

# Ahead of the Curve

May 12, 2017

Market focus this week will be on Banxico’s monetary policy announcement

- **Banxico will remain on hold.** On Thursday, Banxico will announce its monetary policy decision at 2:00pm (EDT), where we expect the central bank to remain on hold. Thus, the reference rate will stand at 6.5%. However, we expect a hawkish tone, where the Board Members will highlight that the three main factors they will evaluate in deciding whether to increase the reference rate in June are: (1) The relative monetary stance between Mexico and the United States; (2) the evolution of inflation; and (3) the evolution of the output gap.
- **Weekly government bond auction.** On Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent-, will offer 5-year fixed-rate Mbonos (Jun’22), 10-year inflation-linked Udibonos (Dec’25), in addition to the “more traditional” 1-, 3-, and 6-month zero-coupon Cetes. As usual, the results will be released at 12:30pm (EDT).

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**Mexico weekly calendar**

DATE	HOUR (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Tue 16-May	10:00am	International reserves	May 12	US\$ bn	--	--	174.8
Tue 16-May	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 50y Mbono (Jun’22); 10y Udibonos (Dic’25)					
Thu 18-May	2:00pm	Banxico’s monetary policy decision	May	%	<u>6.50</u>	6.50	6.50

Source: Banorte-IXE; Bloomberg

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\$166 million amounting to US\$174.8 billion. According to Banxico's report, this figure comes mainly as a result of: (1) US\$12 million dollar sales from Banxico to the Federal Government; and (2) A negative revalorization in central bank assets amounting to US\$138 million. In this context, the Central Bank's international reserves have diminished by US\$1.7 billion this year (please refer to the table below).

**Banxico's foreign reserve accumulation detail**  
US\$, million

	2016	May 5, 2017	May 5, 2017	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	176,542	174,845	-166	-1,697
(B) Gross international reserve	178,025	176,045	-704	-1,980
Pemex	--	--	-26	-634
Federal government	--	--	-25	-402
Market operations	--	--	0	-2,000
Other	--	--	-653	1,055
(C) Short-term government's liabilities	1,483	1,200	-538	-283

Source: Banco de México

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**Auction specifics (Tuesday, May 16, 2017)**

	Maturity	Coupon rate, %	To be auctioned <sup>1</sup>	Previous yield <sup>2</sup>
<b>Cetes</b>				
1m	15-Jun-17	--	7,000	6.49
3m	17-Ago-17	--	11,000	6.78
6m	09-Nov-17	--	11,500	6.95
<b>M Bono</b>				
5y	09-Jun-22	6.50	8,500	6.95
<b>Udibonos</b>				
10y	30-Nov-28	4.00	600	3.46

Source: Banorte-ixe 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

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In the first case, the FOMC kept the *Fed funds* range unchanged at 0.75-1% at its last monetary policy meeting. The US monetary authority stated that the deceleration in 1Q17 is temporary and that the labor market has strengthened despite the slowdown. Moreover, the tone of the recent interventions by different *Fedspeakers* led our international economic analysis team to believe that the Fed will still hike two more times this year, 25bps in June and another 25bps in September. This view is in line with market expectations, which discount a June hike with 97.5% of probability (as implied by *Fed funds* rate futures). As a result, we believe that Banxico will skip the hike in May, but will follow the Fed in June by increasing the reference rate by 25bps.

Regarding inflation, since the last monetary policy meeting that took place on March 30, annual inflation has increased from 5.35% in March to 5.82% in April. Against this backdrop, in terms of the exchange rate and inflation expectations, the outlook is more favorable. Although the peso has depreciated 1.04% since the last monetary policy meeting, it has appreciated 13.7% from the record reached on January 19, from 21.90 to 18.90 pesos per dollar (taking May 11, “*fix*” exchange rate). In addition, although inflation expectations for year-end, according to the latest Banxico’s survey, have increased to 5.7% in April from 5.6% in March, medium and long-term expectations have not shown any additional deterioration standing at 3.5% and 3.4%, respectively.

Finally, regarding the output gap, analyzing Banxico’s methodology to estimate the output gap –where GDP is calculated using a Hodrick-Prescott filter with tail correction–, we have seen several quarters with a negative gap, although it has considerably tightened towards the long term trend. Considering this, we believe that we are close to seeing demand-side pressures on inflation.

In an environment where annual inflation is likely to continue to rise -even though it will only reflect the increase in energy prices in January, and some pass-through effects of the exchange rate-, and expecting a US Fed rate hike in June, we find it very difficult for Banxico to be able to disassociate from the US Fed, particularly now that much of the uncertainty related to Trump's potential policies has dissipated, which could accelerate economic growth in the coming quarters. In this regard we expect a 25bps increase in Banxico’s reference rate at the June 22 meeting.

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