Ahead of the Curve

Banxico to cut the reference rate again by 50bps, to 4.50%

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- **Monetary policy decision (August 13th).** We expect the central bank to cut again the reference rate by 50bps to 4.50%, fifth consecutive of this magnitude. We expect another unanimous vote, as we identified in the latest minutes at least four members that still saw room for additional easing. Nevertheless, this was nuanced with individual comments that pointed to an ample debate about the adequate level of the terminal rate for this cycle. Although there could be changes in the statement's tone, we believe it will remain dovish. For growth, considering the shock to activity in 2Q20, the tone could skew to a looser stance; however, it could be more cautious about the inflation path

- **Industrial production (June).** We anticipate a 17.4% y/y contraction, slightly above the -17.9% implied in the 2Q20 GDP report. Using seasonally adjusted figures, we anticipate a 17.1% m/m rebound. We believe the reclassification as essential of auto production, non-oil mining and construction, further steps to reopen the economy, and the relative strength of the US, were key drivers. In this sense, we expect the recovery to be broad-based, with all major four sectors climbing back in sequential terms, led by manufacturing

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Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 10-Aug		Wage negotiations	July	%	--	--	4.6
Tue 11-Aug	7:00am	Industrial production	June	% y/y	-17.4	--	-30.7
		sa		% m/m	17.1	--	-1.8
		Mining		% y/y	-3.7	--	-5.9
		Utilities		% y/y	-9.8	--	-13.1
		Construction		% y/y	-24.1	--	-36.3
		Manufacturing		% y/y	-19.3	--	-37.1
Tue 11-Aug	10:00am	International reserves	Aug-7	US$ bn	--	--	192.6
Tue 11-Aug		ANTAD: Same-store sales	July	% y/y in real terms	--	--	-20.5
Wed 12-Aug		Change in jobs associated to IMSS	July	thousands	--	--	-83.3
Thu 13-Aug	2:00pm	Banxico's monetary policy decision	Aug-13	%	4.50	--	5.00

Source: Banorte; Bloomberg

Proceeding in chronological order…

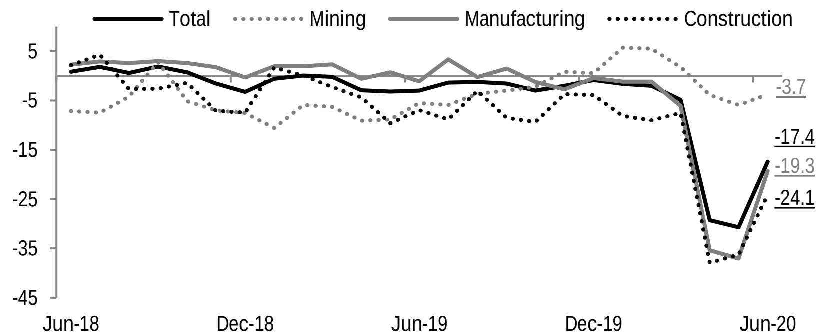
Industrial production to rebound in June. We anticipate a 17.4% y/y contraction, slightly above the -17.9% implied in the 2Q20 GDP report. We note a favorable effect from additional working days in the annual comparison. Despite of the latter, using seasonally adjusted figures, we anticipate a 17.1% m/m rebound. We believe the reclassification as essential of auto production, non-oil mining and construction, further steps to reopen the economy, and the relative strength of the US, were key drivers. In this sense, we expect the recovery to be broad-based, with all major four sectors climbing back in sequential terms, led by manufacturing.

In this respect, the latter is estimated at -19.3% y/y, higher than -37.1% in May. In monthly terms, production would bounce back 22.6%. In this sense, IMEF's manufacturing PMI increased 5.1pts to 43.1pts, with strength in both 'new orders' and 'production'. Trade balance data was also very favorable, with manufacturing exports up 83.6% m/m (-13.5% y/y), boosted by autos. The restart in this sector was very relevant, with 238,946 light vehicles. Although this represents a 29.6% y/y decline, it was far better than the -93.8% seen in the previous month. There was also a favorable performance in other manufacturing exports, probably aided by higher dynamism in the US, as industrial production came in at -11.1% y/y, 5.5%-pts above May's print. On the flip side, formal employment kept declining, with an additional 34.1 thousand jobs lost.

Construction would be at -24.1% y/y (19.9% m/m), supported both from the public and private sector. Within the former, and despite a lack of correlation in the last few prints, physical investment by the Federal Government increased by 11.9% y/y in real terms, adding four months of double-digit growth, which is due to have a positive impact in some moment. The loosening of restrictions could also be favorable. However, the latter would have benefited the private sector more, as evidenced by a broad improvement in several indicators, including business confidence and INEGI's aggregate trend indicator. Within the latter, the rebound concentrated in executed works. In addition, and very importantly, employment recovered by 98.1 thousand positions, one of only two across all sectors with favorable results.

Lastly, mining would come in at -3.7% y/y (+4.0% m/m), also improving relative to May. Performance would be mixed, with the oil sector impacted by the OPEC+ output cuts, taking crude oil production to 1,616 kbpd according to data compiled by the CNH, a new low in little over 40 years. This is equivalent to a 2.9% y/y fall, below last month's -0.9%. Another factor that may have had an impact could be the temporary suspension of Pemex's payments to suppliers, which most likely resulted in an additional production decline. On the contrary, signals from non-oil mining were better, with exports at +9.3% y/y (+21.8% m/m), probably benefited by the designation of the sector as essential.

Industrial production
% y/y



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves increased by US$313 million, closing at US$192.6 billion. According to Banxico's report, this was mainly explained by a positive valuation effect in institutional assets. In this context, the central bank's international reserves have increased by US$11.7 billion so far in 2020 (please refer to the following table).

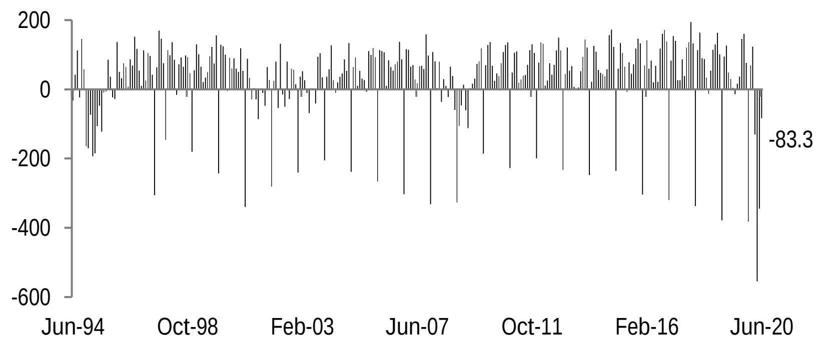
Banxico's foreign reserve accumulation details
US$, million

	2019	Jul 31, 2020	Jul 31, 2020	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	180,877	192,606	313	11,728
(B) Gross international reserve	183,028	197,893	150	14,866
Pemex	--	--	-108	3,259
Federal government	--	--	-139	6,252
Market operations	--	--	0	0
Other	--	--	397	5,355
(C) Short-term government's liabilities	2,151	5,288	-164	3,137

Source: Banco de México

Information suggests additional losses in terms of jobs associated to IMSS, albeit much more marginal in July. On Wednesday, the Mexican Institute for Social Security (IMSS in Spanish) will release its report of total affiliated employees for July. Focus will center on job creation, considering losses accumulated in the last four months that have amounted to little over 1.1 million. In this context, President López-Obrador has made several comments on the figure. On July 24th, he mentioned that so far around 27 thousand positions had been eliminated, while on August 1st, he stated that for the whole month only 3,430 jobs were lost. In this sense, we think that the final figure could be closer to the latter number. Within the report, we will also be looking into wage dynamics, as well as business affiliation numbers, which actually improved in the previous month.

Change in jobs associated to IMSS
Thousands



Source: IMSS, STPS

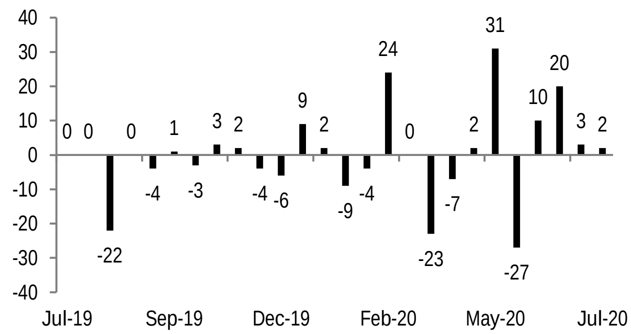
Banxico to cut the reference rate to 4.50%. On Thursday, the central bank will carry out its sixth monetary policy meeting of the year. We expect the central bank to cut again the reference rate by 50bps to 4.50%, fifth consecutive of this magnitude. We expect another unanimous vote, as we identified in the latest minutes at least four members that still saw room for additional easing. Nevertheless, this was nuanced with individual comments that pointed to an ample debate about the adequate level of the terminal rate for this cycle. Although there could be changes in the statement's tone, we believe it will remain dovish. For growth, considering the shock to activity in 2Q20, the tone could skew to a looser stance; however, it could be more cautious about the inflation path. Consensus in the latest *Citibanamex* survey (20 of 28 analysts, including us) expects -50bps, although six expect only a 25bps cut and two more that they leave the rate at its current level.

Regarding the magnitude of the easing cycle, we highlight recent comments by some Board members. In our podcast, *Norte Económico* (only available in Spanish), Deputy Governor Irene Espinosa said that although recent inflation dynamics have been somewhat concerning –particularly, core goods–, she expects pressures to normalize as the situation gradually returns to normal. Nevertheless, her stance seems tilted in favor of more cuts as she stated that prices in services, which reflect domestic conditions more accurately, have moderated given the slack of the economy and the circumstances surrounding the pandemic. Meanwhile, on a presentation in Congress, Deputy Governor Jonathan Heath mentioned that in his opinion, the easing cycle is not yet over, looking to take the rate below its neutral level into easing, while taking into account economic conditions. On the more dovish side, Deputy Governor Gerardo Esquivel said there may be more than one interest rate cut in the pipeline and that he does not rule out having negative real rates if conditions warrant it. He also said that they will see if there is room in this decision and in September, and more toward the end of the year (November and December).

As already mentioned, we believe most changes in terms of the tone could be in inflation, with the balance of risks still characterized as very uncertain. We should mention that, in the minutes, we perceived the majority of members as seeing a more benign outlook for prices as lower global inflation was included as a risk to the downside, among other factors. Despite of this, most recent data has mostly surprised to the upside (see chart below, left).

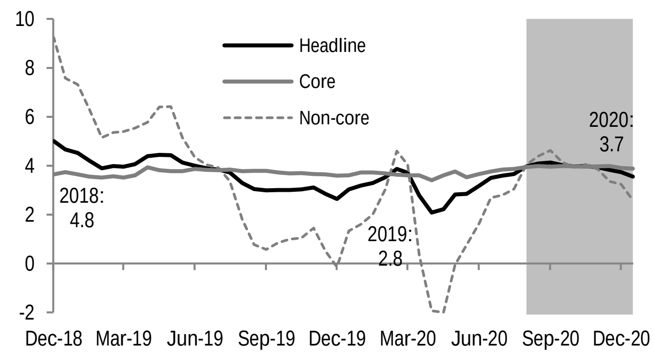
In addition, the annual rate stood at 3.62% at the end of July and, more importantly, core inflation was pressured to 3.85% –highest since April 2019–. Given this backdrop, we expect inflation at 3.7% and 3.9% by the end of the year, respectively (chart below, right). On the other hand, the last central bank survey showed an uptick in the estimate for year-end inflation. We believe these dynamics suggest risks for Banxico's forecasts (estimating an average of 3.5% and 3.8% for both the third and fourth quarters, in the same order) have skewed to the upside since the last decision. Hence, it will be important to see potential changes in terms of the tone and the projected path in the next *Quarterly Report*, to be published on August 26th.

Inflation surprises
Bps, actual less median forecast



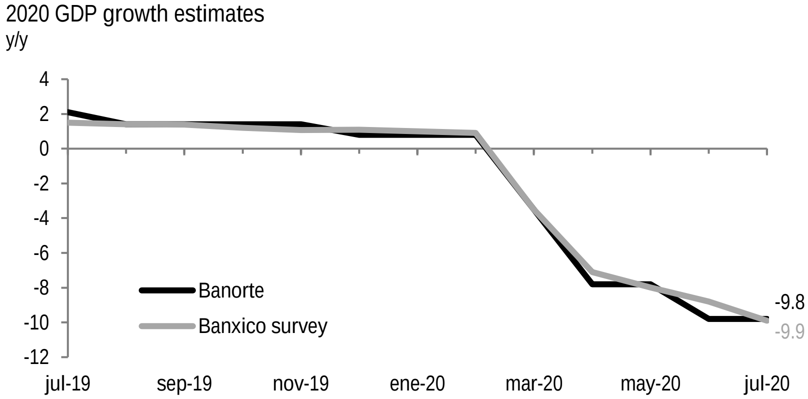
Source: INEGI, Bloomberg

Inflation forecast
% y/y, bi-weekly frequency



Source: INEGI, Banorte

On growth, there is ample consensus of strong weakness, confirmed with the historical plunge of 2Q20 GDP, highlighting also a deeper contraction in May, in contrast to other countries. In the central bank's survey, growth expectations for 2020 have been cut again, with the median at -9.9% y/y, virtually in line with our -9.8% (see chart below). Therefore, the balance or risks would probably be kept as "significantly skewed to the downside". Additionally, we believe it is likely that they consider the possibility of an external deceleration (to a great extent because of the second wage of contagion in the US) in a context in which evolution of the domestic curve has not reached a peak in new daily cases yet.



Source: Banxico and Banorte

Lastly, the majority will likely keep favoring a cautious approach due to financial stability risks, without ruling out new volatility shocks. Although market behavior has been more stable, uncertainty remains very elevated. In the domestic front, they will keep mentioning risks for public finances and stemming from Pemex. Moreover, it is very positive that they continue tracking closely market depth, along recent adjustments to the central bank's facilities to enhance credit provision and liquidity. In this respect, it is important to say that some of them, such as corporate bond repo transactions, have had low demand; nevertheless, this does not necessarily mean that they have been unsuccessful. We think that the central bank will keep reaffirming its commitment to use these tools and announce more measures if needed, with the goal of managing financial and economic shocks that could arise in the future.

After this decision, we reiterate our view of an additional 50bps cut in the decision to be held on September 24th, to 4.00%, where we expect the reference rate to close the year and the easing cycle to end. Specifically, we believe uncertainty and the recent inflation path, geopolitical risks –mainly the upcoming US elections, on November 3rd–, and persistent uncertainty because of the pandemic, will prove enough to limit additional cuts despite the extraordinary accommodative stance of most central banks around the world.

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