Ahead of the Curve

Banxico to cut by 50bps to 5.50%, with a dovish tone albeit staying prudent

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

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

- **Banxico's monetary policy decision (May 14).** We forecast another 50bps rate cut, taking the reference rate to 5.50%, in line with consensus. While we expect a unanimous vote, we do not rule out a dissenter pushing for even more easing. Considering the relative proximity of the last decision –on April 21st– and the minutes released this week, we do not expect significant changes in either the tone –which should remain dovish with prudence– or on the assessment about the economic outlook. We maintain our expectation of an additional 75bps decrease on the June 25th decision, following this cut. Nevertheless, and considering highly changing conditions, we do not rule out another intra-meeting action, bringing forward the latter decision. In either scenario, this would take the reference rate to 4.75%, where we expect it to close this year.

- **Industrial production (March).** We anticipate a 7.6% y/y contraction, surpassing the -6.0% implied in 1Q20 GDP preliminary figures. Monthly dynamics will be affected by the Coronavirus, both via supply chain disruptions as well as reduced activity and factory closures due to social distancing measures. With seasonally adjusted figures, we expect a 3.6% m/m decline. Mining would climb 1.8% y/y (-0.8% m/m), benefited by higher oil production but dragged by the rest of the sectors. In construction, we estimate a steep 16.1% y/y contraction (-6.8% m/m), the hardest hit sector in the month on the retracement from the private-sector and limited support from the public branch. In manufacturing, we forecast a 7.3% y/y decline (-4.0% m/m), with heavy losses especially in the auto sector

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Mexico weekly calendar

DATE	TIME (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 12-May	**7:00am**	**Industrial production**	March	% y/y	-7.6	--	-1.9
		sa		% m/m	-3.6	--	-0.6
		Mining		% y/y	1.8	--	5.5
		Utilities		% y/y	-2.5	--	1.6
		Construction		% y/y	-16.1	--	-9.1
		Manufacturing		% y/y	-7.3	--	-1.0
Tue 12-May	**10:00am**	**International reserves**	May-8	US$ bn	--	--	186.7
Thu 14-May	**2:00pm**	**Banxico's monetary policy decision**	May	%	5.50	5.50	6.00

Source: Banorte; Bloomberg

Proceeding in chronological order...

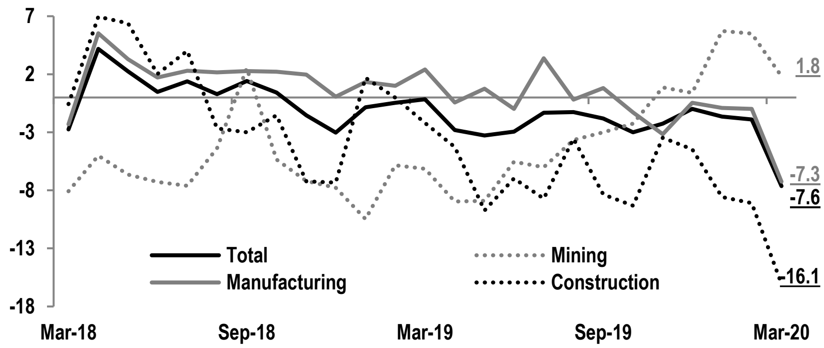
Industrial production to fall steeply as COVID-19 started taking a toll on the economy in March. We anticipate a 7.6% y/y contraction, surpassing the 6.0% decline implied in 1Q20 GDP preliminary figures. In particular, and despite having an additional day in the annual comparison, monthly dynamics will be affected by the Coronavirus, both via supply chain disruptions as well as reduced activity and factory closures due to social distancing measures. In seasonally adjusted terms, we expect a 3.6% m/m decline. Although this would be bleak enough, we forecast additional weakness ahead, as the effects from the fight against the outbreak became more dire in April and so far in May.

On a sector-by-sector basis, mining would climb 1.8% y/y, still benefited by higher oil output. In this sense, domestic oil production reported by the CNH, which aggregates output from Pemex and private firms, edged-up 3.6% y/y, while gas production increased 1.9%. Nevertheless, non-oil mining as well as services to the sector would be a drag, impacted by reduced activity. In this regard, the sector would exhibit a 0.8% m/m contraction.

In construction, we estimate a steep 16.1% y/y contraction (-6.8% m/m). We believe this sector will be the hardest hit in the month, especially as it already came from a weak spot (-9.1% y/y in February). Despite private sector works being halted in some states towards the end of the month –or even at the start of April, as in Mexico City–, we believe the impact started previously, as distancing measures were beginning to be enacted. In this respect, it is our take that an additional shock came from market developments, which were already highly pressured and very volatile, as this sector typically requires high amounts of financing. Moreover, business confidence for the sector plunged in March, reaching (by then) a new historical low. On the contrary, some limited support might come from the public sector, as physical investment by the Federal Government increased 34.2% y/y in real terms. Nevertheless, the latter will not be enough to compensate for the broader deceleration, as this category was already weak despite higher spending.

Finally, in manufacturing, we estimate a 7.3% y/y decline (-4.0% m/m). While IMEF's manufacturing PMI showed a relatively moderate fall of 2.8pts to 44.2pts, its composition was considerably worse. Specifically, the production component came in at 35.5pts (-11.8pts relative to February), lowest in the historical series at the time. Moreover, manufacturing output in the US declined 6.5% y/y. This seems to have had a limited knock-on effect on our country's manufacturing exports, as they only declined 0.1%. However, and much more related to performance in the US, auto plant shutdowns that started since mid-March resulted in a 24.6% decline in auto production. Lastly, we observed a net loss of 25,681 formal jobs in the sector, which was even weaker than in the worst month of 2009, when it reached -23,214 posts.

Industrial production
% y/y



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves increased by US$185 million, closing at US$186.7 billion. According to Banxico's report, this was mainly due to: (1) US$350 million from dollar sales to the central bank from Pemex; and (2) a positive valuation effect in institutional assets of US$177 million. In this context, the central bank's international reserves have increased by US$5.8 billion during 2020 (please refer to the following table).

Banxico's foreign reserve accumulation details
US$, million

	2019	Apr 30, 2020	Apr 30, 2020	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	180,877	186,655	527	5,778
(B) Gross international reserve	183,028	196,146	5,929	13,118
Pemex	--	--	0	2,134
Federal government	--	--	5,710	7,060
Market operations	--	--	0	0
Other	--	--	218	3,924
(C) Short-term government's liabilities	2,151	9,490	5,402	7,340

Source: Banco de México

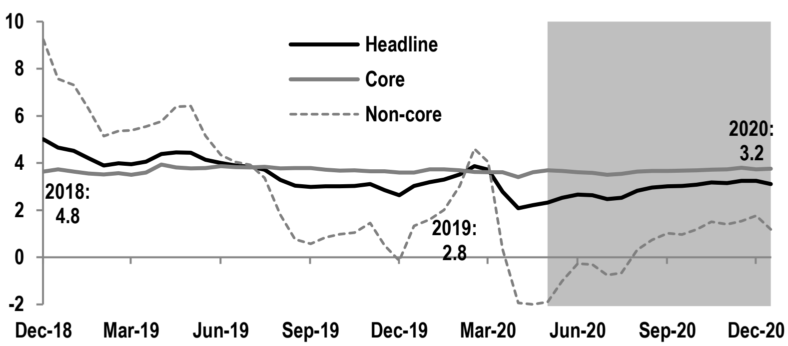
We expect another 50bps rate cut from Banxico. On Thursday, the central bank will carry out its fourth monetary policy meeting of the year, albeit being only the second one in its original schedule. We expect another 50bps rate cut –being the third one of this magnitude in 2020–, taking the reference rate to 5.50%. We expect the vote to be unanimous, as in the previous meeting, although we do not rule out a dissenter pushing for even more easing, as we identified at least one member strongly favoring further accommodation in the latest minutes. Considering the relative proximity of the last decision –on April 21st– and the minutes released this week, in either the tone –which should remain dovish with prudence– or on the assessment about the economic outlook.

On growth, we expect remarks on 1Q20 GDP print, which showed a meaningful contraction due to weakness in March. Nevertheless, we think the most relevant comments will be about the scenario looking forward, particularly if there is more insight on possible changes to Banxico's estimate for this year –to be officially published in the 1Q20 *Quarterly Report,* on May 27th–. In this regard, our GDP forecast of -7.8% y/y is broadly in line with the market, both in Banxico (-7.1%) and *Citibanamex* (-7.5%) surveys.

There could also be comments about employment, as April's figures for the formal sector will be known by the time of the meeting. On the output gap, the expectation is for it to have fallen deeper into negative territory.

Regarding inflation, dynamics in April were still favorable, with the headline at 2.15% y/y, second lowest in history. The core component came in at 3.50%, lowest since December 2016. Non-core inflation furthered its decline at -1.96%, a new historical low by a wide margin. In this context, members keep discussing about offsetting factors, both to the upside (*i.e.* FX passthrough and supply chain disruptions) and to the downside (*i.e.* lower energy prices and higher slack), and their different dynamics in terms of time lags. Nevertheless, those to the downside have gathered short-term momentum, as portrayed in the minutes. Considering this, the balance of risks might actually tilt to the downside, at least in the short term. Despite of this, we believe they will still recognize the high degree of uncertainty that prevails in the medium- and long-term. We believe that a combination of more challenging base-effects later in the year, price adjustments as activity comes back online, and the impact from exchange rate passthrough could drive inflation higher, closing 3.2% by the end of the year.

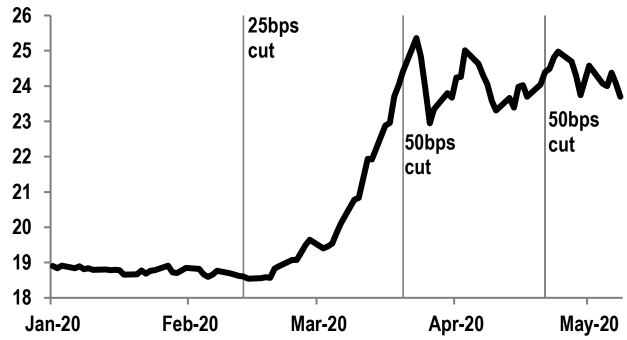
Inflation forecast
% y/y, bi-weekly frequency



Source: Banorte

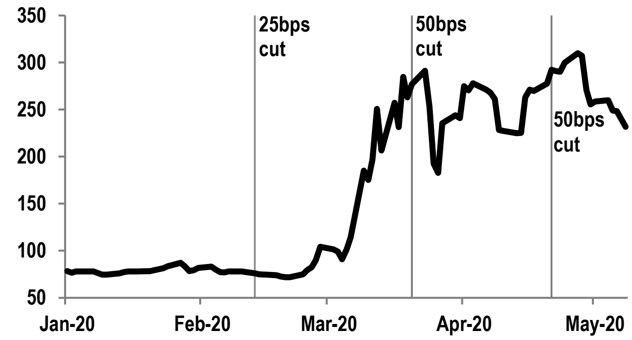
On market developments, since the last meeting the Mexican peso has remained in a high volatility regime. Just in this short time period, the USD/MXN was close to 24.30 per dollar at the time of the last meeting, reaching as high as 24.98 (on a closing basis), with the lows seen today at around 23.70 (see chart below on the left). Nonetheless, in absolute levels it remains very high relative to the start of the year. Local rates have fallen strongly across all tenors in the same timeframe. In this sense, we believe operating conditions have improved at the margin, as also suggested by gauges of short-term volatility in global markets such as VIX and implied FX vols. The central bank is likely still watching carefully these dynamics, despite arguments in the minutes that the level of the reference rate and its spread to the *fed funds* rate might not be very helpful to influence the exchange rate in current market conditions. On the other hand, while measures of risk-premia, such as Mexico's 5-year CDS, have improved in the same time span, its levels also remain very elevated (see chart below on the right). Considering this, as well as other factors such as recent credit rating downgrades, the majority of Banxico members will likely keep favoring a prudent and cautious stance.

Mexican peso
USD/MXN



Source: Bloomberg

Mexican 5-year CDS
Bps



Source: Bloomberg

We maintain our expectation of an additional 75bps decrease on the June 25th decision following this cut. Nevertheless, and considering highly changing conditions, we do not rule out another intra-meeting action, bringing forward the latter decision. In either scenario, this would take the reference rate to 4.75%, where we expect it to close this year. In particular, we do not see further cuts from that point forward as it is our take that higher risk premia will prevent Banxico from further easing, as cutting rates too much could increase risks to financial stability.

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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 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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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		(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
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