

Ahead of the Curve

May 15, 2015

Market focus this week will on 1Q15's GDP report

- Mexico's GDP report.** Next Thursday, at 9:00am (EDT), *INEGI* will publish its GDP report for the first quarter of 2015, where we expect a 2.6% yoy expansion. In seasonally adjusted terms, we expect a 0.1% q/q expansion during 1Q15. Taking a look at the breakdown, we believe that the services sector will show a 2.8% yoy expansion, which would be in line with the 2.8% yoy growth observed in the previous quarter
- Banxico's QIR.** Banco de México will publish its Quarterly Inflation Report (QIR) for 1Q15 next Tuesday around 1:30pm (EDT). The release will be accompanied by a press conference led by Governor Carstens. In our view, market participants will focus on four issues: (1) A downward revision to the central bank's 2015 GDP forecast range, currently at 2.5-3.5%; (2) Banxico's output gap projection; (3) U.S. Fed's monetary policy normalization; and (4) the need to maintain strong macro fundamentals

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Mexico weekly calendar

DATE	TIME (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Tue 19-May	10:00am	International reserves	15-May	US\$ bn	--	--	195.0
Tue 19-May	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 5y Mbono (Dec'19); 10y Udibonos (Dec'25)					
Tue 19-May	1:30pm	Quarterly inflation report	1Q15				
Wed 20-May	4:30pm	Banamex bi-weekly survey of economic expectations					
Thu 21-May	9:00am	GDP	1Q15	% yoy	<u>2.6</u>	2.5	2.6
		(sa)		% q/q	<u>0.1</u>	0.3	0.7
		Primary activities		% yoy	<u>8.0</u>	--	1.1
		Industrial production		% yoy	<u>1.4</u>	--	2.4
		Services		% yoy	<u>2.8</u>	--	2.9
Thu 21-May	9:00am	Global economic indicator	March	% yoy	<u>2.8</u>	2.7	2.3
		(sa)		% m/m	<u>0.2</u>	--	0.0
		Primary activities		% yoy	<u>5.3</u>	--	3.4
		Industrial production		% yoy	<u>1.7</u>	--	1.7
		Services		% yoy	<u>3.4</u>	--	2.6
Fri 22-May	9:00am	CPI inflation	1H May	% 2w/2w	<u>-0.52</u>	-0.45	0.02
				% yoy	<u>2.94</u>	3.01	3.06
		Core		% 2w/2w	<u>0.15</u>	0.11	0.08
				% yoy	<u>2.49</u>	--	2.31

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 \$331mn amounting to US \$195bn on May 8. 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 \$36mn; (2) US \$260mn decrease explained by the introduction of Banxico's USD daily auction; along with a (3) US \$35mn 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 \$1,771mn 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 ¹	Market operations ²	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
08-May-15	195,010	1,771	3,000	1,367	-2,228	-370

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 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, May 19, 2015)

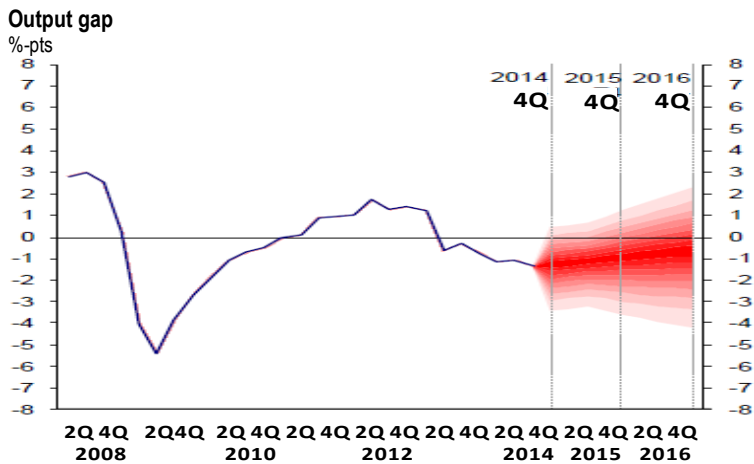
	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	18-Jun-15	--	5,500	2.97
3m	20-Aug-15	--	9,500	3.08
6m	12-Nov-15	--	11,000	3.20
Mbono				
5y	11-Dec-19	5.00	9,000	5.18
Udibono				
10y	04-Dec-25	4.50	750	2.86

Source: Banco de México

Banxico’s Quarterly Inflation Report – Banco de México will publish its Quarterly Inflation Report (QIR) for 1Q15 next Tuesday around 1:30pm (EDT). The release will be accompanied by a press conference led by Governor Carstens. In our view, market participants will focus on four issues: (1) A downward revision to the central bank’s 2015 GDP forecast range, currently at 2.5-3.5%; (2) Banxico’s output gap projection; (3) U.S. Fed’s monetary policy normalization; and (4) the need to maintain strong macro fundamentals.

In the first case, we believe that the central bank could make a downward revision to its GDP forecast for 2015, which could be motivated by the following factors: (1) The MXN 124,300 million (USD 8,229.8 million) cut in public spending announced by the Ministry of Finance back in February; (2) the latest economic activity figures published by the *INEGI* suggest that the inertial growth in Mexico could be lower, which would affect the growth dynamics of the Mexican economy in 2015; (3) the recent downward trend in manufacturing exports given the deceleration of the U.S. economy during the first quarter; and (4) the significant drop in the international prices of oil, and the reduction in Mexico’s oil production platform will have a more visible effect in Mexico’s mining production and on public expenditure. In this context, we believe that the new GDP forecast will be in the range between 2.2% and 3.2%.

Even though we expect Banxico to make downward revisions to its 2015 GDP forecast range, it is going to be interesting to see the output gap projection. We highlight that in the last minutes published by the central bank, one can clearly see how the output gap was closing in 4Q14 (refer to chart below), which could imply that the output gap might be closed by year-end 2016.



Source: Banco de Mexico

Regarding the Banxico’s monetary policy, the board members have been very clear in highlighting that they will be paying close attention to the Fed’s monetary policy normalization. In this context, Banxico’s board members mentioned that: “... there is still uncertainty about the date in which the Federal Reserve will begin its hiking cycle, and the pace at which it’ll take place. Some board members highlighted that market prospects for the Fed’s first rate hike range from September to January of the following year, depending on which indicator is considered ...”

Moreover, with respect to international financial markets, board members believe that there is still a significant risk in terms of high volatility episodes given the divergence of monetary policies in developed countries. In this regard, in the last monetary policy minutes, most board members agreed that acting ahead of the Federal Reserve would have more costs than benefits, given that it could affect Mexico's economic recovery. However, 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. In particular, the minutes included the following comments: *"...one board member emphasized that there is a high probability that markets anticipate the Fed's decision, and that a period of increased turbulence could take place prior to the actual hike. **This member and others** argued that the current monetary conditions -due to the depreciation of the exchange rate-, gives enough leeway to tighten Mexico's monetary policy. **Another member** added that it would be rational for Banxico to act pre-emptively ahead of the Fed's decision..."*

We maintain our view that Banxico's next move will be a rate hike. In our view, such movement will take place in tandem with Fed's first rate increase in June 2015 (Banxico could hike in July 2015). Moreover, we expect a tightening cycle of 100bps this year, so that the reference rate will end the year at 4%. Beyond 2015, there is a high degree of uncertainty about whether the Fed will only hold a "normalization" process and not a "monetary restriction", so it is difficult to predict what Banxico might do in year 2016. Nevertheless, we believe that the long-term equilibrium monetary policy rate in Mexico -incorporating the impact of structural reforms-, is 7%.

Banamex Survey: Market participants will focus on analysts' monetary policy assessments. On Wednesday at 3:30pm (EDT) *Banamex* will release its bi-weekly survey of economic expectations. In the last survey published by *Banamex* 23 out of 24 analysts surveyed expected a rate hike in 2015. Furthermore, analysts will also focus on May's first half inflation forecast (to be published on Friday, May 22), as well as on CPI estimations for 2015. Moreover, we expect moderate downward revisions to the economic growth estimates for 2015.

GDP will show a 2.6% yoy expansion in 1Q15. Next Thursday, at 9:00am (EDT), *INEGI* will publish its GDP report for the first quarter of 2015, where we expect a 2.6% yoy expansion. In seasonally adjusted terms, we expect a 0.1% q/q expansion during 1Q15.

Taking a look at the breakdown, we believe that the services sector will show a 2.8% yoy expansion, which would be in line with the 2.8% yoy growth observed in the previous quarter. We highlight that 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 significantly higher, while trade has begun to show clear signs of acceleration. 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 2.9% yoy as a result of the lower growth in the U.S. economy. Additionally, during this period the occurrence of labor disputes on the west coast in the U.S. led to a slower growth of manufacturing output and exports. Moreover, construction output grew 4.2% yoy, as result of the recovery in household's spending, which has been reflected in the exceptional performance of construction in the residential sector. However, the current recession in the mining industry (-5% yoy) –derived from the significant contraction in Mexico's oil production– has limited the recovery of industrial activity, which we believe grew 1.4% yoy in 1Q15.

We expect a 2.8% yoy expansion in March's IGAE. Also on Thursday, at 9:00am (EDT), *INEGI* will release its monthly global economic indicator for March (monthly proxy for the GDP). We expect a 2.8% yoy expansion of economic activity (0.2% m/m).

As we had mentioned in our last IP report, the 1.7% expansion in industrial production during March was explained in part by the 5.2% expansion in construction output. In this regard, we believe that the better growth dynamics of construction reflects the better growth expectations that prevail today in most of Mexico's private firms. The recovery of households' purchasing power - given the lower inflation levels and the recovery of the Mexican labor market- has led to a significant expansion in residential construction. Looking ahead, we expect construction activity to continue gaining momentum, and will probably strengthen in the first quarter of the year. Moreover, manufacturing output posted a 3.1% yoy expansion. However, given the fall in Mexico's oil production, mining activity posted a 5.3% yoy reduction.

As we explained in the GDP section, we believe that growth in March was driven by the performance of the service sector, which we forecast at 3.4% yoy. We highlight that trade has begun to show clear signs of acceleration. 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. Finally, for the agricultural sector, we estimate a 5.8% yoy expansion.

Inflation in the first half of May will continue to show the application of summer discounts on electricity tariffs. On Friday, at 9:00am, *INEGI* will release its bi-weekly inflation report. We are forecasting a 0.52% 2w/2w decrease in the first half of May below market consensus that expects a -0.45% according to Bloomberg. In the core index, we expect an increase of 0.15% 2w/2w above market consensus (0.11%). Inflation during the period in question will continue to show the application of summer discounts on electricity tariffs, along with lower agricultural prices. Nevertheless, we observed some pressures on merchandise prices.

We expect this figure to be 15.4bps lower than the observed in same period last year, derived from: (1) 3.9bps stemming from a higher contribution of the cost of services (3.6bps vs. -0.3 in 2014); (2) 3.4bps stemming from a higher contribution of merchandise prices (8bps vs. 4.6 in 2014).

By contrast, we expect (3) -12.7bps from a lower contribution agricultural prices (-5.5bps vs. 7.2 in 2014); and (4) -6.5bps stemming from a lower contribution of energy prices (-58.9bps vs. -52.4 in 2014), as shown in the table below.

With these results, annual inflation will stand at 2.94% yoy in the first half of May, while core inflation would be at 2.49% from 2.31% yoy.

1H-May inflation by components
% bi-weekly incidence

	Banorte-Ixe	2014	Difference
Total	-0.52	-0.37	-0.15
Core	0.12	0.04	0.07
Goods	0.08	0.05	0.03
Processed foods	0.03	0.04	-0.01
Other goods	0.05	0.00	0.05
Services	0.04	0.00	0.04
Housing	0.02	0.02	0.00
Education	0.00	0.00	0.00
Other services	0.01	-0.02	0.04
Non-core	-0.64	-0.42	-0.22
Agricultural	-0.06	0.07	-0.13
Fresh fruits and vegetables	-0.04	-0.04	0.00
Meat and egg	-0.02	0.11	-0.13
Energy and government regulated	-0.58	-0.51	-0.08
Energy	-0.59	-0.52	-0.06
Government regulated	0.01	0.01	0.00

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

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