

## Banxico's QIR – A less hawkish Banxico, but still tied to the Fed

- Banxico published today its *Quarterly Inflation Report (QIR)* for 3Q16
- We highlight the following issues:
  - (1) Inflation in 2017 will remain above Banxico's 3% target throughout the year, although it will converge to 3% in 2018
  - (2) The outlook for the global economy became more complex given the outcome of the US election
  - (3) As a result, the balance of risks for the Mexican economy has deteriorated, which prompted a downward revision to Banxico's 2017 growth forecast range, which now stands between 1.5% and 2.5% (previous range: 2%-3%).
  - (4) The output gap will remain in negative territory until 2018; and
  - (5) Banxico published its official monetary policy meetings calendar for 2017
- In the traditional “grey boxes” Banxico's researchers tackle the following topics:
  - (1) The adjustment of relative prices, given the depreciation of the Mexican currency, will be conducted in an orderly fashion; and
  - (2) The neutral interest rate has declined as a result of the international accommodative monetary policies. Therefore, the long-term neutral rate now stands between 4.7% and 6.3%
- We maintain our view that Banxico will increase the reference rate by 25bps in December, immediately after the Fed

**Lower growth ahead but higher inflation.** The monetary authority released its *Quarterly Inflation Report (QIR)* for 3Q16. The release was accompanied by a press conference led by Governor Carstens. We highlight the following issues discussed in the document: (1) Inflation in 2017 will remain above Banxico's 3% target throughout the year, although it will converge to 3% in 2018; (2) the outlook for the global economy became more complex given the outcome of the US election; (3) as a result, the balance of risks for the Mexican economy has deteriorated, which prompted a downward revision to Banxico's 2017 growth forecast range, which now stands between 1.5% and 2.5% (previous range: 2%-3%); (4) the output gap will remain in negative territory until 2018; and (5) Banxico published its official monetary policy meetings calendar for 2017.

In addition, in the traditional “grey boxes” Banxico's researchers tackle the following topics: (1) The adjustment of relative prices, given the depreciation of the Mexican currency, will be conducted in an orderly fashion; and (2) the neutral interest rate has declined as a result of the international accommodative monetary policies. Therefore, the long-term neutral rate now stands between 4.7% and 6.3%.

November 23, 2016

www.banorte.com  
www.ixe.com.mx  
@analisis\_fundam

### Gabriel Casillas

Chief Economist and Head of Research  
gabriel.casillas@banorte.com

### Delia Paredes

Executive Director of Economic Analysis  
delia.paredes@banorte.com

### Alejandro Cervantes

Senior Economist, Mexico  
alejandro.cervantes@banorte.com

### Francisco Flores

Economist, Mexico  
francisco.flores.serrano@banorte.com

### Fixed income and FX Strategy

#### Alejandro Padilla

Head Strategist - Fixed-Income and FX  
alejandro.padilla@banorte.com

#### Juan Carlos Alderete, CFA

FX Strategist  
juan.alderete.macal@banorte.com

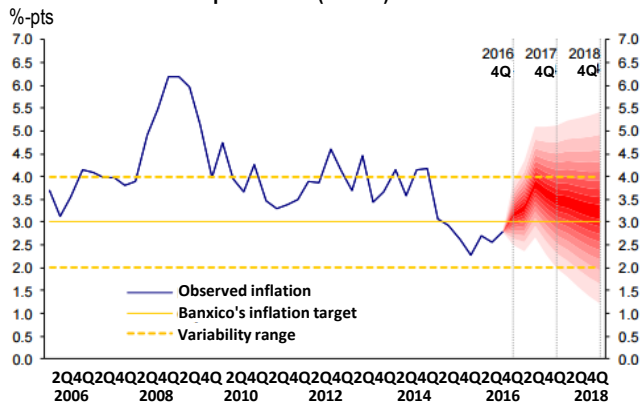
#### Santiago Leal

Analyst Fixed Income and FX  
santiago.leal@banorte.com

Document for distribution among public

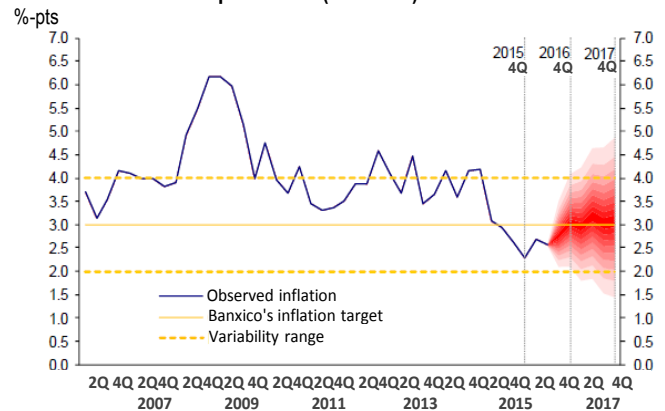
**Inflation above 3% in 2017.** The monetary authority affirmed that the recent upward trajectory of core inflation has been explained by the evolution of the commodity price sub-index, which has absorbed the higher pass-through effect of the depreciation of the Mexican currency to prices. In addition, the recent increase in the non-core sub-index has been explained by the increase of gasoline prices at the Mexican border. In the aggregate, the central bank expects inflation to close the year slightly above its 3% target. However, Banxico did acknowledge that inflation will stand above 3% in 2017 and will gradually to converge to its target by the end of 2018. Among the upward risks, the central bank stressed out that the uncertainty that prevails could accentuate the depreciation of the Mexican currency, which in turn, contaminate inflation expectations and generate second-order effects that adversely affect the price formation process.

**Fan chart: Inflation expectations (Actual)**



Source: Banco de México, 3Q16 QIR

**Fan chart: Inflation expectations (Previous)**



Source: Banco de México, 2Q16 QIR

**Higher economic growth in 3Q16...** The report highlights the performance of the Mexican economy during the third quarter of 2016, as a result of the higher growth of services and agricultural production. However, industrial production has decelerated given the recession in the mining sector. Similarly, construction slowed down due to the fall in public investment, while private construction projects have remained stable. Mexican exports also showed a higher growth due to the greater dynamism of external demand. Moreover, Governor Carstens referred to the expansion of private consumption as a result of credit growth in the private sector, as well as further growth in remittances. However, the greater dynamism of private consumption has not yet translated into greater inflationary pressures.

**... but lower growth in 2017.** Regarding growth forecasts, the central bank narrowed down its estimated growth range for this year between 1.8 and 2.3% (previous: 1.7% and 2.5%). Given the outcome of the US election, (1) the balance of risks for the Mexican economy has deteriorated, which prompted a downward revision to Banxico's 2017 growth forecast range, which now stands between 1.5% and 2.5% (previous range: 2%-3%; Banorte-Ixe: 1.1%). Moreover, the central bank announced its growth estimates for 2018, which estimate a growth between 2.2% and 3.2% (see next box). Regarding the creation of jobs, it revised up his forecast for this year, but lowered that of 2017.

**Banxico's Forecast**

Recent

	2016	2017	2018
<b>GDP (%)</b>	1.8 – 2.3	1.5 – 2.5	2.2 – 3.2
<b>Employment (thousands)</b>	640 - 710	600 – 700	650 – 750
<b>Trade Balance (bn)</b>	-15.2 (1.5% of GDP)	-12.6 (1.2% of GDP)	-12.3 (1.1% of GDP)
<b>Current account (bn)</b>	-31.5 (3.0% of GDP)	-30.9 (3.0% of GDP)	-33.9 (3.0% of GDP)
<b>Inflation</b>			
<b>Headline</b>	Slightly above 3%	Above the permanent inflation target	Close to 3%
<b>Core</b>	Slightly above 3%	Above the permanent inflation target	Close to 3%

Source: Banxico

**Banxico's Forecast**

Previous Quarterly Report

	2016	2017	2018
<b>GDP (%)</b>	1.7 – 2.5	2.0 - 3.0	-
<b>Employment (thousands)</b>	590 - 690	610 - 710	-
<b>Trade Balance (bn)</b>	-16.0 (1.5% of GDP)	-16.0 (1.4% of GDP)	-
<b>Current account (bn)</b>	-32.4 (3.1% of GDP)	-35.6 (3.2% of GDP)	-
<b>Inflation</b>			
<b>Headline</b>	Close to 3%	Around the permanent inflation target	-
<b>Core</b>	Close to 3%	Around the permanent inflation target	-

Source: Banxico

**Banxico published its calendar of monetary policy meetings for 2017.** In our opinion, Banxico is highly aware of the Fed's decision-making process, since all of its monetary policy meetings will be held days after the FOMC meetings. With this, the Banxico's meetings will be more relevant, since the Mexican central bank will have greater flexibility to act in a timely manner in case of an increase in *Fed Funds* rate (refer to the following table).

**Monetary policy meetings: Banxico & Fed**

Month	Banxico	Fed
January		
February	9	1
March	30	15
April	30	
May	18	3
June	22	14
July		26
August	10	
September	28	20
October		
November	9	1
December	14	13

Source: Banorte-ixe with data from the Federal Reserve and Banxico

**The adjustment of relative prices, given the depreciation of the Mexican currency, will be conducted in an orderly fashion.** The first “grey box” analyzes the relationship between the real exchange rate and the relative prices of goods and services. The takeaways of Banxico's research show that the prices of goods do adjust as a result of the volatility in the exchange rates, but they do so in a slow and steady manner. In the context of the current depreciation of the real exchange rate, prices of goods will rise faster than those of services. However, these changes will occur in a steady manner, which Banxico hopes will not impact inflation expectations.

**The neutral interest rate has declined as a result of the international accommodative monetary policies.** In the second research box, the central bank conducted an analysis of the natural interest rate. According to the results of the research, the neutral level of the nominal interest rate in the medium-term is 4.8% (range: 3.9% to 5.6%), below the 7.4% level seen before 2009 (range: 6.8% to 8.2%), mainly as a result of unconventional monetary policies in developed countries, which fostered global liquidity. Regarding long-term equilibrium rate, according to Banxico, the level of the neutral rate is 5.5% (range: 4.7% to 6.3%), influenced by demographic changes and less economic dynamism.

**We expect a 25bps hike in the reference rate in December.** Looking ahead, we continue to forecast a highly volatile exchange rate market, given: (1) If Trump's fiscal stimulus does materialize, inflation might be higher and the Fed's hiking cycle could be faster than our base-case scenario; (2) Trump's future comments regarding NAFTA and the bilateral trade relation; and (3) Oil price volatility. Moreover, we expect a 25bps hike from the Fed in December. In this context, we believe that Banxico will increase the reference rate by 25bps in their next monetary policy meeting on December. However, we do not rule out a 50bps hike if FX volatility increases in the coming weeks.

*From our fixed income and FX strategy team*

**QIR suggests a less aggressive restrictive mode ahead.** Banxico released its *Quarterly Inflation Report* this afternoon, with a rhetoric that suggests that the central bank is likely to be vigilant of market dynamics but will be more resilient in terms of future rate hikes. In our view, these comments give a significant support to the short-end, which is currently pricing in 32bps of implied hikes by year end (i.e. market depicting a strong conviction of a 25bps rate hike on December 15th following Fed's decision on December 14th) and nearly 162bps of cumulative increases by 2017-end, which could portray an overshooting. Before Banxico's QIR was released, the Mexican sovereign yield curve was registering a significant 1-10bps sell-off, mainly on long-term securities. However, post-QIR trading showed local bonds depreciating in a less important magnitude: Mbono Dec'24 went from 7.38% (+6bps) to 7.35% (+3bps) and Mar'26 from 7.46% (+7bps) to 7.43% (+4bps). Regarding real rates, short-term Udibonos strengthened following the publication. In terms of strategy, we hold a negative perspective in terms of the local yield curve, suggesting a short bias and waiting for better market conditions for long directional positions. Local rates have been strongly affected by a threefold situation: (1) Higher interest rates in the U.S. depicting the concerns of higher inflation, (2) a wider country risk premium, and (3) FX depreciation and the expectation of tighter monetary conditions by Banxico. We expect a better performance of the extremes of the yield curve and the market to show a better demand for CPI-adjusted Udibonos, as a defensive strategy against higher inflation in 2017. In the FX market, the Mexican peso is losing 0.5% on the day and went from 20.64 before the report to 20.70 as of the writing of this comment. In our view, the reaction was mostly due to the information contained in Banxico's report as opposed to the Fed minutes. In general, the outlook and analysis shown strengthen our conviction about maintaining a cautious outlook for MXN into year-end and 2017, reiterating our forecasts for December at 21.50 and 23.50, respectively, a weaker peso than current consensus. In our view, the central bank is very clear in portraying the need of a real exchange rate depreciation as the most efficient mechanism to absorb a series of external shocks. In terms of strategy, we have recommended new USD/MXN longs since the latest Banxico decision around 20.40, a 1.5% gain at its current level excluding a slightly negative carry. We suggest maintaining these positions, protecting profits in case of a return towards 20.50 and taking profit if the move extends to 20.90, a recent consolidation zone and below the 21.00 psychological level.

#### **Disclaimer**

The information contained in this document is illustrative and informative so it should not be considered as an advice and/or recommendation of any kind. BANORTE is not part of any party or political trend.

**GRUPO FINANCIERO BANORTE S.A.B. de C.V.**
**Research and Strategy**

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

**Economic Analysis**

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Juan Carlos García Viejo	Economist, International	juan.garcia.viejo@banorte.com	(55) 1670 - 2252
Rey Saúl Torres Olivares	Analyst	saul.torres@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

**Fixed income and FX Strategy**

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal, CFA	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

**Equity Strategy**

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry	marissa.garza@banorte.com	(55) 1670 - 1719
Marisol Huerta Mondragón	Equity Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 1670 - 1746
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research Analyst – Auto parts	valentin.mendoza@banorte.com	(55) 1670 - 2250

**Corporate Debt**

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 1670 - 2248

**Wholesale Banking**

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.cebaldos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Asset Management	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Victor Antonio Roldan Ferrer	Head of Corporate Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454