

Mexico – Economic activity decelerates more than expected

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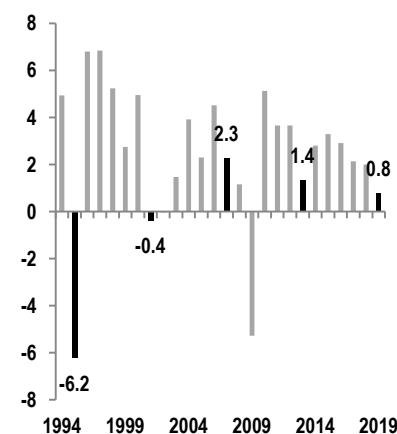
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- Economic activity in Mexico has decelerated more than what we had anticipated
- We revise our GDP forecast to 0.8% yoy, from 1.5% for 2019, and to 1.4%, from 2.1% for 2020. In our view, the Mexican economy is facing additional headwinds, including:
 - (1) Halted construction projects in Mexico City; and
 - (2) Lower-than-expected investment
- Going forward, we anticipate that the pace of public investment and spending to accelerate from current levels, along with the execution of social programs, will support economic activity
- Despite these revisions, we remain confident that the government will keep its commitment with macroeconomic stability, including the goal of maintaining healthy fiscal accounts

Revising lower our GDP forecasts for this year and 2020. One first step to estimate this year’s output growth rate was our potential GDP projection of 2.3% yoy. From this baseline, we had anticipated since early 2018 that the typical slowdown in public spending at the start of a new federal administration, would subtract around 50bps to the annual rate, to 1.8%. As we have mentioned previously, a significant deceleration of economic activity has been observed in the first year of recent administrations (see chart below, left). On one hand, the private sector postpones new investments due to electoral uncertainty. Moreover, new administrations have tended to make personnel changes, which are charge of executing investment outlays and public spending, resulting in a slowdown during the first years of a Presidential term. In February 2019, we made an additional adjustment, mainly due to a series of transitory shocks during the first quarter, which subtracted around 33bps to GDP, implying an expansion of 1.5%.

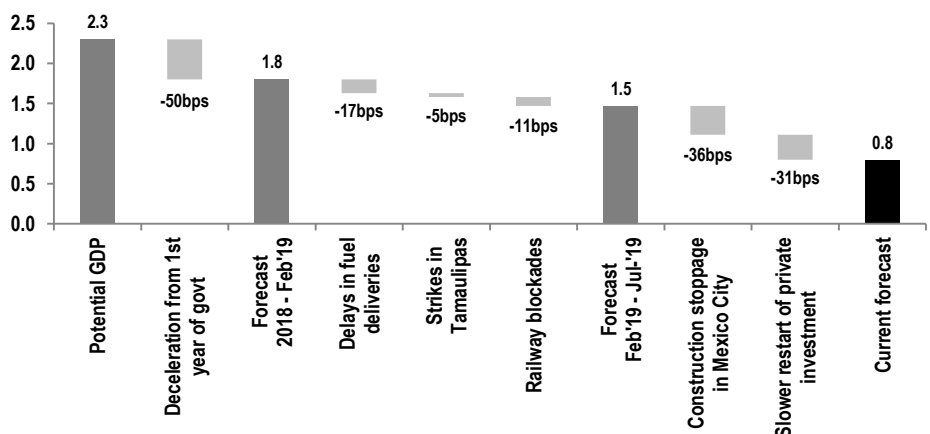
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GDP in the first year of a new administration
% yoy



Source: Banorte with data from INEGI

2019 GDP growth forecast
% and contribution in bps

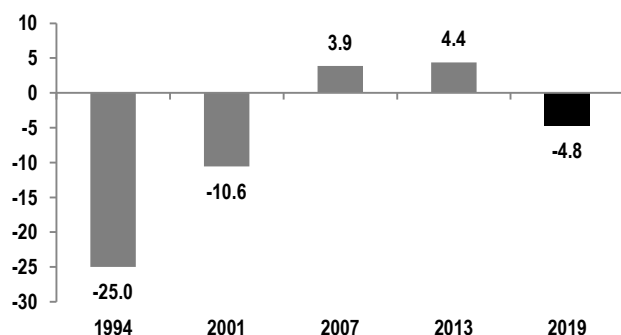


Source: Banorte with data from INEGI

A more pronounced slowdown. In our view, the Mexican economy is facing additional headwinds, in particular: (1) Halted construction projects in Mexico City; and (2) lower-than-expected investments of the private sector, impacted by low confidence levels, with additional effects on aggregate demand and consumption. We estimate these two factors will subtract an additional 70bps to growth in 2019, resulting in our new forecast of 0.8%, as shown in the chart above. For 2020, is our take that government spending will normalize, and social programs could provide some boost to consumption, among other factors.

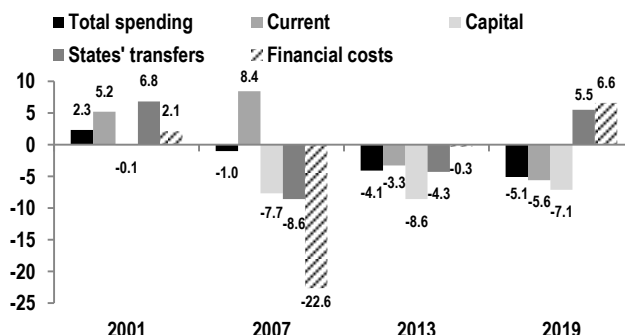
Lower public spending is impacting growth... As mentioned in the introduction, we had taken into account since last year the likely slowdown of public spending, in particular in terms of investment. In this respect, civil engineering works, mostly related to construction activity done by the public sector, has been a higher drag for GDP relative to previous administrations. The chart below on the left shows that this category has plunged 4.8% yoy on a year-to-date basis, its third-worst performance in the last 25 years, only surpassed by 1995 –in the midst of the *Tequila Crisis*– and 2001 –during the crash of the “*dot-com*” bubble–. Apart from the contraction in capital outlays, current spending has also shown a steep decline, down 5.6%, probably due to austerity measures (see chart below on the right). As a result, total public spending has fallen 5.1% yoy in real terms.

Construction*: Civil Engineering
% yoy, YTD until May



*Note: Construction as measured within industrial production
Source: Banorte with data from INEGI

Public Spending
% yoy in real terms, YTD until May



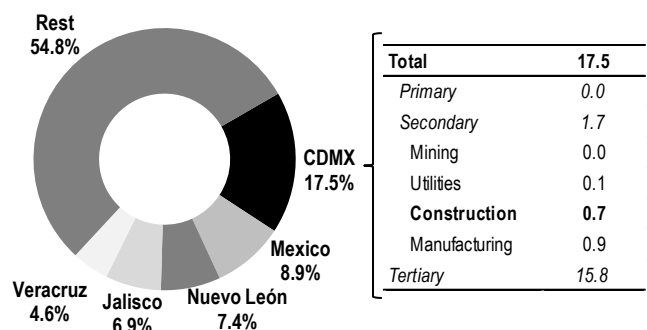
Source: Banorte with data from the Minister of Finance

...while additional headwinds have arisen in 2019. Transitory shocks experienced during 1Q19 that are already incorporated in our estimate include: (1) Interruptions in fuel distribution; (2) *maquila* workers’ strikes in Matamoros, Tamaulipas; and (3) railroad blockades in the state of Michoacán. For details, see: “*A slightly lower growth rate in 2019 due to certain transitory events*”, <[pdf](#)>. Nevertheless, it is our take that additional headwinds will take a toll on GDP this year. Among them, we highlight:

(1) *Halted construction projects in Mexico City.* Last month, Mexico City’s *Urban Development and Housing Ministry* (Secretaría de Desarrollo Urbano y Vivienda, SEDUVI, in Spanish), confirmed that about 200 construction projects under development, both mixed-use and housing, are under revision for alleged irregularities. This resulted in a significant halt of activity during 1H19, with anecdotal evidence and sector experts estimating that it represents around half of the value-added of the city’s construction industry.

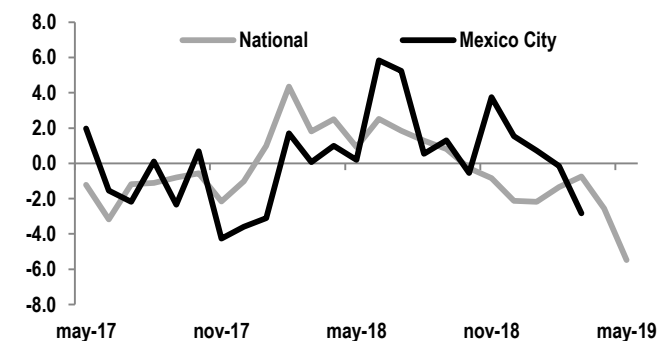
Based on INEGI data for full-year 2017 (latest available), Mexico City's GDP represents 17.5% of national output. Industry comprises 9.7% of the city's activity, from which 41.9% corresponds to construction. Therefore, a simple calculation would imply that the city's sector represents 0.7% of national GDP (chart below on the left). Furthermore, with half of the projects stopped during 1H19, we estimate that 18bps have already been lost. Moreover, industry insiders believe the process could take up to a year, which would slash around 36bps to economic growth for full-year 2019. Supporting our view, hard data shows that dynamism in the city has decelerated meaningfully since December, even contracting at a faster pace than the country in March. This has also been important to explain the steeper decline at the national level for both April (despite being distorted by the timing of the Holy Week) and May, as seen in the chart below on the right.

Real GDP weights
% of national GDP



Source: Banorte with data from INEGI

Construction*: National and Mexico City
% yoy



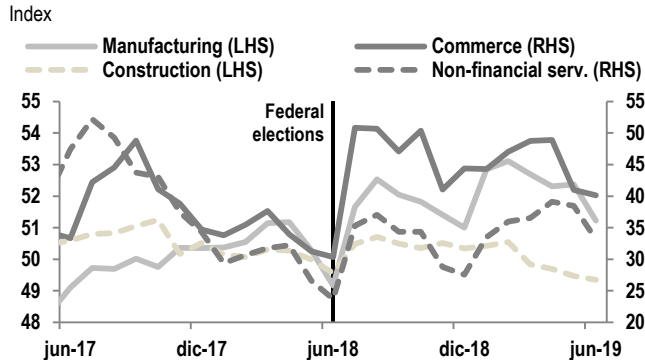
*Note: Construction as measured within industrial production
Source: Banorte with data from INEGI

(2) *Slow recovery in private sector investments.* We believe some decisions of the new government have impacted confidence to invest by the private sector. Among them, we highlight: (a) The cancelation of strategic associations with Pemex in the energy sector, known as farm-outs –only within hours of the signature of an investment agreement with top-tier businesspeople–; (b) the arbitration process started by the state-owned utility, CFE, with several private companies due to some clauses in natural gas pipeline contracts; (c) the resignation of former Minister of Finance, Carlos Urzúa, including the context in which it took place, and even taking into account that the corporate sector, foreign and domestic analysts alike, believe the designation of Arturo Herrera was very positive; (d) some legislative initiatives proposed since last November, which could affect some industries if implemented; and (e) the abovementioned halt in construction. We estimate that this factor will subtract an additional 31bps to annual GDP growth this year.

These headwinds are weighing on business confidence, private investment and consumption. In this respect, the US Department of State released a few days ago its *2019 Investment Climate Statement* for Mexico, which helps to gauge foreign investors' sentiment. The document recognizes that the new administration has signaled its commitment to prudent fiscal and monetary policies since taking office, which is a definite plus.

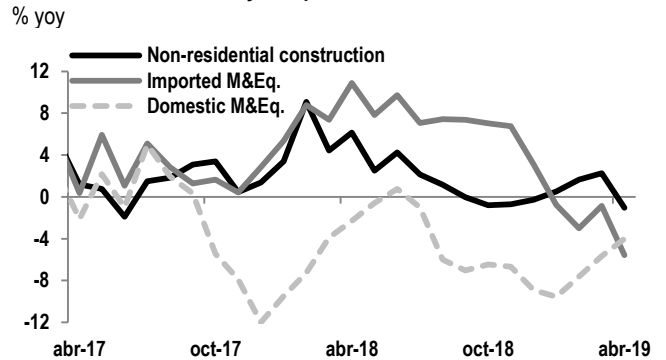
On the other hand: “...Still, conflicting policies, programs, and communication from the new administration have contributed to ongoing uncertainties, especially related to the energy sector and the financial-health of state-owned oil company Pemex...”. Additionally, they said that uncertainty about contract enforcement, insecurity, and corruption, continue to hinder economic growth and have significantly raised the cost of doing business in Mexico. We believe business confidence is also reacting to these drivers, as shown in the decline in the “adequate moment to invest” component (chart below, left) which has ultimately reflected also in gross-fixed investment (chart below, right).

Business confidence*



* Corresponds to the “adequate moment to invest” component by sector
Source: Banorte with data from INEGI

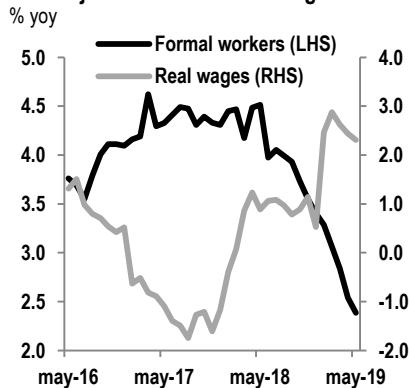
Gross fixed investment by component*



* We have previously estimated that around 86% of GFI is by the private sector
Source: Banorte with data from INEGI

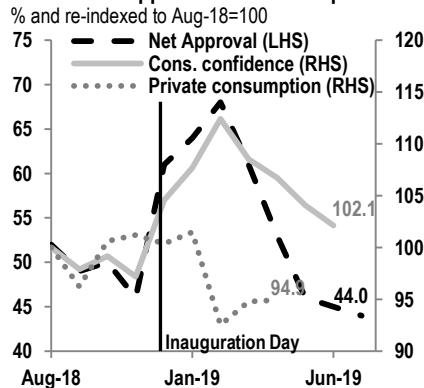
Moreover, it is our take that lower confidence is also impacting private consumption, as it has led to a significant slowdown in employment growth. Using formal job creation data, the annual pace of growth remains positive but has shown a persistent downward trend and is currently at its lowest since 1Q10 (chart below, left). In terms of purchasing power, this has been compensated by higher wages since the start of the year (after the announced hike in the minimum wage) and the accumulated decline in inflation. Nevertheless, and adding evidence to our view, we have noted that: (1) Hard data on private consumption shows a steep moderation despite soaring consumer confidence, in our view much more influenced by political optimism as measured by the president’s approval ratings (chart below, center); and (2) purchases within private consumption have diverged between durable vs. non-durable goods (chart below, right), with the former actually declining strongly as it is more sensitive to uncertainty given its close relationship to permanent income.

Formal job creation and real wages



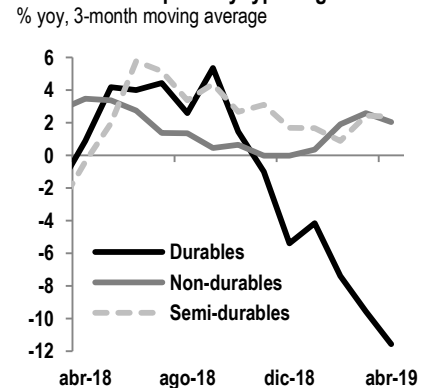
Source: IMSS, INEGI, Labor Ministry, Banorte

Presidential approval and consumption*



* AMLO’s net approval. Source: Banorte with data from Oraculus and INEGI

Private consumption by type of goods



Source: Banorte with data from INEGI

Impact on aggregate supply and demand. The details of our updated forecasts for the rest of 2019 are shown in the table below. As a result of the factors mentioned above, we believe the current backdrop and recent performance is likely to show more muted dynamics of domestic vs. external demand. Investment would remain low, with consumption decelerating more than previously expected. We maintain our view of a contraction in government spending during the first year of the administration. Nevertheless, we adjust our forecast slightly higher as figures for the first quarter were slightly better than anticipated. Meanwhile, trade has surprised to the upside, with a US\$584 million accumulated surplus in the first five months of 2019 against a US\$3,569 million deficit in the same period of the previous year. In particular, Mexico's manufacturing sector has been very resilient despite global trade tensions and the moderation in global industry. Exports have grown 4.2% yoy on a year-to-date basis despite a deteriorated oil balance. Imports have advanced only 1.9%, impacted by the deceleration in consumption and capital goods. Considering this, we believe net trade could show a higher contribution to growth than previously anticipated.

2019 GDP growth forecast

% yoy, nsa

	Current					Previous				
	1Q19	2Q19f	3Q19f	4Q19f	2019f	1Q19	2Q19f	3Q19f	4Q19f	2019f
GDP (aggregate supply)	1.2	-0.3	0.8	1.3	0.8	1.2	0.9	1.5	2.1	1.5
Primary sector	5.8	1.8	3.6	2.2	3.2	5.8	1.8	2.6	2.2	3.0
Secondary sector	-0.7	-2.8	-1.9	-0.9	-1.6	-0.7	-1.0	-0.9	0.2	-0.4
Tertiary sector	1.9	0.6	1.8	2.2	1.6	1.9	1.7	2.4	2.9	2.2
GDP (aggregate demand)	1.2	-0.3	0.8	1.3	0.8	1.2	0.9	1.5	2.1	1.5
Private consumption	1.1	0.7	1.5	2.1	1.4	1.1	2.6	3.4	3.6	2.7
Investment	-0.9	-6.1	-2.4	-1.0	-2.6	-0.9	-2.0	-0.8	0.3	-0.9
Government spending	-0.8	-1.3	-0.3	0.2	-0.5	-0.8	-1.3	-0.9	0.2	-0.7
Exports	2.0	4.2	5.4	6.4	4.6	2.0	3.5	4.9	5.8	4.1
Imports	1.7	0.7	1.0	1.2	1.1	1.7	2.2	2.6	1.8	2.1

Source: Banorte

Relative to market expectations, our forecasts are slightly below consensus for both years, as shown in the table below:

GDP growth expectations

% yoy, median

	2019	2020
Banorte	0.8	1.4
Consensus*	1.0	1.7
Banxico Survey	1.1	1.7
Banxico (1Q19 Quarterly Report)	1.3	2.2
Ministry of Finance	1.6	1.9
IMEF	0.9	1.5
Citibanamex survey	1.0	1.7
Bloomberg	1.1	1.7

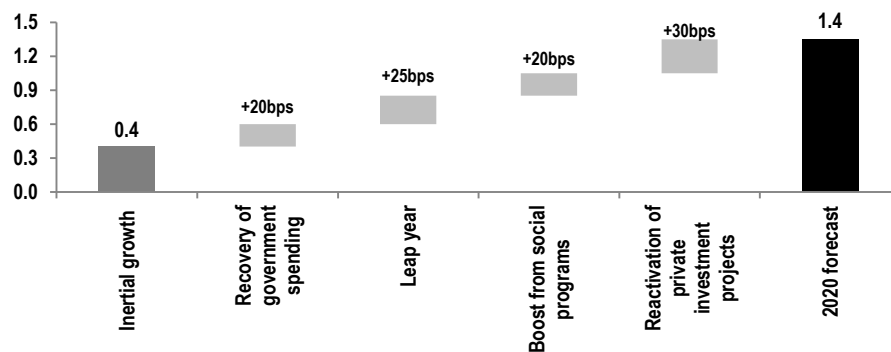
*For consensus expectations, we take the simple average excluding Banxico QR and the MoF

Source: Banorte

2020 GDP to pick-up. We cut our 2020 GDP forecast from 2.1% yoy to 1.4%. It is worth mentioning that this estimate is within the MoF's *Preliminary Economic Criteria* forecast range for 2020, at 1.4-2.4%. Considering a top-down approach and our new 2019 estimate, we forecast inertial growth at 0.4%. Moreover, we see a clearer boost from government spending, particularly public-sector investments, estimated to add about 20bps. Nevertheless, with economic growth in 2019 and 2020 lower than what is assumed in the budget, the risk is skewed towards lower-than-expected fiscal revenues. As a result, our base-case is that the pickup in activity stemming from higher government spending would remain relatively modest, as there are no plans to raise taxes or pursue a broad-based fiscal reform during the first half of the administration. On a more positive note, support for consumption is estimated to be stronger as social programs consolidate nationwide, particularly as they are focalized to benefit the poor and vulnerable groups which are likely to exhibit a higher marginal propensity to consume. Overall, this factor is expected to add around 20bps to annual growth.

Moreover, we believe there is a high likelihood of looser financial conditions as central banks ease monetary policy, including Banxico. For the latter, we expect an easing cycle to start in November this year that could result in accumulated cuts of 125-200bps. This situation, along some expected recovery in business confidence, should help the reactivation of private investments, estimated to push annual growth 30bps higher. Our expectation that the Mexican peso depreciates gradually and in an orderly fashion would also help growth dynamics, particularly manufacturing. On a more technical side, the fact that 2020 is a leap-year (with an additional labor day) is expected to represent around +25bps (see chart below).

2020 GDP growth forecast
% and contribution in bps



Source: Banorte

2020 GDP growth forecast

% yoy, nsa

	1Q20f	2Q20f	3Q20f	4Q20f	2020f
GDP (aggregate supply)	1.9	2.3	1.3	0.3	1.4
Primary sector	-1.0	2.1	1.5	1.2	1.0
Secondary sector	0.8	1.7	0.6	-1.0	0.5
Tertiary sector	2.5	2.7	1.7	0.9	1.9
GDP (aggregate demand)	1.9	2.3	1.3	0.3	1.4
Private consumption	1.9	2.5	1.9	1.6	1.9
Investment	0.3	1.6	0.2	-0.3	0.4
Government spending	0.4	1.1	0.4	0.2	0.5
Exports	4.8	3.7	2.9	1.7	3.2
Imports	2.1	2.9	2.6	2.2	2.5

Source: Banorte

We expect macroeconomic stability to be preserved. It is worth mentioning that despite the downward revisions to our GDP growth estimates, these consider an underlying framework in which macro stability is maintained, with the Federal Government delivering on its commitment to maintain healthy public finances, with the goal of achieving a primary surplus of 1% of GDP this year and 1.3% in 2020 according to the *Preliminary Economic Policy Criteria*. For details, see: “FY2020 Budget - New government confirms fiscal responsibility with conservative assumptions”<[pdf](#)>. We recognize a more muted outlook for growth could put some pressure on these goals, particularly next year. Notwithstanding, we believe fiscal prudence will be maintained as it is a key pillar of the President’s economic strategy. Moreover, we see as positive the combat of fuel theft, measures to boost the financial sector and deepen banking penetration, the labor reform to comply with commitments made under USMCA negotiations, the increase in the minimum wage, and social programs aimed to help vulnerable groups, among others.

The most relevant risk is that the global economy falls into a recession, particularly if it results from a steep escalation in trade tensions, having a sizable impact on trade flows and global manufacturing activity. We perceive this as the most important but not the only risk, considering that geopolitical tensions are also high in several parts of the world. Last but not least, we should also mention that uncertainty could remain elevated and even pick-up further due to other factors, such as the US election in 2020, and negative news about the USMCA ratification process, among others.

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