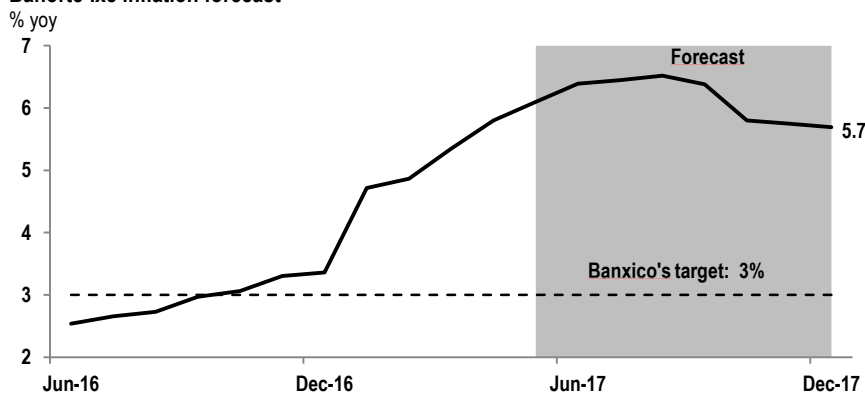
Fan chart: Inflation expectations (Previous)



Source: Banco de México, 2Q16 QIR

We also estimate that inflation will end the year at 5.7% in 2017. Our estimate is in line with Banxico’s view that inflation shocks are temporary and with limited effect on other prices in the economy. In this context, we expect inflation to reach a maximum of 6.52% in August and then end the year at 5.7% per year, as shown in the chart below.

Banorte-Ixe inflation forecast



Source: Banorte-Ixe with data from INEGI

Upgraded economic growth forecasts. The report highlights that the Mexican economy still faces important challenges, given the uncertainty surrounding the future of the US-Mexico trade relationship. As a result, business sentiment has deteriorated, which in turn has resulted in lower investment flows. However, the monetary authority also underlined the better-than-expected performance of the Mexican economy during the first quarter of the year, with the central bank revising its estimated growth range for this year between 1.5% and 2.5% (previous: 1.3%-2.3%, Banorte-Ixe: 1.6%). For 2018, Banxico maintained its growth estimate in a range between 1.7% and 2.7% (refer to the tables below). A fundamental assumption used by Banxico for these economic projections is that Mexico will successfully renegotiate its trade relationship with the U.S. Finally, the output gap projected today by the central bank, clearly shows that it will remain in negative territory throughout the next two years.

Banxico's Forecast		
Recent		
	2017	2018
GDP (%)	1.5 – 2.5	1.7 – 2.7
Employment (thousands)	650 – 750	640 – 740
Trade Balance (bn)	-12.8 (1.2% of GDP)	-12.1 (1.1% of GDP)
Current account (bn)	-24.7 (2.3% of GDP)	-25.8 (2.3% of GDP)
Inflation		
Headline	Considerably above the permanent inflation target	Close to 3%
Core	Above the permanent inflation target	Close to 3%

Source: Banxico

Banxico's Forecast		
Previous Quarterly Report		
	2017	2018
GDP (%)	1.3 – 2.3	1.7 – 2.7
Employment (thousands)	580 – 680	620 – 720
Trade Balance (bn)	-10.1 (1% of GDP)	-9.0 (0.9% of GDP)
Current account (bn)	-26.5 (2.7% of GDP)	-27.8 (2.7% of GDP)
Inflation		
Headline	Above the permanent inflation target	Close to 3%
Core	Above the permanent inflation target	Close to 3%

Source: Banxico

The recent behavior of the prices of liquefied gas has begun to marginally reflect the variations observed at the international level. The first “grey box” analyzes the trend of liquefied gas prices before and after the liberalization of prices, as well as the conditions of competition in the different regions and states of the country. Prior to the liberalization of the prices, these tended to increase despite a decrease in the international reference price. However, since liberalization came into effect, they have tended to mimic this behavior. Additionally, the research also found that conditions of competition seem to have an effect on the increase observed in the CPI, since it was seen that the higher the number of distributors, the lower the increase in prices.

The uncertainty surrounding the future of US-Mexico trade relationship has induced lower private investment. In the second “grey box”, the central bank conducted an analysis of the impact of the uncertainty of the US-Mexico trade relationship on private investment. The analysis included the use of a model to study the relationship of GDP, firms’ expectations and public investment. The results of the model indicates that a sharp fall in expectations, such as the one observed after the US elections, will have a negative impact on private investment. In addition, given Mexico’s GDP growth in recent years, private investment should be growing at a higher rate, which could have an impact on potential output.

We expect a 75bps hike in the reference throughout the year. The central bank reiterated in its last monetary policy statement that the factors that they will closely monitor in order to assess its monetary policy are: (1) The pass-through effect of the depreciation of the MXN and increases in energy prices; (2) the relative monetary stance between Mexico and the US; and (3) the second-round effects stemming from the change in relative prices. In the first case, although we believe that the probability of new waves of high volatility in international financial markets still persists, we believe that the behavior of the exchange rate will be relatively limited throughout the remainder of the year, given Banxico’s hiking cycle (375bp from Dec’15 and 100bp so far in 2017).

However, we cannot rule out abrupt movements of the currency in the event of unforeseen factors, particularly in regard to geopolitical issues, both nationally and globally. In addition, we expect the Fed to raise the Fed funds rate by at least 50bp in the remainder of 2017. As a result, we continue to expect a 75bps hike in Banxico’s reference rate throughout the remainder of the year. For now, we believe that the next movement of Banxico’s rate will be 25bp hike in its meeting on June 22.

From our fixed income and FX strategy team

Flattening bias prevailed in the aftermath of Banxico’s QIR, while the peso recovered strength. Banxico released this afternoon its Quarterly Inflation Report. In line with our expectations, the information depicted by the central bank was characterized by a hawkish rhetoric, similar to the one observed on May 18th with the latest policy decision and to the speeches from board members in recent days. The market is currently pricing in 53bps of cumulative implied hikes for the remainder of the year (Banorte-Ixe +75bps), following the 100bps total hike of 2017 (50bps on February 9th and 25bps on each of the meetings on March 30th and May 18th). Making a deep analysis of Banxico’s QIR, there is enough evidence that supports more restrictive monetary conditions ahead, with a strong likelihood of an important debate regarding the optimal level of the short-term real interest rate given current conditions of the Mexican economy, especially after the remarks from Governor Carstens about Mexico the actual policy rate reaching neutral grounds. This assessment provides enough arguments for an additional flattening of the yield curve, with an inverted slope between the short- and mid-ends.

Market reaction today was consistent with this view, with the short-end selling off 1-3bps and longer tenors rallying 2-3bps. In terms of strategy, we reiterate our negative view in the local rates, mainly in short-term instruments, in a context in which the market could adjust their mid- and long-term expectations about Banxico's reference rate. In our view, these securities could experience additional pressures. Moreover, we expect an increase in the risk premium embedded in local rates near the end of the week, with investors trying to hedge (modestly) risks coming from the local elections to be held on June 4th (e.g. State of Mexico, Coahuila and Nayarit). On the other hand, we still recommend a cautious stance on directional positions in spite of a more attractive valuation in the 5- to 7-year zone in Mbonos. In our view, there is a high probability that these securities extend the correction observed during the last sessions.

In the FX market the USD/MXN is gaining 0.3% to 18.65 per dollar, back from highs of up to 18.77 at the beginning of the trading session that meant one of the worst performances among EM. We believe that the move is at least in part due to expectations of a hawkish tone in the QIR. Considering that it was very similar to most recent communications, the Mexican peso did not react much to the publication, consolidating its daily gain. The report does not add significant new information to our expectations, so we remain cautious on the currency. We do not discard additional profit taking ahead of the local election on Sunday, with investors already with a relatively sizable net long position in MXN (according to futures), and particularly if it is coupled with higher political risk in other regions. Nevertheless, high carry levels and the central bank's tone suggest a likely short-term resistance at the 18.77-18.80 zone at least before this local risk event. In this context, we prefer buying USD/MXN at the current level only for trading positions, waiting for the results of the election to evaluate more clearly the possible bias of the currency for coming days.

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