

2016 IMF/WB Annual Meetings – The limits of monetary policy

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- This weekend took place the IMF/World Bank meetings in Washington, D.C.
- In our opinion, the main issues discussed in the meetings are:
 - (1) There is an imbalance between savings and investments;
 - (2) The effectiveness of monetary policy to boost growth has reached a limit; and
 - (3) Looking ahead, geopolitical factors, particularly the elections, will be present in the outlook both the short-term (U.S.) and in the medium term (elections in France, Germany, among others, coming year)
- Investors are coping with a world of low growth and limited space for central banks
- Market participants are likely to hold their exposure in Mexico but waiting for a delivery of higher growth and sound policies
- Rates: Ground set for steeper curves in 4Q16
- Currencies: US Elections and the Fed could steer a stronger dollar
- Commodities: Oil trading sidelines for a long period, while metals and agriculture with a tough road ahead
- Equities: Growth not supporting current valuations, but with opportunities in specific EM

Relevance of IMF/WB annual meetings. A delegation of Banorte-Ixe attended the annual meetings of the International Monetary Fund (IMF) and World Bank (WB), which were held this weekend in Washington, D.C. In our opinion, attending these meetings is important as it allows us to get the insight of analysts, investors and policymakers on the most important economic and financial issues.

Imbalance between savings and investment; the ineffectiveness of monetary policy and geopolitical risks, central issues of this year's meetings. In the first case, there are high levels of savings, which have not resulted in increased investment, and therefore, in higher rates of growth globally. Once it is recognized the fact that monetary policy alone is not having the required impact on growth, the main challenge by economic policymakers is now to introduce other policies –i.e. fiscal policy and/or bank regulation–, to encourage growth and reduce inequality. Nevertheless, the effect of such policies is likely to take some time. In this context and looking forward, investors are prepared to make decisions under a scenario of reduced growth rates and secularly low and even negative interest rates. In this last point, it should be noted that the environment of negative real interest rates is relatively new to the market without future consequences being understood very well.

Another important point is that in a context of open and globalized economies, monetary policy recipes that have been applied tend to have a more domestic approach, without necessarily taking into account the consequences and effects on other economies. Therefore, coordination among major countries is desirable and necessary. On top of this, geopolitical dynamics has led to anti-globalization that could still delay the recovery of growth rates higher forces.

Monetary policy ineffectiveness. Even though a lot of investors believe that the ultra-easy monetary policies are to blame for the current apparent asset bubble, several economists in these meetings provided a quite different assessment. In this context, one economist portrayed this view as blaming the firefighters for the destruction of a fire, when they obviously arrived to extinguish the fire, not to solve its aftermath. As a result, the discussions moved more towards answering what monetary policy can and cannot do. Using the very same analogy, keeping watering the fire-affected zone once the fire has been put out, is not going to clean up the ashes, nor bring a building up again, and it seems that this is what the issue of negative interest rates is about. Moreover, sometimes watering the fire-affected zone becomes an obstacle for reconstruction. This is not for negative rates only. In fact, this applies to the quite slow and uncertain path that interest rate hikes have observed. As a result, three additional issues usually came into the discussion: (1) The need for structural reform; (2) fiscal policies seem to be welcomed back; and (3) geopolitical risks are adding uncertainty to the already difficult mix. While there is no opposition whatsoever for structural reforms to be implemented, geopolitical risks –arising from the anti-establishment movements-, are not making it easier for structural reforms to be approved, and the risks for fiscal policies are well known and not so easy to handle as historically they have created additional problems, with limited benefits. Last, but not least, there is growing consensus that negative interest rates are not the way to go. While it seems that they could help to stimulate growth, it has not been the case. This has been mainly because on the one hand, negative interest rates have not permeated to consumers, while on the other hand, have had negative impacts on savings, pension funds, insurance companies, and on banks' profits, which result in lower profits, therefore difficulties to generate capital and less incentives to increase credit. All in all, consensus is heading towards three recommendations: (1) The Fed should continue to hike rates in a gradual fashion, trying to provide a higher degree of certainty with respect to the future path; (2) central banks should shy away from negative interest rates, because the abovementioned reasons; and (3) central banks should not be “the only game in town”, and governments should pursue structural reform and be able to provide confidence for companies to invest.

Geopolitical risks. Anti-establishment movements have evolved and have recently become much more problematic. In fact, one aspect that was highlighted in some sessions was the fact that while usually long period of slow growth or long-lasting crises tend to foster populist political movements, the two countries that have shown these political trends are the US and the UK, which actually have actually have observed higher growth rates and lower unemployment.

This is why we perceived more concerns about a higher probability that these political trends could arise in economically-weaker countries, particularly in Europe. So far, the turn to the right that several Latin American countries have done is reassuring investors that the populist trends will not affect this region this time. In this context, a great deal of time was assigned to the US election in which, surprisingly, all political analysts that either participated in conferences or we were able to talk to, directly, had a strong opinion that Hillary Clinton will win the election. We highlight that this happened before the video in which Trump made lewd comments about women was released. The two main reasons political analysts gave for the US election outcome favoring the Democratic Party are: (1) Electoral votes, in which even if Trump wins all the so-called “Romney states”, as well as Florida, Ohio, and Pennsylvania -which in their opinion “sound far-fetched”-, Hillary would still win 273 electoral votes. Three votes above the requirement to become President of the US; and (2) negative opinion. The fact that a majority of registered voters have consistently had a much more negative opinion of Trump throughout the campaign, despite both, Hillary and Trump share a quite high percentage, was an important reason why political analysts believe Hillary will win.

United States – Favorable performance of economic activity, but without boosting investment. The US economy continues its moderate expansion cycle, based primarily on the strength of consumption, although confidence is still not enough to promote investment and thus higher growth rates. Moreover, productivity growth has been disappointing, showing a divergence between the manufacturing sector and the service sector. In terms of labor, Esther George – from the Kansas City Fed, who voted for an increase in the range of the federal funds rate in the September meeting-, said that the latest employment report shows that the recovery continues. She also stressed that it is important not only focus on the short term but to have a wider approach when thinking about labor markets and inflation. In this context, it is important to consider the adverse effects that low interest rates can generate.

Brexit - a divorce that could end in disaster. At this point of time there is no doubt that the UK will start the separation process the next year, which will extend probably until the end of 2019. In the meantime, the referendum outcome has been a more competitive currency with access to the common market. Nevertheless, in the medium term consequences may become more negative on the issue of foreign direct investment, especially considering the dependence of the British economy of financial services.

Eurozone – Structural reforms needed to detonate growth. One of the regions with less favorable prospects for the coming year is precisely Europe. Analysts are concerned about the sustainability of banks in the region in an environment of negative real interest rates. Here it is noteworthy that it is considered that the measures taken so far have been positive while the credit channel is improving, although not necessarily translated into higher levels of investment. This situation demonstrates the need for further progress in the structural reform process, which seems difficult with the bulging political agenda in the coming months. There will be 14 elections in the next 12 months, highlighting in particular the elections in Germany and France.

China - The process of rebalancing progresses. It seems that concerns about China's economy have lost relevance among the participants of this year's meetings. The consensus is that the economy is in the process of rebalancing in an orderly manner with several favorable opportunities that could point to a growth between 5% and 5.5%. With respect to the changes that have been made in the exchange market, they were considered to have been positive and the currency movements have become more predictable. The risk here is that the obsession of the government to target growth above 6% could lead to further credit expansion above sustainable levels. Non-financial debt represents 215% of GDP, of which 150% of GDP is corporate and the rest (60%) is public debt. It is worth noting that this debt is mostly denominated in local currency, while they have high savings rates and the central bank has many assets, factors that reduce the risk of high levels of indebtedness. In the specific case of corporate debt, it is concentrated in certain sectors that are at overcapacity and need to implement reforms. Finally, another important issue in China is that leaders are not concerned with social protection with needs to reform pensions, unemployment insurance, among others. In our opinion, China landing will be soft, but we believe that high levels of indebtedness will be an important issue for the markets, which could possibly begin to give more weight to this issue.

Argentina and Brazil back in the minds of investors. In the first case highlights the need for the new government to establish itself as a major political force, since no one has a majority in Congress, so it is necessary that the current government will win the midterm elections to be held in 2017. The priority is to improve the quality of public finances and make debt levels sustainable. Meanwhile, Brazil is going through the worst recession in its history. It is recalled that the raw materials are very important in its trade balance, but the most important factors are domestic weakness. Analysts believe that the recovery has begun despite weak economic data in 3Q16. As it regards, the debt is at very high levels from 52% to 70% of GDP and could reach 80% before stabilizing and starting down. The government is proposing a privatization program that can boost growth. In our view, Brazil is starting to recover but will continue to shrink this year, and we will see only modest growth next year. But the truth is that both Argentina and Brazil are beginning to return to markets and could eventually be a competition for Mexico flows.

Mexico is weathering an adverse external backdrop. Participants continue to view Mexico as an economy with high growth potential. Economic activity has moderated, although it is held largely thanks to the strength of domestic demand. However, the shock from the cycle of low commodity has had a stronger impact on public finances, which have deteriorated the position of the dynamics of public debt. As for the exchange rate, stresses that the adjustment has had in the last 12 months is not explained by fundamental factors but by the fact that weight is one of the currencies used as hedge in case of volatility.

This has been particularly evident in recent weeks derived from the electoral process in the United States. In this context, a victory for Trump, could have an adverse effect on Mexican assets, although in the medium term would be corrected because the relationship between Mexico and the United States will not change substantially. The flow resulting from trade between the two countries will remain very high and it is difficult to change this kind of dynamic.

Market Watch: Positive views for the region in a complex world

Investors are coping with a world of low growth and limited space for central banks. Global investors gathered in Washington on the occasion of the joint annual meetings of the IMF and World Bank to discuss the most significant topics that will shape the performance of the world economy and financial markets for coming months. Overall, the sentiment was distressed by a threefold concern: (1) An effect of slack in global growth, (2) no space for additional policy stimuli especially from central banks, and (3) geopolitics reshaping market dynamics.

In terms of the first topic, the consensus was that the lack of productivity, the reduction of capex, higher ratios of savings to investment, and even demographics in certain regions have resulted in lower rates of growth observed in recent quarters in tandem with downward adjustments on GDP expectations heading towards 2017. These conditions pose an important risk for expensive valuations in several assets, which are not supported by higher revenues but by active balance sheet strategies.

The second concern centered on the global imbalances driven by central banks and the limited space for further stimuli coming from economic policies. If a low-interest-rate environment prevails, it could result in a curtailed margin for market participants with specific long-term financial needs (*e.g.* insurance firms and pension funds facing significant challenges with the current monetary policy framework). In addition, when the cost of capital is held lower for longer, institutions are willing to take additional risks. A way to explain this is that the world is facing a divorce between economic risk taking and financial risk taking. As a result, transmission mechanisms of monetary and fiscal policies have been losing strength. All of these are problems highlighted during the meetings, focusing on sovereign debt but also in the corporate world. Overall, the comments that took place in Washington suggested a rethinking of the *Secular Stagnation Theory*, even with some market participants starting to believe a shift towards *Hysteresis Theory*. Under this uncertain scenario, firms continue holding a vast amount of cash within their balances (mainly US companies) without propelling investment.

The market is convinced that the Federal Reserve will deliver its second rate hike in December, with a gradual normalization path next year. On the other hand, investors have acknowledged that *ECB* and *BoJ* have been lagging the Fed in recent years, with limited room for further easing of monetary conditions. In the UK the monetary policy will target a tough political framework, with the *BoE* trying to tackle the issues spawned by the *Brexit*. Regarding China, the general sentiment is that the *PBoC* has improved its communication policy and will tend towards a market-friendly strategy with an easing bias. In the EM spectrum, market participants expect loose monetary conditions in most of the regions.

The third aspect of this risk trifecta is the geopolitical environment, which has resulted in a change in risk premium in DM and EM assets, and has undermined, at least in the short-term, the willingness of global investors for betting on region-specific directional strategies, but rather searching for conservative tactical trades. The general feeling is that the political framework of today is showing an antiestablishment trend in several parts of the world and this new paradigm could erode the robustness of any recovery in developed economies. The US Presidential Elections is one clear example. Another is Europe, facing 14 elections in the next twelve months.

Despite the balance of risks depicted above, there are some glimpses of hope among investors. Post crisis policy strategies resulted in a significant inflection point in terms of liquidity provision, which resulted in better financial conditions in the corporate world and deleverage households. An additional positive aspect comes from the combination of regulation and better risk management. The world banking system is better capitalized than before and the upper management of financial firms is targeting the sustainability of the current banking model in an environment of low rates.

Market participants are likely to hold their exposure in Mexico but waiting for a delivery of higher growth and sound policies. Investors acquainted their positive view on Latam, however been more appealed by the stories and market valuations coming from Brazil, Argentina and Peru. The overall view on Mexico remained on the positive ground, despite the negative credit outlooks recently announced by Moody's and S&P. Investors rely on Mexico's strong macro framework, but are waiting for a delivery of higher growth rates and sound fiscal accounts. The main country-specific risks highlighted during the meetings were: (1) US Elections (but with concerns on Trump fading away in the aftermath of recent scandals), (2) Fiscal stance in a world characterized by low oil prices and Mexican decline of production, (3) FX dynamics and policy responses, (4) Doubts about short-term implementation of reforms, and (5) the need of launching an initiative of a rule of law reform in the mid-term. Investors didn't stress out any additional concern about Pemex, the corporate sector, inflation or external accounts. It seems that in the view of global investors, Mexico remains as an attractive EM, but with a low likelihood of additional improvement that could result in different valuations.

Rates: Ground set for steeper curves in 4Q16. In our view, there was a strong consensus during the meetings towards a steeper yield curve in the United States by year-end. The 2y10y slope has moved from 118pb to 91pb during this year (see chart below) but could finish hovering around 105bps. The market is pricing in 63% of implied probability of a 25pb rate hike by 2016-end. In this regard, we expect the Federal Reserve to deliver this rate increment and the 10-year U.S. Treasury to finish the year at 1.85% (2.20% by 2017-end). This scenario takes into consideration three assumptions: (1) Hillary Clinton winning the elections, (2) better growth dynamics in the US in coming quarters, and (3) Fed continuing with the normalization of monetary conditions in coming years. This will likely take place in a market with deleveraged positions in fixed-income assets. On the other hand, low rates are likely to remain in Europe, but stressing the conditions of financial institutions, which could corner the ECB to implement a strategy similar to the one announced recently by the BoJ to manage the duration of its QE program and try to steer a steeper curve. This took place as demographics and the saturation of capital stock were strong drivers of a flatter curve in Japan. Regarding Mexico, foreign investors' holdings are likely to remain stable, especially in long-term securities, as a result of an attractive carry and an expectation of country risk premium trading sidelines in the next months. Investors are aware of potential additional hikes from Banxico, but with a yield curve discounting a feasible monetary scenario, at least for the next 12-month horizon. In this regard, we acknowledge a more attractive valuation in the belly of the Mbonos curve, with a strong likelihood of a steepening bias in the longest-end. This supports our current trade idea of a 5y10y steepener in the THIE-IRS curve. For further details please refer to our research note "*Mexico trade idea: 5y10y THIE-IRS steepener*" <[pdf](#)>, published on October 5th, 2016.

Spread between 2- and 10-year U.S. Treasuries



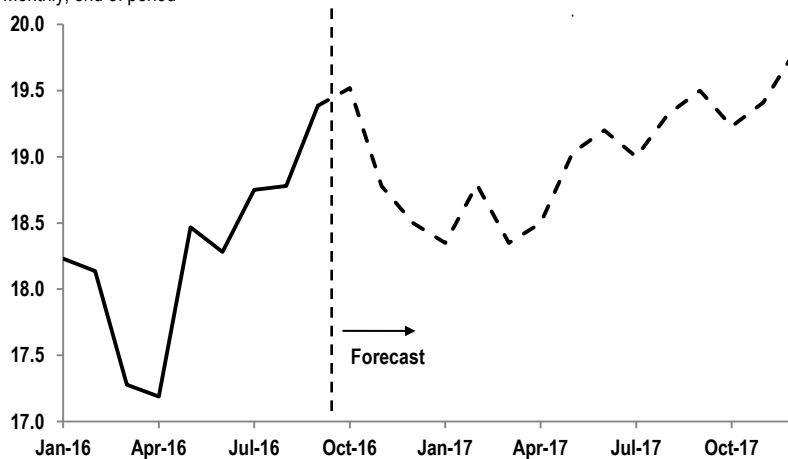
Source: Bloomberg, Banorte-Ixe

Currencies: US Elections and the Fed could steer a stronger dollar. People gathered in Washington came up with the idea that the USD will appreciate against major currencies and also vs EM crosses as a result of expected higher risk aversion, stronger data in the US, idiosyncratic conditions in Europe and

Asia, and the possibility of additional policy divergence between the Federal Reserve and major central banks. The overall sentiment towards the Mexican peso is more bullish than what has been observed in previous months, with investors acknowledging the overshooting driven by US elections, as the peso continues to be considered an important proxy hedge for EM risk. For our views on the Mexican peso please refer to our research note “*Mexican Peso: Catching up to a crude reality*” <[pdf](#)>, published on August 29th, 2016.

USDMXN forecasts

Monthly, end of period



Source: Bloomberg, Banorte-Ixe

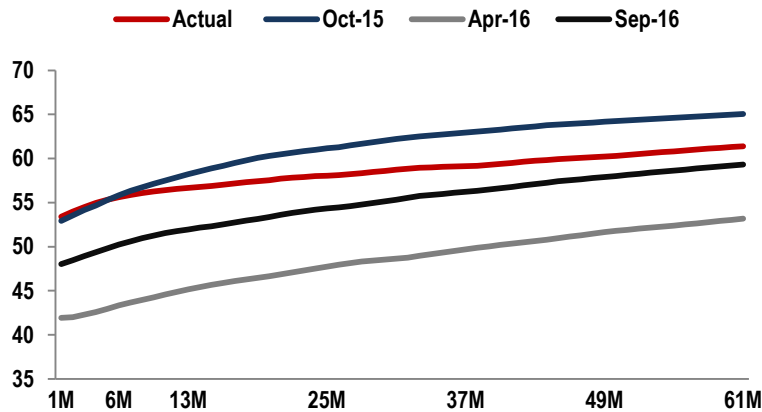
Commodities: Oil trading sidelines for a long period, while metals and agriculture with a tough road ahead. The views from investors regarding commodities are that the overhang observed since mid-2014 might take longer. As a result on an uncertain future, firms continue to reduce capex. The firms have been forced to do balance sheet strategies and not focusing on investment opportunities in their specific sector. However, the downward cycle is likely coming to an end in the next 6-month horizon.

Some of the strategies that have been taking place in the market are in terms of relative valuation, with long positions in commodities-associated equities, given the firms’ abilities to generate cash flow, and shorting the core asset. The assessment is mildly positive for energy, agriculture, while some minerals like copper will continue facing adverse conditions. The expectations regarding oil are more optimistic, especially after OPEC’s announcement in Algeria. More details in our research note “*OPEC at Algeria: Historical agreement with lingering doubts about implementation*” <[pdf](#)>, published on September 29th, 2016. However, with strong skepticism about its implementation, with special focus on the OPEC meeting scheduled for November 30th. The market expect a US\$/bbl 50-60 trading range for the following 12-month horizon. US producers (~80%) were hedged at higher prices in 2015 but have declined throughout this year, with current levels allowing them to deal in a more efficient way to improve their cost structures. This could result in less investment and a production adjustment by mid-2017, as part of production will be unaffected in the next 9-month period. From the supply side investors are waiting for this news coming from OPEC in November. From the demand side, China and India

have been depicting an upward trend of car ownership in the last six months. In addition, demand for gasoline in the US remains relatively strong. The final note on commodities was gold, with expectations for a further correction towards US\$/oz 1,200 in the 4Q16, but with better expectations for next year.

Brent futures curve

\$/bbl



Source: Bloomberg, Banorte-Ixe

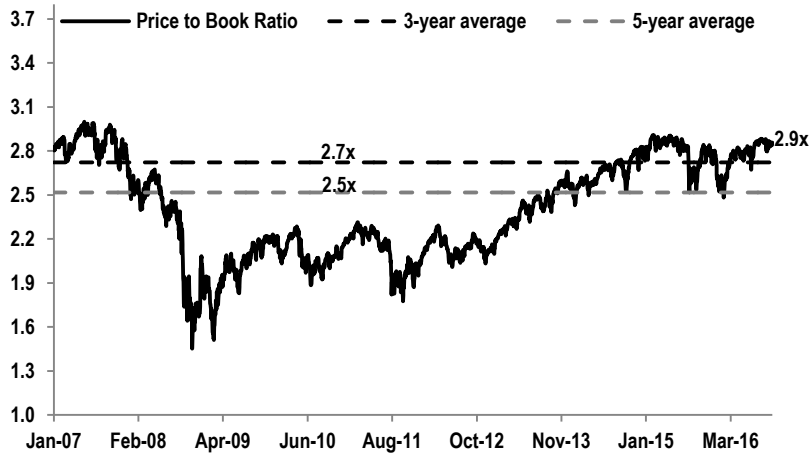
Equities: Growth not supporting current valuations, but with opportunities in specific EM.

Market players are aware of expensive valuations in several equity markets, which could result in a strategy of increasing exposure in positive idiosyncratic growth markets, highlighting South America (*e.g.* Brazil, Argentina and Peru) and emerging Asia (*e.g.* Vietnam). Investors acknowledged that consumption worldwide is in a better shape *vis-à-vis* the assessments from the IMF/WB spring meetings. Some participants continue betting on an optimistic view regarding consumption-related equities in the United States, while European and Japanese equities are facing important challenges coming from lack of growth and structural restrictions.

In this regard, there were some concerns about the banking system in Europe as an important systemic risk ahead. Mexican equities are observed as fairly valued in USD terms, but with a likely pick up in MXN terms after the US elections and with the possibility of a relief rally of the Mexican currency. However, doubts remain about growth dynamics.

S&P500 - Price to book ratio

Daily, 12m trailing book value



Source: Bloomberg, Banorte-Ixe

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