Ahead of the Curve

Banxico unchanged, but with a hawkish tone

June 18, 2021

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- **Banxico's monetary policy decision (Jun-24).** On Thursday, the central bank will carry out its fourth decision of the year, in which we expect the rate on hold, at 4.00%. The vote will likely be unanimous, as in the last three meetings. Specifically, we believe the main driver behind this will be the complex backdrop for inflation, with a relevant increase throughout 2021 that has impacted short-term expectations. In addition, the outlook for activity keeps improving, with epidemiological conditions more positive. Finally, financial conditions tightened in the last few days despite having shown a mostly positive performance in recent weeks. We highlight the more hawkish tone from the Fed in this week's decision. As a result, we expect that Banxico's statement will maintain a hawkish bias, consistent with the latest minutes and the 1Q21 *Quarterly Report*
- **Inflation (1H-Jun).** We expect headline inflation at 0.35% 2w/2w, accelerating relative to the 0.17% of the previous fortnight. Dynamics in the period would be dominated by higher food items, both at the core and non-core, along some relative price changes towards services instead of goods as activity normalizes. In this context, we see the core at 0.29%, contributing 22bps, while non-core would climb 0.52%, translating to 13bps. If our forecast materializes, annual inflation would stand at 6.02% from 5.89% on average in May. It should be mentioned that despite a less challenging base effect, other pressures would maintain inflation high. In this sense, the non-core would accelerate to 10.83% from 10.76% as agricultural goods would remain pressured, in contrast with that they typically do this period. Meanwhile, the core would stand at 4.51% from 4.37%.

Document for distribution among the general public

Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 22-Jun	10:00am	International reserves	Jun-18	US$ bn	--	--	193.5
Tue 22-Jun	4:30pm	Citibanamex bi-weekly survey of economic expectations					
Wed 23-Jun	7:00am	Retail sales	April	%	29.4	31.3	2.5
		sa		%	-0.7	--	3.6
Thu 24-Jun	7:00am	CPI inflation	1H Jun	% 2w/2w	0.35	0.22	0.17
				% y/y	6.02	5.89	5.99
		Core		% 2w/2w	0.29	0.22	0.22
				% y/y	4.51	--	4.51
Thu 24-Jun	7:00am	Unemployment rate	May	%	4.47	4.40	4.65
		sa		%	4.52	--	4.65
Thu 24-Jun	2:00pm	Monetary policy decision (Banxico)	Jun-24	%	4.00	4.00	4.00
Fri 25-Jun	7:00am	Economic activity indicator	April	% y/y	21.7	21.6	0.8
		sa		% m/m	-0.5	0.0	2.6
		Primary activities		% y/y	3.0	--	0.5
		Industrial production		% y/y	36.6	--	1.7
		Services		% y/y	18.2	--	0.3

Source: Banorte; Bloomberg

Proceeding in chronological order…

Weekly international reserves report. Last week, net international reserves decreased by US$302 million, closing at US$193.5 billion (please refer to the following table). According to Banxico's report, this was explained by: (1) US$375 million in sales to the Federal Government; and (2) a positive valuation effect in institutional assets of US$73 million. So far this year, the central bank's international reserves have declined by US$2.2 billion.

Banxico's foreign reserve accumulation details
US$, million

	2020	Jun 11, 2021	Jun 11, 2021	Year-to-date
	Balance		Lows	
International reserves (B)-(C)	195,667	193,467	-302	-2,200
(B) Gross international reserve	199,056	199,592	150	536
Pemex	--	--	0	449
Federal government	--	--	-38	445
Market operations	--	--	0	0
Other	--	--	188	-358
(C) Short-term government's liabilities	3,389	6,125	452	2,736

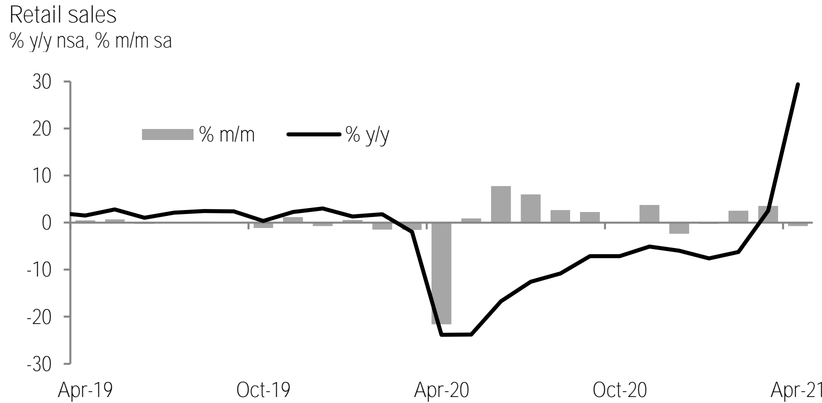
Source: Banco de México

Retail sales to fall slightly in April as payback drives performance. We anticipate 29.4% y/y growth after +2.5% in the previous month. This would be mostly on a much more favorable base effect as strict lockdowns began in this period last year, sharply impacting non-essential goods purchases. Other factors also skew the print, the main being the timing of the *Easter* holiday. Using seasonally adjusted figures to isolate for these effects, we expect a 0.7% m/m fall in sales. This would come after two months of very strong growth, resulting in a more challenging base. While most driving forces were positive, as detailed ahead, we also note some caution signs.

Specifically, we believe inflation may be starting to take a heavier toll, with accumulated price pressures year-to-date matching those seen in 2017, when energy prices were liberalized. For context, annual inflation finished that year at 6.8%. While we see a more modest performance throughout the remainder of this year –closing at 5.5%–, some pressures have concentrated in sensitive sectors, such as food (both at the core and non-core) and energy. In addition, non-oil consumption goods imports declined 6.6% m/m, backtracking after relevant gains and supporting our call of a marginal reduction.

On a more positive note, epidemiological conditions kept improving and vaccinations gathering pace. In this context, total sales by ANTAD members rose 40.9% y/y in real terms, also with a very favorable base. For comparison purposes, they stood 10.5% above 2019. In a similar fashion, vehicle sales grew 139.4% y/y, while gasoline sales volumes were up 28.8%, as mobility levels are still recovering gradually. On fundamentals, remittances remain strong, with two historic prints in March and April –both surpassing US$4 billion– supporting revenue for low-income families. Moreover, employment gains continued, totaling 1 million new jobs in the period, along other indicators suggesting a more favorable outlook for the labor market.

All in all, and despite the expected contraction, retail sales will likely remain on the recovery path. A more positive epidemiological backdrop and most fundamentals, among other factors, would keep underpinning growth. However, not all drivers are good, with some risks stemming from price pressures along shortages amid supply-chain shocks.



Inflation in 1H-June pressured on food costs and a rebalancing of spending towards services. We expect headline inflation at 0.35% 2w/2w, accelerating relative to the 0.17% of the previous fortnight. Dynamics in the period would be dominated by higher food items, both at the core and non-core, along some relative price changes towards services instead of goods as activity normalizes. In this context, we see the core at 0.29%, contributing 22bps, while non-core would climb 0.52%, translating to 13bps. Within the former, goods would rise 0.4% (+14bps), with processed foods leading (0.4%), expecting a substantial and additional impact from corn tortillas –showing a marked upward trend in the past four months– along other relevant goods, including milk. Other goods would be more modest at 0.3%, with limited backlash after *Hot Sale* discounts (considering they were not as widespread as in 2020). Turning to services, these would gain some speed at 0.2% (+8bps), with pressures clearly centered in 'other' at 0.4%. Inside, tourism-related categories –mainly airfares– would keep rising as more people resume pre-pandemic behaviors. This could also be impacting other socially-exposed categories such as restaurants and 'dining away from home'. Moreover, the latter will likely adjust further on passthrough from higher energy and raw-materials costs.

At the non-core, agricultural goods would grow 0.7% (+8bps), pushed higher mainly by fruits and vegetables at 1.6%. Changes in drought conditions seem mixed, with some regions worse at the margin –such as the northwestern part of the country– and others improving –mainly the center and, to a lesser extent, northeast. In this backdrop, performance would be differentiated, with our price monitoring showing sharp increases in tomatoes and a modest relief in chilies and bananas, among others. Meat and egg would rise 0.1%, with seasonal trends offsetting pressures due to higher grain costs –used to feed animals. On energy (0.4%; +4bps), LP gas would be the main driver behind the 1.5% increase, heavily influenced by the performance of international reference prices.

In this context, the *Mexican Federal Economic Competition Commission* (COFECE in Spanish), announced that they have started an investigation on collusion and price-fixing in the distribution of this good. Gasoline would be much more modest, with low-grade at 0.1%. Although prices abroad were also stronger, the relative stability of the exchange-rate and higher subsidies to excise taxes would have helped maintain prices under control. Lastly, government tariffs would stay subdued (0.1%) as Election Day was on June 6th, incentivizing authorities to maintain the cost of services low, albeit expecting stronger adjustments higher in coming fortnights.

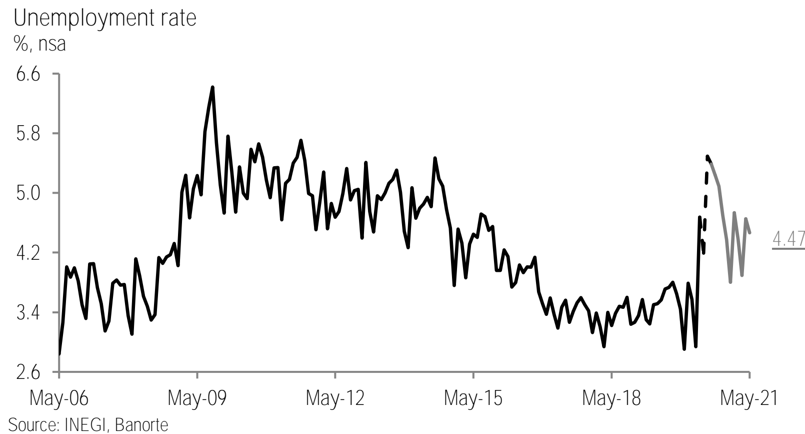
If our forecast materializes, annual inflation would stand at 6.02% from 5.89% on average in May. It should be mentioned that despite a less challenging base effect, other pressures would maintain inflation high. In this sense, the non-core would accelerate to 10.83% from 10.76%, as agricultural goods would remain pressured, in contrast with that they typically do this period. Meanwhile, the core would stand at 4.51% from 4.37%. Although we maintain our forecast of inflation converging towards 5.5% at the end of the year, risks are once again tilting to the upside.

We expect the unemployment rate lower in May, with further adjustments in the labor force. We estimate it at 4.47% (original figures), down 19bps relative to April. This is partly due to a seasonal effect, factoring in the strong adjustments in the previous two months due to temporary hires for *Easter*. Correcting for this with seasonally adjusted figures, we expect a 13bps decline to 4.52%. In this sense, the latter metric shot-up +16bps in April, in our view driven by a strong influx of people into the labor force. This even surpassed a strong print in terms of jobs created, resulting in a sizable upward adjustment in the unemployment rate. Specifically, out of the nearly 1.5 million people back into the labor force, only 1 million did so with a job. This is only one of several distortions induced by the pandemic, expecting them to fade away gradually as conditions return to normal. In May, we expect the adjustment in the labor force to be more modest relative to job gains, which would result in a decline in the rate.

Our view is based on a series of favorable indicators. First, employment affiliated to IMSS rose by 39.0 thousand positions. Nevertheless, adjusting for seasonality, total job creation amounted to 114.9 thousand jobs, accelerating relative to the previous month (+102.0 thousand). Moreover, employment components within aggregate trend indicators –for the four big categories of construction, manufacturing, commerce and non-financial services– improved sequentially after mixed results. Finally, employment categories within IMEF's PMIs increased, +2.0pts for manufacturing, albeit only +0.1pts for non-manufacturing. With this, both bolstered their position in expansion territory (above 50pts).

On complementary indicators, the participation rate would pick up given the return of people to the labor force. Most could come from the 'available for work' category. Part-time levels could show an additional improvement given the gradual normalization of activity. After falling in April, informality could adjust higher, resuming the trend towards its long-term average. On wages, we will continue to observe the pace of average income growth, trying to gauge the pass-through from recent pressures in this category.

We anticipate that the labor market will keep recovering gradually, boosted by the economic reactivation. However, some risks prevail, including those related to industrial activity, as well as recent reforms to the Federal Labor Law focused on limiting outsourcing.

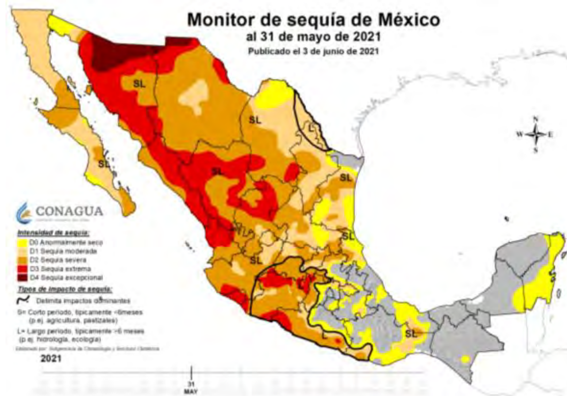


Source: INEGI, Banorte

Banxico to remain on hold, with less *dovish* conditions overall. On Thursday, the central bank will carry out its fourth decision of the year, in which we expect the rate on hold, at 4.00%. The vote will likely be unanimous, as in the last three meetings. Specifically, we believe the main driver behind this will be the complex backdrop for inflation, with a relevant increase throughout 2021 that has impacted short-term expectations. In addition, the outlook for activity keeps improving, with epidemiological conditions more positive. Finally, financial conditions tightened in the last few days despite having shown a mostly positive performance in recent weeks. We highlight the more hawkish tone from the Fed in this week's decision. As a result, we expect that Banxico's statement will maintain a hawkish bias, consistent with the latest minutes and the 1Q21 *Quarterly Report*.

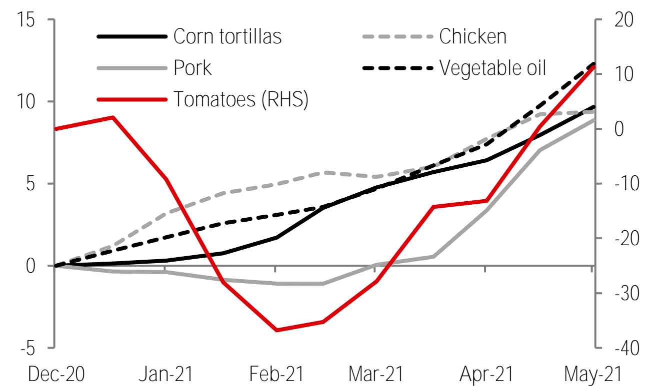
On inflation, we consider that conditions have turned, once again, more adverse at the margin. Several distortions, along prices influenced by both supply and demand effects, are still making decisions tougher for the central bank. On the former, the main ones are related to: (1) The impact of droughts –both locally and abroad– on food prices; (2) supply chains shocks due to the scarcity of key inputs; and (3) cost pressures given high freight tariffs and commodities' prices. On the first, data still shows an extraordinarily high shock (map below, left) despite marginal improvements as rains have started in the last few weeks. In this sense, so far in the year we highlight pressures in key food items within the core and non-core components, such as corn tortillas, tomatoes, chicken, pork and vegetable oil, among others (chart below, right). On the demand side, dynamics seem to be increasingly associated to the reopening, starting to see more relevant adjustments in some services. In this respect, the acceleration has been clearer in 'others' –which include air fares and tourism–, the component most impacted during the lockdowns, albeit also challenged by higher input costs, among others.

Drought monitor in Mexico



Source: CONAGUA. Map only available in Spanish

CPI: Selected food items
%, accumulated inflation since 2H-Dec 2020



Source: Banorte with data from INEGI

Given this, we think the most relevant issue in the statement will be if there are adjustments on the language about inflation, which since the previous decision already had a more prominent focus. Specially, it would be quite important if they signal some skew or deviation relative to their average inflation forecast for 2Q21 which was updated barely two weeks ago. We recall that the central bank expects average inflation of 5.8% in the period. This compares to our 5.9% forecast – with high inflation in 1H-June (see section above). Given the latter, we do not believe there will be meaningful changes. On the other hand, they will still recognize additional increases in short-term inflation expectations, with greater stability in those for the mid-term. In this sense, latest analyst surveys show that inflation will close this year at around 5.0%, remaining at 3.5% in the second case.

Turning to activity, Banxico seems less concerned as they acknowledged a more equilibrated balance of risks, the boost from the US, and their updated forecast of a 6.0% expansion in 2021. In turn, this would result in a faster reversal in slack, although most members probably keep seeing a negative output gap in the forecast horizon. On the financial backdrop, the main sticking point stems from the latest changes in Federal Reserve communications. In particular, upward adjustments in macro estimates and a move higher in the dot-plot –with more members expecting hikes in 2022 and 2023– resulted in a more hawkish tone than anticipated. This triggered an important reaction higher in US interest rates, on top of opening the possibility of a faster-than-expected normalization in the case of more significant inflation pressures. The latter, along a less accommodative stance in other EMs (*e.g.* Brazil, Turkey, Russia, Ukraine, etc.), could reduce the room to maneuver in terms of the relative monetary stance. On the contrary, the ratification of Mexico's sovereign credit rating by *S&P Global Ratings* provides added confidence on the country's position, despite prevailing risks in the fiscal front.

In this context, we have not had a lot of comments from Board members since the *Quarterly Report*. Nevertheless, in the last few days, Deputy Governor Irene Espinosa took part in a webcast in which she suggested that inflationary pressures seem temporary, albeit with attention on whether their causes are temporary or structural. Moreover, she considers most risks for inflation are to the upside, as the institution's consensus.

Although we continue to believe she remains as the most hawkish member, she probably supports maintaining the reference rate stable for longer. Meanwhile, despite the remainder of the Board possibly having a more dovish tilt –especially Deputy Governor Gerardo Esquivel–, we do not rule out that others, such as Deputy Governor Jonathan Heath, can adopt a less accommodative stance given the factors outlined previously.

In our opinion, the stance of the central bank will adjust gradually towards a more hawkish tone, with the need of implementing a more restrictive stance before year end. This would happen in a backdrop in which the price outlook and the relative monetary stance have become more complex. Therefore, we maintain our call of two 25bps hikes each in the November 11th and December 16th meetings. This would take the reference rate to 4.50% by the end of the year, expecting additional tightening at the beginning of 2022.

April's GDP-proxy to contract modestly in sequential terms. We expect the *Global Economic Activity Indicator* (IGAE) at 21.7% y/y, recalling the sizable distortion to annual rates because of strict lockdowns and business closures in the same period last year. This effect could be even more important in May and will remain a heavy influence at least for the rest of 2021. Also, the Easter holiday was at the beginning of the month and there were differences in working days in the annual comparison. Correcting for the latter with seasonally adjusted figures, we expect a 20.8% y/y advance, which is lower than the mid-point forecast in INEGI's *Timely Indicator of Economic Activity*.

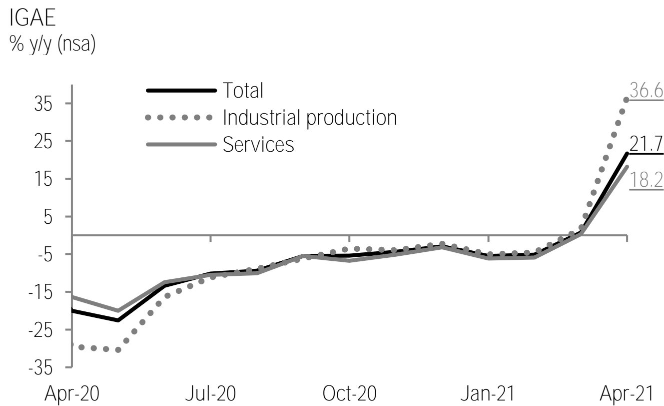
Overall, COVID-19 conditions and vaccinations advanced further. No states were in 'red' and more reached 'yellow' in the 'traffic light' indicator. Meanwhile, the 7-day average of daily inoculations reached a new high by the time. In our view, this boosted consumer and business confidence and was also clearly seen in the extension upwards in mobility indicators. Hence, conditions were mostly favorable. Despite of this, we expect a modest 0.5% m/m contraction. In our view, this would be driven mostly by a statistical effect after March's steep acceleration (2.6%). On this, industry –which is facing a plethora of supply-chain issues– already showed a modest decline (-0.2%), with reversals in manufacturing and construction, while mining surprised favorably.

For services, we estimate +0.7% m/m (18.2% y/y). In our view, it will be very interesting to analyze the breakdown, as more people went out in the holidays, while this same season last year was basically "cancelled" because of the pandemic. In this respect, we expect lodging, recreational and transportation services to lead in terms of annual growth. Nevertheless, all of them will remain significantly below "normal" levels. The overall hotel occupancy rate stood at 37.7%, which is 4%-pts higher than in March. This compares to barely 2.9% in the same period last year, but only about half the level in 2019. In transportation, a possible headwind is manufacturing weakness mentioned above, with delivery times up strongly. Higher mobility is also reflected in the volume of gasoline sales, already accounted for in retail (see section above). We also see some weakness at the margin in wholesales. In this sense, the aggregate trend indicator for commerce showed generalized but modest setbacks except for the demand component.

We think real growth may have been dampened by rising inflationary pressures in goods, including food items. On the contrary, we had other favorable trends, such as in IMEF's non-manufacturing production component, along job creation despite a higher unemployment rate. Lastly, we see a 1.5% m/m contraction (+1.4% y/y) in primary activities. We put some weight to the signal coming from price pressures in fresh fruits and vegetables within inflation. Although this is not necessarily because of lower production, we believe it is was likely the case considering widespread droughts in our country.

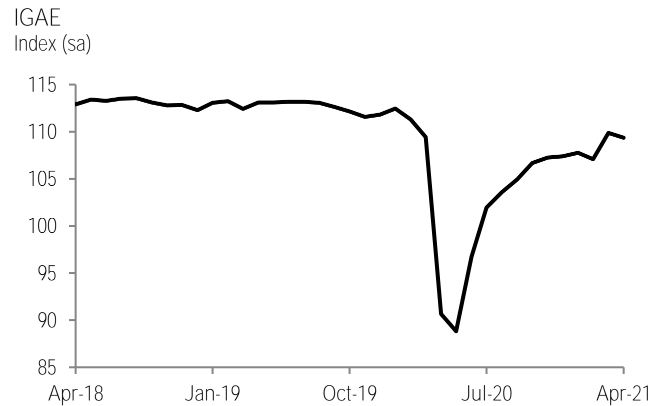
Going forward, we continue expecting the recovery to extend further, with GDP growth accelerating sequentially relative to 1Q21 despite a modest setback at the start of the period. In this sense, available data for May has been more positive, while we will also analyze carefully annual growth rates to judge any potential risk to our current 18.7% y/y GDP forecast for the second quarter and of 5.9% for full-year 2021.

IGAE
% y/y (nsa)



Source: INEGI, Banorte

IGAE
Index (sa)



Source: INEGI, Banorte

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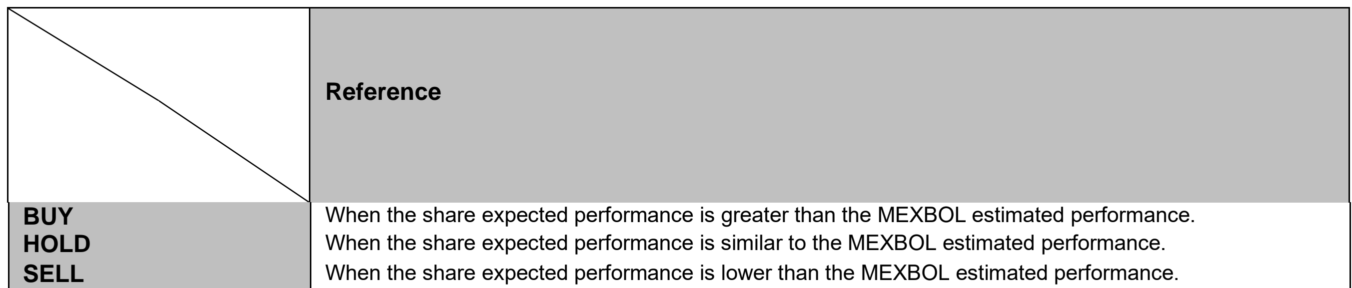

	Reference
BUY	When the share expected performance is greater than the MEXBOL estimated performance.
HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
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