

Ahead of the Curve

August 2, 2019

Annual headline inflation expected to fall further in July to 3.78%

- Inflation report (July).** We estimate headline inflation at +0.38% m/m, with the core component at +0.26%. We anticipate relatively balanced contributions by the core- and non-core, of 20bps and 18bps, respectively. We estimate price pressures to have been mostly concentrated in the first half of the month. In the former, categories such as airfares and tourism services could start to reverse some of the upside driven by the summer holiday season. In the latter, the increase in agricultural goods would mostly have been due to the first fortnight, particularly fresh fruits and vegetables and chicken prices within meat and egg. With these results, headline inflation would continue to moderate, standing at 3.78% from 3.95% in June. The core component would go to 3.82% from 3.85% and non-core inflation to 3.98% from 4.19%
- Industrial production (June).** We estimate activity at - 2.6% yoy. It should be mentioned that this would imply a slight downward revision to the implied figure of -2.3% according to 2Q19 GDP. In seasonally-adjusted terms we anticipate a 0.8% m/m increase, which would be modest when taking into account the 2.1% decline of the previous month. In our view, the annual figure would be impacted by mining (-7.0% yoy) and the weak signal provided by the trade balance in terms of the likely performance of manufacturing (-0.8%). Last but not least, we anticipate construction at -4.9%. Overall, we continue seeing challenges for industrial activity as the global economy slows down, dragged by trade tensions, and with the Mexican peso maintaining its strength on the back of high domestic interest rates, which have limited a boost to relative competitiveness.

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Document for distribution among the general public

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 5-Aug	9:00am	Consumer confidence	July	index	<u>107.8</u>	--	106.1
Tue 6-Aug	9:00am	Gross fixed investment	May	% yoy	<u>-6.6</u>	--	-5.7
		Machinery and equipment		% yoy	<u>-4.4</u>	--	-7.4
		Domestic		% yoy	<u>-3.0</u>	--	0.5
		Imported		% yoy	<u>-5.4</u>	--	-11.8
		Construction		% yoy	<u>-8.5</u>	--	-4.4
Tue 6-Aug	10:00am	International reserves	4-Aug	US\$ bn	--	--	178.9
Tue 6-Aug	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 5y Mbono (Sep'24); 10y Udibonos (Nov'28)					
Tue 6-Aug	4:30pm	Citibanamex bi-weekly survey of economic expectations					
Thu 8-Aug	9:00am	CPI inflation	July	% m/m	<u>0.38</u>	--	0.06
				% yoy	<u>3.78</u>	--	3.95
		Core		% m/m	<u>0.26</u>	--	0.30
				% yoy	<u>3.82</u>	--	3.85
Fri 9-Aug		Wage negotiations	June	%	<u>6.2</u>	--	6.1
Fri 9-Aug	9:00am	Industrial production	June	% yoy	<u>-2.6</u>	--	-3.3
		(sa)		% m/m	<u>0.8</u>	--	-2.1
		Mining		% yoy	<u>-7.0</u>	--	-8.9
		Utilities		% yoy	<u>1.5</u>	--	1.6
		Construction		% yoy	<u>-4.9</u>	--	-8.9
		Manufacturing		% yoy	<u>-0.8</u>	--	0.7

Source: Banorte; Bloomberg

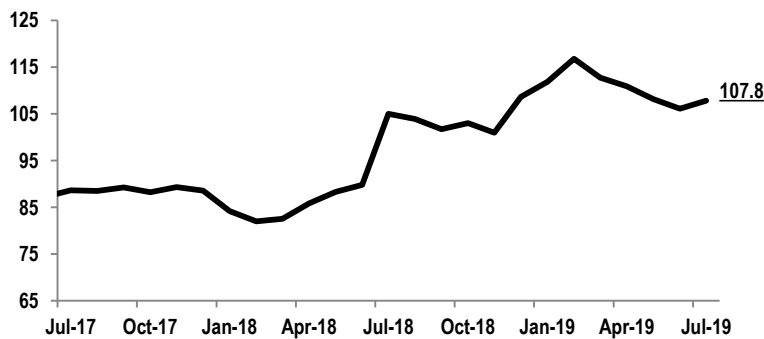
Proceeding in chronological order...

Consumer confidence should bounce slightly on favorable seasonality. We expect confidence to pick-up to 107.8pts in July from 106.1 in June, which would break with four consecutive months of declines. The annual rate would decline from 18.2% in June to 2.7% as a result of a challenging base effect given that confidence surged right after last year’s election. We also note that, historically, seasonality is favorable for this print, which we mostly attribute to the summer holiday season. Adjusting for the latter, we anticipate a 1.2% m/m fall. As mentioned in other occasions, confidence has been highly correlated with political sentiment. In this respect and according to the presidential approval rating compiled by *Oraculus*, his net score declined from 45% to 44% due to a slightly higher disapproval (+1pp). Among the most-talked issues during the period, we highlight the resignation of former Finance Minister Carlos Urzúa, discussions about a ‘technical recession’ in Mexico, and Pemex’s business plan. We should also mention that trade tensions with the US due to migration concerns diminished as an agreement was reached.

In our view, the expected adjustment would be part of a longer-term trend towards a gradual return to longer-term averages as political optimism fades away, particularly impacting the ‘country expectations’ component. Nevertheless, we believe this decline (in seasonally-adjusted terms) will be modest as other factors come into play. In particular, the exchange rate averaged 19.05 per dollar from 19.29 in June, improving at the margin as the threat of US tariffs to Mexican exports diminished. Moreover, annual inflation declined from 4.00% at the end of June to 3.84% in 1H-July, with both the core- and non-core components improving. In our view, these could have helped to support some recovery in the ‘purchasing power’ and ‘households’ expectations’ components, particularly with the former falling significantly in the previous print.

Consumer confidence

Index, nsa

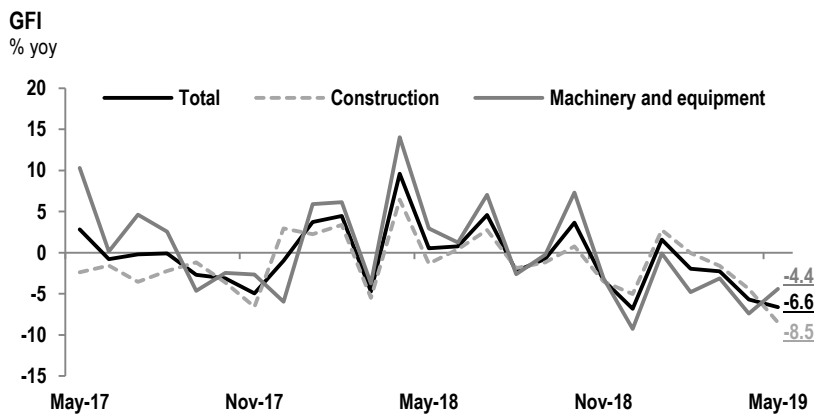


Source: INEGI

Gross fixed investment should remain weak in May. We anticipate GFI at -6.6% yoy, which would result in a fourth consecutive month in contraction in the annual comparison. We see a weak performance in all sectors, albeit highlighting construction, anticipated at -8.5%. This would be the highest fall in little over two years. In this respect, the IP report showed a strong 9.8% decline, led by civil engineering as the Federal Government reduced this type of expenditures. Given the year-to-date performance of the latter at -4.8% yoy, we welcome the recent announcement to accelerate infrastructure spending for the second half of the year. For details, see: “*Mexico – Weakness across the board in June*”, <[pdf](#)>, July 26th, 2019. Moreover, we should remember that edification has also been impacted, falling 8.6% yoy in the month, in our view explained to a great extent by the suspension of construction projects in Mexico City, a factor contributing to our recent revision of full-year GDP to 0.8%.

We anticipate machinery and equipment (MqEq) at -4.4% yoy. Similar to the previous month, this would be mainly due to the 5.4% decline in the imported component, with a slight improvement from the -11.8% observed in April. In this context, capital goods imports were also better at the margin. Lastly, the domestic component would return to contraction at -3.0%, although stronger than the year-to-date average of -4.2%.

Overall, we anticipate weakness in investment to extend, impacted by high uncertainty and muted business confidence. In this respect, capital goods imports in June plunged 21.2%, weakest since the 2008-2009 financial crisis, suggesting prevailing challenges to the sector. We maintain our forecast for investment to fall 2.6% yoy in full-year 2019, with the latest information available skewing this forecast further to the downside.



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves decreased US\$99 million, closing at US\$178.9 billion. According to Banxico’s report, this figure comes mainly from a negative valuation effect in central bank assets. In this context, the central bank’s international reserves have increased US\$4.1 billion during 2019 (please refer to the following table).

Banxico's foreign reserve accumulation detail

US\$, million

	2018	Jul 26, 2019	Jul 26, 2019	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	174,793	178,921	-99	4,128
(B) Gross international reserve	176,384	186,913	-958	10,529
Pemex	--	--	-92	265
Federal government	--	--	-575	6,421
Market operations	--	--	0	0
Other	--	--	-291	3,843
(C) Short-term government's liabilities	1,592	7,992	-858	6,401

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 5-year fixed-rate Mbonos (Sep'24), 10-year inflation-linked Udibonos, in addition to the 1-, 3-, and 6-month zero-coupon Cetes (see following table). As usual, results will be released at 12:30pm (ET).

Auction specifics (Tuesday, August 6th, 2019)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	05-Sep-19	--	6,000	8.01
3m	07-Nov-19	--	9,000	8.12
6m	30-Jan-20	--	12,500	8.09
Mbonos				
5y	05-Sep-24	8.00	11,500	7.37
Udibonos				
10y	30-Nov-28	4.00	UDIS 950	3.41

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

Citibanamex Survey. Markets will center on analysts' inflation forecasts for July (to be published on Thursday, August 6th) along with the 2019 year-end estimate. It will be important to see monetary policy assessments, particularly given the next meeting, which will take place on August 15th. We will also pay attention to GDP growth and the exchange rate.

Inflation in July, a tale of two halves. We estimate headline inflation at +0.38% m/m, with the core component at +0.26%. We anticipate relatively balanced contributions by the core and non-core components of 20 and 18bps, respectively. According to our estimates, price pressures were mostly concentrated in the first half of the month. For example, at the non-core level, agricultural goods increased 1.15% 2w/2w in the former and expect them to decline 0.07% in the second half. As a result, the monthly contribution of this subsector would be 20bps, with 12bps in fresh fruits and vegetables and 8bps in meat and egg. In the latter, we highlight surging chicken prices in the first fortnight, which we estimate could extend but at a much more modest pace.

Similarly, energy would climb 0.06% in the second half, below the 0.20% of the previous period, driven by higher low-grade gasoline prices. We anticipate only a modest increase of this good during the last fifteen days as we saw a marginal increase in the federal subsidy to prices –albeit with a very erratic behavior–, lower prices in the US, and a broadly stable Mexican peso against the dollar.

The core component would exhibit similar dynamics, with +6bps in services concentrated in the first fortnight due to pressures in airfares and tourism services due to the summer holiday season. In our view, these components will start to revert downwards as the flow of tourists diminishes. We estimate a more orderly behavior in goods, with a contribution of 6bps in processed foods and -0.1bps in other goods. With respect to the latter, we think that the recent stability of the exchange rate (with the exception of some bouts of volatility with a brief duration) has helped anchor prices somewhat during the last three months, a factor which would be favorable for core inflation to eventually reestablish a downward trend.

With these results, headline inflation would continue to moderate, standing at 3.78% from 3.95% in June, with two consecutive months below the upper bound of Banxico's variability range. The core component would go to 3.82% from 3.85%, and non-core inflation to 3.98% from 4.19%. If our hypothesis of a more positive behavior at the core—driven by the relative strength of the currency and greater economic slack—proves to be right, it could help Banxico to cut the reference rate in the short term. In particular, our forecast is that a 25bps rate cut will materialize on September 26th, along with a total reduction of 50bps during this year.

We forecast wage negotiations to climb 6.2% in July. This would be an inch higher than the 6.1% of the previous month. We believe this increase will be explained once again by a change in composition within the workers benefited by a revision, tilting even more to the private sector relative to the public branch. In this context, year-to-date increases in the former stand at 6.3% with the latter managing only 3.4%. This is mostly based on its historical behavior – remembering that this indicator is highly seasonal. Nevertheless, it should be considered that in two of the last four years no negotiations were registered, while the remaining two only averaged around 4,500 workers. Going forward and as mentioned in other releases, wage negotiations will likely remain skewed to the upside due to the revision of the minimum wage as well as the lagged impact from high inflation in the previous two years. However, we do not rule out a moderation in the last quarter of the year.

June industrial production to stay negative in annual terms. We estimate industrial activity at -2.6% yoy in the month from -3.3% in May. It should be mentioned that this would imply a slight downward revision to the implied figure of -2.3% according to 2Q19 GDP, published this week. In seasonally-adjusted terms we anticipate a 0.8% m/m increase, which would be a modest rebound when taking into account the 2.1% decline observed in the previous month.

In our view, the annual figure would be impacted by mining and the weak signal provided by the trade balance report in terms of the likely performance of manufacturing. We anticipate this latter sector at -0.8% yoy, driven by the strong 4.2% contraction in intermediate-goods imports, which are intertwined with the sector's supply chain. It should be mentioned that this is the weakest print since October 2016 and the first decline in two years. Moreover, manufacturing exports decelerated to 2.9% from 8.0% in May.

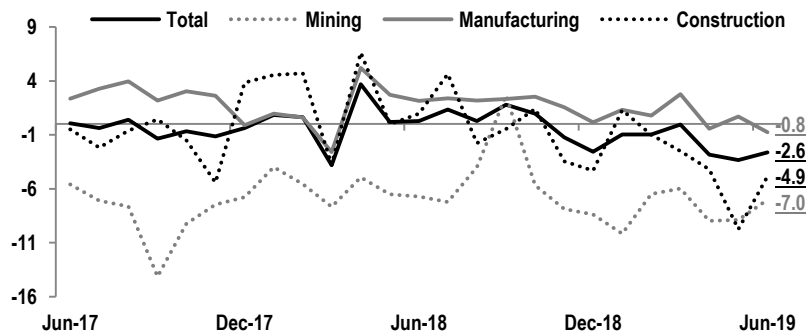
US manufacturing has also slowed down significantly since February, advancing only 0.4% from 0.8% in the previous month. Additional data such as auto production according to *AMIA* reinforces this signal, plunging 5.5% during the month.

On the other hand, we expect mining to remain in contraction at -7% yoy. In this respect, crude oil production in June stabilized sequentially at 1,692kbpd according to Pemex data, albeit decreasing 8.4% yoy. On a more positive note, gas production inched higher (0.1%). Employment figures also point to a weak performance, with a net loss of jobs for a second consecutive month in a row and the fifth print with an annual contraction in total sector employees. Last but not least, we anticipate construction at -4.9%, with business confidence in this sector at 49.3pts in June, down for third consecutive month. The “adequate moment to invest” component, which in our view reflects more accurately conditions in the sector, has fallen to 25.8pts, weakest since February 2017, dragged further by the suspension of construction projects in Mexico City.

Overall, we continue seeing challenges for industrial activity as the global economy slows down, dragged by trade tensions that are impacting manufacturing supply chains and with the Mexican peso maintaining its strength on the back of high domestic interest rates, which have limited a boost to relative competitiveness.

Industrial production

% yoy



Source: INEGI, Banorte

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