Ahead of the Curve

Focus on inflation and the possibility of more rate hikes in Banxico's minutes

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- **Banxico minutes (June 24th).** On Thursday, Banxico will publish the minutes of the June 24th meeting, in which, surprisingly, the Board decided to hike the reference rate by 25bps to 4.25%. The vote was 3-2, with this document revealing the identity of the dissenters and the motives behind their votes. Considering previous stances and recent comments on the media, we believe these were Deputy Governors Galia Borja and Gerardo Esquivel. In addition, within the document we will evaluate with detail discussions on inflation and its outlook, as it is almost a fact that this was the main driver for the hike. It will also be very relevant to see different opinions about the possible path for prices and its implications for monetary policy ahead, as well the associated risks; particularly given that the statement was not clear enough over whether the hike marks or not the start of a tightening cycle
- **Inflation (June).** We expect headline inflation at 0.55% m/m, high relative to similar periods, including the 0.47% seen in 2020 –which was heavily affected by the pandemic, with pressures on goods but very low services. The core would rise 0.56% (contribution: 42bps) and the non-core 0.51% (+13bps). If our forecast materializes, annual inflation would remain at 5.89%, equaling May's level despite a more favorable base effect. This is consistent with our view of higher pressures in prices so far in the year. Meanwhile, the non-core would decline to 10.10% from 10.76%. while the core would climb to 4.56% from 4.37%

Mexico weekly calendar

DATE	TIME (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 5-Jul	7:00am	Consumer confidence (sa)	June	index	42.3	--	42.7
Tue 6-Jul	7:00am	Gross fixed investment	April	% y/y	42.4	41.3	1.4
		sa		%m/m	-2.8	--	2.3
		Machinery and equipment		% y/y	44.9	--	14.8
		Construction		% y/y	40.6	--	-7.8
Tue 6-Jul	7:00am	Private consumption	April	% y/y	--	--	0.4
		sa		%m/m	--	--	2.8
		Domestic (Goods and services)		% y/y	--	--	-2.5
		Imported (Goods)		% y/y	--	--	28.6
Tue 6-Jul	10:00am	International reserves	Jul-2	US$ bn	--	--	192.9
Tue 6-Jul	3:30pm	Citibanamex bi-weekly survey of economic expectations					
Thu 8-Jul	7:00am	CPI inflation	June	% m/m	0.55	0.50	0.20
				% y/y	5.89	5.85	5.89
		Core		% m/m	0.56	0.56	0.53
				% y/y	4.56	--	4.37
Thu 8-Jul	10:00am	Banxico Minutes	Jun-24				
Fri 9-Jul		Wage negotiations	June	%	--	--	4.4

Source: Banorte; Bloomberg

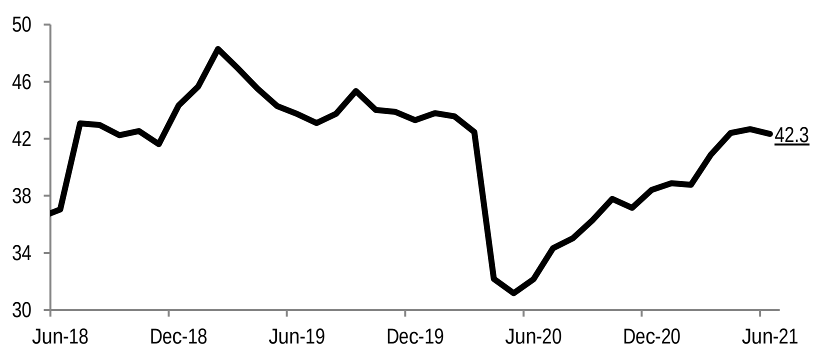
Proceeding in chronological order...

Consumer confidence to backtrack some gains in June. We expect confidence at 42.3pts (seasonally adjusted), below May's 42.7pts. In our view, developments were rather mixed –and even slightly negative at the margin–, which coupled with the recovery observed so far, could result in a modest decline. Nevertheless, the backdrop remained mostly positive, expecting the recovery to extend during the rest of the year.

On the positive side, the elections on June 6th were held in an orderly and peaceful environment. We also had a relatively modest number of legal fights about the results, booting citizen's confidence in institutions. The exchange rate was more volatile though, advancing strongly at the beginning of the period but reversing quickly towards USDM/MXN 20.65 by the 18th, the latest day before the survey closes.

On the contrary, the evolution of COVID-19 cases started to deteriorate. Nevertheless, it did not trigger downgrades in the 'traffic light' indicator during the sample survey, which in our view has served as an important guide for the population. We have also seen that the latter has been correlated with the pace of economic activity. On the other hand, the daily pace of vaccinations also slowed down from a high of 1 million doses at the start of the month, stabilizing around 400,000. If these factors led to increased cautiousness among consumers, we do not rule out a negative impact. Nevertheless, we believe that the main adverse driver has been price pressures, with sequential inflation picking up in recent fortnights and still concentrated in food items, such as in the 1st half of the month. We believe this price adjustments could be particularly relevant for the households' conditions and purchasing power components. Despite this bump in the road –as also suggested by IMEF indicators–, activity likely kept recovering, supported by better fundamentals, particularly in consumption (*e.g.* employment, remittances).

Consumer confidence
Pts, seasonally adjusted



Source: Banorte with data from INEGI

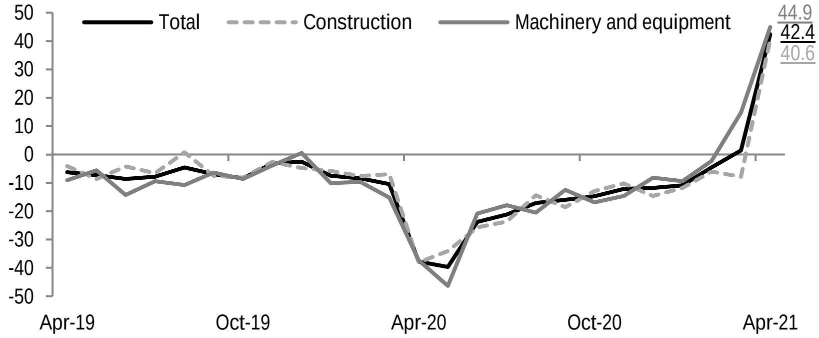
Investment to decline in April after a decent run since the start of the year. We expect GFI at 42.4% y/y, much higher than the 1.4% in March. However, this is heavily distorted by the pandemic last year, when investment plunged 37.8%. There will also be a calendar effect due to the Easter holiday, albeit relatively modest considering that working days were unchanged in the annual comparison. Isolating for these effects, we expect a 2.8% m/m sequential decline after three consecutive months of growth.

We estimate construction at 40.6% y/y (-0.6% m/m). The latter would be below the sector within industrial production, in which "specialized services" picked up strongly, but that are not accounted in investment. Weakness would be focused in the non-residential sector after a good performance since the start of the year. This would be consistent with physical investment data by the Federal government, which also suggested a contraction. The residential sector could be relatively stronger, particularly as it fell 2.1% in March. Nevertheless, we do not rule out that the start of political campaigns may have affected short-term dynamics for the whole sector.

Machinery and equipment would reach 44.9% y/y. Inside, the annual rate would be pushed mainly by the domestic component, at 80.3%. We recall this is also mainly due to a base effect as it contracted 51.5% in the same period of 2020. Specifically, auto production rebounded very strongly (584.6% y/y). Although production and investment are quite different, we believe this likely boosted the result. In a similar fashion, machinery and equipment grew 66.4% y/y. Despite of the latter, we anticipate a 6.2% m/m contraction after growing 7.8% in March, confirming the distortions from base effects. The imported component would stand at 30.4% y/y (-0.5% m/m), above the 21.6% of the previous month. Sequentially, we note that capital goods imports were stronger in March relative to the performance in investment. This is important as both series usually show very high correlation. In our view, trade figures are distorted and/or advanced, which could result in a better performance of this component in April. Apart from this, and in the opposite direction, we highlight that the exchange rate also plays a role as the trade balance is in nominal dollars and investment in real pesos. In this sense, the USD/MXN traded at 20.01 on average in April from 20.76 in March but the annual rate plunged to -17.5% from -7.2% in the same period. This is also because of base effects, as the MXN depreciated strongly at the start of the pandemic. Moreover, inflation rebounded strongly from March to April this year. These two effects could limit the rebound (as they account for lower real pesos per nominal dollar), while also showing clearly the big challenges underlying the estimation because of COVID-19.

Although interpreting the results could be tricky in coming months, we still see a difficult environment for investment, even if it has been improving at the margin. We believe the recovery will continue, although it will ultimately depend on the rebound of activity and that the virus remains under control, which in turn helps as it reduces the general level of uncertainty

GFI
% y/y



Source: INEGI, Banorte

Private consumption still upwards in April, but at a more modest pace. In our opinion March was very positive, with a 2.8% m/m expansion (+0.4% y/y). We believe this was driven by a further reopening of the economy and the resumption of job gains, which were halted during the first two months of the year. Considering this, we see April extending the move higher, albeit at a more modest pace as the base becomes more challenging, which has also been reflected in some indicators. In this backdrop, dynamism would come from better conditions surrounding the virus, including a speedier vaccination process, additional employment gains, and prevailing strength in remittances, with the latter stringing two months above US$4,000 million until then. This is mostly reflected in services within the GDP-proxy (IGAE) which expanded 0.3% m/m, with gains in all but two sectors. However, it would contrast slightly with the standalone retail sales indicator, which fell 0.4%, albeit only after a considerable 3.5% pickup in March. On the external front, non-oil consumption imports fell 6.5%, also with payback after previous gains. Annual figures will also be highly distorted. Going forward and considering more timely data, such as ANTAD sales and the trade balance in May, we do not rule out an acceleration of consumption in said month.

Weekly international reserves report. Last week, net international reserves increased by US$59 million, closing at US$192.9 billion (please refer to the following table). According to Banxico's report, this was explained by a positive valuation effect in institutional assets. So far this year, the central bank's international reserves have declined by US$2.8 billion.

Banxico's foreign reserve accumulation details
US$, million

	2020	Jun 25, 2021	Jun 25, 2021	Year-to-date
	Balance		Lows	
International reserves (B)-(C)	195,667	192,886	59	-2,781
(B) Gross international reserve	199,056	198,920	-78	-136
Pemex	--	--	0	449
Federal government	--	--	-21	-438
Market operations	--	--	0	0
Other	--	--	-57	-147
(C) Short-term government's liabilities	3,389	6,034	-137	2,645

Source: Banco de México

Monthly inflation remains high on pressures in the core component. We expect headline inflation at 0.55% m/m, (previous: 0.20%), high relative to similar periods, including the 0.47% seen in 2020 –which was heavily affected by the pandemic, with pressures on goods but very low services. The core would rise 0.56% (contribution: 42bps) and the non-core 0.51% (+13bps). The report for the first fortnight showed relevant pressures in the former category which we expect to continue, albeit at a lesser extent. In total, goods would climb 0.6% (+25bps), with pressures both in processed foods (0.7%; +15bps) as well as in other goods (0.5%; +9bps). Among the first, we expect a moderation in the pace of increases in the second half, highlighting the stabilization in corn tortillas. Meanwhile, the latter would lose steam at the margin due to the start of summer discounts on clothing, Amazon's *Prime Day* and other offers related to it. In services we expect 0.5% (+17pbs). The increase would be centered in 'others', up 0.8% (+14bps), expecting modest pressures on tourism-related categories and a more relevant uptick in recreational services and restaurants, all of them closely associated to the reopening. Nevertheless, the latter could also be pressured by pass-through from several factors (*e.g.* exchange rate, energy prices, input costs, etc.). Finally, housing would remain modest at 0.2% (+3bps).

At the non-core we flag LP gas (+2.9%) within energy, adding 7bps out of the 10bps expected for this category. This would be motivated by higher prices in international references, along a modest exchange rate depreciation. Gasolines would be more modest, up 0.3% and 0.5% in low- and high-grade, respectively. Despite also seeing higher prices abroad, subsidy to excise taxes for both fuels increased strongly. Performance in agricultural would be mixed, with fruits and vegetables up (0.9%; +4bps) but lower prices in meat and egg (-0.4%; -2bps). We should mention that our monitoring for the second half shows a contrary performance, suggesting that the first fortnight had a greater weight. Specifically, for the latter part of the month we anticipate declines in the first category in tomatoes and avocadoes, but with a slight uptick in onions. We think some of this may be because of the beginning of the raining season, a situation that has started to alleviate the effect of severe droughts in most of the country. In the latter we could see a slight rebound in chicken. Lastly, government tariffs would rise 0.2% (+1bp), starting to accelerate after the end of the electoral season.

If our forecast materializes, annual inflation would remain at 5.89%, equaling May's level despite a more favorable base effect. This is consistent with our view of higher pressures in prices so far in the year. Meanwhile, the non-core would decline to 10.10% from 10.76%. On the contrary, the core would climb to 4.56% from 4.37%, in our view also impacted by relative price adjustments due to the wider reopening of economic activity.

Banxico minutes to focus on inflation, with attention on dissenters from the last decision. On Thursday, Banxico will publish the minutes of the June 24th meeting, in which, surprisingly, the Board decided to hike the reference rate by 25bps to 4.25%. The vote was 3-2, with this document revealing the identity of the dissenters and the motives behind their votes. Considering previous stances and recent comments on the media, we believe these were Deputy Governors Galia Borja and Gerardo Esquivel.

In addition, within the document we will evaluate with detail discussions about inflation and its outlook, as it is almost a fact that this was the main driver behind the hike. It will also be very relevant to see different opinions about the possible path for prices and its implications for monetary policy ahead, as well the associated risks; particularly given that the statement was not clear enough over whether the hike marks or not the start of a tightening cycle.

On the vote, we have considered for a while that most *hawkish* members within the Board are Governor Alejandro Díaz de León and Deputy Governor Irene Espinosa. Helping confirm this, the Governor commented after the decision that future movements will depend on the evolution of inflation, adding that we are in an "*…unprecedented situation…*". Although this is not necessarily restrictive and is more consistent with data dependency, we think the tone represents him more in his role as the institution's speaker and not his specific views. Meanwhile we think Deputy Governor Jonathan Heath joined them in the vote for a hike. Although we had already seen that he was skewing towards a more restrictive stance since several months ago, his participation in our podcast, *Norte Económico* (available only in Spanish), seems to have confirmed this change. We highlight his mention that "*…there are a huge number of risks on the horizon, and the balance of risks which was somewhat uncertain […] today is clearly skewed to the upside. We think most of these effects might be temporary, but it is not so clear…*". Moreover, he added that despite monetary policy not having a substantial effect on inflation when it is due to supply-side factors, it does help limit second-round effects. However, he also mentioned that "*…the best outlook would be to have a relatively prolonged pause for as long we can and wait for the Fed to start raising rates to jump on that wagon and do the same…*". We consider that this suggests that he could vote for a pause in the hiking cycle in the future if inflation conditions improve. On a more *dovish* note, Deputy Governor Gerardo Esquivel commented on a *Bloomberg* interview that "*…precisely, the document was careful of not suggesting that this was the start of a tightening cycle…*". In addition, he argued that the market may have overshot. All of this points that he did not support the hike and does not agree with sizable increases in the short-term.

On inflation, the latest available data (up to the 1st half of June) showed a relevant increase at the core level, both in goods –in our opinion because of several supply shocks and pass-through from higher input costs– as well as services –the latter adjusting due to a greater economic reopening. At the non-core, pressures in agricultural goods have been dominated by severe droughts in our country and across North America. Considering this, we think the effects on the first category might be more persistent as the solution to several of these issues is very complex and/or will take time to happen. On the latter, the outlook seems to be improving at the margin, with recent reports pointing to the beginning of the raining season in mid and southern Mexico, possibly relieving some pressures in coming months. Nevertheless, the scenario is not quite clear, with adverse conditions prevailing in the northwestern part of the country, impacting key crops within the CPI (such as tomatoes). Climate conditions also remain challenging in the US and Canada, which are important buyers of our goods.

In this backdrop, it will be very important to see the Board's opinion on: (1) Adjustments on the forecasted path for inflation –already suggested in the statement–, with updated estimates to be released until the next *Quarterly Report*, on August 31st; and (2) the overall effect of the interaction between several risks for prices, with the balance characterized as tilted to the upside for a second decision in a row.

On economic activity, comments will probably emphasize the view of a more vigorous recovery this year, albeit recognizing the deep divergence at the regional and sector levels. We believe that they will reaffirm that slack will reduce gradually along the forecast horizon. Regarding financial conditions, the MXN showed slight upward pressures before the meeting –in large part because of a more *hawkish* stance by the Fed. However, these losses were erased after the hike. Following the decision, interest rates sold off along the entire yield curve, albeit with more sizable adjustments in short-term tenors and the belly. We think comments in these two fronts will take a secondary role, with attention firmly on inflation. Lastly, we will also see if any member talks about the recent ratification of Mexico's credit rating by the three main agencies.

We maintain our view that the tightening cycle has begun, expecting 25bps hikes in the remaining four meetings to be held this year. This would take the reference rate to 5.25% by year-end. Our expectation rests on several factors, although the most important is our call that the inflation outlook remains more complex than the one expected by the central bank. Specifically, we see headline and core inflation staying above the upper-bound around the target for the remainder of 2021. In addition, the global backdrop has become more challenging, with: (1) Clearer signs of a less *dovish* Fed, expecting them to announce tapering in its September meeting in order to start the process in early 2022; and (2) less monetary largesse in several EMs, limiting Banxico's room to maneuver in terms of its relative stance considering the importance of interest rate differentials for capital flows dynamics and hedging costs, among others.

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