Macro scenario - Mexico

February 17, 2025

Uncertainty takes a toll on economic activity

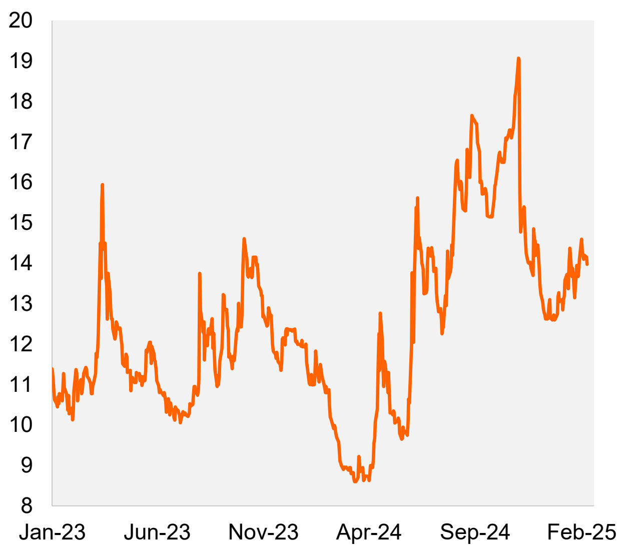
- After the U.S. announced a flat 25% tariff on imports from Mexico and Canada (10% on oil), swift concessions led to a one-month delay in their implementation, which shows some space for negotiating a deal (the more likely outcome is a drug/security war, leading to enhanced border controls, rather than a proper trade war), but risks remain, implying a significant volatility in Mexican assets, especially the peso.
- We revised our 2025 growth forecast down to 0.9% from 1.5% (2026 to 1.4%, from 1.7%) following a deeper economic contraction at the end of last year (lower statistical carryover). Trade uncertainty and fiscal consolidation remain the main headwinds for economic activity in 2025. Confidence indicators keep deteriorating at the margin.
- The balance of risks for inflation, however, is still tilted to the upside, given last year's USDMXN depreciation and the tight labor market. We forecast CPI 2025 at 3.9% and CPI 2026 at 3.6%, with limited room for significant disinflation ahead.
- Our base case remains for the central bank to continue easing in 2025, cutting the policy rate by 50 bps in March and then, as they approach the end of the cycle, choosing a more moderate pace of 25 bps (YE25 8.5%).

Navigating troubled times: uncertainty and volatility to persist during the year

After the U.S. announced a flat 25% tariff on imports from Mexico and Canada (10% on oil), swift concessions led to a one-month postponement of implementation (until at least March 4). These tariff announcements, based on emergency powers (IEEPA), have been motivated by alleged flows of fentanyl to the U.S., failure to curb immigration, and possible inflows of autos originating from China into the U.S. market, via industries in neighboring countries. Delaying the tariff implementation shows some space for negotiating a deal (more likely a drug/security war, leading to enhanced border controls, than a proper trade war), but risks remain, implying significant volatility in Mexican assets, especially the peso.

Regarding the economic impact of a generalized 25% tariff, we see space for a significant GDP contraction this year (a recession between 0.5% and 1.0%), an additional depreciation of the USDMXN (above the 23 level), and an initial net inflationary impact (with Banxico responding depending on the circumstance and nature of the shock).

Tariff threats to keep USDMXN volatility elevated



Source: INEGI, Itaú

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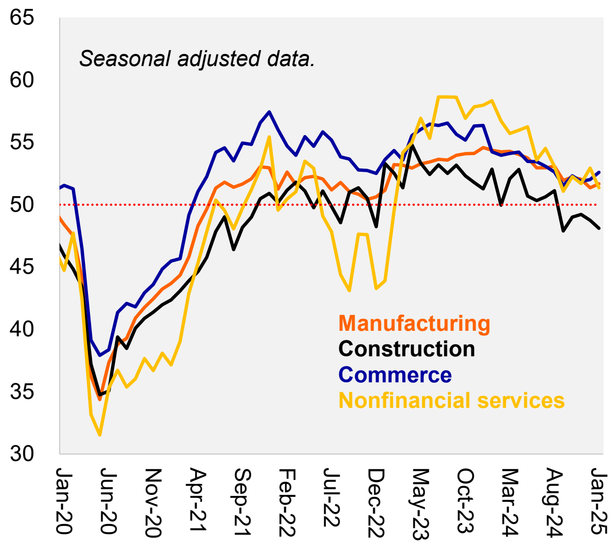
Confidence indicators deteriorating at the margin

Manufacturing leading indicators were on average negative at the end of 2024 and at the start of 2025. Non-manufacturing PMI remained in contractionary territory, while consumer confidence edged slightly down from high levels.

This sense of caution was also reflected in the business expectations, with concerns over insecurity and trade uncertainty. In this context, investment decisions in sectors that were highly favored by nearshoring and public infrastructure in recent years, such as manufacturing and construction, are likely to take a wait-and-see approach for some time.

Persistent deterioration of business sentiment

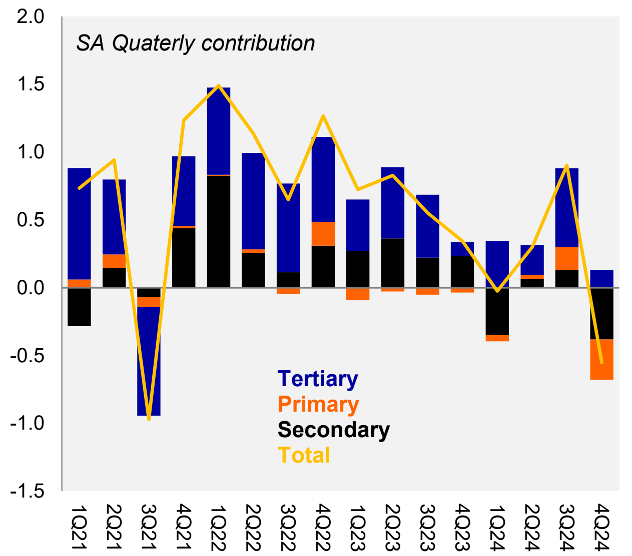


Source: INEGI, Itaú

Economic activity is already contracting sequentially, but with sectoral differences

The 4Q24 flash GDP rose only 0.6% YoY, which represents a deceleration relative to 3Q24 (+1.6% YoY) due to supply shocks that affected the beginning of the quarter (hurricanes, closure of roads, and strikes). Primary activities stood at -4.6%, industry at -1.7% and services at +2.1%, on an annual basis. Using seasonally adjusted data, GDP fell by 0.6% QoQ with industry and primary activities as the main drags at -8.9% and -1.2%, respectively, while services contributed slightly positively with quarterly growth of 0.2%.

Preliminary 0.6% QoQ contraction in 4Q24 GDP



Source: INEGI, Itaú

A very low statistical carryover for 2025 of 0.1%. Looking at the supply side, we expect services to continue to grow (already a 0.7% carryover), due to still positive fundamentals such as an increasing real wage bill and still high levels of consumer confidence. Industry could have some support given the peso depreciation and external demand but will also face some headwinds from trade policy uncertainty. Finally, droughts have affected the agricultural sector more than expected, which might continue this year if "*La Niña"* phenomenon hits the country.

Following a deeper contraction at the end of last year and lower statistical carryover, we revised our 2025 growth forecast down to 0.9% from 1.5%.

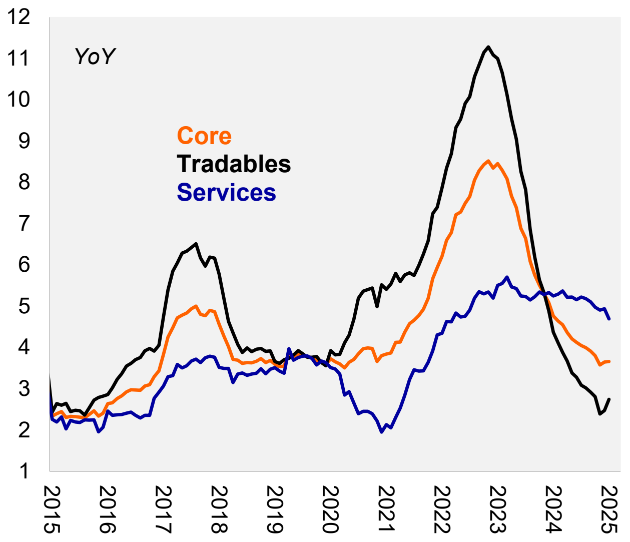
For 2026 we pencil in a bounce back to a below-potential 1.4% (from 1.7% in our previous scenario).

Challenging disinflation with sticky service inflation and FX pass-through

While the disinflationary trend is in motion, also supported by a deceleration in economic activity, the inflation scenario remains challenging, with the peso depreciation and tight labor market still posing risks. For non-core inflation, we expect that global volatility could lead to higher oil and gas prices, while pressures to agricultural prices may come from adverse climate events.

We forecast CPI 2025 at 3.9% and CPI 2026 at 3.6%.

Limited space for any additional relevant disinflation



Source: INEGI, Itaú

Banxico to deliver another 50-bp cut in March (YE25 8.5%)

As expected, Banxico cut the interest rate by 50 bps at the February meeting in a split decision to 9.5% (4-1, with Board member Jonathan Heath voting for 25 bps).

In addition, the new forward guidance signaled another 50-bp cut in March "*going forward, the board could continue to calibrate the monetary stance and consider adjusting it by a similar amount.*" The one-year real ex-ante rate of 5.4% continues above Banxico's real neutral estimate of 2.7%. Regarding the discussion on tariffs, the board only mentions that announcements of economic policy by the new U.S. administration have added uncertainty to the forecasts, but a materialization of them would have an impact on the balance of risks in both directions.

Our base case remains for the central bank to continue easing in 2025, cutting the monetary policy rate by 50 bps in March and then, as they approach the end of the cycle, slowing the pace to 25 bps (YE25 8.5%). Although the inflation scenario remains challenging, economic activity is losing strength faster than anticipated, and USDMXN is somewhat well-behaved at the margin, thus allowing for Banxico to continue to cut rates this year, even in a scenario of high uncertainty/volatility.

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Mexico | Forecast

	2020	2021	2022	2023	2024F		2025F		2026F	
					Current	Previous	Current	Previous	Current	Previous
Economic Activity										
Real GDP growth - %	-8.4	6.0	3.7	3.2	**1.5**	1.7	**0.9**	1.5	**1.4**	1.7
Nominal GDP - USD bn	1,129	1,318	1,463	1,796	**1,905**	1,909	**2,004**	2,016	**2,115**	2,121
Population (millions)	127.7	129.0	130.1	131.2	**132.3**	132.3	**133.4**	133.4	**134.4**	134.4
Per Capita GDP - USD	8,844	10,218	11,241	13,688	**14,400**	14,429	**15,028**	15,117	**15,737**	15,784
Unemployment Rate - year avg	4.4	4.1	3.3	2.8	**2.7**	-	**2.8**	2.8	**2.9**	2.9
Inflation										
CPI - %	3.2	7.4	7.8	4.7	4.2	-	**3.9**	3.9	**3.6**	3.6
Interest Rate										
Monetary Policy Rate - eop - %	4.25	5.50	10.50	11.25	10.00	-	**8.50**	8.50	**8.00**	8.00
Balance of Payments										
MXN / USD - eop	19.9	20.5	19.5	17.0	20.8	-	**21.0**	21.0	**21.3**	21.3
Trade Balance - USD bn	34.2	-10.8	-26.9	-5.5	**8.2**	-10.0	**-15.0**	-15.0	**-15.0**	-15.0
Current Account - % GDP	2.4	-0.3	-1.2	-0.3	**-0.4**	-0.4	**-0.6**	-0.6	**-0.6**	-0.6
Foreign Direct Investment - % GDP	2.8	2.7	2.7	1.7	**3.0**	3.0	**3.5**	3.5	**3.5**	3.5
International Reserves - USD bn	195.7	202.4	199.1	212.8	229.0	-	**230.1**	229.9	**230.6**	230.4
Public Finances										
Nominal Balance - % GDP	-2.8	-2.8	-3.2	-3.3	-5.7	-	**-3.9**	-3.9	**-3.4**	-3.4
Primary Balance - % GDP	0.1	-0.3	-0.4	-0.1	-1.5	-	**0.6**	0.6	**0.5**	0.5
Net Public Debt - % GDP	49.9	48.9	47.6	46.8	51.4	-	**51.8**	51.8	**51.4**	51.4

Source: IMF, Bloomberg, INEGI, Banxico, Haver and Itaú

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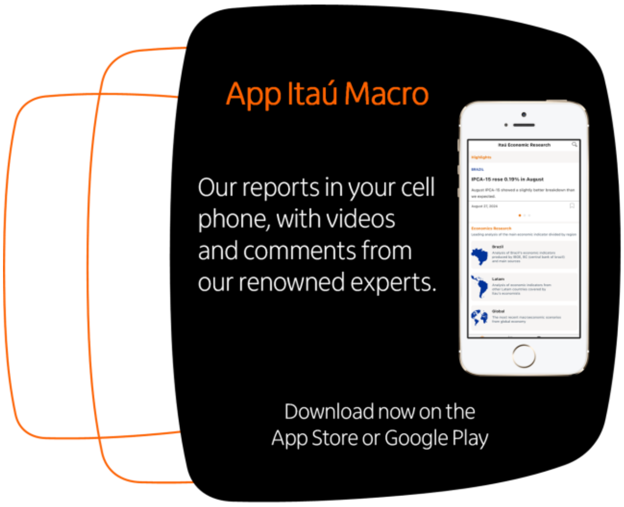

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