BBVA Research

Mexico Economic Outlook

Second Quarter 2019

Creating Opportunities

Contents

Closing date: **March 29, 2019**

1. Summary

The first indicators of economic activity in 2019 show signs of resilience in January, with industry growing at an annualized monthly rate of 8.7%, driven by the construction sector, and services at 4.4%, as a result of the better performance of financial and professional services. While we believe that the resilience of the tertiary sector will last throughout the year, we consider that there are latent risks to economic activity associated mainly with the external sector, which could materialize in the first or second quarter of the year. In particular, the leading indicator for manufacturing orders in the US has shown slower growth since the second half of 2018, a trend that has resulted in lower production since the third quarter of that year. The close link between the production cycles of the manufacturing industries in Mexico and the US suggests slower growth for manufacturing in our country in 2019, so we have revised our growth forecast downwards to 1.4%. The key element in the economy this year will therefore be domestic demand, driven by private consumption, and the recovery of investment toward the second half of the year reflecting a context of less uncertainty.

Inflation started well in 2019: the cumulative increase of 0.1 pp in January-February is the lowest since 2015, a year in which inflation was at an all-time low. As a result, overall inflation fell 0.9 pp between December 2018 and February of that year (from 4.8% to 3.9%), falling below 4.0% for the first time since December 2016. Underlying inflation also fell over these two months, albeit at a slower rate, and moved from 3.7% in December 2018 to 3.5% in February. We anticipate a slower rate of convergence to the target of 3.0% from now on with a predictable temporary increase in overall inflation in 2Q19 that will take it again above 4.0%, before then falling below that level in 3Q19 and having an additional fall to 3.4% by the end of this year (-0.3 pp compared to our previous forecast of 3.7%). We anticipate that underlying inflation will remain relatively stable between March and October (fluctuating between 3.5 and 3.6%) before falling to 3.3% in the last two months of the year (i.e., we maintain our forecast of 3.3%).

In terms of monetary policy, we anticipate caution in the short term and the beginning of a cycle of reductions in the second half of the year. Despite the restrictive tone and wait and see approach that seems to have been adopted by Banxico in 1Q19, we think that sooner rather than later it is likely to switch to an approach of gradually easing monetary policy. There are several reasons for this: i) the Federal Reserve has given clear signs that in the absence of unanticipated increases in inflation it will not increase its monetary rate for the remainder of the year; (ii) the exchange rate is relatively stable despite the risks; (iii) we anticipate that general inflation should be below 4.0% from the summer and remain there; (iv) we anticipate that the underlying rate will remain stable before decreasing in 4Q19; v) the economy is showing clear signs of weakening and this greater weakness of the cyclical position of the economy is translating into an increase in the output gap, limiting the upward risks from the labor market; and vi) the monetary position is highly restrictive: the ex ante real monetary policy rate is above 4.0%, a high level by historical standards, and significantly higher than the estimate of 2.0% for the neutral rate.

Prices of the main domestic assets have recovered from the falls recorded during the final months of 2018, reflecting the reduction in domestic risks and the expectations of a pause in the Federal Reserve's monetary normalization process. After reaching levels above 20.5 pesos per dollar last November, the peso is currently trading at around 19.2 pesos per dollar, which means that the Mexican peso remains the most appreciated currency among the emerging currencies in the last four months. As for interest rates, the 10-year government bond return has recovered more than 100 basis points from its November 9.25% maximum and is currently around 8.0%.

We believe that the risk of a downgrade to Pemex's credit rating decreased considerably with the possible use of the Oil Revenues Stabilization Fund of Mexico (FEIP in Spanish) resources for the repayments and interest payments on the oil company's debt for 2019. This is in addition to federal government measures announced in mid-February to financially support Pemex.

However, we detect some worrying signs for the coming years: i) more resources will be allocated to refining activities, which have caused large losses of about MXN 100 billion a year; ii) farmouts were postponed until October 2019; iii) oil rounds were suspended for three years and there is a risk that they will be canceled at the end of that period; iv) Pemex will face strong pressure to increase its investment in the coming years in view of the relative large amounts of financial debt due for the period 2020-2023 and the restriction of curbing its net indebtedness; (v) for all of the above, it will be difficult not only to reverse the fall in oil production, but also to stabilize it.

Given the expectation of lower economic growth for 2019 and 2020 than anticipated a few months ago, we consider it positive that in the Economic Policy Pre-Criteria document for 2020 the federal government has reflected this through forecasts of lower public revenues than those approved and new cuts to public spending. We also welcome the strong resolve of the federal government to achieve the targets of 1.0% and 1.3% of GDP for the primary surplus in 2019 and 2020, respectively. However, in our view, the target of 1.92 million barrels a day for oil production in 2020 seems somewhat optimistic.

Public finance information for the first two months of the year shows that total net expenditure registered a real annual fall of 7.7%. It is important to mention that on excluding financial investment, federal payments, public pensions and the financial cost of public debt, the rest of expenditure experienced a greater decrease with a real annual contraction of 19.5% during that period. The greater real annual fall experienced by this more limited expenditure concept could be signaling greater efforts by the federal government to maintain a certain degree of financial discipline over the items more directly under its control.

2. Soft landing of the global economy

World growth has slowed down more than expected over recent months, increasing fears of a hard-landing of economic activity. In this context, the Fed and the ECB have altered their roadmap and have announced new monetary stimulus measures. Similarly, China has implemented additional expansive policies, both of a fiscal and monetary nature. This reaction by the economic authorities in the main economies brings about a milder slowdown of world growth. However, an unforeseen reduction in dynamism in the Chinese economy, a new wave of protectionist measures and the disorderly exit of the UK from the European Union, among other risks, could trigger more negative scenarios.

Global economic activity has slowed down, with a particularly weak performance in exports and the manufacturing sector

Having grown at an average of 1% QoQ since 2016, the preliminary data suggest that world GDP could reach 0.8% QoQ in the first quarter of this year. This would mean that, despite a slight improvement in world growth with respect to the last two quarters of last year (0.7% QoQ), economic dynamism continues to be below that of previous years.

A number of factors have contributed to the slowdown in global activity, particularly; i) the structural deceleration of the Chinese economy, now that its indebtedness has stopped increasing ; ii) trade protectionism; iii) in Europe, high uncertainty as well as certain specific—and probably temporary—events, such as the effects of the new European regulations on emissions in the automotive sector; and iv) the cyclical moderation in the US, amid a context where the effects of fiscal stimulus are losing strength.

The factors underlying world slowdown have affected activity, mainly in terms of exports and manufacturing. The weakness in these sectors has been partially offset, for the time being, by the relative strength of private consumption, which remains supported by the dynamism of the labor markets and low inflation.

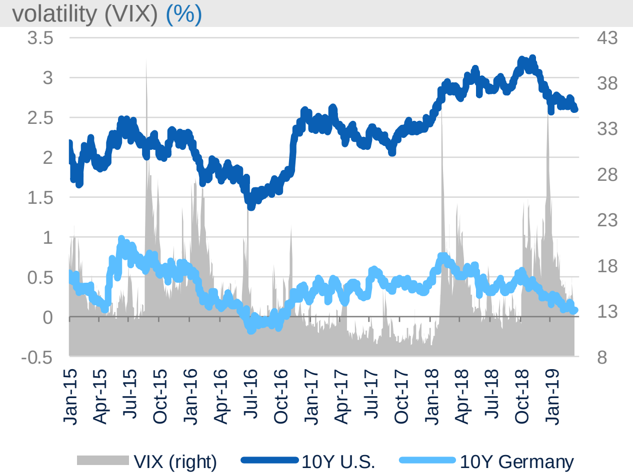
The downturn in growth has led to an unexpected turn in US and Eurozone monetary policy

The more negative tone of the world economy has generated concerns, as well as an increase in financial volatility. Against this backdrop, and given that inflationary pressures continue to be under control, the Fed and the ECB have reacted by giving their policies a sharp turn in their communication about the assessment of the environment and the expected path for their policies. The US monetary authority has significantly adjusted its tone and strategy towards a more accommodating monetary policy. In this regard, as well as revealing it will be "patient" when considering additional interest rate rises, the Fed has announced that its balance reduction process will end sooner than expected, by September of this year, at a level of around 17% of GDP (between 3.5 and 3.8 trillion dollars). The prudence shown by the North American central bank, as well as low inflationary pressures, may cause rates to remain stable, or even to be cut, if activity data reveal a further and significant deterioration of economic growth. Still, there would be room for a final increase of 25 bps, to 2.75% by the end of 2019, if the moderation in growth proves to be mild and constrained (previously, two rate increases were expected in 2019 resulting in reference rates reaching 3%).

As for the ECB, the change towards a more expansive policy has translated into a delay in interest rate rise expectations and the announcement of a new round of liquidity auctions. As for the former, the ECB has delayed its rate increase expectations from summer 2019 to at least the end of the year. On the other hand, the monetary authority announced a new series of targeted longer term refinancing operations (TLTRO-III), to be carried out between September 2019 and March 2021. In this context, rate forecasts have been adjusted, with a first rise in deposit rates expected by June 2020 and that of the official reference rate by December 2020. Moreover, more details about the new TLTRO are expected to be announced in June

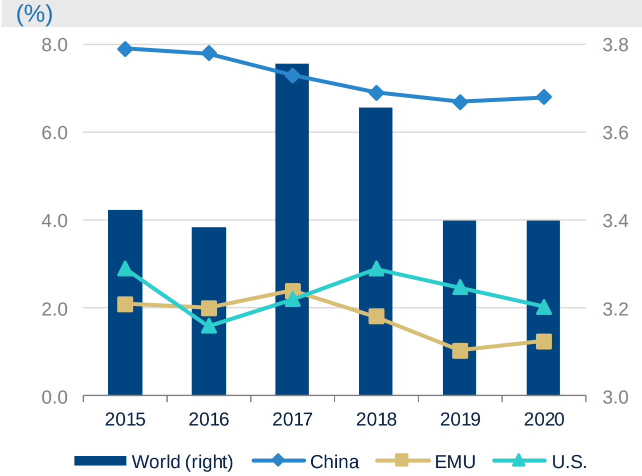
China has also reacted to the increasing concern about the slowdown of the economy. Specifically, local authorities have confirmed a tax cut, focused on VAT, of 2 percentage points of GDP, as well as an increase in public deficit, from 2.6% of GDP in 2018 to 2.8% of GDP in 2019. Signs of greater monetary easing are also evident. In this regard, two additional cuts of 25 bps in the reference interest rates, as well as two reductions in the bank reserve requirements in the second and third quarters, are envisaged.

Figure 2.1 Sovereign debt yields and equities market volatility (VIX) (%)



Source: Haver and BBVA Research

Figure 2.2 Annual GDP growth: 2015–2020 (*) (%)



(*) Forecasts from 2019 onwards.
Source: BBVA Research

Weaker global growth is affecting financial market performance

The deteriorating outlook of global activity and the associated reduction in inflation expectations, along with the central banks' more prudent approach, have led to a sharp drop in the yields of 10 year bonds in the US and Germany (see Figure 2.1), supporting the view that they will remain at significantly low levels for a long period of time. This adjustment has led to the flattening of yield curves, which has given rise to additional doubts regarding economic growth.

In any event, the change by the Fed and the ECB towards a more accommodating monetary policy and a certain optimism regarding the results of the US-China trade negotiations have supported the stock markets, partially offsetting the negative effects of cyclical deterioration. However, if the economic activity continues to disappoint, the financial markets will find it hard to maintain their recovery. Finally, with regard to the equity market volatility, this is most likely to remain relatively low over the coming months, with a VIX between 15 and 18, supported by the prudent approach of the central banks, and below the levels of the last months of the previous year (see Figure 2.1).

Global growth is expected to reach 3.4% both in 2019 and in 2020

The new economic stimuli support an orderly moderation of world growth. Global GDP, which grew by 3.7% in 2018, would grow to 3.4% in 2019 and to 3.4% in 2020 (see Figure 2.2). The soft landing of the world economy is subject to the US and China managing to reach a trade agreement in the second quarter of the year, which is fundamental in reducing uncertainty and preventing an additional deterioration of international trade. Moreover, another important condition in this scenario of gradual moderation of growth is that the UK's exit from the European Union (brexit) does not significantly disrupt the relations between the two regions. Lastly, the probable upcoming reduction in oil prices due to dwindling demand and a growing supply in the US will help to maintain inflationary pressure under control, and provide room for maneuver for the central banks to execute their monetary policy (the price of a barrel of Brent is expected to fall from around 65 dollars in the first quarter of the year to close to 62 and 55 dollars by the end of 2019 and 2020, respectively).

In the US, growth will continue to gradually lose momentum, moving towards potential rates. In particular, US GDP is estimated to grow by 2.5% in 2019 and by 2.0% in 2020, in the wake of the expansion of 2.9% of 2018. Although the growth forecasts for the country remain unchanged, the trend is downward and the risk of recession continues to be significant, given the possibility of greater slowdown in investment, high financial vulnerabilities and the more negative tone of the global scenario, among other factors.

In Europe the downturn in activity, mainly in exports and in the industrial sector, has continued longer than expected. Moreover, the uncertainty regarding the outcome of the Brexit situation, as well as that regarding the US threat to increase tariffs on vehicles produced in the region, remains high. In this context, growth forecasts for the Eurozone have been revised downwards, from 1.4% to 1.0% in 2019, and from 1.4% to 1.3% in 2020, with a downward bias.

As for China, the trade agreement with the US is expected to be formalized and recent stimuli are expected to succeed in supporting domestic demand, which would enable GDP to grow by 6.0% in 2019 and by 5.8% in 2020, in line with previous forecasts. Thus, these more expansive policies reduce the risk of a sharper growth deceleration, but at the cost of hindering the reduction of the country's structural problems, such as its high leverage levels.

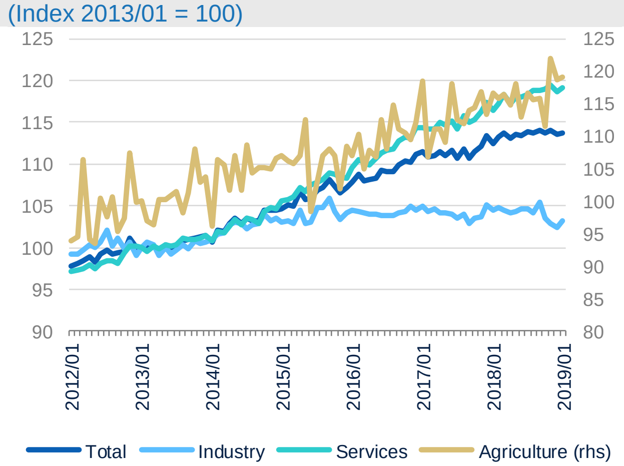
The further slowdown of world growth will bring about additional difficulties for the economic activity of emerging countries. Nonetheless, the more expansive policies of the main economies could take some pressure off exchange rate markets and increase the room for maneuver of monetary policy in emerging economies markets.

In this context, the slowdown in growth will further reduce inflationary pressures, both in developed and in emerging economies. This will be further helped by the expected drop in oil prices.

3. Early indicators in 2019 show signs of resilience in private consumption and risks associated with external demand

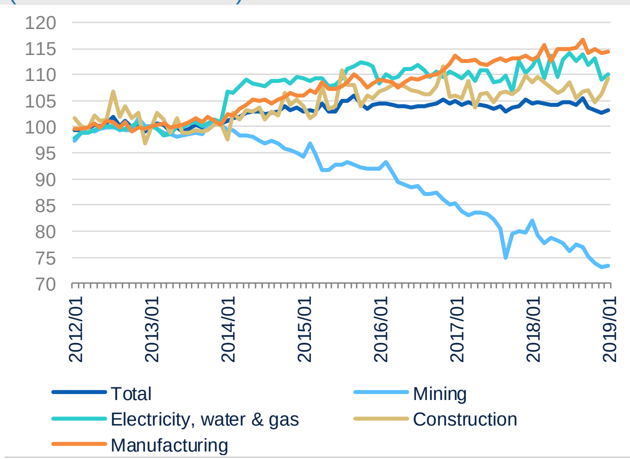
The first activity indicators in 2019 show signs of resilience in January, with industry growing at an annualized monthly rate of 8.7%, driven by the construction sector, and the tertiary sector at 4.4% in the same period. By component, within the secondary sector, construction has recorded the best performance with an annualized monthly rate of 62.9%, the highest since 2015, in line with the stronger growth in investment in the residential segment seen at the close of 2018. The mining sector and the generation and transmission of electricity, water and gas reported increases of 2.9% and 12.5% in the first month of the year, respectively, after registering declines in 4Q18. The manufacturing sector (55% of industry) registered positive but weak growth, with an annualized monthly rate of 1.3%, following a -8.3% change in December.

Figure 3.1 IGAE.
(Index 2013/01 = 100)



Source: BBVA Research / INEGI

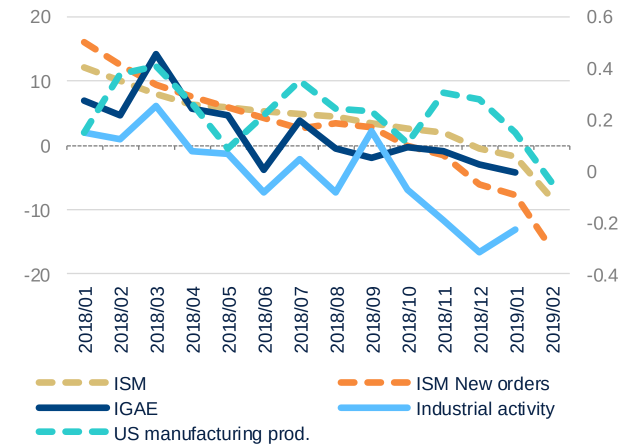
Figure 3.2 Industrial activity
(Index 2013/01 = 100)



Source: BBVA Research / INEGI

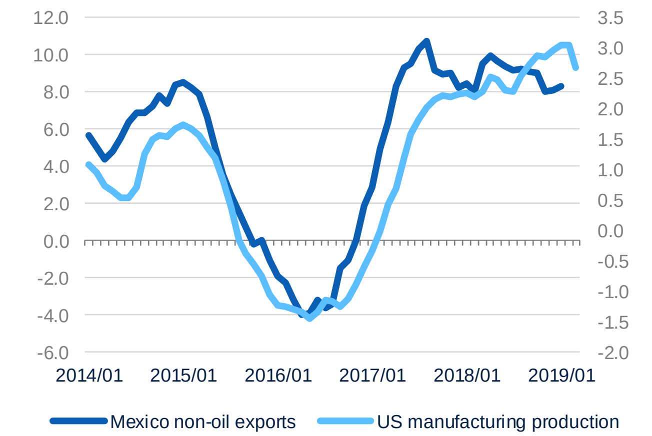
In the tertiary sector, the greatest growth was seen in services, especially personal, corporate, financial and real estate services. In January, professional and corporate services recorded an annualized monthly increase of 21.0%. This was followed by financial and real estate services, with growth of 8.5%, while educational services grew at an annualized monthly rate of 0.9%. Only transport and storage services, as well as accommodation and food preparation, registered falls of -30.1% and -15.6%, respectively. In terms of commerce, both the retail and wholesale segments show signs of greater activity with monthly changes of 5.0% and 8.0% at annualized rates. So, in global terms, the tertiary sector is showing signs of resilience in the early part of 2019.

Figure 3.3 Manufacturing Industry indicators in Mexico and the US
(MoM%, 6-month moving average)



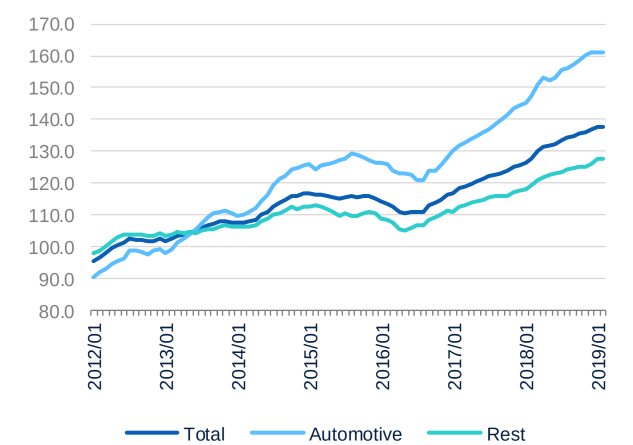
Source: BBVA Research / INEGI

Figure 3.4 Non-oil exports for Mexico and manufacturing production index in the US.
(YoY%, 6-month moving average, US one month ahead)



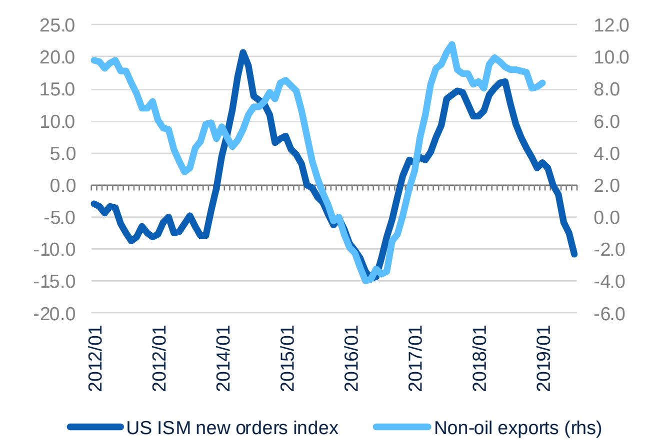
Source: BBVA Research / INEGI

Figure 3.5 Manufacturing Exports
(Index 2013/01 = 100, 6-month moving average)



Source: BBVA Research / INEGI

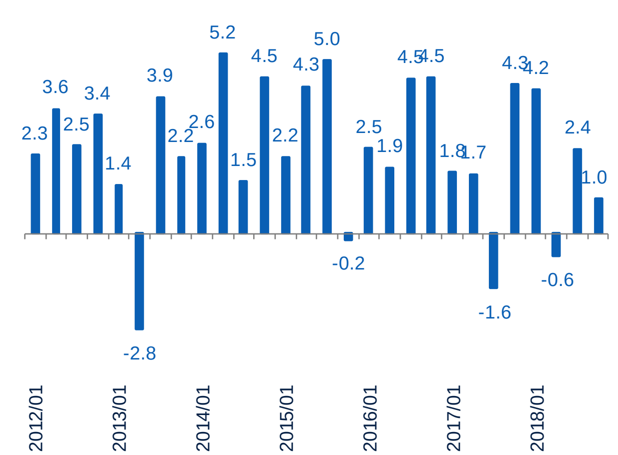
Figure 3.6 Non-oil exports for Mexico and ISM New Orders Index (YoY%, 6-month moving avg., ISM 6 months ahead)



Source: BBVA Research / INEGI

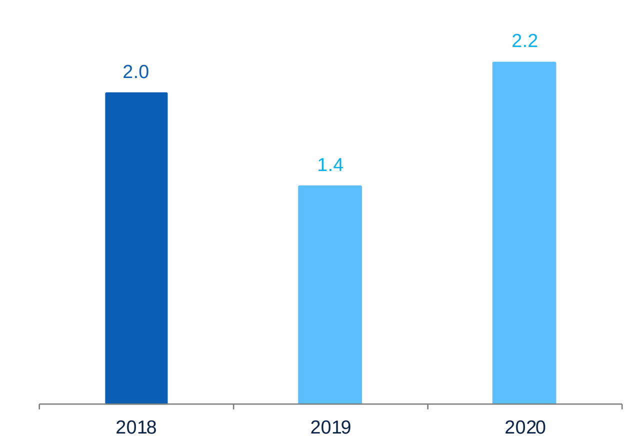
While we believe that the resilience of the tertiary sector will last throughout the year, we consider that there are latent risks to industry associated mainly with the external sector and these could materialize in the first or second quarter of 2019. In particular, the leading indicator for manufacturing orders in the US (ISM) has shown slower growth since the second half of 2018, a trend that has materialized in lower manufacturing production in the US since the third quarter of that year. Manufacturing orders in the US began to decelerate in February 2018 (YoY%) and turned negative in July, the month in which they registered a -0.7% change. Since September, this index has consistently registered negative growth rates, averaging -10.0% from September to December and -12.2% from January to February. Due to the high correlation between Mexican manufacturing exports and US manufacturing production, we estimate that the weaker external demand indicators seen since 2018 will be reflected in the domestic manufacturing sector between the first and second quarter of this year. The first signs are already beginning to appear in 2019. In February, manufacturing exports showed the largest fall in the moving average for the annualized monthly rate since 2016 (1.6%). The slowdown in the export sector in Mexico, especially manufacturing which accounts for 90% of all exports, leads to our downward revision of growth in 2019 to 1.4%, with growth in 1Q19 close to -0.1%. The key element of the economy this year will therefore be domestic demand, driven by private consumption and the gradual recovery of investment toward the second half of the year, in the face of a context of less uncertainty.

Figure 3.7. GDP
(Annualized quarterly rate, %)



Source: BBVA Research / INEGI

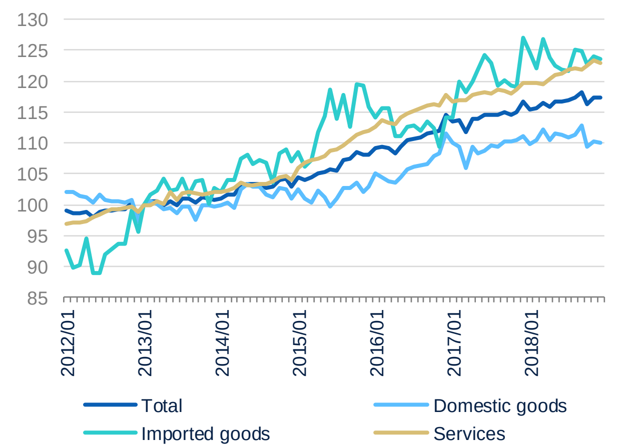
Figure 3.8. GDP
(% YoY)



Source: BBVA Research / INEGI

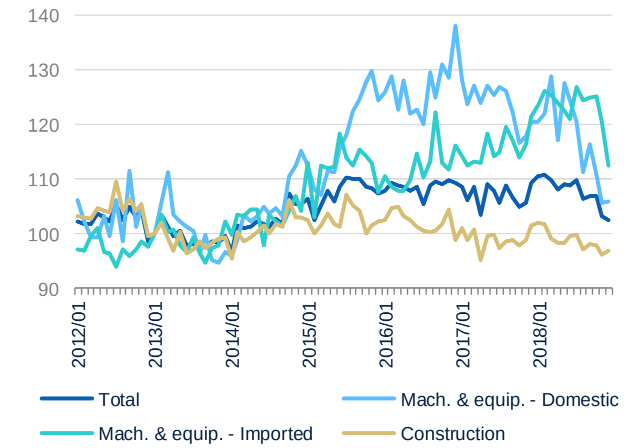
While in the final quarter of 2018 private consumption registered an annualized quarterly change of -1.1%, we consider that its weakness was temporary and associated with the context of uncertainty resulting from the change of administration. Early 2019 figures already show positive signs: for the first time since December 2017 total sales of light vehicles in the country (in vehicle units) registered an increase (YoY%) of 0.4%, after averaging -8.7% in 4Q18, and -5.3% during January and February. In turn, the indices for retail income from the supply of goods and services grew 2.0% in the first month of 2019 (MoM), after averaging -1.4% in 4Q18. We believe that in 2019 private consumption will be favored by the greater purchasing power of economic agents in a scenario of lower inflation and at the margin by higher expenditure derived from the new social programs, so we anticipate real growth in this component of GDP of close to 2.0% per year.

Figure 3.9 Monthly private consumption indicator
(Index 2013/01 = 100)



Source: BBVA Research / INEGI

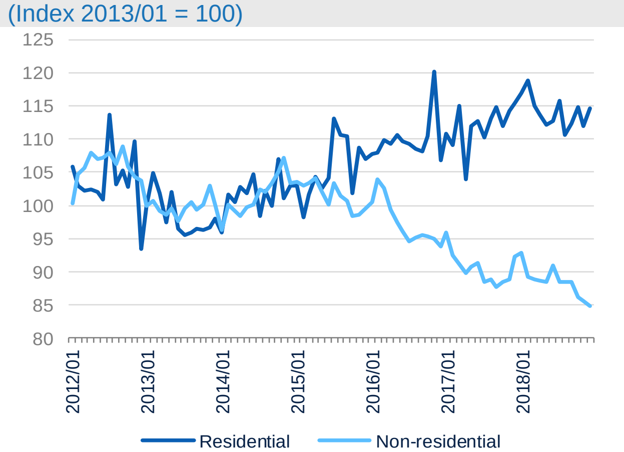
Figure 3.10 Gross Fixed Investment
(Index 2013/01 = 100)



Source: BBVA Research / INEGI

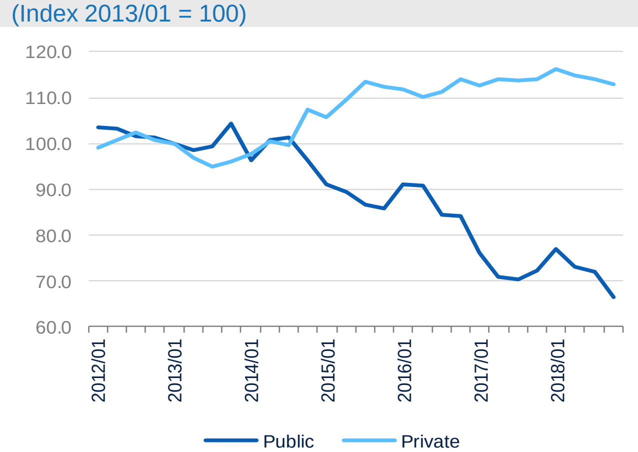
In 4Q18, for the third consecutive quarter, private investment registered a quarterly fall, equivalent in annualized terms to -3.8%, as a result of falls in the domestic and imported machinery and equipment and non-residential construction segments. The first of these segments registered a decrease of -7.4% and -4.8% (QoQ), respectively, while the latter showed a change of -3.3% (QoQ). Only residential construction has reported growth in recent months, with an average growth of 8.5% from October to December. Since 2016, private investment has followed a low-growth path that was accentuated toward the second half of 2018 as a result of the election and the greater uncertainty associated with the economic and social policies of the new government. Although the low growth in investment is likely to continue into 1Q19, we believe that this variable will gain momentum progressively from the second half of the year as concerns about what path the economic policy of the new administration will take eventually dissipated. The business confidence and right time to invest indicators for March are already pointing in that direction, reporting higher growth in March, especially in the services sector and construction. Thus, we anticipate that private investment will grow by about 3% by 2020.

Figure 3.11 Construction
(Index 2013/01 = 100)



Source: BBVA Research / INEGI

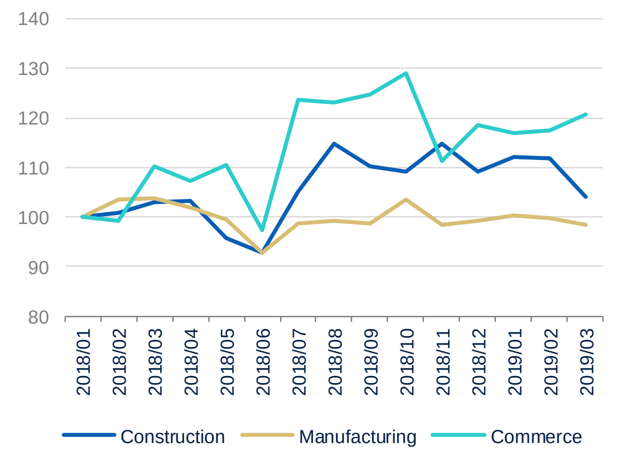
Figure 3.12 Gross Fixed Investment
(Index 2013/01 = 100)



Source: BBVA Research / INEGI

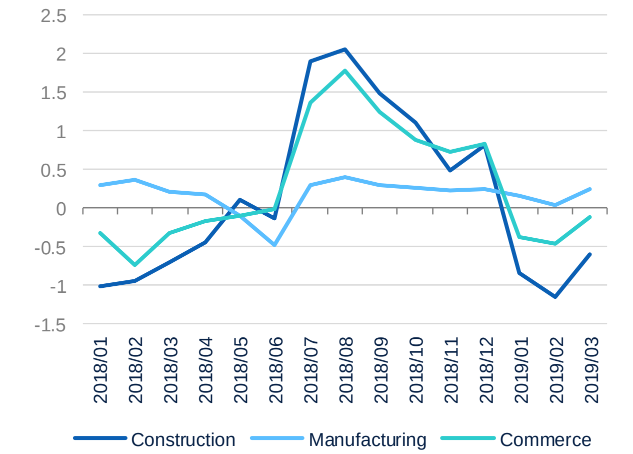
For the third consecutive quarter, public investment found itself in negative territory at the end of 2018, with a slowdown of -27.5% in annualized terms for 4Q18. The historical series for this variable points toward a marked slowdown at the end of each six-year period that generally continues into the first year of the incoming administration, so we anticipate that the slow dynamism of public investment will continue in 2019, recording an annual growth rate of about -4%. In keeping with public investment, we estimate that government consumption will record low growth rates since we are in the first year of the new government, which represents a learning curve in terms of carrying out spending. In annual terms, we anticipate that public consumption will show a change of about -0.5%.

Figure 3.13 Right Time to Invest
(Index 2018/01 = 100)



Source: BBVA Research / INEGI

Figure 3.14 Business Confidence Indicator
(MoM%, 6-month moving average)



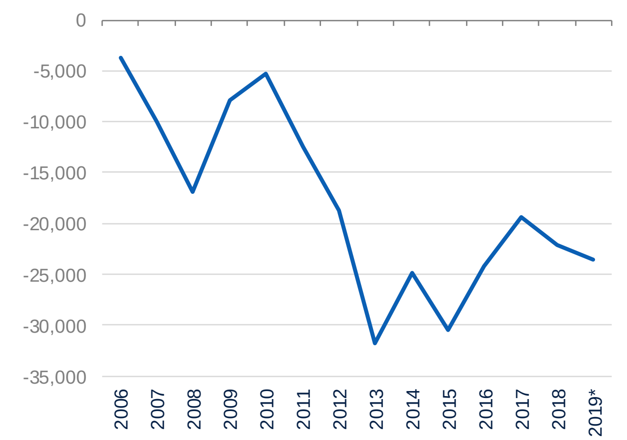
Source: BBVA Research / INEGI

The current account deficit increased marginally in 2018 vs. 2017, due mainly to larger deficits in the balances for oil products and primary income.

Having stood at US$19.4 billion in 2017, the current account deficit increased to US$22.2 billion in 2018 (Figure 3.15). In terms of GDP, the current account deficit increased from 1.7% to 1.8% (Figure 3.16). The information for the fourth quarter of 2018 indicates that the current account deficit was US$3.4 billion, the annualized figure for which equates to 1.1% of GDP. For 2019 we predict that the current account deficit will be roughly US$23.6 billion, or 1.8% of GDP.

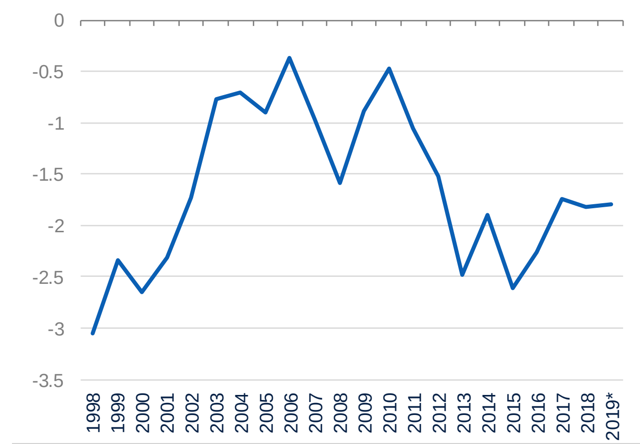
On analyzing the behavior of the current account deficit in the fourth quarter of 2018, we see that it declined relative to the figure from the third quarter of 2018 (Table 3.1). This is mainly due to a bigger surplus in the non-oil goods balance.

Figure 3.15 Current account
(US$ millions)



* Forecast
Source: BBVA Research with Banxico data

Figure 3.16 Current account
(% GDP)



* Forecast
Source: BBVA Research with Banxico data

When we compare the behavior of the current account deficit in 2018 vs. 2017, we can note that the increase in this deficit by US$2.8 billion is mainly due to the higher deficits in balances for oil goods and primary income (Table 3.2). The latter is largely due to the more dynamic evolution of imports of gasoline and diesel, as well as to the higher net return on fixed and financial assets held by non-residents. In relation to gasoline imports, Mexico imported from the US (its main international supplier of gasoline) an average of 517,000 barrels a day in 2018 vs. 425,000 barrels a day in 2017. In other words, these imports showed an annual increase of 21.7% in 2018.

Table 3.1 The current account and its components in the fourth quarter of 2018 and the third quarter of 2018
(US$ millions)

	Jul-Sep 18 (A)	Oct-Dec 18 (B)	Difference (B-A)
Current account	**-5.703**	**-3.424**	**2.279**
Bal. on goods and services	-8.660	-5.208	3.452
Balance on goods	-5.721	-3.534	2.186
Bal. on oil products	-6.037	-6.866	-829
Bal. on non-oil goods	363	3.385	3.021
Bal. on goods procured in ports by carriers	-47	-53	-6
Balance on services	-2.939	-1.673	1.266
Bal. on primary income	-5.313	-6.779	-1.466
Bal. on secondary income	8.269	8.563	294

Source: BBVA Research based on data from Banxico

Table 3.2 The current account and its components in 2017 and 2018
(US$ millions)

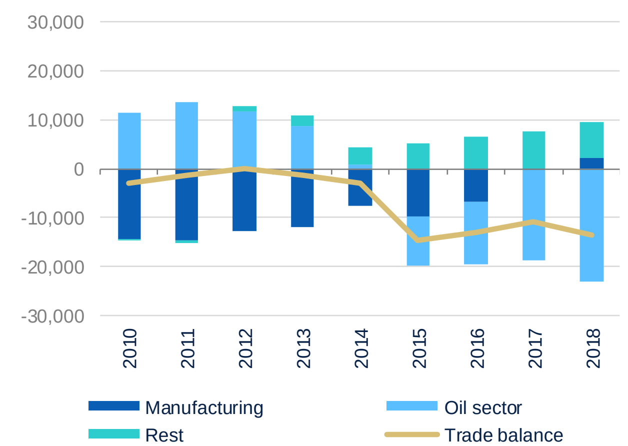
	Jan-Dec 17 (A)	Jan-Dec 18 (B)	Difference (B-A)
Current account	**-19.401**	**-22.186**	**-2.785**
Bal. on goods and services	-20.807	-22.587	-1.780
Balance on goods	-10.990	-13.882	-2.892
Bal. on oil products	-18.309	-23.190	-4.881
Bal. on non-oil goods	7.341	9.485	2.144
Bal. on goods procured in ports by carriers	-22	-178	-156
Balance on services	-9.817	-8.705	1.112
Bal. on primary income	-28.268	-32.277	-4.009
Bal. on secondary income	29.674	32.678	3.004

Source: BBVA Research based on data from Banxico

With regard to the balance of trade, the deficit increased from US$11.0 billion in 2017 to US$13.7 billion in 2018. This larger deficit was mainly explained by the substantial increase in the deficit of the oil trade balance, which increased from US$18.3 billion to US$23.2 billion between 2017 and 2018 (Figure 3.17). For 2019 we estimate that the trade deficit will stand at US$13.8 billion.

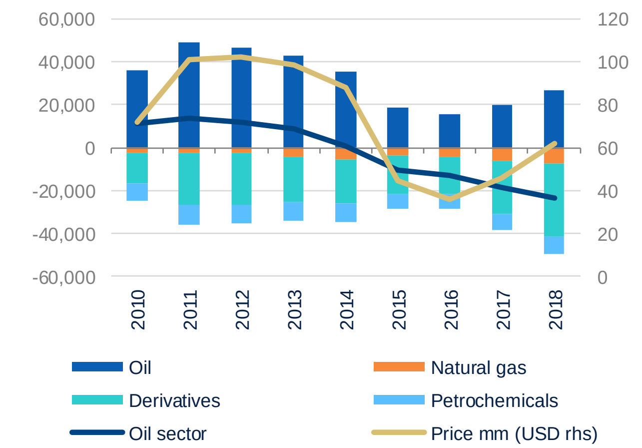
It is worth noting that the balance of trade in crude oil, natural gas and petroleum products has been in deficit since 2015 (historically, this balance had been in surplus). Despite the yearly increase in the value of crude oil exports in 2018, the balance of trade of the oil industry as a whole increased its deficit relative to 2017 (Figure 3.18). This was mainly due to the increase in the trade deficit of petroleum products resulting from higher levels of gasoline and diesel imports.

Figure 3.17 Balance of trade and main components
(US$ millions)



Source: BBVA Research based on INEGI data

Figure 3.18 Trade balances in the oil sector
(US$ millions)



* mm. means Mexican export mix
Source: BBVA Research based on INEGI data

Public Finances: total public revenues for the first two months of 2019 registered a real annual fall of 3.9%, while total net expenditure showed a real annual reduction of 7.7% in the same period.

Total public sector budget revenue showed a real annual decrease of 3.9% in the January-February 2019 period. If we break down total budgetary revenues into components, non-tax income (including the federal government's petroleum revenue) reported a real annual reduction of 4.8% in the same period. Tax revenues meanwhile showed a real annual increase of 3.4% in the first two months of 2019. Although excise tax (IEPS) on gasoline and diesel contributed 4.0 pp to the real annual change in tax revenue, this positive contribution was frustrated by the 2.6 pp dampening effect on any tax revenue buoyancy of VAT. For its part, income tax (ISR) also made a positive contribution of 1.6 pp to tax revenue growth. With regard to import taxes, they added 0.4 pp to the real annual growth of tax revenues.

Income tax is an important component of tax revenue due to its weight in its overall structure (accounting for 53.1% in January-February 2018). Although income tax showed a real annual change of 3.1% in this period, this compares unfavorably with real annual growth of 5.2% observed in January-February 2018.

Public sector oil revenues accounted for 12.3% of total budget revenues in the period January-February 2019 (17.6% during the same period in 2018). It is important to note that this revenue item decreased in annual terms in January-February 2019, at a real rate of 32.7%.

Table 3.3 Total public sector budget revenue in January-February (MXN billions)

	2018	2019	Real % change	Struc. %
Total	853.2	853.9	-3.9	100.0
Federal Government	660.3	700.5	1.9	82.0
Tax	536.6	577.8	3.4	67.7
Income tax	285.5	306.6	3.1	35.9
VAT	173.3	165.7	-8.2	19.4
Non-tax	123.7	122.7	-4.8	14.4
Budget controlled agencies and companies	60.2	65.8	4.9	7.7
State-owned production enterprises	132.7	87.7	-36.5	10.3
Pemex	68.0	24.5	-65.4	2.9
CFE (state-owned electric utility)	64.7	63.2	-6.2	7.4
Total	853.2	853.9	-3.9	100.0
Oil revenue	150.5	105.5	-32.7	12.3
Non-oil revenue	702.6	748.5	2.3	87.7

Source: BBVA Research with SHCP data

Table 3.4 Net public sector expenditure in January-February (MXN billions)

	2018	2019	Real % change	Struc. %
Total	933.7	897.2	-7.7	100.0
Projected expenditure	639.6	629.7	-5.5	70.2
Current expenditure	525.8	511.9	-6.5	57.1
Capital expenditure	113.8	117.9	-0.6	13.1
Non-projected	294.1	267.4	-12.7	29.8
Funding for States	144.7	162.0	7.5	18.1
Borrowing cost	81.8	94.6	11.1	10.5
Adefas* and other	67.6	10.8	-84.6	1.2

* Debts from previous fiscal years
Source: BBVA Research with SHCP data

As far as net public sector expenditure in January-February 2019 is concerned, this registered a real annual fall of 7.7%. This was mainly due to non-projected expenditure (which represented 29.8% of total net public sector expenditure in January-February 2019), with a real annual reduction of 12.7% in the period. Projected expenditure exhibited a real annual decline of 5.5% in the first two months of 2019. Within this expenditure, it should be noted that this decline is almost entirely explained by current expenditure cuts, which experienced a real annual decrease of 6.5%, while capital expenditure registered a real annual fall of 0.6%.

It is important to recognize that federal funding, public pensions, and the cost of public borrowing continued to place pressure on the public finances in January-February 2019. Nevertheless, our calculations show that without financial investment and the expenditure items referred to, other expenditure saw a bigger fall, having shown a real annual decrease of 19.5% over that period.

The greater real annual decrease experienced by this more limited expenditure item is a sign of an even greater effort on the part of the federal government to maintain a certain degree of financial discipline over the items that are more directly under its control. The federal government will have to continue with its spending containment efforts during the February-December 2019 period to achieve the target of MXN 241.7 billion or 1.0% of GDP for the primary surplus.

In the period January-February 2019, the public sector's primary balance showed a total of MXN 57.7 billion vs. 7.3 billion in the same period of 2018. The primary surplus was largely due to the positive balance of MXN 73.8 billion from the federal government, which was offset by the negative balance of MXN 22.4 billion from agencies and companies.

Table 3.5 Indicators of public expenditure in the period January-February (MXN billion)

	2018	2019		
	Nominal	Nominal	Real	Real % change
Total net expenditure	933.7	897.2	861.4	-7.7
Without financial investment	918.8	876.4	841.5	-8.4
Without financial investment and state funding	774.1	714.4	685.9	-11.4
Without financial investment, state funding and pensions	636.6	560.0	537.7	-15.5
W/o financial investment, state funding, pensions & cost of borrowing	554.9	465.4	446.8	-19.5

Source: BBVA Research with SHCP data

Table 3.6 Financial position of the public sector in January-February (MXN billion)

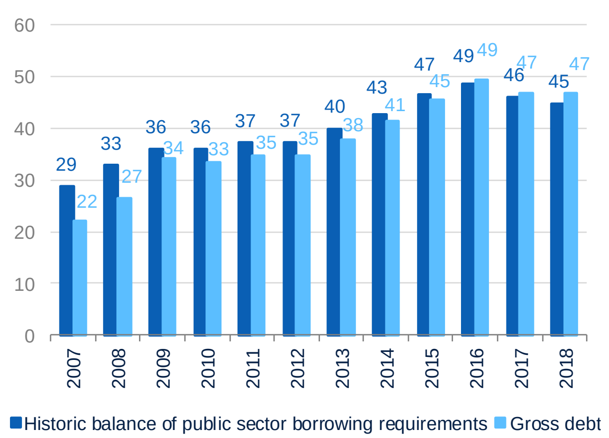
	2018	2019	Real % change
Public balance	-67.8	-27.6	-60.9
Public bal. w/o prod. invt.	30.6	69.3	117.6
Budget balance	-80.5	-43.2	-48.5
Budget revenue	853.2	853.9	-3.9
Net budget expenditure	933.7	897.2	-7.7
Federal Government balance	-74.9	8.7	n.s.
Bal. Agencies and companies	-5.6	-51.9	783.6
Primary balance	7.3	57.7	663.1
Budget balance	1.2	51.4	3950.8
Federal Government	-27.7	73.8	n.s.
Agencies and companies	28.9	-22.4	n.s.
Pemex	-0.8	-54.4	6368.0
Other institutions	29.7	31.9	3.3
Indirectly-controlled institutions	6.0	6.3	-0.2

n.s. non-significant
Source: BBVA Research with SHCP data

Gross public debt stood at 46.8% of GDP at the close of 2018. The debt level is 0.1 pp lower than the ratio of public debt to GDP seen at the close of 2017. As regards the breakdown of this debt into domestic and external components, external debt fell from 37.3% in 2017 to 36.1% at the end of 2018.

At the end of 2018, the stock of public debt (SHRFSP) was 16.0 pp of GDP higher than its level in 2007. This broad indicator of public debt stood at 44.8% and 46.0% of GDP at the end of 2018 and 2017 respectively. We anticipate that the SHRFSP will close 2019 at 45.5% of GDP.

Figure 3.19 Gross debt and the balance of public sector borrowing requirements (% of GDP)



Source: BBVA Research with SHCP data

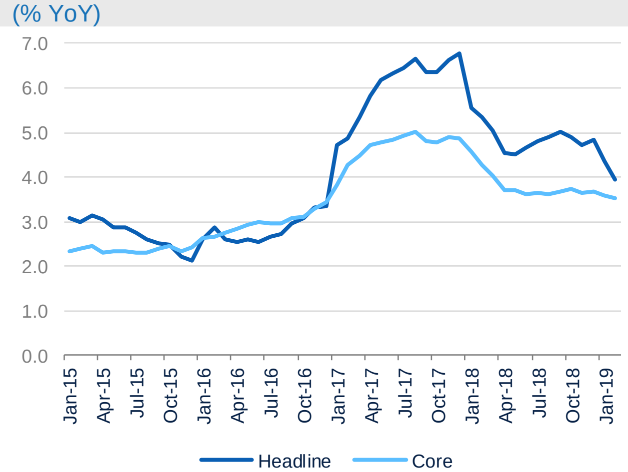
Figure 3.20 Percentage structure of internal and external public sector debt (% of total debt)

Source: BBVA Research with SHCP data

4. Inflation has had a great start to 2019: the cumulative increase of 0.1 pp in January-February is the lowest since 2015, a year in which inflation reached an all-time low

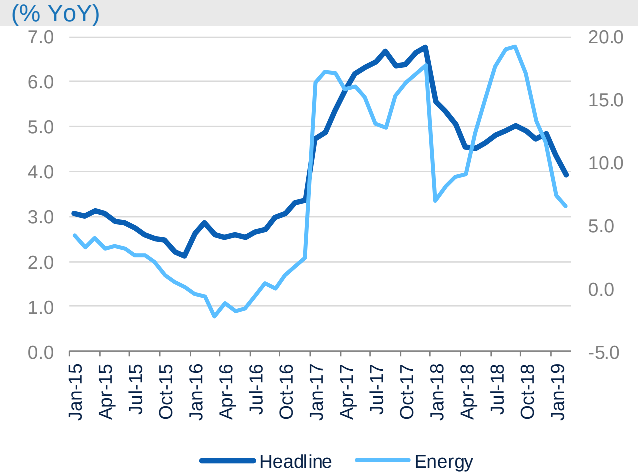
Following the temporary increase in general inflation in the third quarter of 2018, which was mainly due to the acceleration in the increase in energy prices (see Figure 4.2), it fell by 0.1 pp on average in the fourth quarter (from 4.91% to 4.82%). This decrease is explained by the fall in non-underlying inflation from an average of 8.78% to an average of 8.32%, with stable underlying inflation - increasing from 3.64% in 3Q18 to 3.68% in 4Q18 - despite the scale of the supply shocks in energy prices. Thus, following the rapid decline in underlying inflation in the first four months of 2018, in which it decreased by 1.2pp (from 4.87% to 3.71%), inflation fluctuated in a narrow range of 3.6-3.7% for the rest of the year. The resistance of underlying inflation to any decrease during this period was mainly explained by a slight increase in service prices (inflation in this sub-index increased from 3.15% in April 2018 to 3.47% in December) which was offset by lower inflation for goods which fell from 4.35% in April to 3.92% in December. The increase in service prices was mainly due to indirect effects on transport services resulting from a sharp increase in gasoline prices. For its part, the lower rate of decline in goods is explained by a temporary rebound in inflation for processed food that was also due to indirect effects following sharp increases in perishable food prices in the second half of the year. It is noteworthy that underlying inflation remained stable despite the increases observed in real wages and the context of little economic slack during 2018.

Figure 4.1 General and Underlying Inflation*
(% YoY)



Source: BBVA Research / INEGI

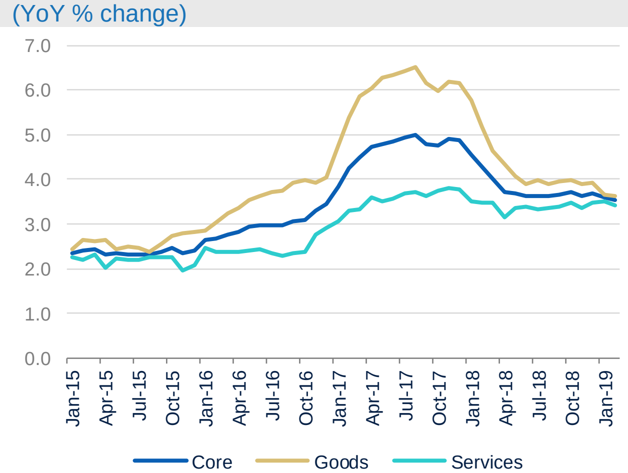
Graph 4.2 General and Energy Inflation*
(% YoY)



Source: BBVA Research / INEGI

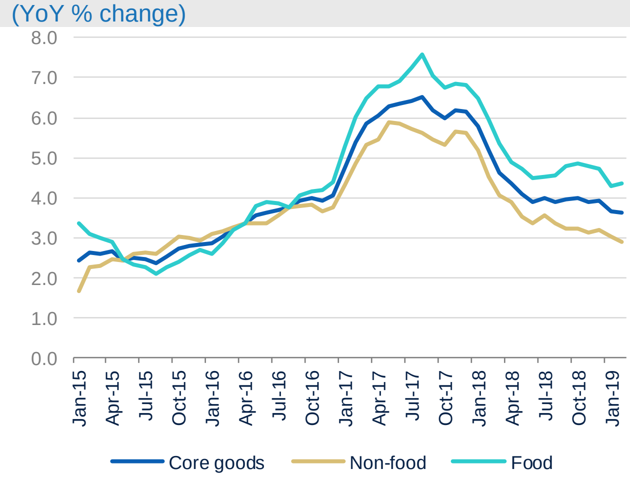
In contrast to the temporary increase in general inflation in the second half of 2018 (from 4.65% in June to 4.83% in December) and the stability of underlying inflation in the same period (from 3.64% in June to 3.68% in December), in the first two months of 2019 it has had a very favorable performance. The cumulative increase of 0.1 pp in January–February is the lowest since 2015, when inflation reached a historical minimum of 2.1%. In that year, cumulative inflation—so low for a period in which it typically increases between 0.8 and 0.9 pp (see Figure 4.1)—was a response to the favorable effects of telecommunications reform that removed a range of charges, including those for long distance calls. In fact, cumulative inflation in 2019 is even lower (0.06 pp compared to 0.10 pp in 2015). In light of this, headline inflation fell 0.9 pp between December 2018 and February of this year (from 4.83% to 3.94%), falling below 4.0% for the first time since December 2016. This decrease is due to lower energy prices (see Figure 4.2) and a fall of 12 pp in fruit and vegetable prices between the first half of January and the second half of February. In these two months, core inflation also fell, albeit at a slower rate, moving from 3.68% in December to 3.54% in February. This slight decrease, which finally saw core inflation fall below the narrow 3.6–3.7% band it occupied between between April 2018 and January 2019, was in response to a slight decrease in the inflation of goods (see Figure 4.3). This in turn was due to the continued good numbers for non-food goods (see Figure 4.4), where inflation has already fallen 0.3 pp so far this year (it fell from 3.18% in December 2018 to 2.90% in February) and it is now below 3.0% for the first time since December 2015. This was back before the whole pass-through period (i.e. the transfer of the exchange rate to prices), caused by the effects on the exchange rate of Trump's presidential candidacy nomination in April 2016 and his eventual triumph in November of the same year. The effects of the pass-through on inflation have now dissipated. If core inflation has not decreased at a slower rate, it is because of shocks that have been recorded to energy and perishable food prices. In the absence of these shocks, core inflation would have been less resistant to the fall and have been closer to 3.0%.

Figure 4.3 Core inflation and components
(YoY % change)



Source: BBVA Research/INEGI (National Statistics Institute)

Figure 4.4 Core inflation of goods and components
(YoY % change)

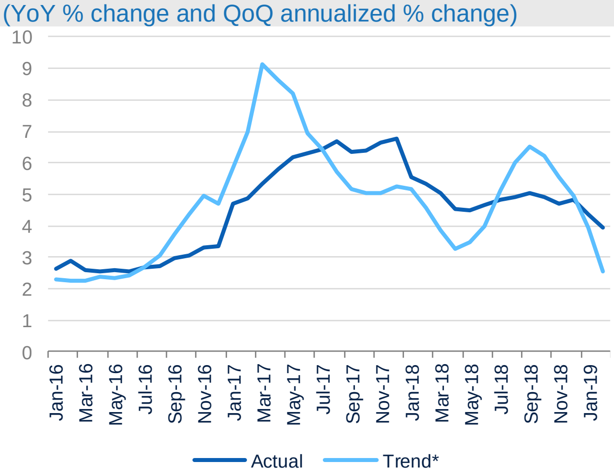


Source: BBVA Research/INEGI

Slower convergence rate than the current 3.0% target with a predictable transient increase in headline inflation in 2Q19

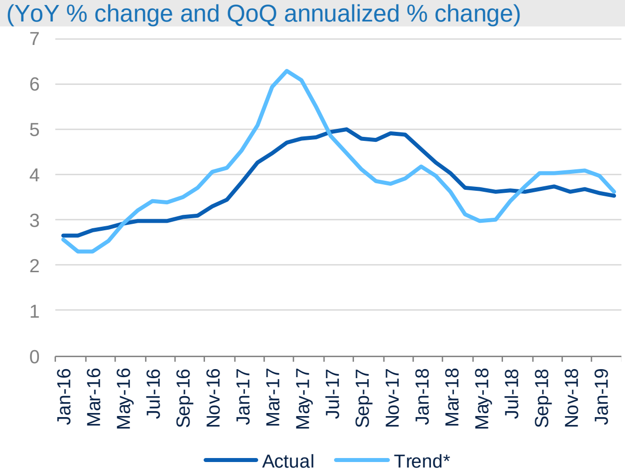
Recent trends in overall and headline inflation suggest that both will decrease in the coming months, although core inflation will fall at a slower rate (see Figures 4.5 and 4.6). However, we anticipate a transitory increase in headline inflation by 2Q19 that will take it again above 4.0% before falling below that level in 3Q19. It should then fall further to 3.4% by the end of this year (-0.3 pp compared to our previous forecast of 3.7%). On the other hand, we anticipate that core inflation will remain relatively stable between March and October (fluctuating between 3.5 and 3.6%) before falling to 3.3% in the last two months of the year (i.e. we are maintaining our forecast of 3.3%).

Figure 4.5 Headline inflation: actual and trend*
(YoY % change and QoQ annualized % change)



*Own calculations based on seasonal adjustment of the headline inflation index.
Source: BBVA Research/INEGI

Figure 4.6 Core inflation: actual and trend*
(YoY % change and QoQ annualized % change)



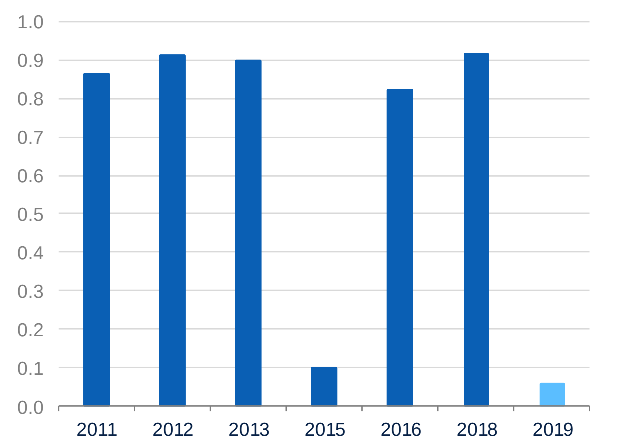
Own calculations based on seasonal adjustment of the core inflation index.
Source: BBVA Research/INEGI

The balance of risks for inflation has improved and is more balanced

Our inflation forecasts are subject to both downside and upside risks. The risks have improved and are more balanced. The main upside risks continue to be associated with future exchange rate performance. We believe that the risks to the exchange rate continue to skew upwards. This could be affected by both external factors, such as a possible resurgence of fears over the failure of the US Congress to ratify the new North American Free Trade Agreement in the US Congress, and internal ones, such as a possible further deterioration in the Pemex situation affecting the exchange rate if the perception is that the deterioration would eventually result in a deterioration of public finances. In addition to these upside risks associated with the exchange rate, pressures on energy prices and/or fruit and vegetable prices could resurface, resulting in new supply shocks. In our view, the increase in the minimum wage does not represent an upside risk. This is because the increase does not exceed that of labor productivity over the last 25 years, only 3% of workers in the formal sector receive it and, in a context of a weaker economy/higher output gap, it will not increase the bargaining power of workers who receive two or more minimum wages, thereby avoiding a transfer of this increase to other wages.

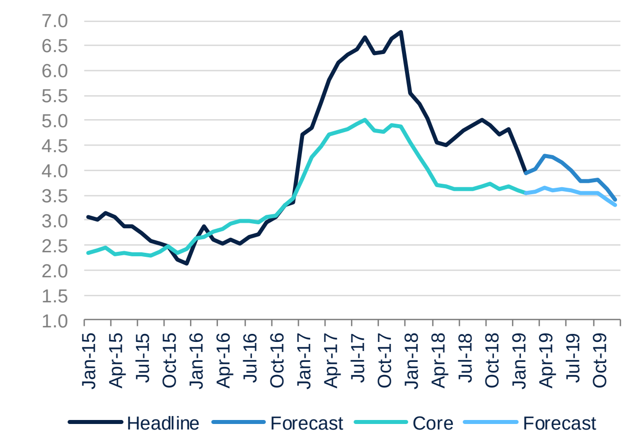
The main downside risks are associated with the weakness of the economy, which is translating into a higher output gap and continues to explain the absence of demand pressures on prices. In addition, the favorable performance of non-core prices could continue in a context where the new administration has committed itself not to increase gasoline prices beyond inflation. If this target were reached in 2019, gasoline prices (representing 6% of the basic goods subject to headline inflation) would not increase for the rest of the year, limiting the potential upward pressures resulting from a possible surge in energy prices on the international market.

Figure 4.7 Cumulative inflation January-February by year (Percentage points)



Source: BBVA Research/INEGI

Figure 4.8 Outlook for headline and core inflation (YoY % change)



Source: BBVA Research/INEGI

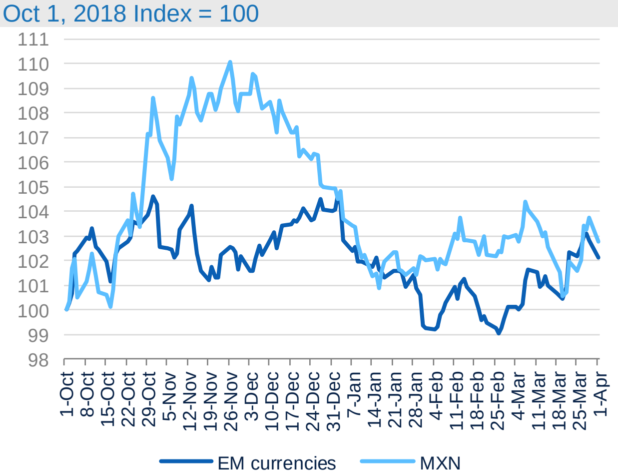
Monetary policy: caution in the short term; start of cycle of falls in the second half of the year

After the Banco de Mexico Governing Board (the Board) decided to increase the monetary rate by 25 basis points (bp) as a preventative measure at each of its last two meetings of 2018 (in November and December), bringing the rate to 8.25%, it decided unanimously to leave the rate unchanged at its February and March meetings this year. Although the language of the last two Banxico monetary policy statements remains hawkish, with the door even being left open to fresh hikes if necessary (monetary policy will be adjusted "in a firm and timely manner"), the tone is less restrictive than it has been on previous occasions and shows signs that, in the absence of any further decline in the balance of risks for inflation, a monetary pause is the most likely scenario in the coming months.

Although Banxico's communication gives no sign that it has begun to discuss the possibility of lowering the monetary rate, and in general terms, the Board has not softened its tone, it also seems clear that Banxico is no longer inclined to make additional preventive increases. As we anticipated, Banxico has changed from a preventive approach (with preventive increases in the monetary rate), to a cautious one of wait and see regarding the evolution of the balance of risks for inflation. The monetary policy paragraph in the last statement remained unchanged. The Board repeated that "it will maintain a prudent monetary policy stance" and adjust rates in a "firm and timely" manner if necessary. The Board also repeated that the balance of risks for inflation remains tilted upwards. Banxico noted that inflation has fallen this year and acknowledged that core inflation declined, but downplayed the latter by noting that processed food prices have recently increased. It also highlighted the risk posed by persisting core inflation. Banxico also acknowledged the recent decline in analysts' inflation expectations and those implicit in market instruments, but stressed that they remain high and above target. From our point of view, the statement added a slight dovish change by mentioning that "some of the risk factors [of inflation] have intensified downwards." However, Banxico stressed that "other factors may push it further upwards and divert it from the expected trajectory."

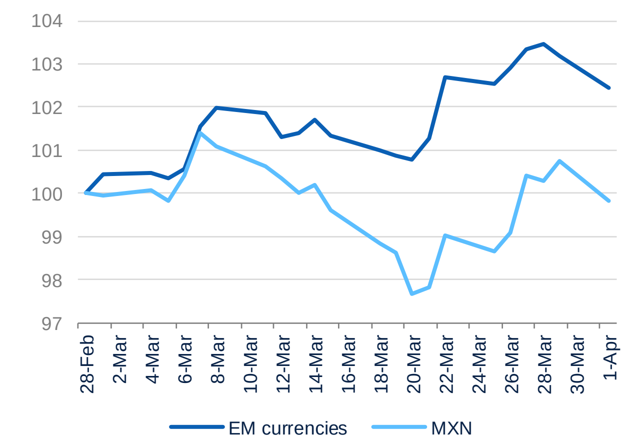
Despite the hawkish tone and the wait-and-see approach that Banxico seems to have adopted in 1Q19, we believe that it is likely to change to a gradual easing approach to its monetary stance sooner rather than later. There are several reasons for this: i) the Federal Reserve has given clear signs that in the absence of unanticipated increases in inflation it will not increase its monetary rate for the remainder of the year; ii) the exchange rate is relatively stable despite the risks; iii) we forecast headline inflation to be below 4.0% permanently after summer; (iv) we anticipate that the core rate will remain stable before falling in 4Q19; v) the economy is showing clear signs of weakening and, consequently, the weaker cyclical position of the economy is translating into an increase in the output gap, limiting the upward risks from the labor market; and vi) the monetary stance is highly restrictive: the forecast real monetary policy rate is above 4.0%—high by historical standards—and significantly higher than the estimate of 2.0% for the neutral rate.

Figure 4.9 MXN vs emerging currencies*
Oct 1, 2018 Index = 100



* Own calculations based on a reweighting of the JP Emerging Markets Currency Index after removing MXN
Source: BBVA Research/Bloomberg

Figure 4.10 MXN vs emerging currencies*
Feb 28, 2019 Index = 100



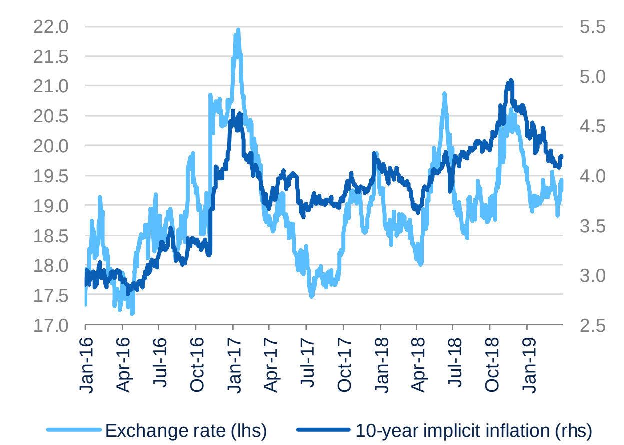
*Own calculations based on a reweighting of the JP Emerging Markets Currency Index after removing MXN
Source: BBVA Research/Bloomberg

In this context, in our view, the case for a less restrictive monetary policy stance will be strengthened in a few months. We believe that Banxico will begin to make its monetary stance more flexible in August and we forecast rate cuts of 50 bp this year (25 bp in August and 25 bp in November, reducing the policy rate to 7.75% by year-end) and another 100 bp of cuts next year (to 6.75%).

Why we expect Banxico to start reducing rates this year...

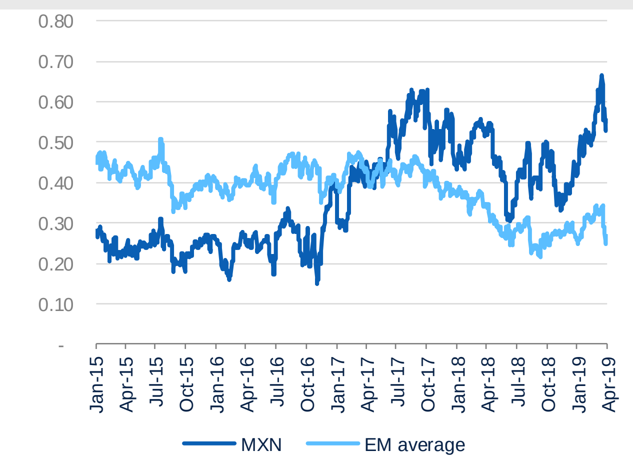
1. The balance of risks for inflation continues to improve, with the good inflation behavior, the strengthening of the peso and the subsequent relative stability of the exchange rate, and the decline in inflation expectations. Headline inflation has fallen more than expected in 1Q, which gives Banxico less reason to be concerned about its trend, after the rebound driven by the supply shocks observed during 4Q18. After strengthening during December and the first half of January, the peso has been relatively stable. In fact, concerns about Mexico have decreased and with this, the peso has completely recovered from the marked negative differentiation observed between October and November 2018 after the cancelation of NAIM (Mexico City's new international airport) (see Figures 4.9 and 4.10). Risks to the peso continue to skew upwards, and are mainly related to Pemex (the government still needs to address Pemex's problems in a credible way), sovereign rating, implementation of the 2019 budget and future fiscal pressures, and a possible delay by the US Congress in ratifying the North American Trade Agreement. However, with the Federal Reserve on the sidelines and fewer concerns about Mexico, the context for emerging currencies and the MXN has improved. In addition, long-term market-based inflation expectations have receded after the peso spike (see Figure 4.11) and analysts' consensus estimates have also declined (analysts' consensus now expects headline inflation of 3.7% by year-end compared to 4.0% at year-beginning).

Figure 4.11 Long-term inflation expectations derived from market instruments* and exchange rate
% and ppd (pesos per dollar)



* 10-year breakeven
Source: BBVA Research/Bloomberg

Figure 4.12 Risk-adjusted carry-trade*
%

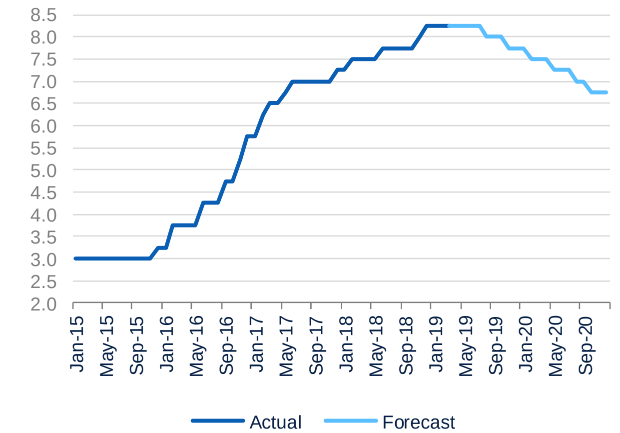


* Own calculations based on the monetary rate differential and adjusted with implied volatility to one month for each currency
Source: BBVA Research/Bloomberg

2. The Federal Reserve is likely to remain on the sidelines. It was difficult for Banxico to start cutting rates with a cycle of Fed increases and inflation above 4.0%, but with a less favorable outlook for the US economy, there is an increasing likelihood of no more rate increases in 2019. In fact, after its last meeting, the Fed indicated that in the absence of higher inflationary pressures in the US (our base scenario), it would feel comfortable keeping rates unchanged. In addition, if economic conditions deteriorated significantly, the Fed could begin to consider possible rate cuts. In this context, Banxico should have fewer concerns about the relative position of monetary policy, even if it begins to cut rates by the end of this year, as the risk-adjusted carry-trade of the MXN remains very attractive (see Figure 4.12).

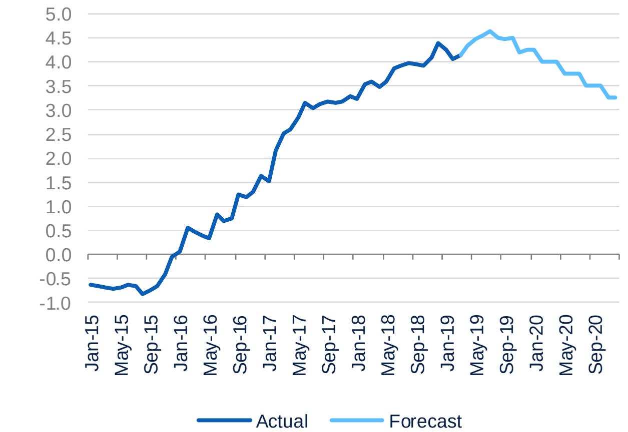
3. The marked slowdown in economic activity during 4Q18–1Q19 implies a weaker cyclical position. Consequently, the absence of demand pressures is expected to continue with the increase in output gap.

Figure 4.13 Monetary rate outlook, nominal
%



Source: BBVA Research/Banxico

Figure 4.14 Monetary rate outlook, real ex ante*
%



* The real ex ante rate is calculated as the difference between the monetary rate and the 12-month inflation expectations of the Banxico survey. Forecasts are based on our inflation forecasts.
Source: BBVA Research/INEGI/Banxico

...but not until the third quarter

Inflation is likely to rise in 2Q. Headline inflation surprisingly fell in the first five fortnights of the year, pushing annual inflation down to 3.9% from 4.8% in December. Core inflation has fallen to 3.5% from 3.7% at the end of last year, and the narrow 3.6–3.7% band in which it moved from April 2018 to January 2019. However, the sharp decline in headline inflation is mainly due to a sharp drop in fruit and vegetable prices (-12.0% between the first half of January and the second half of February). Annual headline inflation is likely to bounce back in the second quarter and remain above 4.0% at least until June, as we argued in the previous section. Core inflation is also unlikely to fall further until the fourth quarter. Therefore, Banxico will likely continue signaling that core inflation shows signs of downward rigidity. In this context, we believe it would be difficult for Banxico to start a gradual cycle of relaxation before 3Q.

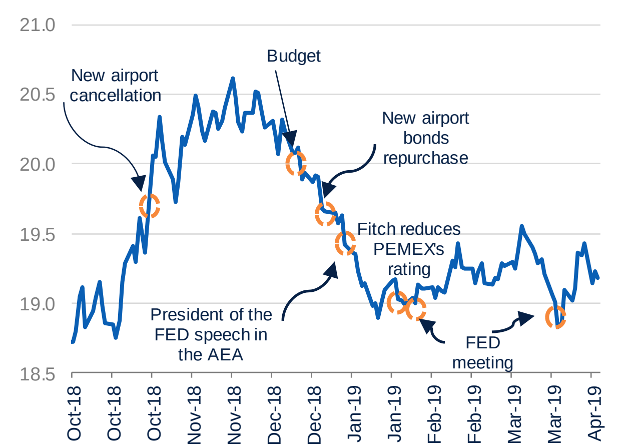
5. Recovery of domestic assets in an environment of less domestic uncertainty and monetary pause in the US

In an environment with signs of global economic slowdown, the pause in the process of monetary normalization by the US Federal Reserve (Fed) and reduced domestic risk are the main factors behind the movements in national financial markets in recent months.

The handing down of a fiscally prudent 2019 budget and the repurchase of NAIM bonds has led to market participants perceiving that the risks associated with the policies of the new administration are less likely to occur. And after the cancelation of the NAIM and the subsequent emergence of legislative initiatives on the removal of bank commissions and the nationalization of the retirement savings system, the markets seemed to disregard an adverse scenario that called compliance with fiscal discipline into question. This was clearly reflected in a negative differentiation in domestic asset prices that led to an exchange rate above 20.5 pesos to the dollar and a 10-year bond yield over 9.0%, something not seen since 2009.

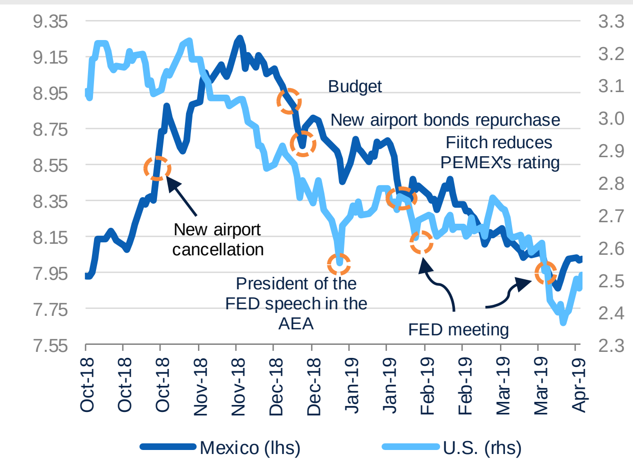
The change in investor perception of domestic risks led to a rapid recovery in asset prices, which was significantly strengthened by the change in the Fed's position. Indeed, the sudden change in language from the Fed Chairman at the beginning of January toward a "patient" stance and a greater dependence on economic data to continue the process of monetary normalization, coupled with the weakness of global economic data, caused the markets to factor in further rises in the federal funds rate in 2019. This, in turn, resulted in increased demand for emerging market assets, to the point that by mid-January, the exchange rate was below 19 pesos and the 10-year bond yield was below 8.60%.

Figure 5.1 Exchange rate (pesos to the dollar)



Source: BBVA Research based on Bloomberg data

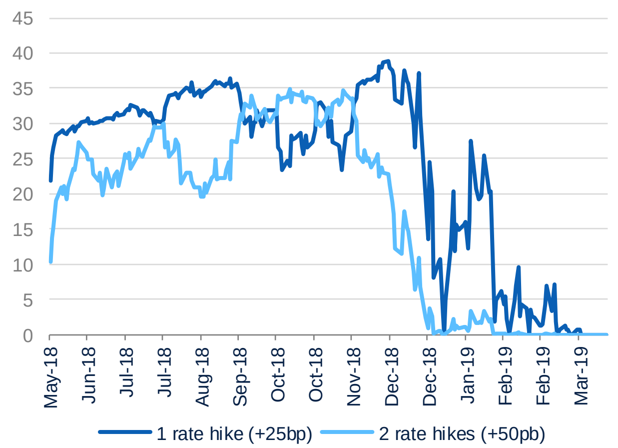
Figure 5.2 10-year bond yield, US and Mexico (%)



Source: BBVA Research based on Bloomberg data

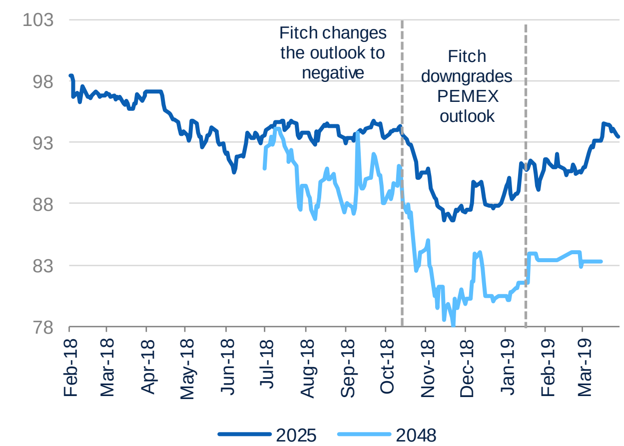
From this point, the change toward a scenario incorporating a global economic slowdown, a monetary pause by the Fed and lengthier lax positions adopted by the rest of the main central banks in developed countries was confirmed. As a result, short-term movements in financial markets have been associated with the performance of economic data as expected, in an attempt by investors to assess whether lower incomes from the economic slowdown or lower discount rates will prevail in the valuation of assets. This is particularly the case in the US, which remains the main driver of global growth while operating as a developed nation with growth above its potential.

Figure 5.3 Implicit probability of increases in the federal funds rate in 2019 (%)



Source: BBVA Research based on Bloomberg data

Figure 5.4 Price of Pemex bonds (USD)



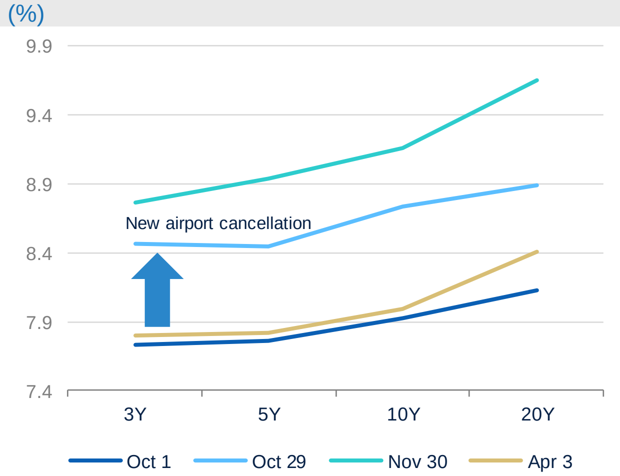
Source: BBVA Research based on Bloomberg data

While the scenario changes described above have ruled Mexican asset prices, the volatility generated by renewed concerns about Pemex's financial situation cannot be ignored. The first few weeks of the year saw growing concern regarding the financial situation of Pemex, given the risks associated with the change to its business model against a backdrop of falling oil production and debt exceeding USD 100 billion. Given the aforementioned difficult environment, the limited confidence that Pemex's directors were able to generate amongst investors and the company's difficulty obtaining significant support from the federal government resulted in Fitch Ratings downgrading its Pemex rating from BBB+ to BBB-. In addition, the close relationship between the performance of the oil company and the country's public finances has increased pressure on the country's sovereign debt rating, to the point that Standard & Poor's changed Mexico's debt outlook from stable to negative. As a result, not only did the oil company's debt experience pressure, but also several macroeconomic indicators. While Pemex's 10-year bond yield in dollars went above 8.0%, the peso was de-linked from the behavior of emerging currencies and the exchange rate again reached levels around 19.5 pesos to the dollar between February and March. However, the announcement that USD 7 billion from the Oil Revenue Stabilization Fund (FAIEP) will be used to pay off Pemex's debt maturities, thus avoiding recourse to financial markets, eased investors' concerns and managed not only to revalue Pemex's bonds, but also to regain the high correlation of the peso with emerging currencies. With this, the exchange rate is currently around 19.2 pesos to the dollar, which places it as the sixth highest appreciating currency so far this year. It should be noted that the peso has already eliminated the negative differentiation observed after the cancelation of the NAIM and has appreciated more than any other currency (6.2%) since December 1, 2018, back when the idiosyncratic risks had not yet dissipated and the Fed had not changed its position.

The fears about Pemex's financial situation had more limited effects on the Mexican curve, all of whose nodes are currently practically equal to those recorded before the NAIM was canceled. So, in an environment with falls of 70 basis points in the 10-year treasury bond yield in the last five months, the positive inflation surprises and the prospects of a cut in the monetary policy rate during the second half of the year combined so that the 10-year government bond yield fell another 60 basis points to its January level and is currently at 8.0%.

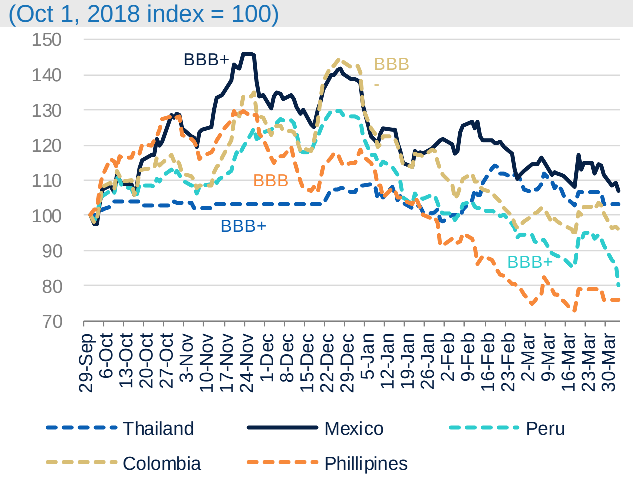
The recovery in the foreign exchange and domestic fixed income markets is far from what happened in terms of sovereign risk. While the factors described above also enabled the reduction of the sovereign risk premium, measured as the 5-year credit default swap (CDS) spread, from its maximum of 163 basis points in November, markets continue to place Mexico on par with nations like Colombia and even Russia that have debt ratings two steps below Mexico's (BBB+). This behavior has been observed for years; however, in recent months it has been accentuated by the increase in idiosyncratic risks. A similar phenomenon occurs in the dollar debt market, where Mexican debt yields remain far from Mexico's rating peers, such as Peru, and also close to those of countries like Russia that are just above investment grade. In practical terms, markets provide funds to Mexico at a significantly higher cost than warranted by its sovereign debt rating.

Figure 5.5 Government yield curve
(%)



Source: BBVA Research based on Bloomberg data

Figure 5.6 Sovereign risk, 5-year CDS spread
(Oct 1, 2018 index = 100)



Source: BBVA Research based on Bloomberg data

In terms of capital flows to domestic fixed-income instruments by foreigners, expectations of a pause by the Fed, which market participants factor in along with the restrictive levels of the monetary policy rate in our country, opened up arbitrage opportunities that were reflected in higher demand for short-term debt. In fact, the number of CETES (Mexican Federal Treasury Certificates) as a proportion of the total in circulation held by foreigners has increased from 25% to about 35% so far this year. It is important to note that before the Fed began with its monetary normalization process, foreigners held 70% of the total number of CETES in circulation. As for medium- and long-term bonds, foreigners maintain their positions without significant changes, which is similar to the behavior observed in recent years.

In sum, the signs of fiscal prudence by the new government and, above all, the change in the Fed's position, have significantly reduced price pressures on domestic assets. Looking forward, it is expected that the relative stability we have observed since the beginning of the year can be maintained as long as there are no abrupt changes in market expectations regarding the interest rate trajectory in the US. The chances of our northern neighbor experiencing a recession remain low. This is all in a domestic environment where the federal government seems to have gained time to deal with Pemex's financial situation, which is undoubtedly the main idiosyncratic risk. In this context, we expect the exchange rate to close 2019 at average levels of 19 pesos, while we expect 10-year bond yields to continue their downward trajectory to close the year below 8.0%.

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6. Forecasts

Table 6.1 Macroeconomic forecasts: Gross Domestic Product

	2016	2017	2018	2019	2020
United States	1.6	2.2	2.9	2.5	2.0
EMU	1.9	2.5	1.8	1.0	1.3
Germany	2.2	2.5	1.5	0.8	1.4
France	1.1	2.3	1.6	1.2	1.5
Italy	1.2	1.7	0.8	-0.2	0.5
Spain	3.2	3.0	2.6	2.2	1.9
UK	1.8	1.8	1.4	1.3	1.6
Latin America*	-0.2	1.8	1.5	1.7	2.3
Mexico	2.7	2.3	2.0	1.4	2.2
Brazil	-3.3	1.1	1.1	1.8	1.8
Eagles**	5.2	5.4	5.2	4.9	5.0
Turkey	3.2	7.4	2.6	1.0	2.5
Asia-Pacific	5.6	5.6	5.6	5.3	5.2
Japan	0.6	1.9	0.8	0.7	0.5
China	6.7	6.8	6.6	6.0	5.8
Asia (exc. China)	4.6	4.6	4.7	4.6	4.6
World	3.3	3.7	3.6	3.4	3.4

* Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru and Uruguay.
** Bangladesh, Brazil, China, Egypt, Philippines, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Pakistan, Russia, Turkey and Vietnam.
Forecasts closing date: 5 April 2019.
Source: BBVA Research & IMF

Table 6.2 United States indicators and forecasts

	2017	2018	2019	2020	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
Real growth (%)	2.2	2.9	2.5	2.0	1.7	2.6	2.3	1.5	2.1	2.3	1.8	2.0
Personal consumption (real % change)	2.5	2.6	2.8	2.1	3.1	2.5	2.1	2.2	2.1	2.2	2.0	2.0
Govmnt. consumption (real % change)	-0.1	1.5	1.6	0.7	2.0	1.6	1.2	0.8	0.5	0.5	0.3	0.2
Gross fixed investment (real % change)	4.8	6.0	5.2	4.0	2.7	6.0	5.2	1.2	4.4	5.0	3.7	4.8
Construction[1]	3.3	-0.2	-1.2	1.2	-2.2	1.2	1.8	1.2	0.9	1.3	1.3	1.1
Industrial prod. (real annual % change)	1.6	4.0	2.6	2.4	0.4	2.5	2.4	1.8	2.7	2.9	2.6	1.8
Current account balance (% of GDP)	-2.3	-2.3	-2.8	-2.9	-2.7	-2.8	-2.8	-2.9	-2.9	-2.9	-2.9	-3.0
Final annual inflation	2.1	1.9	2.2	1.9	1.4	2.4	2.4	2.4	1.6	1.8	2.0	2.2
Average annual inflation	2.1	2.4	1.7	2.1	0.6	2.4	2.4	2.4	1.9	1.8	1.9	2.1
Primary fiscal balance[2] (% of GDP)	-3.4	-3.9	-4.2	-4.1	-4.2	-4.2	-4.2	-4.2	-4.2	-4.2	-4.1	-4.1

1: Residential investment
2: Fiscal balance (% of GDP)
Source: BBVA Research

Table 6.3 Mexico indicators and forecasts

	2017	2018	2019	2020	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
GDP (seasonally-adjusted)												
Real annual % change	2.3	2.0	1.4	2.2	0.6	1.3	1.5	2.0	2.6	2.5	2.1	1.8
Per inhabitant (US dollars)	9,478	9,793	10,285	10,721	10,002	10,269	10,408	10,460	10,609	10,630	10,779	10,866
US$ billions	1,171	1,221	1,295	1,346	1,253	1,293	1,312	1,321	1,341	1,351	1,372	1,385
Inflation (average, %)												
Headline	6.04	4.90	3.95	3.69	4.11	4.24	3.85	3.62	3.93	3.80	3.53	3.51
Core	4.68	3.82	3.54	3.38	3.57	3.62	3.56	3.41	3.42	3.37	3.39	3.33
Financial Markets (eop, %)												
Interest rates												
Bank funding	6.75	7.69	8.10	7.21	8.25	8.25	8.08	7.83	7.58	7.33	7.08	6.83
28-day Cetes	6.69	7.62	7.94	7.17	7.97	8.02	7.99	7.80	7.55	7.30	7.05	6.80
28-day TIIE	7.12	8.06	8.43	7.51	8.56	8.59	8.34	8.09	7.84	7.59	7.34	7.09
10-year Bond (%, average)	7.18	7.97	8.10	7.58	8.56	8.10	8.04	7.91	7.77	7.66	7.51	7.39
Exchange rate (average)												
Pesos per dollar	18.8	19.3	18.9	19.0	19.2	18.7	18.8	19.0	19.1	19.0	18.9	19.0
Public Finances												
FRPS (% of GDP)	-1.1	-2.3	-2.5	-2.1				-2.5				-2.1
External Sector[1]												
Trade balance (US$ billions)	-11.0	-13.7	-13.8	-15.2	-3.2	-1.5	-7.0	-2.1	-3.5	-1.9	-7.4	-2.4
Current account (US$ billions)	-19.4	-22.2	-23.6	-27.6	-7.3	-3.4	-5.3	-7.6	-8.3	-4.4	-6.3	-8.6
Current account (% of GDP)	-1.7	-1.8	-1.8	-2.0	-2.3	-1.0	-1.6	-2.3	-2.4	-1.3	-1.8	-2.4
Employment												
Formal Private (annual % chge.)	4.3	3.6	3.2	3.0	3.2	3.0	3.1	3.2	3.4	3.3	3.1	3.0
OUR (% active population)	3.4	3.3	3.9	3.8	3.9	3.9	3.9	3.9	3.8	3.8	3.7	3.8

1: Accumulated, last 12 months
*FRPS: Financial Requirements of the Public Sector
OUR: Open Unemployment Rate
Source: BBVA Research with Banxico, INEGI & SHCP data

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