

# Ahead of the Curve

May 8, 2015

Market focus this week will be on Banxico's minutes

- Banxico's minutes.** Next week (Thursday, May 14), Banco de Mexico will publish the minutes of its monetary policy meeting held back on April 30, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view -and in line with the last statement- the tone of the minutes will be slightly more dovish, particularly given that: (1) The balance of risks for economic growth continues to be deteriorated, and there isn't any concerns regarding inflation; (2) they will be attentive to Mexico's relative monetary conditions, particularly with respect to the U.S.; and (3) the board stated again that market's perception regarding the next hike in the Fed's fund rate could be delayed
- March's industrial production report.** On Tuesday, at 9:00am (EDT), *INEGI* will release its monthly industrial production report. We anticipate a 2% yoy expansion in total output during the third month of the year. Taking a look at the breakdown, we believe that construction output could have expanded 3.1% yoy. Additionally, we believe that manufacturing production could post a 3.9% yoy expansion. However, we believe that the increase in industrial output during March will be limited by the poor performance of mining activity. In this regard, we expect a 4% yoy contraction

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

**Mexico weekly calendar**

DATE	HOURL (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Tue 12-May	9:00am	Industrial production	March	% yoy	<u>2.0</u>	2.0	1.6
		(sa)		% m/m	<u>0.4</u>	0.4	0.2
		Mining		% yoy	<u>-4.0</u>	--	-3.8
		Utilities		% yoy	<u>4.1</u>	--	3.8
		Construction		% yoy	<u>3.1</u>	--	1.1
		Manufactures		% yoy	<u>3.9</u>	3.7	4.0
Tue 12-May	10:00am	International reserves	8-May	US\$ bn	--	--	195.3
Tue 12-May	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 20y Mbono (Nov'34); 5y Bondes D					
Wed 13-May	1:30pm	Government extraordinary auction: 168-, 266-, 350-days CETES					
Thu 14-May	10:00am	Banxico's minutes of April 30 meeting					

Source: Banorte-IXE; Bloomberg

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Proceeding in chronological order...

**We expect a 2% yoy expansion in March's industrial output.** On Tuesday, at 9:00am (EDT), *INEGI* will release its monthly industrial production report. We anticipate a 2% yoy expansion in total output during the third month of the year. Taking a look at the breakdown, we believe that construction output could have expanded 3.1% yoy. We believe that construction has consolidated its recovery given the better growth dynamics in households' durable goods expenditure. Moreover, formal employment generated within this sector has shown a significant recovery in the past year, which supports our view of a more positive perspective regarding the recovery of this sector. This would imply that construction could reach its tenth positive growth rate after adding 17 consecutive months in contraction.

Additionally, we believe that manufacturing production could post a 3.9% yoy expansion, explained by faster growth in manufacturing exports (8.8% yoy) and vehicle production (8.1% yoy). We believe that in the short run the Mexican manufacturing sector will show better growth prospects, derived from: (1) A stronger external demand, particularly coming from the U.S.; (2) the recent depreciation of the Mexican currency; and (3) the recovery of private consumption in Mexico, which will eventually translate into a higher domestic demand for manufacturing products.

However, we believe that the increase in industrial output during March will be limited by the poor performance of mining activity. In this regard, we expect a 4% yoy contraction derived from lower oil production and the reduction in the extraction of other minerals.

**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 \$237mn amounting to US \$195.3bn on April 30. 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 \$37mn; (2) US \$208mn decrease explained by the introduction of Banxico's USD daily auction; along with a (3) US \$8mn increase 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 \$2,102mn 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 <sup>1</sup>	Market operations <sup>2</sup>	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
30-Apr-15	195,340	2,102	3,000	1,403	-1,968	-335

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 20-year fixed-rate Mbonos (Nov'34) as well as 5-year Bondes D, 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). We highlight that on Wednesday, May 13; there will be a Cetes extraordinary auction in three different securities: 168-, 266-, and 350-days, for an amount of 25,000mn pesos.

**Auction specifics (Tuesday, May 12, 2015)**

	Maturity	Coupon rate, %	To be auctioned <sup>1</sup>	Previous yield <sup>2</sup>
<b>Cetes</b>				
1m	11-Jun-15	--	5,500	2.98
3m	13-Aug-15	--	9,500	3.09
6m	12-Nov-15	--	11,000	3.21
<b>Mbono</b>				
20y	23-Nov-34	7.75	3,000	6.43
<b>Bondes D</b>				
5y	02-Apr-20	--	3,000	0.25

Source: Banco de México

**Banxico's minutes – Slightly more dovish minutes.** Next week (Thursday, May 14), Banco de Mexico will publish the minutes of its monetary policy meeting held back on April 30, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view -and in line with the last statement- the tone of the minutes will be slightly more dovish, particularly given that: (1) The balance of risks for economic growth continues to be deteriorated, and there isn't any concerns regarding inflation; (2) they will be attentive to Mexico's relative monetary conditions, particularly with respect to the U.S.; and (3) the board stated again that market's perception regarding the next hike in the Fed's fund rate could be delayed.

In terms of economic growth, we believe that Banxico's tone within the minutes will be as *dovish* as the *communiqué*, given that in the last monetary policy statement, even though the Board considered that the balance of risks for global economic growth has remained stable, Banxico stressed out that: *"...given that Mexico's economy is highly integrated to the Global economy, in particular to the U.S., the Fed's monetary policy could have a significant impact on the exchange rate, inflation expectations, and therefore the overall price dynamics in Mexico. Taking the above-mentioned factors into account, the Board will remain focused... on Mexico's relative monetary conditions, particularly with respect to the US, as well as the performance of the exchange rate."*

However, we continue to believe that the Fed's monetary policy and FX performance will be Banxico's main focal points within the minutes. In particular, Banxico in their last monetary policy statement stressed out that *"...given that Mexico's economy is highly integrated to the Global economy, in particular to the U.S., the Fed's monetary policy could have a significant impact on the exchange rate, inflation expectations, and therefore the overall price dynamics in Mexico. Taking the above-mentioned factors into account, the Board will remain focused... on Mexico's relative monetary conditions, particularly with respect to the US, as well as the performance of the exchange rate."* As we have mentioned throughout our publications, Banxico does not manage the reference rate in absolute terms but, given the global influence of the U.S. monetary policy, it only sets the spread between Mexico's rate and the U.S. federal funds rate. Thus, if the Federal Reserve decides to hike its rate in June, almost independently of Mexico's economic cycle and inflation, Banco de Mexico *"will have to maintain"* the differential between the interest rates in both countries. Particularly given that not doing it could trigger a significant depreciation of the Mexican peso against the dollar.

Given that economic activity in Mexico will expand at a higher rate this year (*vis-à-vis* last year), and that the Fed will raise the federal funds rate (probably in June), we consider it highly likely that Banxico will also start a hiking cycle (in July), even though inflation in Mexico will be around its 3% target. In this regard, we believe that the hiking cycle will be supported by: (1) Greater concern for the pass-through effect of the depreciation of the peso against the dollar to inflation; and (2) the board will probably be more empathic in the next monetary policy announcements about Mexico's relative monetary conditions, in particular to the U.S., given that it is a key factor to decide Mexico's reference rate path. In this context, we acknowledge that given the global deflationary environment, there is a chance that the U.S. Fed might postpone the beginning of its hiking cycle. If this is the case, then we would change our Banxico monetary policy call as well.

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

Gabriel Casillas Olivera	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
Livia Honsel	Economist, Europe	livia.honsel@banorte.com	(55) 1670 - 1883
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Rey Saúl Torres Olivares	Analyst, Mexico	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) 5004 - 1275
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 5004 - 1231
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry	marissa.garza@banorte.com	(55) 5004 - 1179
Marisol Huerta Mondragón	Equity Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 5004 - 1227
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 5004 - 1266
Valentín III Mendoza Balderas	Equity Research Analyst	valentin.mendoza@banorte.com	(55) 5268 - 9000 x 1267
María de la Paz Orozco García	Analyst	maripaz.orozco@banorte.com	(55) 5004 - 5262

**Corporate Debt**

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5004 - 1405
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugo.gomez@banorte.com	(55) 5004 - 1340
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 5004 - 1437

**Wholesale Banking**

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Managing Director – Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Jorge de la Vega Grajales	Managing Director – Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Managing Director – Private Banking	lpietrini@ixe.com.mx	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Managing Director – Asset Management	pimentelr@ixe.com.mx	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Managing Director – International Banking	rvelazquez@ixe.com.mx	(55) 5268 - 9879
Victor Antonio Roldan Ferrer	Managing Director – Transactional Banking	voldan@ixe.com.mx	(55) 5004 - 1454