Ahead of the Curve

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Market focus this week will on Banxico's monetary policy decision

- **Banxico's monetary policy decision next Thursday: Rate unchanged, but hawkish tone.** This week, Banxico will hold its first monetary policy meeting of the year on Thursday (March 26) at 3:00 pm (EDT). We believe that board members will decide to leave the reference rate at 3%, as it is widely expected. However, we consider that the Board will maintain the tone of the statement accompanying the decision, denoting a greater bias towards hiking (i.e. more hawkish tone)

- **Bi-weekly inflation report (1H-Mar).** On Tuesday, at 10:00am (EDT), *INEGI* will release its bi-weekly inflation report. We are forecasting a 0.29% 2w/2w increase in the first half of March above market consensus that is forecasting a 0.25% according to Banamex. In the core index, we expect an increase of 0.21% 2w/2w in line with market consensus (0.20%)

Mexico weekly calendar

DATE	TIME (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Mon 23-Mar	**10:00am**	**Aggregate Demand**	4Q14	%yoy	3.2	--	3.0
		Private consumption		%yoy	3.0	--	2.2
		Government consumption		%yoy	4.6	--	3.1
		Gross-fixed investment		%yoy	5.8	--	4.3
Tue 24-Mar	**10:00am**	**CPI inflation**	1H Mar	%2w/2w	0.29	0.21	0.08
				%yoy	3.09	3.02	2.97
		Core		%2w/2w	0.21	0.20	0.05
				%yoy	2.49	--	2.4
Tue 24-Mar	**11:00am**	**International reserves**	20-Mar	US$ bn	--	--	195.4
Tue 24-Mar	**1:30pm**	**Government weekly auction: 1-, 3-, 6-month CETES; 5y Mbono (Dec'19); 10y Udibono (Dec'25)**					
Wed 25-Mar	**10:00am**	**Global economic indicator**	January	% yoy	1.9	1.8	3.2
		(sa)		**% m/m**	-0.5	--	-0.3
		Primary activities		% yoy	6.4	--	3.4
		Industrial production		% yoy	0.3	--	3.0
		Services		% yoy	2.4	--	3.2
Thu 26-Mar	**3:00pm**	**Banxico's monetary policy decision**	March	**%**	3.00	3.00	3.00
Fri 27-Mar	**10:00am**	**Unemployment rate**	February	%	4.20	**4.41**	4.51
		sa		%	4.36	--	4.43
Fri 27-Mar	**10:00am**	**Trade balance**	February	US$ mn	-55.7	**310**	-3,247.50
		Total exports		%yoy	6.2	**--**	-1.8
		Oil exports		%yoy	-52.5	**--**	-47.3
		Non-oil exports		%yoy	14.9	**--**	5.7
		Total imports		%yoy	9.7	**--**	-1.4

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

We estimate a 3.2% yoy expansion in aggregate demand (AD) during 4Q14. On Monday, *INEGI* will publish its aggregate supply and demand report for 4Q14, where we believe aggregate demand increased 3.2% yoy, vs. the 3% yoy expansion observed in 3Q14. Taking a look at the breakdown, we expect a 3% yoy increase in private consumption, while we estimate a significant 5.8% yoy expansion for gross fixed investment. Moreover, we believe that government spending will likely show a 4.6% yoy increase.

Aggregate demand
% yoy

	4Q14	3Q14	2Q14	1Q14
Aggregate demand	**3.2**	**3.0**	**2.1**	**2.7**
Private consumption	3.0	2.2	1.3	1.6
Government consumption	4.6	3.1	1.9	2.9
Gross fixed investment	5.8	4.3	-0.6	-0.5
Exports	6.8	7.1	5.0	6.4
Aggregate demand	**3.2**	**3.0**	**2.1**	**2.7**
GDP	2.6	2.2	1.6	1.9
Imports	4.9	5.6	3.5	5.2

Source:INEGI and Banorte-Ixe

Minor exchange rate pass-through in inflation numbers for the first half of March. On Tuesday, at 10:00am (EDT), *INEGI* will release its bi-weekly inflation report. We are forecasting a 0.29% 2w/2w increase in the first half of March above market consensus that is forecasting a 0.25% according to Banamex. In the core index, we expect an increase of 0.21% 2w/2w in line with market consensus (0.2%)

In our view, inflation during the period in question will show minor evidence of exchange rate pass-through. Our price monitoring suggest pressures on merchandise prices –both on the prices of processed foods and other merchandise-, which tend to be highly sensitive to exchange rate swings.

Nevertheless, we expect this figure to be 12.1bps higher than the observed in same period last year, derived from: (1) 3.1bps stemming from a higher contribution of goods (7.5bps vs. 4.4 in 2014); (2) 4.7bps stemming from a higher contribution of services prices (8.4bps vs. 3.7 in 2014). By contrast, we expect (3) a lower contribution agriculture prices (4.8bps vs. 5.1 in 2014) along with (4) 0.6bps stemming from a higher contribution of government tariffs (0bps vs. -0.6 in 2014), as shown in the table below. With these results, annual inflation will remain at levels around 3.1% yoy in the first half of March, while core inflation is likely to jump to 2.49% from 2.4% yoy.

1H-March inflation by components
% bi-weekly incidence

	Banorte-Ixe	2014	Difference
Total	0.29	0.17	0.12
Core	0.16	0.08	0.08
Goods	0.08	0.04	0.03
Processed foods	0.04	0.01	0.03
Other goods	0.04	0.03	0.00
Services	0.08	0.04	0.05
Housing	0.02	0.02	0.00
Education	0.00	0.00	0.00
Other services	0.07	0.02	0.04
Non-core	0.13	0.09	0.04
Agriculture	0.05	0.05	0.00
Fruits & vegetables	0.04	0.03	0.01
Meat & eggs	0.01	0.02	-0.01
Energy & government tariffs	0.09	0.04	0.05
Energy	0.09	0.05	0.04
Government tariffs	0.00	-0.01	0.01

Source: Banorte-Ixe with data from INEGI and Banco de México.
Note: Contributions might not add due to the number of decimals allowed in the table.
Previous to year 2011, contributions might not add because of the change in CPI-calculation methodology.

Weekly international reserves report. On Tuesday, at 11:00am (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves increased by US$487mn amounting to US$195.4bn on March 13. According to Banxico's report, this figure comes mainly as a result of: (1) Dollar sales by the Federal Government to the Central Bank for US$785mn; (2) US$156 decrease explained by the introduction of Banxico's USD daily auction given recent volatility in external markets that have pushed the MXN to its weakest level since 2009; along with a (3) US$142 decrease 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$2,186mn 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[1]	Market operations[2]	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
13-Mar-15	195,425	2,186	3,000	758	-356	-1,216

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 5-year fixed-rate Mbonos (Dec'19) as well as 10-year inflation-linked Udibonos (Dec'25), 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 1:30pm (EDT).

Auction specifics (Tuesday, March 24, 2015)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	23-Apr-15	- -	5,500	3.04
3m	25-Jun-15	- -	9,500	3.17
6m	17-Sep-15	- -	11,000	3.40
Mbono				
5y	11-Dec-19	5.00	9,000	5.05
Udibono				
10y	04-Dec-25	4.50	750	2.62

Source: Banco de México

We expect a 1.9%yoy expansion in January's IGAE. On Wednesday, at 10:00am (EDT), *INEGI* will release its monthly global economic indicator for January (GDP monthly proxy), where we expect a 1.9%yoy expansion. We believe that IGAE's growth during the first month of 2015 was driven by the performance of the service sector, which we forecast at 2.4%yoy. Similarly, we highlight that industrial production increased a scant 0.3% yoy.

As we had mentioned in our last IP report, the 0.3% expansion in industrial production during January was explained in part by the 1.2% yoy growth in manufacturing output. However, part of the deceleration in manufacturing production was simply explained by a calendar effect, given that Jan'15 had an additional weekend day. Controlling by this calendar effect, manufacturing production increased 2.3% yoy. In this regard, although Mexico's manufacturing sector decelerated in January, we believe that the recovery of this industry is on the way, and will strengthen in the first half of the year given: (1) A significant recovery in external demand, particularly from the U.S.; (2) Mexico's manufacturing exports have shown solid growth rates; (3) the recent and significant depreciation of the Mexican currency will translate into stronger growth dynamics for the manufacturing exports; and (4) the recent Mexican car industry figures remain strong. In this regard, we believe that the recovery of both manufacturing and construction industries will continue in 1H15.

Moreover, construction output grew 4.2% yoy. In this regard, we believe that the significant expansion in construction reflects the better growth expectations that prevail today in most of Mexico's private firms. In addition, the recovery of households' purchasing power –given the lower inflation levels and the recovery of the Mexican labor market– has led to a significant increase in residential projects. However, IP's headline figure was confined by the current recession in the mining industry –derived from the significant contraction in Mexico's oil production–.

We also believe that the 2.4%yoy estimated expansion in services will be explained by the recovery in private consumption. In this regard, *INEGI's* January's retail sales report will show that consumers' spending is gaining momentum, whereas formal job creation has observed a significant recovery in the last 5 months. However, it is likely that the slowdown in manufacturing output during January will affect certain subsectors within the services, such as the transport and trade.

Monetary policy decision next Thursday: Rate unchanged, but hawkish tone. This week, Banxico will hold its first monetary policy meeting of the year on Thursday (March 26) at 3:00 pm (EDT). We believe that board members will decide to leave the reference rate at 3%, as it is widely expected. However, we consider that the Board will maintain the tone of the statement accompanying the decision, denoting a greater bias towards hiking (*i.e.* more hawkish tone).

The most recent monetary policy announcement by the Fed suggests that the FOMC could begin a hiking cycle as soon as June. In this regard, we highlight that 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 (refer to the chart below). 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.

In sum, 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 restrictive monetary cycle will be of 100bps in 2015. Finally, we believe that the "hawkish" tone in the communiqué will be reflected in: (1) A much more optimistic outlook for the US economy, especially in light of the growth momentum given the lower gasoline prices (in that country); (b) greater concern for the pass-through effect of the depreciation of the peso against the dollar to inflation; and (c) they will probably be more empathic 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 US 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. The minutes of this meeting will be published on April.

We expect a reduction of oil exports in February. Next Friday (March 27), at 10:00am (EDT), *INEGI* will make its February's trade report available, where we expect to see a US$ 55.7 million deficit. On the exports side, we will probably see a 52.5% yoy contraction of oil exports given the significant fall in oil prices. Moreover, non-oil exports could have expanded 16.9%yoy. In particular, we expect that manufacturing exports could show an 15.4%yoy expansion.

On the imports side, we estimate a 9.7% yoy increase in total imports. Taking a look at the breakdown, we estimate that imports of consumption goods (excluding oil) increased 2.4% yoy, while imports of intermediate goods (excluding oil) could have increased 12% yoy. Finally, we estimate an 2.1% expansion in capital goods imports.

Unemployment rate in February will stand at 4.21%. Next Friday, *INEGI* will publish its employment report for the second month of 2015, in which we estimate an unemployment rate of 4.21% nsa, below the 4.51% observed in January. In seasonally-adjusted terms, we believe that the unemployment rate could stand at 4.36%, which implies a monthly fall of 0.1%-pts.

It is likely that the job creation in February was positively affected by better growth dynamics of the economy. In this regard, we believe that the Mexican labor market will continue to recover given the recent upward trend in the Mexican economy, which will eventually reduce the level of unemployed workers.

Looking ahead, we are still positive on the outlook regarding the recovery of the economic activity, which will have a significant positive impact on firms' expectations about domestic demand, resulting in a more dynamic labor market.

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