

Ahead of the Curve

August 5, 2016

Market focus this week will on Banxico's monetary policy announcement

- Banxico's monetary policy announcement.** This week, Banxico will hold its sixth policy meeting of the year. The monetary policy communiqué will be published on Thursday (August 11) at 2:00pm (EDT). We believe that board members will remain on hold, leaving the reference rate at 4.25%. However, we expect a hawkish tone in the *communiqué*, in which the central bank will probably emphasize on the following issues: (1) The balance of risks for inflation in the horizon in which monetary policy operates has deteriorated, highlighting the upward trend in core inflation, particularly in merchandises and services prices; (2) the higher probability of financial volatility, given geopolitical risks including the US elections, China's economic and financial situation, and the expectation of further monetary easing from advanced economies; and (3) the lower growth prospects for the Mexican economy, given the lower external demand, the contraction in Mexico's mining sector, and the low public investment levels, reflecting the Federal Government's recent fiscal consolidation efforts
- Industrial production.** On Thursday at 9:00am (EDT), *INEGI* will release its monthly industrial production report. We anticipate a scant 0.7% yoy expansion in total output during June, after the 0.4% increase in the previous month. Taking a look at the breakdown, manufacturing production could post a 1.3% yoy expansion. Moreover, we expect a 4.1% yoy contraction in mining output derived from lower oil production and the reduction in the extraction of other minerals. Finally, we believe that construction output will show a 2.4% increase

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Document for distribution among the general public

Mexico weekly calendar

DATE	HOURL (EDT)	EVENT	PERIOD	UNIT	BANORTE-IXE	CONSENSUS	PREVIOUS	
Tue 9-Aug	9:00am	CPI inflation	July	% m/m	<u>0.27</u>	0.34	0.11	
				% yoy	<u>2.66</u>	2.74	2.54	
				Core	% m/m	<u>0.19</u>	0.20	0.25
				% yoy	<u>3.00</u>	--	2.97	
Tue 9-Aug	10:00am	International reserves	5-Aug	US\$ bn	--	--	177.4	
Tue 9-Aug	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 10y Mbono (Mar'26); 5y Bondes D						
Wed 10-Aug		Wage negotiations	July	%	<u>4.3</u>	--	4.4	
Thu 11-Aug	9:00am	Industrial production (sa)	June	% yoy	<u>0.7</u>	--	0.4	
				% m/m	<u>0.6</u>	--	0.3	
				Mining	% yoy	<u>-4.2</u>	--	-4.7
				Utilities	% yoy	<u>5.8</u>	--	6.2
				Construction	% yoy	<u>2.4</u>	--	2.8
				Manufactures	% yoy	<u>1.3</u>	--	0.8
Thu 11-Aug	2:00pm	Banxico's monetary policy announcement	August		<u>4.25</u>	4.25	4.25	

Source: Banorte-IXE; Bloomberg

Proceeding in chronological order...

Inflation in July will be explained by pressures on non-core prices. On Tuesday, at 9:00am, *INEGI* will release its monthly inflation report. We are forecasting a 0.27 m/m increase in July, below the 0.34% median forecast, according to *Bloomberg's* survey. In the core index, we expect a 0.19% m/m increase (consensus: 0.2% m/m).

Core inflation during the period in question will be explained by pressures on services prices. Our daily price monitoring suggests a greater contribution from housing costs, as well as from other services, particularly coming from tourism services, coupled with higher airfares, given the summer vacations.

For the non-core index, we expect a 0.51% m/m expansion coming from: (1) Higher energy prices, given the 1.5% increase of government-regulated low-grade gasoline price; (2) the 0.6% m/m increase in electricity tariffs; (3) a higher contribution of other government-regulated tariffs given the hike in public transportation services; and (4) lower agricultural goods prices, where we highlight the decline in prices of tomatoes and the “*meat and egg*” sub-index.

With these results, annual inflation should remain around 2.66% yoy in July, above the 2.54% observed in June. Moreover, core inflation will marginally edge up to 3% from 2.97%yoy.

Inflation by components in July

%monthly incidence	Banorte-lxe	2015	Difference
Total	0.27	0.15	0.12
Core	0.15	0.13	0.02
Goods	0.01	-0.02	0.03
Processed foods	0.00	0.02	-0.01
Other goods	0.00	-0.04	0.04
Services	0.14	0.15	-0.01
Housing	0.04	0.03	0.01
Education	0.01	0.01	0.00
Other services	0.09	0.12	-0.03
Non-core	0.12	0.02	0.11
Agriculture	-0.09	0.01	-0.095
Fruits & vegetables	-0.05	0.07	-0.12
Meat & eggs	-0.04	-0.06	0.02
Energy & government tariffs	0.22	0.01	0.21
Energy	0.11	0.01	0.10
Government tariffs	0.11	0.00	0.11

Source: Banorte-lxe 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 (EDT), Banco de Mexico will release its weekly balance report. Last week, net international reserves increased by US\$284mn amounting to US \$177.4bn on July 29. According to Banxico's report, this figure comes mainly as a result of: (1) Dollar sales by Banxico to the Federal Government for US\$72mn; along with a (2) US\$356mn increase due to changes in the valuation of the Central Bank's assets. In this context, the Central Bank has accumulated US\$653mn international reserves this year (please refer to the table below).

Banxico's foreign reserve accumulation details

US\$, million

	2015	29/Jul/2016	29/Jul/2016	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	176,735	177,389	284	653
(B) Gross international reserve	177,597	179,652	627	2,055
Pemex	--	--	428	3,514
Federal government	--	--	-152	1,416
Market operations	--	--	0	-5,562
Other	--	--	351	2,688
(C) Short-term government's liabilities	861	2,263	343	1,403

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 5-year fixed-rate Mbonos (Jun'21), as well as 10-year inflation-linked Udibonos (Dec'25), in addition to the “more traditional” 1-, 3-, and 6- month zero-coupon Cetes (please refer to the table below). The results will be released at 12:30pm (EDT).

Auction specifics (Tuesday, August 9, 2016)

	Maturity	Coupon rate, %	To be auctioned ¹	Previous yield ²
Cetes				
1m	8-Sep-16	--	5,500	4.22
3m	10-Nov-16	--	9,500	4.38
6m	2-Feb-17	--	11,000	4.69
Mbono				
5y	10-Jun-21	6.50	7,500	5.59
Udibonos				
10y	4-Dec-25	4.50	650	2.57

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

July's wage negotiations. On Wednesday, the Ministry of Labor (*STPS*) will make its contractual wage negotiations monthly data available. We anticipate workers to have negotiated an average wage increase of 4.3% in July, in line with the 4.3% average observed in the first half of the year. In this context, we believe that July's figure was mainly driven by the increase in wage negotiations within the syndicates of most of the local governments of Mexico's federal entities, where we highlight the increase of wages for local police forces in Michoacan, Baja California, and Oaxaca.

We expect a 0.7% yoy expansion in June’s industrial output. Next Thursday at 9:00am (EDT), *INEGI* will release its monthly industrial production report. We anticipate a scant 0.7% yoy expansion in total output during June, after the 0.4% increase in the previous month.

Taking a look at the breakdown, manufacturing production could post a 1.3% yoy expansion, explained by: (1) the 0.7% yoy growth in the U.S. manufacturing sector; (2) the 4.1% yoy increase in Mexico’s vehicle production; and (3) the 3.4% reduction in manufacturing exports.

Moreover, the 0.7% yoy increase in industrial output during June will be also explained by the poor performance of mining activity. In this regard, we expect a 4.1% yoy contraction derived from lower oil production and the reduction in the extraction of other minerals. Finally, we believe that construction output will show a 2.4% increase given the moderate expansion in private construction investment projects, coupled with the reduction in public infrastructure, given the recent fiscal cuts announced by the Federal Government.

Industrial production estimates: June 2016

% yoy

%yoy	Jun-16	Jun-15	Jan-Jun, '16	Jan-Jun, '15
Total	0.7	1.2	0.7	1.2
Mining	-4.2	-6.4	-3.6	-6.6
Utilities	5.8	2.1	3.6	4.4
Construction	2.4	2.4	2.5	3.9
Manufacturing	1.3	3.8	1.4	3.1

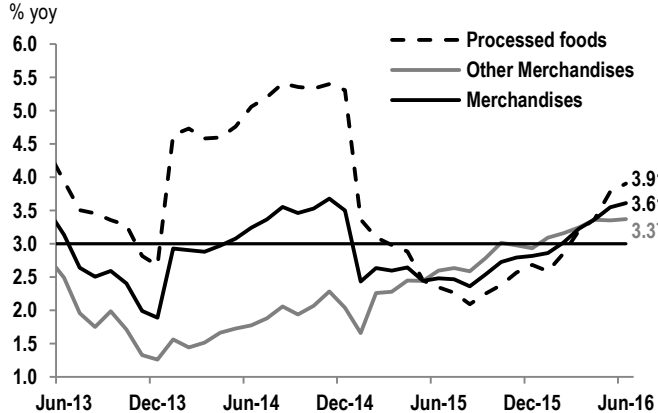
%m/m sa	Jun-16	May-16	Difference
Total	0.6	0.3	0.3
Mining	0.8	-0.5	1.3
Utilities	0.4	1.4	-1.0
Construction	0.2	0.2	0.0
Manufacturing	0.6	0.3	0.3

Source: Banorte-Ixe

Banxico – Setting the table for a September rate hike Finally on Thursday, Banxico will hold its sixth policy meeting of the year. The monetary policy *communiqué* will be published at 2:00pm (EDT). We believe that board members will remain on hold, leaving the reference rate at 4.25%. However, we expect a hawkish tone in the communiqué, in which the central bank will probably emphasize on the following issues: (1) The balance of risks for inflation in the horizon in which monetary policy operates, has continued to deteriorate, highlighting an upward trend in core inflation, particularly in goods and services prices; (2) the higher probability of financial volatility, given geopolitical risks including the US elections, China’s economic and financial situation, and the expectation of further monetary easing from advanced economies; and (3) the lower growth prospects for the Mexican economy, given the lower external demand, the contraction in Mexico’s mining sector, and the low public investment levels, reflecting the Federal Government’s recent fiscal consolidation efforts.

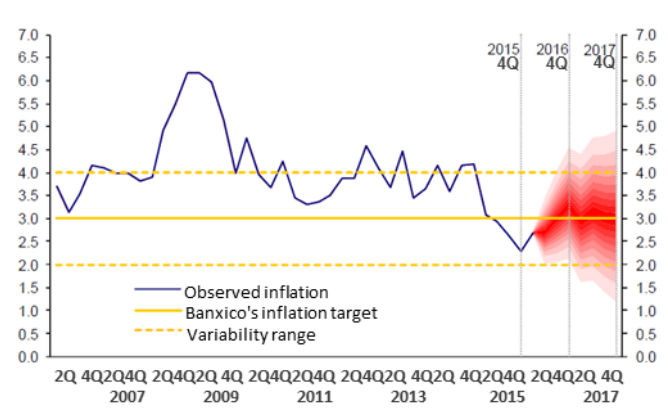
In the first case, even though Mexico’s headline CPI index has remained below Banxico’s 3% target, most of the board members believe that the balance of risks for inflation has deteriorated. In particular, core inflation has maintained an upward trend, where we highlight the recent acceleration in “goods” and “services” prices (refer to the chart on the left). In fact, most of the Board members expressed this concern in the last monetary policy statement. In this context, we believe this week’s monetary policy statement will incorporate Banxico’s concern that there is a possibility that the depreciation of the Mexican currency will exacerbate the growing trend of core inflation, and could affect the trajectory of the non-core sub-index, through energy tariffs, particularly through gasoline prices. However, even though Banxico has expressed a growing concern regarding the deterioration of the balance of risks for inflation, Banxico’s inflation forecast –published in their fan charts–, does not show a significant inflationary risk (refer to the following chart on the right). In this context, we continue to believe that inflation will stand around 3% by year-end.

Inflation: Merchandises and services sub-index (excluding telecomm services)
% yoy



Source: Banorte-ixe using INEGI's figures

Banxico's inflation forecast: Fan Chart
% yoy



Source: Banxico

In regard to the FX volatility, Banxico has strongly emphasized the importance of keeping inflation expectations firmly anchored in line with its 3% target. In fact, most of the board members agreed that the 50bps rate hike in June was justified by the significant depreciation of the Mexican currency, and its potential negative impact on inflation expectations.

In contrast, we believe that Banxico’s perspectives regarding Mexico’s economic growth will be the reason to justify staying put in August. According to *INEGI*’s preliminary GDP report for the second quarter, the Mexican economy grew a scant 2.4%, driven by the slowdown in external demand, coupled with the reduction in public investment given the fiscal consolidation efforts of the Federal Government. However, private consumption has maintained a favorable growth, reflected in the upward trend of retail sales. In the latter aspect, it is likely that the central bank will emphasize again the risk involved in the higher current account deficit, given that its financing structure is highly dependable of short-term capital flows.

Taking into consideration that Banxico has made explicit references to possible geopolitical events that could increase the volatility of financial markets – including the US elections–, but taking also into consideration the deceleration of the Mexican economy, it is likely that the central bank will wait until September to increase the reference, given that this will be the last monetary policy meeting before the US elections. In this regard, we continue to believe that the central bank will increase the reference rate 50bps in September, and then again in December, leaving it at 5.25 % by year-end.

Disclaimer

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