Ahead of the Curve

Banxico to stay dovish after strong revisions to 2020 GDP and inflation in the Quarterly Report

- **Banxico's Quarterly Report and Minutes.** In the former, attention will center on updated estimates for GDP and inflation, which will be very important given high levels of uncertainty. We will also watch comments about financial stability, probably explained with greater depth within the minutes. On growth, we estimate that the mid-point of the range for 2020 will be reduced between 800 and 850bps, standing between -7.0% and -7.5%. Regarding inflation, we expect strong revisions in the short-term outlook, especially in 2Q20 (to 2.4%-2.5%) and 3Q20 (to 2.6%-2.7%). For 2021, we see modest adjustments higher, which will be even more interesting as they will transmit more clearly which factors could be having a greater impact on the bank's expectations. Overall, these documents will maintain a dovish tone, signaling Banxico's disposition to continue lowering the reference rate. We maintain our expectation of two additional 50bps cuts in the upcoming two decisions, in June and August. This would take the reference rate to 4.50%, where we expect it to remain by year-end. On the specific timing, we do not rule out these could be earlier, in another intra-meeting decision.

May 22, 2020

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Winners of the award for best economic forecasters for Mexico in 2019, granted by *Refinitiv*

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Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 25-May	**7:00am**	**Trade balance**	April	US$ mn	2,653.8	--	3,391.8
		Total exports		% y/y	-32.7	--	-1.6
		Oil exports		% y/y	67.0	--	-47.1
		Non-oil exports		% y/y	-30.6	--	1.3
		Total imports		% y/y	-37.3	--	-6.7
Mon 25-May	**10:00am**	**Current account**	1Q20	US$ mn	--	--	2,486.0
Tue 26-May	**7:00am**	**GDP**	1Q20 F	% y/y	-1.5	-1.6	-1.6
		sa		% q/q	-1.5	-1.7	-1.6
		Primary activities		% y/y	0.5	--	1.5
		Industrial production		% y/y	-2.9	--	-3.2
		Services		% y/y	-1.0	--	-0.9
Tue 26-May	**7:00am**	**Economic activity indicator**	March	% y/y	-2.9	-4.5	-0.6
		sa		% m/m	-1.5	-4.3	-0.2
		Primary activities		% y/y	10.0	--	-8.4
		Industrial production		% y/y	-5.0	--	-1.9
		Services		% y/y	-2.7	--	0.4
Tue 26-May	**10:00am**	**International reserves**	May-24	US$ bn	--	--	186.9
Wed 27-May	**1:30pm**	**Banxico's Quarterly Report**	1Q20				
Thu 28-May	**10:00am**	**Banxico's minutes**					
Fri 29-May	**10:00am**	**Commercial banking credit**	April	% y/y	8.9	--	7.0
		Consumption		% y/y	-0.5	--	0.0
		Mortgages		% y/y	5.7	--	6.2
		Corporates		% y/y	13.2	--	10.0
Fri 29-May	**3:30pm**	**Budget balance (as measured by PSBRs)**	April	MXN bn	--	--	-49.7

Source: Banorte; Bloomberg

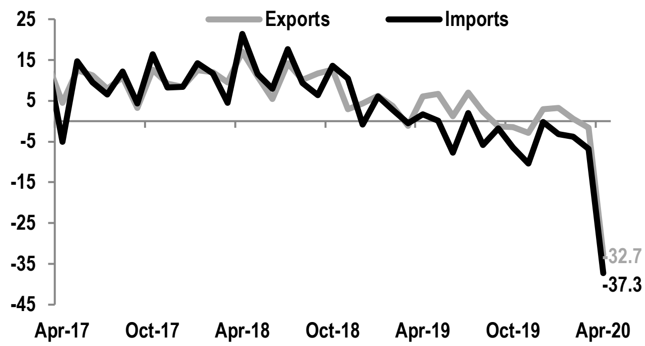
Proceeding in chronological order...

Trade to fall more steeply in April. We estimate a US$2,653.8 million surplus, which if it materializes would be its third consecutive month in positive territory. Similar to March, this should not be interpreted as positive as it is highly likely that we will see an even higher downfall in volumes due to the suspension of activities in a plethora of industries due to COVID-19. Specifically, we anticipate a strong contraction in both exports (-32.7% y/y) and imports (-37.3%). The sum of these components –typically used as a measure of trade openness– would reach slightly more than US$50 billion, which represents a 34.9% y/y decline.

We anticipate the steepest fall in oil, with a US$1,247.1 million deficit. It should be remembered that the price of the Mexican oil mix plunged during the period, averaging 12.23 US$/bbl and even printing negative one day (April 20th). This represents an 80.8% y/y contraction, which would be partially compensated by higher volumes. In particular, we estimate a 67.0% decline in exports, with crude oil at -69.7%. In imports we would also observe an unprecedented decline (-54.1%), both in consumption goods –affected by lower mobility that cut gasoline demand, which according to Pemex fell 72% in the period– and intermediate goods. Our monitoring showed higher volumes, implying an accumulation of inventories. The price in the US declined about 67%. Going forward, we expect results to stay very weak on low prices (despite a slight improvement since the minimum on April 20th), the OPEP+ agreement which takes effect in May and June, and the closure of some new wells, among the main factors.

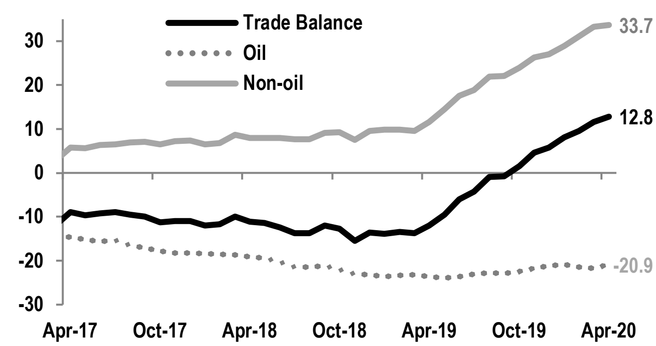
The non-oil balance would exhibit a US$3,900.9 million surplus, with exports falling 30.7% and imports -35.1%. The most affected sector would be autos within manufacturing as practically all Mexican and US plants closed and/or cut operations. According to AMIA, only 27,899 vehicles were sent abroad, a historic decline of 90.2% y/y. In the US, the sector plunged 70.9% according to the industrial production report. Hence, we estimate a 61.6% y/y contraction, partially compensated by auto parts. Another heavily impacted industry was non-oil mining, which had to stop operations as they were not considered essential. Other manufacturing would also dip, albeit less in relative terms (-14.1%). This is consistent with other data in the US, such as those from home appliances and food, along the imports' component within the ISM manufacturing which increased to 42.7pts from 42.1 in March, improving at the margin but with three months in a row in contraction. Nevertheless, and on the contrary, the PMI declined strongly. We believe imports will be very affected by the depreciation of the Mexican peso, averaging 24.26 per dollar (27.8% y/y). The most relevant decline would be on capital goods (-47.8%) as they are more closely related to investment and durables. Intermediate goods would fall 34.5%, maintaining their strong correlation with manufacturing although noting that a relevant share comes from China, which started to reactivate by late March. Lastly, consumption goods would fall 28%, more modest as these purchases are more difficult to substitute or delay.

Exports and Imports
% yoy



Source: INEGI, Banorte

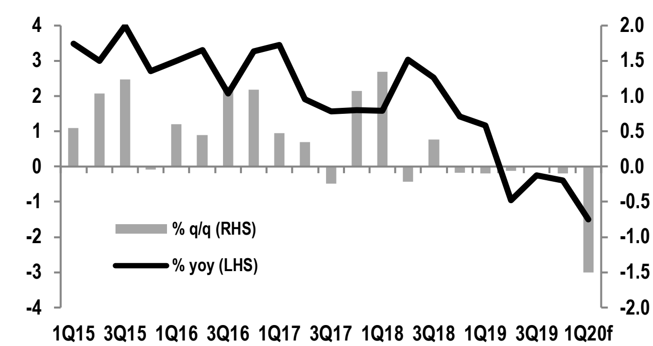
Trade balance
US$ billion, 12-month rolling sum



Source: INEGI, Banorte

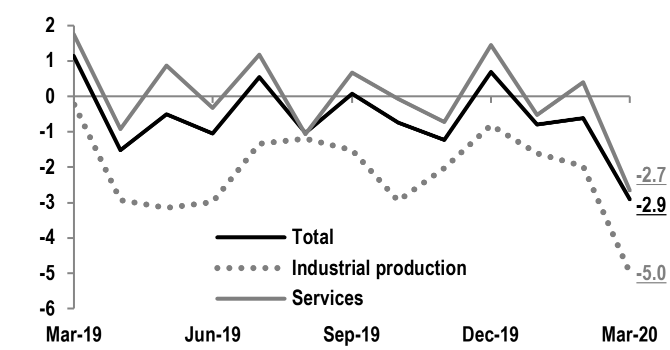
Mexico's final 1Q20 GDP to be revised slightly higher. We anticipate 1Q20 GDP at -1.5% y/y, about 10bps higher than the preliminary estimate. With seasonally adjusted figures we see a revision to -1.5% q/q from -1.6%. These would imply a contraction of 2.9% y/y (-1.5% m/m) in March's GDP proxy (IGAE), to be released at the same time.

GDP
% yoy nsa, q/q sa



Source: INEGI, Banorte

IGAE
% yoy nsa



Source: INEGI, Banorte

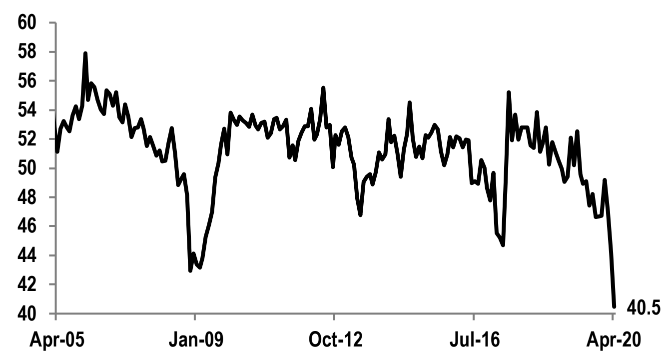
Relative to the implied figure in the preliminary report, industry was slightly better but still quite weak. Construction came in stronger, while manufacturing started to de disrupted by COVID-19. Mining was relatively resilient given the continuation of activities in the oil sector. Using already known data, quarterly IP would be revised to -2.9% from -3.2% y/y, in sequential terms coming at -1.2% from -1.4% q/q. Only taking this into account, GDP in 1Q20 would be revised to -1.5% from -1.6% y/y.

In services we forecast a 1.0% y/y decline (-1.5% q/q). This would be below the -0.9% in preliminary GDP. In our view, additional reports published for March in the sector suggest a slight revision downward. On a positive note, remittances climbed 35.8% y/y in dollar terms (highest since late 2003, when the base was much lower) and 57.8% in pesos, boosted by MXN depreciation and very favorable given more adverse economic conditions. Current federal government spending also accelerated to 22.1% from 5.2% in February.

On the contrary, transportation was probably affected by industry weakness, with manufacturing plunging 6.1% y/y, lowest since late 2009 in the midst of the crisis. Tourism extended its downfall in the second half of the period, accumulating a historical decline of 23.2%-pts in hotel occupation rates during the month relative to the previous year. Meanwhile, retail sales fell 1.3% y/y, worse than market expectations but better relative to our estimate.

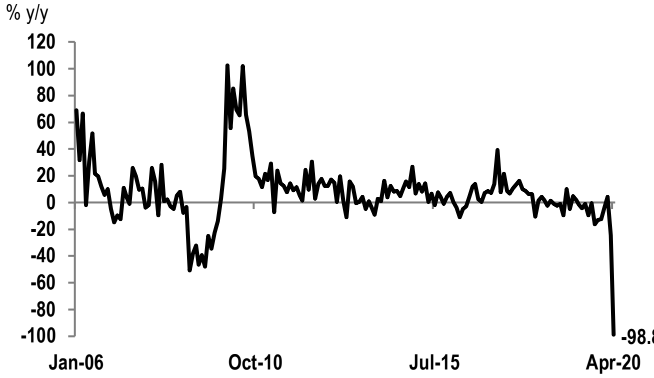
Going forward, we continue seeing weakness concentrated in 2Q20, as the economy was brought to a halt in April up until today. We maintain our estimate of a 17.1% y/y contraction (-11.7% q/q) in this period. In manufacturing, forward looking data shows a steeper decline, with IMEF's manufacturing PMI for April at new record lows of 40.5pts (chart below, left), while auto production fell 98.8% y/y (chart below, right). Reports suggest mining was also affected, with a higher impact in the non-oil sector as it is not considered an essential activity. The oil sector may have been relatively resilient in April but started decelerating more forcefully in May, as Pemex scaled back several operations (removal of personnel from offshore rigs on top of the output cut commitment with OPEC+). Finally, in construction, development of key projects continued. Nevertheless, the stoppage in private sector activity was more marked, as affirmed by leaders from business organizations of the sector, such as CMIC.

IMEF manufacturing PMI
Index, sa



Source: IMEF

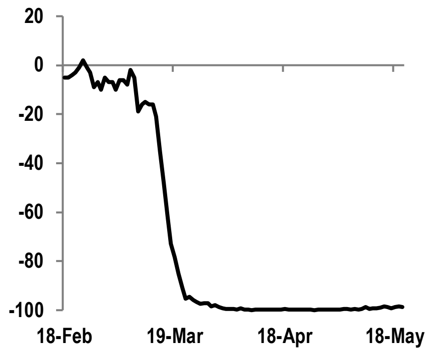
Auto production
% y/y



Source: INEGI

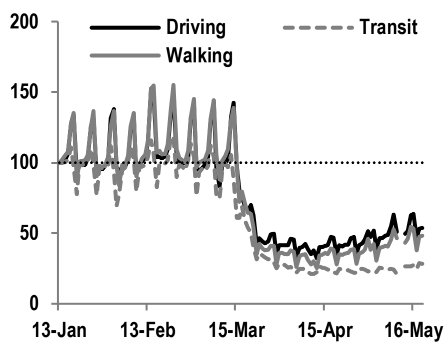
Going to services, signals are also very weak. The non-manufacturing PMI from IMEF dipped even further in April, also reaching a new historical low at 35.5pts. Same-store sales from ANTAD plunged 24.5% y/y in real terms, with a marked contraction in departmental stores. In tourism, the hotel occupancy rate fell to 4.4%, while passenger traffic in private airports (OMA, GAP and ASUR) declined 92.8% y/y. Restaurant reservations according to *Open Table* have stayed virtually at -100% since late March (chart below on the left). On the contrary, health services will likely keep climbing, with utilized capacity strained as we get closer to the peak of the pandemic. Financial services and some corporates could show some resiliency, depending whether they are considered essential or not and the possibility of utilizing home office schemes. Looking at most recent figures, mobility data from *Apple* and *Google* confirm low activity levels continued in May, albeit slightly better than April (charts below on the middle and right).

Online reservations for restaurants in Mexico in 2020
% y/y



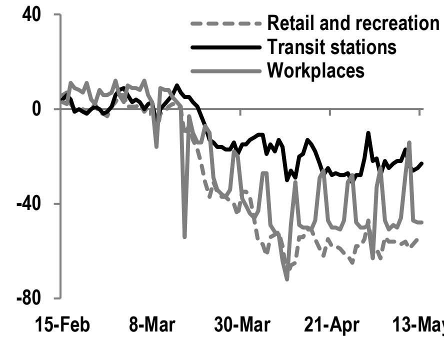
Source: Open Table

Change in routing requests in Apple Maps in Mexico
Deviation from level seen in January 13



Source: Apple

Movement trends in public places according to Google
Deviation from the trend as a percentage change



Source: Google

The government laid out a plan to restart some economic activities as soon as this week, which would be slightly positive for May and more so until June 1st, when it officially enters its third phase. If it evolves as planned, we believe this is consistent with our central scenario of a sequential recovery in the third and fourth quarters, which assumes that the number of new cases starts to clearly diminish. Nevertheless, this is still an open question, as official data has not yet shown a peak in the number of new cases. A full-scale reopening or a more relaxed attitude of the population remains risky, as it could lead to a second wave of contagion. Moreover, conditions that need to be met to reopen, as published so far, may be difficult to comply with, especially for MSMEs. All in all, we maintain our estimate of a 7.8% y/y contraction y/y in this year's GDP, although we keep warning that unprecedented uncertainty makes forecasting a more challenging task than usual.

Weekly international reserves report. Last week, net international reserves increased by US$279 million, closing at US$186.9 billion. According to Banxico's report, this was explained by: (1) An increase of US$300 million from dollar sales from Pemex to the central bank; and (2) a negative valuation effect in institutional assets of US$21 million. In this context, the central bank's international reserves have increased by US$6.0 billion during 2020 (please refer to the following table).

Banxico's foreign reserve accumulation details
US$, million

	2019	May 15, 2020	May 15, 2020	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	180,877	186,922	279	6,045
(B) Gross international reserve	183,028	196,611	109	13,583
Pemex	--	--	290	2,424
Federal government	--	--	-104	7,311
Market operations	--	--	0	0
Other	--	--	-77	3,848
(C) Short-term government's liabilities	2,151	9,689	-170	7,538

Source: Banco de México

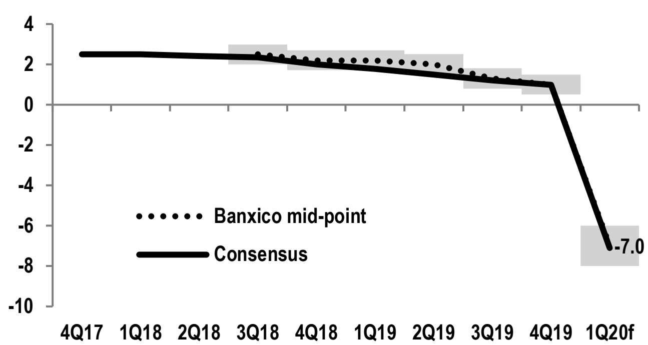
Banxico's *Quarterly Report* and minutes. The central bank will release its *Quarterly Report* (QR) for 1Q20 on Wednesday –around 1:30pm (ET)– and the minutes of the last monetary policy meeting on Thursday –at 10:00am (ET)–.

In the former, attention will center on updated estimates for GDP and inflation, particularly important given high levels of uncertainty. We will also be vigilant on comments regarding financial stability, which will probably be explained with greater depth within the minutes.

On growth, it is practically a fact that Banxico will revise its estimates downward, with the real question being the magnitude. In their latest communications they highlighted that both the global and domestic outlook deteriorated significantly. In its communiqué they seemed highly concerned with the contraction in the first quarter, but more so on the outlook for 2Q20. They have also said that preliminary estimates point to a contraction greater than 5% y/y in the first semester. In this regard, we estimate that the mid-point of the range will be reduced between 800 and 850bps, standing between -7.5% to -7.0% (see chart below on the left). This compares to an expectation of -7.1% in April's central bank survey, as well as the -7.6% in the one carried out by *Citibanamex.* Moreover, we believe it is very likely to see a wider range –currently at one percentage point– given extraordinary conditions of uncertainty, as in the surveys mentioned above. They will likely emphasize risks associated with the pandemic and its impact, considering that we still do not have enough information to estimate when it will end or if there could be another wave of contagion that leads to additional periods of stoppage in activities. We will also be looking to possible precisions about the sector-by-sector impact, which could be described in one of the *grey boxes*.

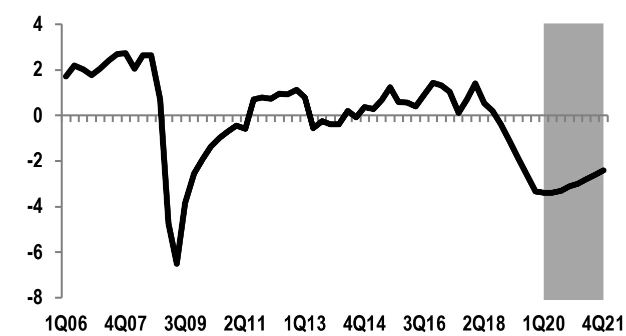
Another very important subject will be updated estimates of the output gap. In the latest report, the estimate for YE2020 came in at -3.1%. In this regard, we believe that: (1) New estimates will surpass the previous confidence intervals downwards and even those seen during the 2008-2009 financial crisis, with the most negative print in 2Q09 at -6.5%; and (2) the whole path will be revised down, with the point estimate probably at the lowest point in 2Q20 and below 3% for all the forecast period (until late 2021). This is quite relevant given that Banxico's Board could maintain a *dovish* bias for a prolonged time given that said outlook could translate into limited or non-existent demand-side pressures to prices.

GDP Forecasts – 2020
% y/y, nsa



*Note: Market consensus corresponds to the median in Banxico's survey at the time of publication of the QR. Shaded area represents Banxico's forecast range
Source: Banxico

Banxico's output gap estimate
% of potential GDP



*Note: Estimates as presented in the 4Q19 QR (published in February 2020). Shaded area indicates estimations based on forecasts from the central bank
Source: Banxico

Other relevant adjustments would come in labor market figures, with the Board likely showing a high degree of concern. An additional challenge is that information so far is scarce as we only have data for the formal sector up to April, when a little over half a million jobs were lost. We should remember that Banxico forecasts formal employment but not the unemployment rate. This is important as *INEGI* informed that they will suspend the release of the latter at least for the months of April and May, due to the pandemic. In this context, we believe the central bank will adjust the mid-point of the estimate to a loss of 1 to 1.5 million jobs this year. The trade balance could be estimated with a surplus from a deficit of US$10.9 billion previously, although the current account could continue at a deficit (albeit more moderate) given the expected fall in income from tourism and remittances.

On inflation, estimate changes will be useful to evaluate with greater detail the view about the balance of risks, which is still characterized as uncertain. We expect strong revisions in the short-term outlook, especially in 2Q20 and 3Q20, recognizing recent dynamics. The first could be revised to 2.4%-2.5%from 3.3% (see table below) and the second to 2.6%-2.7% from 3.4%. For the fourth quarter, the adjustment (lower) would be more modest, to or very close to 3%. In addition, we consider changes for 2021 will be even more interesting, given that they will transmit more clearly which factors could have a greater impact on the bank's assessment. We highlight at least two: (1) The magnitude of the passthrough effect given the depreciation of the Mexican peso (27.8% in twelve months until last April, as shown in the chart below to the right); and (2) base effects due to the current level of inflation, driven by the non-core component (*e.g.* the strong decline in energy prices).

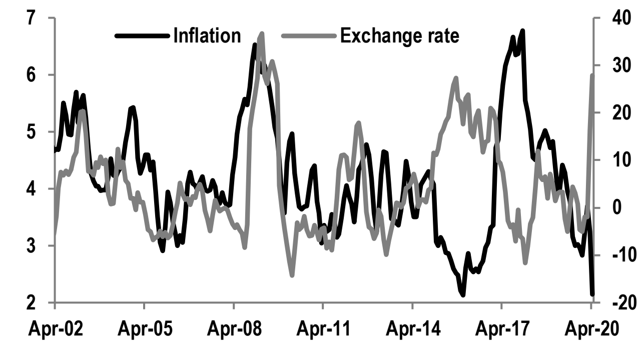
On the former, comments from Board members suggest the magnitude of the passthrough effects depends significantly on slack, which will be higher. This would result in a lower impact in prices relative to a situation in which GDP growth is more robust. Nevertheless, the magnitude of exchange rate pressures has been very significant, apart from the possibility of being permanent. Hence, we believe revisions for next year will give signals about the importance of these factors. Besides, it would also be very relevant if the central bank updates their estimates of the magnitude of the passthrough under different economic conditions in one of the *grey boxes*. We consider that projections for 2Q21 and 3Q21 will be revised up moderately, given that, even with rising energy prices going forward, the government's policy in this topic will continue to limit very strong increases in this component. It should be noted that our year-end inflation forecast is 3.2%, slightly above target but still inside the variability range. Despite of this, we believe the scenario, at least in the short-term, still calls for additional cuts of the reference rate.

Banxico's headline inflation forecasts
% y/y, quarterly average

QR	2019		2020				2021			
	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Aug-19 (2Q19)	3.3	3.2	3.4	3.1	3.1	3.0	2.9	3.0		
Nov-19 (3Q19)	3.3	3.0	3.5	3.1	3.1	3.0	2.8	2.9	2.9	
Feb-20 (4Q19)		2.9	3.3	3.3	3.4	3.2	3.0	3.0	3.1	3.0
May-20 (1Q20)			3.4	--	--	--	--	--	--	--

*Note: Grey boxes indicate actual data. Rows refer tp the Quarterly Report released, while columns show the forecasts of the quarter done in the respective document
Source: Banxico, INEGI

Exchange rate* and inflation
% y/y



*Note: Positive growth rate denotes a depreciation of the Mexican peso
Source: Banxico, INEGI

On the contrary, we believe the main drag for more aggressive cuts are risks to financial stability, which we expect to be discussed at greater length in the minutes. In this respect, we highlight recent comments from Governor Díaz de León, affirming that it is necessary to identify the rhythm and monetary policy actions that contribute to an orderly adjustment both in the economy and in financial markets. In our opinion, this is the key reason why rate cuts have been in 50bps clips and not greater, situation we expect to prevail in the near future. Moreover, we think most members agree on maintaining a prudent stance, reaffirmed after the last decision's unanimous vote. In this sense, a moderate pace of cuts allows the central bank to evaluate its effect on financial markets and risk premiums, fostering more orderly adjustments in terms of capital flows. This is important as shocks to variables such as the exchange rate can impact growth, inflation, external accounts and the fiscal deficit, among others.

Overall, we believe these documents will maintain a dovish tone, signaling Banxico's disposition to continue lowering the reference rate. In tandem, they will reaffirm the need to maintain caution and prudence due to increased uncertainty, as has been the case since the start of the easing cycle. Taking all these into account, we maintain our expectation of two additional 50bps cuts in the upcoming two decisions, in June and August. This would take the reference rate to 4.50%, where we expect it to remain by year-end. On the timing, another intra-meeting decision can certainly happen, particularly when considering the current backdrop and concerns over the challenges for monetary policy. In our view, additional surprises in terms of economic and market events could trigger an earlier action. Specifically, we cannot rule out new episodes of meaningful market stress which could compromise financial conditions once again, impacting risk premiums and liquidity levels, convincing the central bank to act sooner again.

Banking credit to grow 8.9% y/y in April, driven by corporates. This would be above the +7.0% observed in March. As already mentioned, this would be explained by the 13.2% expansion in credit to corporates, remembering that businesses have tapped their credit lines since the previous month given increased liquidity needs. Meanwhile, mortgages would decelerate again, growing 5.7%. Finally, consumer credit could actually fall 0.5%, a situation not seen since late 2010. It should be noted there is a favorable effect from inflation, which came in at 2.15% y/y in April, 110bps below March's print.

MoF's public finance report (April). Attention will center on Public Balance and Public Sector Borrowing Requirements (PSBR) –with the latter at -$49.7 billion in 1Q20– and comparing them to forecasts in the *2021 Preliminary Economic Policy Assumptions.* We will also be looking at the primary balance, as it will relay more data about the additional pace of spending on efforts to combat COVID-19, increasing sharply in April. Regarding revenue and spending, we will also be watching performance in the annual comparison, particularly the former, as these could offer additional insights on economic activity. Finally, we will also analyze public debt, which as of March stood at MXN$11.9tn (as measured by the HBPSBRs).

Analyst Certification

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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	Reference
BUY	When the share expected performance is greater than the MEXBOL estimated performance.
HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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