Ahead of the Curve

Expecting a historical plunge in April's industrial activity and a rebound in May's inflation

June 5, 2020

www.banorte.com
@analisis_fundam

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

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

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

STARMINE AWARDS FOR REUTERS POLLS FROM REFINITIV

Document for distribution among the general public

- **Industrial production (April).** We anticipate a historical contraction of 21.6% y/y, explained by measures to fight-off the Coronavirus pandemic, which brought large parts of industrial activity to a halt. In seasonally adjusted terms, the contraction would be 15.1% m/m. We believe this will be the most impacted month, with strong declines across the board. In May, we think that activity will likely remain very weak, although there seems to be some signs of a slightly higher pace of activity. Manufacturing would be most affected, coming in at -26.8% y/y (-19.3% m/m), with the most eye-popping negative signal in auto production. A similar situation would be observed in construction, expected at -21.4% y/y (-10.5% m/m). We should mention that this sector was not catalogued as essential, except for some public sector projects. Finally, mining would fall 8.4% (-8.8% m/m), with strength in oil outweighed by the erosion in non-oil

- **Inflation (May).** We estimate headline inflation at 0.49% m/m (previous: -1.01%). Similar to the first half of the month, effects stemming from the COVID-19 pandemic will continue to trigger some distortions in the period. Core prices would pick up strongly, at 0.41% (with a contribution of 31bps), mostly driven by higher prices in processed foods. Meanwhile, the non-core index would rise 0.74% (adding 18bps), resenting the upward shock in agricultural goods in the first fortnight as well as the recovery in energy prices excluding electricity tariffs, which actually fell on seasonal discounts. With these results, annual inflation would climb to 2.94% from 2.15% in April, giving strong signals of having already bottomed out in the previous month

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 9-Jun	7:00am	CPI inflation	May	% m/m	0.49	0.52	-1.01
				% y/y	2.94	2.98	2.15
		Core		% m/m	0.41	0.40	0.36
				% y/y	3.76	--	3.50
Tue 9-Jun	10:00am	International reserves	Jun-8	US$ billion	--	--	187.3
Wed 10-Jun		Wage negotiations	May	%	--	--	5.5
Thu 11-Jun	7:00am	Industrial production	April	% y/y	-21.6	--	-5.0
		sa		% m/m	-15.1	--	-3.4
		Mining		% y/y	-8.4	--	1.3
		Utilities		% y/y	-6.9	--	-0.8
		Construction		% y/y	-21.4	--	-7.5
		Manufacturing		% y/y	-26.8	--	-6.1
Fri 12-Jun		Formal job creation	May	thousands	--	--	-555.2

Source: Banorte; Bloomberg

Proceeding in chronological order...

Inflation to climb in May, still impacted by COVID-19 distortions. We estimate headline inflation at 0.49% m/m (previous: -1.01%). Inside, core prices would pick up strongly at +0.41% (with a contribution of 31bps). Meanwhile, the non-core index would rise 0.74% (adding 18bps). In general, and similar to the first half of the month, effects stemming from the COVID-19 pandemic will continue to trigger part of the distortions in the period, particularly in the core component.

Within the latter, processed foods would extend their recent increase, with a total monthly contribution of 27bps. In the second fortnight, our monitoring showed additional upticks in some staples such as sugar, cereal, beans, and milk. On the contrary, we expect other goods to remain relatively stable, with an impact of -2bps. Although our analysis suggests a further increase in some essential goods such as diapers and toilet paper, we believe discounts from the *Hot Sale* campaign and online by departmental stores more than compensated for these increases. Services would remain relatively low, adding only 6bps. In recent fortnights, housing has shown a more modest performance, so we expect a contribution of only 1bp. Meanwhile, other services would add the remaining 5bps, impacted by upward adjustments in air fares in the first half of the period.

Going into the non-core component, dynamics would be very different between both halves of the month. On fresh fruits, the first fortnight was characterized by strong pressures, led by tomatoes. On the contrary and according to our monitoring, the correction was relatively fast, with declines in onions, husk tomatoes and tomatoes themselves, although not enough to reverse the previous impact and estimated to end with a monthly contribution of +35bps. Meat and egg moved inversely, with strong declines in the first half followed by a slight recovery in the second (contribution: -12bps). As a result, agricultural goods would add 24bps. Meanwhile, energy would subtract 7bps, still driven by the seasonal decline in electricity tariffs (-39bps). Nevertheless, the increase in LP gas and gasolines would extend, with a contribution from these goods at +31bps. Specifically, on gasoline, although the exchange rate declined markedly since the middle of May, increases in reference prices likely more than compensated for the latter, this in a context in which excise tax subsidy remains at zero.

With these results, annual inflation would climb to 2.94% from 2.15% in April, giving strong signals of bottoming out in the previous month. Core inflation would stand at 3.76% from 3.50%, influenced mainly by the increase in goods outlined previously but also a more challenging base effect. The non-core index would increase to 0.42% from -1.96%, impacted by fresh fruits and vegetables as well as energy (ex. electricity tariffs). In this context, recent dynamics, as well as recent forecast revisions by the central bank, support our 3.2% forecast by year-end. Although some of price distortions could start to fade away once social distancing measures begin to be lifted, we believe that FX passthrough and some adverse factors –such as a more challenging base effect– will limit downside for the headline index.

Weekly international reserves report. Last week, net international reserves increased by US$144 million, closing at US$187.3 billion. According to Banxico's report, this was explained by a positive valuation effect in institutional assets. In this context, the central bank's international reserves have increased by US$6.4 billion during 2020 (please refer to the following table).

Banxico's foreign reserve accumulation details
US$, million

	2019	May 22, 2020	May 22, 2020	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	180,877	187,316	144	6,438
(B) Gross international reserve	183,028	197,396	327	14,369
Pemex	--	--	-80	2,624
Federal government	--	--	-27	7,200
Market operations	--	--	0	0
Other	--	--	434	4,545
(C) Short-term government's liabilities	2,151	10,081	183	7,930

Source: Banco de México

Industrial production to show a record plunge in April due to the pandemic. We anticipate a 21.6% y/y contraction, lowest ever. This would be explained by measures to fight-off the Coronavirus pandemic, which brought large parts of industrial activity to a halt. In seasonally adjusted terms, the contraction would also be historic, plunging 15.1% m/m. We believe this will be the most impacted month, showing hefty declines in all categories. Going into May, we expect activity to remain very weak, although there seems to be some signs of a slightly higher pace of economic activity.

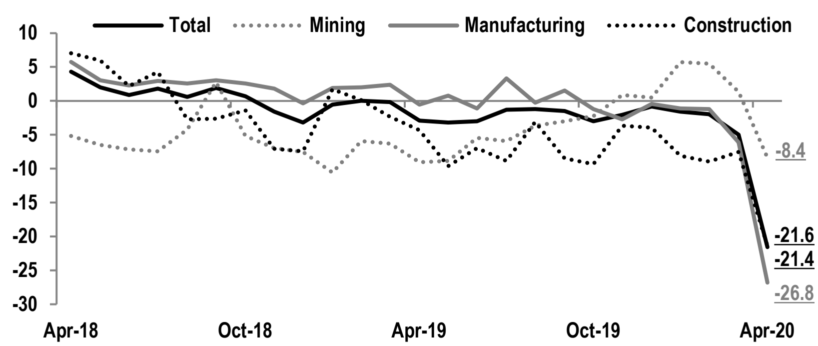
The most impacted would be manufacturing, coming in at -26.8% y/y (-19.3% m/m). In particular, the most eye-popping signal came from auto production, plunging 98.8% with only 3,722 vehicles produced, most of them by KIA. The production component within IMEF's PMI reached 28.6pts, down 6.6pts to an all-time low and after -11.7pts in March. In addition, formal employment declined by 99.7 thousand jobs, its steepest fall for any given month, also on top of 25.7 thousand losses in the previous month. US manufacturing plunged 19.8% y/y, also weakest ever, dragging down Mexico's manufacturing exports which stood at -41.9%. Despite of the latter, we should mention that the breakdown showed sharp differences, with auto exports at -79.1% while the rest of manufacturing stood at -20.9%, suggesting a more modest impact in the latter. This might be explained by two factors: (1) The continuation of activities in essential sectors (*i.e* food industry, chemicals, healthcare equipment, etc.); and (2) possible non-compliance of social-distancing recommendations and orders to stop activities by some businesses. All in all, despite these latter factors potentially limiting some losses, the disruption to manufacturing is poised to be record-breaking.

A similar situation would be observed in construction, expected at -21.4% y/y (-10.5% m/m). As previously mentioned, private construction was not designated as essential, albeit with some public works continuing. These include some of the government's flagship projects such as the Santa Lucía Airport and Dos Bocas refinery. Other reports point to a continuation in some works at the state and municipal levels.

In this context, physical investment by the Federal Government increased 22.2% y/y in real terms. Although we do not expect a rise of this magnitude in civil engineering, it should at least give this sector –and some specialized works with it– some support. As such, the main drag would be the private sector. According to business chambers' representatives, around 80% of firms stopped activities, mainly MSMEs, with many also in a challenging financial situation. Meanwhile, confidence levels plunged to historical lows, particularly in the 'adequate moment to invest component, down 8.9pts from an already low level of 22.7pts. Indicators about executed works also exhibited historical declines, both for contractors and subcontractors. Finally, employment was among of the most impacted, losing 197,155 positions (-15.0% y/y). Considering all these, we believe the contraction in edification will vastly outweigh some stability in other categories, which were weak even before the outbreak.

Finally, mining would fall 8.4% (-8.8% m/m), with strength in the oil sector outweighed by the erosion in non-oil. In particular and in the former, Pemex data showed an increase of about 3.0% y/y in crude-oil output, while gas production inched up 0.2%. It should be noted that agreed cuts under the OPEC+ agreement started to be binding in May. Nevertheless, it is our take that non-oil mining will be impacted very significantly, as mines and quarries were shut down as they were catalogued as non-essential, with a plethora of reports of halted activities in much of the sector in several states nationwide.

Industrial production
% y/y



Source: INEGI, Banorte

We expect formal job losses to continue in May. On Friday, the National Social Security Institute (IMSS) will release its monthly report of insured workers in May. We expect losses to have continued during the month, albeit moderating relative to the 555.2 thousand positions lost observed in April. In this context, President López-Obrador stated in one of his press conferences that, according to preliminary data, the figure could show a decline of around 350 thousand jobs. We will also be looking into wages and the number of businesses affiliated, which will provide us with additional information about the degree of the impact of the virus to economic activity.

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.

Relevant statements.

In accordance with current laws and internal procedures manuals, analysts are allowed to hold long or short positions in shares or securities issued by companies that are listed on the Mexican Stock Exchange and may be the subject of this report; nonetheless, equity analysts have to adhere to certain rules that regulate their participation in the market in order to prevent, among other things, the use of private information for their benefit and to avoid conflicts of interest. Analysts shall refrain from investing and holding transactions with securities or derivative instruments directly or through an intermediary person, with Securities subject to research reports, from 30 calendar days prior to the issuance date of the report in question, and up to 10 calendar days after its distribution date.

Compensation of Analysts.

Analysts' compensation is based on activities and services that are aimed at benefiting the investment clients of Casa de Bolsa Banorte and its subsidiaries. Such compensation is determined based on the general profitability of the Brokerage House and the Financial Group and on the individual performance of each analyst. However, investors should note that analysts do not receive direct payment or compensation for any specific transaction in investment banking or in other business areas.

Last-twelve-month activities of the business areas.

Grupo Financiero Banorte S.A.B. de C.V., *through its business areas, provides services that include, among others, those corresponding to investment banking and corporate banking, to a large number of companies in Mexico and abroad. It may have provided, is providing or, in the future, will provide a service such as those mentioned to the companies or firms that are the subject of this report. Casa de Bolsa Banorte or its affiliates receive compensation from such corporations in consideration of the aforementioned services.*

Over the course of the last twelve months, Grupo Financiero Banorte S.A.B. C.V., has not obtained compensation for services rendered by the investment bank or by any of its other business areas of the following companies or their subsidiaries, some of which could be analyzed within this report.

Activities of the business areas during the next three months.

Casa de Bolsa Banorte, Grupo Financiero Banorte or its subsidiaries expect to receive or intend to obtain revenue from the services provided by investment banking or any other of its business areas, by issuers or their subsidiaries, some of which could be analyzed in this report.

Securities holdings and other disclosures.

As of the end of last quarter, Grupo Financiero Banorte S.A.B. of C.V. has not held investments, directly or indirectly, in securities or derivative financial instruments, whose underlying securities are the subject of recommendations, representing 1% or more of its investment portfolio of outstanding securities or 1 % of the issuance or underlying of the securities issued.

None of the members of the Board of Grupo Financiero Banorte and Casa de Bolsa Banorte, along general managers and executives of an immediately below level, have any charges in the issuers that may be analyzed in this document.

The Analysts of Grupo Financiero Banorte S.A.B. of C.V. do not maintain direct investments or through an intermediary person, in the securities or derivative instruments object of this analysis report.

Guide for investment recommendations.

	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.

Even though this document offers a general criterion of investment, we urge readers to seek advice from their own Consultants or Financial Advisors, in order to consider whether any of the values mentioned in this report are in line with their investment goals, risk and financial position.

Determination of Target Prices

For the calculation of estimated target prices for securities, analysts use a combination of methodologies generally accepted among financial analysts, including, but not limited to, multiples analysis, discounted cash flows, sum-of-the-parts or any other method that could be applicable in each specific case according to the current regulation. No guarantee can be given that the target prices calculated for the securities will be achieved by the analysts of Grupo Financiero Banorte S.A.B. C.V, since this depends on a large number of various endogenous and exogenous factors that affect the performance of the issuing company, the environment in which it performs, along with the influence of trends of the stock market, in which it is listed. Moreover, the investor must consider that the price of the securities or instruments can fluctuate against their interest and cause the partial and even total loss of the invested capital.

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
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 Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Frigolet Vázquez Vela	Head of Sólida Banorte	alejandro.frigolet.vazquezvela@banorte.com	(55) 5268 - 1656
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Carlos Alberto Arciniega Navarro	Head of Treasury Services	carlos.arciniega@banorte.com	(81) 1103 - 4091
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
Lizza Velarde Torres	Executive Director of Wholesale Banking	lizza.velarde@banorte.com	(55) 4433 - 4676
Osvaldo Brondo Menchaca	Head of Specialized Banking Services	osvaldo.brondo@banorte.com	(55) 5004 - 1423
Raúl Alejandro Arauzo Romero	Head of Transactional Banking	alejandro.arauzo@banorte.com	(55) 5261 - 4910
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