

Ahead of the Curve

June 12, 2015

Market focus this week will on Banxico's minutes

- Banxico's minutes.** Next week (Thursday, June 18), Banco de Mexico will publish the minutes of its monetary policy meeting held back on June 4, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view, the tone of Banxico's minutes will be quite similar to the last *communiqué*, mainly focused on two issues: (1) The balance of risks for economic growth continues to be relatively weak, with no concerns regarding inflation; and (2) their attention is focused on the timing at which the U.S. Fed will begin its hiking cycle, given that any actions from the U.S. Fed could have repercussions on the Mexican exchange rate and inflation expectations
- Aggregate supply and demand report.** On Friday, *INEGI* will publish its aggregate supply and demand report for 1Q15, where we believe aggregate demand increased 2.7% yoy, vs. the 4% yoy expansion observed in 4Q14. Taking a look at the breakdown, we expect a 3.4% yoy increase in private consumption, while we estimate a significant 5.4% yoy expansion for gross fixed investment. However, we believe that government spending will likely show a 0.1% yoy contraction

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Mexico weekly calendar

| DATE | TIME (EDT) | EVENT | PERIOD | UNIT | BANORTE-IXE | CONSENSUS | PREVIOUS |
|------------|------------|---|--------|---------|-------------|-----------|----------|
| Tue 16-Jun | 10:00am | International reserves | 12-Jun | US\$ bn | -- | -- | 193.3 |
| Tue 16-Jun | 12:30pm | Government weekly auction: 1-, 3-, and 6-month Cetes; 5y MBono (Dec'19); 10y Udibono (Dec'25) | | | | | |
| Thu 18-Jun | 10:00am | Banxico's minutes of June 4 meeting | June | | | | |
| Fri 19-Jun | 9:00am | Aggregate Demand | 1Q15 | % yoy | <u>2.7</u> | -- | 4.0 |
| | | Private consumption | | % yoy | <u>3.4</u> | -- | 2.7 |
| | | Government consumption | | % yoy | <u>-0.1</u> | -- | 1.9 |
| | | Gross-fixed investment | | % yoy | <u>5.4</u> | -- | 5.8 |

Source: Banorte-IXE; Bloomberg

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Proceeding in chronological order...

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 \$596mn amounting to US \$193.3bn on June 5. 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 \$8mn; (2) US \$260mn decrease explained by the introduction of Banxico's USD daily auction; along with a (3) US \$328mn 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 \$66mn of international reserves this year (please refer to the table below).

Banxico's foreign reserve accumulation details

US\$, million

| | 2014 | 5/Jun/2015 | 5/Jun/2015 | Year-to-date |
|---|---------|------------|------------|--------------|
| | Balance | | Flows | |
| International reserves (B)-(C) | 193,239 | 193,305 | -596 | 66 |
| (B) Gross international reserve | 195,682 | 195,349 | -1,106 | -332 |
| Pemex | -- | -- | -723 | 3,441 |
| Federal govt | -- | -- | 218 | 365 |
| Market operations | -- | -- | -260 | -3,164 |
| Other | -- | -- | -341 | -975 |
| (C) Short-term government's liabilities | 2,443 | 2,044 | -510 | -398 |

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 5-year fixed-rate Mbonos (Dec'19) as well as 10-year inflation-linked Udibonos (Dec'25), 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 16, 2015)

| | Maturity | Coupon rate, % | To be auctioned ¹ | Previous yield ² |
|----------------|-----------|----------------|------------------------------|-----------------------------|
| Cetes | | | | |
| 1m | 16-Jul-15 | -- | 5,500 | 2.96 |
| 3m | 17-Sep-15 | -- | 9,500 | 3.11 |
| 6m | 10-Dec-15 | -- | 11,000 | 3.27 |
| Mbono | | | | |
| 5y | 11-Dec-19 | 5.00 | 9,000 | 5.26 |
| Udibono | | | | |
| 10y | 04-Dec-25 | 4.50 | 750 | 2.88 |

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

Banxico Minutes – Did Banxico discuss calendar changes to its monetary policy announcements? Next week (Thursday, June 18), Banco de Mexico will publish the minutes of its monetary policy meeting held back on June 4, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view, the tone of Banxico’s minutes will be quite similar to the last *communiqué*, mainly focused on two issues: (1) The balance of risks for economic growth continues to be relatively weak, with no concerns regarding inflation; and (2) their attention is focused on the timing at which the U.S. Fed will begin its hiking cycle, given that any actions from the U.S. Fed could have repercussions on the Mexican exchange rate and inflation expectations.

While Banxico’s board members believe that market participants expect a more restrictive monetary stance from the U.S. Fed, they stressed out that “... *In response to weakness in economic activity [in the US] in the first quarter and to the revisions in growth expectations for 2015, consensus agrees that the date of the first increase in the reference rate will be delayed, and that the pace of subsequent increases will be gradual...*”.

In terms of growth, the tone of the last statement was marginally more positive than in the statement published in April. While the central bank considers that the balance of risks for both, global and the Mexican economy has not changed since the last meeting, Banxico highlights the improvement in non-oil exports and the fact that some indicators of consumption seem to be recovering. However, they also highlighted that the recovery of investment has been significantly slower, while industrial output remain subdued as a result of lower levels of oil production.

Moreover, the monetary authority highlighted in their last monetary policy statement that Mexico’s cyclical conditions show weakness, while inflation will remain below the 3% target in 2015. However, as it was abovementioned, the board members warned that: “...*the Fed's actions could have repercussions on the exchange rate and inflation expectations...*”. In this regard, Banxico’s board of governors will pay particular attention to “... *the relative monetary conditions between Mexico and the United States, the exchange rate and the evolution of the slack in the economy...*”

Another important point that might be discussed in Banxico’s minutes will be the time gap between the FOMC and Banxico meeting schedules. 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 at 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's meeting. We believe it would be advisable for the board to modify its calendar, so that the next monetary policy announcements could take place exactly one day after the FOMC. While this change could trigger some movements in the FX and TIE futures market, we believe that these movements will be non-disruptive, nor highly distortionary. Conversely, Banxico could remove a source of uncertainty.

Dates of the upcoming monetary policy decisions

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

Source: US Fed and Banco de México

All in all, we maintain our view that the central bank's next move will be a hike, immediately after the Fed. While Banxico's central scenario seems to be of economic weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to the exchange rate dynamics and inflation levels in Mexico. Given this, we believe that Banxico's next move will be a rate hike, immediately after the Fed starts its hiking cycle in September 16-17. This implies that the central bank could be raising rates in the next regular meeting on October 15th, four weeks after the Fed's first rate hike. Nevertheless, we cannot rule out that, since this four-week period could create a high volatility scenario in domestic financial markets, there is the possibility that Banxico could act preemptively, if and only if, the board perceives higher risks to inflation and/or financial stability.

We estimate a 2.7% yoy expansion in aggregate demand (AD) during 1Q15. On Friday, *INEGI* will publish its aggregate supply and demand report for 1Q15, where we believe aggregate demand increased 2.7% yoy, vs. the 4% yoy expansion observed in 4Q14. Taking a look at the breakdown, we expect a 3.4% yoy increase in private consumption, while we estimate a significant 5.4% yoy expansion for gross fixed investment. However, we believe that government spending will likely show a 0.1% yoy contraction.

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