

# Ahead of the Curve

May 29, 2015

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

- Banxico's monetary policy meeting.** Next week, Banxico will hold its fourth monetary policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (June 4) at 2:00pm (EDT). We believe that board members will decide to leave the reference rate at 3%, as it is widely expected. Nonetheless, we believe that Banxico will maintain the tone of the last *communiqué* in which the main message was that in the absence of inflationary pressures and moderate growth, the board will focus on the time when the Fed will start its hiking cycle
- IMEF's PMI surveys.** On Monday, *IMEF* (Mexican Institute of Financial Executives) will publish its PMI business confidence indicators. We expect manufacturing PMI at 52.3 in May, above the 51.4 observed in April (seasonally adjusted terms). We believe that manufacturing activity in May was supported by the recovery of consumer spending in Mexico and the significant depreciation of the MXN. However, we believe that the strong recovery in retail sales might have affected the "inventories" component. However, we believe that the non-manufacturing PMI will stand at 51 points slightly below the 51.3 observed in April. In this regard, we believe that the recent downward trend in consumer confidence could have triggered a slight deceleration within the services in May

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## Mexico weekly calendar

DATE	HOOR (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Mon 1-Jun	10:00am	Family remittances	April	US\$ mn	<u>2,164.5</u>	2,135	2,258
Mon 1-Jun	1:00pm	PMI's survey (IMEF)	May				
		Manufacturing		index	<u>52.3</u>	51.7	51.4
		Non-manufacturing		index	<u>51.0</u>	51.0	51.3
Tue 2-Jun	10:00am	Banxico's survey of economic expectations	May				
Tue 2-Jun	10:00am	International reserves	29-May	US\$ bn	--	--	194.3
Tue 2-Jun	12:30pm	Government weekly auction: 1-, 3-, 6-, and 12-month Cetes; 3y MBono (Dec'18); 3y Udibono (Jun'19)					
Wed 3-Jun	9:00am	Gross fixed investment	March	% yoy	<u>8.0</u>	6.7	1.3
		Machinery and equipment		% yoy	<u>14.1</u>	--	1.9
		Domestic		% yoy	<u>12.2</u>	--	11.5
		Imported		% yoy	<u>15.0</u>	--	-2.3
		Construction		% yoy	<u>4.2</u>	--	0.9
Thu 4-Jun	2:00pm	Banxico's monetary policy decision	June	%	<u>3.00</u>	3.00	3.00
Fri 5-Jun	9:00am	Consumer confidence	May	index	<u>92.1</u>	92.2	91.3
Fri 5-Jun	4:30pm	Banamex bi-weekly survey of economic expectations					

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

**Family remittances will post a 9.5% yoy expansion.** On Monday, at 10:00am (EDT), Banxico will make its family remittances monthly report available. We expect Mexican workers living abroad -mainly in the US-, to have sent US\$2,164.5 million to their families in Mexico during April. This would imply a 9.5% yoy expansion. The latest CPS figures show that the employment for Mexican workers edged-up during April (19,594 jobs created, seasonally adjusted figures), which would point towards a higher remittance inflow. Looking ahead we believe that family remittances will show a significant recovery given the improvement in the US labor market, which will translate in better growth dynamics for the Mexican workforce in the U.S.

**May's PMI surveys.** On Monday, *IMEF* (Mexican Institute of Financial Executives) will publish its PMI business confidence indicators. We expect manufacturing PMI at 52.3 in May, above the 51.4 observed in April (seasonally adjusted terms). We believe that manufacturing activity in May was supported by the recovery of consumer spending in Mexico and the significant depreciation of the MXN. However, we believe that the strong recovery in retail sales might have affected the “inventories” component.

However, we believe that the non-manufacturing PMI will stand at 51 points slightly below the 51.3 observed in April. In this regard, we believe that the recent downward trend in consumer confidence could have triggered a slight deceleration within the services in May.

**Banxico's survey of economic expectations.** On Tuesday, at 10:00am (EDT), 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 3.07% (Banorte-Ixe: 3%); (2) mid-term inflation expectations -quite important for the central bank's board- that are currently at 3.44% (Banorte-Ixe: 3%); and (3) the analysts' assessments of GDP growth for 2015 -given the downward revision made by the MoF and the central bank- which currently stand at 2.88% (Banorte-Ixe: 3.6%).

**Weekly international reserves report.** On Tuesday, at 10:00am (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves decreased by US \$658mn amounting to US \$194.3bn on May 22. 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 \$33mn; (2) US \$260mn decrease explained by the introduction of Banxico's USD daily auction; along with a (3) US \$365mn decrease 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, given that on November 2011, the FEC (Federal Exchange Commission) decided to shut down the options scheme that Banxico also used to accumulate reserves. In this context, the central bank has accumulated US \$1,063mn of international reserves this year (please refer to the table below).

**Banxico's foreign reserve accumulation details**

US\$, million

	Foreign Reserve		Breakdown			
	Level	Chg	Pemex	Federal govt <sup>1</sup>	Market operations <sup>2</sup>	Other
2006	67,680					
2007	77,991	10,311	12,899	-4,218	-4,240	5,870
2008	85,441	7,450	22,754	-5,413	-18,674	8,783
2009	90,838	5,397	11,529	6,573	-16,246	3,541
2010	113,597	22,759	16,037	2,338	4,466	-83
2011	142,475	28,878	18,692	2,439	4,614	3,134
2012	163,516	21,116	17,867	2,805	-646	1,089
2013	176,522	13,063	18,100	-1,251	0	-3,788
2014	193,239	16,717	14,500	2,570	-200	-154
22-May-15	194,302	1,063	3,000	1,299	-2,748	-490

Source: Banorte-Ixe, Banco de México; \*Year-to-date

1. Includes short-term government's liabilities

2. Includes Banxico's US dollar sales to Mexican financial institutions as well as the Foreign Exchange Commission's USD Put/MXN Call options

\*Year-to-date

**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'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 (EDT).

**Auction specifics (Tuesday, June 2, 2015)**

	Maturity	Coupon rate, %	To be auctioned <sup>1</sup>	Previous yield <sup>2</sup>
<b>Cetes</b>				
1m	02-Jul-15	--	5,500	2.99
3m	03-Sep-15	--	9,500	3.08
6m	26-Nov-15	--	11,000	3.19
<b>Mbono</b>				
3y	13-Dec-18	8.50	9,500	5.07
<b>Udibono</b>				
3y	13-Jun-19	4.00	850	2.30

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

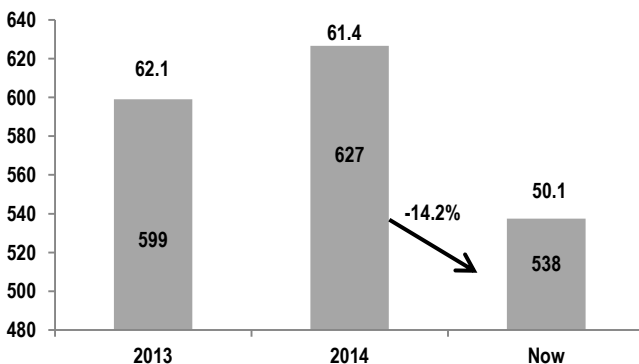
**We expect a 8% yoy expansion in March's GFI.** Next Wednesday at 9:00am (EDT), *INEGI* will publish its March's gross fixed investment (GFI) report. We anticipate GFI up by 8% yoy. We believe that within the report we will probably see a 15% yoy expansion in imported machinery and equipment given that trade balance figures for March showed a similar growth rate. Moreover, we expect a 12.2% growth in domestic machinery and equipment. Finally, we believe that construction spending could increase 4.2% yoy.

**Banxico’s monetary policy meeting – Uncomfortably numb.** Next week, Banxico will hold its fourth monetary policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (June 4) at 2:00pm (EDT). We believe that board members will decide to leave the reference rate at 3%, as it is widely expected. Nonetheless, we believe that Banxico will maintain the tone of the last *communiqué* in which the main message was that in the absence of inflationary pressures and moderate growth, the board will focus on the time when the Fed will start its hiking cycle.

While the Fed’s minutes of the last monetary policy meeting denoted a clear division between the FOMC members about the normalization process, many participants: “...*thought it unlikely that the data available in June would provide sufficient confirmation that the conditions for raising the target range for the federal funds rate had been satisfied, although they generally did not rule out this possibility...*”. While the Fed’s minutes make it clear that the decision is very data dependent –and that it will be determined on a meeting-by-meeting basis-, the Fed seems not to rule out June completely. However, the most recent economic activity indicators, coupled with the fact that inflation remains well below the 2% target, lead us to believe that the Fed would like to wait until September’s FOMC meeting. We believe that this “*bias to wait*” by several FOMC members will be taken into account in Banxico’s next monetary policy decision.

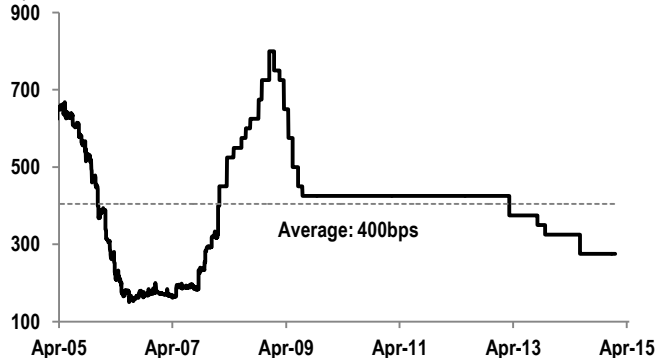
. In our view, a rate hike in the U.S. will trigger a similar action from Banxico (current reference rate is at 3% since March 2014). In fact, we believe that an increase in the U.S. reference rate is a sufficient condition to trigger a rate hike in Mexico –despite the fact that economic activity has 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. Moreover, in the last monetary policy minutes published in May 14, most board members agreed that taking into account the recent fiscal adjustments and given that inflation expectations are well anchored, acting ahead of the Federal Reserve would have more costs than benefits to Mexico’s economic recovery.

**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

Moreover, Banxico's last monetary policy statement was published one day after the Fed's announcement (*i.e.* Fed's announcement took place in April 29, while Banxico's *communiqué* was published on April 30). As we have mentioned throughout our publications, the central bank is in no hurry to raise the reference rate, given Mexico's moderate growth, inflation stands below 3%, and without any inflationary pressures on the horizon. If Banxico intends to "*follow the Fed*" it would be convenient for Banxico to "*pay-to-see the Fed's hand*". However, Banxico's monetary policy meetings will take place between four and five weeks after the Fed meetings, which could qualify as an "*eternal gap*" for fixed-income and derivatives traders (refer to the table below). We believe that this could be a decisive factor that could trigger Banxico to raise rates in an intra-meeting fashion. Moreover, if the Fed begins to hike in December, Banxico will no longer have a regular monetary policy meeting scheduled this year after the Fed meeting.

In this regard, in the last monetary policy minutes, at least 4 Board members agreed that given the greater volatility generated in anticipation of the Fed's decision, the monetary policy stance in Mexico would also have to anticipate the Fed's decision. Even though we believe that the Banxico's reference rate hike will take place immediately after the Fed's hike in September (*i.e.* Banxico's hike will begin in October 2015), these comments do open the possibility that Banxico could act preventively anticipating the Fed's decision, if and only if the central bank perceives strong risks to inflation and/or financial stability.

#### Dates of the upcoming monetary policy decisions

	FOMC	Banxico	Difference (in days)
1	--	Thu 4-Jun	--
2	Wed 17-Jun	Thu 23-Jul	36
3	Wed 29-Jul	Thu 3-Sep	36
4	Thu 17-Sep	Thu 15-Oct	28
5	Wed 28-Oct	Thu 3-Dec	36
6	Wed 16-Dec	--	--

Source: US Fed and Banco de México

To sum up, since our call for the Fed's first rate hike stands in September, we are penciling Banxico's first move to be a rate hike of 25bps at October 15 meeting, which is the first one to take place after the FOMC meets in September 16-17. In addition, we continue to believe that the Mexican monetary authority will hike 25bps at each of its meetings until the end of the year. This implies a 50bps increase in the reference rate vs. the 100bps previously forecasted. Beyond 2015, there is a high degree of uncertainty about whether the Fed will hold only a process of "*normalization*" and not monetary "*restriction*", so it is difficult to predict what Banxico could do in this period. Nevertheless, we consider that the long-term monetary policy reference rate in Mexico, incorporating the impact of structural reforms, stands at 7%.

**Consumer confidence will show signs of recovery in May.** On Friday, at 9:00am (EDT), Banxico and *INEGI* will publish its May's monthly survey on consumer confidence, where we expect a 1.5% yoy expansion, with the index reaching 92.1 points (vs. 90.7 in May 2014). We highlight that this could be the seventh positive annual growth rate since October 2013. In seasonally adjusted terms, we expect confidence levels to increase 1.3% m/m. We believe that consumer confidence (measured in seasonally adjusted terms) could show visible signs of recovery given the better growth dynamics of the Mexican economy and the downward trend in inflation.

***Banamex* Survey: Market participants will focus on analysts' monetary policy assessments.** Finally, on Friday at 4:30pm (EDT) *Banamex* will release its bi-weekly survey of economic expectations. In the last survey published by *Banamex* 24 out of 25 analysts surveyed expected a rate hike in 2015. Furthermore, analysts will also focus on May's inflation forecast (to be published on Tuesday, June 9), as well as on CPI estimations for 2015. Moreover, we expect moderate downward revisions to the economic growth estimates.

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