Ahead of the Curve

Banxico minutes focused on risks to inflation and its expectations

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- **Banxico Minutes (September 30th).** On Thursday, Banxico will publish the minutes of the September 30th meeting, in which, in line with expectations, the Board decided to hike the reference rate by 25bps to 4.75%. Contrary to our call, the only dissenter was Gerardo Esquivel, with Galia Borja –which voted for an unchanged stance in the previous two meetings– now supporting the hike. Just because of this, the statement was more hawkish. In this respect, we will analyze comments from each member, particularly the main factors behind their vote, views on expectations –given added emphasis on this– and possible scenarios for the reference rate ahead. We will keep paying special attention to inflation, particularly on three fronts: (1) Recent dynamics; (2) updated forecasts and the delayed convergence to the target; and (3) the balance of risks. We believe these factors will at least validate –or could even reinforce– the hawkish bias of the statement, supporting our view of additional hikes in this cycle

- **Industrial production (August).** We expect a 0.4% m/m decline, reflecting an extension of a very challenging environment given persistent supply restrictions, deterioration of virus conditions and other domestic challenges. In this sense, the main lag would be mining, at -1.3% m/m and especially due to the oil sector given the fire on August 22nd in a rig in the *Ku-Maloob-Zaap* complex. However, we expect manufacturing at -0.5% m/m, returning to contraction after the +1.4% from July. Finally, and surprisingly positive, construction would rise 0.9% m/m. Although the overall decline would be modest, we expect headwinds to extend into 2022

Mexico weekly calendar

DATE	TIME (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Mon 11-Oct		ANTAD: Same-store sales	September	% y/y in real terms	--	--	-1.0
Tue 12-Oct	7:00am	Industrial production	August	% y/y	3.9	--	7.3
		sa		% m/m	-0.4	--	1.1
		Mining		% y/y	-0.1	--	3.2
		Utilities		% y/y	-0.4	--	4.1
		Construction		% y/y	5.9	--	15.0
		Manufacturing		% y/y	4.8	--	6.2
Tue 12-Oct	10:00am	International reserves	Oct-8	US$ bn	--	--	198.6
Tue 12-Oct	1:00pm	Job creation affiliated to IMSS	September	thousands	--	--	128.9
Thu 14-Oct	10:00am	Monetary policy decision (Banxico)	Sep-30				

Source: Banorte; Bloomberg

Proceeding in chronological order…

Industry contraction again in August, with several headwinds at play. We expect a 3.9% y/y increase, decelerating in annual terms for a fourth month in a row as base effects becomes less favorable. Based on our calculations, this would result in +3.7% y/y seasonally adjusted, with an additional working day in the annual comparison and below INEGI's *Timely Indicator of Economic Activity* at 4.1%. In sequential terms we expect -0.4% m/m, reflecting a continuously challenging backdrop on persistent supply constraints, worsening COVID-19 conditions and other domestic challenges.

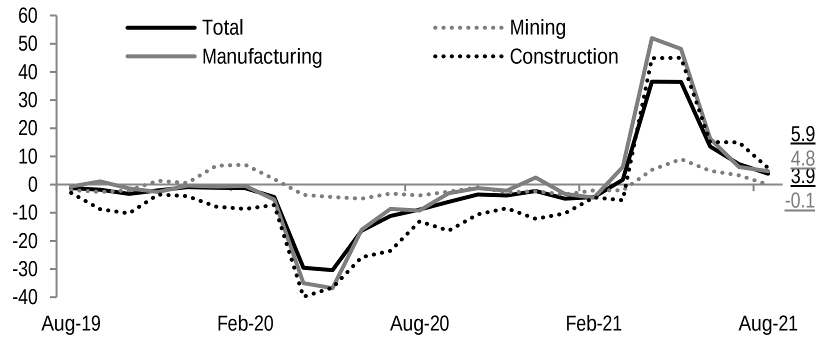
The main drag would be mining, at -1.3% m/m (-0.1% y/y). This would be driven by the oil sector, with CNH data showing production at 1,616kbpd, a new low since July 2020. This was likely explained by the effect from a fire in an offshore rig in the *Ku-Maloob-Zaap* complex that broke out on August 22nd. According to Pemex officials, production was affected for eight day across 125 fields and meant the deferral of 1.6 million barrels (equivalent to around 1 day of national output). This also impacted gas output, with sequential figures also lower. In addition, we do not rule out some disruptions because of hurricanes in the period, including Grace, and to a lesser extent, Ida. On non-oil mining, prices remained but are not accelerating as much, possibly resulting in a more modest performance. IMSS-affiliated employment improved, which may have been positive at the margin.

We expect manufacturing at -0.5% m/m (4.8% y/y), returning to contraction after the +1.4% rebound in July. Nevertheless, in our view it is still limited by global supply constraints, with COVID-19 also at play. The auto sector is still the most salient, with stoppages at least in Toyota, GM and VW, as well as some of their suppliers. In this sense, auto production came in at 237.0 thousand units. Using seasonally adjusted figures (calculated by us) this implies a 13.8% m/m decline. This is also in the same direction as manufacturing exports, down 5.0% m/m. In addition, there may be other idiosyncratic factors weighing, such as prevailing railway blockades in Michoacán. Signals from employment are mixed, with positive results from IMSS contrasting with broad losses in INEGI's report.

Lastly, and surprising positively, construction would increase 0.9% m/m (+5.9% y/y). While it would build up on the +0.6% of the previous month, it would fall short from June's massive 2.0% decline. Signals for the sector are mixed. Business confidence edged down across all subsectors, including the 'adequate moment to invest'. However, aggregate trend indicators were higher at the margin, boosted by works executed by primary contractors. A relevant factor we will be looking into is civil engineering projects, especially given the unusual spike of the previous month. We believe this will be quite telling for the case of a boost from public spending or if it was just a fluke. In this context, physical investment by the federal government decelerated at the margin to 14.3% y/y in real terms from 18.6% in July, albeit with relevant caveats due to different accounting methods.

While the decline would be modest, we expect headwinds for the sector to extend into 2022. As such, we will remain on the look over additional risks and global COVID-19 trends, considering that supply chains are still struggling to keep up with surging demand.

Industrial production
% y/y



Source: INEGI, Banorte

Weekly international reserves report. Last week, net international reserves increased by US$344 million, closing at US$198.6 billion (please refer to the following table). According to Banxico's report, this was explained by: (1) A US$500 million sale from Pemex to the central bank; and (2) a negative valuation effect in institutional assets for US$156 million. So far this year, the central bank's international reserves have increased by US$2.9 billion.

Banxico's foreign reserve accumulation details
US$, million

	2020	Oct 1, 2021	Oct 1, 2021	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	195,667	198,560	344	2,893
(B) Gross international reserve	199,056	211,435	19	12,378
Pemex	--	--	500	949
Federal government	--	--	-212	-154
Market operations	--	--	0	0
Other	--	--	-269	11,583
(C) Short-term government's liabilities	3,389	12,874	-326	9,485

Source: Banco de México

Banxico minutes to shed additional light on the inflation outlook and risks to expectations. On Thursday, Banxico will publish the minutes of the September 30th meeting, in which, in line with expectations, the Board decided to hike the reference rate by 25bps to 4.75%. Contrary to our call, the only dissenter was Gerardo Esquivel, with Galia Borja –which voted for an unchanged stance in the previous two meetings– now supporting the hike. Just because of this, the statement was more hawkish. In this respect, we will analyze comments from each member, particularly the main factors behind their vote, views on expectations –given added emphasis on this– and possible scenarios for the reference rate ahead. We will keep paying special attention to inflation, particularly on three fronts: (1) Recent dynamics; (2) updated forecasts and the delayed convergence to the target; and (3) the balance of risks. We believe these factors will at least validate –or could even reinforce– the hawkish bias of the statement, supporting our view of additional hikes in this cycle.

We highlight that most Board members have commented in recent days, which should help us in identifying their position in the document. Starting with Governor Alejandro Díaz de León, he held several interviews after the decision and this week. As the first ones are made on behalf of the institution as a spokesman, the latter may be even more important. At AMIB's annual conference, he mentioned that the gradual approach taken by the central bank has allowed for an orderly adjustment of risk premiums and the exchange rate amid recent market volatility. In his view, this is very important ahead of the Fed's tapering. These comments reinforce the prudent stance that has characterized him during his tenure and support our belief that he will push for more hikes through the end of the year. Still more hawkish, Irene Espinosa mentioned in an interview for *Bloomberg* that the increase in energy prices has increased risks about possible second-order effects on goods, acknowledging rigidities of the core component. More importantly, she stated that the institution is open to 50bps hikes, although she doesn't see a need to do so right now. This is in line with our view that risks may be tilting towards a more accelerated pace instead of a pause in the cycle.

Taking a more moderate stance, but in our view also skewing to the hawkish side of the spectrum, Jonathan Heath spoke with *Reuters* and *El Economista* newspaper. He argued about the need to continue hiking the rate due to current inflation pressures. He was specific enough to say that around two more increases may be warranted for an end to the hiking cycle. Given that we had recently identified him as the 'marginal' voter (a situation that has shifted somewhat because there was only one dissenter), we think that this is a strong signal about further hikes during the rest of the year. Despite of this, he kept stressing the need to find a balance with current economic conditions, reiterating its high dependency to incoming data.

Lastly, Gerardo Esquivel reiterated his dovishness in an interview for *Arena Pública* and a presentation posted at the central bank's website. He believes that Banxico's actions have reinforced forecasts of higher inflation and affected expectations to the upside, as they validate that the current inflation spike is more permanent than it really is. However, he also stated that "*…his view and response is different but complacent with inflation…*". Considering this, it is likely that he will remain as a dissenter going forward. Lastly, and as far as we know, Galia Borja did not address the media. This could have been key to expose the reasons behind her switch, thus making her remarks within the minutes even more relevant.

On prices, we will focus on several issues. Firstly, we will look for drivers about their recent performance, expanding on those quoted in the statement which mainly focused on global issues (*e.g.* supply bottlenecks, rising commodities prices, etc.). However, we will also be looking for local drivers, which could possibly have more sway on the Board. In both, we will try to gauge individual opinions about whether they are still considered 'transitory' or if they are becoming more entrenched. Views on expectations will be especially relevant, in our view, as the statement flagged more concerns. These were not only for the move higher in year-end forecasts, but also on 12-month and YE2022 metrics. Therefore, we expect some comments about this and the overall anchoring of inflation.

We note that the last minutes had very brief details on the upward adjustment of inflation estimates –first released in a decision on August 12th–, despite being sizable. Hence, we will see if this is expanded or not, considering that in our view it has become the new centerpiece of the communiqué. Lastly, we remain vigilant on the balance of risks, with the factors unchanged but still tilted to the upside even after estimates changed.

On activity, we believe the statement still suggests some optimism as they see the recovery extending through the remainder of the year and into 2022. However, we will search for comments about possible downside risks based on our assessment of a stronger deceleration in domestic demand. In the macro financial front, we expect relevant comments about market dynamics amid recent volatility, triggered by financial concerns in China along some tensions over the debt ceiling in the US. This is especially key for portfolio flows and the exchange rate. We will also evaluate comments about public finances and Pemex, especially after the introduction of the *2022 Budget* proposal.

We maintain our view that the tightening cycle remains alive and well, expecting 25bps hikes in the two remaining meetings of the year, closing December at 5.25%. Moreover. we expect three additional increases of the same magnitude in 2022, with two of them at the start of the year and the third one at the end, influenced by the eventual start of the Fed's hiking cycle. As such, the rate would reach 6.00% by the end of said period.

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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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