Macro scenario - Mexico

April 12, 2024

Start of the easing cycle

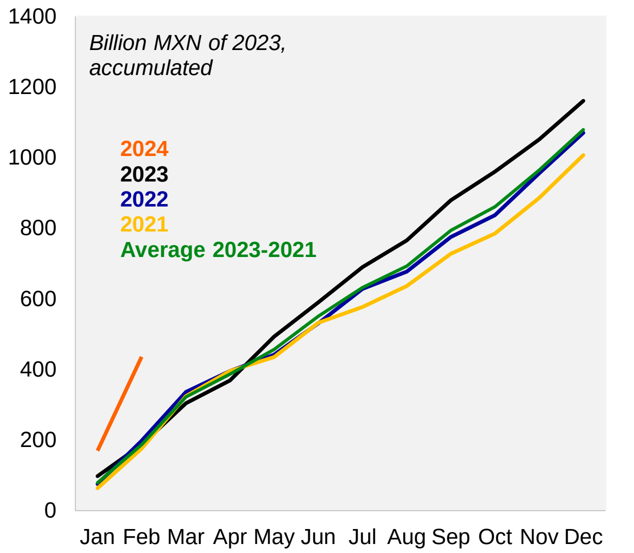
- Fiscal data reflect a front-loading of social programs and fixed capital expenditure with a presidential election in the middle of the year and a change of administration in 2H24. Despite strong fiscal spending, and resilient activity in the US, monthly GDP at the beginning of the year has been weak. Our GDP growth forecast of 2.8% for 2024 has a downside bias.
- As expected, the central bank of Mexico started its easing cycle by cutting its policy rate by 25 bps in March, down to 11.00%. Its monetary forward guidance suggests further rate cuts will be data dependent. Further declines in core inflation amid soft activity at the beginning of the year support the continuation of the easing cycle in May, but we changed our call for a pause in May, given Fed repricing pointing to a delay in the beginning of the easing cycle. Our end of year policy rate forecast now stands at 9.75% (previously at 9.50%).
- The ruling-party candidate, Claudia Sheinbaum, continues to lead the presidential race with a 17-percentage-point advantage over opposition-coalition candidate Xochitl Galvez, according to the most recent poll from local newspaper El Financiero, with Sheinbaum at 51% and Xochitl at 34%.

Where is the fiscal impulse?

Fiscal spending as of February reveals a significant positive fiscal impulse. We expect the expansionary fiscal stance in 2024 to be concentrated mainly in social programs and public construction, and to be reflected in the first half of the year given general elections in the middle of the year (June 2) and a change of administration in the second half of the year. Social-program expenditure is concentrated mainly in the fiscal aggregate subsidies and transfers, which stood at MXN 436 billion YTD in February in real terms, compared with the same period average for 2023-2021 of 187 billion. Likewise, expenditure in subsidies and transfers is above the average of previous election periods (2018, 2012, 2006) of MXN 108 billion in real terms as of February. We note that the subsidies and transfers expenditure evolution is reflecting, among other things, a front-loading of three social programs (universal pension, pension for persons with disabilities and support for working mothers) into the first two months of 2024 from the second and third two-month periods, as they are forbidden from being distributed during the official electoral period which started in March and ends in June.

Fixed capital direct spending, associated with public construction, is also booming. Fixed capital direct spending stood at MXN 83 billion YTD in February in real terms, compared with a MXN 48 billion average for previous years (2023-2021) and a MXN 56 billion average for previous presidential election periods (2018, 2012 and 2006). Fiscal subsidies and transfers and fixed capital direct spending represented 1.2% of GDP and 0.2% of GDP, respectively, as of February. We note the Ministry of Finance (MoF) recently updated its primary deficit estimate to 1.4% of GDP for 2024 (previously at a deficit of 1.2% of GDP), increasing the Balance of Public Sector Borrowing Requirements to GDP (the broadest measure of debt) ratio to 50.3% for the end of this year (from 48.8% of GDP).

Fiscal Subsidies & transfers



Source: SHCP, INEGI.

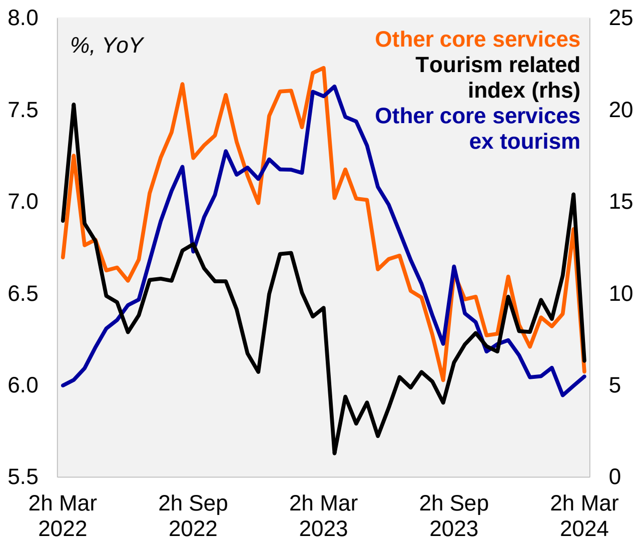
Activity has been weaker than expected, despite strong fiscal spending. Monthly GDP in January fell by 0.6% MoM/SA, with services contracting by 0.5%, which seems inconsistent with the front-loaded execution in fiscal subsidies and transfers. Looking at internal demand indicators, monthly private consumption for January also fell by 0.6% MoM/SA. Overall, activity momentum remained weak in January, with the qoq/saar at -2.9% (from -0.5% in 4Q23). February's industrial production suggest soft activity evolution persisted. Industrial production fell by 0.1% MoM/SA, dragged by construction output (-2.5%) despite a strong public capital expenditure. While leading indicators suggest an improvement in private consumption, it seems unlikely to result in a strong 1Q24. Non-oil consumption imports MoM/sa stood at a positive 2.1% in February.

The easing cycle begins

In a divided decision, Banco de Mexico (Banxico) cut its policy rate by 25 bps (to 11.00%), as expected. While four of the five Board members voted for the 25-bp cut, deputy governor Irene Espinosa voted to leave the policy rate unchanged at 11.25%. We note she had previously expressed concerns about the inflationary environment. The new forward guidance suggests further rate cuts will be data dependent: "In the next monetary policy meetings, it will make its decisions depending on available information." However, the fact that the statement does not explicitly mention "the possibility of adjusting its policy rate," as in the previous communique, suggest pauses cannot be ruled out. In fact, this risk has increased, given higher uncertainty about US monetary policy. Following the decision, the one-year ex-ante real rate fell from 7.43% to 7.10%, still well within contractionary territory. The meeting's monetary policy minutes showed a divided board on further rate cuts. Deputy governor Irene Espinosa, who voted to keep the policy rate unchanged, is still uncomfortable with the inflation outlook. In contrast, the rest of the Board is open to consider further rate cuts depending on the incoming data, but with one of them with a bias to pause.

Accommodation of sharp, but seemingly transitory services inflationary pressures should support the central bank continuing to cut its policy rate. After tourism-related prices exerted significant upward pressure on the other core services inflation index in the first half of March (1.03% bw/bw) due to the Easter holidays, the second-half March figure is easing (-0.13% bw/bw). Tourism-related prices are likely to ease further in the first half of April. We note that tourism-related prices are quite volatile, distorting the disinflationary progress made in the services index (see chart below). The annual other core services index stood at 6.46% for the full month of March (from 6.36% in February), while the same index excluding tourism-related prices stood at 6.02% (practically unchanged from the previous month). Headline and core inflation stood at 4.42% in March (from 4.40% in February) and 4.55% (from 4.64%), respectively. On top of that, the weak monthly GDP in January, despite the strong fiscal spending execution, should also give some comfort to Banxico board members to continue cutting its policy rate in the next meeting. However, the risk of a pause in the next meeting increased substantially given a Fed repricing pointing to a delay in the beginning of the easing cycle.

Other services inflation



Source :INEGI, Itaú.

The ruling party still leads the presidential race

The ruling-party candidate, Claudia Sheinbaum, continues to lead the presidential race with a 17-percentage-point advantage over opposition-coalition candidate Xochitl Galvez, according to the most recent poll from local newspaper, *El Financiero*. According to the poll, Sheinbaum and Xochitl stood at 51% in March (from 50% in February) and 34% (from 33%), respectively. The slight gain in preferences in March relative to February for Xochitl and Sheinbaum came from both the undecided (8%, from 9%) and distant-third-place opposition candidate Jorge Alvarez (7%, from 8%). Another interesting result from the poll is that most of Sheinbaum supporters are beneficiaries from AMLO's social priority programs (64%).

Strong peso and higher rates

While further declines in core inflation and weak activity at the beginning of the year support the continuation of the easing cycle, we changed our call for a pause in May, given Fed repricing pointing to a delay in the beginning of the easing cycle. Our end of year policy rate forecast now stands at 9.75% (previously at 9.50%).

We reduced our end-of-year 2024 and 2025 currency forecast to 17.9 pesos to the U.S. dollar (previously at 18.2) and 19.3 pesos (from 18.9), respectively, given a stronger-than-expected evolution of the peso and despite the strengthening of the USD globally. While we kept our 2024 GDP growth forecast at 2.8%, our call has a downside bias given a weaker-than-expected monthly GDP print in January. We prefer to see further activity indicators before adjusting our GDP growth call, considering the strong fiscal-expenditure execution at the beginning of the year.

We widened our nominal fiscal deficit estimates for 2024 and 2025 to 5.0% of GDP (previously at 4.9% of GDP) and 2.5% of GDP (from 2.2% of GDP), respectively, in line with the new Ministry of Finance estimates. Consistently, our new net public debt ratios are estimated at 49.9% of GDP (from 49.7% of GDP) and 50.3% of GDP (from 49.9% of GDP), respectively.

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Mexico | Forecast

	2019	2020	2021	2022	2023	2024F		2025F	
						Current	Previous	Current	Previous
Economic Activity									
Real GDP growth - %	-0.3	-8.6	5.7	3.9	3.2	**2.8**	2.8	**1.8**	1.8
Nominal GDP - USD bn	1,300	1,129	1,313	1,464	1,796	**2,043**	2,003	**2,019**	1,983
Population (millions)	125.6	127.7	129.0	130.1	131.2	**132.3**	132.3	**133.4**	133.4
Per Capita GDP - USD	10,352	8,844	10,183	11,248	13,688	**15,442**	15,135	**15,143**	14,868
Unemployment Rate - year avg	3.5	4.4	4.1	3.3	2.8	**2.7**	2.7	**2.7**	2.7
Inflation									
CPI - %	2.8	3.2	7.4	7.8	4.7	**4.2**	4.2	**3.7**	3.7
Interest Rate									
Monetary Policy Rate - eop - %	7.25	4.25	5.50	10.50	11.25	**9.75**	9.50	**7.75**	7.50
Balance of Payments									
MXN / USD - eop	18.9	19.9	20.5	19.5	17.0	**17.9**	18.2	**18.9**	19.3
Trade Balance - USD bn	5.4	34.2	-10.8	-26.9	-5.5	**-17.0**	-17.0	**-20.0**	-20.0
Current Account - % GDP	-0.3	2.4	-0.3	-1.2	-0.3	**-0.7**	-0.7	**-0.8**	-0.8
Foreign Direct Investment - % GDP	2.3	2.8	2.6	2.7	1.7	**3.0**	3.0	**3.5**	3.5
International Reserves - USD bn	180.9	195.7	202.4	199.1	212.8	**210.0**	210.0	**215.0**	215.0
Public Finances									
Nominal Balance - % GDP	-1.6	-2.8	-2.8	-3.2	-3.3	**-5.0**	-4.9	**-2.5**	-2.2
Net Public Debt - % GDP	43.8	50.0	49.0	47.6	47.0	**49.9**	49.7	**50.3**	49.9

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

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