

Ahead of the Curve

August 19, 2016

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

- Banxico's minutes.** Next Thursday at 10:00am (EDT), Banco de Mexico will publish the minutes of its monetary policy meeting held back on August 11, in which the board decided to remain on hold, as it was widely expected. We believe that the decision was unanimous. In addition, we expect discussions during the meeting to have focused on two issues: (1) The higher probability of financial volatility on the back of geopolitical risks including the US elections and the normalization of the Fed's monetary policy; and (2) the balance of risks for inflation in the horizon in which monetary policy operates remained unchanged, on the back of June's 50bps rate hike
- We expect a 2.5% yoy growth in Mexico's second quarter GDP.** On Monday, at 9:00am (EDT), *INEGI* will publish its GDP report for the second quarter of 2016, where we expect a 2.5% yoy expansion, marginally above the 2.4% growth reported in *INEGI*'s preliminary GDP report. In seasonally adjusted terms, we expect a 0.2% q/q reduction

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Document for distribution among the general public

Mexico weekly calendar

DATE	TIME (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Mon 22-Aug	9:00am	GDP	2Q16	% yoy	<u>2.5</u>	2.3	2.6
		(sa)		% q/q	<u>-0.2</u>	-0.2	0.8
		Primary activities		% yoy	<u>1.8</u>	--	3.1
		Industrial production		% yoy	<u>1.0</u>	--	0.4
		Services		% yoy	<u>3.4</u>	--	3.7
Mon 22-Aug	9:00am	Global economic indicator	June	% yoy	<u>2.2</u>	1.8	2.2
		(sa)		% m/m	<u>0.7</u>	--	1.0
		Primary activities		% yoy	<u>6.4</u>	--	-3.5
		Industrial production		% yoy	<u>0.6</u>	--	0.5
		Services		% yoy	<u>3.0</u>	--	3.5
Mon 22-Aug	4:30pm	Banamex bi-weekly survey of economic expectations					
Tue 23-Aug	9:00am	Retail sales	June	% yoy	<u>6.9</u>	7.0	8.6
Tue 23-Aug	10:00am	International reserves	19-Aug	US\$ bn	--	--	176.6
Tue 23-Aug	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 3y Mbono (Dec'19); 3y Udibonos (Jun'19)					
Wed 24-Aug	9:00am	CPI inflation	1H-Aug	% 2w/2w	<u>0.47</u>	0.36	-0.04
				% yoy	<u>2.96</u>	2.83	2.65
		Core		% 2w/2w	<u>0.23</u>	0.16	0.04
				% yoy	<u>3.07</u>	--	2.97
Thu 25-Aug	10:00am	Banxico's minutes					
Thu 25-Aug	10:00am	Current account	2Q16	US\$ bn	<u>-5.6</u>	-6.7	-7.0
Fri 26-Aug	9:00am	Trade balance	July	US\$ mn	<u>-1.804</u>	-1,526.9	-523.6
		Total exports		% yoy	<u>-1.6</u>	--	-5.4
		Oil exports		% yoy	<u>-18.4</u>	--	-27.5
		Non-oil exports		% yoy	<u>-0.5</u>	--	-3.8
		Total imports		% yoy	<u>-3.1</u>	--	-6.1

Source: Banorte-IXE; Bloomberg

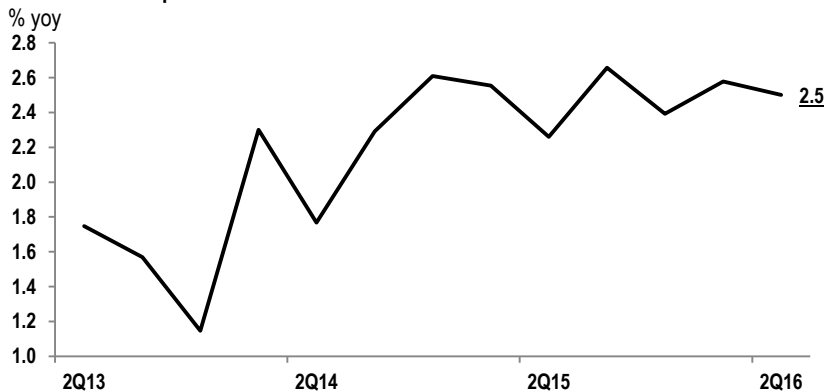
Proceeding in chronological order...

GDP will show a 2.5% yoy expansion in 2Q16. On Monday, at 9:00am (EDT), *INEGI* will publish its GDP report for the second quarter of 2016, where we expect a 2.5% yoy expansion, marginally above the 2.4% growth reported in *INEGI*'s preliminary GDP report. In seasonally adjusted terms, we expect a 0.2% q/q reduction.

Taking a look at the breakdown, we believe that the services sector will show a 3.4% yoy expansion, which would be marginally below the 3.7% yoy growth observed in the previous quarter. In this regard, we have seen a significant recovery in several of the indicators associated with household spending. In particular, the creation of jobs in the formal sector during the period in question has been higher, while domestic trade has accelerated. However, we believe that the lower growth in the Mexican manufacturing industry will have a negative impact on other services associated with this sector, such as transportation.

Regarding industrial activities, manufacturing output expanded a scant 1.6% yoy as a result of the lower growth in the US manufacturing sector, which led to a deceleration of Mexico's manufacturing output and exports. Moreover, construction output increased 3.1% yoy, as result of a significant downturn in non-residential construction, and the recovery in private housing construction. However, the current recession in the mining industry (-4.3% yoy) –derived from the contraction in Mexico's oil production– has limited the recovery of industrial activity, which we believe grew a scant 1% yoy in 2Q16.

Gross domestic product



Source: Banorte-Ixe

We expect a 2.2% yoy expansion in June's IGAE. Also on Monday, at 9:00am (EDT), *INEGI* will release its monthly global economic indicator for June (monthly proxy for the GDP). We expect a 2.2% yoy expansion of economic activity (0.6% m/m).

As we had mentioned in our last IP report, the 0.6% yoy growth in industrial production during June was explained in part by the moderate 1.2% yoy expansion in manufacturing output. Moreover, construction increased 3.1% yoy as a result of the fall in public investment projects and a higher growth in residential construction. Finally, given the fall in Mexico's oil production, mining activity posted a 5.8% yoy reduction, now adding 25 consecutive months in contraction.

As we already explained in the GDP section, we believe that growth in June was driven by the performance of the service sector, which we forecast at 3% yoy. We highlight that domestic trade has continued to show clear signs of acceleration. Finally, for the agricultural sector, we estimate a 6.4% yoy expansion.

***Banamex* Survey: Market participants will focus on inflation and monetary policy forecasts.** Also, on Monday at 4:30pm (EDT) *Banamex* will release its bi-weekly survey of economic expectations, where market participants will focus on analysts' monetary policy assessments given the hawkish tone in Banxico's latest monetary policy statement.

Furthermore, analysts will also focus on the inflation report for the first half of August (to be published on Wednesday, August 24), as well as on CPI estimations for 2016 and 2017. Moreover, *Banamex* will also publish consensus' growth and FX forecasts for 2016-17. In the first case, we do not expect strong revisions to the median GDP forecast. In the second case, we expect moderate downward revisions to the FX estimates for 2016.

Retail sales will post a 6.9% yoy expansion in June. On Tuesday at 9:00am (EDT), *INEGI* will publish its retail sales report for June 2016. We anticipate a 6.9% yoy expansion explained by the favorable performance of durable goods sales. In particular, vehicles sales increased by 20.4% yoy growth according to *AMIA*'s report. Moreover, *ANTAD* total store sales increased 5.9% yoy in real terms during the period in question. However, consumption goods imports -which have a strong correlation with retail sales-, posted a 10% yoy reduction.

Looking ahead, we believe that retail sales will continue to show a favorable performance derived from: (1) An improvement in private banking credit; (2) the contained levels of inflation; and (3) the stronger growth dynamics in the Mexican labor market.

Weekly international reserves report. On Tuesday, at 10:00am (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves increased by US\$21 million amounting to US \$176.6 billion on August 12. According to Banxico’s report, this figure comes mainly as a result of: (1) Dollar sales by Banxico to the Federal Government for US\$240 million; along with a (2) US\$261 million increase due to changes in the valuation of the Central Bank’s assets. In this context, the Central Bank’s international reserves have diminished by US\$107 million this year (please refer to the table below).

Banxico's foreign reserve accumulation details

US\$, million

	2015	12/Aug/2016	12/Aug/2016	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	176,735	176,628	21	-107
(B) Gross international reserve	177,597	180,783	2,543	3,187
Pemex	--	--	-353	2,030
Federal government	--	--	2,632	4,091
Market operations	--	--	0	-5,562
Other	--	--	263	2,627
(C) Short-term government's liabilities	861	4,155	2,522	3,295

Source: Banco de México

Weekly government bond auction. Also on Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent-, will offer 3-year fixed-rate Mbonos (Dec’19), 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 (EDT).

Auction specifics (Tuesday, August 23, 2016)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	22-Sep-16	--	5,500	4.27
3m	24-Nov-16	--	9,500	4.33
6m	16-Feb-17	--	11,000	4.55
Mbono				
3y	11-Dec-19	5.00	7,500	5.41
Udibono				
3y	13-Jun-19	4.00	750	1.91

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

Inflation in the first half of August will be explained by pressures on energy prices along with higher merchandise prices. On Wednesday, at 9:00am, INEGI will release its bi-weekly inflation report. We are forecasting a 0.47% 2w/2w increase in the first half of August, above market consensus that is forecasting a 0.36% according to Bloomberg. In the core index, we expect an increase of 0.23% 2w/2w above market consensus (0.16%).

Inflation during the period in question will be explained by pressures on energy prices amid the increases announced by the government in the price of low grade gasoline and electricity tariffs. In addition, we continue to see pressures on merchandise prices, on the back of some pass-through from FX depreciation.

In fact, we expect this figure to be 35.9bps higher than the observed in same period last year, derived from: (1) 22.9bps stemming from a higher contribution of energy prices (24.5bps vs. 1.6 in 2015); and (2) 7.9bps stemming from a higher contribution of services prices (7.6bps vs. -0.2 in 2015). In addition, we expect a lower contribution from government tariffs prices (0.5bps vs. 2.1 in 2015), as shown in the table below.

With these results, annual inflation will edge up to 2.96% yoy in the first half of August from previous 2.65% while core inflation is at 3.07% from 2.97%yoy.

1H-August inflation by components

% bi-weekly incidence

	Banorte-Ixe	2015	Difference
Total	0.47	0.12	0.36
Core	0.17	0.09	0.08
Goods	0.10	0.10	0.00
Processed foods	0.03	0.02	0.00
Other goods	0.07	0.07	0.00
Services	0.08	0.00	0.08
Housing	0.01	0.01	0.00
Education	0.05	0.05	0.00
Other services	0.01	-0.07	0.08
Non-core	0.30	0.02	0.28
Agriculture	0.05	-0.01	0.06
Fruits & vegetables	0.04	-0.02	0.06
Meat & eggs	0.01	0.01	0.00
Energy & government tariffs	0.25	0.04	0.21
Energy	0.25	0.02	0.23
Government tariffs	0.01	0.02	-0.02

Source: Banorte-Ixe with data from INEGI and Banco de México.

Note: Contributions might not add due to the number of decimals allowed in the table.

Previous to year 2011, contributions might not add because of the change in CPI-calculation methodology.

Hawkish minutes in order to prepare the market for a rate hike in September. Next Thursday at 10:00am (EDT), Banco de Mexico will publish the minutes of its monetary policy meeting held back on August 11, in which the board decided to remain on hold, as it was widely expected. We believe that the decision was unanimous. In addition, we expect discussions during the meeting to have focused on two issues: (1) The higher probability of financial volatility on the back of geopolitical risks including the US elections and the normalization of the Fed's monetary policy; and (2) the balance of risks for inflation in the horizon in which monetary policy operates remained unchanged, on the back of June's 50bps rate hike.

According to Banxico's last monetary policy *communiqué*, Banxico highlighted the higher volatility of domestic financial markets, as a result of the recent geopolitical events –including Brexit–. However, the *communiqué* also referred to the efforts made by the central bank to limit the negative impact of these events on local financial markets, like the 50bps rate hike in June that resulted in the appreciation of the Mexican currency. In this context, Banxico's Board warned that: “...*Looking ahead we cannot rule out other episodes of increased volatility in financial markets, on the back of geopolitical risks including the US elections, and the normalization of the Fed's monetary policy...*”. Moreover, and considering that the central bank has already made reference to the effect of the depreciation of the Mexican currency on inflation expectations, Banxico also mentioned in their statement that: “...*the central bank will adjust its monetary stance with flexibility, in an effort to keep inflation and inflation expectations well-anchored, which in turn will contribute to greater financial stability...*”.

Banxico also mentioned that inflation still remains below the 3% target. However, core inflation is still showing an upward trend on the back of the adjustment of relative prices as a result of the depreciation of the exchange rate. In the coming months, the central bank estimates that inflation will likely end the year close to 3% yoy, as a result of the changes made by the government to the formula to determine energy prices. The monetary authority said that “*Taking into account the increase of 50bps in the reference rate last June the balance of risks to inflation –in the horizon over which monetary policy takes effect-, remained unchanged...*”. In this regard, once again Banxico commented that one of the main risks to the inflation outlook is a larger-than-expected pass-through from the FX depreciation, particularly in the core index. Meanwhile, in the non-core index, the main risk comes from the upward trend observed in energy prices.

On the other hand, according to the *communiqué*, the balance of risks for growth deteriorated over the intermeeting period. In particular, Banxico said that the outlook for global growth continued to deteriorate, while US economic activity in 2Q16 was lower than anticipated. In Mexico, Banxico said the contraction of economic activity in the second quarter was explained by the reduction in industrial output and null growth in services activities. In this context, the central bank said that “... *during the second quarter the output gap seems to have remained negative ...*”

Banxico's last monetary policy statement suggests that the central bank believes that preemptive measures –such as the one taken in June-, could be useful to improve the balance of risks for inflation. Looking ahead we continue to forecast a highly volatile exchange market that could affect the performance of inflation in the horizon over which monetary policy takes effect, so we anticipate that the central bank will increase the reference rate by 50bps again in September, and then again in December. In addition, it is worth noting that September's meeting will be the last before the US election, an event that could be particularly volatile for the Mexican exchange rate market. The minutes of this meeting will be published on August 25, and the next monetary policy announcement will take place on the 29th of September.

Current account (2Q16): Banorte-Ixe: US\$ -5,646 million; previous: US\$ -6,991mn. On Thursday (August 23), at 10:00am, Banxico will publish its balance of payments report for the second quarter of the year. We are forecasting a current account deficit of around US\$5,646 million. According to already reported trade balance figures, trade deficit amounted to US\$3,131 million, while net transfers increased on the back of a more dynamic flow of remittances up 11.9% yoy. In our opinion, external accounts remain solid with current account deficit financed by long term investment flows.

Oil exports will continue to fall in July. Finally, on Friday at 10:00am (EDT), *INEGI* will make available its trade report for July, where we expect to see a US\$1,804 million deficit. On the exports side, we will probably see a 18.4% yoy contraction of oil exports given the significant fall in exports and prices during the period in question. Moreover, non-oil exports could have decreased 0.5% yoy, on the back of a 0.9% drop in manufacturing exports.

On the imports side, we estimate a 3.1% yoy contraction in total imports. Taking a look at the breakdown, we believe that imports consumption goods decreased 6.9% yoy, while imports of intermediate goods could have fallen 2.3% yoy. Finally, we estimate a 4.4% reduction in capital goods imports.

Disclaimer

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