Ahead of the Curve

A dovish tone in Banxico minutes and a historical plunge in May's industrial production

- **Banxico minutes (June 25th).** We expect the minutes to convey the more dovish tone we perceived in the statement, with investors likely focusing on comments about the growth and inflation outlook. About the former, we will pay attention to the possibility that some members mention which of the scenarios in the Quarterly Report may be materializing with a higher probability, or even if they see the need of adjusting them, among others. In the latter, we perceived a bias favoring a lower-than-expected path for inflation relative to their latest forecasts, so it will be relevant to see how the assessment of risks may have changed. We maintain our expectation of two additional rate cuts of 50bps each, in August and September, with the reference rate closing the year at 4.00%

- **Industrial production (May).** We anticipate a 30.0% y/y contraction, a new historical low for second consecutive time after the -29.3% observed in April. Broadly speaking, this would be a result of basically unchanged measures to cope with COVID-19. Although the government unveiled plan to reopen the economy by the middle of the month, companies had to comply with certain sanitary requirements before restarting operations, delaying the process. Along bottlenecks in some industries and other specific factors, data suggests the economy remained at a stand-still and at a level very close to the previous month. With seasonal adjusted data, we forecast a 0.6% m/m decline

July 3, 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

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 6-Jul	7:00am	Gross fixed investment	April	% y/y	-34.6	-25.8	-11.0
		sa		% m/m	-23.7	--	-3.1
		Machinery and equipment		% y/y	-31.9	--	-16.1
		Domestic		% y/y	-43.4	--	-14.9
		Imported		% y/y	-24.8	--	-16.9
		Construction		% y/y	-36.5	--	-7.2
Tue 7-Jul	10:00am	International reserves	Jul-3	US$ bn	--	--	188.9
Tue 7-Jul	3:30pm	Citibanamex bi-weekly survey of economic expectations					
Thu 9-Jul	7:00am	CPI inflation	June	% m/m	0.42	0.40	0.39
				% y/y	3.20	3.18	2.84
		Core		% m/m	0.27	0.30	0.30
				% y/y	3.61	--	3.64
Thu 9-Jul	10:00am	Banxico's minutes					
Fri 10-Jul		Wage negotiations	June	%	--	--	4.7
Fri 10-Jul	7:00am	Industrial production	May	% y/y	-30.0	--	-29.3
		sa		% m/m	-0.6	--	-25.1
		Mining		% y/y	-6.3	--	-3.6
		Utilities		% y/y	-5.5	--	-3.5
		Construction		% y/y	-35.8	--	-38.0
		Manufacturing		% y/y	-36.6	--	-35.3

Source: Banorte; Bloomberg

Proceeding in chronological order…

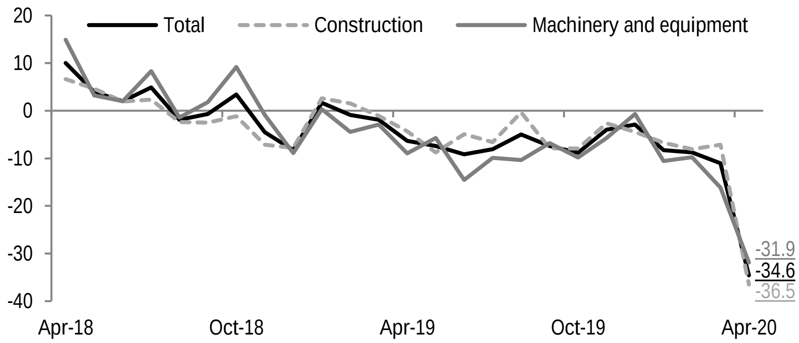
High double-digit decline in investment expected in April. We anticipate GFI at a whopping -34.6% y/y, extending the -11.0% of the previous month. If our forecast materializes, it would only rival the deepest contractions observed during the Tequila crisis, when investment plunged slightly more than 40% y/y from April to August 1995. This would be driven by the stoppage of activity and social distancing measures during the period, exacerbated by the surge in uncertainty. In this sense, supply-side data showed the economy plunged 19.9% y/y according to IGAE, with this component of aggregate demand likely the most affected.

We expect construction at -36.5% y/y, slightly above the -38.0% in the industrial production report. In our view, restrictions impacted the private sector relatively more than public works –as some key projects of the latter kept going given that they were catalogued as essential–. In this respect, edification plunged by 40.4%, while civil engineering fell 31.9%, contrary to recent trends. Moreover, business confidence plunged to a new historical low (by the time, as it fell further in May) in both the headline index and the 'adequate moment to invest' components. Contrary to this, public finance data shows that federal spending in physical investments went up by 22.2% y/y, although we fade out this data point as it has not provided a useful signal of performance, while a plethora of reports affirmed activity in several states was brought to a complete halt.

We anticipate machinery and equipment at -31.9%. Contrary to recent prints, the imported component would "outperform", at -24.8% y/y, with capital goods imports for the period at -26.7%, highest decline since the 2009 crisis. This would happen despite the strong depreciation of the Mexican peso, which averaged 24.2658 per dollar against 22.3784 in April. We believe this could be related to previously placed orders that were fulfilled in the month. On the other hand, we estimate the domestic to fall 43.4%, reflecting the decline in confidence to new lows in virtually all sectors considered in the survey.

Going forward, investment will likely remain heavily pressures. The main reasons behind our expectation include: (1) Global and domestic uncertainty staying very elevated given the evolution of the pandemic and the lack of an effective treatment or vaccine; (2) GDP growth expectations continue to be cut, limiting profit opportunities; (3) restrictions imposed to fight the virus have had an adverse impact on sales, deteriorating businesses' balance sheets; and (4) capital spending is likely to stay unfavored for a while as entrepreneurs prioritize current expenses while trying to maintain adequate liquidity levels.

GFI
% y/y



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves increased by US$655 million, closing at US$188.9 billion. According to Banxico's report, this was explained by: (1) Sales of US$550 million from the Federal Government to the central bank; and (2) a negative valuation effect in institutional assets of US$115 million. In this context, the central bank's international reserves have increased by US$8.1 billion during 2020 (please refer to the following table).

Banxico's foreign reserve accumulation details
US$, million

	2019	Jun 26, 2020	Jun 26, 2020	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	180,877	188,941	665	8,064
(B) Gross international reserve	183,028	197,053	114	14,025
Pemex	--	--	0	2,624
Federal government	--	--	-30	6,975
Market operations	--	--	0	0
Other	--	--	144	4,426
(C) Short-term government's liabilities	2,151	8,112	-551	5,961

Source: Banco de México

Inflation to keep climbing in June. We estimate headline inflation at 0.42% m/m (previous: 0.39%). Inside, core prices would be an inch lower relative to May, at +0.27% (with a monthly contribution of 21bps). Nevertheless, the non-core index would rise more (+0.87%, adding also 21bps), mainly on the back of an extension higher in energy prices. As a result, annual inflation would pick up to 3.20% from 2.84% in May, with the core broadly stable at 3.61% (previous: 3.64%). The non-core index, on the other hand, would adjust to 1.92% from 0.35%, still low by historical standards. Broadly speaking, we see faster increases in some categories on the back of the gradual reopening of the economy, which has been matched by signals that mobility is improving. Nevertheless, these should not be of great concern as they are likely to be modest in magnitude, given that FX volatility has diminished, and economic slack remains very wide.

Within the core, we highlight that housing keeps showing muted pressures, likely influenced by low demand. Meanwhile, we estimate airfares (6.4% m/m) and tourism services (1.6%) to show more stability in the second half after increasing in the previous fortnight –particularly the former–, with little room for additional reductions given that annual rates are already very low, impacted by the pandemic.

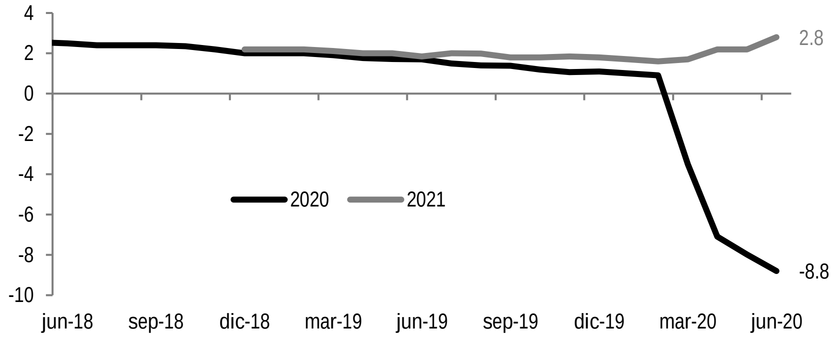
On the other hand, goods would decelerate at the margin relative to April, at 0.40%. In this component, it is welcome news that processed foods seem to be less pressured after dynamics observed in April and May, which were affected upward by the pandemic. In contrast, other goods would gather some steam at 0.6%, mainly affected by the reversal of discounts from the *Hot Sale* campaign during the first fortnight, but also as more businesses opened.

Going to the non-core, the main highlight is that upward pressures in energy prices would have extended, estimating a 5.7% increase. Among them, low-grade gasoline will account for the strongest share, estimated at 8.8% m/m (contribution: 37bps). For the latter, we incorporate that gasoline prices in the US climbed quite strongly and the MXN depreciated during the second fortnight, while subsidies to excise-taxes to this good remained at zero. LP gas would also climb, estimated at 2.8%. On agricultural goods we expect a mixed performance. Fresh fruits and vegetables (-5.8%) would fall again the second half of the period, with our monitoring signaled a sizable adjustment in tomatoes, along declines in chilies and other fruits. In contrast, we had reports of relevant price hikes in chicken and eggs, enough to reverse the fall of the first half to end at 0.7% m/m.

Banxico's minutes to convey a dovish but prudent approach. The central bank will release the monetary policy minutes of its decision held on June 25th, in which the reference rate was cut by 50bps to 5.00% with a unanimous vote. In our view, the document will reflect the more *dovish* tone we perceived in the statement, with investors likely focusing on comments about the growth and inflation outlook. Is in this backdrop in which, after the decision, we adjusted our monetary policy expectations, currently seeing two additional rate cuts of 50bps each, in August and September, with the reference rate closing the year at 4.00%. In our view, the most relevant issues will be:

(1) *The outlook for growth.* We believe it is important to mention that the central bank anticipates even more economic slack, suggesting that the latest data, such as April's IGAE, have been below their expectations. We will be focused on the discussion in this front, including the possibility that some members mention which of the scenarios in the Quarterly Report may be materializing with a higher probability, or even if they see the need of adjusting them. In this backdrop, we should say that the simple average of the three scenarios for GDP this year stood at -7.2% y/y, above the median of -8.8% in the latest central bank survey (see chart below). We will also be looking for comments about the evolution of the pandemic and how it could be affecting their expectations, not only locally, but also because of increased fears of a "second wave" of contagion, including in the US. In this respect, it is important to remember that they argued that the economic reopening could help the economy recover in May and June. Nevertheless, and as mentioned below in the case of industrial production, signals so far –at least for May– have been mixed at best.

GDP growth estimates
% y/y



Source: Banxico

(2) *The path and risks for inflation*. In the statement, we perceived a bias favoring a lower-than-expected path for inflation relative to their latest forecasts. Considering this and based on our estimate for the 2nd half of June, average annual inflation in 2Q20 would be at 2.7%, in line with Banxico's estimate. Nevertheless, our expected path is slightly lower relative to that of the central bank for both the third and fourth quarters. In terms of the effect of slack on prices –which was emphasized by the monetary authority–, the component in which we have observed it more clearly is in housing prices. On the other hand, it will also be important to see: (a) Any comment about the potential effect of the gradual economic reopening on prices of some goods and services (*e.g.* airfares and tourism services) and the possibility of pressures driven by the effect of supply chain disruptions; (b) the analysis of the consequences of lower global inflation, as it was included as a new risk to the downside; (c) the potential effect on decisions stemming from greater measurement challenges and the bias inserted in prices due to the pandemic; and (d) some thoughts about the implications that could result from recent deviations of inflation relative to market expectations, suggesting higher underlying volatility. Despite of these caveats and broadly speaking, we believe most members of the Board are not concerned about the outlook for inflation even with higher uncertainty, reaffirmed for quite some time through the characterization of the balance of risks as uncertain.

All in all, we believe Banxico will confirm that the majority still sees room for additional rate cuts. Among them, Deputy Governor Javier Guzmán –which we identify as relatively *hawkish*– recently said they can still make additional adjustments, reinforcing our recent modest change in expectations. Nevertheless, we also think cautiousness will prevail, remembering that both external and domestic risks remain high. Apart from the pandemic, we highlight the upcoming electoral process in the US ahead of the elections to be held on November 3rd. Among the relevant events this quarter we highlight National Conventions, both by Democrats (August 17th to 20th) and Republicans (August 24th to 27th). Moreover, the first presidential debate will be held on September 29th, followed by two more in October. In our view, this will be a relevant risk that will be incorporated by Banxico, more so given its potential effect on financial conditions, including on volatility levels and depth of local markets.

Industrial production to have stayed deeply down in May. We anticipate a 30.0% y/y contraction, a new historical low for second consecutive time after the -29.3% observed in April. Broadly speaking, this would be a result of basically unchanged measures to cope with COVID-19. We should say the government unveiled its plan to reopen the economy by the middle of the month, which included the designation of additional industries as essential. Nevertheless, companies had to comply with certain sanitary requirements before restarting operations, delaying the process. Along bottlenecks in some industries and other specific factors, data suggests the economy stayed at a stand-still and at a level very close to the previous month. Overall, we forecast a 0.6% m/m decline with seasonally adjusted data. If we are right, this would challenge our view that the bottom in activity was in April.

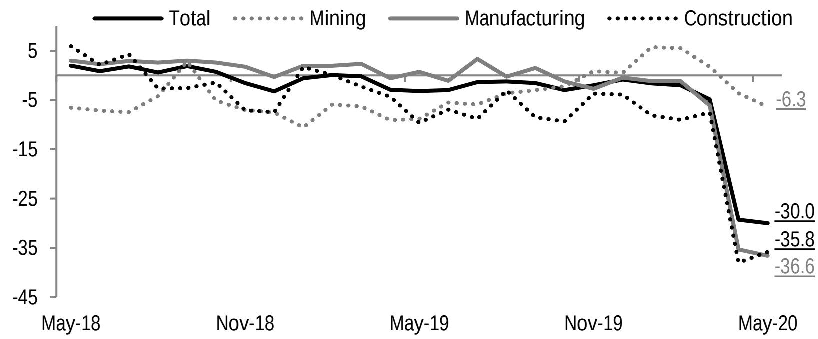
One important drag –at the margin– would be mining, estimated to fall -6.3% y/y (-3.7% m/m) from -3.6% in April. As mentioned before, the OPEC+ agreement became binding in May, with PEMEX's CEO affirming they complied at 100%. This was corroborated later with production data, with the state-owned company reporting 1,677kbpd of oil (agreed: 1,681kbpd), equivalent to a 0.3% y/y decline –first contraction this year– after +3.1% in the previous month. Apart from this, gas was down more strongly at -7.9%. In non-oil, the sector's production in April was very low but exports high, suggesting an inventory drawdown, which was reinforced by figures showing shipments abroad plunged in May.

We see construction at -35.8% y/y (-0.4% m/m). Despite a more favorable base effect, the sector remained very limited by its non-essential status. On the positive side, reports affirm that flagship Federal Government projects continued, while the Mexican Chamber of the Construction Industry (*Cámara Mexicana de la Industria de la Construcción* or CMIC, by its Spanish acronym) also said some highway maintenance projects resumed at a limited scale, among other news.

Nevertheless, support from this to the headline index will likely be modest as the private sector's share of total activity is much higher. Regarding the latter, we highlight that available data on employment, business confidence, and executed works, were all broadly weaker.

Lastly, we anticipate manufacturing at -36.6% y/y (+0.3% m/m), an inch lower to the -35.3% in April. As in construction, signals are mixed. The main indicator pointing to a rebound is auto production, with 22,119 vehicles after only 3,722 in the previous month. In annual terms, the rate inched higher, to -93.7% from -98.8%. Moreover, US industrial production improved at the margin, at -16.5% from -20.3%. In contrast, the trade balance was universally weaker, with exports dipping 58.7% and intermediate goods imports falling 41.8%. The latter was reinforced by IMEF's manufacturing PMI, with the 'production' component declining to 25.9pts (sa), a new historical low. Coupled with inventories' dynamics, we think supply chain disruptions continued and affected production slightly more, as raw materials were scarcer. Employment figures also showed additional job losses, with the annual rate at -4.4%, lowest since the 2009 financial crisis.

Industrial production
% y/y



Source: INEGI, Banorte

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, Eridani Ruibal Ortega and Juan Barbier Arizmendi, 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
Juan Barbier Arizmendi	Analyst	juan.barbier@banorte.com	(55) 1670 - 1746
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