

Banxico QR – Lower growth estimates reinforce the dovish bias

- Banxico published today its 3Q19 *Quarterly Report (QR)*
- The release was accompanied by a press conference by Governor Alejandro Díaz de León
- As expected, Banxico modified its growth and inflation forecasts. Specifically:
 - (1) Growth for 2019 was revised down, between -0.2% to 0.2% (mid-point: 0.0%) from 0.2-0.7% (mid-point: 0.5%), slightly above our -0.1%
 - (2) The forecast range for 2020 was also lowered, to 0.8-1.8% (mid-point: 1.3%; Banorte: 1.4%). For 2021, they introduced a range between 1.3-2.3% (mid-point: 1.8%)
 - (3) Average headline inflation for 4Q19 was reduced to 3.0% from 3.2%, with a slight adjustment in the opposite direction for the first quarter of 2020. Nevertheless, core inflation was increased between 10-20bps) in each quarter up to 3Q20
- The traditional ‘grey boxes’ deal mostly with estimating economic activity and the importance of central bank autonomy
- Banxico also released its calendar for 2020, in which monetary policy decisions are still closely aligned to those of the US Fed
- In our view, the document reaffirms the central bank’s dovish tone, providing further details about the outlook and the balance of risks. Moreover, it helps to confirm that Banxico is likely in the middle of an easing cycle, which will be carried out in a prudent manner
- We maintain our view of a 25bps rate cut in December, to 7.25%, extending into 2020 with an additional 125bps of easing, likely front-loaded during the first half and with the reference rate closing next year at 6.00%
- Market pricing is consistent with Banxico’s tone in recent communications

We consider that the *Quarterly Inflation* reaffirmed Banxico’s dovish tone, with the central bank in the midst of an easing cycle. Banxico published today its *Quarterly Report (QR)* for 3Q19. The release was accompanied by a press conference led by Governor Alejandro Díaz de León. In our view, the tone remains dovish, signaling strongly that the central bank is in the midst of an easing cycle, which will continue to be managed in a prudent manner. This is very similar to what we perceived in the monetary policy statement of the November 14th meeting. Revisions in terms of growth and the output gap have strengthened the case for rate cuts. Nevertheless, we believe caution is still warranted given the adjustments higher in core inflation forecasts up to 3Q20. All in all, we maintain our view of a 25bps cut to 7.25% in December, within an easing cycle that we estimate will take the reference rate to 6.00% by year-end 2020.

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Slower GDP growth expected in coming years. For 2019, the estimated range was reduced, between -0.2% to +0.2% (mid-point: 0.0%), from 0.2-0.7% yoy (mid-point: 0.5%), slightly higher than our -0.1%. For 2020, the adjustment was in line with our expectations, with the range reduced to 0.8-1.8% (mid-point: 1.3%), slightly lower than our forecast of 1.4%. Moreover, they introduced a forecast range for 2021 bounded between 1.3-2.3% (mid-point: 1.8%). We also noted that the central bank made significant changes to their estimation of the output gap, widening for all the periods presented previously, while remaining negative at least until year-end 2021. Although the central bank had already warned about these changes, which are broadly in line with market expectations, we believe they support the case for additional rate cuts. For additional reference, the latest median estimates in Banxico's survey stand at +0.2% for 2019 and +1.2% for 2020.

Considering that the balance of risks to growth was already skewed to the downside in the latest communique, it is worth noting that they modified one factor to reflect a more adverse environment while adding an additional one, respectively: (1) A stronger persistence of the weakness observed in the components of aggregate demand, while in the previous QR they only stated uncertainty that had affected consumption and investment; and (2) lower fiscal spending in 2020 than expected. About this latter factor, we should highlight that in the latest minutes, some central bank members warned that several analysts thought some of the assumptions were optimistic, resulting in prevailing risks for fiscal policy. We think this concern is granted, particularly given year-to-date figures in terms of underspending, which has partially been a result of lower growth that has impacted revenues.

Additionally, we also noted that one of the upside risks was eliminated, which referred to more dynamism in aggregate demand due to stimulus measures announced by the Ministry of Finance. In this respect, back in late July, the Federal Government announced three measures amounting to MXN\$485bn to stimulate the economy, which included: (1) Infrastructure projects with no impact on the budget (MXN\$50bn); (2) credits to support consumption and investment (MXN\$320bn); and (3) resources to accelerate hiring and advance projects tenders into 2020 (MXN\$116bn). For details, see: "*MoF appoints Undersecretary and announces measures to support economic activity*", [pdf](#), July 30, 2019. Overall, the QR is consistent with the central bank's signal in its latest communique, adding details about the main factors considered behind the balance of risks. In this respect, it is our take that the tone remains dovish.

Banxico's Forecasts
Current Report (3Q19)

	2019	2020	2021
GDP (%)	-0.2 – 0.2	0.8 – 1.8	1.3 – 2.3
Employment (thousands)	300 – 370	500 – 600	510 – 610
Trade Balance (bn)	-0.2 (0.0% of GDP)	-10.9 (0.8% of GDP)	-15.6 (1.1% of GDP)
Current account (bn)	-5.8 (0.5% of GDP)	-18.1 (1.4% of GDP)	-23.7 (1.7% of GDP)

Source: Banxico

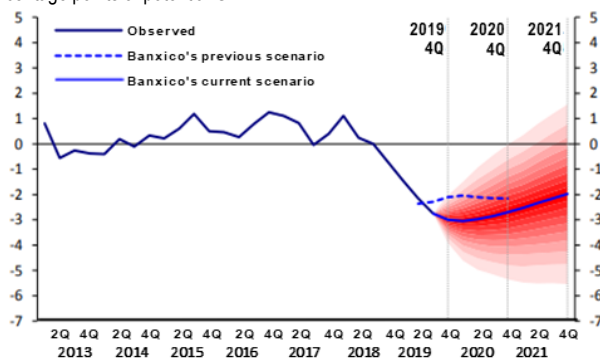
Banxico's Forecasts
Previous Quarterly Report (2Q19)

	2019	2020
GDP (%)	0.2 – 0.7	1.5 – 2.5
Employment (thousands)	450 – 550	590 - 690
Trade Balance (bn)	-7.8 (0.6% of GDP)	-12.1 (0.9% of GDP)
Current account (bn)	-15.2 (1.2% of GDP)	-22.0 (1.6% of GDP)

Source: Banxico

Output gap

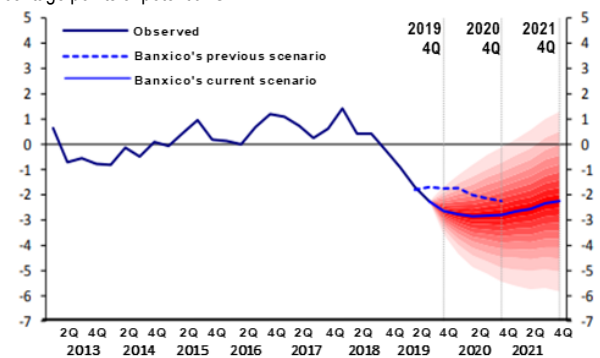
Percentage points of potential GDP



Source: Banco de Mexico; 2Q19 QR

Output gap ex oil production

Percentage points of potential GDP



Source: Banco de Mexico; 2Q19 QR

Marking-to-market inflation forecasts, with slightly more persistence to the upside in core inflation. Also in line with expectations, Banxico made slight adjustments to its inflation forecasts. Regarding the headline, the average forecast for 4Q19 was lowered 20bps to 3.0%, in line with our year-end estimate. The path for the next quarters was broadly unchanged, with the convergence towards the 3% target remaining in 4Q20, when excluding the brief period in which it would also reach this level at the end of the current year. Moreover, the path for core inflation was increased more significantly, by 10-20bps in each of the quarters up to 3Q20. This implies a slight adjustment lower in non-core prices. On risk factors, few changes were made relative to the previous QR, highlighting that they removed the escalation of protectionist measures globally, and that wage increases surpassing productivity gains was ranked higher, as already known in the communique.

In our view, this factor is likely behind part of the move higher in core inflation forecasts. In the press conference, Governor Diaz de Leon declined to comment on specific minimum wage increases that have been commented on publicly, stressing that hikes above productivity gains could spur inflation and that they should be done at a pace that does not distort the labor market. In this respect, the head of the *National Minimum Wage Commission* (Conasami) –the entity in charge of setting this concept for the country–, recently commented about a new MW between 128 to 132 pesos per day. This would represent an upward adjustment between 24.7% and 28.6%, surpassing the 16.2% seen for 2019 and our estimate of 10-15%. Nevertheless, this is not the final number, which should be released soon.

Broadly speaking, we think that the changes presented are consistent with the central bank maintaining a prudent stance, particularly given that higher core inflation estimates in a context of a more negative output gap implicitly reinforce that most members see that this component will maintain its resistance to the downside in upcoming quarters.

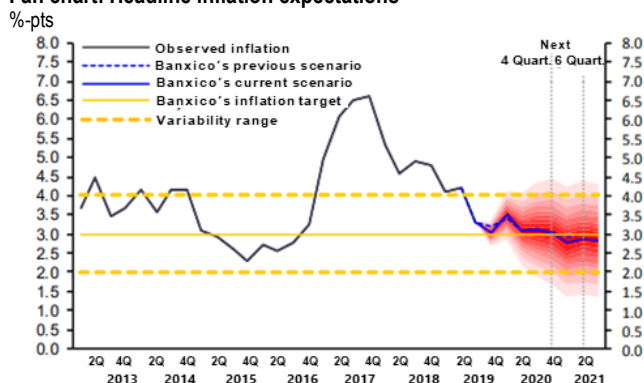
CPI forecasts

% yoy, quarterly average

	2019		2020				2021		
	III	IV	I	II	III	IV	I	II	III
CPI									
Current forecast	3.3*	3.0	3.5	3.1	3.1	3.0	2.8	2.9	2.9
Previous forecast	3.3	3.2	3.4	3.1	3.1	3.0	2.9	3.0	--
Core									
Current forecast	3.8*	3.6	3.6	3.2	3.1	2.9	2.8	2.9	2.9
Previous forecast	3.7	3.5	3.4	3.1	3.0	2.9	2.9	3.0	--

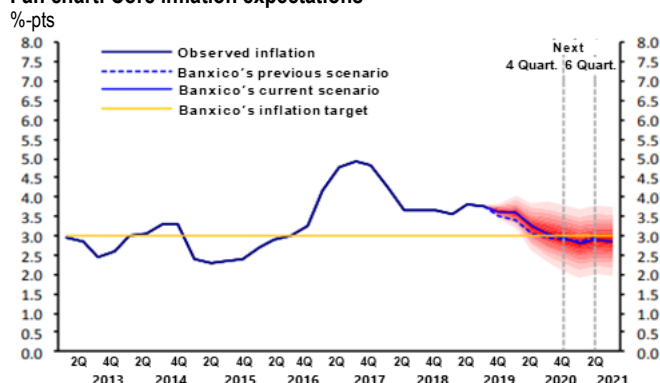
Source: Banco de México, 2Q19 QR; *Observed data

Fan chart: Headline inflation expectations



Source: Banco de Mexico; 2Q19 QR

Fan chart: Core inflation expectations



Source: Banco de Mexico; 2Q19 QR

The traditional ‘grey boxes’ deal mostly with estimating economic activity and the importance of central bank autonomy. These included: (1) The effect of trade tensions and monetary policy actions in the US on the global economy; (2) a model to complement other measures of economic activity, based on signal extraction methods, using data from both the supply and demand side; (3) a decomposition analysis (in terms of the effect due to changes in quantities and prices) of the trade balance surplus in non-oil exports and imports experienced during the second and third quarters of 2019; (4) a statistical analysis of the monetary aggregate M1 to predict economic activity and to anticipate periods in which it is likely to decelerate; (5) an analysis of the factors behind the gap in inflation levels between the components within core goods, processed foods and other goods, with the latter possibly benefitted to the downside from a higher share of imports, particularly those coming from China, which have presented very low or even negative levels of annual inflation; and (6) the importance of central bank autonomy and its mandate of price stability, which has contributed to reduce the level, volatility and persistence of inflation, benefitting society as a whole.

Banxico policy decisions in 2020 will remain aligned with those of the US Fed. Similar to recent years, Banco de Mexico’s monetary policy meetings will take place with a lag no greater than two weeks from the Fed’s decisions (refer to the table below). It should be mentioned that this remains the case even with Banxico signaling in its latest communique that it will likely decouple from the Fed, looking more closely to relative monetary conditions with respect to emerging markets.

Monetary policy meetings

Month	Federal Reserve	Banxico
January	29	--
February	--	13
March	18	26
April	29	--
May	--	14
June	10	25
July	29	--
August	--	13
September	16	24
October	--	--
November	5	12
December	16	17

Source: Banxico, Federal Reserve

We maintain our view that Banxico is in the midst of an easing cycle. It is our take that the document reaffirms the dovish tone observed in recent central bank communications, providing further details about the outlook for growth and the factors driving the assessment behind the balance of risks, which remains skewed to the downside. On inflation, adjustments were more modest. In our view, this combination helps to confirm that Banxico is likely in the middle of an easing cycle, which will be carried out in a prudent manner, particularly given the extent to which inflation has benefitted this year from the decline in the non-core component. We maintain our view of a 25bps rate cut in December, to 7.25%, extending into 2020 with an additional 125bps of easing, likely front-loaded during the first half and with the reference rate closing next year at 6.00%.

From our fixed income and FX strategy team

Market pricing is consistent with Banxico’s tone in recent communications. Banxico’s QR confirmed the bias in the last monetary policy meeting held two weeks ago, where the benchmark rate was cut 25bps with a dovish tone, holding the market’s perception regarding the execution of looser monetary conditions going forward. Details highlighted new downward revisions to growth forecasts for this year and in 2020, coupling to CPI forecasts’ tuning that, broadly speaking, held close to the central bank’s target. In balance, this combination suggests conditions that will allow the central bank to extend its monetary stimulus efforts.

As a consequence, the local yield curve is currently pricing in 25bps of implied rate cuts for year-end 2019 and 122bps accumulated for 2020, in line with our view of a 25bps rate cut for next meeting on December 19th, and 125bps for next year, leaving the benchmark rate at 6.00%. A relevant theme that we expect to be addressed in a more detailed fashion in tomorrow's minutes, will be the discussions around the intention of decoupling from the Fed in terms of the relative monetary policy conduction, as the latter has signaled its intentions to pause its rate-cutting cycle, a situation that could start to stress the favorable differentials Mexico still exposes against U.S. rates. The local yield curve did not experience a material reaction to Banxico's QR, holding a performance with mixed variations between $\pm 1-2$ bps, within a session that has been characterized by some risk appetite improvement. The foreign scene has significantly weighted in the local fixed-income market price action in the last weeks, with pressures that are averaging in November 33bps for the Mbonos curve. In our view, these adjustments are mostly derived from the uncertainty prevailing on geopolitical themes affecting investor's sentiment, chiefly the absence of trade agreements between the U.S. and China. As a consequence, the local risk premium approached by the 10-year spread between Mexico and the U.S. has increased to its highest since mid-September, trading at 539bps from 493bps as its lowest in November, and a 12-month mean at 557bps. In strategy terms, we wait for better entry levels and market conditions for new directional recommendations.

In the FX market, the Mexican peso has experienced similar dynamics to those seen in local rates, registering a 1.7% sell-off during this month, that despite being defensive vs other EM pairs, reflects the less favorable foreign conditions for risk assets recently. USD/MXN has consistently breached fresh lows not seen since October, reaching yesterday 19.59, its weakest level since October 10th. In the aftermath of Banxico's Report, the peso did not depict major adjustments, holding trading levels close to 19.55 (-0.2%). In our view, the peso will continue under a weak performance going forward, mainly as an effect of the carry erosion that will result from the rate spreads' compression between Mexico and the U.S. as Banxico endures its monetary stimulus path. In a shorter-term, we do not rule out to see some breather to the recent depreciation, triggered by a potential improvement, at least partial, in the uncertainty faced by several trade fronts (e.g. USMCA, U.S./China). In this sense, we wait for new attractive levels for USD tactical longs, acknowledging a relevant resistance at 19.27 where the 200-day MA stands, and supports at 19.65.

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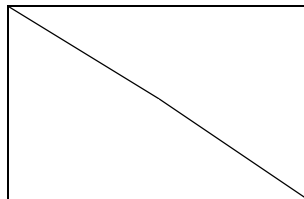
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