Ahead of the Curve

We expect another 25bps rate cut in the aftermath of the US election

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- **Banxico's monetary policy decision (November 12th).** Next Thursday, Banco de México will carry out its eighth monetary policy meeting of the year. We modify our expectations, now anticipating that the monetary authority will cut the reference rate by 25bps, to 4.00% (previous: 4.25%). This adjustment responds to several recent developments, including: (1) The market reaction after the electoral process in the US; (2) signals of better price dynamics in the short- and medium-term; and (3) greater risks for the economic recovery in 4Q20. Considering comments in the latest minutes, we think the decision might be split, with at least one and even maybe two members voting for an unchanged stance. In this backdrop, we also revise our year-end estimate, now expecting it to close at 4.00%. This would imply no further action on the meeting taking place on December 17th

- **Inflation (October).** We estimate the headline at 0.62% m/m and the core prices at +0.27%. The non-core component would rise 1.70%, with seasonal effects driving the result (the end of summer discounts on electricity tariffs in the first fortnight). Considering this, annual inflation would stand at 4.09%, above the 4.01% of September, with the core practically unchanged at 4.01% (previous: 3.99%). Looking at the whole month, the contribution from the core would be 21bps, with a similar performance in both halves. We expect some specific pressures in other goods during the second half as businesses gear up for *El Buen Fin* (Mexico's version of Black Friday). Within the non-core, LP and agricultural goods –especially fresh fruits and vegetables– would extend higher. In contrast, gasoline would decline despite pressures in the first half of the month

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STARMINE AWARDS FOR REUTERS POLLS FROM REFINITIV

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 9-Nov	**7:00am**	**CPI inflation**	October	% m/m	0.62	0.57	0.23
				% y/y	4.09	4.06	4.01
		Core		% m/m	0.27	0.26	0.32
				% y/y	4.01	--	3.99
Tue 10-Nov		**Wage negotiations**	October	%	--	--	4.1
Tue 10-Nov	**10:00am**	**International reserves**	Nov-6	US$ bn	--	--	194.4
Wed 11-Nov		**ANTAD: Same-store sales**	October	% y/y in real terms	--	--	-4.1
Wed 11-Nov	**7:00am**	**Industrial production**	September	% y/y	-5.9	-6.2	9.0
		sa		% m/m	0.3	0.8	3.3
		Mining		% y/y	-3.4	--	-3.5
		Utilities		% y/y	-3.1	--	-4.5
		Construction		% y/y	-8.7	--	-13.7
		Manufacturing		% y/y	-5.9	-6.7	-9.2
Thu 12-Nov	**1:00pm**	**Job creation of workers affiliated to IMSS**	October	thousands	--	--	113.9
Thu 12-Nov	**2:00pm**	**Banxico's monetary policy decision**	Nov-12	%	4.00	4.00	4.25

Source: Banorte; Bloomberg

Proceeding in chronological order…

An additional uptick in annual inflation in October. We estimate the headline at 0.62% m/m (previous: 0.23%), with core prices at +0.27%, lower than the previous month's 0.32%. The non-core component would rise 1.70%, with seasonal effects driving the result. We should remember that, in the first fortnight, the end of summer discounts on electricity tariffs in some states drove the increase, while there was also a relevant uptick in prices of fruits and vegetables. At the core, pressures kept subsiding, consistent with an additional normalization in consumption patterns. Considering this, annual inflation would stand at 4.09%, higher than the 4.01% of September, with the core practically unchanged at 4.01% (previous: 3.99%).

Looking at the whole month, the contribution from the core would be 21bps, with a similar performance in both halves. Specifically, we expect goods at 0.3% m/m (+13bps), evenly split between processed foods and other goods. Nevertheless, we expect some specific pressures in the latter during the second half as businesses gear up for *El Buen Fin* (Mexico's version of Black Friday). It is important to say that, this year and due to the pandemic, this season was extended, starting a week earlier (November 9th) through the 20th. Meanwhile, services are estimated at +0.2% (+7bps), with housing still very modest and education slightly negative. On the other hand, we expect that slight pressures in tourism-related categories could extend in the second half, with the *Day of the Dead* holiday possibly pushing prices as people has been more willing to go out. Remaining categories could also see some upside, with fatigue about the pandemic as well as a modest seasonal effect.

The non-core would contribute with 41bps. As mentioned, there is a significant impact from electricity tariffs, already known and at 27bps. In addition, LP would extend higher, with a total monthly increase of 3.1%. In the second half, we identified some pressures in the reference price in the US, driven by falling inventories and expectations of a colder winter in said country. For gasoline, we expect -0.9% in low-grade and -0.6% in high-grade, with declines in the second fortnight more than compensating for the expansion in the first half. Specifically, both the MXN and international price dynamics were better, with no significant distortions from hurricanes in the period. Agricultural goods would be higher, with fresh fruits and vegetables up 2.9% (+15bps) albeit with meat and egg lower at -0.4% (-2bps). In the former, our monitoring suggests that tomatoes and onions were pushed even higher in the last few weeks, with lemons further down.

Weekly international reserves report. Last week, net international reserves decreased by US$120 million, closing at US$194.4 billion. According to Banxico's report, this was explained by a negative valuation effect in institutional assets. The central bank's international reserves have expanded by US$13.5 billion so far in 2020 (please refer to the following table).

Banxico's foreign reserve accumulation details
US$, million

	2019	Oct 30, 2020	Oct 30, 2020	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	180,877	194,351	-120	13,474
(B) Gross international reserve	183,028	198,721	-1,651	15,693
Pemex	--	--	-75	5,149
Federal government	--	--	-1,609	5,292
Market operations	--	--	0	0
Other	--	--	32	5,252
(C) Short-term government's liabilities	2,151	4,370	-1,531	2,219

Source: Banco de México

Industrial production to continue improving in September. We anticipate a 5.9% y/y decline, better than the -9.0% of the previous month. In addition, this is broadly in line with the implied figure in 3Q20 preliminary GDP –assuming no revisions are made to the previous months–, suggesting that final figures for the quarter may not change much. Part of the jump in the month is due to an additional working day in the annual comparison (vs. one less in August) as well as a marginally more favorable base effect. Considering this, the uptick in sequential terms (using seasonally adjusted figures) would be 0.3% m/m, decelerating relative to the 3.3% in August, remembering that base effects keep compounding, making an acceleration more difficult.

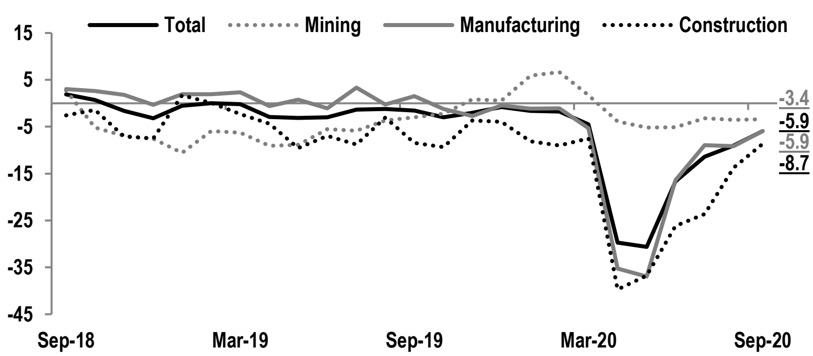
We expect manufacturing at -5.2% y/y (previous: -9.2%). In sequential terms, the expansion would be 0.5% m/m, building up on the 0.8% in August and adding four months to the upside, consistent with the reopening timeframe. Most signals are positive, albeit also moderating. Manufacturing exports expanded 1.5% m/m (vs. +3.5% previously), with strength concentrated in 'other' at +2.4%, while autos were slightly lower at -0.2%. This could be driven by a decrease in auto parts, as final vehicles produced in the month stood at 301,426 units (at -5.5% y/y vs. -13.2% in August). In addition, IMEF's PMI showed a 1.2pts rebound in September, driven by 'production', with data for October being much more positive and suggesting even more dynamism. On the contrary, US manufacturing production decelerated slightly, at -6.5% y/y from -6.2% previously, even with the positive effects previously outlined. We will follow this closely, considering that if the effects of no additional stimulus are impacting activity, the spillover effect to our country would be negative. In addition, concerns are lingering around about railway blockades in October, which could be a deterrent for a ramp-up in production.

Construction likely improved further, at -8.7% y/y (previous: -13.7%), albeit more stable in the monthly comparison at 0.6% after a massive 11.2% in August. During the month, business confidence increased after a slight slump, with the 'moment to invest' component leading. Meanwhile, the aggregate trend indicator advanced more modestly but in a generalized fashion across components, which bodes well for activity. In addition, the fact that Mexico City allowed for work in the sector to be conducted an additional day in the week (6 vs. 5) should also help. On the public sector, spending in physical investment by the Federal Government came in at -2.3% y/y, better than the -17.4% in August, possibly aiding 'civil engineering', which remains low. Finally, employment associated to IMSS improved an additional 20.5 thousand positions, with almost 180 thousand jobs recovered since the May lows.

Lastly, mining would stand at -3.4% y/y (previous: -3.5%). In monthly terms, this would represent +0.3%. Despite of this, both oil and non-oil mining would decline, with the boost from related services. In this sense, 451 jobs associated to IMSS were created, adding two months to the upside. According to data compiled to CNH, crude oil production stood at 1,644kbpd, higher than the 1,633kbpd in August but lower in the annual comparison, to -3.9% (previous: -3.3%). Once again reports suggest no major impact from storms. Meanwhile, signals for non-oil mining are also negative, such as mining exports (ex. oil) decreasing 21.6% m/m.

The report would still be consistent with the gradual recovery of the economy, although also reflecting the prevailing impact of COVID-19 and related pressures that it has on economic activity. If our forecast materializes, IP would accumulate a 12.3% y/y year-to-date decline.

Industrial production
% y/y



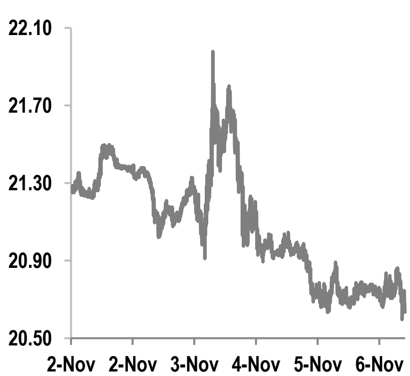
Source: INEGI, Banorte

We expect an additional rate cut to the reference rate after the US election. Next Thursday, Banco de México will carry out its eighth monetary policy meeting of the year. We modify our expectations, now anticipating that the monetary authority will cut the reference rate by 25bps, to 4.00% (previous: 4.25%). This adjustment responds to several recent developments, including: (1) The market reaction after the electoral process in the US; (2) signals of better price dynamics in the short- and medium-term; and (3) greater risks for the economic recovery in 4Q20. Considering comments in the latest minutes, we think the decision might be split, with at least one and even maybe two members voting for an unchanged stance. In this backdrop, we also revise our year-end estimate, now expecting it to close at 4.00%. This would imply no further action on the meeting taking place on December 17th.

Regarding the first point, the most immediate vote tally, as well as counting early Wednesday, pointed to a much closer result, favoring president Donald Trump at some point. In this context, market volatility shot higher, impacting several risky asset classes, including the Mexican peso. During Tuesday night and throughout the early morning hours of the next day, we saw a high of USD/MXN 21.98 (see chart below left).

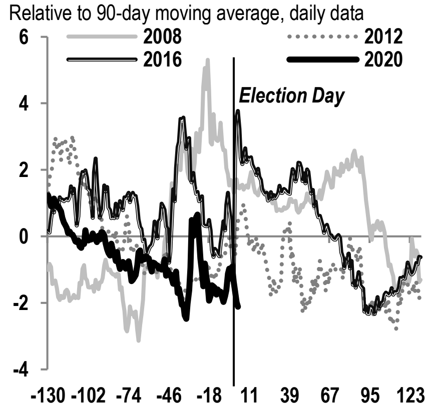
Nevertheless, with vote counting continuing in swing states, trends started to show a win from the Democratic Party candidate, Joe Biden. This led to a renewed positive performance in risky assets, a generalized USD decline and additional strength in our currency, currently close to USD/MXN 20.57. Although we still do not have a definitive result, markets are discounting that the latter candidate will be the winner. However, there is still uncertainty as President Trump has said that he will go to the courts to challenge some states' results –trying to reverse mail-in and other votes that did not benefit him–. Nonetheless, our view of more persistent volatility did not play out (charts below, middle and right). Given this market reaction, we believe the central bank will take advantage of the available room to extend the easing cycle, while simultaneously keeping a prudent stance.

Mexican peso intraday performance
USD/MXN



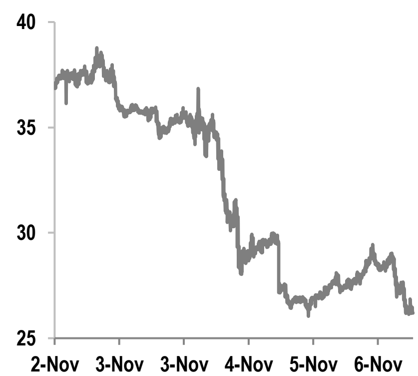
Source: Bloomberg

USD/MXN: Z-score*
Relative to 90-day moving average, daily data



Source: Bloomberg, Banorte *up means MXN depreciation

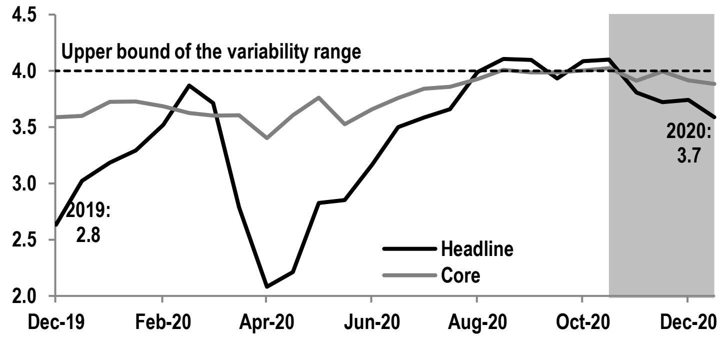
VIX intraday performance
Points



Source: Bloomberg

Going to inflation, although most recent dynamics have not been entirely favorable as the price index climbed to 4.09% y/y in the first half of October, a large part of the increase is due to adverse moves in the non-core component, mainly agricultural goods and energy. Meanwhile, core inflation has been more stable, hovering around 4.0% since early August. More importantly, recent signs for the latter suggest a more positive performance after strong upward pressures since the pandemic started. We highlight processed foods, which have moderated their pace of increase, currently nearing their five-year average. On the contrary, services are gaining some momentum, although still quite low (2.4% y/y) and limited by wide economic slack. At the non-core, we think LP gas could remain high. Nevertheless, our price monitoring points toward a relevant decline in gasoline prices at the start of November, with this latter effect overpowering the former. Moreover, and despite not expecting an immediate adjustment down in fruits and vegetables, their historical performance leads us to believe that in the next few months we could see a reversion lower. In the medium term, the outlook has also turned more favorable, with the rejection of some proposals within the Revenue Law which might have had an adverse effect on price dynamics. We highlight that they ruled out the implementation of an additional tariff on excise taxes for fuel, which we estimated could have increased inflation by about 50bps in the annual rate. In addition, upward adjustments on collection from the use of the radio spectrum were more modest, which should be favorable for telecommunication services within the core component.

Inflation trajectory
% y/y, bi-weekly frequency



Source: INEGI, Banorte

Regarding economic activity, a large part of the rebound in the immediate months after the end of the lockdown was driven by base effects, with several sectors resuming operations. Nevertheless, there are some sectors in which challenges remain high, as seen in some in the latest published figures. Specifically, we still see a strong recovery in activities related to external demand, with domestic sectors –such as consumption and investment– lagging somewhat behind. In addition, epidemiological conditions both globally and domestically have deteriorated in the last few weeks, increasing risks for a new impact on activity especially with winter nearing. Considering this backdrop, we do not rule out that the Board will look to incentivize activity, adopting a looser stance.

Despite of this, we believe this is a very complex decision for the Board. As we mentioned, the latest minutes were very clear in showing an ample debate among Board members. In particular, we identified two suggesting the end of the easing cycle, which we think were Deputy Governors Irene Espinosa and Javier Guzmán. On the contrary, two members mentioned it should continue, which we think were Deputy Governors Gerardo Esquivel and Jonathan Heath. Lastly, we Governor Alejandro Díaz de León is likely more neutral, looking at incoming data and the economic environment. Considering the abovementioned factors, it is our take that he will likely back an additional cut. Nevertheless, we do not rule out that Irene Espinosa and/or Javier Guzmán could dissent, mainly because figures in October are likely to show that inflation has not yet reached an inflection point and that it would stand marginally above the upper bound of the variability range.

In this context, we expect the reference rate at 4.00% by year-end. Following the expected cut on Thursday, we call for Banxico to halt its easing cycle, opting to remain on hold in the decision to be held on December 17th, the last scheduled meeting of the year. With this, we estimate the *ex ante,* real short-term interest rate to fall to around 0.4%, which in our view could represent an important limit for the majority of Board members, which will probably prefer the rate to stay in positive territory. It is also our take that the cost/benefit analysis of further cuts will weigh on the decision-making process, with a more cautious outlook about the risks to financial stability. These include a potentially renewed global fragility because of the pandemic, but also several idiosyncratic risks on the horizon. Therefore, we believe that the reference rate will remain at 4.00% in 2021, even taking into account the possibility of a more dovish bias within the Board following the departure of Deputy Governor Javier Guzman on December 31st.

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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HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
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