Ahead of the Curve

Banxico to remain on hold in the last policy meeting of the year

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- **Banxico monetary policy decision (December 17th).** On Thursday, the central bank will carry out its ninth and final monetary policy meeting of the year, in which we expect the reference rate on hold, at 4.25%. This would be the second time in a row with no changes, following the surprise decision on November 12th. We do not rule out one or more dissenters in favor of a cut, as in the previous meeting. Our expectation is mainly based on the assessment of the latest minutes and *Quarterly Report* (QR), in which most agreed that a 'pause' was necessary to corroborate if inflation is trending downwards. We should mention that the latter document already incorporated the latest information on prices within their updated inflation estimates. We expect no change despite an additional improvement in financial markets and heightened concerns about economic activity in the short-term

- **Aggregate supply and demand (3Q20).** We expect both aggregate supply and demand to show a 10.5% y/y contraction, up from the -21.6% observed in the second quarter, driven by the economic reopening. This would imply a year-to-date decline of 11.4%. On supply, GDP contracted 8.6% y/y, while we estimate imports at -15.7%. Going to demand, we anticipate consumption at -13.3%. Meanwhile, GFI would stand at -18.0%, in line with figures seen in the monthly indicator. Lastly, we see a 0.7% increase in government spending, with exports at -3.2%

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Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Sat 12-Dec		Job creation associated to IMSS	November	thousands	--	--	200.6
Tue 15-Dec	10:00am	International reserves	Dec-11	US$ bn	--	--	194.4
Thu 17-Dec	10:00am	Banxico's survey of economic expectations					
Thu 17-Dec	2:00pm	Banxico's monetary policy decision		%	4.25	4.25	4.25
Fri 18-Dec	9:00am	Aggregate supply and demand	3Q20	% y/y	-10.5	--	-21.6
		Private consumption		% y/y	-13.3	--	-20.6
		Gross-fixed investment		% y/y	-18.0	--	-34.0
		Government consumption		% y/y	0.7	--	2.4
		Exports		% y/y	-3.2	--	-30.9
		Imports		% y/y	-15.7	--	-29.7

Source: Banorte; Bloomberg

Proceeding in chronological order...

Weekly international reserves report. Last week, net international reserves increased by US$71 million, closing at US$194.4 billion. According to Banxico's report, this was mainly explained by a positive valuation effect in institutional assets. The central bank's international reserves have expanded US$13.5 billion so far in 2020 (please refer to the following table).

Banxico's foreign reserve accumulation details
US$, million

	2019	Dec 4, 2020	Dec 4, 2020	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	180,877	194,359	71	13,482
(B) Gross international reserve	183,028	201,583	494	18,555
Pemex	--	--	0	5,149
Federal government	--	--	498	8,143
Market operations	--	--	0	0
Other	--	--	-4	5,263
(C) Short-term government's liabilities	2,151	7,224	423	5,073

Source: Banco de México

Banxico's survey of economic expectations. As usual, market participants will focus on inflation, growth, reference rate, and exchange rate forecasts. In the first, analysts expect 2020 year-end inflation at 3.64%, above our 3.5%. Nevertheless, after November's inflation, we do not rule out an additional adjustment to the downside. For 2021, consensus puts it at 3.6%. Meanwhile, medium and long-term expectations will likely remain unchanged, still above target. On GDP, this year's estimate stands at -9.0%, in line with our estimate. Nevertheless, for 2021 it only forecasts growth at 33% vs. our 4.1%. The current view on the reference rate by YE20 is 4.25%, in line with its current level, although discounting a 25bps cut to 4.00% in 2021. Finally, the year-end exchange rate estimate stands at USD/MXN 20.50 (Banorte: 20.50), with a slight depreciation in 2021 towards USD/MXN 21.20.

Banxico to remain on hold during the final meeting of 2020. On Thursday, the central bank will carry out its ninth and final monetary policy meeting of the year, in which we expect the reference rate on hold, at 4.25%. This would be the second time in a row with no changes, following the surprise decision on November 12th. We do not rule out one or more dissenters in favor of a cut, as in the previous meeting. This expectation is mainly based on our assessment of the latest minutes and *Quarterly Report* (QR), in which most agreed that a 'pause' was necessary to corroborate if inflation is trending downwards. We should mention that the latter document already incorporated the latest information on prices within updated inflation estimates. We expect no change despite an additional improvement in financial markets and heightened concerns about economic activity in the short-term. Our expectation is similar to consensus according to the latest *Citibanamex* survey, with 72% of respondents (18 out of 25) agreeing with us, while the remaining 28% (7 participants) expect -25bps.

We believe that the scenario has not changed drastically relative to the information published in the QR. On inflation (which seems to us the most immediate concern), INEGI published inflation for November this week, with the annual comparison plunging to 3.33% from 4.09% in October.

This was below expectations and will be the last available print by the time of the decision. Despite of this, it is our take that some of the issues pondered by the central bank are still unknown, mainly if discounts from *El Buen Fin* are transitory or more persistent. In this sense, we should recall that these are typically reversed in the 1st half of December. In our view, this reversal could be more evident this year given the extension in some deals, mainly due to *Black Friday* and *Cyber Monday*. Data for this period will be released on the 23rd, practically a week after the meeting. In addition, our price monitoring suggests some modest increases in both gasoline and fruits and vegetables, which could also drive inflation up after a very benign performance in both during November.

Analyzing inflation relative to the central bank's forecasts, quarter-to-date CPI stands at 3.7%, slightly above the 3.6% in the last QR. Considering our expectations for December, the quarter will likely converge towards the estimate. We think the central bank will be focused more on longer-term dynamics, remembering that revisions to the QR were upwards, in turn the key driver that likely prompted the pause. It is our take that it would be somewhat confusing to resume cuts after only one additional inflation print, particularly as it is broadly in line with their expectations. As stated before, we think the monetary authority is more likely to wait until inflation comes back more clearly into the target range –probably sometime in May– or if core inflation provides more consistent downward surprises. We do not rule out the later happens sooner, although still until 2021.

On activity, forward-looking indicators have started to post a mixed performance, including IMEF's PMIs and auto sector data. Considering that dynamism remains weak at the margin, especially in domestic demand, we could see increased concerns from the central bank. This reinforces the skew in the balance of risks, which remains firmly to the downside. Despite of this, medium-term expectations are turning slightly better, with the deployment of the vaccine probably helping activity to gain back momentum in 2H21. Given changes in the last statement, in which growth took the backseat relative to inflation, we expect attention to remain low on this factor.

Going to financial conditions, news have been mostly positive. Since the decision, the Mexican peso reached a low of USD/MXN 19.77, nearing a nine-month lows, albeit with some pressures in recent days taking it close to 20.10, still above pre-pandemic levels. This has been driven by several factors, including: (1) The outcome of the US election; (2) expectations of additional stimulus, both fiscal and monetary; and (3) increased risk appetite towards EM. It has translated in a recent increase in foreigners' holdings in Mexican sovereign bonds. Nevertheless, they continue lagging peers on a year-to-date basis, even despite very attractive real rates. Maintaining conditions to regain some of these inflows could be an additional reason to argue in favor of a 'high' rate. Moreover, both Fitch Ratings and S&P Global Ratings affirmed the sovereign and Pemex's rating. Nevertheless, they kept highlight risks about low tax revenues and the financial position of the latter company, which has also been stressed by Banxico for a while now. However, these issues may also have taken a step back, given the firm focus on inflation.

Finally, considering the current skew of the members based on our analysis of the minutes, we do not think the most hawkish members –Deputy Governors Irene Espinosa and Javier Guzmán– will be convinced to vote for a cut. In the middle of the road, we believe Governor Alejandro Díaz de León could also opt to maintain the rate at 4.25%. Specifically, we believe he will support waiting for more information based on our analysis for inflation described above. Deputy Governor Gerardo Esquivel is more likely to change his opinion relative to the last meeting, albeit in our view maintaining a more data dependent approach this time around while remaining dovish. Lastly, we think Deputy Governor Jonathan Heath is most likely to support a cut again. Nevertheless, considering some of his most recent public comments, it is not totally out of the table to also see him vote for no change despite his dovish stance.

Looking ahead, we expect easing to resume in 2021. Several factors support our view, including: (1) The clear signal in the statement that November's decision was a 'pause' in the easing cycle, as opposed to an end; (2) the departure of Deputy Governor Javier Guzmán and the incorporation of Galia Borja to replace him, probably assuming a less hawkish stance; (3) prevailing weakness on activity, especially in the domestic front, even with better expectations due to the deployment of the vaccine; and (4) the likely downward trend in inflation after peaking in early 2Q21, due to negative base effects. Hence, we reaffirm our call of cuts restarting at some point in the second quarter, with an accumulated reduction in 2021 between 50 to 75bps.

Aggregate demand in 3Q20 to confirm trends between external and domestic sectors. We expect both aggregate supply and demand to show a 10.5% y/y contraction, up from the -21.6% observed in the second quarter, driven by the economic reopening. This would imply a year-to-date decline of 11.4%, with imports dragging the result relative to GDP, which has accumulated a 9.6% contraction during the same period.

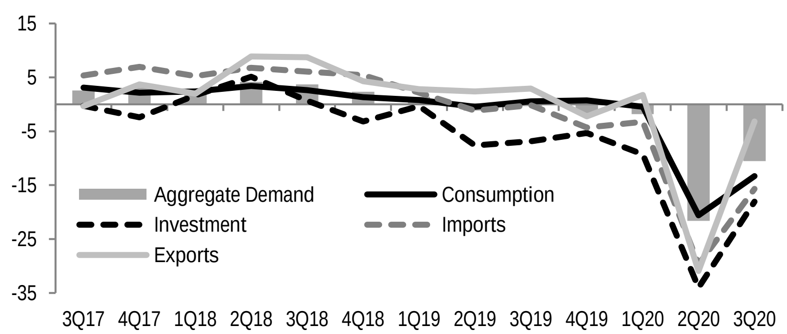
On supply, GDP contracted 8.6% y/y, with industry leading in sequential terms, agriculture surprising higher and services more dampened, albeit with all sectors strengthening relative to the previous period. In turn, we estimate imports at -15.7% y/y. Both the trade balance –which considers goods– and the current account –which also includes income and expenses on services– show declines close to 20% in nominal USD terms. Nonetheless, the Mexican peso remain weak in the period despite recovering some ground after the initial shock from COVID-19, trading at 22.1 per dollar on average (13.7% y/y) from 23.33 in 2Q20, which should soften the blow. Turning to demand, we expect figures to confirm that domestically oriented sectors lagged relative to those more sensitive to external conditions, both in absolute terms and relative to our previous expectations. In this sense, we expect steeper declines mainly in consumption and investment. Government spending, exports and imports would be better at the margin.

In consumption, the monthly indicator fell 13.2% y/y. As mentioned previously, there are some differences between the latter and the corresponding component in aggregate demand, mainly that imported services are not accounted in the high-frequency indicator. Considering this, we expect a 13.3% contraction, below our previous forecast of -11.9%.

As in 2Q20, durables and semi-durables remain lower than non-durables. Similarly, the monthly GFI index stood at -18.0%, which we believe will be the final figure. This is also lower than our previous call, at -17.8%. As stated in our latest report (see link above), this component remains very weak, contracting in September relative to the previous month, dragged mainly by construction –also related to domestic conditions and, to a lesser extent, government projects–. We see a 0.7% increase in government spending, with a more challenging base effect, although with the pandemic still ongoing and a nominal increase of 2.9% in current spending, according to public finance reports. Finally, we see exports at -3.2% y/y, with a very strong rebound relative to the 30.9% plunge in the previous quarter. The effect of the exchange rate mentioned above would also be present here, with total shipments of goods abroad in local currency surging +8.6% y/y, while income in the current account more modest, at 5.0%. As stated in other reports, these have been aided by unprecedented stimulus –both fiscal and monetary–, mainly in the US. Nonetheless, we should recall that the measure in this report is in value added terms.

Overall, data suggests that these trends continued in the last quarter of the year. On the other hand, risks to the recovery have heightened given the rise in new COVID-19 cases and the lack of fiscal stimulus, both domestically and abroad. As such, we maintain our call that GDP will contract by 9.0% in full-year 2020, with activity in 4Q20 advancing only by 0.5% q/q, highlighting that October's trade balance suggest renewed domestic weakness, along a moderation in manufacturing in November (which could dampen both exports and imports).

Aggregate demand
% y/y, nsa



Source: INEGI, Banorte

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