

Ahead of the Curve

October 4, 2019

Banxico's minutes to maintain a dovish tone

- Banxico's minutes (September 26th).** We believe the document will maintain a dovish tone, with the majority of the Board biased for lower rates. We will evaluate the reasons behind the dissenting votes of two members in favor of a 50bps cut, which we believe were likely made by Deputy Governors Gerardo Esquivel and Jonathan Heath. In our view, one of the most interesting potential debates will be the assessment about the inflation outlook, particularly at the core component, as it has maintained resistance to the downside and recent news show the Federal Government is looking for another increase in the minimum wage for 2020. We think Banxico will cut the reference rate by 25bps in each of the two remaining meetings of 2019, with the reference rate at 7.25% by year-end. Moreover, we estimate the easing cycle will continue in 2020, with 75 bps of cuts front-loaded to the first semester and an additional 50bps during the second half, resulting in a reference rate of 6.00% by the end of next year
- Industrial production (August).** We estimate activity at -1.9% yoy from -1.7% in July, which would be its tenth consecutive print in negative territory. Nevertheless, some impact would come from the period having one less working day relative to August 2018. In seasonally-adjusted terms we anticipate a 0.5% m/m rebound, mostly on less drag from construction and resiliency in manufacturing. Going forward, we keep anticipating stronger performance, mainly in sectors more sensitive to external demand. Additional factors that could provide some cushion include (1) The depreciation of the peso; (2) lower interest rates globally and also by Banxico; and (3) market share gains in the US, mostly from China

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Document for distribution among the general public

Mexico weekly calendar

DATE	HOOR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 7-Oct	7:00am	Gross fixed investment (sa)	July	% yoy	<u>-7.9</u>	-7.6	-8.8
				% m/m	<u>-0.9</u>	--	-0.8
		Machinery and equipment	% yoy	<u>-10.7</u>	--	-14.0	
			Domestic	% yoy	<u>-2.0</u>	--	-4.9
			Imported	% yoy	<u>-15.8</u>	--	-20.3
			Construction	% yoy	<u>-5.7</u>	--	-4.6
Mon 7-Oct	3:30pm	Citibanamex bi-weekly survey of economic expectations					
Tue 8-Oct	10:00am	International reserves	Oct-4	US\$ bn	--	--	180.2
Tue 8-Oct	12:30pm	Government weekly auction: 1-, 3-, 6-, 12-month CETES; 30y Mbono (Nov'47); 30y Udibonos (Nov'50); 5y Bondes D					
Wed 9-Oct	7:00am	CPI inflation	September	% m/m	<u>0.25</u>	0.25	-0.02
				% yoy	<u>2.98</u>	2.99	3.16
			Core	% m/m	<u>0.29</u>	0.28	0.20
				% yoy	<u>3.74</u>	--	3.78
			September	%	<u>6.0</u>	--	4.4
Thu 10-Oct		Wage negotiations	September	%	<u>6.0</u>	--	4.4
Thu 10-Oct	10:00am	Banxico's minutes	September				
Fri 11-Oct	7:00am	Industrial production (sa)	August	% yoy	<u>-1.9</u>	-1.9	-1.7
				% m/m	<u>0.5</u>	--	-0.4
		Mining	% yoy	<u>-6.1</u>	--	-7.5	
			Utilities	% yoy	<u>1.4</u>	--	-1.0
			Construction	% yoy	<u>-5.6</u>	--	-8.4
			Manufacturing	% yoy	<u>0.6</u>	--	3.0

Source: Banorte; Bloomberg

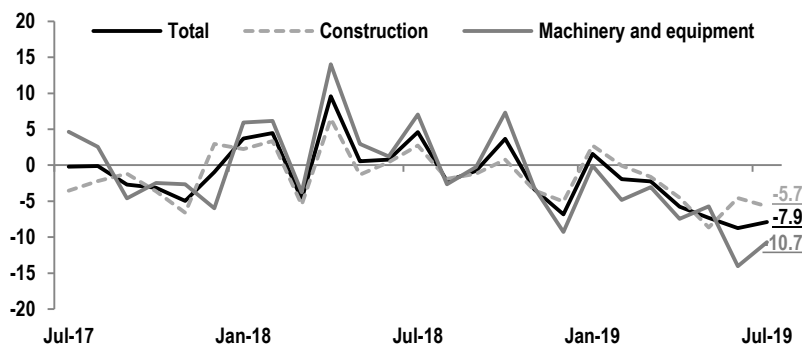
Proceeding in chronological order...

Gross fixed investment to contract further in July. We anticipate GFI at -7.9% yoy, slightly higher than the -8.8% of the previous month. Despite of the latter, using seasonally adjusted figures this would result in a -0.9% m/m contraction, slightly worse than the -0.8% observed in June. This latter difference would be driven by the fact that July 2019 had one more working day in the annual comparison, while June had one less. Overall, this performance would remain very disappointing, confirming that investment remains the weakest link of GDP.

We forecast construction at -5.7% yoy. According to the IP report, the sector reversed back after some green shoots in June, with edification plunging 6.6% and civil engineering down 4.6%. For details, see: “*Industrial production – Slight contraction in July despite resilient manufacturing*”, <pdf>, September 11th, 2019. We believe that a recovery in business confidence is a key missing ingredient, not materializing during this month as the headline fell further and the ‘adequate moment to invest’ component reached a low since February 2017. Despite of the latter, tentative signs of bouncing back have emerged according to most recent figures, consistent with the main business chamber’s expectations of a stronger performance in 2H19.

On the other hand, machinery and equipment (M&Eq) would plunge 10.7%, above the -14.0% of the previous month but by no means positive. The main drag would still be the imported component, estimated at -15.8% as capital goods imports fell 16.5% and stayed weak despite other elements showing a stronger performance. For details, see: “*Trade balance – Modest deficit in July signals a possible rebound in activity*”, <pdf>, August 27th, 2019. This performance was observed even with a stronger exchange rate, signaling that the decline was driven by additional factors other than price considerations. On the contrary, the domestic component will likely improve for a second month in a row in the annual comparison, estimated at -2.0%, with some positive signals in industrial production data along a more favorable base-effect.

GFI
% yoy



Source: INEGI, Banorte

Citibanamex Survey. Markets will center on analysts' inflation forecasts for September (to be published on Wednesday, October 9th) along with the 2019 year-end estimate. It will be important to see monetary policy assessments, particularly after the last decision in which Banxico cut the reference rate by 25bps in a majority decision. We will also pay attention to GDP growth and the exchange rate.

Weekly international reserves report. Last week, net international reserves increased US\$193 million, closing at US\$180.2 billion. According to Banxico's report, this comes mainly from a positive valuation effect in central bank assets. In this context, the central bank's international reserves have increased US\$5.4 billion during 2019 (please refer to the following table).

Banxico's foreign reserve accumulation detail

US\$, million

	2018	Sep 27, 2019	Sep 27, 2019	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	174,793	180,213	193	5,420
(B) Gross international reserve	176,384	182,874	98	6,490
Pemex	--	--	-216	143
Federal government	--	--	67	1,030
Market operations	--	--	0	0
Other	--	--	247	5,317
(C) Short-term government's liabilities	1,592	2,661	-95	1,070

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent, will offer 30-year fixed-rate Mbonos (Nov'47), 30-year Udibonos (Nov'50), 5-year Bondes D, in addition to the 1-, 3-, 6-, and 12-month zero-coupon Cetes (see following table). As usual, results will be released at 12:30pm (ET).

Auction specifics (Tuesday, October 8th, 2019)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	07-Nov-19	--	6,000	7.65
3m	09-Jan-20	--	10,500	7.61
6m	08-Apr-20	--	14,500	7.58
6m	08-Oct-20	--	14,500	7.39
Bondes D				
5y	22-Aug-24	--	6,500	0.15
M Bono				
30y	07-Nov-47	8.00	4,000	7.52
Udibono				
30y	03-Nov-50	4.00	UDIS 550	3.53

Source: Banorte 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

Annual inflation to stay close to the central bank's target. We estimate headline inflation at +0.25% m/m, with the core at +0.29%. Continuing with the behavior of the first half of the month, we expect this latter component to lead the contribution, adding 22bps to the headline. On the other hand, non-core would only add 3bps (+0.12% m/m).

Even though we do not expect additional pressures within education during the second fortnight of September, the total contribution for the month would stand at 7.8bps, the highest among services. Meanwhile, other services could subtract 4bps, continuing the downward trend seen in the first half of the period and in line with its typical seasonality. Finally, we expect a 15bps contribution from core goods, split somewhat equally between processed foods (+8bps) and other goods (+7bps).

Regarding the non-core component, we expect energy to add 3bps, driven higher mainly by an uptick in LP gas, part of which is from the first half of the month. We believe this adjustment would be due to rising international prices. Regarding other hydrocarbons, we anticipate low-grade gasoline to revert part of the increase in the first fortnight, resulting in a monthly contribution to the headline of +1bp. In this context, the excise tax subsidies kept climbing in the second part of the month, in an environment characterized by high oil price volatility after attacks on Saudi Arabia's infrastructure (for more information see: "*Ataque a infraestructura en Arabia Saudita incrementa los riesgos para el escenario global*", [pdf](#)), September 19th [available only in Spanish]), although moderating towards the end of the month. For agricultural goods, we expect a null contribution, with +1bps from fruits and vegetables compensated by an equally-sized fall in meat and egg. Within the latter, we expect a mixed performance, with pressures on pork, still impacted by rising prices due to the swine flu outbreak in Asia. Nevertheless, this would be more than compensated by lower prices of poultry.

With these results, annual inflation would come in at 2.98% from 3.16% in August, lowest in three years. In particular, the non-core component would only increase 0.67%, a new historical low –noting that the monthly series is only available since January 1983–. Meanwhile, core inflation would improve marginally, at 3.74% (previous: 3.78%). Going forward, we believe one of the key factors for inflation to hover around the 3% level will be non-core index dynamics, which has been the main driver for inflation to return to the central bank's target. On monetary policy, we consider that this print will reinforce the Banxico's dovish bias, reiterating our forecast for two additional 25bps cuts for the remainder of the year, driving the reference rate to 7.25%.

We forecast wage negotiations to climb 6.0% in September. This would be considerably above the 4.4% seen in the previous month. We believe this increase will be explained by a change in composition within the workers benefited by a revision, with the private sector recovering share relative to public employees. In this context, revisions within the first one have averaged 6.4%, while in the second they only reach 3.4%. Going forward and as mentioned in other releases, wage negotiations will likely remain skewed to the upside due to the revision of the minimum wage as well as the lagged impact from high inflation in the previous two years. However, we do not rule that given the recent fall in inflation, coupled with the deceleration in economic activity, could result in a lower pace of growth for salaries.

Banxico minutes to reinforce the easing bias. Next Thursday, Banxico will publish the minutes of the monetary policy meeting held on September 26th, when the Board cut the reference rate by 25bps to 7.75%, in line with our expectation. We believe the document will maintain a dovish tone, as in our view the majority of the Board is biased for lower rates. Moreover, it is our take that dynamics in terms of three main factors have provided additional room for cuts, including: (1) The stagnation of economic activity; (2) the fall in headline inflation, virtually at the central bank's target; and (3) the global easing wave.

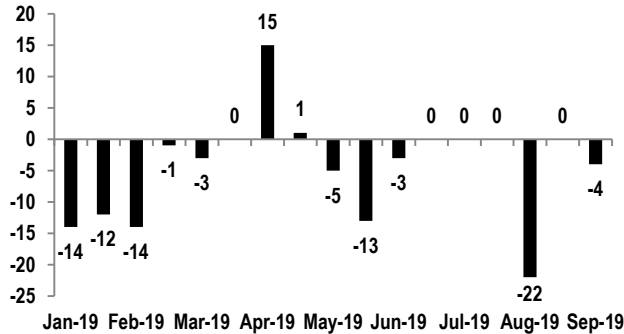
First and foremost, we will evaluate the reasons behind the dissenting votes of two members in favor of a 50bps cut. We believe these were likely made by Deputy Governors Gerardo Esquivel and Jonathan Heath. About the former, his comments have remained dovish for some time now, including the dissenting vote in the June 27th meeting in favor of a 25bps rate cut. Among his reasons, he stated that inflation had been better than forecasted and that by year-end 2019 it would end close or even below 3.4%. He added the loosening of monetary policy in advanced economies and the noticeable deceleration of the Mexican economy. Since then, it is our take that all these factors have materialized or even exacerbated at the margin, supporting the case of a slightly stronger pace of cuts. In the case of Jonathan Heath, we have perceived increasing concerns about the slowdown in activity, adding to this the decline to contraction territory of the ISM manufacturing in the US in September and August's trade balance in Mexico, among others. In this respect, he argued recently that with growth stagnant (in our view staying that way in July, as portrayed by IGAE data) and inflation closer to target (where it stands, as of the latest print), an opportunity exists to lower the interest rate even more. He was careful to note that this would not necessarily mean that the central bank will adopt an outright accommodative stance, but only turning less restrictive. With the reference rate currently at 7.75% and Banxico's point estimate of neutrality at 5.6% (range: 4.8-6.4%), it is our take that he believes there is still ample room to ease.

We should mention that the communique did not show significant changes in the balance of risks, either for growth –still tilted to the downside, both for the global and domestic economy– or inflation –suggesting a neutral balance, with unchanged risk factors in both directions–. Nevertheless, our linguistic analysis showed “*inflation*” was no longer the most mentioned word, replaced by “*risks*”. In addition, “*prices*” lost relative weight, while “*convergence*” gained. In our view, both subtle changes pointed to a slightly more dovish stance.

In this respect, we believe one of the most interesting potential debates will be the assessment about the inflation outlook. On one hand, the Board already acknowledged the strong decline in headline inflation to 2.99% yoy. Based on our estimates, next week's print for the entire month of September will result in an additional marginal decline to 2.98% (0.09% 2w/2w). If this materializes, average inflation in 3Q19 would stand at 3.3%, exactly at Banxico's forecast. For year-end, the latest central bank survey saw a relevant decline to 3.1% from 3.4%, driven by recent downward surprise relative to market expectations (see chart below, left).

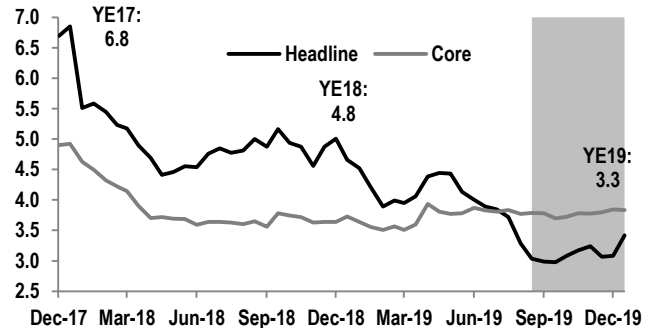
We maintain our estimate at 3.3%, with risks skewed slightly to the downside (see chart below, right). Moreover, for 2020 the median estimate declined to 3.5% from 3.6% previously.

Bi-weekly inflation surprises
bps, actual less median forecast



Source: Banorte with data from INEGI, Bloomberg

Inflation forecasts
% yoy, bi-weekly frequency



Source: INEGI, Banorte

Despite of this, the debate will likely center on core inflation, estimated at 3.8% yoy on average during 3Q19, an inch higher than Banxico’s 3.7% forecast. According to our calculations, economic slack has widened since 4Q18 but the annual rate has been hovering around 3.8% since picking up from 3.6% in April. The central bank has reiterated in several occasions that one of the risks for prices is if wage increases surpass productivity gains, eventually leading to cost pressures. In our view, these have already been reflected at least partially in some components within core services. This is relevant as the Federal Government is looking to the possibility of another increase in the minimum wage (MW) for 2020, with President Andrés-Manuel López-Obrador arguing there should be an additional hike on top of this year’s +16.2%, as the latter was “not enough”. He also stated they will reach for the central bank’s opinion, which in the 2Q19 *Quarterly Report* concluded in one of its ‘grey boxes’ that the MW increase was one of the factors behind the deceleration in formal job creation, warning that it could have more sizable effects as additional increases would impact a greater share of the labor force. Although as far as we know the central bank has not updated its latest study on the potential impact of a higher MW on prices, we believe the majority still sees this as one of the main upside risks for the inflation outlook.

In our view, Board members’ relative stance about the resistance to the downside of core inflation, and the risks going forward, will be key ingredients to assess further the potential magnitude of the easing cycle that started in August. As we mentioned after the decision, we think that Banxico will cut the reference rate by 25bps in each of the two remaining meetings of 2019, with the reference rate at 7.25% by year-end. Moreover, we estimate the cycle will continue in 2020, with 75 bps of cuts front-loaded to the first semester and an additional 50bps during the second half, resulting in a reference rate of 6.00% by the end of next year. This path implies 225bps of accumulated cuts from the 8.25% level just before the August decision.

The most relevant support for our outlook is the fact that global central banks have started to cut simultaneously, providing Banxico with additional flexibility for more stimulus while at the same not reducing the short-term spread (both in nominal and real terms) with the US as significantly as if Banxico ‘*goes solo*’ or in a context of tighter global monetary conditions.

Nevertheless, behind our expectation also underlies the view that inflation will remain under control and close to target, recognizing that a relevant risk that could eventually result in more modest easing would be sizable increases in costs (including wages) that reinforce the resistance to the downside of the core component, along with a more noticeable effect in terms of higher mid- and long-term inflation expectations.

Modest rebound in August’s industrial production. We estimate industrial activity at -1.9% yoy from -1.7% in July, which would be its tenth consecutive print in negative territory. Nevertheless, some impact would come from the period having one less working day relative to August 2018. In seasonally-adjusted terms we anticipate a 0.5% m/m rebound, mostly on less drag from construction and resiliency in manufacturing.

Regarding the former, we forecast a 5.6% yoy decline, above the -8.4% observed in July. Signals in terms for performance have been mixed. On the technical side, one less working day in the annual comparison is a negative but a less challenging base effect would be helpful. In terms of sentiment, business confidence remains contained as the headline index inched lower again, although the ‘adequate moment to invest’ component went up from a minimum since February 2017 at 24.3pts, towards 25.0pts. The latter may suggest that pessimism is bottoming out given that it is the first increase in four months, with data for September extending the upside. According to recent news, Mexico City’s government has been working to reactivate the sector and speed-up regulatory processes. As far as we know, these started to be more noticeable since September, so activity likely remained modest, as suggested by formal employment data which showed low net job creation. We continue believing that activity will gradually improve as projects resume.

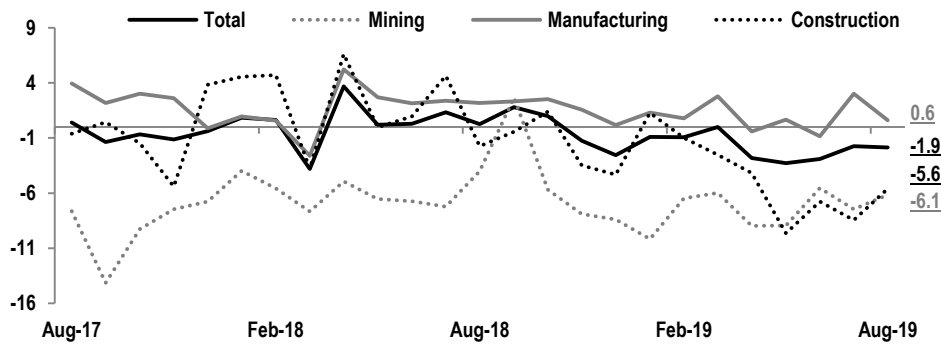
In manufacturing, we anticipate a 0.6% increase, much lower than the 3.0% of the previous month. We expect the sector to have stayed resilient despite of the latter, with calendar effects also playing an important part in explaining the moderation. Nevertheless, this was likely not the only driver, with some signals of an inventory drawdown as businesses’ kept experiencing robust external demand and took advantage of peso weakness –which went from 19.05 in July to 19.65, on average–. For example, auto production fell 9.6%, weakest on a year-to-date basis, albeit exports remained strong as they increased 9.7% yoy. Moreover, non-oil intermediate goods imports, closely linked to manufacturing activity, fell 1.8% from +7.3% in the previous month, also suggesting lower in inventories. Regarding demand, US industrial production was stronger at the margin, falling 0.4% vs -0.6% previously.

Last but not least, mining would stay negative as we estimate a 6.1% contraction. Crude-oil production keeps showing some stabilization, increasing 0.6% on a sequential basis to 1,708kbpd according to Pemex, albeit still negative in annual terms at -8.3%. In a similar fashion, gas production was up 0.8%, improving relative to July. On the other hand, we estimate the non-oil sector up 0.8%. In this respect, official data suggests that efforts to increase oil production have been positive, which could result in this sector's performance being less of a drag to industry, at least for now.

Going forward, we keep anticipating that industry will show a stronger performance during the rest of the year, as we have observed some green shoots, mainly in sectors sensitive to external demand. Additional factors that could provide some cushion include (1) The depreciation of the peso; (2) lower interest rates globally and by Banxico; and (3) market share gains in the US, mostly from China. Nevertheless, we still forecast that industry will contract in full-year 2019, with a challenging environment ahead as global economic activity looks to have decelerated further.

Industrial production

% yoy



Source: INEGI, Banorte

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HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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