Mexico Macro Update

EXECUTIVE SUMMARY:

- **Growth in Mexico is gaining steam, but there are still some laggard sectors—primarily oil & gas extraction, as well as infrastructure. The labor market continues very strong, both in terms of the unemployment rate and formal job creation; this is one of our primary concerns on the inflation front.**
- **In terms of monetary policy, if the consensus call proves correct, and inflation drops rapidly, converging to 3.8% by end-2018, we could see Banxico start to ease its monetary policy stance. A risk to this view is that heading into an election year in 2018, and with the NAFTA negotiations potentially being noisy—even if the results are positive—we could see MXN weakening sharply, preventing the drop in inflation.**

MACRO SITUATION

The economy is gradually improving. After the shock produced by Trump's triumph, different economic indicators are now showing positive signs of improvement. GDP growth has been better than expected. In Q2, total GDP grew 1.8% y/y in real terms (we were expecting 1.2%). INEGI reported a 3.0% real growth using the seasonally adjusted figures, which could be a little exaggerated.

There are marked contrasts among sectors. Industrial production fell 1.0% y/y in real terms (see chart 1), but a large part of the industrial weakness is concentrated in two sectors: oil and gas extraction (-8.5% real y/y) and civil engineering construction (-10.0% real y/y)—both of these are affected by PEMEX problems and the government cuts in investment spending. Manufacturing activity grew 2.0% y/y in real terms, with an outstanding +10.6% y/y in the transport equipment component. Services sector, which represents close to two-thirds of economic activity, grew 3.2% y/y, with a remarkable +9.9% y/y growth in financial services and +7.6% in hotels and restaurants (all of this in real terms).

Labor markets are on solid footing. There is a positive trend in the main labor market indicators: job creation, according to the number of new insured persons in the Mexican Social Security Institute, reached 566 thousand in the first 7 months of the year and 824 thousand in the last 12 months to July (see chart 2). The unemployment rate reached 3.27% in June, the lowest for such a month since 2007. Banxico's Board has said that there is no slack remaining in the labor market—which is among the main inflation risks—as well as for the market consensus of monetary policy easing kicking off in 2018. Anecdotal information gathered from our different advisory councils (in Tijuana, Querétaro, Puebla, Monterrey, Guadalajara, Mérida) suggest that firms are facing difficulties finding workers for positions they are looking to fill.

Domestic consumption keeps growing at healthy rates. Private domestic consumption grew 5.0% y/y in May and averaged 3.4% y/y in January–May (in real terms). Several factors are propelling internal consumption, starting with already mentioned strong job creation. Another factor is remittances, which

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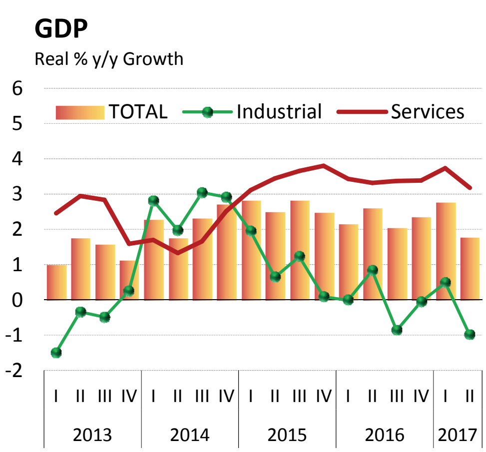
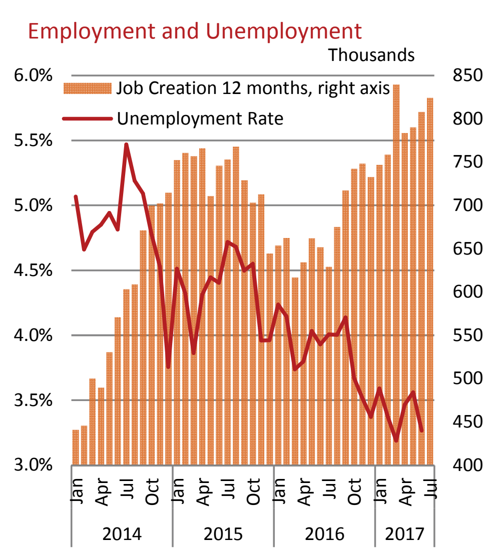
Chart 1: Growth is improving gradually, even if some components, such as oil & gas extraction and infrastructure execution remain sluggish.



Source: INEGI.

Chart 2: Employment creation remains very strong, which is one of our concerns on the inflation front.

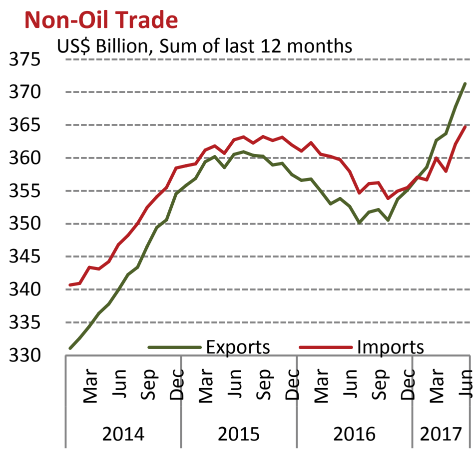


Source: INEGI.

reached US$2.4 billion last June (the highest for a similar month) and US$13.9 billion in the first half of the year. Worth noting is that, once converted to Mexican pesos, these transfers represented an accumulated amount of 271 billion in January–June.

Non-oil trade is recovering. Non-oil exports and imports are reacting to the faster pace of economic activity, both in Mexico and the USA, and are recovering from the low levels reached last year (see chart 3).

Chart 3: Outside of oil, the trade balance is responding to stronger activity in both Mexico and the US



Source: Banco de Mexico.

THE POSSIBILITY OF A DOWNGRADE OF SOVEREIGN DEBT HAS DISSIPATED

After the government took the necessary actions to stabilize public debt growth, partly helped by the unusually large operational surplus of Banco de Mexico, two of the three largest rating agencies (Standard & Poors and Fitch) changed their outlook for the Mexican sovereign debt, to "stable" from "negative". This action significantly reduces the probability for a downgrade in the coming year and a half at least.

FINANCIAL MARKET IMPROVEMENT

The MXN has been reacting positively to a less uncertain environment, recording a strong appreciation from January to early August (+17%, the strongest performance among the 31 major currencies), while the Mexican Stock Exchange showed a rally of 12.5% year to date (chart 4). Both markets have been positively reacting to growing optimism that NAFTA talks will end with a positive deal for Mexico, even if negotiations are turbulent. Worth noting is that foreign holdings of Mexican Cetes and MBonos have recovered around 54 billion pesos through the year, reaching 2.1 trillion pesos. This represented 55% of the total by mid-August.

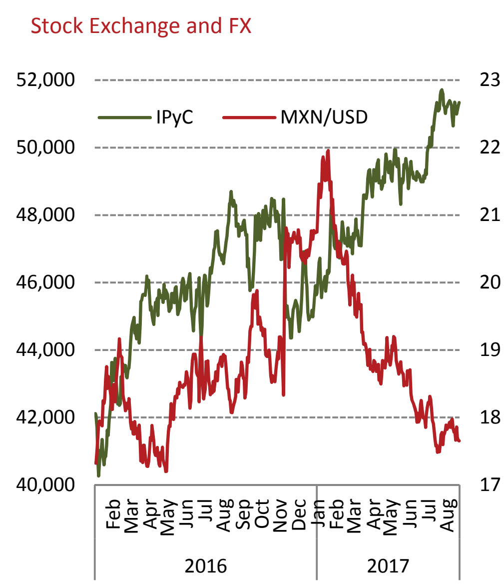
THE NAFTA RENEGOTIATION PROCESS STARTED WITH AN UNFRIENDLY WELCOME FROM THE USA TEAM

Even though we expected some political positioning from USTR Robert Lighthizer, his comments were harsh, and reflected some influence by President Trump's objectives and negotiations approach. The USTR insisted on reducing the trade deficit as one of the key aims of the process, while expressing NAFTA has failed many Americans.

INFLATION KEEPS RISING AND IS A RELEVANT RISK TO THE OUTLOOK

General inflation reached 6.44% y/y in July, while core inflation reached 4.94%, both well above the 4% upper limit of Banco de Mexico's target range (see chart 5). From the close to 300 specific prices within the CPI, 79% are now showing a y/y increase above 4%. Even though there is a wide consensus that temporary factors are affecting inflation and, once those factors dissipate, inflation should rapidly descend, that descent may not be enough to bring inflation within Banxico's target range, according to Scotiabank forecasts (4.3%), although consensus has end-2018 inflation at 3.8%. The risk of inflation falling into a negative spiral (i.e., continues to rise, by entering a self-reinforcing dynamic) is relevant, and will remain one of Banco de Mexico's main concerns. The good news on the inflation front is that producer prices, which have in the past been a good leading indicator of consumer prices, have fallen rapidly over recent months, with PPI inflation dropping from over 12% to under 6% in the latest print. Some within Banxico's Board appear concerned over potential negative inflation dynamics, and highlight that long term inflation expectations from the analysts' survey have always remained stubbornly above the middle of the central bank's target range.

Chart 4: Market sentiment towards Mexico has improved markedly, lifting both the peso, and local equities

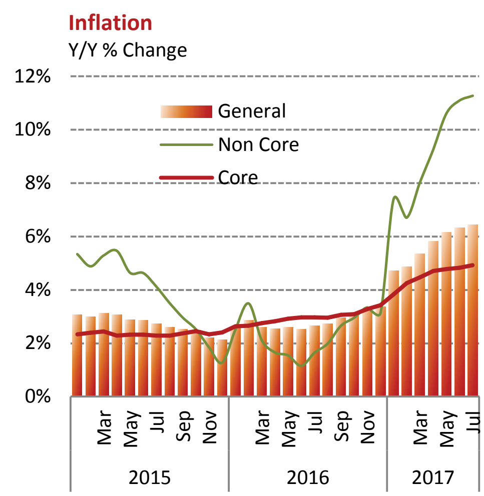


Source: Thompson Reuters.

WAGES ARE INCREASING AT THEIR FASTEST PACE SINCE 2002

Strong job creation and high inflation are being reflected in higher contractual wages at a National level. The last two reported figures (June, +5.4% and July, +5.8%) are the highest wages increase since 2002 (see chart). However, it is worth noting that real wage growth is negative at the moment, given inflation is above 6%. The ability to curb wage pressures will be a key factor in containing inflationary pressures, and a determinant of whether Banxico will be able to ease policy going forward.

Chart 5: Inflation continues to rise, but is expected to start falling gradually towards the end of the year.



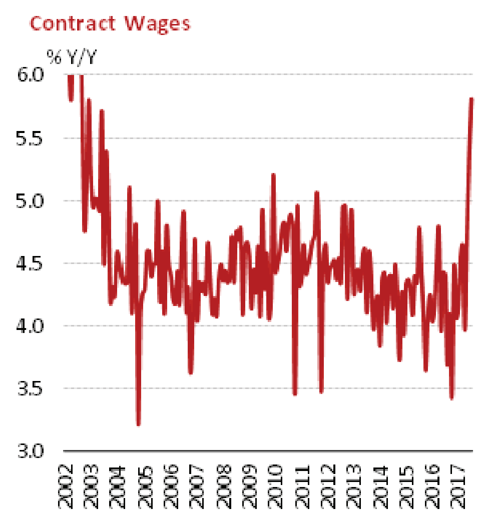
Source: INEGI.

BANCO DE MEXICO MONETARY POLICY COULD SURPRISE MARKETS

Recent polls and market interest rates are expecting Banco de Mexico will cut its reference interest rates in 2018, reflecting some comments made by the Minister of Finance a couple of months ago, as well as expectations that if inflation does fall to the consensus level at the end of 2018 (3.8%), real rates would be near their record since Banxico adopted an interest rate target. Hence, markets are pricing in interest rate cuts by the central bank to kick-off over the next year. The risks to this view include:

- First and most importantly, Banco de Mexico has a single mandate—price stability, and there are still important risks on the inflation front, as can be seen from the previous paragraphs.
- The economy seems to be gaining momentum and Banco de Mexico just changed this risk balance to a neutral position, reducing the urgency to start easing policy. However, if inflation does fall in line with consensus, current rate settings would be very tight. According to the IMF, estimates for Mexico's neutral interest rates are around 0.8%. More specifically, they wrote: "currently the real neutral rate is about 0.8, although the 90 percent confidence interval around this estimate is very wide, ranging from -0.5 to 1.8 ". This means that if inflation does fall to consensus expectations, real rates would be over 3.0%, meaning very tight monetary policy settings.
- An important risk to the market view that inflation will fall rapidly is MXN: If the peso were to suffer a sharp sell-off, either due to domestic or external factors, we could see the view of rapidly falling inflation evaporate.

Chart 6: Among the main risks we see on the inflation front, is that contractual wage negotiations have started to show an upswing.



Source: Banco de Mexico

Taking all of this into account, Scotiabank's call is that if inflation remains biased higher; then it could be necessary for Banco de Mexico to make a couple of additional hikes. Our call has been that the overnight rate will reach 7.50% at the beginning of next year, and then remain there for the rest of 2018. This call is under review because, if inflation does converge towards consensus, then Banxico could shift into easing mode.

SCOTIABANK'S MACROECONOMIC SCENARIO (UNDER REVIEW)

- Uncertainty remains elevated, due to the many factors that could have a significant impact on the Mexican economy, especially in the global environment: the Trump factor, the US budget and debt ceiling discussions in Congress, the Fed's monetary normalization process and many geo-political tensions.
- Mexican economic activity is expected to keep gaining traction, due to a positive dynamism of the internal market and an improving external demand.

- Inflation is expected to start a downward trend before year's end, but could remain above Banco de Mexico's range during 2018.
- Scotiabank's call is currently that Banco de Mexico could make two more interest rates hikes before 2018's 1st quarter—however, this is dependent on inflation dynamics.
- Mexican peso will remain sensitive to changes in global conditions and subject to high volatility.
- Fiscal targets are basically met, providing some reassurance for financial markets.
- NAFTA talks are expected to be volatile, but end in a positive outcome.

POLITICAL ENVIRONMENT

- Presidential race has started, and the electoral logic now predominates.
- Presidential candidates will be defined in the coming months.
- There is a widespread perception of corruption as the main ballast for economic activity in most of the country.
- The concern of a populist turn in 2018 elections will add to the already high uncertainty of the economic outlook.

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