Banxico QR – Retaining a dovish bias on growth with modestly higher inflation

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- **Banxico published today its 4Q19 *Quarterly Report* (QR). The release was accompanied by a press conference by Governor Alejandro Díaz de León**
- **As already previewed by the central bank, growth and inflation forecasts were modified. Specifically:**
  - **(1) Growth for 2020 was revised lower, between 0.5% to 1.5% (mid-point: 1.0%) from 0.8-1.8% (mid-point: 1.3%), in line with market consensus and slightly above our 0.8%**
  - **(2) The forecast range for 2021 GDP was also adjusted downwards, to 1.1-2.1% (mid-point: 1.6%) from 1.3-2.3% (mid-point: 1.8%)**
  - **(3) Average headline inflation is modestly higher, with slight differences relative to our expectations. The path was adjusted up between 10-30bps, although with 1Q20 cut 20bps, to 3.3%. Core inflation was increased only between 10-20bps**
- **Moreover, we highlight that the convergence of inflation to the 3% target was delayed to 1Q21, from 4Q20 previously**
- **The traditional *'grey boxes'* deal with the impact of uncertainty in economic activity, along a study of the 2019 minimum wage increase on prices**
- **In our view, the document has a slightly more dovish tone than the latest communique, reaffirming that Banxico will likely continue easing monetary policy in coming months**
- **We maintain our view of two additional 25bps cuts, in March and May, for the reference rate to end the year at 6.50%. Nevertheless, we recognize risks are skewed towards more easing given a downside bias to growth and the possibility of a less restrictive stance globally due to the "Coronavirus" outbreak**
- **In the aftermath of the QR, we hold our preference for long-term Mbonos**

We consider that the *Quarterly Report* shows a slightly more dovish tone. Banxico published today its *Quarterly Report* (QR) for 4Q19. The release was accompanied by a press conference led by Governor Alejandro Díaz de León. In our view, the tone was slightly more dovish *vis-à-vis* the latest policy communiqué, especially in terms of the short-term inflation outlook and the magnitude of the adjustment lower in the output gap. We were surprised by the 20bps decrease in the forecast for average headline inflation in 1Q20, from 3.5% to 3.3% On the other hand, the path for the remaining part of the estimated horizon was broadly in line with our expectations. Going forward, we believe the key element to gauge the extent of the easing cycle is how much prices could be pressured in coming months. High uncertainty prevails in this front, in a context of higher slack but with risks stemming from other factors, such as unusually benign non-core inflation last year and wage hikes, among the most relevant.

Moreover, risks to the downside for growth, particularly due to the Coronavirus outbreak and the potential response by global central banks, could provide additional room to extend the easing cycle. All in all, we maintain our view of two additional 25bps cuts, in March and May, for a year-end rate of 6.50%. Nevertheless, we recognize risks are skewed towards an even lower rate.

2020 GDP growth cut to the market's consensus. As previewed in the latest monetary policy decision, the estimated range for this year was reduced to 0.5-1.5% y/y (mid-point: 1.0%), from 0.8-1.8% (mid-point: 1.3%). The mid-point is equal to the median in the latest analyst survey by Banxico, although 20bps higher than our 0.8% forecast. For 2021, the range was lowered 20bps, to 1.1-2.1% (mid-point:1.6%), as shown in the tables below. We also highlight that the central bank's estimate of the output gap widened significantly, from -2.8% of potential GDP in the 3Q19 QR (estimated with the information available until then) to -3.3% at the end of the last year. The estimated gap was also extended lower until the end of 2021 (see charts below).

In terms of the balance of risks for growth –which remains to the downside– we should mention the latest communique did not specify them given recent changes to the communication strategy. In that respect, we highlight two notable adjustments relative to the 3Q19 QR, both in this direction. First, they added the possibility of a deceleration in global activity and trade as a result of the Coronavirus outbreak. Second, they eliminated the risk of an extension of the ratification process of USMCA, considering that it has already been approved in Mexico and the US. All in all, it is our take these adjustments show a slightly more dovish tone by the central bank, highlighting the downgrade of growth expectations and the magnitude of the adjustment lower in the output gap, which could translate into lower demand-side pressures for prices.

Banxico's Forecasts
Current Report (4Q19)

	2020	2021
GDP (% a/a)	0.5 – 1.5	1.1 – 2.1
Employment (thousands)	440 – 540	470 - 570
Trade Balance (bn)	-5.9 (0.4% of GDP)	-13.5 (1.0% of GDP)
Current account (bn)	-11.6 (0.9% of GDP)	-20.6 (1.5% of GDP)

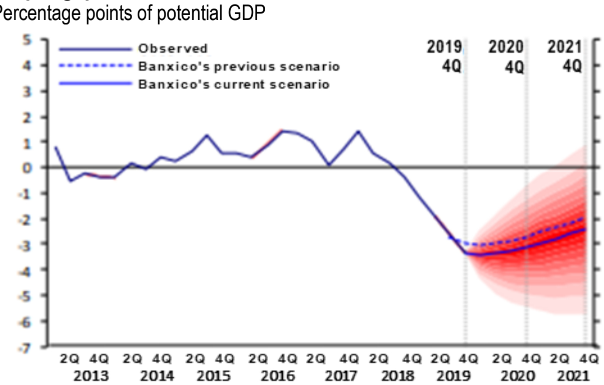
Source: Banxico

Banxico's Forecasts
Previous Quarterly Report (3Q19)

	2019	2020	2021
GDP (% a/a)	-0.2 – 0.2	0.8 – 1.8	1.3 – 2.3
Employment (thousands)	300 – 370	500 – 600	510 – 610
Trade Balance (bn)	-0.2 (0.0% of GDP)	-10.9 (0.8% of GDP)	-15.6 (1.1% of GDP)
Current account (bn)	-5.8 (0.5% of GDP)	-18.1 (1.4% of GDP)	-23.7 (1.7% of GDP)

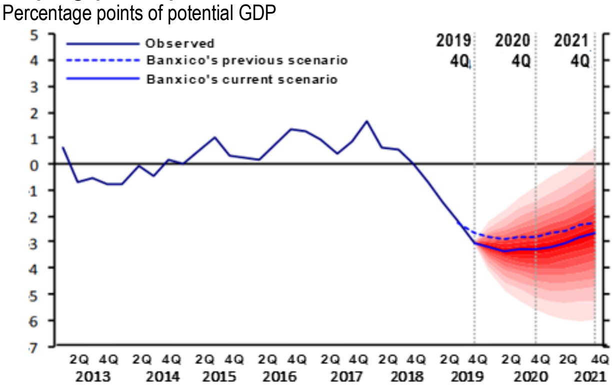
Source: Banxico

Output gap
Percentage points of potential GDP



Source: Banco de Mexico; 4Q19 QR

Output gap ex oil production
Percentage points of potential GDP



Source: Banco de Mexico; 4Q19 QR

Short-term inflation down, with the medium- and long-term trajectory slightly higher. As mentioned, we were surprised by the 20bps reduction in average headline inflation estimate for 1Q20, particularly as the communiqué only alluded to an upward adjustment due to recent price dynamics. However, the rest of the forecast horizon was moved higher and broadly in line with our expectations. The steepest changes are concentrated this year, with the maximum revision (+30bps) taking place in 3Q20. In this sense, convergence towards the target was pushed one quarter, from 4Q20 to 1Q21. The path for core inflation was also revised up –although by a lower degree– with the highest increase of +20bps in 1Q21 (see tables and charts below).

Nevertheless, the balance of risks remains characterized as uncertain, albeit with some changes relative to the statement, including: (1) A perceived lower relevance of an appreciation of the Mexican currency, which might be associated to its most recent performance; and (2) further details about the possible upward risks from both wages and the exchange rate, which we believe were not fully explained yet.

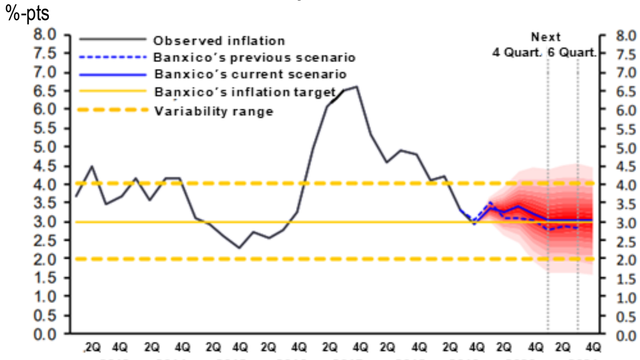
Broadly speaking, the main driver behind our perception of a slightly more dovish tone is the cut to the 1Q20 inflation estimate, as the more modest view on growth was already anticipated. We believe this suggests the inflation outlook is conducive for the monetary authority to continue its easing cycle, although adding some downside risks to our current estimate of a year-end rate of 6.50%.

CPI forecasts
% y/y, quarterly average

	2019	2020				2021			
	IV	I	II	III	IV	I	II	III	IV
CPI									
Current forecast	2.9*	3.3	3.3	3.4	3.2	3.0	3.0	3.1	3.0
Previous forecast	3.0	3.5	3.1	3.1	3.0	2.8	2.9	2.9	--
Core									
Current forecast	3.6*	3.6	3.3	3.2	3.0	2.9	2.9	2.9	2.9
Previous forecast	3.6	3.6	3.2	3.1	2.9	2.8	2.9	2.9	--

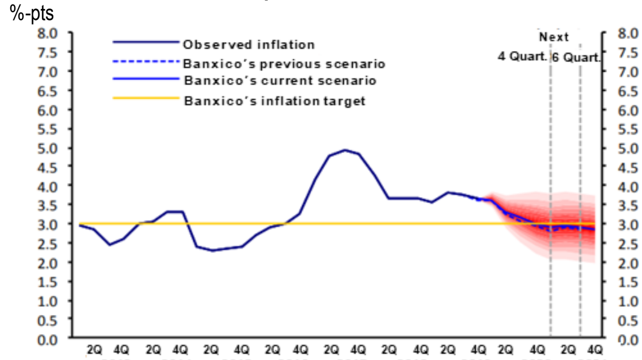
Source: Banco de México, 4Q19 QR; *Observed data

Fan chart: Headline inflation expectations
%-pts



Source: Banco de Mexico; 4Q19 QR

Fan chart: Core inflation expectations
%-pts



Source: Banco de Mexico; 4Q19 QR

Relevant takes on uncertainty and inflation in the *grey boxes*. In this report, Banxico presented four research notes, focused on (1) Investment and uncertainty in developed economies; (2) the impact of uncertainty on consumption and investment in Mexico; (3) inflation indicators related to supply-side factors; and (4) the impact of the 2019 minimum wage increase on prices. We focus on points (2) and (4).

In the former, the central bank constructs a *Macroeconomic Uncertainty Index* using an external methodology, which then is used as a key input in a VAR model to estimate its impact on both consumption and investment. Other control variables used include the Fed funds rate, nominal exchange rate, GDP monthly proxy (IGAE), consumption or investment (depending the case) and the CETES rate. The investment model also includes public investment as an additional control variable. Both models conclude that the variable with the most impact is uncertainty, which leads the monetary authority to state that certainty is key to boost economic growth.

On the latter, Banxico conducted an analysis to differentiate the impact in 2019 from the minimum wage hike in the northern border (100%) and in the rest of the country (16.2%). This helps isolate the marginal effect of this increase on prices. They found out that the total contribution from the one-time impact of these adjustments is close to 42bps at the national level. Out of these, 8bps correspond to the northern border, while 33bps can be attributed to the remainder of the country. However, the central bank noted these estimations are surrounded by a relatively high degree of uncertainty, as they have different assumptions regarding the behavior of some components within CPI, as well as the cyclical position of the economy. Although we believe the study is very valuable given the current backdrop of above average increases in the minimum wage, it should be taken with caution due to the significant number of assumptions needed to reach the final estimate of the effect of this increase in inflation.

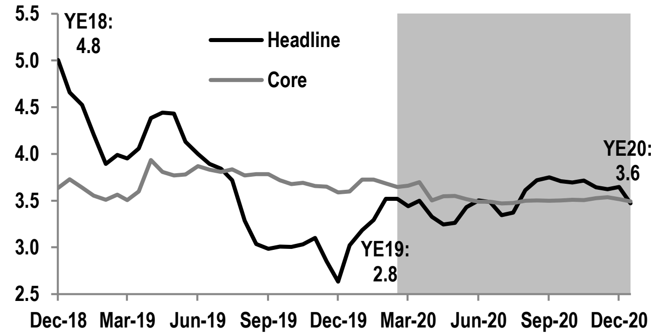
We maintain our view that Banxico will cut by an accumulated 50bps in 2020. We reiterate our call of two 25bps cuts in each of the following policy meetings, to be held on March and May. Nevertheless, today's report inserts some risks that may support additional easing. In particular: (1) The magnitude of the estimate of the output gap, reaching levels not seen since the Financial Crisis and below -3.0%, and: (2) more benign inflation dynamics at the start of the year as suggested by the downward revision to headline inflation in 1Q20. Moreover, the fact that disruptions because of the Coronavirus outbreak are still ongoing, while some global central banks investigating possible options in terms of further easing, may provide more room for Banxico to do the same. In this respect, it should be mentioned that the central bank decoupled from the Fed in late 2019, stating instead that they will continue monitoring their relative policy stance. Despite of the latter, our inflation forecasts anticipate it staying higher than those of the central bank (see table and chart below), not allowing them to continue easing beyond what we estimate in order to protect their credibility. Factoring this, and the prudent stance that we have perceived from the majority of the Board, we maintain our forecast for a year-end reference rate of 6.50%.

Inflation forecasts
% y/y, quarterly average

	1Q20	2Q20	3Q20	4Q20
Banorte				
Headline	3.4	3.4	3.6	3.6
Core	3.7	3.5	3.5	3.5
Banxico				
Headline	3.3	3.3	3.4	3.2
Core	3.6	3.3	3.2	3.0

Source: Banxico, Banorte

2020 Inflation forecasts
% y/y, bi-weekly frequency



Source: INEGI, Banorte

From our fixed income and FX strategy team

In the aftermath of the QR, we hold our preference for long-term Mbonos. Banxico adjusted its growth and inflation forecasts as anticipated in its previous communications, depicting a slightly more dovish bias. Meanwhile, foreign conditions have triggered a rather significant rally in sovereign bonds, a reflection of heightened uncertainty about the Coronavirus. Thus, the 10-year US Treasury note is trading close to historic lows at 1.30%, with the entire curve rallying ~16bps month-to-date. This context has benefited local fixed-income securities, as Mbonos have rallied ~11bps in February. In our view, this inertia will continue favoring their mid-term performance, although we stress an expensive valuation for the short-end which is currently pricing-in accumulated rate cuts by Banxico during 2020 of 94bps. In this sense, we see higher value in long-term Mbonos, highlighting the Nov’38 and Nov’42 maturities. In real rates and after taking profits in two long-Udibono trade ideas (Jun’22 and Nov’28) we suggest limiting exposure in these securities considering a carry that will become less attractive in coming months, joining PPI dynamics that have displayed a downward trend.

Pushed by higher risk premium on the back of escalating uncertainty due to the virus, the Mexican peso has depreciated to its weakest since December, pairing the rally that just a week ago was still positioning it as the strongest currency among main crosses. Trading at 19.21 per dollar, and in spite of its appealing implied rate, the peso has revealed itself as not immune to risk aversion shocks, scoring a 3.8% sell-off from its strongest level of 18.52 on February 17th. We acknowledge a relevant technical figure at 19.20 (200-day MA) which is close to a cluster of short-term option expirations with strikes at 19.25. However, we do not rule out additional weakening in this volatility regime, opening room for price action with further support at USD/MXN 19.30.

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We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Tania Abdul Massih Jacobo, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo, Jorge Antonio Izquierdo Lobato and Eridani Ruibal Ortega, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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