

# Ahead of the Curve

October 6, 2017

Market focus this week will be on September's inflation and August's industrial production

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- **Inflation report (September).** On Monday, at 9:00am, *INEGI* will release its monthly inflation report for September. We are forecasting a 0.38% m/m increase in the headline index, while we expect the core index to rise 0.32% m/m. Inflation during the period in question will be explained by increases in education and energy prices. Moreover, we also anticipate some pressures in the prices “other goods”, as well as processed foods. However, after the September 19 earthquake, telephones and internet charges for some providers were suspended. Moreover, government regulated prices –such as public transportation and some toll roads– stopped charging for their services. We believe that it will result in a lower contribution of government tariffs and other services prices
- **Industrial production (August).** On Thursday at 9:00am, *INEGI* will release its monthly industrial production report. We anticipate a 0.4% yoy contraction in total output during August, after the 1.6% reduction in the previous month. Taking a look at the breakdown, manufacturing production could post a moderate 2.7% yoy expansion. In addition, industrial output during August will be also explained by: (1) The 2% yoy reduction in construction output; and (2) the poor performance of mining activity, where we estimate a 6.7% yoy contraction.

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**Mexico weekly calendar**

| DATE       | HOURL (EDT) | EVENT   | PERIOD    | UNIT        | BANORTE-IXE | CONSENSUS | PREVIOUS |  |
|------------|-------------|---|-----------|-------------|-------------|-----------|----------|--|
| Mon 9-Oct  | 9:00am      | CPI inflation   | September | % m/m       | <u>0.38</u> | 0.42      | 0.49     |  |
|            |             |   |           | % yoy       | <u>6.42</u> | 6.46      | 6.66     |  |
|            |             | Core  | % m/m     | <u>0.32</u> | 0.36        | 0.25      |          |  |
|            |             |   | % yoy     | <u>4.84</u> | --          | 5.00      |          |  |
| Tue 10-Oct |             | Wage negotiations   | September | %           | <u>4.6</u>  | --        | 4.1      |  |
| Tue 10-Oct | 10:00am     | International reserves  | 6-Oct     | US\$ bn     | --          | --        | 173.0    |  |
| Tue 10-Oct | 12:30pm     | Government weekly auction: 1-, 3-, 6-, 12-month CETES; 20y Mbono (Nov'36); 30y Udibonos (Nov'46); 5y Bondes D |           |             |             |           |          |  |
| Thu 12-Oct | 9:00am      | Industrial production   | August    | % yoy       | <u>-0.4</u> | -0.5      | -1.6     |  |
|            |             |   |           | % m/m       | <u>0.4</u>  | --        | -1.0     |  |
|            |             | (sa)  |           |             |             |           |          |  |
|            |             | Mining  | % yoy     | <u>-6.7</u> | --          | -8.6      |          |  |
|            |             | Utilities   | % yoy     | <u>-1.1</u> | --          | -2.7      |          |  |
|            |             | Construction  | % yoy     | <u>-2.0</u> | --          | -3.7      |          |  |
|            |             | Manufactures  |           | % yoy       | <u>2.7</u>  | 3.4       | 2.2      |  |
| Thu 12-Oct | 10:00am     | Banxico's minutes   | September |             |             |           |          |  |

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

**Inflation during September will be explained by increases in education and energy prices.** On Monday, at 9:00am, *INEGI* will release its monthly inflation report for September. We are forecasting a 0.38% m/m increase in the headline index, while we expect the core index to rise 0.32% m/m.

Inflation during the period in question will be explained by increases in education and energy prices. Moreover, we also anticipate some pressures in the prices “other goods”, as well as processed foods. However, after the September 19 earthquake, telephones and internet charges for some providers were suspended. Moreover, government regulated prices –such as public transportation and some toll roads– stopped charging for their services. We believe that it will result in a lower contribution of government tariffs and other services prices.

We forecast inflation to be 20.3bp lower than the observed in same period last year, derived from: (1) 6.1bp from a lower contribution of fresh fruits and vegetables prices (-5.6bp vs. 0.5bp in 2016); (2) 4.2bp derived from a smaller contribution of processed foods (3bp vs. 7bp in 2016); 3.9 bp derived from a lower contribution of government tariffs (-3bp vs. 0.9bp in 2016); (4) 3.3bp stemming from a smaller contribution of meat and egg (1.5bp vs. 3.9bp in 2016) and (5) 2.4bp as a result of a lower impact of “other goods” prices (1.5bp vs. 3.9bp in 2016), as shown in the table below.

With these results, annual inflation will stand at 6.42% in September, (previous: 6.66% yoy), while core inflation will be at 4.84% (previous: 5% yoy). Moving forward, we will be attentive to the evolution of energy prices and the behavior agricultural prices and the impact they might have in Mexico’s CPI. Additionally, we expect the prices of services and government tariffs to bounce back in the first half of October.

**September inflation by components**  
% monthly incidence

|                                 | 2017 Forecast | 2016  | Difference |
|---------------------------------|---------------|-------|------------|
| Headline                        | 0.38          | 0.61  | -0.23      |
| Core                            | 0.24          | 0.36  | -0.12      |
| Goods                           | 0.11          | 0.23  | -0.12      |
| Processed foods                 | 0.03          | 0.11  | -0.07      |
| Other goods                     | 0.08          | 0.12  | -0.04      |
| Services                        | 0.13          | 0.13  | -0.01      |
| Housing                         | 0.03          | 0.03  | 0.00       |
| Education                       | 0.13          | 0.12  | 0.00       |
| Other services                  | -0.03         | -0.02 | -0.01      |
| Non-core                        | 0.14          | 0.25  | -0.11      |
| Agricultural                    | 0.00          | 0.28  | -0.28      |
| Fresh fruits and vegetables     | 0.00          | 0.20  | -0.21      |
| Meat and egg                    | 0.01          | 0.08  | -0.07      |
| Energy and government regulated | 0.14          | -0.04 | 0.18       |
| Energy                          | 0.14          | -0.05 | 0.19       |
| Government regulated            | -0.01         | 0.01  | -0.01      |

Source: Banorte-Ixe, INEGI

**Wage negotiations will climb 4.6% during September.** On Tuesday, the Ministry of Labor (MoL) will publish the contractual wage negotiations for September. We expect workers to have negotiated an average increase of 4.6%, above the 4.1% increase seen in August, and still exceeding the ten year average of 4.4%. We believe that negotiations will remain relatively high in the coming months due to two factors: (1) The minimum wage increase that was announced last December; and (2) the elevated inflation observed throughout 2017.

**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\$245 million amounting to US\$173 billion. According to Banxico’s report, this figure comes mainly as a result of: (1) US\$29 million dollar sales from Banxico to the Federal Government; and (2) a negative revalorization in central bank assets amounting to US\$193 million. In this context, the Central Bank’s international reserves have diminished by US\$3.5 billion this year (please refer to the table in the next page).

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

|   | 2016    | Sep 29, 2017 | Sep 29, 2017 | Year-to-date |
|---|---------|--------------|--------------|--------------|
|   | Balance |              | Flows        |              |
| International reserves (B)-(C)          | 176,542 | 173,031      | -245         | -3,510       |
| (B) Gross international reserve         | 178,025 | 174,889      | -665         | -3,136       |
| Pemex                                   | --      | --           | -141         | -857         |
| Federal government                      | --      | --           | -147         | -3,694       |
| Market operations                       | --      | --           | 0            | -2,000       |
| Other                                   | --      | --           | -377         | 3,415        |
| (C) Short-term government's liabilities | 1,483   | 1,858        | -420         | 374          |

Source: Banco de México

**Weekly government bond auction.** On Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent–, will offer 20-year fixed rate Mbonos (Nov’36), 30-year inflation-linked Udibonos (Nov’46), and 5 year Bondes D, in addition to the “more traditional” 1-, 3-, 6-, and 12-month zero-coupon Cetes (please refer to the table below). As usual, the results will be released at 12:30pm (EDT).

**Auction specifics (Tuesday, October 10, 2017)**

|                 | Maturity  | Coupon rate, % | To be auctioned <sup>1</sup> | Previous yield <sup>2</sup> |
|-----------------|-----------|----------------|------------------------------|-----------------------------|
| <b>Cetes</b>    |           |                |                              |                             |
| 1m              | 09-Nov-17 | --             | 7,000                        | 7.03                        |
| 3m              | 11-Jan-18 | --             | 11,000                       | 7.06                        |
| 6m              | 12-Apr-18 | --             | 11,500                       | 7.12                        |
| 12m             | 11-Oct-18 | --             | 12,500                       | 7.18                        |
| <b>Bondes D</b> |           |                |                              |                             |
| 5y              | 08-Sep-22 | --             | 3,750                        | 0.20                        |
| <b>M Bono</b>   |           |                |                              |                             |
| 20y             | 20-Nov-36 | 10.00          | 2,500                        | 7.16                        |
| <b>Udibono</b>  |           |                |                              |                             |
| 30y             | 08-Nov-46 | 4.00           | 400                          | 3.56                        |

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

**We expect a 0.4% yoy contraction in August's industrial output.** On Thursday at 9:00am (EDT), *INEGI* will release its monthly industrial production report. We anticipate a 0.4% yoy contraction in total output during August, after the 1.6% reduction in the previous month. Taking a look at the breakdown, manufacturing production could post a moderate 2.7% yoy expansion.

In addition, industrial output during August will be also explained by: (1) The 2% yoy reduction in construction output, as a result of the lower growth in private construction investment projects derived from the uncertainty surrounding Mexico's economic outlook, coupled with the contraction in public investment projects given the Federal Government's austerity program; and (2) the poor performance of mining activity, where we estimate a 6.7% yoy contraction.

**Industrial production estimate: August 2017**

% yoy nsa; % m/m sa

| <b>% yoy</b>   | <b>Aug-17</b> | <b>Aug-16</b> | <b>Jan-Aug, '17</b> | <b>Jan-Aug, '16</b> |
|----------------|---------------|---------------|---------------------|---------------------|
| Total          | -0.4          | 0.3           | -0.5                | 0.2                 |
| Mining         | -6.7          | -8.5          | -9.5                | -4.9                |
| Utilities      | -1.1          | 3.2           | -1.5                | 3.7                 |
| Construction   | -2.0          | -0.2          | -0.8                | 1.4                 |
| Manufacturing  | 2.7           | 3.7           | 3.3                 | 1.2                 |
| <b>%m/m sa</b> | <b>Aug-17</b> | <b>Jul-17</b> | <b>Difference</b>   |                     |
| Total          | 0.4           | -1.0          | 1.4                 |                     |
| Mining         | 0.4           | -1.4          | 1.8                 |                     |
| Utilities      | 0.3           | -0.3          | 0.6                 |                     |
| Construction   | 0.5           | -2.1          | 2.6                 |                     |
| Manufacturing  | 0.4           | 0.3           | 0.1                 |                     |

Source: Banorte-ixe

**Banxico's minutes – The central bank will stay put throughout the year.**

Next Thursday at 10:00am (EDT), Banco de Mexico will publish the minutes of its monetary policy meeting held back on September 28, in which the board decided to maintain the reference rate at 7%. Within the minutes, we expect the discussions to have focused on four issues: (1) The transitory and limited adverse effects of recent earthquakes and hurricanes on inflation and growth, which prompted a deterioration in the balance of risks for inflation; (2) the absence of slack in the labor market; that it has not yet translated into significant wage pressures on prices; (3) the deterioration of the balance of risks for growth, given the perception of a higher probability of an unfavorable outcome in the prospects of the US-Mexican commercial relationship; and (4) the restrictive monetary policy implemented since 2015 will continue to influence inflation dynamics.

Since Banxico's Board considers that inflation will converge to its 3% target towards the end of 2018, there aren't any inflationary pressures stemming from the demand, and the current level of the reference rate is consistent with the convergence of inflation to its 3% target, we still consider that the monetary authority will maintain the reference rate at 7% throughout the year. Looking ahead, we believe that Banxico could start an easing cycle in the second half of 2018 (August) as inflation will start to converge towards the 3% target and most of the uncertainty will be significantly reduced by then. We believe that the central bank has room to reduce the reference rate between 150-200bps over the next two years, from which 100bps could take place in the second half of 2018.

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