

Ahead of the Curve

Banxico will set the table for a rate cut

- Monetary policy decision (August 15th).** We expect Banxico to leave the reference rate unchanged at 8.25%, albeit with some analysts and market participants anticipating a cut. In this context, we believe the tone of the communicate will be very dovish, setting the table for a 25bps rate cut in September. This would be consistent with our view that recent inflation dynamics, weakness in economic activity, and the recent rate cut by the US Fed, have provided enough room for a cut sooner than previously expected. Moreover, we believe that the most recent developments since then provide additional support to our call, on balance. These include: (1) The possibility of a downward revision in 2Q19 GDP growth in the midst of persistent declines in consensus growth expectations for 2019 and 2020; (2) the convergence of inflation to target, broadly in line with Banxico's forecasts; and (3) the global wave of monetary easing, which has tightened Mexico's relative policy stance. On the contrary, the recent depreciation of the Mexican peso could induce some additional caution to the Board, more so given that some risks to financial stability remain in place. Nevertheless, we believe this is not highly concerning as the nature of the factors behind it has been almost completely external and because it has been matched by most of its emerging market peers.

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Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 13-Aug	10:00am	International reserves	Jul-27	US\$ bn	--	--	179.4
Tue 13-Aug	12:30pm	Government weekly auction: 1-, 3-, 6-, 12-month CETES; 20y Mbono (Nov'38); 30y Udibono (Nov'50); 5y Bondes D					
Thu 15-Aug	2:00pm	Banxico's monetary policy decision	Aug-2	%	8.25	8.25	8.25

Source: Banorte; Bloomberg

Proceeding in chronological order...

Weekly international reserves report. Last week, net international reserves increased by US\$476 million, closing at US\$179.4 billion. According to Banxico's report, this figure comes mainly from a positive valuation effect in central bank assets. In this context, the central bank's international reserves have increased US\$4.6 billion during 2019 (please refer to the following table).

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

	2018	Aug 2, 2019	Aug 2, 2019	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	174,793	179,397	476	4,605
(B) Gross international reserve	176,384	188,245	1,331	11,860
Pemex	--	--	-54	211
Federal government	--	--	894	7,315
Market operations	--	--	0	0
Other	--	--	492	4,335
(C) Short-term government's liabilities	1,592	8,847	855	7,256

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 20-year fixed-rate Mbonos (Nov'38), 30-year inflation-linked Udibonos (Nov'50), 5-year Bondes D, in addition to the 1-, 3-, 6-, and 12-month zero-coupon Cetes (see following table). As usual, results will be released at 12:30pm (ET).

Auction specifics (Tuesday, August 13th, 2019)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	12-Sep-19	--	6,000	8.15
3m	14-Nov-19	--	9,000	8.09
6m	13-Feb-20	--	12,500	8.07
6m	13-Aug-20	--	13,500	8.04
Bondes D				
5y	27-Jun-24	--	6,500	0.14
Mbonos				
20y	18-Nov-38	8.50	3,700	7.69
Udibonos				
30y	03-Nov-50	4.00	UDIS 600	3.75

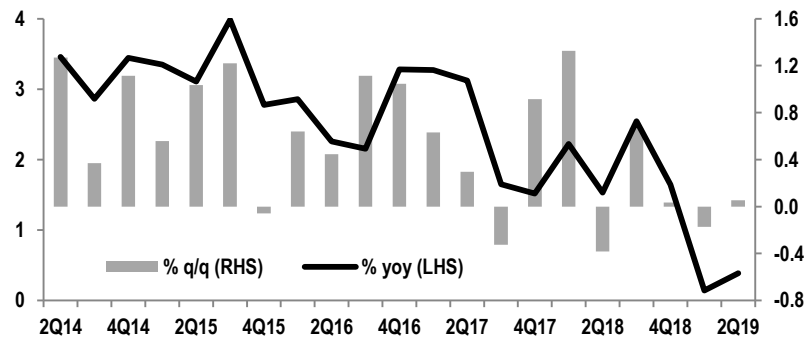
Source: Banorte with data from Banco de México 1. Except for Udibonos, which are expressed in UDI million, everything else is expressed in MXN million. 2. Yield-to-maturity reported for Cetes, Mbonos and Udibonos

Banxico's monetary policy decision to signal a rate cut soon. Next Thursday, Banxico will hold its fifth meeting of 2019, in which we expect the reference rate unchanged at 8.25%. According to *Bloomberg* at this edition's close, 8 out of 16 economists (50%) anticipate a cut. The signal from interest rate futures is less dovish, with markets discounting about 8bps of cuts, roughly equating to a probability of 31% for a 25bps decrease. Considering these, the decision is likely to induce some market reaction whether the rate is left unchanged or reduced. We believe the tone will be very dovish. This would be consistent with our view that recent inflation dynamics, economic activity, and the relative monetary policy stance with the US, among others, have provided enough room for a cut sooner than previously expected. In particular, we expect a 25bps rate cut in September and an accumulated of -50bps in full-year 2019. For details, see: "*Banxico – A rate cut is closer than it looks*", <pdf>, July 31st, 2019.

We believe other developments since then provide additional support to our call, on balance. First, latest data suggests that risks for the final release of 2Q19 GDP, to be published on August 23rd, are skewed to the downside. According to the preliminary estimate, activity fell 0.7% yoy (+0.4% yoy sa, +0.1% q/q), avoiding a so-called ‘technical recession’ (see chart below). The secondary sector, which in our view was the main drag, was estimated at -2.8% yoy (flat on a quarterly basis). Today’s hard data for June showed that secondary activities actually fell 3.0% in the quarter, below the preliminary result. Assuming no additional changes, this would be enough for the final 2Q19 GDP print to be revised to -0.8% yoy from -0.7%, a weaker performance at the margin. Other inputs for GDP were also published, including private consumption and gross fixed investment for May, tracking at 1.0% and -3.2% yoy so far this year, respectively. In our view, the most concerning is the latter, affected mainly by construction, a sector with a high sensitivity to interest rates. Moreover, the latest central bank survey for GDP in 2019 and 2020 was downgraded to 0.8% and 1.5%, in the same order, from 1.1% and 1.7% at the latest meeting. Estimates in more timely surveys, such as that of *Citibanamex*, are even lower, at 0.6% and 1.4%, respectively.

GDP

% yoy sa; q/q sa



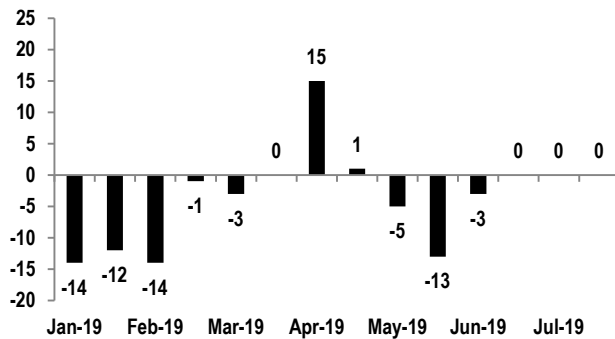
*2Q19 based on the preliminary GDP release; all others are final figures
Source: INEGI

It is our take that members are taking into account growth conditions due to the impact that the recent slowdown is having on the output gap, which could induce lower demand-side pressures on inflation. Currently, the central bank estimates the output gap at its most negative since the financial crisis, and which according to our calculations is currently around -1.1% of potential. In the latest minutes, the majority of the Board said that economic slack widened more than estimated. If 2Q19 GDP is revised lower, the output gap would likely widen at the margin. In our view, this is important as one dovish member said that: “...if the behavior of inflation continues to be aligned with the convergence to its target, it will be necessary to begin a cycle of monetary policy easing in a relatively short horizon. He/she pointed out that there is the risk of maintaining a tight monetary policy for a prolonged period, to the detriment of economic growth, public finances, and financial costs...”.

Therefore, and considering inflation, the July print stood at 0.38% m/m, virtually in line with market expectations (0.37%). In terms of surprises, 8 out of 14 bi-weekly prints so far in 2019 have been lower than anticipated (see chart below, left). In 2Q19, average headline inflation was 4.2% yoy, below the central bank's estimate of 4.3% in the latest *Quarterly Report*. Core inflation reached 3.8%, in line with Banxico. This is the second consecutive quarter with a slight undershoot of headline inflation. We believe this is relevant as comments in the latest minutes stressed the importance of inflation converging to target, which is on track according to both our estimates (chart below, right) and those of the central bank.

Bi-weekly inflation surprises

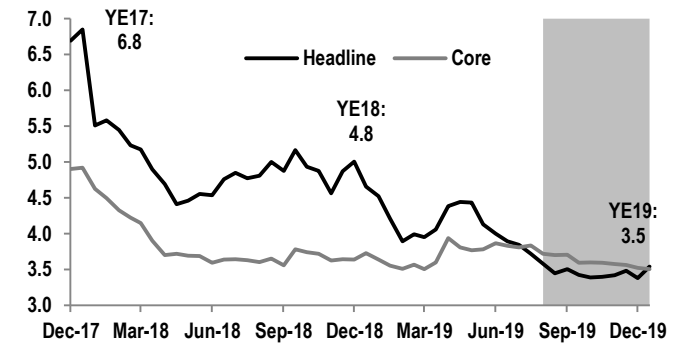
Bps, actual less median



Source: Banorte with data from INEGI and Bloomberg

Inflation forecasts

% yoy

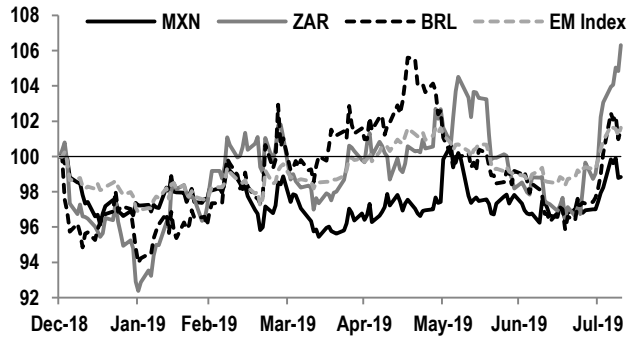


Source: INEGI, Banorte

On the contrary, the Mexican peso has been pressured, going from around 19.15-19.20 per dollar at the June meeting to about 19.40 currently. The adjustment is mostly due to external factors, highlighting the Fed's decision (which, despite the 25bps rate cut, was less dovish than expected) and the escalation of trade tensions between the US and China. This is clearer when looking at the recent performance relative to other EM (see chart below on the left). The move has been broadly in line with peers and has happened in an orderly manner, helping temper some concerns about financial stability risks. Moreover, the global wave of monetary easing is well under way, a situation that has not escaped some Board members such as Deputy Governors, Jonathan Heath and Gerardo Esquivel. Just this week, the central banks of Peru, India, Thailand, and New Zealand eased monetary policy, on top of those who have already done so this year (see chart below, right). This is relevant as Mexico's relative monetary stance, approximated through the short-term rate spread, has tightened not only relative to the US but also to these countries, providing additional room to maneuver.

USD performance against selected EM currencies

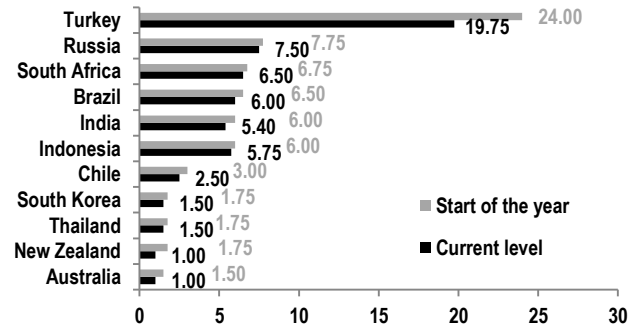
Index 100= 31-Dec-18



*An increase reflects USD appreciation
Source: Bloomberg

Reference rate in selected countries

%



Source: Bloomberg

All in all, we believe that the communique will be very dovish, with Banxico setting the table for a rate cut in September. Although a case could be made for more caution considering the recent depreciation of the MXN, we believe it is not highly concerning due to the nature of the drivers behind it –almost completely external– and because it has been matched by most of its peers. In addition, we think that recent developments on growth, inflation and the relative monetary policy stance will more than compensate for some lingering financial stability risks. In particular, we have credited Pemex’s financial position and its implication on its own and the sovereign’s credit rating as one of the main factors that could delay the start of an easing cycle.

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HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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