Macro scenario - Mexico

October 4, 2024

More headwinds for activity?

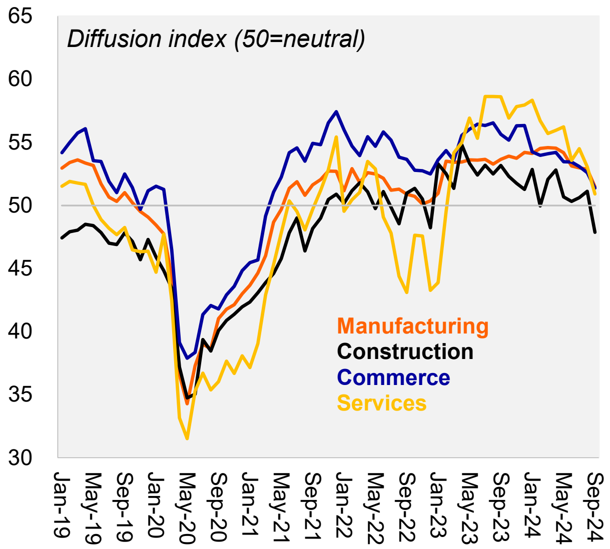
- We revised our growth forecast for 2025 down to 1.3% from 1.5%, mainly because of an expected deterioration of the investment outlook that is signaled by falling business confidence and the decline in capital goods imports along with an expected retrenchment of fiscal spending, and the softening of the U.S. economy.
- We believe Banxico's recent guidance opens the door for continuous rate cuts, and it will continue to ease at a 25-bp pace in the remaining meetings this year. Domestic financial volatility related to the approval of the judicial reform seems to have faded, for now. However, the deterioration of the growth outlook toward next year, lower inflation, and the Fed's easing cycle should open the door for Banxico to have a less contractionary policy rate; we revised our year-end 2025 call to 7.5% from 8.0%.

Jump in the volatile primary sector led to a stronger activity print at the start of 3Q24

Mexico's growth outlook has deteriorated gradually throughout the year, with most of the recent revisions driven by a weaker-than-expected activity print in 2Q24. However, the monthly GDP proxy (IGAE) surprised to the upside in July, rising by 3.8% yoy, mainly driven by a jump in the volatile agricultural sector (+11.6% MoM). On a sequential basis, activity increased by 0.6% mom/sa in July, building on the 0.2% seen in June, leading to three consecutive monthly sequential expansions. Manufacturing output growth, in contrast, decelerated to 0.2% mom/sa, the slowest pace in the past three months, while services rose by 0.4% mom/sa (0.0% in June). Even though activity started 3Q24 on a stronger foot, the surprise was mainly driven by volatile items, and as such is likely to revert in the coming months.

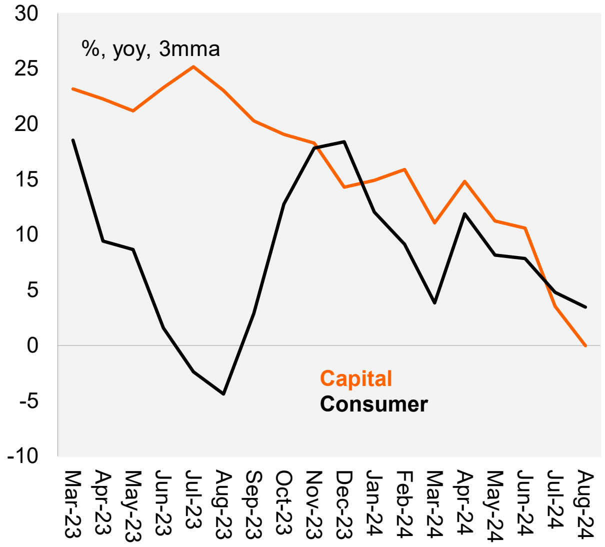
Some signs of concern. Survey-based data point to a deterioration in business confidence over the last few months, which may spill over to investment decisions. Imports of capital goods, a bellwether for investment, have flattened out since 3Q23, and contracted for the first time in annual terms in the rolling quarter ending in August. However, in contrast, the still-strong labor market supports private consumption growth.

Business confidence falling fast



Source: INEGI, Itaú

Imports have decelerated sharply



Source: INEGI, Itaú

Continuous cuts signaled

The central bank of Mexico (Banxico) cut the policy rate by 25 bps for the second consecutive meeting, to 10.50% in September, as expected. In contrast to the previous split decision, when deputy governors Irene Espinosa and Jonathan Heath voted for a pause, in this meeting only board member Jonathan Heath voted for it. The forward guidance was adjusted to reflect further cuts, in our view, explicitly stating *"Looking ahead, the Board expects that the inflationary environment will allow further reference rate adjustments."*

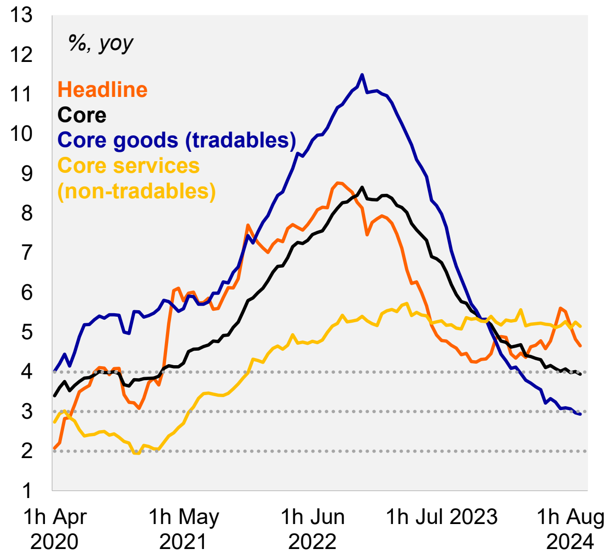
Following the decision, the real one-year-ahead ex-ante policy rate fell to 6.74%, down from 6.99%, well above Banxico's neutral real rate of 2.7%. Persistent divided decisions regarding easing suggest a discussion of accelerating the pace in the near term is unlikely. However, we believe an improvement in the disinflationary process, especially in core services, further downside revisions to activity, or a faster Fed, could eventually lead it to larger cuts.

Banxico's inflation forecasts, especially core, were revised down, but the balance of risks for inflation remained tilted to the upside. Still, both headline and core inflation are expected to converge to 3.0% in 4Q25, as in August's statement. Importantly, the September statement recognizes the improvement in the inflation outlook. Of note, inflation risks stemming from the significant depreciation of the peso (roughly 15% since early June) seem to be contained by the deterioration of the activity outlook, as described in Banxico's recent inflation report.

Gradual disinflation process continues

Headline CPI rose by 0.09% in the first half of September, below the Bloomberg median market expectations of +0.13%. Core inflation rose by 0.21%, in line with market expectations. On an annual basis, headline inflation fell to 4.66% (from 4.99% in August), while core inflation fell to 3.95% (from 4.00% in August). On the positive side, core inflation entered Banxico's target range of 3+/-1%; however, the decline is mainly driven by core goods inflation, as core services remains sticky, mainly reflecting the still-tight labor market.

Inflation breakdown



Source: INEGI, Itaú

"Plan C" to move forward

The judicial reform was approved and concluded its legislative process with the reform's core – judges being elected by popular vote – remaining unchanged. The reform's implementation will take place during President Claudia Sheinbaum's term, with an extraordinary election to take place in 2025, in which all supreme court judges and around half of other judges would be renewed by popular vote, suggesting that the ruling party and coalition could capture the top court at the beginning of Sheinbaum's administration. The rest would be renewed on the same date as a federal election (the next is scheduled for 2027). Other constitutional reforms that could add greater rigidity to fiscal spending are likely to be in the spotlight in the near term, especially considering the projected fiscal consolidation; the incoming administration must present the 2025 budget by mid-November.

A slightly weaker activity outlook for 2025

We maintained our below-consensus 2024 GDP growth forecast at 1.4%, as we believe the volatile-agriculture-sector driven, stronger-than-expected start to 3Q24 is likely to revert. Moreover, reaching our forecast implies an important sequential acceleration starting in 3Q24, which seems challenging considering the deterioration in business confidence, an expected retrenchment of fiscal spending, and the softening of the U.S. economy. We revised our growth forecast for 2025 down to 1.3%, from 1.5%, mainly because of an expected deterioration of the investment outlook.

We maintained our currency forecast unchanged at 19.0 pesos to the dollar, and our end-of-year inflation forecast at 4.3%. Higher domestic risk premium adds a depreciation bias to our USD/MXN call by year-end.

We believe Banxico's recent guidance opens the door for continuous rate cuts, and it will continue to cut at a 25-bp pace in the remaining meetings this year. Domestic financial volatility related to the approval of the judicial reform seems to have faded, for now. However, the deterioration of the growth outlook towards next year, lower inflation, and the Fed's easing cycle should open the door for Banxico to have a less-contractionary policy rate; we revised our year-end 2025 call to 7.5% from 8.0%, which implies larger cuts in 2025.

Andrés Pérez M.

Mexico | Forecast

	2019	2020	2021	2022	2023	2024F		2025F	
						Current	Previous	Current	Previous
Economic Activity									
Real GDP growth - %	-0.4	-8.4	6.0	3.7	3.2	**1.4**	1.4	**1.3**	1.5
Nominal GDP - USD bn	1,298	1,129	1,318	1,463	1,796	**1,931**	1,931	**1,908**	1,908
Population (millions)	125.6	127.7	129.0	130.1	131.2	**132.3**	132.3	**133.4**	133.4
Per Capita GDP - USD	10,335	8,844	10,218	11,241	13,688	**14,593**	14,593	**14,305**	14,305
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	**4.3**	4.3	**3.9**	3.9
Interest Rate									
Monetary Policy Rate - eop - %	7.25	4.25	5.50	10.50	11.25	**10.00**	10.00	**7.50**	8.00
Balance of Payments									
MXN / USD - eop	18.9	19.9	20.5	19.5	17.0	**19.0**	19.0	**19.3**	19.3
Trade Balance - USD bn	5.4	34.2	-10.8	-26.9	-5.5	**-10.0**	-10.0	**-15.0**	-15.0
Current Account - % GDP	-0.3	2.4	-0.3	-1.2	-0.3	**-0.4**	-0.4	**-0.6**	-0.6
Foreign Direct Investment - % GDP	2.3	2.8	2.7	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	**220.0**	220.0	**225.0**	225.0
Public Finances									
Nominal Balance - % GDP	-1.6	-2.8	-2.8	-3.2	-3.3	**-5.0**	-5.0	**-2.5**	-2.5
Primary Balance - % GDP	1.1	0.1	-0.3	-0.4	-0.1	**-1.4**	-1.4	**0.9**	0.9
Net Public Debt - % GDP	43.9	49.9	48.9	47.6	46.8	**50.2**	50.2	**50.6**	50.6

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

Macro Research – Itaú

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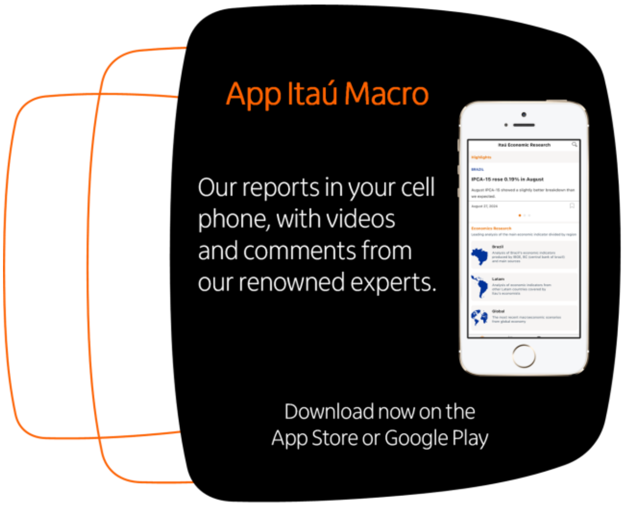

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