Banxico's Q3-2020 Quarterly Report: Improved outlook for growth with higher inflation at sight

- Banco de México published its Q3-2020 Quarterly Report (QR). The 3 main topics under the spotlight were: i) the updates to GDP growth estimates and inflation projections; ii) the general tone of the messages conveyed; and iii) any element that would shed light on Banxico's strategy to confirm the "downward path for headline and core inflation towards the 3% target."
- The 3 alternative scenarios presented before, with averaging growth rates of -11% in 2020 and 3.2% in 2021, were replaced by a baseline one that assumes a gradual recovery for this and next year and an inertial growth environment afterwards. Central estimates improved to -8.9% and to 3.3%, respectively, and a 2.6% growth estimate for 2022 was presented for the first time. However, the uncertainty surrounding them remained high.
- The average headline inflation estimate for Q4-2020 improved due to lower than previously expected non-core inflation. From Q4-2021 onwards, both core and non-core inflation projections increased, thus taking headline inflation projections to 3.3% in Q4-2021, and to 3.1% by the end of the forecasted horizon. Despite this deterioration, the Bank emphasized that inflation would lie around the 3% target within the next 12 to 24 months.
- A sense of prudence and caution in the main messages prevailed also in other elements of the macro-financial environment.
- Although the above seems to be in line with the pause in the adjustments to the reference rate, we did not find conclusive evidence to reaffirm that Banxico will remain on hold for a prolonged period. The Minutes corresponding to the last monetary policy decision will allow us to gather additional relevant information.
- For the time being, we stick to our view that the reference rate will remain at 4.25% during the rest of the year.

***

Jessica Roldán Peña *
Chief Economist
jroldan@finamex.com.mx
+ 52 (55) 5209 2056

Víctor Gómez Ayala
Senior Economist
vgomez@finamex.com.mx
+ 52 (55) 5209 2151

Montserrat Aldave
Economist
caldave@finamex.com.mx
+ 52 (55) 5209 2029

Pablo Mendoza
Economist
pmendozai@finamex.com.mx
+52 (55) 5209 2169

Ana López Velasco Del Pino
Economist
alvdelpino@finamex.com.mx
+ 52 (55) 5209 2080

Yesterday afternoon Banco de México published its new Quarterly Report (QR), the one corresponding to Q3-2020. Together with the inflation print for the first fortnight of November, published on Tuesday, and the Minutes of the last monetary policy decision, released this morning, this report constitutes one of the most important pieces of information that we get prior to the last monetary policy decision of 2020, on December 17th.

The three main topics under the spotlight were: i) the updates to the Central Bank's GDP growth estimates and inflation projections; ii) the general tone of the messages conveyed; and iii) any element that would shed light on Banxico's strategy to confirm the consolidation of the "downward path for headline and core inflation towards the 3% target" –which, as explained in the latest policy statement, was the rationale behind the pause in the adjustments to its reference rate.

Improved but uncertain GDP growth estimates. The three alternative scenarios presented in the two preceding QRs (V-shaped recovery, Deep v-shaped recovery and Deep u-shaped recovery), with averaging growth rates of -11% for 2020 and 3.2% for 2021, were replaced by a baseline scenario that assumes a gradual recovery for this and next year and an inertial growth environment afterwards. The current so-called "central" estimates improved relative to prior averages to -8.9% in 2020 and 3.3% in 2021. However, the uncertainty surrounding them, especially next year, remained pretty high, as can be appreciated by the wide intervals associated to them (see Figures 1A and 1B). In addition, a GDP growth range estimate between 2.6% and 3.8% for 2022 was presented for the first time, with a "central" estimate of 2.6%, i.e. the range's lower bound (see Figure 1C). Despite this (somewhat) improved outlook, Banco de México emphasized that its balance of risks is tilted to the downside, while pointing as some of the main risks: a) the extension or increased severity of social distancing measures; b) more permanent scarring of the effects of the pandemic; c) possible future downgrades to sovereign and Pemex's debt ratings; and d) the prevalence of an unfavorable environment for investment. Moreover, it also affirmed that the level of economic activity would not return to its 2019 pre-pandemic level until the end of 2023 (2022), under its baseline (optimistic/upper bound) scenario (see Figure 1D).

Figure 1A. 2020 GDP growth expectations (YoY %)

Figure 1B. 2021 GDP growth expectations (YoY %)

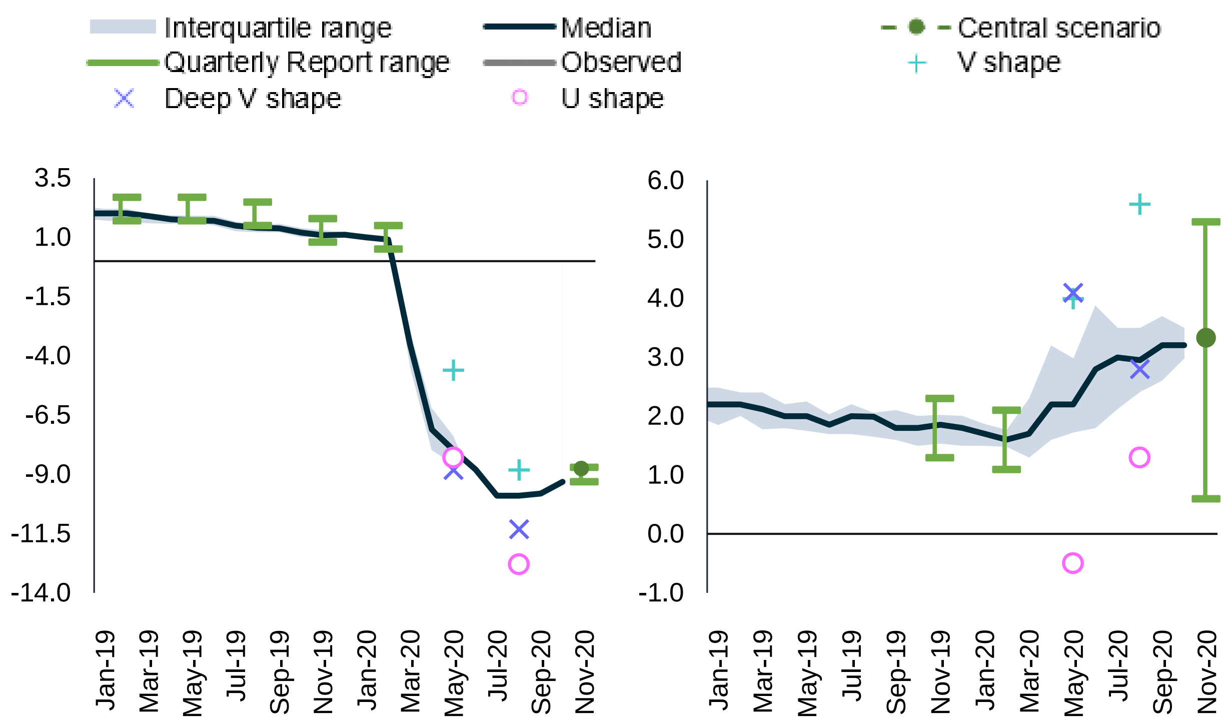


Figure 1C. 2022 GDP growth expectations (YoY %)

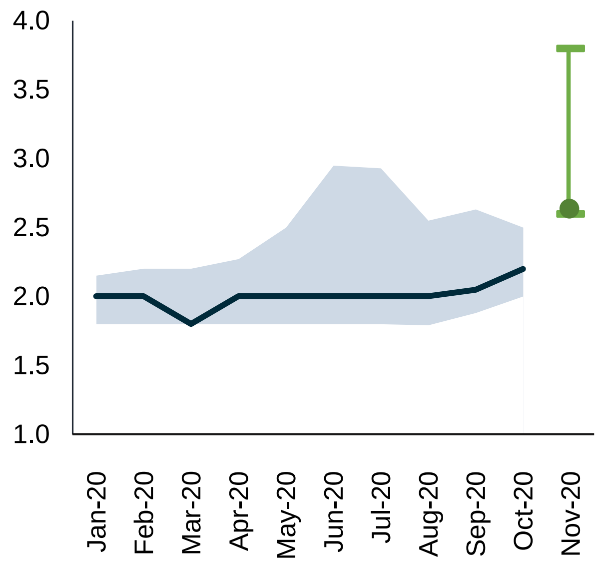
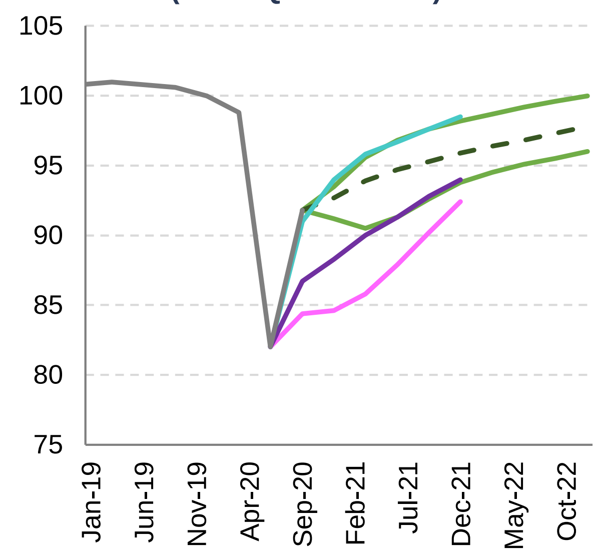


Figure 1D. GDP trajectory (Index Q4-2019=100)



Source: Finamex Economic Research with data from Banco de México: Quarterly Reports and Expectations Survey.

Inflation projections: Slightly lower in the very short term - higher in the medium term. The average headline inflation estimate for Q4-2020 improved due to lower than previously expected non-core inflation. From Q4-2021 onwards, both core and non-core inflation projections increased, thus taking headline inflation projections up to 40 bps up in Q4-2021, from 2.9% to 3.3%, and to 3.1% by the end of the forecasted horizon (see Table 1 and Figure 2). In core inflation's case, the upward adjustment ranged between 20-30 basis points (bps) and was mainly attributed to reduced slack conditions and increased inflation persistence. In the non-core component's case, the adjustment ranged between 60-100 bps and was mainly attributed to changes in the prospect for energy prices. Despite this deterioration, the Bank emphasized that inflation would lie around the 3% target within the next 12 to 24 months.

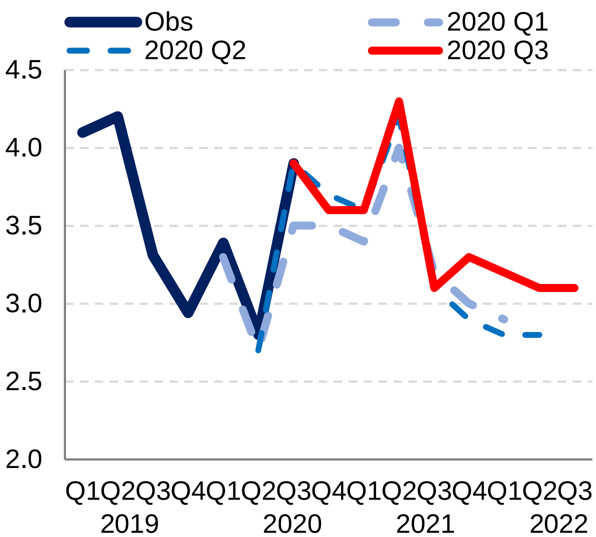
Table 1. Banco de México's inflation projections (YoY %)

	2020				2021				2022		
	I	II	III	IV	I	II	III	IV	I	II	III
Headline inflation											
Q1-2020 Report	3.4	2.7	3.5	3.5	3.4	4.0	3.2	3.0	2.9		
Q2-2020 Report	3.4	2.8	3.9	3.7	3.6	4.2	3.1	2.9	2.8	2.8	
Q3-2020 Report	**3.4**	**2.8**	**3.9**	**3.6**	**3.6**	**4.3**	**3.1**	**3.3**	**3.2**	**3.1**	**3.1**
Core inflation											
Q1-2020 Report	3.7	3.7	3.8	3.8	3.7	3.2	2.7	2.6	2.5		
Q2-2020 Report	3.7	3.6	3.9	3.8	3.8	3.5	3.0	2.8	2.7	2.7	
Q3-2020 Report	**3.7**	**3.6**	**3.9**	**3.8**	**3.9**	**3.6**	**3.0**	**3.1**	**2.9**	**2.9**	**2.9**

Source: Finamex Economic Research with data from Banco de México.

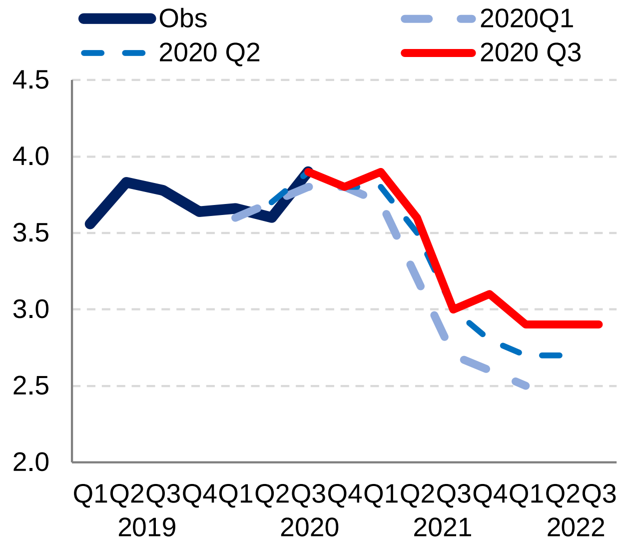
As usual, the balance of risks for this outlook remained uncertain, and the number of risks to the upside and to the downside leveled. Nevertheless, some new pieces of information caught our attention. On the one hand, that Banxico considers that some of the price reductions observed during the sales of "El Buen Fin" could become more persistent and/or that wage revisions could not exert disinflationary pressures, in the midst of demand weakness. Both arguments would entail better prospects for the outlook. On the other hand, and somewhat offsetting the previous statements that it resorts to the expected dynamics of seasonally-adjusted annualized quarterly inflation to suggest that recent sudden adjustments in observed inflation –both upwards and downwards– should be taken with a grain of salt. Our reading of this: just as in the case of future monetary policy adjustments, Banxico does not want to tie its hands yet validating the recent surprise to the downside in core inflation.

Figure 2A. Headline inflation: Banxico's projections (%, average)



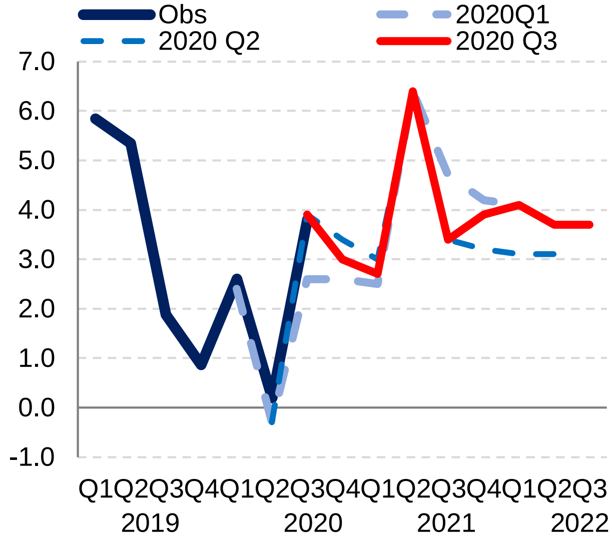
Source: Finamex Economic Research with data from INEGI and Banco de México.

Figure 2B. Core inflation: Banxico's projections (%, average)



Source: Finamex Economic Research with data from INEGI and Banco de México.

Figure 2C. Implicit non-core inflation projections (%, average)



Source: Finamex Economic Research with data from INEGI and Banco de México.

A neutral tone. A sense of prudence and caution in the main messages prevailed, not only in the outlook for inflation, as we just argued, but also in other elements of the macro-financial environment. "This context poses significant challenges for the recovery of the Mexican economy, the labor market, and for the financial system," the Bank claimed. According to the descriptions in the QR, economic activity has indeed improved but remains at low levels and, as the pandemic follows its course and its consequent risks are latent, uncertainty regarding its future performance is high. Also noteworthy, although the recent favorable evolution of international and domestic financial markets was acknowledged, there was no room for lowering the guard, as the Bank made an exhaustive list of possible elements that could bring back volatility episodes.

Prolonged pause vs mini-pause. The above, in combination with the idea that the conduction of monetary policy has induced an orderly reduction of the yield curve, hence lowering the economy's financing costs with relatively limited increases in risk premia (as Box 7 of the QR explains), seems to be in line with the pause in the adjustments to the reference rate that Banco de México announced a couple of weeks ago. Nevertheless, we did not find conclusive evidence to reaffirm that it will remain on hold for a prolonged period. In this regard, the fact that Governor Díaz de León reinforced the data-driven approach that will guide future monetary policy, including "before our decision of mid-December" –in the Q&A session– was a bit puzzling. As we have mentioned several times, he has played a pivotal role before and we expect he continues doing so in December.

The Minutes corresponding to the last monetary policy decision will allow us to gather additional relevant information, particularly, with respect to the reasons why one of the dovish Board members, namely Deputy Governor Esquivel, voted in favor of keeping the reference rate unchanged. For the time being, we stick to our view that the reference rate will remain at 4.25% during the rest of the year. However, we will look for evidence that allows us to confirm our current assessment that the recently announced pause is a prolonged one.

Technical boxes

- Box 1. The US Federal Reserve New Monetary Policy Strategy. Seeking to increase its Monetary Policy effectiveness, the Federal Reserve approved the actualization of their long-term objectives and monetary policy strategy, consisting on a flexible scheme with average inflation goals and an asymmetric and inclusive objective of maximum employment. Among the recent changes, the fact that the horizon to calculate average inflation was left undefined and the absence of maximum values of inflation to be tolerated stand out. Also, the Box comments on some of the challenges for its implementation, mainly in an environment in which inflation expectations have remained persistently below the 2% target. It also argues that the changes adopted by the Federal Reserve are not necessarily applicable to other economies, such as emerging market economies, which face different conditions than those prevailing in the U.S.
- Box 2. Use of Balance Sheets and Liquidity Provision Programs in the Central Banks of Emerging-Market Economies. COVID-19 pandemic has led to a worsening condition on financial markets belonging to emerging-market economies. The Box describes the measures adopted by central banks in emerging-market economies that have entailed the use of their respective balance sheets. A distinction is made between the traditional measures of liquidity provision, such as repos, and asset purchase programs were also emphasized. The risks associated to them, and their differences with non-conventional measures in advanced economies, are analyzed. It is noted that the adoption of different measures is a function of the specific conditions of every economy. Finally, the Central Bank mentioned that Mexico took traditional measures of liquidity provision, along with other policy responses, in view of the worsening of trading conditions in different financial markets.
- Box 3. Fiscal Response to the COVID-19 Pandemic. This box describes how authorities across different countries have deployed a toolkit of fiscal and monetary stimuli to face the downturn resulting from the COVID-19 pandemic. Despite unprecedented fiscal stimulus amounting to nearly 12% of the global GDP, there has been some heterogeneity between advanced and emerging economies. The fiscal response has varied across countries depending on each economy's structural conditions and relative space. In advanced economies, the fiscal support was allocated mainly through spending and reduced tax burden to firms and households. Also, some measures below the line have complemented the stimulus. As for emerging economies, there have been several spending and revenue collection measures, but in this case, there are fewer measures below the line relative to those of advanced economies.

- Box 4. Recent Dynamics of IMSS-Insured Jobs. This box analyses the formal labor market dynamics from March to August. The formal job losses (those affiliated to the IMSS) registered in Q2-2020, are associated with three movements: i) an increase in job destruction –both from businesses that remained active and from those that closed because of the pandemic–; ii) a decrease in job creation –from currently active businesses that hired less new people–;and iii) lower registration of new operations. Moreover, it evaluates the effects of the pandemic on wage dynamics through a regression analysis. The main finding is that people who lost their job –either voluntarily or involuntarily– and reincorporated to the formal labor market months after, return with a lower wage than the one they had before.

- Box 5: Effects of the COVID-19 Pandemic on Core Inflation's Components. This box studies the evolution of merchandises and services prices in 2020 and compares it to its 2010-2019 average. Food merchandises prices were higher than average during April and May, although those upside pressures have decreased since then. Some non-food merchandises prices, like clothing, were lower than average at the start of the pandemic and during the first half of November because of "El Buen Fin" sale. Services prices, particularly those related to tourism, food, and entertainment experienced downward pressures during April and July. Most of these pressures on services have gradually dwindled, except for tourism-related ones, which continue to show high volatility. This box also shows that econometric models that only take into account usual inflation determinants (FX, slack conditions, international prices, wages, etc.) do a poor job fitting current data, especially between April and June.

- Box 6: Impact of the COVID-19 Pandemic on Consumer Price Dynamics in the U.S. and Mexico. The effects the pandemic has had on prices are ambiguous: the demand for some goods and services decreased while that of others increased, and the supply of many goods decreased. Given the simultaneity of these shocks, this box identifies the contribution of supply and demand factors on the dynamics of inflation in Mexico and the U.S. at the sector level. In the U.S., the estimated VAR model shows that the decrease in monthly inflation observed during March-May 2020 was predominantly due to demand considerations, in a context of strict containment measures to deal with the spread of the pandemic. However, demand factors had a positive contribution to prices when activities resumed at the end of the third quarter of 2020. Supply factors also had a significant contribution to the rise in inflation due to restrictions on production and/or the obstruction of value chains: Although the magnitude of these contributions have decreased in the last months, some restrictions on the operation of various productive sectors remain. Mexico has a similar dynamic, the main differences being that in August, demand shocks continued to be a factor that contributed to keeping inflation below its trend and that, between June and August, the contribution of upward supply shocks to inflation offset the downward pressure from demand factors.

- Box 7. Evolution of the Yield Curve in Emerging Market Economies. The pace of the economic activity recovery forward will depend on the support of aggregate demand. In this context, it is desirable that the entire yield curve presents an ordered downward adjustment. Contrary to AEs, where both short-term and long-term interest rates have decreased and remained constant since March, in the case of EMEs, the behavior of interest rates has been heterogeneous. On the one hand, the Central Banks have eased their monetary policy stance, in some cases even leading reference rates near zero. On the other hand, long-term interest rates have generally decreased. However, there are cases where these rates have increased, implying greater risk premia. In this box, Banxico analyses the behavior of the yield curve in Mexico compared to other emerging economies. Through a principal component analysis, they find that the first two components, which can be related to the level and the slope of the yield curve, respectively, explain 90% of the variance. When comparing the response of the yield curve in Mexico with respect to other EMEs, results suggest that the interest rates have had an orderly and significant downward adjustment in 2020. This, considering that while other EMEs' short-term interest rates are lower, in some cases their financing costs have increased.
- Box 8. Evolution of Sovereign Risk in Emerging Market Economies. This box refers to the recent performance of credit default swaps (CDS) in emerging economies by analyzing their determinants. First, a panel-data model suggests that although risk-aversion swings in global markets explain sovereign risk, it also responds to macro fundamentals. Metrics as the debt-to-GDP, deficit-to-GDP, and the economic growth rate explain the sovereign risk dynamics. Moreover, using a principal component analysis, results show that global conditions better explained the behavior of sovereign risk over emerging economies between December 2019 and May 2020. Nevertheless, from June 2020 onwards, idiosyncratic drivers for each country became more relevant. Finally, through a vector autoregressive model specific for Mexico, estimates reveal that the reduction in the Mexican sovereign risk premium is consistent both with the recovery of global conditions and idiosyncratic factors.

Disclaimer

The information in this document shall not be construed to describe in full detail the terms and conditions of a particular transaction. The terms and conditions applicable to a particular transaction shall be included in documents to be executed between the parties. The information in this document is based on sources which are considered to be trustworthy and reliable; however, it does not entail, imply or guarantee their accuracy or reliability, and can be subject to change, amendment, addition, clarification or substitution at any time, without notice. Likewise, this document is intended for informational and guidance purposes; therefore, it shall not be construed to constitute a recommendation to invest, investment advice, or an offering of financial or investment instruments or securities for purposes of sale, purchase or subscription. Past returns do not guarantee future returns. This document does not constitute accounting, tax, legal or other recommendation, advice or opinion; such aspects must be independently assessed by each party assisted by such advisors as are deemed necessary. Casa de Bolsa Finamex, S.A.B. de C.V. (including its shareholders, officers and employees) shall not be liable for any damages or losses purportedly based on the use of this document or its contents.

The information in this document is strictly confidential for its intended recipient and its total or partial reproduction without prior written consent of Casa de Bolsa Finamex, S.A.B. de C.V. is forbidden.

(*) Research analyst(s) primarily responsible for the preparation and content of this research report.