Ahead of the Curve

Banxico to cut one last time in this cycle by 25bps, in a very difficult decision

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- **Banxico's monetary policy decision (March 25th).** On Thursday, the central bank will carry out its second decision of the year, in which we expect a 25bps rate cut, to 3.75%. This would be the second consecutive reduction after the pause in the meetings in November and December. If the cut materializes, a total decline of 450bps would have accumulated since the easing cycle began (August 2019). We believe the call for a cut in this decision has become more complicated than at the time of the last meeting. In this sense, we expect a split decision instead of the unanimous vote seen in February, with one or two members favoring to keep the rate unchanged

- **Inflation (1H-March).** We expect headline inflation at 0.35% 2w/2w and the core at 0.21%. The non-core would grow 0.79%, driving most of the advance (contribution: 20bps). on higher agricultural and energy prices. Specifically, we expect some impact in both because of supply issues from cold weather in the southern US and in northern states of Mexico, among other factors. Within the core, pressures would remain concentrated in goods. Services would be more contained, albeit accelerating relative to their recent performance. We highlight slight increases in tourism-related activities due to the *Easter* seasonality, although lower relative to pre-pandemic years. If our forecast materializes, annual inflation would pick up again, now at 3.93% from 3.76% on average in February, barely below the central bank's upper bound of its variability range. The core would climb to 3.95% and the non-core to 3.88%.

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 22-Mar	5:30pm	Citibanamex bi-weekly survey of economic expectations					
Tue 23-Mar	11:00am	International reserves	Mar-19	US$ bn	--	--	195.0
Wed 24-Mar	8:00am	CPI inflation	1H Mar	% 2w/2w	--	--	195.0
				% y/y	0.35	0.30	0.31
		Core		% 2w/2w	3.93	3.88	3.68
				% y/y	0.21	0.21	0.18
Wed 24-Mar	8:00am	Unemployment rate	February	%	3.95	--	3.89
		sa		%	4.27	4.41	4.73
Thu 25-Mar	8:00am	Economic activity indicator	January	% y/y	4.44		4.47
		sa		% m/m	-5.6	-5.4	-2.7
		Primary activities		% y/y	0.0	0.0	0.1
		Industrial production		% y/y	3.7	--	0.9
		Services		% y/y	-4.9	--	-2.1
Thu 25-Mar	8:00am	Retail sales	January	%	-6.7	--	-3.1
		sa		%	-8.5	-7.7	-5.9
Thu 25-Mar	3:00pm	Monetary policy decision (Banxico)	Mar-25	%	-1.1	-1.8	-2.4
Fri 26-Mar	8:00am	Trade balance	February	US$ mn	3.75	4.00	4.00
		Exports		% y/y	2,779.2	2,779.2	-1,236.4
		Imports		% y/y	-6.3	--	-2.6

Source: Banorte; Bloomberg

Proceeding in chronological order...

Weekly international reserves report. Last week, net international reserves decreased by US$83 million, closing at US$195.0 billion (please refer to the following table). According to Banxico's report, this was mainly explained by a negative valuation effect in institutional assets. So far this year, the central bank's international reserves have fallen by US$694 million.

Banxico's foreign reserve accumulation details
US$, million

	2020	Mar 12, 2021	Mar 12, 2021	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	195,667	194,973	-83	-694
(B) Gross international reserve	199,056	199,618	-471	562
Pemex	--	--	0	450
Federal government	--	--	-216	1,833
Market operations	--	--	0	0
Other	--	--	-255	-1,721
(C) Short-term government's liabilities	3,389	4,645	-387	1,256

Source: Banco de México

Inflation in 1H-March skewed-up on seasonal trends, weather and global pressures. We expect headline inflation at 0.35% 2w/2w, above the 0.31% of the previous fortnight. We see the core at 0.21%, contributing 16bps to the total and relatively close to its five-year average. The non-core would grow 0.79%, driving most of the advance. This would translate into a 20bps contribution, with relevant increases in both agricultural and energy prices. In the former, fruits and vegetables would add 7bps, explained by: (1) Rebounds in some products such as onions and tomatoes, after recent seasonal declines; and (2) supply shocks from cold weather in the southern US and in the northern states of Mexico. Specifically, the second factor would also push meat and egg upwards, expected at +4bps. Energy would add 8bps. Some prices normalized after distortions in the US market, albeit some others stayed high. The former was more evident in LP gas, with international references falling marginally, albeit compensated by the 2.1% 2w/2w depreciation in the MXN. On the contrary, references for gasolines extended further higher, adjusting around 11% in commodity futures. Hence, excise tax subsidies for low-grade gasoline averaged $2.03, considerably above $0.78 on average in the previous fortnight. Support for high-grade kicked in on March 6th, albeit below the former. In this context, both would contribute 7bps.

Within the core, pressures would remain concentrated in goods, contributing +9bps. Specifically, processed foods would add 5bps, with signals of higher prices in tortillas and beans to such extent that they were highlighted by President López-Obrador. On the former, international corn prices have trended higher, while the latter was distorted by cold weather conditions. Nevertheless, we think that economic slack will help maintain other prices somewhat modest. Other goods would contribute +4bps, still with distortions given the reopening of shopping malls and with a possible upward skew given the recent depreciation of the MXN. Services would be more contained at +7bps, albeit accelerating relative to their recent performance.

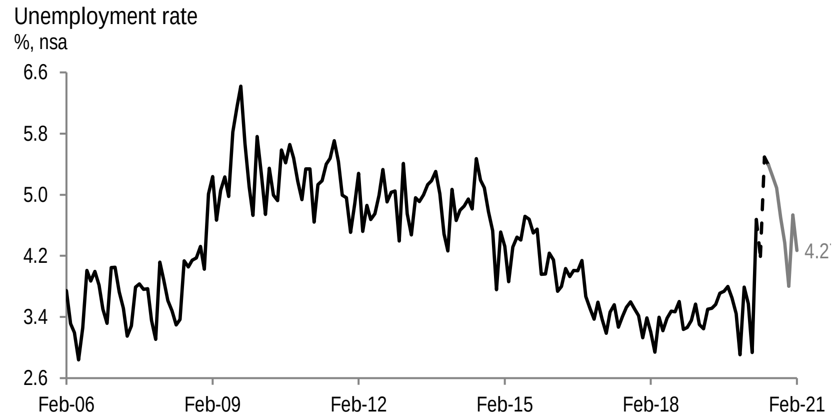
We anticipate slight increases in tourism-related categories due to the *Easter* seasonality, albeit lower than in pre-pandemic years as profit margins for service providers remain limited and demand is still relatively weak. On the other hand, we keep seeing some pass-through from energy to restaurants and other food services. On the contrary, housing would remain quite limited, resenting more the overall weakness in economic activity.

If our forecast materializes, annual inflation would pick up again, now at 3.93% from 3.76% on average in February, barely below the central bank's upper bound of its variability range. Base effects from the *Easter* holiday would be at play, along others from early distortions of the pandemic last year. In this context, the core would climb to 3.95% (previous: 3.87%), highest since late October. Lastly, the non-core would stand at 3.88% from 3.43%.

The unemployment rate to tick lower in February on higher mobility. We estimate the unemployment rate at 4.27% (original figures), down 46bps relative to January. A big chunk of this decline would be driven by a seasonal effect which is driven by distortions that occur with the start of the new calendar year (*e.g.* we begin to see people back in to the labor force). In this respect, using seasonally adjusted figures we estimate only a modest 3bps decline, to 4.44%. In our view, the fall would be limited as epidemiological conditions only improved meaningfully until the second half of the month. On the other hand, we believe the impact from the blackouts and the undersupply of natural gas will not be very significant, considering that the shock was very brief.

In this respect, available indicators are mostly favorable. Employees associated to IMSS increased by 115.3 thousand, helped by a seasonal effect. Nevertheless, adjusting for this, job creation stood at 37.9 thousand, back to positive after losses in January. In annual terms, affiliated workers remained practically unchanged at -3.2%. 'Employment' components within IMEF indicators were also stronger, with gains mostly in the non-manufacturing (+3.6pts) but also in manufacturing (+1.0pts). This is consistent with our call that the reopening helped services more (also seen in mobility indicators), while manufacturing was more stable despite blackouts. Nevertheless, the latter indeed affected industrial production, according to INEGI's *Timely Indicator of Economic Activity*. Meanwhile, employment within aggregated trend indicators in construction, commerce and non-financial services also improved. We will remain vigilant on the potential impact from the increase in the minimum wage, both in overall employment and income levels, which increased slightly in the previous report. Regarding complementary indicators, the participation rate could increase at the margin as workers return to the labor force. Underemployment levels could fall, and the informality rate could go up slightly, reversing part of the adjustments seen in the previous month and influenced by higher mobility.

Going forward, we still see a gradual recovery of the labor market, with the rate going lower at a modest pace. Nevertheless, it could well be faster than previously anticipated due to stronger support from the economy. This, after upgrading our view of GDP growth this year, to 5.3% from 4.1% previously.

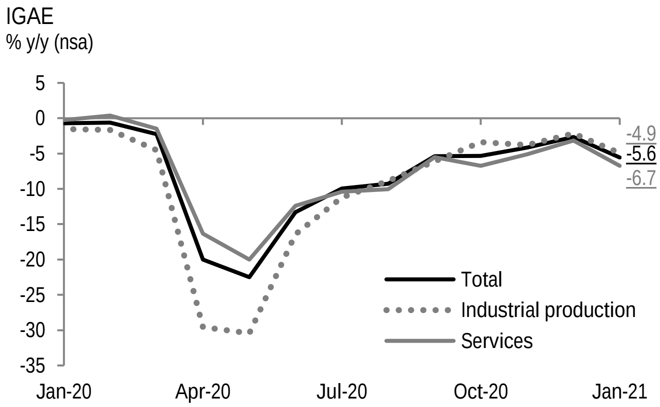


Source: INEGI, Banorte

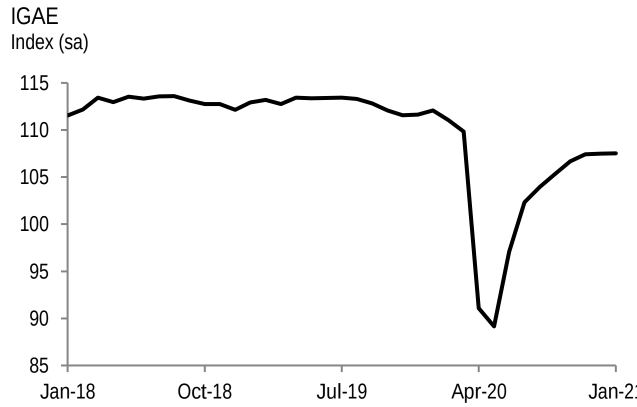
January's GDP-proxy to stall. We expect the *Global Economic Activity Indicator* (IGAE) at -5.6% y/y in the first month of 2021, lower than December's -2.7%. One important driver would be a quite negative calendar effect, with two less working days in the annual comparison (vs. +2 in December). Adjusting for this, activity would contract 4.3% y/y, below INEGI's *Timely Indicator of Economic Activity* (see link in section above) at -4.0%. In sequential terms it would stall at 0.0% m/m. In our view, performance would be dragged by worse COVID-19 dynamics that impacted mobility, especially affecting services.

As already known, industrial production fell 4.9% y/y (nsa), in line with our expectations. In monthly terms it climbed 0.2%, with construction lifting the result (+1.5%) and mining also a bit higher (+0.2%). In contrast, manufacturing was weaker at -0.5%, with relevant declines in key sectors such as autos.

For services we expect -6.7% y/y (nsa), translating to a 0.3% m/m contraction with seasonally adjusted figures. As stated previously, we believe this sector felt the brunt of the lockdowns, with socially dependent activities leading losses again. In this context, IMEF's non-manufacturing PMI was unchanged relative to December at 48.3pts. However, all components moved lower, with 'deliveries' and 'employment' leading to the downside. On the latter, INEGI's employment report showed a loss of 468.8 thousand jobs, suggesting a relevant impact from lockdowns. Looking closer on sectors more exposed to social interactions, air passenger traffic plunged 46.6% y/y (previous: -39.1%), which we see as rather bad given that some travel restrictions –both to Canada and the US– did not impact traffic that much, as they were enacted almost at the end of the month. Hotel occupancy rates declined to 25.4% from December's 29.9%. While there is a seasonal distortion, we think it was weaker at the margin. On less exposed sectors, retail sales would also be affected by lockdowns, especially on discretionary spending (see section below for details). We expect healthcare to be resilient, as the peak in cases was registered on January 21st. Other essential sectors could remain somewhat stable, as we have seen in the last few months.



Source: INEGI, Banorte



Source: INEGI, Banorte

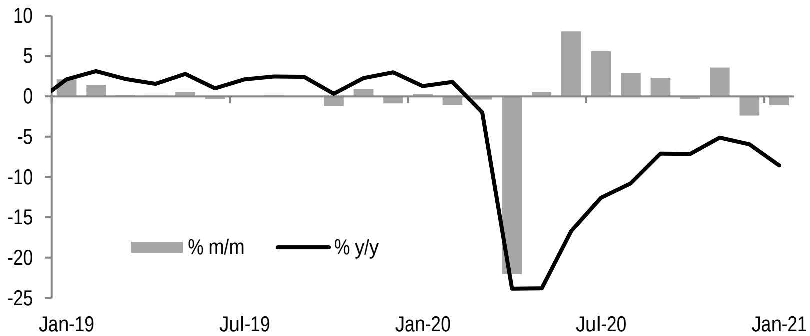
Retail sales to extend their decline in January. We anticipate an 8.5% y/y decline, lower than the -5.9% of the previous month. With seasonally adjusted figures, we expect a 1.1% m/m contraction on top of December's 2.4% decline. The main driver would be an extension of restrictions in more states, with a total of 10 in 'red' by the end of the period. Also relevant was that some relief measures (*e.g.* shopping malls opening at reduced capacity) were not implemented until February.

In this sense, ANTAD's total sales declined 9.5% y/y in real terms, weakest since last July, just after the reopening started. Tailwinds were especially evident in departmental stores, plunging 22.1% (previous: -12.6%), with supermarkets more stable at +1.6% (previous: +1.4%). Other signals also suggest a deceleration. Gasoline sales –in volume– fell to -24.1% y/y (previous: -17.2%), consistent with the decline in mobility. Moreover, non-oil consumption goods imports plunged 7.4% y/y from +2.9%, albeit taking this figure with caution as some distortions have been persistent. Lastly, durable goods sales will remain weak, as portrayed by the -22.6% in auto sales. An additional factor that could be weighing here is that some people remain on partial lockdowns –under home-office schemes–, limiting their demand for vehicles.

On fundamentals, remittances remain the bright spot, posting a massive +33.3% y/y in local currency (MXN), up from 22.6% previously. However, other relevant indicators remain subdued, including unemployment as the rate posted a 9bps increase to 4.47% (seasonally adjusted figures). Moreover, consumer credit remains pressured, consistent with prevailing uncertainty.

Going forward, signals suggest a stronger February, aided by relief measures at the start of the month and the sharp improvement in epidemiological conditions in the second fortnight. In particular, by the end of the month only two states remained in 'red'. In this backdrop, ANTAD sales also rebounded at -3.2% y/y in real terms, with a sizable improvement in departmental stores. We remain on the look about how persistent this performance can be, as signs of caution are still on the horizon.

Retail sales
% y/y nsa, % m/m sa



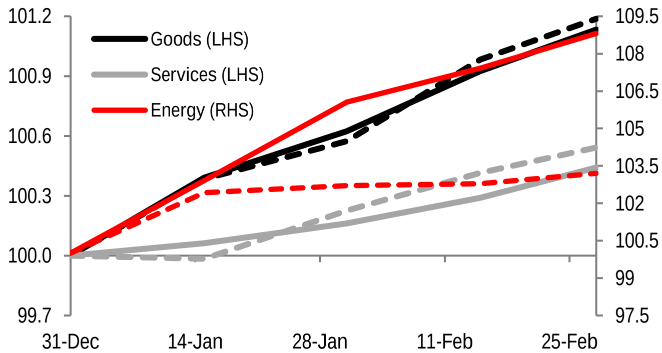
Source: INEGI, Banorte

The last cut in Banxico's easing cycle. On Thursday, the central bank will carry out its second decision of the year, in which we expect a 25bps rate cut, to 3.75%. This would be the second consecutive reduction after the pause taken in the meetings in November and December, resulting in a total decline of 450bps since the easing cycle began (August 2019). We think the call for a cut for this decision has become more complicated than at the time of the last meeting. In this sense, we expect a split decision instead of the unanimity seen in February, with one or two members voting to keep the rate unchanged. Specifically, we identify developments in two fronts as those that make this decision more complex:

(1) *Inflation dynamics*. At the last decision, inflation stood at 3.54% y/y (using monthly figures). However, by February it had climbed to 3.76%, with our expectation being of additional pressures in early March (see section above for details). This will be the last known print before the decision. We should note that pressures have been centered on the non-core component, especially energy prices. This has been the result of: (a) An upward trend in commodities given expectations of an acceleration in global growth; and (b) a transitory shock from cold weather disruptions in the US. Considering the nature of the latter, the Board is likely to be more concerned about dynamics resulting from the former. Its most direct effect has been in gasoline prices, with low-grade accumulating a 10.8% year-to-date increase (from 2H-Dec to 2H-Feb). While this is technically out of the realm of direct influence of monetary policy, concerns may be rising about potential second round effects to core dynamics. Despite of this, we believe it is precisely the latter component that still helps build the case for one last cut. Specifically, core inflation has averaged 3.9% y/y in the first two months of 2021, exactly at the central bank's forecast for the first quarter. Our estimates are at the same level for the full period, even incorporating pressures in March. Moreover, we note that year-to-date dynamics for both goods and services are below their respective 5-year averages (see chart below left), particularly in the latter, which is more affected by economic slack. Hence, underlying core inflation dynamics would suggest the window is almost, but not yet, closed. Specifically, after this meeting inflation will start reflecting the adverse base-effect from plunging energy prices last year, leading to the so-called 'hump' that will push inflation above the upper-bound around the target at least until June, according to our forecasts (see chart below, right).

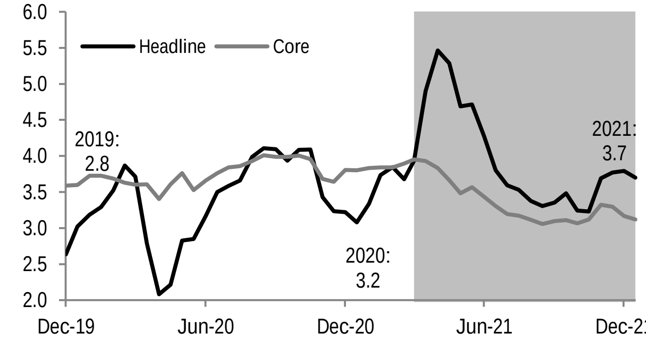
It is our take that this fact will act as a strong deterrent –at least for most members– to even consider additional cuts in the short-term, particularly given their focus on a prudent management of policy in the face of higher market volatility (see below).

Inflation: Current data vs. five-year average*
Index, 2H-Dec = 100



*Note: Continuous line refers to 2021 data, with the five-year average represented in dotted lines
Source: Banorte with INEGI

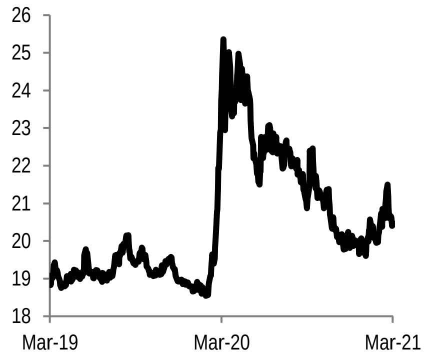
Inflation trajectory
% y/y, bi-weekly frequency



Source: INEGI, Banorte

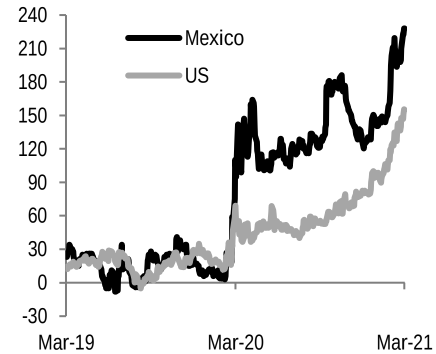
(2) *Higher financial market volatility.* In this front, the central bank has maintained a very cautious and prudent stance, remembering that is has always been very clear on the importance of maintaining financial stability and conditions for market adjustments to happen in an orderly fashion. In this context, the Board largely determines short-term financing costs in MXN, which in turn influences the exchange rate, especially through the *carry-trade*. Lower interest rates incentivize a depreciation of the currency given that they could trigger larger outflows by investors and reduce the cost of shorting the currency. In addition, a reduced value in the MXN could result in rising inflationary pressures by pushing imported goods prices higher. This could exacerbate in an environment of increased global volatility, such as the one we are experiencing currently. Although this is a relevant risk, we consider that the Mexican peso has posted an orderly behavior, with pressures in the last few weeks reversing (see chart below on the left). In our opinion, this was also aided by the dovish surprise from the Fed in its last decision. We believe the latter provides support to our expectation of one last cut. However, the strong increase in long-term interest rates globally –induced by Treasuries– has resulted in a steepening of the yield curve (chart below, middle). This is an additional factor that is very important, and likely will be discussed at length by the Board. We do not rule out that these adjustments could convince most members that it is best not to cut, although our base case is that this will not happen. This is mainly due to the movement responding to dynamics in foreign rates –over which Banxico has no power–, more so than for an increased risk premium in local assets. In this sense, a metric that helps to differentiate the dynamic is the 5-year CDS. In particular, said instrument has only increased 16.3bps since the start of the year, standing at 97.8bps (chart below, right), considerably below the highs seen last year at the beginning of the COVID-19 shock. On the contrary, this market dynamic could remain for a longer time. As a result, we are very aware that some members could opt to increase cautiousness, judging that the "window of opportunity" for more cuts has closed.

Mexican peso
USD/MXN



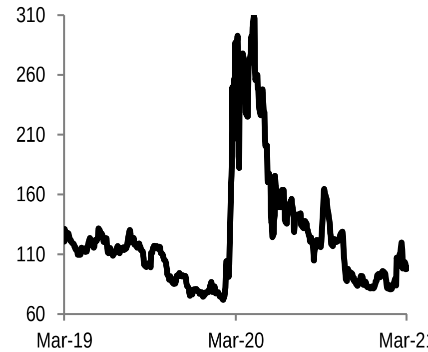
Source: Bloomberg

2/10 sovereign yield spread
Bps



Source: Bloomberg, Valmer

5-year CDS
Bps



Source: Bloomberg

About the vote, we identify three members with a clearer bias based on our analysis of the latest minutes: Deputy Governors Irene Espinosa (voting for an unchanged rate), Galia Borja (-25bps) and Gerardo Esquivel (-25bps). In contrast, we are relatively more uncertain about Governor Alejandro Díaz de León and Deputy Governor Jonathan Heath. In an interview during the 84th National Banking Convention, the Governor acknowledged the recent increase in market volatility, stressing that they are assessing market dynamics and the possible effects on inflation of the approval of fiscal stimulus in the US. This is consistent with his remarks on data-dependency, which has remained a constant during his tenure. Moreover, he stated that they (the central bank) "*…hope that the rest of the adjustment keeps happening in an orderly manner…*". In our view, this implies that adjustments have remained orderly overall, leaving the door still slightly open to support an additional cut while maintaining a prudent stance. However, it may well be that the challenge stemming from market dynamics is high enough to tip the scale for no cuts. Turning to the Deputy Governor, we did not identify any recent comments that could provide us with additional information. Based on what we attribute as his comments on the minutes, he could argue for a last cut before the 'window' closes due to the upcoming 'hump' in inflation, as he is still concerned about the economic recovery, but price dynamics going forward are very uncertain. Nevertheless, we identified him with a slightly less dovish tone due to recent inflation dynamics, so we cannot fully rule out that this could tip him to favor keeping the rate at 4.00%.

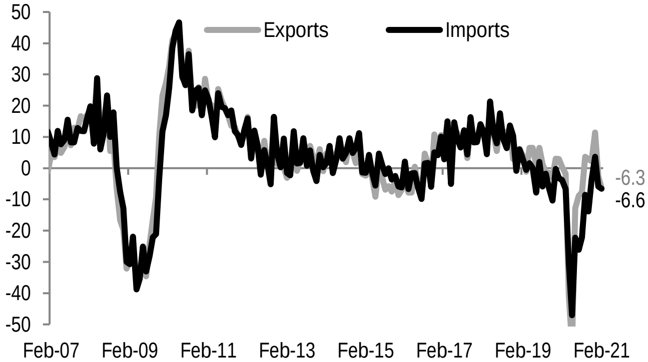
Based on this analysis, we expect the central bank will go forward with a 25bps cut in this meeting. Nevertheless, it feels like a very close call. If they do not reduce the rate next week, it is our take that market conditions will probably not allow for a restart of the easing cycle at least this year. Among them, we note: (1) The possibility of higher inflation expectations globally, pushing other EM central banks to adopt less accommodative stances –as Brazil and Turkey this week–; (2) stronger economic growth, limiting the need for more cuts; and (3) idiosyncratic volatility around Mexico's mid-term elections in June, among others local risk factors. As a result, we expect the reference rate to end 2021 at 3.75%.

February's trade balance back to surplus. We estimate a US$2,779.2 million surplus, back from the US$1,236.4 million deficit in January as a result of a seasonal trend. We believe that the impact from extreme weather conditions in the Northern border will be seen in several fronts. Another relevant factor is the calendar effect due to the leap-year, with one less day relative to 2020. However, it might be somewhat modest as working days remained unchanged relative to said period. We estimate total exports at -6.3% y/y (previous: -2.6%), with imports also more negative, at -6.6% (previous: -5.9%).

We expect a US$911.3 million deficit in the oil balance. The period's dynamic was characterized by surging prices, both for crude and other finished products –such as gasoline– due to cold weather disruptions. The Mexican oil mix averaged 57.65 US$/bbl from 51.06 in January, translating to +26.9% y/y (previous: -5.3%). Nevertheless, this also affected volumes as refineries and ports had to be closed. In addition, reports about loading issues in the *Pajaritos* terminal continued, seemingly solved until early March. Even so, we expect the first factor to more than compensate for the latter, with an 8.5% y/y increase in oil shipments. Going to imports, available volume data showed a yearly decline while the Governor of Texas prohibited natural gas exports to other states and/or countries from February 17th to the 19th. Nevertheless, prices of these two commodities surged, which should moderate the decline. Hence, we expect total imports in this category at -17.0%.

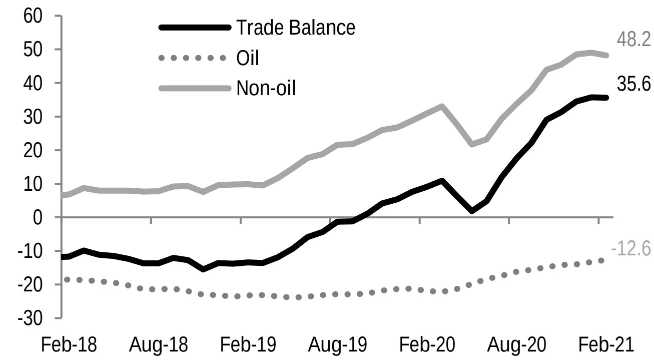
The non-oil balance is estimated to post a US$3,690.6 million surplus. Exports would be hit to -7.0% from -1.4% in January. In contrast, imports would outperform at -5.5%, above exports for the first time in annual terms since May. In the former, some signs suggest strength in agricultural (3.9%) goods, including higher domestic prices. Non-oil mining would stay high at 40.8%, driven by high global commodity prices despite some potential shocks from the blackouts. On the contrary, manufacturing would be sharply down at -8.4%, highly impacted by the outages. Autos would contract 11.8%, with AMIA data showing vehicle exports down 21.8% in the period. This is consistent with automakers' comments that they had to halt production due to the undersupply of natural gas, on top of other stoppages because of the lack of semiconductors. These problems were also flagged by the 5.7% decline in US auto production. Other manufacturing exports would be slightly stronger at -6.4%, with better results in other key sectors within US industry, albeit also dragged from this shock. In imports, we expect the impact from cold weather to be rather modest, as inflows are relatively more diversified. Moreover, we anticipate some distortions due to the timing of the Chinese New Year –from February 11th to the 17th–, with the possibility of front-loaded shipments from the Asian country that would have a positive effect. In this context, we expect consumption and intermediate goods at -3.1% and -5.1%, respectively. Last but not least, capital goods should stay dampened at -11.5%, with some negative drivers including exchange rate volatility and rising yields at the long end of the curve.

Exports and Imports
% y/y nsa



Source: INEGI, Banorte

Trade balance
US$ billion, 12-month rolling sum



Source: INEGI, Banorte

Analyst Certification

We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldívar, Marissa Garza Ostos, 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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The Analysts of Grupo Financiero Banorte S.A.B. of C.V. do not maintain direct investments or through an intermediary person, in the securities or derivative instruments object of this analysis report.

Guide for investment recommendations.

	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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