Ahead of the Curve

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Market focus this week will be on Banxico's monetary policy decision and March's inflation

- **Monetary policy announcement (April 12).** We believe that Banxico will not increase the reference rate next Thursday**,** despite the Fed's more hawkish stance. We consider that the FX market has not only incorporated the electoral uncertainty, but now anticipates that NAFTA can be renegotiated sooner than initially anticipated. In this context, we consider that it is very likely that the Mexican peso may lose ground against the US dollar as we get closer to the elections and thus, Banxico will have to implement an additional 25bps hike before the presidential elections that will take place the 1st of July, either at the May 17 meeting or in the June 21 meeting

- **Monthly inflation report (March).** On Monday, at 9:00am, *INEGI* will release its monthly inflation report for March. We are forecasting a 0.41% m/m increase in the headline index, while we expect the core index to rise 0.37% m/m. Inflation during the period in question will be mainly explained by increases in the prices of tourism services and airfares given the holiday period. Moreover, gasoline prices will continue their upward trend. With these results, annual inflation will stand at 5.13% in March, lower than the 5.34% seen in February

Mexico weekly calendar

DATE	TIME (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 9-Apr	**9:00am**	**CPI inflation**	March	% m/m	0.41	0.38	0.38
				% yoy	5.13	5.1	5.34
		Core		% m/m	0.37	0.35	0.49
				% yoy	4.06	--	4.27
Tue 10-Apr		**Wage negotiations**	March	**%**	4.9	--	5.6
Tue 10-Apr	**10:00am**	**International reserves**	Apr-6	US$ bn	--	--	173.2
Tue 10-Apr	**12:30pm**	**Government weekly auction: 1-, 3-, 6-month CETES; 30y MBono (Nov'47); 5y BondesD**					
Wed 11-Apr	**9:00am**	**Industrial production**	February	% yoy	1.5	--	0.9
		(sa)		% m/m	0.6	--	0.0
		Mining		% yoy	-4.4	--	-5.0
		Utilities		% yoy	2.0	--	1.6
		Construction		% yoy	2.0	--	4.0
		Manufactures		% yoy	3.1	--	1.7
Thu 12-Apr	**3:00pm**	**Banxico's monetary policy decision**	April	%	7.50	7.50	7.50

Source: Banorte; Bloomberg

Proceeding in chronological order...

Inflation during March will be explained by increases in the prices of tourism services and airfares given the holiday period. On Monday, at 9:00am, *INEGI* will release its monthly inflation report for March. We are forecasting a 0.41% m/m increase in the headline index, while we expect the core index to rise 0.37% m/m.

Inflation during the period in question will be mainly explained by increases in the prices of tourism services and airfares, given the holiday period. Moreover, gasoline prices will continue their upward trend.

We forecast inflation to be 20bps below the figure seen in 2017 as a result of: (1) a lesser contribution of fresh fruits and vegetables (-2bps vs. 18bps in 2017); (2) a greater impact of energy (9bps vs. -4bps in 2017); (3) a smaller participation of processed foods (3bps vs. 12bps in 2017); (4) a lesser contribution of other goods (7bps vs. 15bps in 2017); and (5) a greater impact of meat and egg (6bps vs. 1bps. in 2017), as shown in the table below.

With these results, annual inflation will stand at 5.13% in March, lower than the 5.34% seen in February. Moreover, we forecast core inflation at 4.06% yoy (previous: 4.27% yoy). Moving forward, we will focus on the evolution of energy prices and the behavior of agricultural prices, and the impact they might have in Mexico's CPI.

March inflation by components
% Monthly incidence

	2018 F	2017	Difference
Headline	0.41	0.61	-0.20
Core	0.27	0.43	-0.16
Goods	0.09	0.27	-0.17
Processed foods	0.03	0.12	-0.09
Other goods	0.07	0.15	-0.08
Services	0.18	0.16	0.02
Housing	0.04	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.14	0.12	0.02
Non-core	0.14	0.18	-0.05
Agricultural	0.04	0.20	-0.16
Fresh fruits and vegetables	-0.02	0.18	-0.21
Meat and egg	0.06	0.01	0.05
Energy and government regulated	0.10	-0.02	0.12
Energy	0.09	-0.04	0.12
Government regulated	0.01	0.02	-0.01

Source: Banorte, INEGI

Wage negotiations will climb 4.9% during March. On Tuesday, the Ministry of Labor (MoL) will publish the contractual wage negotiations for March. We expect workers to have negotiated an average increase of 4.9%, below the 5.6% seen in February. This figure will be mainly explained by a greater dynamism in the negotiations of the private sector, which averaged 5.9% in the first two months of 2018. On the other hand, some of the syndicates of several higher education institutions negotiated increases below 4%. Looking ahead, we believe that negotiations will remain relatively high due to the minimum wage increase in late 2017 and the persistence of high inflation levels.

Weekly international reserves report. On Tuesday, at 10:00am (ET), Banco de Mexico will release its weekly balance report. Last week, net international reserves increased by US$12 million amounting to US$173.2 billion. According to Banxico's report, this figure comes mainly as a result of a positive valuation effect in central bank assets. In this context, the Central Bank's international reserves have increased by US$430 million during 2018 (please refer to the table below).

Banxico's foreign reserve accumulation detail
US$, million

	2017	Mar 28, 2018	Mar 28, 2018	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	172,802	173,232	12	430
(B) Gross international reserve	175,450	177,601	754	2,152
Pemex	--	--	107	-523
Federal government	--	--	42	1,630
Market operations	--	--	0	0
Other	--	--	604	1,045
(C) Short-term government's liabilities	2,648	4,370	743	1,722

Source: Banco de México

Weekly government bond auction. Also on Tuesday, the Ministry of Finance (MoF) –via Banco de Mexico as its financial agent–, will offer 30-year fixed rate Mbonos (Nov'47), 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, April 10, 2018)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	10-May-18	- -	7,000	7.46
3m	12-Jul-18	- -	11,000	7.67
6m	11-Oct-18	- -	11,500	7.69
Bondes D				
5y	09-Mar-23	- -	5,000	0.18
M Bono				
30y	07-Nov-47	8.00	3,000	3.93

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

We expect a 1.5% yoy expansion in February's industrial output. On Wednesday at 9:00am (ET), *INEGI* will release its monthly industrial production report. We anticipate 1.5% yoy growth in total output during February, after the null growth in the previous month. Taking a look at the breakdown, we expect a 3.1% yoy expansion in manufacturing production, as a result of the recovery in IMEF's purchasing managers index, as well as February's vehicle production.

In addition, industrial output during February will be also explained by: (1) The 2% yoy expansion in construction output, as a result of the higher growth in public construction investment projects, given the presidential elections on July 1st; and (2) the poor performance of mining activity, where we estimate a 4.4% yoy reduction.

Industrial production estimate: February 2018
% yoy nsa; % m/m sa

% yoy	Feb-18	Feb-17	Jan-Feb, '18	Jan-Feb, '17
Total	1.5	-2.3	1.2	-1.0
Mining	-4.4	-14.3	-4.7	-11.8
Utilities	2.0	-1.1	1.8	-0.1
Construction	2.0	-0.1	3.0	0.2
Manufacturing	3.1	1.2	2.4	2.7

%m/m sa	Feb-18	Jan-18	Difference
Total	0.6	0.0	0.6
Mining	-0.6	1.6	-2.2
Utilities	0.4	2.0	-1.6
Construction	-0.8	0.5	-1.3
Manufacturing	1.8	-0.5	2.3

Source: Banorte

Banxico's monetary policy announcement. On Thursday, Banxico will announce its monetary policy decision at 1:00pm (ET), where we expect the monetary authority to maintain the reference rate unchanged at 7.5%.

On March 21, the FOMC announced its monetary policy decision, in which the Fed increased the Fed funds range by 25bps. The monetary policy statement was very relevant for Banxico given that: (1) The dot-plot indicated that the majority of the FOMC members considered at least two additional rate increases during 2018 (in fact, the number of members that advocated at least three more rate hikes this year increased to 7 from 4); and (2) the economic growth forecasts for 2018 and 2019 were revised upwards, as well as the median core inflation forecast for 2019. Similarly, the estimated unemployment rate was significantly lower for 2018 and 2019.

Powell's first press conference maintained a hawkish bias, since he mentioned the possibility of increasing the reference rate in the US at a faster pace. Powell also highlighted the greater economic growth, which has been reflected in the growth dynamics of the labor market.

The President of the FOMC also referred to the impact that the fiscal package could have on economic growth and pointed out that it could affect the price formation process in the economy. Similarly, Powell argued that additional increases in the Fed funds rate during this year still imply a “gradual” increase in the Fed's monetary stance.

For Banxico, the Fed’s hawkish stance represents an important challenge for the implementation of monetary policy in our country. The last presentations made by several board members seemed to have become more dovish. In addition, Governor Alejandro Diaz de León speech in Banxico’s last quarterly report mentioned that February’s rate hike *“...took into account the more restrictive monetary conditions that [were] expected in the US”*, which implies that the central bank signaled that they won’t raise the reference rate in April.

However, the Fed's more restrictive monetary stance is a significant constraint in Banxico’s reaction function. In a “normal” monetary policy cycle a rate hike in the U.S. is a sufficient condition to trigger a rate hike in Mexico, given that the holdings of foreign investors in the medium and long-end of the curve is elevated, making even more relevant the spread between Mexico’s reference rate and the *Fed funds* rate. Therefore, if the Fed decides to raise rates, practically independently of Mexico’s economic cycle and the level of inflation, Banxico “would” have to maintain the differential between the interest rates of both countries. The failure to do so could lead to a depreciation of the Mexican peso against the dollar, which could lead to deterioration in inflationary expectations.

However, Banxico’s monetary cycle implemented since December 2015 has been more hawkish than the one implemented by the Fed, given that the rate differential between Mexico and the US has expanded in response to both external and domestic shocks that impacted inflation. In this context, by previously implementing this restrictive monetary policy, the Mexican central bank was successful in anchoring inflationary expectations and limiting the volatility of inflation in our country.

Thus, despite the Fed’s more hawkish stance, we believe that Banxico will not increase the reference rate next Thursday. We consider that the FX market has not only incorporated the electoral uncertainty, but now anticipates that NAFTA can be renegotiated sooner than initially anticipated. In this context, we consider that it is very likely that the peso may lose ground against the US dollar as we get closer to the elections and thus, Banxico will have to implement an additional 25bps hike before the presidential elections that will take place the 1st of July, either at the May 17 meeting or in the June 21 meeting. Looking ahead, and as volatility due to the electoral process starts to dissipate, it is likely that the Central Bank could cut rates by 50bps in the second half of 2018.

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