Ahead of the Curve

We expect Banxico's minutes to signal that further cuts are off the table

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Juan Carlos Alderete, CFA
Director of Economic Research
juan.alderete.macal@banorte.com

Francisco Flores
Senior Economist, Mexico
francisco.flores.serrano@banorte.com

- **Banxico minutes.** The central bank will release the minutes of the monetary policy meeting held on May 13th, in which the Board again voted unanimously to maintain the reference rate at 4.00%. We noted a more hawkish tone, with an additional focus on inflation, consistent with the recent increase in both actual data and short-term expectations, while recognizing that risks are tilted to the upside. Therefore, we will be analyzing comments on the latter, looking for further details on changes to forward-looking factors as well as on most recent price dynamics. We will also search for comments from Board members about the chances of resuming the easing cycle, as in the previous meeting at least three of them saw that a 'window of opportunity' for additional cuts may occur after passing through the 'hump' in inflation

- **Inflation (1H-May).** We expect headline inflation at 0.00% 2w/2w, with the core at 0.24%. The non-core would decline 0.71%. The latter would be driven by the period's seasonality due to the second phase of summer discounts on electricity tariffs, subtracting 38bps. Nevertheless, this would be mostly compensated by pressures in the rest of energy as well as agricultural goods. If this materializes, annual inflation would stand at 5.81% from 6.08% on average in April. It should be mentioned that the difficult base effect starts to moderate, and will be gradually less challenging in coming months

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 24-May	7:00am	CPI inflation	1H May	% 2w/2w	0.00	-0.15	0.25
				% y/y	5.81	5.66	6.12
		Core		% 2w/2w	0.24	0.16	0.17
				% y/y	4.13	--	4.13
Tue 25-May	7:00am	Trade balance	April	US$ mn	2,457.2	200.0	-3,003.6
		Exports		% y/y	73.7	--	12.2
		Imports		% y/y	44.2	--	31.4
Tue 25-May	10:00am	Current account	1Q21	US$ bn	--	-2.5	17.4
Tue 25-May	10:00am	International reserves	May-21	US$ bn	--	--	194.6
Wed 26-May	7:00am	GDP	1Q21 (F)	% y/y	-3.5	-3.5	-3.8
		sa		% q/q	0.7	0.7	0.4
		Primary activities		% y/y	2.8	--	2.8
		Industrial production		% y/y	-2.7	--	-3.0
		Services		% y/y	-3.8	--	-4.2
Wed 26-May	7:00am	Economic activity indicator	March	% y/y	0.8	0.1	-5.1
		sa		% m/m	2.2	2.6	-0.3
		Primary activities		% y/y	0.2	--	5.9
		Industrial production		% y/y	1.7	--	-4.5
		Services		% y/y	0.5	--	-5.8
Thu 27-May	7:00am	Unemployment rate	April	%	4.27	4.20	3.89
		sa		%	4.41	--	4.43
Thu 27-May	10:00am	Banxico minutes					
Fri 28-May		Budget balance (measured with PSBR)	April	MX$ bn	--	--	-180.8

Source: Banorte; Bloomberg

Proceeding in chronological order…

Inflation in 1H-May unchanged, with seasonal downturns in electricity offset by mounting pressures in other categories. We expect headline inflation at 0.00% 2w/2w, below the 0.25% of the previous fortnight. We see the core at 0.24% contributing 18bps to the total, considerably above its five-year average. The non-core would decline 0.71% (-18bps). The latter would be driven by the period's seasonality due to the second phase of summer discounts on electricity tariffs, subtracting 38bps. Nevertheless, this would be mostly compensated by pressures in the rest of energy as well as agricultural goods. In the former, we expect LP gas up 0.9% (+2bps), influenced by peso weakness –with a 0.7% depreciation in the fortnight– as well as higher international references. In addition, gasolines would be more vigorous, expecting low-grade at +0.6% (+3bps). Similar to gas, this would be influenced by the same two factors, partly offset by higher stimulus on excise taxes. Specifically, this climbed to $1.80 from $1.56 per liter on average. High-grade would increase +0.7% (+0.5bps), with less support from stimulus. In agricultural goods, we expect fruits and vegetables at +2.2% (+10bps). Our monitoring showed added pressures on tomatoes –adding several fortnights with important adjustments, even surpassing the period's seasonality– as well as other products such as chilies and potatoes, with several others also showing slight upticks. We believe this could be related to droughts that have impacted vast regions of the country (and other places worldwide). Meanwhile, meat and egg would rise 0.7% (+4bps), with cost pressures –mainly on grains– impacting final prices.

Within the core we also identified relevant pressures. Goods would keep climbing (+0.3%; +12bps), divided almost evenly between processed foods (+6.5bps) and other goods (+5.5bps). In the former, some pressures in key components could extend, such as corn tortillas. In the latter, a pattern seems to be emerging of greater increases in the first half of the month, possibly responding to some pass-through from higher costs (including shipping). In addition, we do not rule out an adjustment before *Hot Sale* discounts. Services would increase +0.2% (+7bps). Specifically, we expect 'others' at +0.3%. Pressures would be seen in categories related to tourism –on an improvement on virus conditions– as well as others more susceptible to raw materials, such as restaurants and dining away from home.

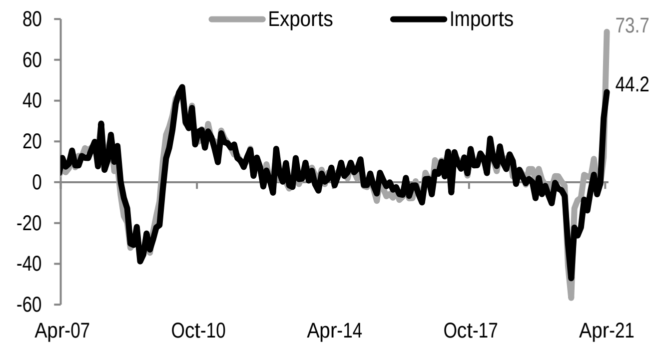
If our forecast materializes, annual inflation would stand at 5.81% from 6.08% on average in April. It should be mentioned that the difficult base effect starts to moderate, will be gradually less challenging in coming months. The non-core would come in at 11.2% (previous: 12.3%), with energy still the highest. Lastly, the core would be more stable at 4.13% (previous: 4.13%). Despite of this, risks seems that remain tilted to the upside, so we will still be very vigilant of price dynamics in coming fortnights.

April's trade balance back to surplus after a surprising deficit in March. We estimate a US$2,457.2 million surplus, up from -US$3,003.6 million in the previous month, resuming the overall trend seen in the last few years. In addition, we could see some payback after a very relevant sequential acceleration across several categories in the last report. In turn, this could have been related to lingering distortions to trade and inventories due to blackouts and other energy disruptions in February. As if this were not enough, we should recall that annual rates are entering their most extreme period of comparison because of the pandemic shock last year. Therefore, we should see unusually high growth rates in almost every category. In this respect, we estimate total exports at 73.7% y/y and imports at 44.2%, remembering that the latter were more resilient in the first lockdown months.

We expect a US$1,107.4 million deficit in the oil balance, reversing to a more 'normal' level after the massive -US$4,454.7 million of the previous month. Disruptions to the energy market dissipated since March, so the Mexican oil mix averaged 59.43 US$/bbl from 60.80 previously. Nevertheless, the annual comparison surged to a whopping 378.2% because of a very low base effect. Coupled with higher volumes, exports would grow 160.2%. Within imports, prices were also more stable at the margin, while gasoline volumes were stronger. We believe the latter is in part a result of a fire in the Minatitlan refinery in early April, resulting in lower processing capacity domestically which would need to be offset with inbound shipments to fulfill demand. Nevertheless, we expect some of the surge in March to moderate, especially in intermediate goods. As a result, total oil imports would come in at +51.2%.

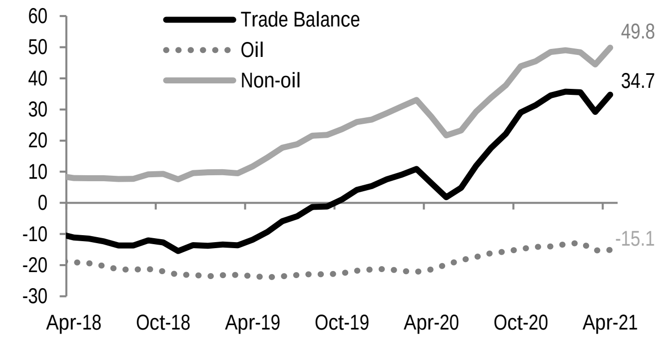
The non-oil balance is estimated to post a US$3,564.6 million surplus. Exports would climb 70.8% y/y, with imports slightly more modest at 43.6%. As mentioned, pandemic distortions for the period are among the highest due to the halt of activities last year, especially for the former. While both non-oil mining (+45.2%) and agricultural (+13.0%) goods were relatively isolated, manufacturing was highly affected, expecting them at 76.6%. Inside, autos would "outperform" substantially (+319.3%). This has already been flagged by the triple-digit increase in AMIA exports and the sector's production in the US. However, we do recognize some limits to output, as several manufacturers (including GM, Toyota and Honda, among others) had to partially shut-down operations due to the lack of semiconductors. Meanwhile, other manufacturing shipments would climb 40.5%, with a more moderate base as inventories were drawn down last year. This would still represent a positive signal in terms of sequential activity, with less of an impact from the scarcity of raw materials. Base effects would also distort import figures, with the largest uptick in consumption goods (+59.1%), consistent with other signals of a pick-up in domestic demand. Intermediate (41.6%) and capital goods (45.5%) would be favorable, also reflecting more dynamism given higher input costs.

Exports and Imports
% y/y nsa



Source: INEGI, Banorte

Trade balance
US$ billion, 12-month rolling sum



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves decreased by US$484 million, closing at US$194.6 billion (please refer to the following table). According to Banxico's report, this was explained by: (1) US$375 million sales to the Federal Government; and (2) by a negative valuation effect in institutional assets of US$109 million. So far this year, the central bank's international reserves have fallen by US$1,022 million.

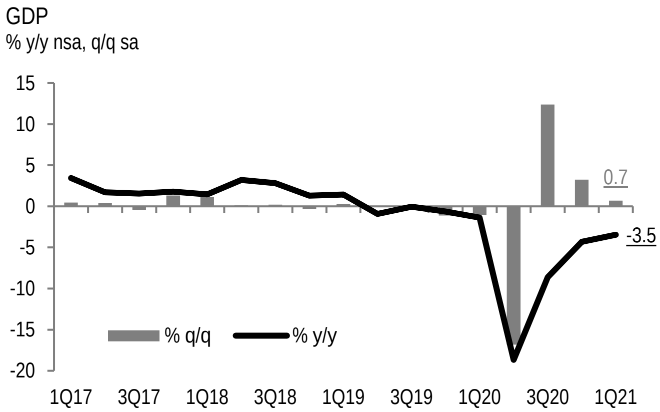
Banxico's foreign reserve accumulation details
US$, million

	2020	May 14, 2021	May 14, 2021	Year-to-date
	Balance		lows	
International reserves (B)-(C)	195,667	194,645	-484	-1,022
(B) Gross international reserve	199,056	199,420	-2,364	364
Pemex	--	--	0	449
Federal government	--	--	-2,430	780
Market operations	--	--	0	0
Other	--	--	66	-865
(C) Short-term government's liabilities	3,389	4,776	-1,880	1,386

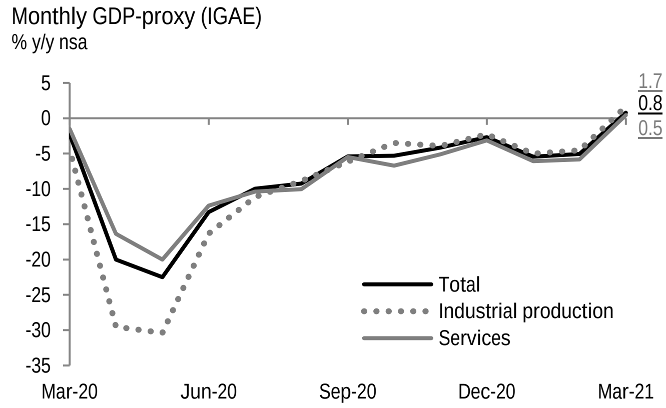
Source: Banco de México

Mexico's final 1Q21 GDP to be revised up. We anticipate 1Q21 GDP to be revised about 30bps higher relative to the preliminary estimate, to -3.5% y/y. This would be driven by already known upward revisions in industry, while we also expect a stronger print in services. Hence, with seasonally adjusted figures, the economy would have expanded 0.7% q/q (preliminary: 0.4%).

Specifically, March was likely better than originally estimated. In this respect, we see the monthly GDP proxy (IGAE) at 0.8% y/y. According to our calculations, this would be considerably above the -0.3% implied in the GDP estimate. Figures for the period have several calendar effects distorting them –from an additional working day to the timing of the *Easter* holiday. Correcting for this, it would stand at 0.4% y/y, below the 0.9% within INEGI's *Timely Indicator of Economic Activity*. More important, this would imply a rebound of about 2.3% m/m, ending with three consecutive months in contraction and suggesting that activity is back on the recovery path. As mentioned before, this would be mainly driven by an improvement in epidemiological conditions, support from external demand and a more positive outlook domestically.



Source: INEGI, Banorte



Source: INEGI, Banorte

Back to quarterly GDP, we expect industry with a 0.3% q/q expansion (-2.7% y/y) much better than the 0.0% in the preliminary report. This would be consistent with March's industrial production, which advanced 0.7% m/m, supported by a rebound in utilities and manufacturing after temporary disruptions in February.

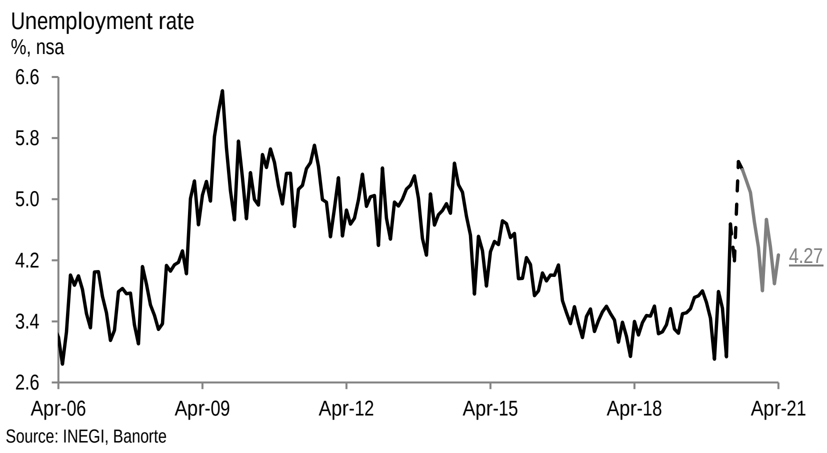
Services would rise 1.0% q/q (-3.8% y/y), +30bps relative to the preliminary print at 0.7%. Although data for the sector is still scarce, so far it suggests benefits from looser distancing restrictions and additional businesses reopening. Among them, IMEF's non-manufacturing indicator reached 51.9pts, back in expansion for the first time in thirteen months, with 'new orders' and 'production' outperforming. Retail sales expanded 3.6% m/m, with favorable developments in non-essential categories. Turning to tourism, air passenger traffic surged to 4.3 million from 2.9 million in February. In our view, this was helped by the *Easter* holiday, in turn benefited by a more favorable backdrop about the virus. This is also seen in hotel occupancy rates, up to 33.7% from 25.0% in February. We should mention that the holiday was only a boost in the final days of the month. It is our take that this was also reflected in other entertainment and leisure services, as seen partly in the performance of some components within business confidence for non-financial services. In transportation, another relevant boost–on top of higher tourism– could have been the rebound in manufacturing, particularly on the shipment of goods. On essential sectors, we think that health services could be relatively stable, with lower COVID-19 cases possibly being offset by additional patients attending non-critical issues. As schools remained closed, education would also probably remain somewhat flat. Finally, government activities could gain some momentum considering spending data the latest public finance report.

Looking forward, we continue seeing a favorable outlook, with activity gaining further momentum in the remainder of the year, especially in the second quarter. This would be supported by spillover effects from US stimulus and a faster improvement in domestic demand, underpinned by notable progress in the vaccination campaign. However, some risks are gaining traction, mainly those related to possible effects from supply chains disruptions on production and prices, as well as those related to another wave of cases (seemingly decreasing). All in all, we maintain our forecast of a 5.9% y/y expansion in 2021.

We expect the unemployment rate to extend lower in April, with further job gains. We estimate it at 4.27% (original figures), up 38bps relative to March. This is due to a seasonal effect, with a reversal after the strong correction in the previous month. In this sense, with seasonally adjusted figures we estimate a 2bps decline, to 4.41%. We still expect support from net job creation, with most people returning to the labor force with an occupation. Nevertheless, the decrease in the unemployment rate would be modest due to two factors: (1) People classified as 'unemployed' are below their historical average, suggesting greater difficulties for an additional decline; and (2) as more people come back into the labor market, unfortunately some will have to do so without a job. Indicators for the period were somewhat mixed, albeit with mostly positive signs. Employment associated to IMSS rose 44.8 thousand positions. However, adjusting for seasonal effects, job creation was at 107.4 thousand. In annual terms this translates into a 0.7% expansion in total affiliated workers, albeit distorted by losses related to the pandemic last year. Meanwhile, employment components within aggregate trend indicators were mixed, with gains in construction but losses in manufacturing, non-financial services and commerce. Finally, IMEF indicators were marginally negative, with 0.1pts decline in employment components in both manufacturing and non-manufacturing.

On complementary indicators, the participation rate will probably increase as more people return to the labor force, partly as a result of an additional decrease in the 'available for work' component outside of the labor force. Meanwhile, part-time levels could decline further, supported by a larger reopening. On the contrary, informality could keep rising, albeit recalling that it is not far off from its long-term average. Lastly, we will remain vigilant on wages, analyzing average earnings and the wage distribution as the effects of minimum wage hikes continue permeating to the economy.

We expect the labor market to keep recovering, driven by the reactivation of activity, in turn tied to the epidemiological backdrop. Considering improvements in this front, along support from abroad and a better performance of domestic demand, the uptick could be somewhat vigorous. Nevertheless, risks remain, including industry disruptions due to the scarcity of raw materials, as well as negative effects from the implementation of reforms to the Federal Labor Law, focused on limiting *outsourcing* practices.



Banxico's minutes to shed light on future rate movements. The central bank will release the minutes of the monetary policy meeting held on May 13th, in which the Board again voted unanimously to maintain the reference rate at 4.00%. We noted a more hawkish tone, with an additional focus on inflation, consistent with the recent increase in both actual data and short-term expectations, while recognizing that risks are tilted to the upside. Therefore, we will be analyzing comments on the latter, looking for further details on changes to forward-looking factors as well as on most recent price dynamics. More importantly, we will search for comments from Board members about the chances of resuming the easing cycle, as in the previous meeting at least three of them saw that the 'window of opportunity' for additional cuts may reopen after passing through the 'hump' in inflation.

On prices, the acknowledgment of a higher-than-expected path in the short-term was relevant to us, suggesting a more pronounced impact from current pressures. We should recall that Banxico's current estimate for average headline inflation in 2Q21 stands at 4.5% y/y. Considering April's 6.08%, data in May and June would have to be at 3.7% on average, which is almost unreachable. In this sense, they have already said that upward adjustments will be made in the next *Quarterly Report* (QR, to be published on June 2nd). Nevertheless, the magnitude of these changes will be very important, while they highlighted that the convergence to target is still expected to happen in 2Q22. In addition, the acknowledgment of risks for inflation being tilted to the upside was also key to our view that the statement's tone was more hawkish. As such, we believe the debate over these will be very informative on the relative importance of factors driving price pressures, with those from abroad seemingly as the most important.

In our view, the previous minutes suggested two major "camps" of opinion. First, we believe Governor Alejandro Díaz de León and Deputy Governor Irene Espinosa were on the relatively hawkish side. Meanwhile, leaning dovish were Deputy Governors Jonathan Heath, Galia Borja, and Gerardo Esquivel. Nevertheless, given recent developments, it is our take that the composition might be shifting. Specifically, Deputy Governor Heath seems to be showing greater concerns of inflation. In a recent note he authored for *Forbes* on May 14th, he explained that prices have been highly distorted by several factors, ranging from demand and supply imbalances, challenging base effects, and shifting consumption patterns. As a result, he concluded that "*…the path of the pandemic inflation will likely be long and winding, thus not being easy…*". While not an outright call for tightening, this and other comments suggest that he may see the window for easing as closed. On a more hawkish tone, Deputy Governor Espinosa mentioned in a *Bloomberg* interview (May 18th) that "*…there is no room for further rate cuts, and the bank may eventually need to start withdrawing stimulus if inflation pressures remain elevated…*". She also stated that, with inflation above the target, this is a very different backdrop than in the US, which could imply that hikes might happen before the Fed adjusts its policy. While this helps confirms her bias, it also sheds light on her views about inflation and the balance of risks. On the other side of the spectrum, Deputy Governor Esquivel –which we think is the most *dovish*– tweeted after the release of inflation for the first half of April that the increase in annual inflation is transitory, mostly due to base effects.

Hence, he thinks explaining this should not contaminate inflation expectations and the price-formation process. In our opinion, this may suggest that he sees risks ahead as more benign, allowing for the possibility of further easing in the near future. Overall, we expect the majority (3 or more members) to consider that the easing cycle is over. On the contrary, it still looks complicated to us that they could reach a consensus about signaling future hikes, albeit probably trending toward that stance in future meetings.

On growth, we expect a more positive outlook, pointing to an upward revision in the QR. Turning to financial stability, we expect additional comments on the recent performance of the MXN and local rates, which improved relative to the previous meeting. Also, we could see some analysis of the recent rating action by Moody's –with Fitch's decision occurring afterwards–, and its possible implication on public finances and Pemex, as well as the mid-term elections and other geopolitical risks.

All in all, we think the outlook for inflation –which is the central bank's single mandate– has turned more complex and has closed the possibility of additional easing. Not only that, but also that rate hikes will likely begin towards year-end. In this sense, we maintain our view of two 25bps increases taking place in the November 11th and December 16th meetings. This would take the reference rate to 4.50%. On top of a more complex backdrop for prices, we also recognize other risk factors, including recent actions from EM central banks which already have started to tighten their monetary stance, and the high likelihood that the Fed will announce the tapering of assets purchases as soon as September (in advance of starting in early in 2021).

MoF's public finance report (Jan-Apr). Attention will center on the Public Balance and Public Sector Borrowing Requirements (PSBR) in the first four months of the year. Specifically, we will be looking to its performance relative to the latest estimates outlined in the Preliminary Budget Criteria. We note that until March, the PSBR deficit amounted to $180.8 billion, equivalent to 0.7% of GDP. We will also pay attention to revenue and spending dynamics in the annual comparison, looking for clues about activity levels and possible adjustments to expenditures. Lastly, we will analyze public debt, at MXN$12.4tn (as measured by the Historical Balance of the PSBR) as of March, representing 49.2% of GDP.

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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	Reference
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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.

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GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy			
Gabriel Casillas Olvera	IRO and Chief Economist	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Economic Research and Financial Market Strategy			
Alejandro Padilla Santana	Executive Director of Economic Research and Financial Markets Strategy	alejandro.padilla@banorte.com	(55) 1103 - 4043
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251
Economic Research			
Juan Carlos Alderete Macal, CFA	Director of Economic Research	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Francisco José Flores Serrano	Senior Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Katia Celina Goya Ostos	Senior Economist, Global	katia.goya@banorte.com	(55) 1670 - 1821
Luis Leopoldo López Salinas	Economist, Global	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
Market Strategy			
Manuel Jiménez Zaldívar	Director of Market Strategy	manuel.jimenez@banorte.com	(55) 5268 - 1671
Fixed income and FX Strategy			
Santiago Leal Singer	Senior Strategist, Fixed Income and FX	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Strategist, Fixed Income and FX	leslie.orozco.velez@banorte.com	(55) 5268 - 1698
Equity Strategy			
Marissa Garza Ostos	Director of Equity Strategy	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Senior Strategist, Equity	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Senior Strategist, Equity	valentin.mendoza@banorte.com	(55) 1670 - 2250
Víctor Hugo Cortes Castro	Senior Strategist, Technical	victorh.cortes@banorte.com	(55) 1670 - 1800
Eridani Ruibal Ortega	Analyst	eridani.ruibal.ortega@banorte.com	(55) 1103 - 4000 x 2755
Juan Barbier Arizmendi, CFA	Analyst	juan.barbier@banorte.com	(55) 1670 - 1746
Corporate Debt			
Hugo Armando Gómez Solís	Senior Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248
Economic Studies			
Delia María Paredes Mier	Executive Director of Economic Studies	delia.paredes@banorte.com	(55) 5268 - 1694
Miguel Alejandro Calvo Domínguez	Senior Analyst, Economic Studies	miguel.calvo@banorte.com	(55) 1670 - 2220
Wholesale Banking			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(81) 8319 - 6895
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Frigolet Vázquez Vela	Head of Sólida Banorte	alejandro.frigolet.vazquezvela@banorte.com	(55) 5268 - 1656
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Carlos Alberto Arciniega Navarro	Head of Treasury Services	carlos.arciniega@banorte.com	(81) 1103 - 4091
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
Lizza Velarde Torres	Executive Director of Wholesale Banking	lizza.velarde@banorte.com	(55) 4433 - 4676
Osvaldo Brondo Menchaca	Head of Specialized Banking Services	osvaldo.brondo@banorte.com	(55) 5004 - 1423
Raúl Alejandro Arauzo Romero	Head of Transactional Banking	alejandro.arauzo@banorte.com	(55) 5261 - 4910
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Commercial Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454