# Ahead of the Curve

## Lower GDP and higher inflation for 2020 in Banxico's Quarterly Report

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- **Banxico's Quarterly Report and minutes.** We expect the 2Q20 Quarterly Report to show lower forecasts for GDP growth scenarios, with the simple average for 2020 coming down around 300bps, closer to our -9.8% y/y forecast. If we are right, the mid-point for 2021 will likely be increased, currently at 2.5%. Updates on the output gap will also be important, possibly reaching around -20% in the second quarter and recovering slowly. On inflation, we expect the overall tone to be more cautious and less dovish, especially in the short term. Average headline inflation for 3Q20 and 4Q20 could be adjusted higher. Going into 2021, we think risks to the downside will weigh more heavily, with estimates likely closer to the target. In the minutes, attention will probably focus on the possible terminal rate of the current easing cycle, which is also a hot debate among market participants. All in all, changes to the QR are likely to portray a more difficult backdrop, while the minutes could shed light about members' opinions on how all these translate to the "available room to maneuver". We reiterate our call of a 50bps cut on September 24th, to 4.00%, albeit with the risk towards more modest easing (only -25bps).

- **Gross domestic product (2Q20 F).** We anticipate a revision of around 10bps lower relative to the preliminary estimate, to -19.0% y/y. This would be driven by mixed changes, improving in industry but weaker in services. In seasonally adjusted terms, performance would remain unchanged, at -17.3% q/q. We maintain our -9.8% y/y full-year GDP forecast, expecting a gradual recovery in the second half of 2020, led by external demand

Mexico weekly calendar

| DATE | HOUR (ET) | EVENT | PERIOD | UNIT | BANORTE | CONSENSUS | PREVIOUS |
|---|---|---|---|---|---|---|---|
| Mon 24-Aug | 7:00am | CPI inflation | 1H-Aug | % 2w/2w | 0.13 | 0.15 | 0.14 |
| | | | | % y/y | 3.87 | 3.91 | 3.62 |
| | | Core | | % 2w/2w | 0.08 | 0.13 | 0.09 |
| | | | | % y/y | 3.83 | -- | 3.85 |
| Tue 25-Aug | 10:00am | Current account | 2Q20 | US$ bn | -- | -- | -981.8 |
| Tue 25-Aug | 10:00am | International reserves | Aug-21 | US$ bn | -- | -- | 192.5 |
| Wed 26-Aug | 7:00am | GDP | 2Q20 (F) | % y/y | -19.0 | -18.9 | -18.9 |
| | | sa | | % q/q | -17.3 | -17.4 | -17.3 |
| | | Primary activities | | % y/y | -0.7 | -- | -0.7 |
| | | Industrial production | | % y/y | -25.7 | -- | -26.0 |
| | | Services | | % y/y | -15.6 | -- | -15.8 |
| Wed 26-Aug | 7:00am | Economic activity indicator | June | % y/y | -12.0 | -13.6 | -22.7 |
| | | sa | | % m/m | 10.5 | 10.0 | -2.6 |
| | | Primary activities | | % y/y | -5.0 | -- | 2.5 |
| | | Industrial production | | % y/y | -16.7 | -- | -30.6 |
| | | Services | | % y/y | -10.9 | -- | -20.3 |
| Wed 26-Aug | 1:30pm | Banxico's Quarterly Report | 2Q20 | | | | |
| Thu 27-Aug | 7:00am | Trade balance | July | US$ mn | 1,631.3 | -- | 5,546.7 |
| | | Exports | | % y/y | -6.6 | -- | -12.8 |
| | | Imports | | % y/y | -13.6 | -- | -22.2 |
| Thu 27-Aug | 10:00am | Banxico's Minutes | | | | | |
| Fri 28-Aug | 2:30pm | Budget balance (measured with the PSBRs) | July | MX$ bn | -- | -- | -338.7 |

Source: Banorte; Bloomberg

## Proceeding in chronological order...

**Inflation to step off the accelerator at the beginning of August.** We estimate headline inflation at 0.13% 2w/2w, with the core at 0.08% (contribution: +6bps) and the non-core at 0.27% (contribution: +7bps). We expect the slight breather observed in the previous fortnight to extend through this period, with the effects of the pandemic still influencing price dynamics, albeit this time to the downside. With these results, annual inflation would stand at 3.87% from 3.62% in July. It should be noted this is due to some extent because of a more challenging base effect, especially at the non-core component, which would climb to 4.01% from 2.92%. We should remember that, in 2019, we saw a relevant decline in fresh fruits along lower pressures in energy, which extended further into September. On the other hand, the core would tick slightly lower, at 3.83% from 3.85%.

Going to the core, we highlight our view of relatively low pressures in education related categories, including tuitions –adding only 1bp–, as well as uniforms and other supplies –which are accounted for in other goods–. This would be mainly explained by the delay in the physical return to schools, as COVID-19 contagion conditions still prevent it. Meanwhile, airfares (-1.5bps) and tourism services (-1.3bps) would extend their latest decline, influenced by its usual seasonality due to the end of summer vacations, as well as aggressive promotional campaigns. Nevertheless, we think the fall will be dampened somewhat by the impact from the pandemic, which has already strongly hit the sector's profitability. Meanwhile, housing will likely continue showing muted pressures on very high economic slack, adding only 0.5bps. Turning our attention to goods, we believe they will remain relatively more modest when compared to their recent performance. Processed foods could add 2.5bps, with some staples such as milk, finally showing some relief, according to our monitoring. Other goods would come in at +4.5bps, quite low with respect to figures for the same period in recent years, due to: (1) Lower demand of some goods related to education compared with the one typically observed in the period; and (2) More stability in other goods, possibly aided by the economic reopening and recent FX dynamics.

At the non-core, energy would be flat (0bps), with a mixed performance inside. Both electricity tariffs (+0.7bps) and LP gas (+1.1bps) would move higher, with the latter adding eight fortnights to the upside, mainly on higher reference prices. On the contrary, gasolines would subtract 2bps, driven by lower international prices which more than compensated for a modest depreciation of the Mexican peso. On agricultural goods, the trend is up. Fresh fruits would add 4bps, with some disruptions to crops after Hurricane Hanna, which impacted northern states in the latter part of July. This would be show mainly in onions and to a lesser extent in tomatoes and lemons. Meanwhile, meat and egg would inch higher (+2bps), with reports suggesting a slight but broad increase across categories.

**Weekly international reserves report.** Last week, net international reserves decreased by US$123 million, closing at US$192.5 billion. According to Banxico's report, this was mainly explained by: (1) US$120 million sales from Pemex to the central bank; and (2) a negative valuation effect of US$243 million in institutional assets. In this context, the central bank's international reserves have increased by US$11.7 billion so far in 2020 (refer to the following table).

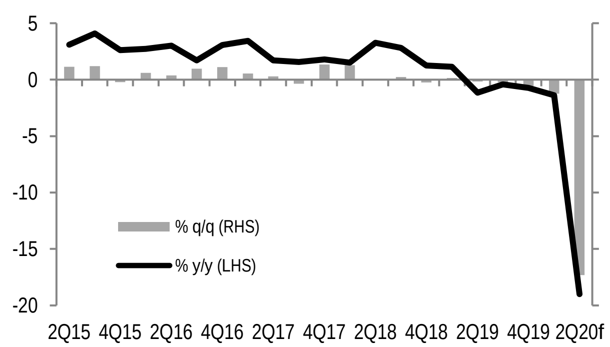
Banxico's foreign reserve accumulation details
US$, million

| | 2019 | Aug 14, 2020 | Aug 14, 2020 | Year-to-date |
|---|---|---|---|---|
| | Balance | | Flows | |
| International reserves (B)-(C) | 180,877 | 192,531 | -123 | 11,654 |
| (B) Gross international reserve | 183,028 | 197,404 | -429 | 14,376 |
| Pemex | -- | -- | 120 | 3,379 |
| Federal government | -- | -- | -21 | 6,169 |
| Market operations | -- | -- | 0 | 0 |
| Other | -- | -- | -527 | 4,828 |
| (C) Short-term government's liabilities | 2,151 | 4,873 | -306 | 2,722 |

Source: Banco de México

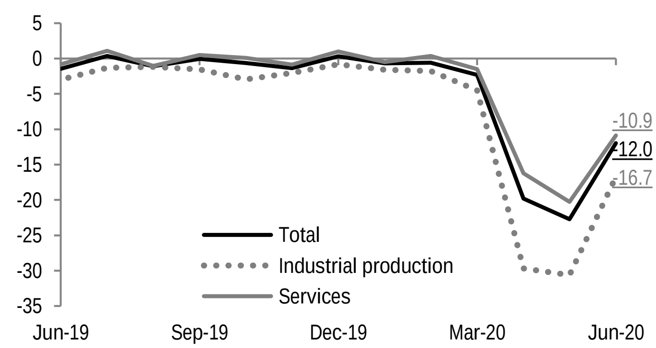
**Mexico's final 2Q20 GDP likely an inch lower.** We anticipate 2Q20 GDP to be revised around 10bps lower relative to the preliminary estimate, to -19.0% y/y. This would be driven by mixed changes among its components, improving in industry but weaker in services when compared to that report. In seasonally adjusted terms, performance would remain unchanged, at -17.3% q/q. If this is the case, these figures would imply a 12.0% y/y contraction in the monthly GDP-proxy IGAE for June, which will be released simultaneously. Although the annual rate would remain very weak in the latter case, it is consistent with an important 10.5% m/m recovery, in line with a series of available data pointing to stronger dynamism due to the economic reopening, higher mobility and the designation of new industries as essential, among other factors.

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 surprised to the upside in June, mainly because of the manufacturing sector although also improving sequentially in construction and mining. As a result, secondary activities for the full quarter would be revised to -25.7% y/y from -26.0% originally. Taking only this into account, it would be enough for 2Q20 GDP increase to -18.9% y/y from -18.8%.

Despite of the latter, we believe this will be compensated by a weaker services sector relative to the implied -15.6% y/y in GDP, cut by around 20bps to -15.8%. In our view, the highest risk to our forecast is that the relative strength of manufacturing in June pulls transportation services higher. Nevertheless, we think formal employment figures suggest some limitations, losing 113,851 posts in the services sector and with the annual rate in terms of total workers at -3.5% y/y, a new historical low –which exacerbated in July–.

Nevertheless, we should say that, according to INEGI's employment report, the period registered net positive job creation in both the formal and informal sector, albeit concentrated in the latter and among people in the low-end of the wage distribution. Coupled with a recent inflation pick-up, this suggests limits to total households' income. In this environment, retail sales for the period, published today, showed a 16.6% y/y decline, which was in line with our expectation.

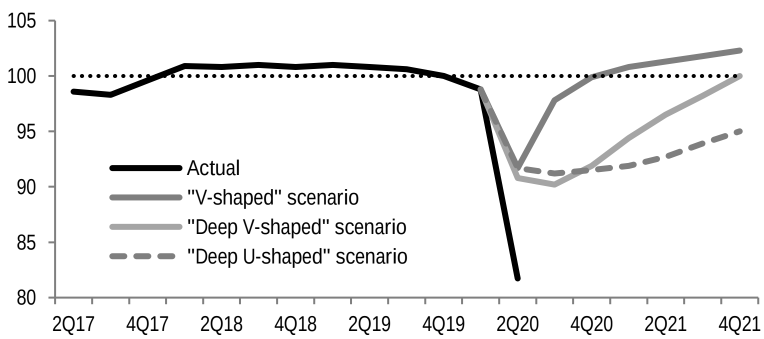
Going forward, these results would be consistent with our expectation that the recovery in Mexico will be led by support from external demand, with the domestic front facing against stronger challenges. In this context, we maintain our -9.8% y/y full-year GDP forecast, expecting a gradual recovery in the second half of 2020. In our view, risks are balanced. In monthly frequency, data keeps confirming that the bottom in terms of activity (in seasonally adjusted terms) was observed in May. Our base-case is that strict lockdowns –such as those experienced in 2Q20– will not be repeated, with less willingness by authorities to implement them given their economic impact. Nevertheless, the degree of uncertainty remains very high mainly because of two factors, both related to the pandemic: (1) The possibility that restrictions are re-imposed domestically as the curve of new cases has not reached a peak yet, albeit more focalized given the 'traffic-light' system used by the government to differentiate which activities may be carried out; and (2) additional disruptions of external supply chains cannot be ruled out either, as some countries have shown a 'second wave' of contagion, most importantly among them the US. All in all, we estimate a sequential recovery in economic activity of 4.4% q/q in 3Q20 and 6.3% in the fourth quarter, although with annual rates still negative in both periods.

**Banxico's *Quarterly Report* and minutes.** The central bank will release its *Quarterly Report* (QR) for 2Q20 on Wednesday –around 1:30pm (ET)– and the minutes of the last monetary policy meeting on Thursday –at 10:00am (ET)–. As usual, attention in the former will center on updated estimates for GDP and inflation. On the latter, we will watch for comments on policy going forward, considering relevant changes to the last statement –reaffirming that room for further easing will be data-dependent– as well as one dissident vote.

On economic activity, 2Q20's preliminary print at -18.9% y/y was considerably below Banxico's forecast in the QR (see chart below). For example, their worst case for the period was in the "Deep V-shaped" scenario, which implied a 9.9% y/y contraction (sa), about half the decline observed. In this sense, language since then (*e.g.*, that the balance of risks is significantly skewed to the downside) suggests the Board has already incorporated a deeper economic contraction this year. Considering this, it is practically a given that 2020 GDP will be revised meaningfully downwards. Thus, we believe that it will be more relevant: (1) The magnitude of the adjustment; and (2) if scenarios are provided again or the central bank returns to a single forecast. On the former, recent comments from Deputy Governor Jonathan Heath suggest his expectations are not far off from the market. Meanwhile, Governor Alejandro Díaz de León said after the last decision that the outlook will depend on a possible treatment and/or a vaccine against the virus. He stated that the longer it takes, the scenario might resemble more a "Deep U-shaped".

We think these comments hint that scenarios will be presented again, with relevant adjustments in each of them. It could possibly be that three are unveiled, as uncertainty about the path for activity remains elevated. Nonetheless, we also see a high chance that different "shapes" than those already presented are estimated. In this respect, Deputy Governor Javier Guzmán said recently that we could see a "W-shaped" recovery. Meanwhile, and given the magnitude of the contraction in the second quarter, we believe the "V-shaped" scenario could be eliminated. In either case, considering that the simple average of the previous scenarios stood at -7.2% y/y, it is our take that this metric will come down around 300bps, closer to our -9.8% and the market's -9.9% seen in the latest Banxico survey. If we are right, the mid-point for the forecast in 2021 will likely be increased due to a more favorable base-effect, currently at 2.5%.

Banxico GDP forecasts
Index sa, 4Q19 =100




*Note: Actual incorporates 2Q20 preliminary GDP as released by INEGI's, with the index level implied by the annual change in seasonally adjusted figures
Source: Banxico, INEGI

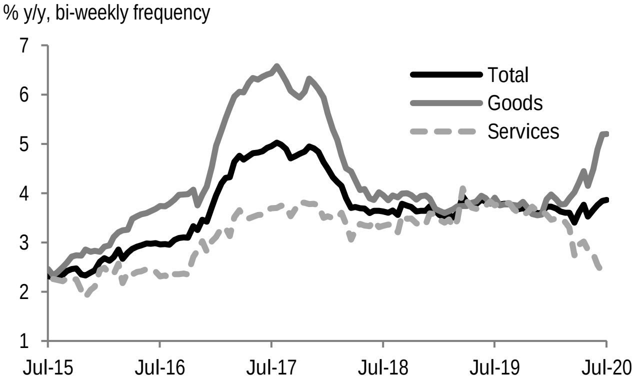
We expect revisions in other forecasts, such as those for the labor market. In the previous QR, Banxico estimated job losses of people affiliated to IMSS between 800 thousand and 1.4 million. Despite a larger-than-expected contraction in activity, year-to-date losses until July stand at 925.5 thousand. Considering a relatively favorable position in this front, we could see a slight upward adjustment and a tighter range, albeit still large compared to the usual 100 thousand mark. On external accounts, estimates could skew further to a trade balance surplus, considering recent prints and our view that the recovery will mainly be externally-driven. The current account will probably remain on deficit, albeit also narrowed down.

Updates on the output gap will also be very important, as recent communications have stressed that "*...greater economic slack is expected within the time frame in which monetary policy operates…*". This would be consistent with downward revisions to GDP, possibly reaching around -20% in the second quarter (previous: -12.3% in the worst scenario) and recovering slowly in the latter part of 2020 and into 2021. This would also be shown for each scenario, as in the last QR. We believe this has had very relevant implications for the central bank's assessment and dovish tone on activity –with the estimated gap already negative since 4Q18, even before the COVID-19 shock– and their outlook on demand-side pressures for inflation, as outlined in the section below.

On inflation, we expect the overall tone to be more cautious and less dovish, especially in the short term. First, we highlight that the balance of risks has been characterized as uncertain for a little over a year, with the last statement adding new risks to the upside –persistently high core inflation– and to the downside –lower services prices on reduced demand–. Considering recent dynamics, particularly in core goods (see chart below, left), the former will probably weigh more heavily for coming quarters. As a result, we estimate 3Q20 could be adjusted around +30pbs, to 3.8% from 3.5%. Adjustments to 4Q20 could be more modest, by about +10 to +20bps (to 3.6%-3.7%), incorporating the central bank's new estimates about slack conditions.

On the other hand, it is our take that the Board is still relatively comfortable about the mid-term outlook, as suggested by the comment that "*...headline and core inflation* […] *are expected to lay around 3% within the 12-24 month forecast horizon…*". In our view, this shows some confidence on reaching the target despite recent price pressures that have pushed headline inflation above 3%. Thus, going into 2021, we think risks to the downside will weigh more heavily, with a key role played by the degree of slack in Banxico's assessment. In this sense, estimates will likely remain closer to the target–except for 2Q21, on an adverse base effect–. This could result in modest downward adjustments in 3Q21 and 4Q21. We stress that this contrasts with our forecasts (see table below, right) as we anticipate higher inflation throughout the horizon. We believe that a relevant factor behind these differences is our assumption that some negative effects due to the pandemic will linger around, highlighting among them: (1) A weaker peso against the dollar, which we see as more permanent in nature, resulting in a higher pass-through effect than observed recently; (2) a negative supply-side effect stemming from business closures, allowing for more market pricing power for remaining companies; (3) social-distancing measures staying in place that increase operating costs; and (4) a hit to potential GDP, with the downshift in investment underway for some time now, plunging heavily in 2020 and only with a very modest recovery in 2021.

Core inflation
% y/y, bi-weekly frequency




Source: INEGI

Inflation forecasts
% y/y, quarterly average

| | 2020 | | | 2021 | | | |
|---|---|---|---|---|---|---|---|
| | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q |
| Headline | | | | | | | |
| Banxico (QR 1Q20) | 2.7 | 3.5 | 3.5 | 3.4 | 4.0 | 3.2 | 3.0 |
| Banorte | 2.8* | 3.9 | 3.8 | 3.5 | 4.3 | 3.7 | 4.0 |
| Core | | | | | | | |
| Banxico (QR 1Q20) | 3.7 | 3.8 | 3.8 | 3.7 | 3.2 | 2.7 | 2.6 |
| Banorte | 3.6 | 3.9 | 3.9 | 4.0 | 4.1 | 4.0 | 4.1 |

*Note: Figure is actual data for 2Q20
Source: Banxico, INEGI, Banorte

In the minutes, attention will probably focus on the possible terminal rate of the current easing cycle, which is also a hot debate among market participants. In our view, the tone of the statement was less dovish, supporting the view that the end is near. Specifically, we will be looking to identify Board members' positions about the relative costs and benefits of further cuts.

We will also analyze the reasons behind the dissenter's vote –which we think was by Deputy Governor Guzmán– for only a 25bps reduction. If we are right, it could help us gauge some of the concerns that may be shared also by other members. We also highlight a very important addition to the statement that reaffirmed the Board's data-dependency, stating that "*...the available room for maneuver will depend on the evolution of the factors that have an incidence on the outlook for inflation and its expectations, including the effects that the pandemic might have on both factors…*". Despite the caveats above, we think the stage is being prepared for the end of the cycle soon, mainly based on our outlook for inflation. Nevertheless, additional information within the minutes will help us either strengthen or weaken our base case.

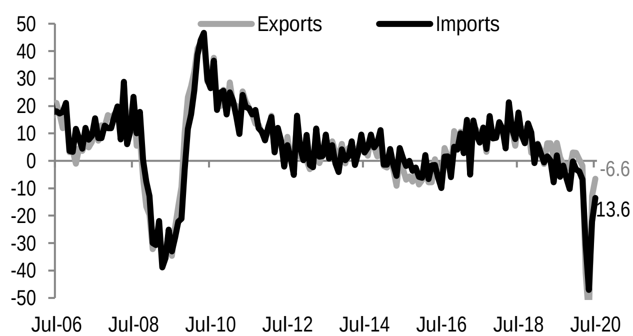
All in all, changes to the QR are likely to portray a more difficult backdrop, as inflation has not fallen as the central bank expected despite an even larger drop in activity. In this sense, the magnitude and direction of forecast adjustments will be very important to analyze how they see the balance of risks, especially in a difficult financial environment, characterized by unusual uncertainty –not only because of the virus, but also other geopolitical risks such as the US election–. We expect the minutes to shed light about the specific opinions among members on how all these translate to the "available room to maneuver". We reiterate our call of a 50bps cut on September 24th, to 4.00%, albeit with the risk towards more modest easing (only -25bps). We maintain it mainly on two factors. First, GDP forecasts have been falling while Banxico has not shown grave concerns about mid- and long-term inflation expectations. Second, a 50bps cut is still consistent with a positive real rate, which may be a lower bound for the majority. However, given the latest developments, we cannot rule out an even more cautious stance, particularly as 375bps of cuts have accumulated since the start of the easing cycle.

**Trade balance to remain in surplus in July.** We estimate a US$1,631.3 million surplus, moderating relative to the historical high of +US$5,546.7 million observed in June, albeit still positive. We expect an extension of the recovery in trade as measured by the total volume (exports plus imports), estimated to reach US$71,488 million, 10.1% y/y down after falling 17.3% in June. We expect total exports at -6.6% y/y and imports at -13.6%.

In oil, we estimate a US$1,045.3 million deficit, widening at the margin. On exports, the price of the Mexican oil mix averaged 37.49 US$/bbl, extending the recovery that began in May. Nevertheless, available data suggests modest shipped volumes despite Mexico's share in the OPEC+ production cut ending. We see total oil exports at -35.2% y/y, with crude-oil at -34.4%, improving only modestly when compared to June –also affected by a more difficult base effect–. Imports would fall 39.3%, still affected by Pemex's declaration of *force majeure* clauses due to the pandemic. Consumption goods are expected to decline 38.4%, significantly above the -69.8% of the previous month, boosted by higher gasoline prices in the US and stronger volumes likely related to higher mobility levels. Intermediate imports would also be slightly better relative to June, at -39.9%.

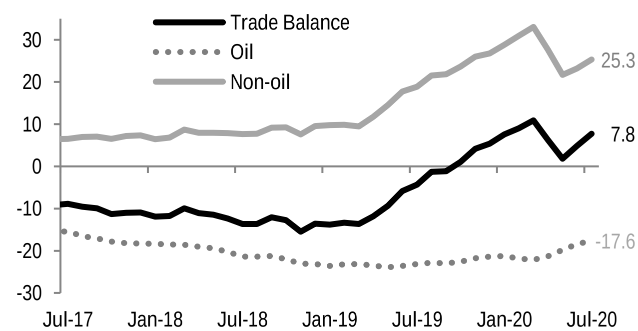
The non-oil balance would come in with a US$2,676.6 million surplus. Broadly speaking, exports (-4.8% y/y) would show a much better performance relative to imports (-10.7%). We believe this should result from the boost provided by policy measures in the US, which has supported households' income and purchasing power. In this respect, we note the ISM manufacturing picked up meaningfully in the period to 54.2pts, highest since March 2019. More importantly, the 'imports' component (related to Mexico's exports given our relevance as trade partner) rebounded to 53.1pts from 48.8pts in June; in contrast, 'exports' fell to 49.3pts from 58.9pts. In our view, this suggests differentiated dynamics between Mexico's demand from abroad (its exports) relative to purchases (imports), consistent with our view that the recovery will be led by the external sector. Within exports we expect manufacturing at -5.2%. We highlight our view of the relative improvement in autos, which seems to be rebounding very quickly after activities were virtually halted in April and May. This is also supported by US industrial production, which showed a 1.1% y/y increase in the sector. Specifically, we anticipate a 10.5% contraction from the -31.0% observed in the previous month. Other manufacturing would also be stronger, at -2.3% (previous: -3.3%), limited somewhat by an adverse base effect. In imports, the main headwind would be in consumption goods (-33.0%), while intermediate goods (-6.8%) are likely to be better on more dynamism in manufacturing. Lastly, we see capital goods as muted (-19.4%), with more moderate declines in annual terms but only considering that it is coming off already low levels. Nevertheless, the outlook for investment remains challenging, while costs of this type of goods are likely higher if only because of higher levels for the exchange rate.

Exports and Imports
% y/y nsa




Source: INEGI, Banorte

Trade balance
US$ billion, 12-month rolling sum




Source: INEGI, Banorte

**MoF's public finance report (July).** Attention will center on the Public Balance and Public Sector Borrowing Requirements (PSBR) –with the latter at -$338.7 billion in June– and comparing them to forecasts updated in the latest quarterly report. We will also look to revenues and spending, particularly in the annual comparison. Specifically, the former could offer additional insights on economic activity, while in the latter we will focus in spending on key sectors, considering austerity efforts coupled with higher spending to combat COVID-19 and its effects on the economy. Finally, we will also analyze public debt, which as of June stood at MXN$12.3tn (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, 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.**

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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. |

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.

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