

Ahead of the Curve

November 6, 2015

Market focus this week will on Banxico's minutes

- Banxico's minutes.** Next week (Thursday, November 12), Banco de Mexico will publish the minutes of its monetary policy meeting held back on October 29, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view, discussions during the meeting were focused on two issues: (1) The relative monetary conditions, particularly vs. those in the United States and exchange rate; and (2) the assessment of the balance of risks for growth and inflation. Moreover, we believe that the decision was unanimous
- October's monthly inflation report.** On Monday, at 9:00am (EST), INEGI will release its monthly inflation report. We are forecasting a 0.51% m/m increase in October, marginally below consensus' 0.52%, according to *Banamex* survey. In the core index, we expect a 0.26% m/m increase, in line with market consensus. Inflation during the period in question will be explained by pressures on energy prices, as summer discounts on electricity tariffs ended applying in the first half of the month. Moreover, we expect some pressures on merchandise prices as we perceive an incipient pass-through from FX depreciation

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Mexico weekly calendar

DATE	HOUR (EST)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS
Mon 9-Nov	9:00am	CPI inflation	October	% m/m	<u>0.51</u>	<u>0.52</u>	0.37
				% yoy	<u>2.48</u>	<u>2.48</u>	2.52
		Core	% m/m	<u>0.26</u>	<u>0.26</u>	0.37	
			% yoy	<u>2.47</u>	--	2.38	
Tue 10-Nov	10:00am	International reserves	6-Nov	US\$ bn	--	--	175.6
Tue 10-Nov	12:30pm	Government weekly auction: 1-, 3-, 6-, 12- month CETES; 30y Mbono (Nov'42); 30y Udibono (Nov'46); 5y Bondes D					
Tue 10-Nov		Wage negotiations	October	%	<u>3.6</u>	--	4.1
Wed 11-Nov	9:00am	Industrial production	September	% yoy	<u>1.5</u>	<u>1.3</u>	1.0
				(sa)	% m/m	<u>0.5</u>	--
		Mining	% yoy	<u>-4.0</u>	--	-5.8	
		Utilities	% yoy	<u>4.0</u>	--	4.5	
		Construction	% yoy	<u>4.3</u>	--	2.1	
		Manufactures	% yoy	<u>2.1</u>	<u>3.2</u>	3.1	
Thu 12-Nov	10:00am	Banxico's minutes of October 29 meeting					
Fri 13-Nov		The Good weekend					

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

Inflation in October will be explained by pressures on energy prices, along with higher merchandise prices. On Monday, at 9:00am (EST), *INEGI* will release its monthly inflation report. We are forecasting a 0.51% m/m increase in October, marginally below consensus' 0.52%, according to *Banamex* survey. In the core index, we expect a 0.26% m/m increase, in line with market consensus.

Inflation during the period in question will be explained by pressures on energy prices, as summer discounts on electricity tariffs ended applying in the first half of the month. Moreover, we expect some pressures on merchandise prices as we perceive an incipient pass-through from FX depreciation

Nevertheless, we expect this figure to be 4bps lower than the observed in same period last year, derived from: (1) 7.2bps stemming from a higher contribution of merchandise prices (13.1bps vs. 5.9 in 2014); (2) another basis point stemming from a higher contribution of government tariffs (1.4bps vs. 0.3 in 2014). By contrast, we expect (3) a lower contribution from energy prices (33.1bps vs. 44.2 in 2014); and (4) -1.4bps stemming from a lower contribution of agricultural prices (-0.5bps vs. 1 in 2014), as shown in the table below.

With these results, annual inflation will stand at 2.48% yoy in October from 2.52%, while core inflation would be at 2.47% from 2.38% yoy.

Inflation by components in October

% monthly incidence

	Banorte-Ixe	2014	Difference
Headline	0.51	0.55	-0.04
Core	0.19	0.13	0.07
Goods	0.13	0.06	0.07
Processed foods	0.07	0.04	0.02
Other goods	0.07	0.02	0.05
Services	0.06	0.07	0.00
Housing	0.02	0.03	-0.01
Education	0.00	0.00	0.00
Other services	0.04	0.04	0.00
Non-core	0.33	0.44	-0.11
Agricultural	0.00	0.01	-0.01
Fresh fruits and vegetables	0.01	0.01	0.00
Meat and egg	-0.02	0.00	-0.01
Energy and government regulated	0.34	0.44	-0.10
Energy	0.33	0.44	-0.11
Government regulated	0.01	0.00	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 10:00am (EST), Banco de Mexico will release its weekly balance report. Last week, net international reserves decreased by US\$1,413mn amounting to US \$175.6bn on October 30. According to Banxico’s report, this figure comes mainly as a result of: (1) Dollar sales by the Central Bank to the Federal Government for US\$86mn; (2) US\$1,000mn decrease explained by the introduction of Banxico’s USD daily auction without minimum price and US\$200mn with minimum price; along with a (3) US\$127mn reduction 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. In this context, the central bank has an accumulated reduction of US\$17,674mn international reserves this year (please refer to the table below).

Banxico's foreign reserve accumulation details
US\$, million

	2014	30/Oct/2015	30/Oct/2015	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	193,239	175,565	1,413	-17,674
(B) Gross international reserve	195,682	177,125	-1,124	-18,557
Pemex	--	--	-247	2,690
Federal govt	--	--	100	-1,042
Market operations	--	--	-1,000	-20,005
Other	--	--	23	-200
(C) Short-term government's liabilities	2,443	1,560	289	-882

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 30-year fixed-rate Mbonos (Nov’42), 30-year inflation-linked Udibonos (Nov’46), as well as 5-year BondesD, 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 (EST).

Auction specifics (Tuesday, November 10, 2015)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	10-Dec-15	--	5,500	3.03
3m	11-Feb-16	--	9,500	3.18
6m	12-May-16	--	11,000	3.33
12m	13-Oct-16	--	11,000	3.53
Mbono				
30y	13-Nov-42	7.75	2,500	6.90
Udibono				
30y	08-Nov-46	4.00	500	3.64
Bondes D				
5y	24-Sep-20	--	5,000	0.23

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

October's wage negotiations. On Tuesday, the Ministry of Labor (STPS) will make its contractual wage negotiations monthly data available. We anticipate workers to have negotiated an annual average wage increase of 3.6% in October. This would be below the 4.3% average observed year-to-date. In this regard, we believe that October's figure was mainly driven by the increase in wage negotiations in the health sector, specifically wage increases in the Union of the *Mexican Institute of Social Security (IMSS)*, benefiting more than 320,000 workers with a salary increase of 3.3%. Moreover, we highlight the revisions made in the sugar and baking industry, specifically in the *Mexican Chamber of the Sugar Industry* (42,000 workers with a wage increase of 5%) and in the *Mexican Workers Union of Flour and Bakers*, belonging to *Bimbo* (44,000 workers with an increase of 4%). Finally, we also highlight salary revisions in the educational sector, such as those made by the union workers of the *National Autonomous University of Mexico (STUNAM)*, benefiting about 25,000 workers with an increase of 3.15% on their salary.

We expect 1.5% yoy growth in September's industrial output. On Wednesday, at 9:00am (EST), *INEGI* will release its monthly industrial production report. We anticipate a 1.5% yoy expansion in total output during the ninth month of the year. Taking a look at the breakdown, we believe that construction output could have expanded 4.3% yoy. In this regard, construction has consolidated its recovery. However, the latest IP reports show that construction output has decelerated, probably as a result of the recent volatility in financial markets, which has driven Mexican firms to postpone their investment projects.

Moreover, we believe that manufacturing production could post a 2.1% yoy expansion, explained by a 0.7% yoy contraction in manufacturing exports, a 4.2% yoy increase in September's vehicle production, and a scant 0.9% yoy expansion in U.S. manufacturing output, which has a strong correlation with Mexico's manufacturing sector. Looking ahead, we believe that the Mexican manufacturing sector will show better growth prospects, derived from: (1) A stronger external demand, particularly coming from the U.S.; (2) the strong depreciation of the Mexican currency which will eventually translate into a fast recovery of Mexican exports; and (3) the recovery of private consumption in Mexico, which will eventually translate into a higher domestic demand for manufacturing products.

Finally, we believe that the scant 1.5% yoy growth in industrial output during September will be mainly explained by the poor performance of mining activity. In this regard, we expect a 4% yoy contraction derived from lower oil production and the reduction in the extraction of other minerals.

Banxico's minutes – Banxico's hike still tied to the U.S. Fed. Next week (Thursday, November 12), Banco de Mexico will publish the minutes of its monetary policy meeting held back on October 29, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view, discussions during the meeting were focused on two issues: (1) The relative monetary conditions, particularly vs. those in the United States and exchange rate; and (2) the assessment of the balance of risks for growth and inflation. Moreover, we believe that the decision was unanimous.

In our opinion, the tone of October's *communiqué* regarding Mexico's economic growth was slightly more negative than in previous statement. In particular, the central bank considered that the recent figures suggest that exports have decelerated given the slower growth dynamics of external demand, while investment continues to show a weak expansion. Moreover, the board mentioned that they don't see any demand-side pressure mounting on prices given the slack that remains in the economy. In addition, the board considered that the balance of risks for the Mexican economy has worsened in relation to September's meeting.

The monetary authority concluded that cyclical conditions of the Mexican economy continued to show weakness, while inflation will remain below the target in 2015. However, board members warned again that: *"...any actions from the U.S. Fed could have additional repercussions on the Mexican exchange rate, inflation expectations, and the overall price dynamics..."*. In this context, the board will pay particular attention to *"... the pass-through of the exchange rate to inflation, the relative monetary conditions between Mexico and the United States, and the evolution of the slack in the economy..."*.

We maintain our view that the central bank's next move will be a hike, immediately after the Fed in December. While Banxico's central scenario seems to be of economic weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given these factors, we believe that Banxico's next move will be a rate hike, immediately after the Fed starts its normalization of monetary policy in December 15-16. This implies that the central bank could be raising rates at its next regular meeting on December 17. However, the central bank's more dovish stance in terms of growth relative to the Fed suggests that Banxico will adequate its monetary policy to Mexico's business cycle, and will not necessarily follow the Fed in 2016.

Disclaimer

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