Banxico QR – No surprises, with lower growth but high inflation

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www.banorte.com
@analisis_fundam

Alejandro Padilla
Chief Economist and Head of Research
alejandro.padilla@banorte.com

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

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

Fixed income and FX Strategy

Manuel Jiménez
Director of Market Strategy
manuel.jimenez@banorte.com

Santiago Leal Singer
Senior Strategist, Fixed-Income and FX
santiago.leal@banorte.com

Leslie Orozco
Strategist, Fixed Income and FX
leslie.orozco.velez@banorte.com

- **Banxico published today its 3Q21 *Quarterly Report* (QR). The release was accompanied by a press conference by Governor Alejandro Díaz de León**
- **We highlight the downward revision in GDP for this year, to 5.4% from 6.2%. For 2022, the forecast was up by 20bps, to 3.2%. Inflation estimates were unchanged relative to the last statement**
- **We continue seeing a hawkish bias, especially regarding the price outlook. In this sense, we highlight that:**
  (1) The balance of risks for inflation remains skewed to the upside;
  (2) Governor Díaz de León clarified the meaning about inflation being 'transitory', which remains as the base case; and
  (3) The heat-map analysis shows that a plethora of shocks have affected inflation
- **Despite of the downward revision to 2021 GDP, employment forecasts were higher for both this year and next. Moreover, the trade and current account balances are seen with wider deficits, except for the latter in 2022**
- **There were eight traditional *grey boxes,* focused on COVID-19 related impacts. We center our attention on one analyzing price revisions during the pandemic and their effect on inflation**
- **With no meaningful new developments, we reiterate our call that Banxico will hike by 25bps in December, to 5.25%, along 125bps in accumulated increases in 2022. Nevertheless, there is still a high probability of an acceleration in the pace to 50bps as soon as in the upcoming decision**
- **The market holds an aggressive pricing for Banxico, mainly for next year**
- **For the USD/MXN, we adjust our forecast to 21.10 for year-end 2021 and to 21.80 for 2022**

Modest changes to the outlook in Banxico's *Quarterly Report*. The central bank published today its *Quarterly Report* (QR) for 3Q21, accompanied with a press conference led by Governor Alejandro Díaz de León. We think the document maintains a hawkish bias. In line with our expectations, the forecast for GDP this year was revised lower, to 5.4% from 6.2%. In turn, the forecast for 2022 stands at 3.2%, slightly higher on a more benign base effect. For 2023, they expect growth at 2.7%, with the output gap closing by the end of said year. On inflation, forecasts stayed unchanged relative to the latest decision, similar to the previous QR. In this sense, we only highlight additional comments from the Governor in the Q&A about the meaning of the word 'transitory', a debate currently ongoing also at the global level. All in all, and given that there were no meaningful new developments, we reiterate our call that Banxico will hike by 25bps in December, to 5.25%. Moreover, we expect accumulated increases of 125bps in 2022, with the rate reaching 6.50% by year-end. Nevertheless, there is still a high probability of an acceleration in the hiking pace to 50bps clips as soon as in the upcoming decision.

Banxico's 2021 policy decisions

Date	Decision
February 11	-25bps
March 25	0bps
May 13	0bps
June 24	+25bps
August 12	+25bps
September 30	+25bps
November 11	+25bps
December 16	--

Source: Banxico

Inflation forecasts unchanged relative to the last statement… As in the previous report, the central bank maintained the estimates published in the last monetary policy meeting, held on November 11th. However, they updated fan charts on CPI, with the upper-bound in the short-term coming in slightly above 7.0%. This has already materialized in the latest print. As such, attention turned to other fronts on prices, mainly the expanded balance of risks and the analysis of current dynamics under other metrics. On the former, the skew remains unchanged and to the upside. The five factors are the same as in the statement. To the downside, they were slightly expanded. The first three unchanged, adding to the tail-end of the list: (4) Slack conditions in the economy and the labor market mitigating cost and wage pressures; and (5) energy prices below expectations.

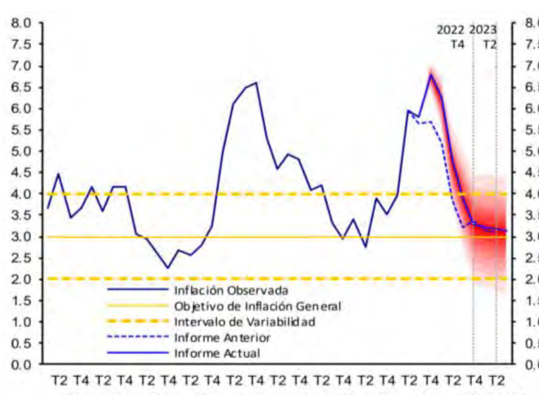
…still expecting high inflation to be 'transitory'. Regarding the latter, and more important in our view, we focused on the heat-map outlining the drivers behind current inflation levels. Some of these include: (1) The overall trend; (2) economic activity; (3) international prices; (4) global inflation; (5) cost pressures; and (6) the exchange rate. Specifically, we highlight that the degree of severity seems at its highest since the analysis is presented, starting in 2013. Moreover, the current inflationary episode has been driven by a plethora of factors, in our view portraying the very difficult global and local backdrop for prices. Another relevant study comes as part of a set of new charts in the report, showing inflation estimates in seasonally adjusted, annualized terms (SAAR). These suggest that the worst pressures –both at the headline and core– have already been left behind. In turn, this is consistent with the view that the increase is 'transitory' and about the convergence towards the target within the forecast horizon. On this point, both Alejandro Díaz de León and Gerardo Esquivel were questioned during the Q&A, with both agreeing that the term is prone to confusion. However, the common definition, used by them, is that it implies that the effects on the *annual variation* will fade out eventually, which is quite different than stating the same for the price level.

CPI forecasts
% y/y, quarterly average

	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23
Headline	5.8*	6.8	6.3	4.8	3.9	3.3	3.2	3.2	3.1
Core	4.8*	5.5	5.8	5.3	4.3	3.5	3.0	2.7	2.6

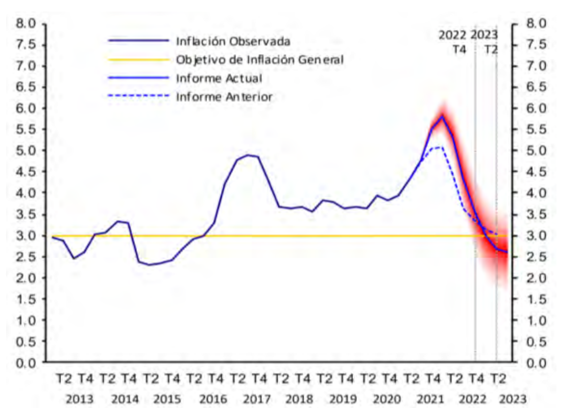
Note: Comparisons to the previous QR are not presented because forecasts have been updated in tandem with policy decisions
Source: Banco de México. *Observed data

Fan chart: Headline inflation*
% y/y



Source: Extracted directly from Banxico's 3Q21 Quarterly Report, only available in Spanish

Fan chart: Core inflation*
% y/y

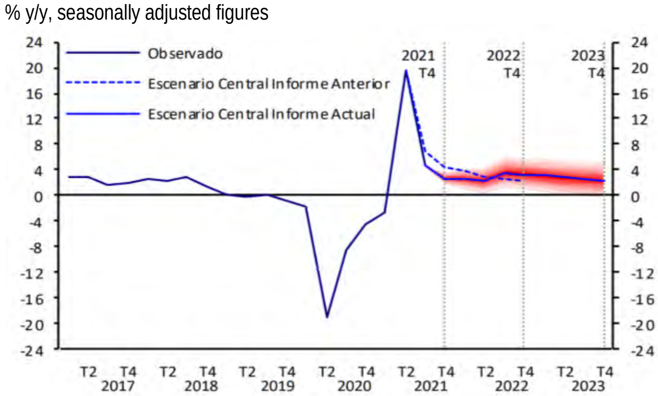


Source: Extracted directly from Banxico's 3Q21 Quarterly Report, only available in Spanish

Mixed changes to GDP growth estimates. As expected, the central bank cut its forecast for this year, with the mid-point from 6.2% to 5.4% (range: 5.0% to 5.7%). Our estimate stands at the upper limit of the range. According to Banxico, this was driven by lower-than-expected performance in the third quarter, in turn affected by worsening COVID-19 conditions during the period, among other factors. Nevertheless, they reiterated that the economy will resume its recovery in the fourth quarter, supported by both external and domestic demand. For 2022, the estimate picked up 20bps, to 3.2% (range: 2.2% to 4.2%). In our view, this is mainly because of a more favorable base effect, without signaling a brighter outlook relative to previous expectations. Given the differences with our call for 2021, the estimate is broadly consistent with our 3.0% for said year. This is seen more clearly with the expected moment in which the economy could return to pre-pandemic levels (4Q19). Broadly in line with our projections, the central bank's base case sees it in the third quarter of 2022 (Banorte: late in 2Q22). If growth reaches the upper end of the ranges, it would be in 2Q22. In contrast, if the economy performs at the lower-end, this level would be observed in the fourth quarter. In either case, the economy would return to pre-pandemic levels next year based on these confidence intervals. It is important to say that the output gap would stay negative until late 2023, as activity still needs to make up for the room between the level in 4Q19 and higher potential GDP since then. For 2023, they estimate growth at 2.7% (range: 1.7% to 3.7%).

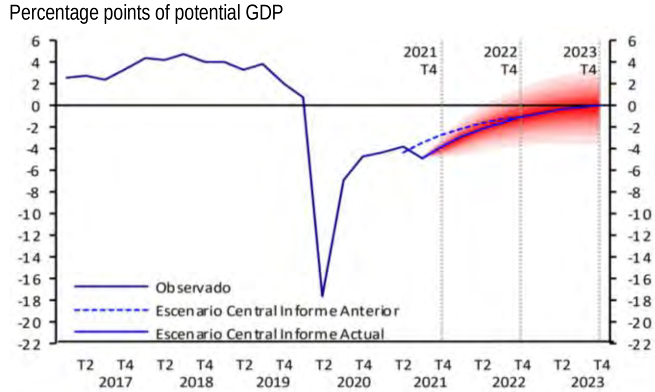
Risks to growth remain to the downside. As has been for several months, the balance of risks for growth remains skewed to the downside. Among the main risks, they note: (1) New lockdowns in case of a worse evolution of the pandemic, either because of new variants or not enough vaccine coverage; (2) an extension and/or intensification of supply chain problems, as well as higher input costs in several economic sectors; (3) additional bouts of volatility that affect financing flows to emerging markets; and (4) lower-than-expected or not enough investment to support the economy. On the other hand, upside risks include less COVID-19 contagion, higher confidence supported by global stimulus measures, benefits to activity from a reconfiguration of supply chains backed by the USMCA, and global financial conditions leading to an accelerated recovery.

GDP forecasts
% y/y, seasonally adjusted figures



Source: Extracted directly from Banxico's 3Q21 Quarterly Report, only available in Spanish

Output gap
Percentage points of potential GDP



Source: Extracted directly from Banxico's 3Q21 Quarterly Report, only available in Spanish

Modest changes in other forecasts. Despite lower projected growth for 2021, the central bank increased their estimates for job creation of people affiliated to IMSS for both this year and next, based on available information. Moreover, they now see a wider trade and current account deficit for the same periods than previously. The only exception was the latter for 2022, which is less negative. On our view, this is favorable at the margin given the higher likelihood of less accommodative monetary policy worldwide. For further details, please refer to the tables below.

Banxico's Forecasts
Current Report (3Q21)

	2021	2022	2023
GDP (% y/y)			
Central scenario	5.4	3.2	2.7
Range	5.0 to 5.7	2.2 to 4.2	1.7 to 3.7
Employment (thousands)	730 to 880	560 to 760	510 to 710
Trade Balance (bn)	-14.9 to -10.9 (-1.1% to -0.8% of GDP)	-16.1 to -10.1 (-1.1% to -0.7% of GDP)	-18.6 to -10.6 (-1.2% to -0.7% of GDP)
Current account (bn)	-7.5 to -0.5 (-0.6% to 0.0% of GDP)	-8.5 to 1.5 (-0.6% to 0.1% of GDP)	-9.1 to 2.9 (-0.6% to 0.2% of GDP)

Source: Banxico

Banxico's Forecasts
Previous Report (2Q21)

	2021	2022
GDP (% y/y)		
Central scenario	6.2	3.0
Range	5.7 to 6.7	2.0 to 4.0
Employment (thousands)	640 to 840	500 to 700
Trade Balance (bn)	-8.7 to -3.7 (-0.7% to -0.3% of GDP)	-11.8 to -5.8 (-0.8% to -0.4% of GDP)
Current account (bn)	-6.4 to 1.6 (-0.5% to 0.1% of GDP)	-10.2 to -0.2 (-0.7% to 0.0% of GDP)

Source: Banxico

Relevant topics in the traditional *grey boxes,* focused on COVID-19 related impacts. As usual, the central bank included a deep analysis of several important issues. In this occasion, they centered on factors related to the pandemic and its aftermath, including on activity, employment, and prices. The eight boxes were: (1) Financial household savings across different countries during the pandemic; (2) Estimation of inflation drivers in Latin American countries; (3) Evolution of unit value indices and terms of trade of Mexican goods during the pandemic; (4) Job dynamics affiliated to IMSS after changes on outsourcing; (5) Measurement of labor market slack conditions during the pandemic; (6) Drivers of banking credit to corporates; (7) Price revisions during the pandemic and their effect on inflation; and (8) Relation between the 10-year US Treasury bond yield and financial markets in Mexico. Considering prevailing concerns on inflation, we focus on box (7).

The pandemic has distorted the way price revisions are conducted. Using CPI micro-data, the central bank aims to understand two factors: (1) If the current inflationary process is driven by focused pressures in some items or pushed by generalized but more modest expansions; and (2) the degree of synchronicity of increases across goods and services. On the first point, the study finds that, in the first stages of the pandemic, price dynamics were driven by stronger adjustments on fewer goods. Nevertheless, throughout 2021 the opposite happened, with more generalized adjustments at a slower pace. This is particularly true for the core and its different subcomponents. As such, the central bank attributes more recurrent increases on heightened uncertainty and changing cost pressures. Regarding the second point, synchronization spiked at the start of the pandemic across all categories in the core index, but it gradually declined in subsequent periods, closing-in on long-term averages. As a result, the *box* concludes that these distortions do represent a relevant risk for the price formation process. As such, they should be closely monitored by the Board.

Banxico policy decisions in 2022 will remain aligned with the Fed. Similar to recent years, Banco de Mexico's monetary policy meetings will take place with a lag no greater than two weeks from the Fed, as shown in the table below.

Monetary policy meetings

Month	Federal Reserve	Banxico
January	26	--
February	--	10
March	16	24
April	--	--
May	4	12
June	15	23
July	27	--
August	--	11
September	21	29
October	--	--
November	2	10
December	14	15

Source: Banxico, Federal Reserve

Unchanged monetary policy call, but uncertainty remains elevated. Given no meaningful new developments in today's report, we reiterate our call that Banxico will hike by 25bps in December, to 5.25%. We also maintain our view of 125bps in accumulated increases during 2022. As we now know the calendar for the meetings in 2022, we expect 25bps hikes in each of the decisions that will take place in February, March, May, September and December. On the other hand, this does not imply that economic conditions have remained the same. Specifically, market jitters have increased further due to the discovery of the 'Omicron' variant, which may well result in an additional impact to growth prospects and the inflation outlook, both abroad and domestically. Nevertheless, information so far has been scarce, making it quite difficult to assess how it may turn out. Hence, we believe more information is needed to have a more detailed evaluation of its potential effects in economic policy. For now, and as warned with the release of the latest minutes, we also think there is a high probability of an acceleration in the hiking pace to 50bps as soon as in the upcoming decision. In this sense, data and events going into December 16th may well tilt the balance of the Board, reminding us of the difficult and unprecedented environment that poses additional challenges for monetary policy.

From our Fixed income and FX strategy team

The market holds an aggressive pricing for Banxico, mainly for next year. Interest rates in Mexico reflected modest adjustments to Banxico's *Quarterly Report*, marginally more pressured, although with the session's price action widely contaminated by volatility in global rates. As a result, the TIIE-28 IRS curve reflected was pressured up to 12bps in the short-end, slightly strengthening the market's pricing for a 50bps hike for Banxico's decision on December 16th. In this sense, the curve is pricing-in implied hikes of 39bps by the end 2021 from 36bps yesterday. Meanwhile, the pricing for 2022 kept reflecting more aggressive bets, with 240bps increases incorporated through year-end and above our estimate of a reference rate closing 2022 at 6.50%.

In terms of strategy, we wait for better market conditions and recommend caution. The risk configuration could still result in further deterioration impacting Mexican risk premiums, mainly as the pandemic remains undefined about the effect of the new variant and its ramifications for structuring containment policies.

For the USD/MXN, we adjust our forecast to 21.10 for year-end 2021 and to 21.80 for 2022. In the FX market, the Mexican peso also observed a performance mainly driven by the session's fragile risk appetite, closing near USD/MXN 21.40 (+0.3%) and having traded at up to 21.11 intraday. The peso has recovered close to 3.5% from its weakest level the previous week at 22.15, yet it heads for a 4% sell-off in the quarter. In recent weeks the FX market has experienced a remarkable trend change driven by the Fed's more hawkish tone and higher risk premiums linked to the pandemic. This situation has occurred in a context of deteriorating local inflation dynamics and downward revisions to growth expectations. Global volatility has increased substantially and the Mexican peso, given its market depth, has experienced an even sharper effect as it is used as a proxy for emerging markets. This scenario has impacted the pesos' valuation, with our fair value model (approached by the real effective exchange rate) moving to USD/MXN 20.90 at the end of November from 20.77 a month earlier and having ranged close to 20.60 for much of 2021. Likewise, the MXN has depicted a more stressed volatility regime, printing the last three weeks a deviation in the spot above 1.5σ relative to its 90-day average, consistent with the asymmetry it commonly reelects in its recovery dynamics with respect to the initial shocks. Meanwhile, in our view the Fed's relative position will still result in greater dollar strength in the following months, where the MXN carry attractiveness is likely to result in a lower anchoring factor *vis-á-vis* other phases. Based on these factors, we adjust our USD/MXN forecast to 21.10 from 20.50 for 2021 year-end and to 21.80 from 21.20 for 2022 year-end. Our trajectory incorporates levels near 20.50 in the 2Q22 and pressures reaching up to 22.10 in the 4Q22.

Analyst Certification

We, Alejandro Padilla Santana, 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, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez and Gerardo Daniel Valle Trujillo 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
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.

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

Research and Strategy			
Alejandro Padilla Santana	Chief Economist and Head of Research	alejandro.padilla@banorte.com	(55) 1103 - 4043
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
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
Víctor Hugo Cortes Castro	Senior Strategist, Technical	victorh.cortes@banorte.com	(55) 1670 - 1800
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			
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	(55) 1670 - 1889
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5004 - 1282
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 - 5140
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) 8173 - 9127
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) 5249 - 6423
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) 5004 - 1051
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) 1670 - 1899