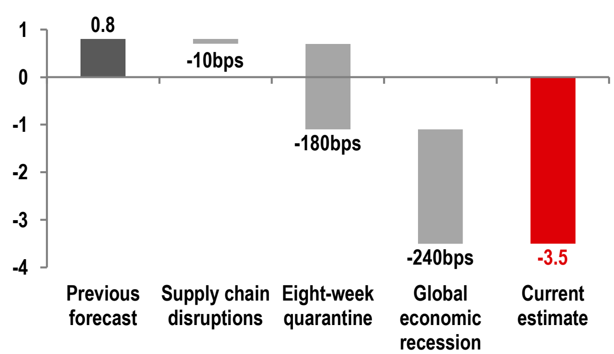
The economic consequences of COVID-19 in Mexico

- **The world is experiencing very turbulent and highly uncertain times**
- **We update our 2020 macroeconomic framework for year 2020**
- **Our research team now estimates a contraction of GDP in Mexico of 3.5% in 2020, assuming a 2.3% decline in the US this year**
- **We anticipate a USD/MXN exchange rate of 22.00 for year-end 2020, while we keep our annual CPI inflation forecast at 3.6%**
- **It is now our take that Banxico will cut the reference rate all the way down to 5.50% this year**

Turbulent and highly uncertain times. Forecasting economic variables is usually a very hard job, and it is even harder during highly turbulent and uncertain times, like the ones the world is experiencing today. However, with the information we have available today, we update our macroeconomic framework for year 2020, and provide our forecasts for year 2021, as well. Even though we were indeed anticipating a global economic recession, we were not expecting it until year 2021. It all seems now the new Coronavirus is bringing the global recession forward this year.

Macroeconomic framework update. Even though we had a high degree of conviction in our 0.8% GDP forecast for year 2020 in Mexico, the COVID-19 pandemic –which arrives at a time of global economic cycle exhaustion– will have a significant impact on the global economy. In this context, we now anticipate a contraction of GDP in Mexico of 3.5% this year, assuming a 2.3% decline in US GDP. In the chart below on the left, we depicted the three underlying reasons why we are revising our forecast downwards: (1) A global supply chain disruption, already happening; (2) an eight-week full quarantine in Mexico; and (3) an impact of a global economic recession, in several aspects, similar to the one in the Global Financial Crisis (GFC) back in 2008-2009. In the table on the right, we update our USD/MXN, CPI inflation, and monetary policy reference rate projections for year-end 2020, and 2021.

GDP estimate for 2020
% y/y, contributions to the annual change in basis points



Source: Banorte

Macroeconomic forecasts for 2020 and 2021

Variable	2020 Current	2020 Previous	2021 Current
US GDP (% y/y)	-2.3	1.8	1.5
Mexico GDP (% y/y)	-3.5	0.8	1.0
Mexican peso (USD/MXN)	22.00	19.80	21.00
Inflation (% y/y)	3.6	3.6	4.2
Reference rate (%)	5.50	6.50	5.00

Source: Banorte

March 20, 2020

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Gabriel Casillas
IRO and Chief Economist
gabriel.casillas@banorte.com

Alejandro Padilla
Executive Director of Economic Research and Financial Markets Strategy
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA
Director of Economic Research
juan.alderete.macal@banorte.com

Francisco Flores
Senior Economist, Mexico
francisco.flores.serrano@banorte.com

COVID-19 and the shape of recovery. The duration and depth of the recession is quite unclear yet. More so because there is no perfect foresight about how fast COVID-19 spreads in different countries, with different public health policy responses. As a result, we do not know if the world will face a V-shaped or an L-shaped recovery. The L-shaped recovery happens when consumers and businessmen decide not to purchase or invest in certain goods or services, once the shock is over, if economic perspectives ahead are not rosy. It is likely that the US will face a V-shaped recovery, particularly because of the plethora of adjustment measures that both, the US government, and the US Fed are implementing. Nevertheless, even though these policies will help the world economy and the Mexican economy to recover, the lack of fiscal and monetary policy space in Mexico will probably not foster such a vigorous recovery. In this context, we are forecasting GDP growth of 1% in year 2021.

An optimistic appraisal of economic growth in the light of the GFC? GDP in Mexico registered a contraction of 5.3% in year 2009, while US GDP fell 2.5%. So, the question is why we are projecting a -3.5% growth forecast for this year in Mexico, while we are forecasting -2.3% GDP growth in the US. Should not be a number closer to -5%, given what happened back in 2009? In our view, the answer is no because of three important differences now *vis-à-vis* the GFC: (1) We are not anticipating massive banking failures in any advanced economy this time, as it happened back in 2008-2009; (2) GDP in Mexico and the US are not as highly correlated as they used to. In other words, the correlation between GDP of the two countries was 0.88 in the 2001-2019 time period. This came down to 0.06 in the 2010-2019 timespan, despite there is no doubt that both countries are highly integrated, particularly in the manufacturing sector; and (3) the Mexican economy has already suffered a considerable deceleration since year 2018. These abovementioned factors are the underlying reasons why we believe Mexico GDP growth has a limited downside this year, *vis-à-vis* the GFC.

Exchange rate and inflation. In our view, USD/MXN exchange rate is currently far away from our country's macro fundamentals. Our long-term equilibrium models suggest that it should be closer to the 21-22 pesos per US dollar interval. This is why we are forecasting this relative price to gradually go back to the aforementioned levels, to reach 22.00 pesos per dollar by year-end 2020, and 21.00 by YE21. Shifting gears to inflation, we keep our 3.6% 12-month CPI inflation projection unchanged for the end of this year, mainly explained by two factors: (1) Even though the peso depreciation adds pressure to several important CPI components, we believe the exchange rate passthrough to inflation has declined significantly compared to the nineties or even with respect to the beginning of this century (please see the gray box on the right). Therefore, we estimate an impact of 35 basis points (bps) to headline inflation; however, (2) energy prices have plummeted. Nobody really knows how long this situation will hold. However, we see not much upside risks, given the recessionary environment the world is currently living. This, in our view, will subtract 35pbs from headline inflation, allowing us to leave our 3.6% forecast unchanged. Going forward, we expect inflation to end 2021 at 4.2%, mainly explained by a base of comparison effect.

Lower FX-inflation passthrough

We have not only observed that the FX-inflation passthrough in Mexico has been declining since year 2004. We have studied this phenomenon, thoroughly and arrived at the following general conclusion. In the nineties up to year 2004, a 10% depreciation of the peso *vis-à-vis* the US dollar had an impact of 100bps on headline inflation. This happened in a three-month timespan, and economic activity did not matter at all. Nevertheless, after year 2004, the very same 10% depreciation of the peso vs dollar has had an impact of only 25bps on headline inflation, distributed in a nine-month time span, and economic activity matters in terms of the magnitude of the passthrough.

Monetary policy call. In an environment observing a significant GDP contraction and local currency depreciation *vis-à-vis* the US dollar, but with controlled inflation, we expect *Banco de México* to continue cutting the reference rate by 100bps this year (in addition to what they did today in an intra-meeting fashion), taking it all the way down to 5.50% by year-end. This is an important change to our monetary policy call, as we were previously expecting the reference rate to end this year at 6.50%, today's current level. It is our take that the monetary policy committee will do as much as they can to help the Mexican economy to adjust to the current global shock, in a scenario of moderate inflation, not allowing the exchange rate to deviate much from its longer-term macro fundamentals, particularly in episodes of low liquidity.

Analyst Certification

We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Luis Leopoldo López Salinas, Jorge Antonio Izquierdo Lobato, Eridani Ruibal Ortega and Leslie Thalía Orozco Vélez, 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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GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy			
Gabriel Casillas Olvera	IRO and Chief Economist	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Economic Research and Financial Market Strategy			
Alejandro Padilla Santana	Executive Director of Economic Research and Financial Markets Strategy	alejandro.padilla@banorte.com	(55) 1103 - 4043
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251
Economic Research			
Juan Carlos Alderete Macal, CFA	Director of Economic Research	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Francisco José Flores Serrano	Senior Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Katia Celina Goya Ostos	Senior Economist, Global	katia.goya@banorte.com	(55) 1670 - 1821
Luis Leopoldo López Salinas	Economist, Global	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
Market Strategy			
Manuel Jiménez Zaldívar	Director of Market Strategy	manuel.jimenez@banorte.com	(55) 5268 - 1671
Fixed income and FX Strategy			
Santiago Leal Singer	Senior Strategist, Fixed Income and FX	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Strategist, Fixed Income and FX	leslie.orozco.velez@banorte.com	(55) 5268 - 1698
Equity Strategy			
Marissa Garza Ostos	Director of Equity Strategy	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Senior Strategist, Equity	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Senior Strategist, Equity	valentin.mendoza@banorte.com	(55) 1670 - 2250
Víctor Hugo Cortes Castro	Senior Strategist, Technical	victorh.cortes@banorte.com	(55) 1670 - 1800
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
Eridani Ruibal Ortega	Analyst	eridani.ruibal.ortega@banorte.com	(55) 1103 - 4000 x 2755
Corporate Debt			
Tania Abdul Massih Jacobo	Director of Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248
Economic Studies			
Delia María Paredes Mier	Executive Director of Economic Studies	delia.paredes@banorte.com	(55) 5268 - 1694
Miguel Alejandro Calvo Domínguez	Senior Analyst, Economic Studies	miguel.calvo@banorte.com	(55) 1670 - 2220
Wholesale Banking			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(81) 8319 - 6895
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Commercial Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454