

## Banxico's QIR – Inflation close to a turning point

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- **Banxico published today its *Quarterly Inflation Report (QIR)* for 2Q17**
- **We highlight the following issues:**
  - (1) **The central bank made a marginal upward revision to its inflation forecasts for 2017;**
  - (2) **However, in their traditional fan charts, the monetary authority is expecting inflation to fall below its 3% target in 2018; and**
  - (3) **The economic outlook for Mexico became more positive, which prompted an upward revision to Banxico's 2017 growth forecast range, which now stands between 2% and 2.5% (previous range: 1.5%-2.5%);**
- **In the traditional “grey boxes” Banxico's researchers tackle the following topics:**
  - (1) **The evolution of the FX depreciation to prices; and**
  - (2) **The pass-through effect of recent inflationary shocks in Mexico**
- **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**

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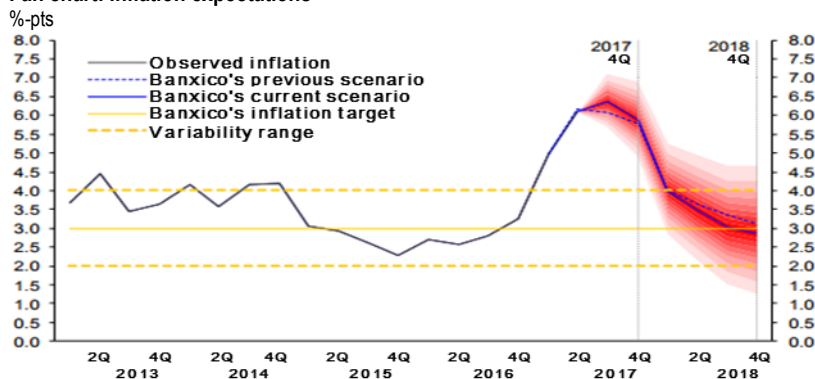
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**Lower inflation coupled with higher growth.** The monetary authority released its *Quarterly Inflation Report (QIR)* for 2Q17. The release was accompanied by a press conference led by Governor Carstens. We highlight the following issues discussed in the document: (1) The central bank made a marginal upward revision to its inflation forecasts for 2017; (2) however, in their traditional fan charts, the monetary authority is expecting inflation below its 3% target in 2018; and (3) the economic outlook for Mexico became more positive, which prompted an upward revision to Banxico's 2017 growth forecast range, which now stands between 2% and 2.5% (previous range: 1.5%-2.5%).

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**Inflation around 6% in 2017, but below 3% in 2018.** The central bank argued that the balance of risks of inflation was neutral and inflation will remain around 6% in the short term. Governor Carstens also highlighted that inflation is close to its peak. In terms of headline inflation, the central bank denoted within the quarterly report that it is expected to resume a downward trend and will begin to converge to the 3% target in the third quarter of 2018. However, the fan charts presented within the document show that inflation is likely to close marginally below 6% by 2017. By contrast, the central bank’s estimates that year-end inflation for 2018 will stand below 3%. Among the upside risks for inflation, the central bank highlighted: (1) The probability of second order effects due to an increase in the number and magnitude of observed shocks; (2) the probability of a negative impact on the FX dynamics, as a result of an adverse shock; (3) higher-than-expected pressures on agricultural goods prices; and (4) inflationary pressures stemming from the upward trend in unit labor costs.

**Fan chart: Inflation expectations**



Fuente: Banco de Mexico; 2Q17 QIR

**The effect of the FX depreciation to prices has not drastically changed.** The first “grey box” analyzes the impact of the exchange rate pass-through on prices. The study takes into account two periods, one from Jun’01 to May’16, while the other reaches until May’17. The results of the base model, in which significant variables are used for the Mexican economy, show that there is no considerable change in the degree of the pass-through effect. In addition, other studies were carried out to try to verify the impact of the economic cycle on the pass-through effect, the impact depending on whether there is an appreciation or depreciation, and the asymmetry of a low depreciation environment against a high depreciation setting. In the first case the results were not significant, while in the second study a greater impact is observed when the currency depreciates than when it gains vs. the US dollar. Finally, in the third analysis Banxico found that if there is a difference, but it is not relevant in economic terms.

**The behavior of inflationary shocks has moderated in recent months.** In the second “grey box”, the central bank conducted an analysis of the various shocks to the inflationary process. Four different studies were carried out. The first one shows the variation of generic prices, while the second makes a truncated mean analysis –in which the observations with the greatest variations are excluded–. The third shows the frequency of the increases in prices over time, alluding to a greater impact when there is an increase in frequency, and the fourth shows the correlation between the variations of generic products and services with the headline index. The first one shows that the distribution of the generic products variation has compressed, with a lower mean of the distribution. The second study shows that both the headline index and the non-core index showed a greater impact of increases of a few goods, which would mean the absence of a generalized increase in prices. For the third, a higher frequency of changes was observed at the beginning of the year, consistent with higher inflation. Finally, the fourth study shows that the correlation between the variation of generics and the general index increased at the beginning of the year, but has declined in recent months.

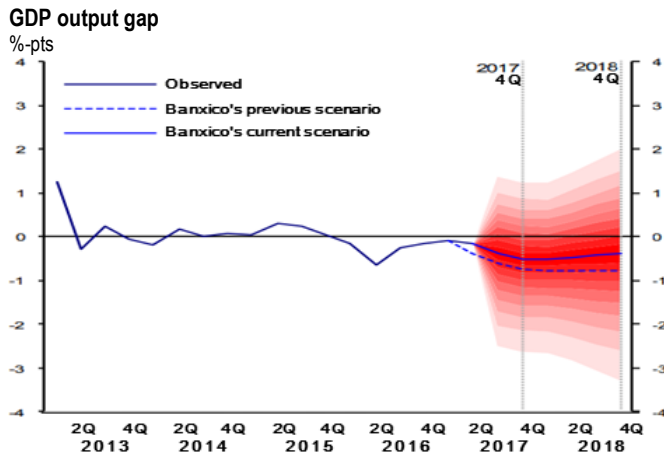
**Higher economic growth forecasts.** The report also highlights that the growth outlook for the Mexican economy has improved. In today’s QIR, the monetary authority stressed that while uncertainty persists over the future of the US-Mexico trade relation, the likelihood of an adverse scenario affecting Mexico’s growth dynamics has diminished. As a result, the central bank revised its estimated growth range for this year between 2% and 2.5% (previous: 1.5%-2.5%, Banorte-Ixe: 1.9%). For 2018, Banxico also revised its growth estimate to a range between 2% and 3% (from 1.7%-2.7%, refer to the tables below). Finally, the output gap projected today by the central bank clearly shows that it will remain in negative territory throughout the next two years. However, Banxico’s central projection suggest that the output gap will narrow at a faster rate (refer to the chart in the next page).

Banxico’s Forecast Recent		
	2017	2018
<b>GDP (%)</b>	2.0 – 2.5	2.0 – 3.0
<b>Employment (thousands)</b>	660 – 760	670 – 770
<b>Trade Balance (bn)</b>	-13.2 (1.2% of GDP)	-12.5 (1% of GDP)
<b>Current account (bn)</b>	-25.0 (2.2% of GDP)	-27.1 (2.2% of GDP)
<b>Inflation</b>		
<b>Headline</b>	Will start a downward trend	Convergence to the 3% target
<b>Core</b>	Above 4%, but below headline inflation	Close to 3%

Source: Banxico

Banxico’s Forecast Previous Quarterly Report		
	2017	2018
<b>GDP (%)</b>	1.3 – 2.3	1.7 – 2.7
<b>Employment (thousands)</b>	580 – 680	620 – 720
<b>Trade Balance (bn)</b>	-10.1 (1% of GDP)	-9.0 (0.9% of GDP)
<b>Current account (bn)</b>	-26.5 (2.7% of GDP)	-27.8 (2.7% of GDP)
<b>Inflation</b>		
<b>Headline</b>	Above the permanent inflation target	Close to 3%
<b>Core</b>	Above the permanent inflation target	Close to 3%

Source: Banxico



**Rate cut in the second half of 2018.** In our view, we expect Banxico to remain on hold for the remainder of the year, as we estimate that inflation will peak in August to then converge to our 6.2% year-end forecast. 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 Banxico has room to reduce the reference rate between 150-200bps over the next two years from which 100bps could take place in 2018.

*From our fixed income and FX strategy team*

**Modest market reaction following Banxico's QIR.** Inflation keeps surprising the market to the upside, maintaining relatively negative dynamics. It is worth noting that analysts have consistently underestimated inflation, suggesting the possibility of upward adjustments in market forecasts in the near future. Moreover, the 3-year breakeven is at 3.61%, below the 12-month average of 3.70%, and  $-0.3\sigma$  of its 3-month MA, suggesting an attractive valuation. Based on our inflation forecasts, 12m carry in UDIS is at 4.76%, significantly higher than consensus, one-year forward inflation of 3.92% (median) according to Banxico's latest survey. On the other hand, the disruptions in crude oil, gasoline and other energy markets following Hurricane Harvey could result in some inflationary pressures ahead, adding to the positive factors for this trade idea commented in previous publications. Taking into account this scenario, we recommend holding the long positions in the 3-year Udibono Dec'20 with entry level of 3.05%, target of 2.90%, stop-loss of 3.15%, and current level of 3.04%. More details in our research note "*We recommend long positions in the 3-year Udibono Dec'20*" [<pdf>](#), published on August 9<sup>th</sup>, 2017.

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