Ahead of the Curve

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Market focus this week will be on Banxico's monetary policy decision and the preliminary GDP for 2Q18

- **Banxico's monetary policy decision (August 2).** Next Thursday, at 2:00 p.m., Banco de México's board of governors will announce its monetary policy decision, the first one after the July 1st election. We expect Banxico to maintain the reference rate unchanged at 7.75%, while the tone of the communiqué will remain hawkish and cautious given the future outlook. In this context, our view is based on the evaluation of the three factors that the monetary authority will focus for its decision: (1) Inflation and the exchange rate; (2) the relative monetary stance vs. the United States; and (3) the output gap. Looking ahead, although we anticipate that Banxico will leave the reference rate unchanged in the next 18 months
- **Gross Domestic Product (2T18 P).** On Tuesday, *INEGI* will publish its preliminary 2Q18 GDP report. Given the economic figures published in April and May, we are forecasting a 2.9% yoy growth for the Mexican economy, above the 1.3% observed in 1Q18. We highlight that part of this surge in the rate of growth will be explained by a calendar effect, given that the Easter holiday period increased the working days in the annual comparison

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 30-Jul	3:30pm	**Budget balance**	June	MXN bn	--	--	-36.9
Tue 31-Jul	9:00am	**GDP**	2Q18	% yoy	2.9	--	1.3
		(sa)		% q/q	0.4	--	1.1
		Primary activities		% yoy	5.7	--	5.4
		Industrial production		% yoy	1.3	--	-0.8
		Services		% yoy	3.6	--	2.0
Tue 31-Jul	10:00am	**Comercial banking credit**	June	% yoy	7.3	--	7.7
		Consumption		% yoy	3.2	--	3.1
		Housing		% yoy	3.5	--	3.6
		Non-banking private firms		% yoy	10.2	--	12.3
Tue 31-Jul	10:00am	**International reserves**	Jul-27	US$ bn	--	--	173.3
Tue 31-Jul	12:30pm	**Government weekly auction: 1-, 3-, 6-month CETES; 20y Mbono (Nov'38); 5y Bondes D**					
Wed 1-Aug	10:00am	**Family remmittances**	June	US$ mn	2,711.8	--	3,096.7
Wed 1-Aug	10:00am	**Banxico's survey of economic expectations**	July				
Wed 1-Aug	1:00pm	**PMI's survey (IMEF)**	July				
		Manufacturing		index	52.3	--	52.6
		Non-manufacturing		index	51.3	--	51.0
Thu 2-Aug	2:00pm	**Banxico's monetary policy decision**	Aug-2	%	7.75	--	7.75
Fri 3-Aug	9:00am	**Consumer confidence**	July	index	89.3	--	89.8

Source: Banorte; Bloomberg

Proceeding in chronological order...

MoF's monthly report. Next Monday, the Ministry of Finance (MoF) will release its monthly finance report for June. In it, we will focus on the income and spending dynamics of the Federal Government. On the revenue side, we will be looking at non-oil tax collection, as it will provide additional information about domestic demand behavior.

In addition, markets will focus on the spending side of the report, in particular comparing it vs. 2017, both on the discretional side as well as with the debt servicing costs. Finally, it will be important to evaluate the evolution of public sector debt, which currently represents close to 43.4% of Mexico's GDP.

Mexico's preliminary GDP will stand at 2.9% yoy in 2Q18. On Tuesday, *INEGI* will publish its preliminary 2Q18 GDP report. *INEGI* uses the economic reports published for the first two months of each quarter and adds the available information for the third month to calculate this figure. The missing figures for the last month of the quarter are estimated using econometric models. In this regard, GDP is calculated 80% with the direct information available, while the rest (20%) is based on estimations.

Given the economic figures available for April and May, we are forecasting an economic expansion of 2.9% yoy growth for the Mexican economy during 2Q18, above the 1.3% observed in 1Q18. We highlight that part of the higher rate of expansion will be explained by a calendar effect, given that the *Easter* holiday period increased the working days in the annual comparison.

We believe GDP growth in the second quarter of the year was supported by a favorable performance in the services sector, with a rate of expansion in the area of 3.6% yoy nsa, on the back of the dynamism observed in banking credit along with a solid expansion of the Mexican formal labor market.

In addition, we believe that weakness in industrial output –explained by the recession in the mining sector-, continued to be a drag for economic activity in 2Q18. Nevertheless, we expect the manufacturing output to have expanded 3.4% yoy nsa in the period in question, after a marginal reduction of 0.1% in the previous quarter. This figures imply a 1.3% yoy nsa expansion of the industrial sector overall. Finally, we anticipate a 5.7% yoy nsa increase in agricultural activities after a favorable agricultural cycle.

Banking credit will show a 7.3% yoy increase in June. Banco de Mexico will make available its banking credit report on Tuesday at 10:00am (ET). It is our take that banking credit continued flowing in June. In particular, we estimate a 7.3% yoy expansion in banking credit (in real terms), as a result of a 3.2% increase in consumer credit, coupled with a 3.5% and 10.2% expansion in mortgage and business credit, respectively.

Weekly international reserves report. Also on Tuesday, at 10:00am (ET), Banco de Mexico will release its weekly balance report. Last week, net international reserves decreased by US$23 million amounting to US$173.3 billion. According to Banxico's report, this figure comes mainly as a result of a negative valuation effect in central bank assets. In this context, the central bank's international reserves have increased by US$471 million during 2018 (please refer to the following table).

Banxico's foreign reserve accumulation detail
US$, million

	2017	Jul 20, 2018	Jul 20, 2018	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	172,802	173,273	-23	471
(B) Gross international reserve	175,450	177,261	-791	1,811
Pemex	--	--	-515	-358
Federal government	--	--	-230	1,130
Market operations	--	--	0	0
Other	--	--	-46	1,039
(C) Short-term government's liabilities	2,648	3,988	-768	1,340

Source: Banco de México

Weekly government bond auction. In addition, on Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent–, will offer 20-year fixed rate Mbonos (Nov'38),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 (ET).

Auction specifics (Tuesday, July 31st, 2018)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	30-Aug-18	- -	7,000	7.72
3m	01-Nov-18	- -	11,000	7.89
6m	31-Jan-19	- -	11,500	8.03
Bondes D				
5y	06-Jul-23	- -	5,000	0.16
M Bono				
20y	18-Nov-38	8.50	2,000	7.94

Source: Banorte 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

Family remittances will post a 12.2% yoy expansion in June. On Wednesday, at 10:00am (ET), Banxico will make its family remittances monthly data available. We expect Mexican workers living abroad –mainly in the US–, to have sent US$2,711.8 million to their families in Mexico during June. This would imply a 12.2% yoy expansion.

We believe that the remittances inflows will be explained by two factors: (1) The anti-migration policy measures taken by the U.S. administration, particularly given the separation of migrant parents from their children. In addition, we expect that the depreciation of the Mexican currency during the first half of the month will also contribute positively to the monthly figure. Looking ahead, we believe that the flow of remittances will be mainly explained by the growth trend in the US labor market and Trump's anti-migration policy.

Banxico's survey of economic expectations. Also on Wednesday, at 10:00am (ET), Banco de Mexico will publish its monthly survey of economic expectations. Market focus will be on inflation forecasts, particularly that of 2018, which as of last survey stands at 4% (Banorte: 4.3%), as well as inflation expectations for the medium and long term.

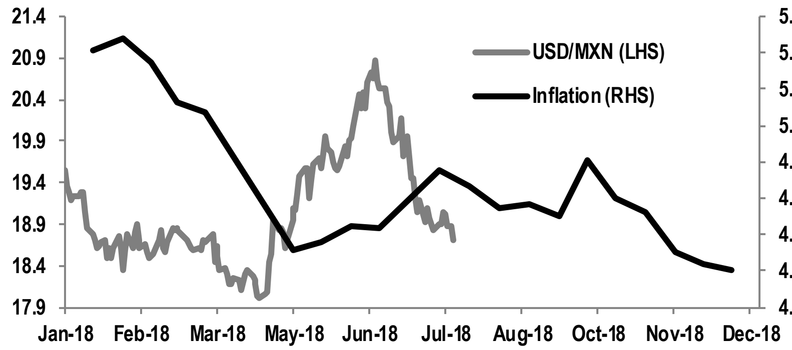
Moreover, attention will also be on monetary policy forecasts, for which we do not expect further movements in the next 18 months. Additionally, we will be looking into 2018's GDP forecast, which we expect at 2.5% (consensus: 2.3%). Furthermore, we expect downward revisions to FX forecasts, and we will be particularly attentive to its trajectory throughout the next twelve months.

July's PMI surveys. In addition, on Wednesday, *IMEF* (*Mexican Institute of Financial Executives*) will publish its PMI business confidence indicators for July. We expect the manufacturing PMI at 52.3 points (seasonally adjusted figures), below June's 52.6 pts. We believe that the fall in the manufacturing PMI during the month will be explained by the recent appreciation of the Mexican currency, given that it might reduce competitiveness of Mexican exports in the short term. Regarding the non-manufacturing PMI, we believe that it will stand at 51.3 points, up from 51.0 points in June (sa figures). We consider that the increase will be explained by better consumption prospects.

Banxico's monetary policy decision. Next Thursday, at 2:00 p.m., Banco de México's board of governors will announce its monetary policy decision, the first one after the July 1st election. We expect Banxico to maintain the reference rate unchanged at 7.75%, while the tone of the *communiqué* will remain hawkish and cautious given the future outlook. It is worth noting that TIIE markets discount a 25bp hike with a probability of 22%, while only 2 of the 24 analysts in the latest *Citibanamex survey* are penciling a movement in the same direction. In this context, our view is based on the evaluation of the three factors that the monetary authority will focus for its decision:

(1) *Inflation and the exchange rate*. Although inflation has picked from 4.41% in the second half of April to 4.85% in the first half of July, we believe that inflation will remain at levels above 4.5% in the following months –in part explained by the increase in the international price of gasoline, which has been reflected in domestic prices–, but will converge towards our year-end estimate of 4.3% (see chart below on the left). Regarding the exchange rate, in line with our estimate, the Mexican peso rallied after the election appreciating from USD/MXN20.88 in mid-June to 18.63 at the end of the week (see chart below).

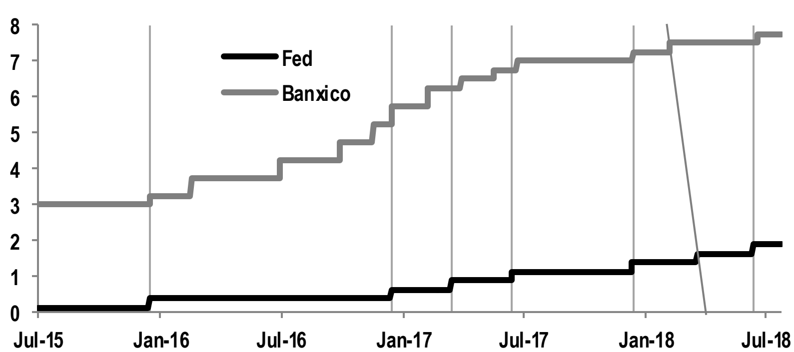
Inflation trajectory and exchange rate
% yoy; USD/MXN



Source: INEGI, Bloomberg, Banorte

(2) *The relative monetary stance vs. the United States*. The FOMC will also hold its monetary policy meeting next week (Wednesday), one day before Banxico. We do not expect changes in the range of the *Fed funds*, in line with consensus. We anticipate a *hawkish* tone that will continue to point towards four hikes this year (they already have done two 25 bp hikes). In this context, it is worth mentioning that, since the beginning of the normalization of monetary policy in the US, Banxico has followed the Fed, at least, in each of the rate hikes. Nevertheless, in this period -which began in December 2015-, the Fed has increased its reference rate by 175bp, while Banxico has increased it by 475bp (see chart below), which gives the Mexican monetary authority some leeway to remain cautious going forward.

Reference rates in Mexico and the US
%



Source: Banxico, US Fed, Banorte

(3) *Output gap*. Mexico's GDP expanded 2.5% -corrected by calendar effects-, in 1Q18. Data for the second quarter points to a slowdown in economic activity, with growth in April-May down to 1.8% vs. 2.5% in 1Q18 (using calendar-adjusted figures), according to the data from the *Global Economic Activity Indicator* (IGAE). Moreover, judging also by Banxico's own output gap projections, there is no signs of an overheating economy.

Looking ahead, although we anticipate that Banxico will leave the reference rate unchanged in the next 18 months, we continue to consider that the bias is for another rate hike before the end of the year. This would materialize, in our opinion, in the event of increased volatility in USD/MXN –due to a significant depreciation of the peso and with EM currencies not showing a similar behavior–, or if inflation does not converge to our estimate. In addition, inflation expectations –as measured by inflation *breakevens*– have somewhat deteriorated since Banco de Mexico's last monetary policy meeting, with the 3-year breakeven moving to 4.17% (as of yesterday's close) from 4% seen the day of the central bank's last monetary policy decision. Nevertheless, expectations for the medium term in Banxico's survey of analysts have remained relatively unchanged for the past few months. Moreover, the probability of a rate hike would be even higher if the new administration proposes to Congress a budget that implies a larger public deficit, which we believe has a low possibility of occurrence given the firm commitment we have observed.

Consumer confidence will post a slight slowdown in July. Finally on Friday, at 9:00am (EDT), Banxico and *INEGI* will publish its monthly survey on consumer confidence for July, where we expect a 0.7% yoy expansion, with the index reaching 89.3 points. Nevertheless, in seasonally adjusted terms, we expect confidence levels to fall 0.4% in the monthly comparison.

We believe that this contraction in consumer confidence will be explained by the recent temporary pickup in inflation. In this regard, headline inflation in the first half of July stood at 4.85% yoy from the 2018-low seen in the second half of April (4.41%). However, this will be partially offset by the appreciation of the Mexican currency during the month.

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