Banxico QR – A more difficult short-term backdrop for further easing

- **Banxico published today its 2Q20 *Quarterly Report* (QR). The release was accompanied by a press conference by Governor Alejandro Díaz de León**
- **In line with our view, for 2020, GDP forecasts were lowered but inflation estimates were nudged higher. We believe this signals a more challenging short-term backdrop for strong additional easing. We see the tone of the document as less dovish at the margin, in line with the latest statement**
- **The central bank maintained three different scenarios for GDP, given persistent uncertainty about the evolution of the pandemic. A simple average of these forecasts shows GDP in 2020 at -11.0% y/y from -7.2% previously (Banorte: -9.8% For 2021, it stands at 3.2% from 2.5% (Banorte: 1.8%)**
- **Regarding inflation, we highlight higher estimates for both the headline and core at least until the first half of 2021, albeit with the latter also adjusted upwards for the rest of the horizon. Nonetheless, the convergence towards the 3% target remains unchanged, on 4Q21**
- **Moreover, the balance of risks for inflation remains characterized as uncertain. In this respect, we highlight that:**
  (1) Two additional drivers were included both to the downside and to the upside; and
  (2) Three factors are common to both sections (FX, energy, and relative demand considerations). In our view, this clearly shows the high uncertainty that prevails about their dynamics going forward, suggesting that they could pressure inflation either way
- **After these adjustments, Banxico's inflation forecasts are more in line with our short-term outlook, but maintain important differences for next year, as we see more pressures**
- **The traditional *grey boxes* expanded on the effects of the pandemic, providing valuable information given a highly uncertain environment**
- **Given relatively few surprises in today's document, we reiterate our call of a 50bps cut on September 24th, to 4.00%, with risks tilted towards more modest easing (only -25bps)**
- **Local yield curve reflecting the debate on the magnitude of further rate cuts**

The *Quarterly Report* maintains a less dovish tone at the margin. Banxico published today its *Quarterly Report* (QR) for 2Q20. The release was accompanied by a press conference led by Governor Alejandro Díaz de León. In line with our view, GDP forecasts were lowered but inflation estimates were nudged higher. We believe this signals a more challenging short-term backdrop for strong additional easing. Overall, we see the tone of the document as less dovish at the margin, in line with the latest statement.

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Banxico's 2020 policy decisions

Date	Decision
February 13	-25bps
March 20 (intra-meeting)	-50bps
April 21 (intra-meeting)	-50bps
May 14	-50bps
June 25	-50bps
August 13	-50bps
September 24	--
November 12	--
December 17	--

Source: Banxico

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

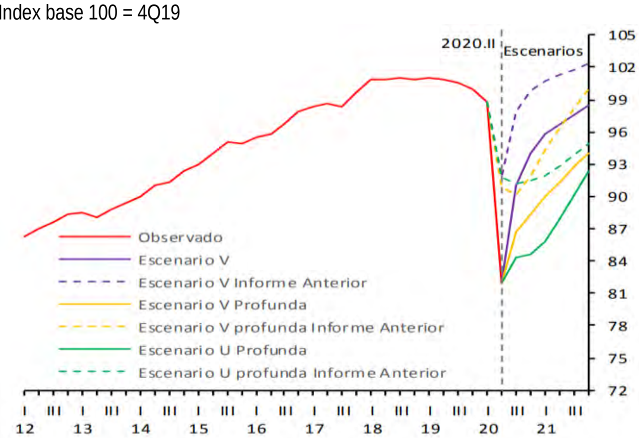
STARMINE AWARDS FOR REUTERS POLLS FROM REFINITIV

All GDP scenarios revised down. In line with the previous QR, and still considering a high degree of uncertainty about the pandemic and its evolution, Banxico maintained three different scenarios for GDP. The 'shapes' described are the same but all of them were revised lower, which we think was mainly due to the higher-than-expected plunge in 2Q20, as seen in the chart below on the left. As a result, the simple average for 2020 was adjusted to -11.0% y/y from -7.2%, surpassing both our expectations (-9.8%) and consensus (-9.9% according to the latest central bank survey). Thus, 2021 was revised higher to +3.2% from +2.5%. Similar to the previous occasion, each scenario takes on different assumptions. The following list updates the main changes:

(1) "*V-shaped*": Assumes again that the recovery started in June, just like in the previous QR and after data already published for the month, specifying also the view of a relatively speedy recovery in 3Q20, followed by a more gradual performance in the rest of the year and in forecast horizon.
(2) "*Deep V-shaped*": Also contemplates a reactivation in 3Q20, slightly earlier than in the last report, albeit at a slower pace than in the "V-shaped" scenario above. This reflects the possibility of some persistence of the pandemic –both locally and globally–, with measures to fight it lifted more gradually.
(3) "*Deep U-shaped*": Instead of a slow recovery as soon as September, it now forecasts a weak economy during the rest of 2020 as infections flare-up at a global scale, resulting in more persistent shocks to aggregate supply and demand.

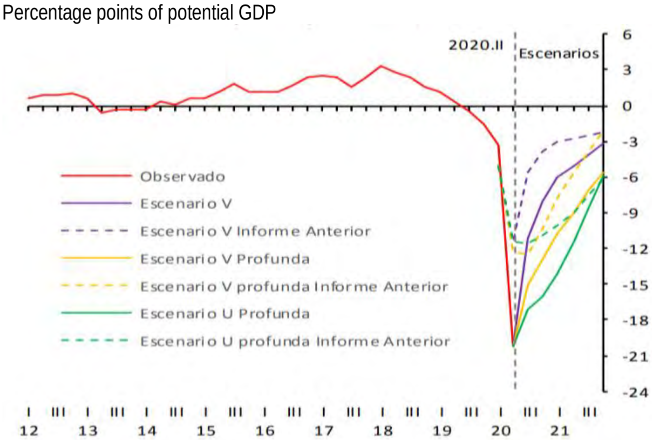
For all of these, point estimates for 2020 and 2021 are outlined in the table below. However, and as in the last QR, there were no explicit probabilities stated for them, with Governor Díaz de León highlighting that uncertainty remains very high. We should mention that our expectation for 2020 of a 9.8% y/y decline, seems to lie somewhere between the "V-shaped" and "Deep V-shaped" forecasts; for 2021, our +1.8% is closer to the "Deep V-shaped" and "Deep U-shaped" outlook.

GDP forecasts
Index base 100 = 4Q19



Source: Extracted directly from Banxico's 2Q20 Quarterly Report, only available in Spanish

Output gap
Percentage points of potential GDP



Source: Extracted directly from Banxico's 2Q20 Quarterly Report, only available in Spanish

Unprecedented degree of slack. In line with comments in recent monetary policy statements and minutes, the output gap widened considerably, reaching close to -20% of GDP in 2Q20. Considering this, as well as downward revisions across the board for economic activity, all three scenarios consider levels of slack between -3% to -6% of GDP by the end of 2021. We believe this is very important for understanding adjustments made to inflation forecasts, as detailed in a following section.

Relevant revisions in other estimates. Updated estimates were provided for IMSS employment, trade balance and current account. It should be noted that the outlook for employment looks more favorable, with an estimated loss of -925 thousand jobs, and the current upper bound at the mid-point in the last QR. This happened despite lower GDP expectations. Therefore, we believe it was driven by better-than-expected figures in previous months, considering that year-to-date (until July) losses stand exactly at 925k jobs. Meanwhile, the central bank now expects a trade balance surplus in all scenarios, with the mid-point at US$6.1 billion. This is very relevant as it supports our view that the recovery in 2H20 will be externally driven. Finally, the current account might remain in deficit, as portrayed by the -US$500 million simple average balance.

Banxico's Forecasts
Current Report (2Q20)

	2020	2021
GDP (% a/a)		
V-shaped	-8.8	5.6
Deep V-shaped	-11.3	2.8
Deep U-shaped	-12.8	1.3
Employment (thousands)	-1,100 to –750	100 to 450
Trade Balance (bn)	3.3 to 8.8 (0.3% to 0.9% of GDP)	-5.7 to 4.2 (-0.5% to 0.4% of GDP)
Current account (bn)	-6.0 to 5.0 (-0.6% to 0.5% of GDP)	-18.1 to -2.3 (-1.5% to -0.2% of GDP)

Source: Banxico

Banxico's Forecasts
Previous Quarterly Report (1Q20)

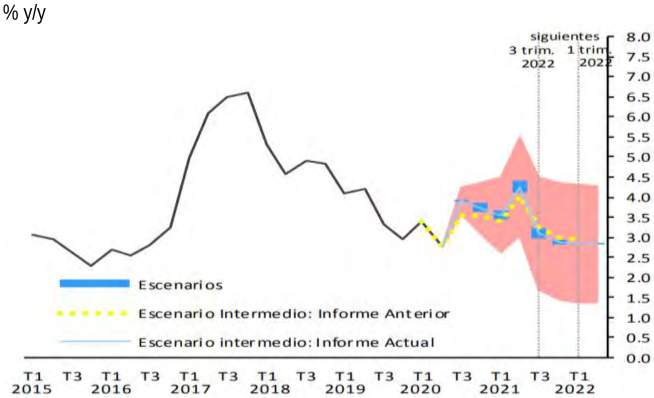
	2020	2021
GDP (% a/a)		
V-shaped	-4.6	4.0
Deep V-shaped	-8.8	4.1
Deep U-shaped	-8.3	-0.5
Employment (thousands)	-1,400 to -800	-200 to 400
Trade Balance (bn)	-4.8 to 4.6 (-0.5% to 0.5% of GDP)	-7.2 to 4.5 (-0.6% to 0.5% of GDP)
Current account (bn)	-15.1 to -3.1 (-1.5% to -0.3% of GDP)	-20.5 to -4.6 (-1.8% to -0.5% of GDP)

Source: Banxico

As expected, inflation forecasts were adjusted higher, particularly for the short term. In line with our expectations, inflation estimates were revised upwards, particularly for the rest of 2020 (see chart and table below). The central bank stressed this reflects mainly higher non-core prices (particularly energy) and therefore its impact is expected to be transitory. Nonetheless, there were also adjustments at the core –albeit of a more modest magnitude– that primarily incorporate higher goods' prices, something that has been an increasing concern for some Board members. Overall, we see these changes as not very surprising and less dovish at the margin. Moreover, we believe it is key that the expected timeframe for the convergence towards the target was unchanged, at 4Q21. This is consistent with the signal in the last statement that inflation in the medium term remains well anchored. Specifically, in the case of the headline inflation, 3Q20 was increased by 40bps (to 3.9%) and 4Q20 by 20bps (to 3.7%). The latter magnitude is also repeated for the first half of next year. Nevertheless, starting in 2H21, estimates were lowered by 10bps in each of the remaining quarters, mostly reflecting the arithmetic impact of a higher base-effect.

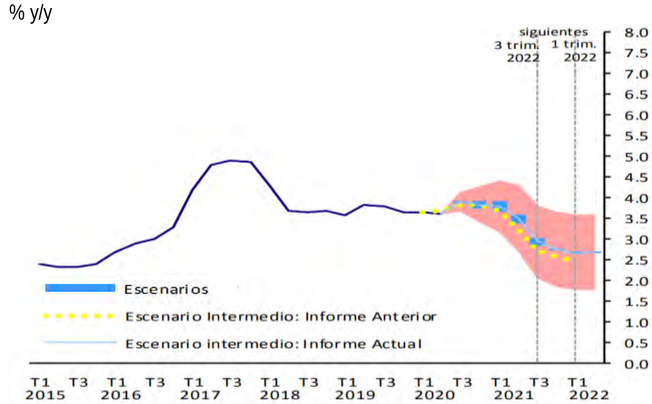
More importantly though, in our view, is that core inflation was increased for all periods in the forecast horizon (except 4Q20), in magnitudes between 10bps to 30bps. Despite of the latter, we also note that the central bank still expects a downward trend, likely related to: (1) The gradual fading out of shocks explained directly by the pandemic; and (2) the effect of even higher anticipated economic slack on demand-side pressures to prices.

Fan chart: Headline inflation*
% y/y



Source: Extracted directly from Banxico's 2Q20 Quarterly Report, only available in Spanish

Fan chart: Core inflation*
% y/y



Source: Extracted directly from Banxico's 2Q20 Quarterly Report, only available in Spanish

CPI forecasts
% y/y, quarterly average

	2020			2021				2022	
	II	III	IV	I	II	III	IV	I	
CPI									
Current	2.8*	3.9	3.7	3.6	4.2	3.1	2.9	2.8	2.8
Previous	2.7	3.5	3.5	3.4	4.0	3.2	3.0	2.9	--
Difference (bps)		40	20	20	20	-10	-10	-10	--
Core									
Current	3.6*	3.9	3.8	3.8	3.5	3.0	2.8	2.7	2.7
Previous	3.7	3.8	3.8	3.7	3.2	2.7	2.6	2.5	--
Difference (bps)		10	0	10	30	30	20	20	--

Source: Banco de México, 2Q20 QR; *Observed data

More relevant changes in main risks driving inflation… We should mention that the central bank maintains the characterization of the balance of risks as uncertain, as has been the case for little over a year. Nevertheless, and coupled with changes to their mid-estimates, the list of drivers was also updated. First, they listed five in each case –to the upside and downside– instead of only three in the last statement. We note that energy prices were included in both sections, while a lower than anticipated exchange rate was added in those to the downside, which previously was only stated in the ones that could push inflation higher. Similar to the latter, higher relative demand for certain goods was included in those to the upside and maintained in those to the downside. This is most likely reflecting the trend observed in core goods, particularly in processed foods given their status as essential. Second, on those to the upside, potential supply chain problems and higher costs to comply with sanitary measures was given relatively more weight than previously, at the second place only behind potential FX pressures. Overall, we highlight that three factors are common to both sections (FX, energy, and relative demand considerations). In our view, this clearly shows the high uncertainty that prevails about their dynamics going forward, suggesting that they could pressure inflation either way and therefore support the characterization of the balance as risks as uncertain.

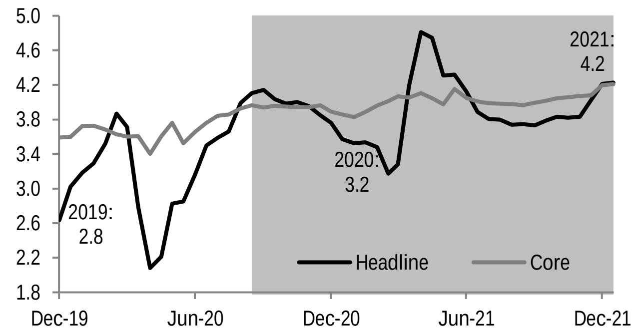
…which on balance, we see more tilted to the upside. After these adjustments, Banxico's forecasts are more in line with our short-term outlook but maintain important differences for next year (particularly in 2H21), as we see more pressures (see table and chart below). Specifically, we think that the key factor behind these is our assumption that some negative effects due to the pandemic will linger around for longer, highlighting among them: (1) A weaker peso against the dollar, which we see as more permanent in nature, possibly increasing the magnitude of the pass-through effect despite the ample degree of slack; (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.

Inflation forecasts
% y/y, quarterly average

	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
Headline								
Banxico	3.4*	2.8*	3.9	3.7	3.6	4.2	3.1	2.9
Banorte			3.9	3.9	3.5	4.4	3.8	4.0
Core								
Banxico	3.7*	3.6*	3.9	3.8	3.8	3.5	3.0	2.8
Banorte			3.9	3.9	4.0	4.1	4.0	4.1

* Actual data. Source: Banxico, Banorte

Banorte inflation forecasts
% y/y, bi-weekly frequency



Source: INEGI, Banorte

Extended analysis of the pandemic's effects in the *grey boxes*. The notes studied the direct impact of COVID-19 on a specific economic sector, direct and indirect effects on the markets, and of policies adopted to combat the pandemic. These included: (1) Effects of lockdown measures in global activity; (2) The COVID-19 pandemic and economic activity in Mexico; (3) Recent evolution of monetary and credit aggregates in different economies; (4) Special accounting criteria and its effects on banking loans to private non-financial institutions; (5) Higher inflation volatility and its expectations in the midst of the pandemic; (6) Inflation dynamics in different countries; and (7) Capital flows and risk aversion. We were particularly interested in *boxes* (2) and (5). In the former, we highlight that a correlation was found between reduced mobility and lower contagion, albeit at the cost of lower economic activity and higher job losses. However, it also shows that performance across the country was rather heterogeneous, consistent with data released so far. On the latter, prices have shown more volatility because the pandemic, evidenced by relatively fat tails as well as a higher skew on relevant categories, such as core goods and services. The analysis affirms that this has also contaminated inflation expectations, with higher standard deviations in private-sector analysts' estimates.

We maintain our view that Banxico will cut 50bps in September 24th, to 4.00%. Given no strong surprises relative to our expectations today, we reiterate our call of a 50bps cut on September 24th, to 4.00%. Nevertheless, we also see the risk of more modest easing (only -25bps), mainly because of changes in short-term inflation forecasts. We maintain our view because of two main factors: (1) GDP forecasts have been falling for some time by now, while Banxico has not shown grave concerns about mid- and long-term inflation expectations; and (2) a 50bps cut is still consistent with a positive real rate, which may be a lower bound for the majority. However, given 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. On the latter, we think that the minutes of the last meeting, to be published tomorrow, could shed additional insight about the relative stance of Board members. Especially, we will focus on possible comments about the available "room to maneuver", despite the central bank's signal that this is mostly dependent on new information about inflation and its expectations. It is our take that Deputy Governor Javier Guzmán was the dissenter in favor of 25bps, while we will also pay attention to opinions about the adequate monetary policy in a highly uncertain environment, not only because of the virus, but also other geopolitical risks, such as the upcoming US election.

From our fixed income and FX strategy team

Local yield curve reflecting the debate on the magnitude of further rate cuts. The local fixed-income market has experienced a week under pressure, pushed since Monday in the aftermath of the upward surprise in August's first bi-weekly CPI report and under a widespread sell-off in global sovereign bonds. In this context, the Treasuries curve has steepened again, with the market waiting anxiously the Jackson Hole Symposium starting tomorrow under a robust risk-on mood. Following Banxico's *Quarterly Report*, the local yield curve extended by 2-3bps a session already pressured, closing with losses of 6bps on average for Mbonos and 4bps in TIIE swaps, with pressures as high as 12bps and 7bps, respectively, in long-term securities. Coupled with a yield curve pricing which currently incorporates implied rate cuts for Banxico of 30bps in the remainder of 2020, this reaction reflects market positioning still debating the magnitude of the last rate cuts in this easing cycle. Given this situation, tight valuations, and relatively narrow deviations in spreads along the nominal yield curve, we wait for better entry levels to build new directional recommendations.

In the FX market, the Mexican peso experienced a slight depreciation during the Quarterly Report, moving from USD/MXN 21.92 to 21.98, an adjustment that has eased back to levels close to 21.92, fairly unchanged with respect to yesterday's close. The currency has remained under a remarkably narrow range since mid-June, trading between 21.85 and 23.23 in the last 11 weeks. It has joined an extensive realized volatility compression in the foreign exchange universe but has decoupled from a strong US dollar weakening. In our view, the peso could still benefit from an additional global risk-on impulse, which we suggest capitalizing to position before the US electoral phase. We expect a more volatile performance by the end of this quarter, with a trajectory mainly linked to this geopolitical premium. In this sense, we see the USD/MXN 21.50 attractive for USD longs, acknowledging a strong resistance at 21.80.

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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