BBVA Research

Creating Opportunities

Mexico Economic Outlook

Third quarter 2019

Index

1. Summary 3
2. Global environment marked by trade tensions and the reaction of the central banks 6
3. The economy grew by 0.1% (QoQ) in 2Q19 driven by the service sector; industry continues to slow down 10
4. In line with expectations, inflation regained its downward trend in May, after reaching its peak of the year in April, and is already below 4.0%. 21
5. Forecasts 29

Closing date: August 2, 2019

1. Summary

The economy continues to grow 0.4% at an annualized rate in 2Q19 due to the resilience of the service sector; the industry continues to slow down. Services and trade will continue to show resilience in the quarters to come, although industry risks mainly associated with the external sector remain, and these could intensify in the second half of the year. In particular, the performance of leading indicators of economic activity in the US manufacturing sector suggests decreased external demand in the coming quarters. This adds to the delay in the approval of the United States–Mexico–Canada Agreement (USMCA) by the US Congress and the intensification of domestic risks for private investment as a result of the uncertainty associated with contract reviews by the federal government.

The creation of formal employment has slowed down as a result of the low dynamism in the economy, with an average annual growth rate of 2.4% during the first six months of the year — the lowest average growth since 2010. At the same time, the rise in real wages has also led to a 5.4% increase in the total wage bill for the same period; however, this has not been accompanied by increased productivity, which is necessary for it to be sustainable. As a result of the economic growth and gradual economic recovery forecasts, we expect average employment rates to remain close to a quarterly figure of 2.4% at the close of the year. Real wages will continue to grow, but at a slower pace, closing the last quarter of the year with an average annual growth of around 1.8%.

As such, the slowdown of the export sector in Mexico, together with the slowdown of the industrial sector, points toward the tertiary sector as the main anchor of economic activity in the second half of 2019.

In May, inflation returned to its downward trend after reaching its peak in April and is already below 4.0%. The cumulated increase of 0.7 pp forecast for January to July will be the lowest since 2015-2016, when inflation reached historic lows of 2.7% and 2.8%, respectively. Despite the downward resistance of core inflation, headline inflation has performed very strongly in the first seven months of the year. The cumulative increase of 0.7 pp from January to July is the third lowest increase in the last nine years. It is similar to the 0.6% increase observed in 2016, the second lowest in this period, and significantly less than the average 1.2% observed during the period 2011–2018, excluding 2015 (when cumulative inflation until July was the lowest in history, due to the favorable effects of the telecommunications reform and the elimination of certain charges such as long distance tariffs) and 2017 (when cumulative inflation until July was very high due to the shift to higher exchange rates on the prices of goods following Trump's rise to power). It is worth noting that, despite the downward resistance of core inflation, the cumulative increase in headline inflation as of July is (-)0.4 pp lower than the typical average for this decade. We expect inflation to continue to progress favorably; our forecasts for 2019 and 2020 remain unchanged. We continue to anticipate that headline inflation will close the year at 3.4% and core inflation at 3.3%. Our forecasts for the close of 2020 remain at 3.5% and 3.3%, respectively.

Changes in Banxico's tone indicate greater flexibility and an improved characterization of recent inflation developments and its most probable future performance (the continuation of a downward trend). We believe that in June Banxico moved slightly closer to the start of an early relaxation of its monetary stance. We continue to anticipate a drop of 50 basis points (bp) in the monetary rate (to 7.75% at year-end), beginning with -25 bp in September. For 2020, we continue to foresee an additional cumulative cut of 100 bp to 6.75%.

We believe that Banxico will most likely switch toward a gradual relaxation of the monetary stance sooner rather than later. This could possibly be in the meeting in August where it could state that lower interest rates are imminent. There are several reasons for this: i) the Federal Reserve cut its reference rate in July and made it clear that it will not return to a hike cycle for at least the remainder of the year; this has further widened the high interest rate differential between Mexico and the U.S. ii) the exchange rate is relatively stable despite risks and the recent increase (accumulated depreciation of 3% due to trade tensions and global risk aversion); iii) as we anticipated, headline inflation is already below 4.0% and will maintain a downward trend for the rest of the year; core inflation will resume a clearer downward trend in the fourth quarter but in the third quarter it is expected to return to the narrow range in which it fluctuated between 2Q18 and 1Q19; iv) the economy is showing clear signs of weakness (GDP growth of just 0.1% QoQ in 2Q19 after contracting (-)0.1% QoQ in 1Q19) and, consequently, the increased weakness of the cyclical position of the economy is translating into an increase in the output gap, not only limiting the possible upside risks but tilting them downward; and v) the monetary stance is highly restrictive: the real ex-ante monetary policy rate stands at over 4.0% (at 4.3% in July), which is a high level by historic standards, and significantly higher than the estimate of 2.0% of the neutral rate.

In this context, we believe that the case for a less restrictive monetary policy stance is growing ever stronger. We believe that Banxico will significantly relax its communication in August and gradually and cautiously begin to ease its monetary stance in September.

With regard to the exchange rate, currently affected by the recent significant rise in global risk aversion, its recent evolution shows a positive differentiation and we expect it to return to somewhat more moderate levels if this aversion subsides. In fact, since June 7, when the risk of possible tariffs on exports from Mexico to the U.S. lifted, the peso has performed better than other emerging currencies. It is important to reiterate that risks to the peso continue to skew upward, 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 U.S. Congress in ratifying the North American Trade Agreement. However, with the Federal Reserve on the sidelines, the context for emerging currencies will improve when trade tensions between the U.S. and China calm.

With respect to Pemex, we consider that its business plan does not affect the risk of Moody's downgrading its credit rating. While the business plan includes some measures to strengthen both Pemex's finances and production capacity, we believe that they are insufficient to solve the company's two major structural problems: excessive financial indebtedness and the fall in production. In order to increase the probability of significantly increasing oil production over the last three years of the six-year period, we suggest reactivating the business model based on farmouts. This would allow Pemex to share not only exploration risk, but also investment and technological know-how, with other leading companies in the oil industry.

The permanent reduction in Pemex's tax burden and capital injections into Pemex beyond 2022 should be accompanied by changes in tax collection policy that do not jeopardize the achievement of fiscal objectives. Such a move would mitigate the risk of a reduction in the sovereign credit rating in the short and medium term.

In terms of public finance, the 95% progress made in fulfilling the goal of 1.0% of GDP for the primary balance for 2019 allows us to predict that this year's fiscal goal will be met. The total public sector budget revenue showed a real annual increase of 0.6% in the period of January to June 2019. In the breakdown of total budgetary revenues into components, non-tax income (including the federal government's petroleum revenue) reported a real annual decrease of 9.6% in the same period. For its part, tax revenue showed a real annual increase of 4.4% in the first half of 2019. In

particular, the IEPS (Impuesto Especial sobre Producción y Servicios — Special Tax on Production and Services) for gasoline and diesel contributed 3.7 percentage points (pp) to the real annual variation in tax revenues. This positive contribution was offset by the negative effect of 0.1 pp in VAT on tax revenue dynamism. ISR (Impuesto sobre la renta — Income tax) also made a positive contribution of 0.8 pp to tax revenue dynamism.

Regarding net public sector expenditure in the period of January to June 2019, a real annual fall of 4.5% was recorded. It is important to recognize that federal funding, public pensions, and the cost of public borrowing continued to place pressure on public finances in the period from January to June 2019. Nevertheless, our calculations show that without financial investment and the mentioned expenditure items, the remaining expenditure experienced a larger decrease with a real annual decrease of 13.1% during that period.

2. Global environment marked by trade tensions and the reaction of the central banks

In recent months, the rise of protectionism has intensified and trade tensions have increased. **Although the USA and China announced a truce during the last G20 summit that provided an opportunity to resume negotiations, doubts about a final agreement will not go away easily and will continue to slow down global growth**. In this context, with continued low inflation and very present growth risks, **the central banks have changed their position and seem to be inclined to reduce interest rates again**. This shift by monetary authorities is expected to offset the negative effect of increased trade tensions and stabilise global growth, although at lower levels than in previous years.

The escalation of protectionism remains a source of uncertainty, even after the latest trade truce between the USA and China

Over the past few months, we have seen how trade disputes have intensified, which has been further exacerbated by tensions in the area of technology. The US government announced new tariff increases from 10% to 25% on imports from China worth USD 200 billion, and threatened to extend them to all other imports (an additional USD 230 billion). It also added Huawei to a blacklist of companies, thereby blocking business transactions. For its part, China responded with tariffs of 25% on imports from the USA worth USD 60 billion. However, **at the most recent G20 summit, a truce was declared** (although tariff increases have not been rolled back), thereby cooling tensions and allowing negotiations to be resumed. In any case, although the worst-case scenario has been avoided, the intensity and extent of the issues being disputed suggest that it won't be easy to come to a trade agreement, and that tensions between the two countries will continue in the future.

Despite new monetary stimuli, there is a strong safe-haven effect in the financial markets

The high uncertainty generated by trade tensions strongly increased risk aversion in the markets, in such a way that the VIX rose significantly to around 20 (+7 bp) during the first half of May, triggering an adjustment in world stock markets of an average of 6%. All of this increased the safe-haven demand and, together with the more accommodating attitude of the central banks, caused the ten-year German bond yield to reach a historic low, and the ten-year US bond yield to fall to lows seen in 2016 (see Graph 2.1). However, the reduced level of safe-haven asset yields and the confidence that the action from central banks will sustain growth have generated a search for alternative yields, which has resulted in both an increase in the stock markets (the S&P 500 has once again reached historically high levels) and in the bonds of emerging countries and peripheral European countries. In any case, the lack of a generalised risk appetite continues to be felt.

In a context of high uncertainty and low inflation, trade tensions have led central banks to reassess their policy

To counter the negative effects of increased protectionism and the concern on the global markets, **the Federal Reserve and the ECB (in this order) have indicated their intention to adopt new stimulus measures** as insurance against increasingly likely risk scenarios and to counteract the continued decline in long-term inflation expectations. The Federal Reserve made changes to its 19 June meeting statement that set the stage for the start of interest rate cuts. It warned that inflation could fall below the 2% target, changed the description of its growth rating from 'solid' to 'moderate' and, faced with trade threats and political uncertainty, changed its approach from patience to close monitoring. For its part, the ECB has reinforced its accommodating stance on monetary policy, approving a new liquidity provision programme (LTRO-III) and delaying its commitment to maintain interest rates at current levels from the end of 2019 to the middle of 2020. In addition, it has noted that it has a range of instruments to combat the risks of low growth and inflation, including reducing deposit rates and revitalising the bond purchase programme (QE), which is a development on previous communications.

For its part, **China announced that it had a lot of room to adjust its monetary policy if the trade conflict intensified.** In fact, cuts to loan rates and the banks' required reserve ratio (RRR) are expected. It also announced that it will use USD 43 billion in rediscount quotas and standing lending facilities (SLFs), and that it will begin accepting interbank certificates of deposits and bank certificates as collateral for small banks to support liquidity. **As regards fiscal policy,** there will be increased debt issuance by local governments and a USD 14.5 billion training plan for those individuals who have lost their jobs due to the slowdown.

World growth continues in a slight downwards trend

In the second half of 2018, world growth was below the average of previous years. This is due, in large part, to the poor performance of exports, which have remained virtually stagnant since the middle of last year and have mainly affected the manufacturing industry. **Activity data shows how the industrial sector has continued to slow down from the beginning of the year to April,** despite a good March. **This trend will most likely continue,** as manufacturing PMIs continued to fall in May and June, tumbling into contractive territory. However, **growth in the first quarter of 2019 regained some momentum**, although it remained below average.

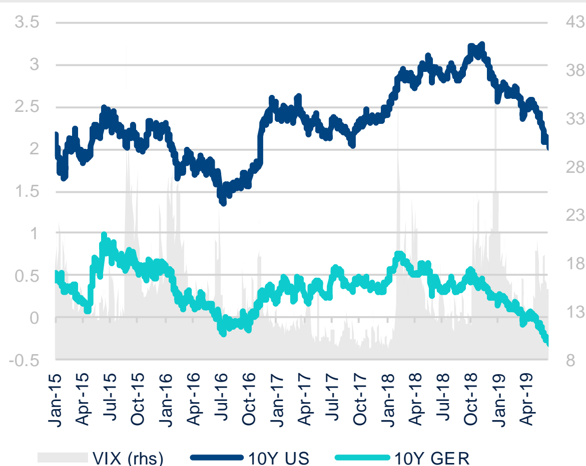
For the rest of the year, there is a risk that weak manufacturing and exports will end up infecting the services sector, which remains relatively robust, supported by the strength of employment and low inflation. In this regard, **our BBVA-GAIN model suggests a stable quarterly growth of around 0.8% at the global level,** in line with our forecast (3.3%) for 2019 annual growth.

The scenario for growth remains almost unchanged, but downside risks are rising

The base scenario incorporates the **assumption that the USA and China will eventually come to a trade agreement, possibly towards the end of the year**, thus cooling trade tensions, although not eliminating them. It is also expected that there will be no significant increase in tensions between the USA and Europe (the US threat to increase automobile tariffs still looms). **In principle, the UK leaving the EU should not have any significant impact** on the global economy. In addition, with regard to the crude oil market, a slight reduction in Brent prices is anticipated (from around USD 68 per barrel in the second quarter of the year to around USD 62 and USD 55 at the close of 2019 and 2020, respectively) owing to the increase in supply from the USA and the fall in demand, which more than offsets the OPEC production cuts.

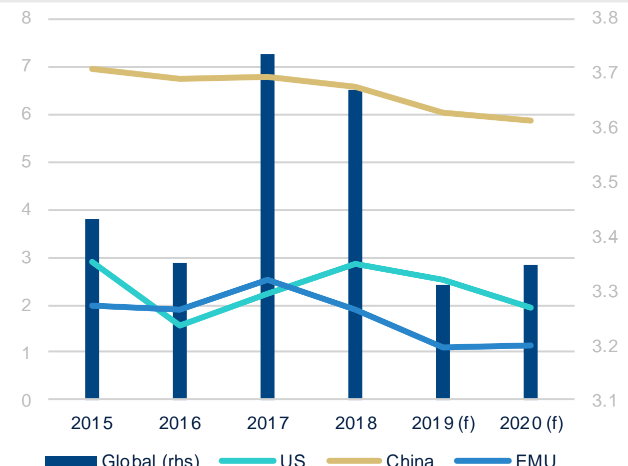
Lastly, **it is expected that monetary stimuli will offset the effects of prolonged trade tensions and potential future shocks**, although both factors operate through different channels, with trading uncertainty being a negative supply factor and monetary stimuli being a positive demand stimulus. Global growth would therefore stabilise, but at lower levels than in previous years. We therefore maintain the forecast **that global GDP, which climbed 3.8% in 2018, will grow by 3.3% in 2019 and by 3.4% in 2020** (see Graph 2.2).

Figure 2.1. **SOVEREIGN DEBT YIELDS**



Source: Bloomberg and BBVA Research

Figure 2.2. **ANNUAL GDP GROWTH 2015–2020 (*) (%)**



(*) Forecasts as of 2019.
Source: BBVA Research

In the USA, growth should gradually lose momentum, moving towards its potential growth rates. In particular, **US GDP is estimated to grow by 2.5% in 2019 and by 2.0% in 2020, in light of the 2.9% growth recorded in 2018.** In order to sustain economic expansion at the risk of lower growth and low inflation, the **Federal Reserve is in a position to start an expansion cycle in 3Q19**, **reducing its rates by up to 75 bp** over the next few quarters, and then keeping them stable until 2022.

In Europe, growth will be more modest owing to weak industry and high uncertainty (trade and Brexit). It is therefore expected that **the ECB will strengthen its forward guidance and further reduce deposit rates (-10 bp in 3Q19),** leaving them unchanged until the end of 2021. In addition, it is anticipated that a staggered deposit system will be adopted, and, if the situation worsens, that quantitative easing (QE) measures will be re-implemented. Therefore, **the scenario for Europe remains the same with very few changes**. With the strong data from the first quarter, **growth has been revised upwards in 2019 by one tenth to 1.1%** and, owing to the persistent weakness of the industrial sector and the greater uncertainty, there has been a **slight downwards revision for 2020 of one tenth to 1.2%.**

In China, more fiscal stimulus measures are expected (tax cuts and growth of regional government debt) that, along with loan interest rate cuts, bank swaps and specific medium-term credit, among other measures, can sustain the country's growth, therefore countering the negative effect of the trade war. These stimulus measures **will help GDP to grow by 6.0% in 2019 and 5.8% in 2020, in line with previous forecasts.**

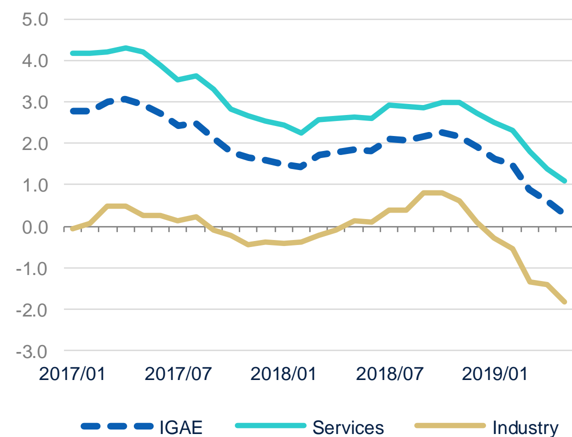
Although the view of the global economy does not differ much from what was published in the previous edition of this report, the risks to this global scenario are relatively higher due to the escalation of protectionism and its potential impact at the global level. An expansion in trade tensions to other sectors and countries is also not to be ruled out, as US tariff threats to the automobile sector are still pending. There is also an increased risk that the USA will enter an economic downturn, while political risks in Europe remain relevant (Brexit and fiscal policy in Italy). Lastly, China's stimuli stop the country's deleveraging process and therefore increase its vulnerability in the medium and long term.

3. The economy grew by 0.1% (QoQ) in 2Q19 driven by the service sector; industry continues to slow down

In the second quarter of the year the economy showed signs of resilience driven by the tertiary sector (63% of GDP), which grew 0.2% during this period (QoQ, ea), representing an annualized monthly rate of 0.4%. Industry (29% of GDP), on the other hand, continued to show low growth rates, with zero growth in the same period, while the primary sector (3% of GDP) showed a variation of -3.4% (QoQ, ea).

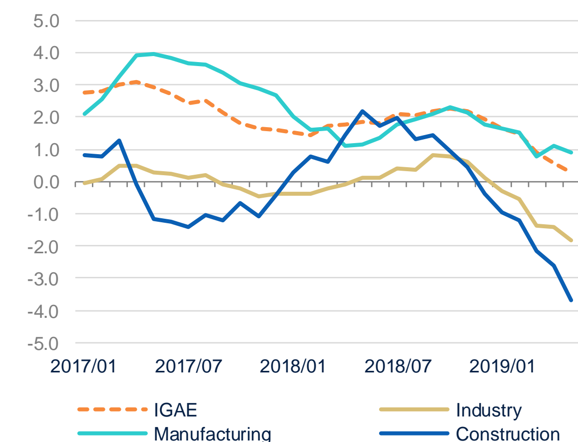
The monthly activity indicators available to date reveal a further weakening of the construction sector in industry, with a monthly variation of -6.2% in May, the lowest figure since 2010. The manufacturing sector showed greater signs of slowing with a variation of -0.2% for the same period, following positive variations since January. We anticipate that this sector will show greater weakness during the second half of the year due to lower growth in external demand as a result of the weakness of the U.S. manufacturing sector. The latest US ISM manufacturing production indicator in July shows a fall to 51.2, from 51.7 in the previous month, the lowest figure in three years. The performance of mining reflects the continuing reduction in oil production, with a variation of -1.3% for the third consecutive month. The sector associated with the generation and transmission of electricity, water, and gas reported a variation of -0.6% in May, respectively, after registering 2.0% growth the previous month.

Figure 3.1 **IGAE** (Indicador Global de la Actividad Económica — Global Indicator of Economic Activity) (YoY%, 6-MONTH MOVING AVERAGE)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

Figure 3.2 **INDUSTRIAL ACTIVITY** (YoY%, 6-MONTH MOVING AVERAGE)

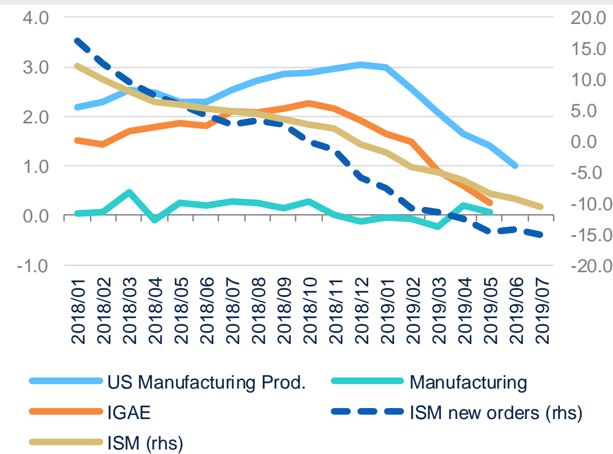


Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

In the tertiary sector, the strongest growth was recorded in services, most notably in personnel, corporate, financial, and real estate, with monthly growth of 5.2% in May (vs. -3.7% previously). This is followed by temporary accommodation and food preparation services, with a monthly variation of 3.8% in the same period, while retail trade grew at a monthly rate of

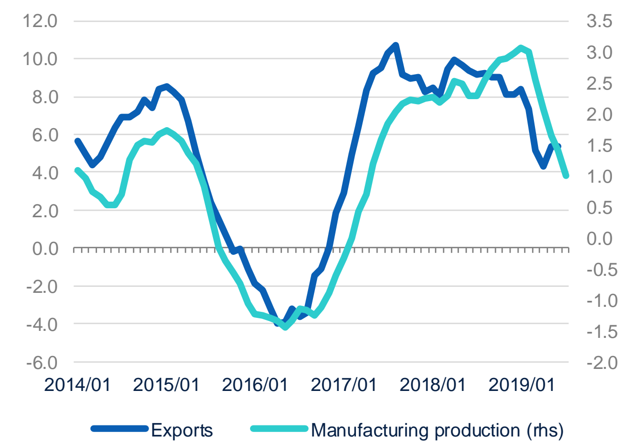
2.4%. Educational, health, social care and leisure services, along with legislative and government activities, recorded less growth in May with monthly variations of -0.1%, -0.6%, and -0.6%, respectively. Thus, in global terms, the tertiary sector showed signs of resilience in 2Q19, after zero growth in 1Q19 (IGAE, QoQ%, ea).

Figure 3.3 **MANUFACTURING SECTOR INDICATORS IN MEXICO AND THE USA** (YoY%, 6-MONTH MOVING AVERAGE)



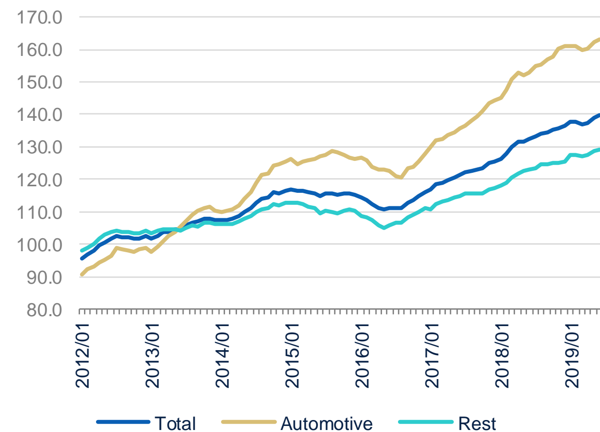
Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

Figure 3.4 **NON-OIL MEXICAN EXPORTS AND US MANUFACTURING PRODUCTION INDEX** (YoY%, 6-MONTH MOVING AVERAGE, USA, ONE MONTH IN ADVANCE)



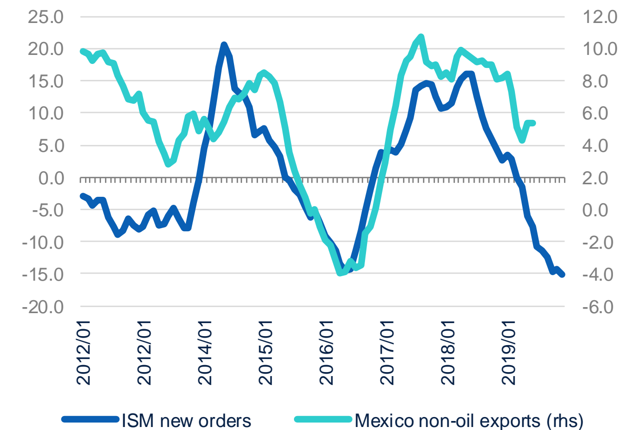
Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

Figure 3.5 **MANUFACTURING EXPORTS** (2013/01 INDEX = 100, 6-MONTH MOVING AVERAGE)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

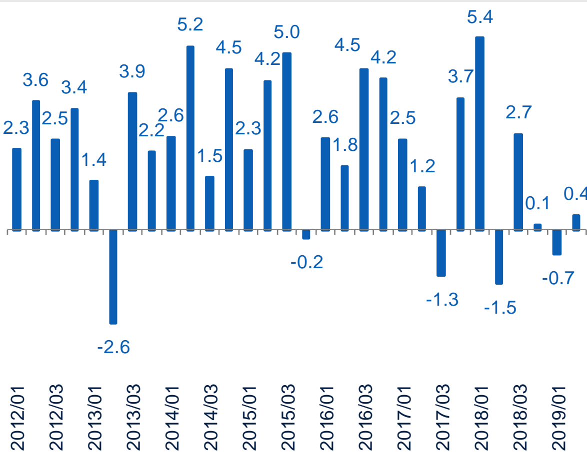
Figure 3.6 **NON-OIL MEXICAN EXPORTS AND THE ISM NEW ORDERS INDEX** (YoY%, 6-MONTH MOVING AVERAGE, ISM 6 MONTHS IN ADVANCE)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

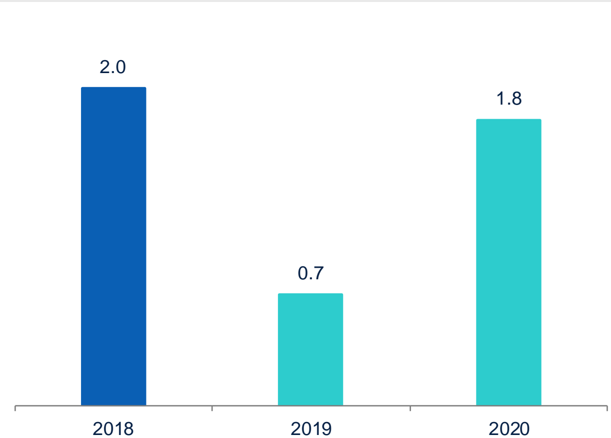
Although we estimate that services and trade will continue to show resilience in the coming quarters, we believe that the risks to industry associated mainly with the external sector remain and could intensify in the second half of the year. In particular, the performance of leading indicators of economic activity in the US manufacturing sector suggests decreased external demand in the coming quarters. The ISM New Orders Index recorded a value of 50.8 in July for the U.S., down from 58.2 at the beginning of the year. Since January, the USA's manufacturing production has recorded a greater slowdown with a year-on-year growth rate of 1.1% for that month (down from 2.7% in December, ea), reaching 0.5% in June. Due to the high correlation between Mexican manufacturing exports and US manufacturing production, we estimate that the lower growth shown by external demand indicators in recent quarters will be reflected further in the domestic manufacturing sector during the second half of this year, taking into account the effect transmission lags. The first signs are already apparent: the growth rate for exports in dollars during the first half of the year (accumulated January-June) recorded a growth of 5.5%, down from a variation of 9.1% seen during the same period last year. The slowdown of the Mexican export sector along with the slowdown of the industrial sector points toward the tertiary sector as the main anchor of economic activity in the second half of 2019.

Figure 3.7 **GDP**
(ANNUALIZED QUARTERLY RATE, %)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

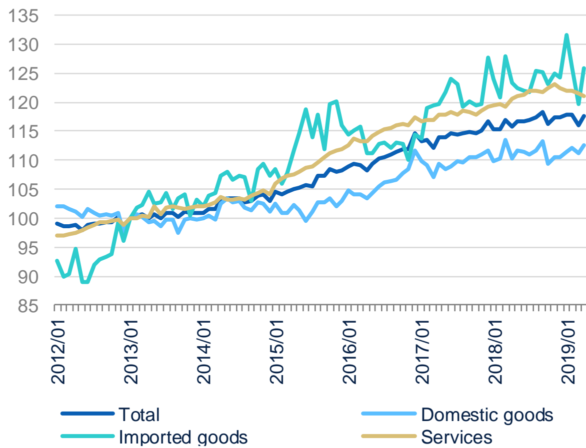
Figure 3.8 **GDP**
(ANNUAL % VAR.)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

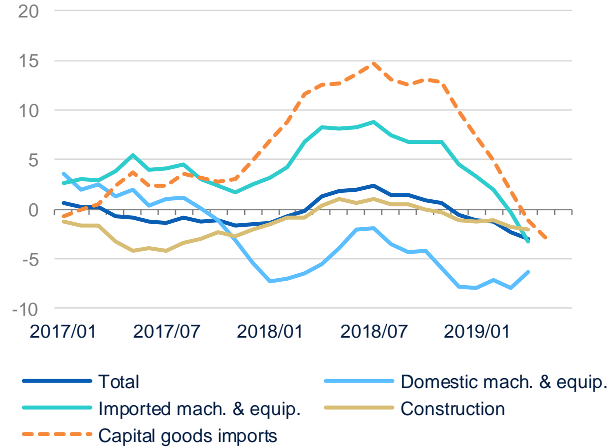
Although in the last quarter of 2018 private consumption recorded an annualized quarterly variation of -1.1%, its weakness seems to be transitional. In 1Q19, this segment of the economy grew by 0.2% (QoQ), which represented an annualized rate of 1.0%. The tertiary sector's performance in 2Q19 points toward a positive variation, but with a moderate trend in consumption in 2Q19. Data available to date from the supply of goods and retail services income indicator anticipate this positive behavior: in May, this index recorded a monthly growth of 0.7% (ea), which is close to the variation of 0.9% seen in April. We consider that this year's expected lower inflation will encourage the purchasing power of economic agents, which will be coupled with the marginal effect on private consumption as a result of the federal government's recently announced action plan to boost the economy. Therefore, we anticipate that this component of GDP will continue to be the main anchor of growth in 2019.

Figure 3.9 **MONTHLY PRIVATE CONSUMPTION INDICATOR** (2013/01 INDEX = 100)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

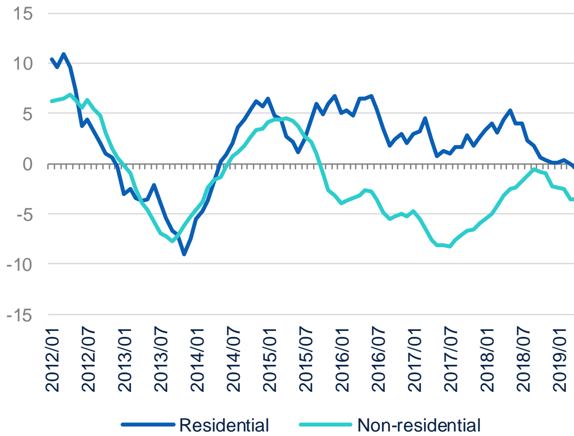
Figure 3.10 **Gross Fixed Investment and Imports of Capital Goods** (YoY%, 6-month moving average)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

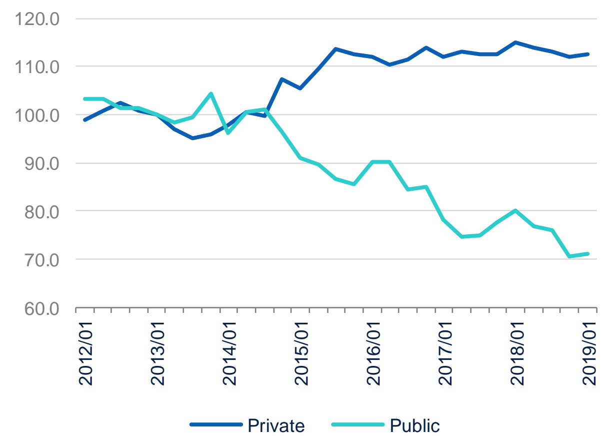
In 1Q19, private investment recorded a quarterly growth of 0.5% (QoQ, ea), representing an annualized rate of 2.2%. According to the data available to date on the gross fixed investment indicator, it continued to slow down in April, with a year-on-year variation of -2.4% (ea), as a result of the low dynamism of the imported machinery and equipment sector and construction. In this last item, the most notable slowdown can be observed in the non-residential sector, which recorded a year-on-year variation of -2.7% in the same month. The imports of capital goods in the second quarter of the year also anticipate reduced growth for private investment in 2Q19, with a quarterly growth rate of -6.4% (ea) at the close of June. Since 2016, private investment has followed a trend of low growth exacerbated by the election period, the new government's economic policy lines, and the delay in the approval of the USMCA in the USA. This year domestic and external risks are higher for private investment, first, as a result of the uncertainty arising from the review of contracts by the federal government, and second, due to the lower growth forecast for the Mexican manufacturing sector, resulting from lower dynamism in the US industrial sector. Indicators for when to invest in 2Q19 clearly indicate less certainty for investors, with a variation of -13.2% (ea) for the construction sector and -2.1% for manufacturing in 2Q19.

Figure 3.11 **CONSTRUCTION** (YoY%, 6-MONTH MOVING AVERAGE)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

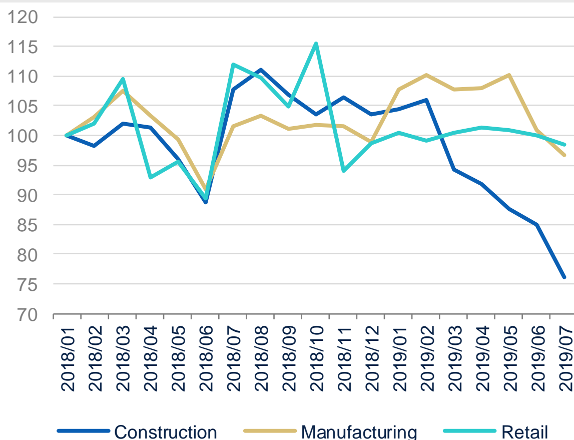
Figure 3.12 **GROSS FIXED INVESTMENT** (2013/01 INDEX = 100)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

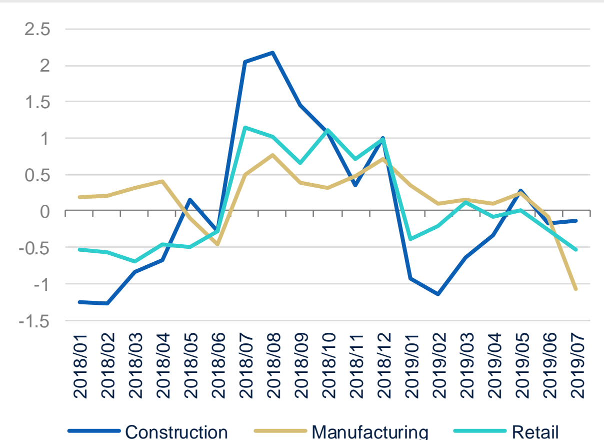
Public investment grew by 0.8% in 1Q19 (3.4% at an annualized quarterly rate), following three quarters of negative variations, partly driven by the purchase at the beginning of the year of transportation equipment by the federal government in order to address issues relating to fuel distribution. The 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, and we therefore anticipate that the slow dynamism of public investment will persist in the second half of 2019. 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 implementation of expenditure. The under-spending recorded in the first half of the year is indicative of this.

Figure 3.13 **RIGHT TIME TO INVEST** (2018/01 INDEX = 100)



Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

Figure 3.14 **BUSINESS CONFIDENCE INDICATOR** (MoM%, 6-MONTH MOVING AVERAGE)

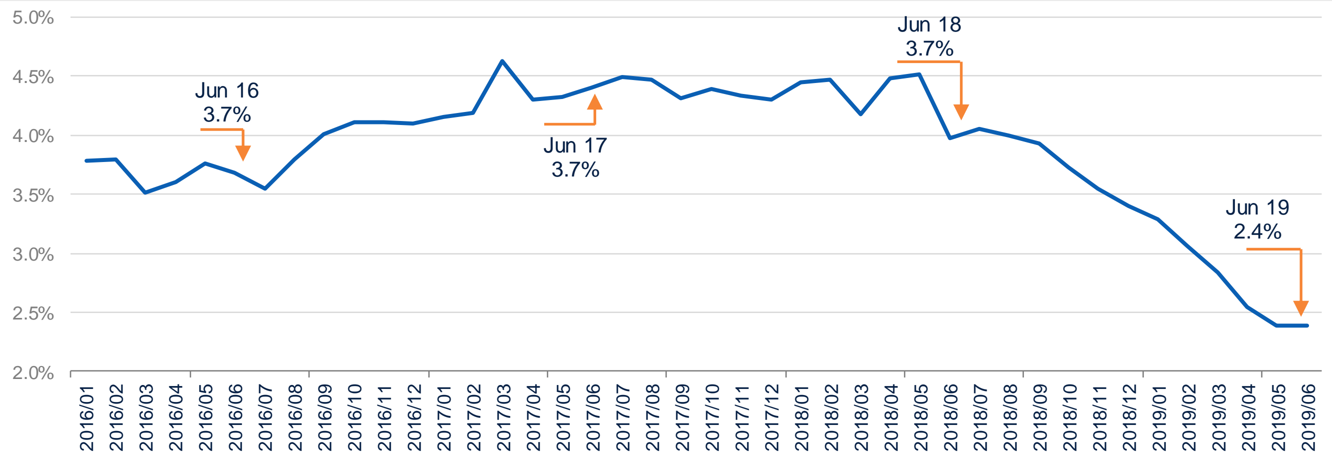


Source: BBVA Research based on data from the Mexican National Institute of Statistics and Geography (INEGI)

Economic slowdown has resulted in a deceleration in the generation of formal employment

The creation of formal employment during the first six months of the year has seen a significant slowdown. According to figures from the Mexican Institute of Social Security (IMSS), in June 2019 the number of affiliated workers reached a figure of 20.38 million, representing an annual growth of 2.4% during the first six months of the year, a significantly lower level than the rate recorded in the first six months of 2018, which reached an annual of 4.0%. This decline in employment growth has been intensifying throughout the year, with January beginning with an annual growth rate of 3.3% and by June reaching a rate of 2.4%; it should be noted that these rates are the lowest since 2010.

Figure 3.15 **INSURED PERSONS ASSOCIATED WITH EMPLOYMENT AFFILIATED TO THE MEXICAN SOCIAL SECURITY INSTITUTE (IMSS),** (% ANNUAL VARIATION)

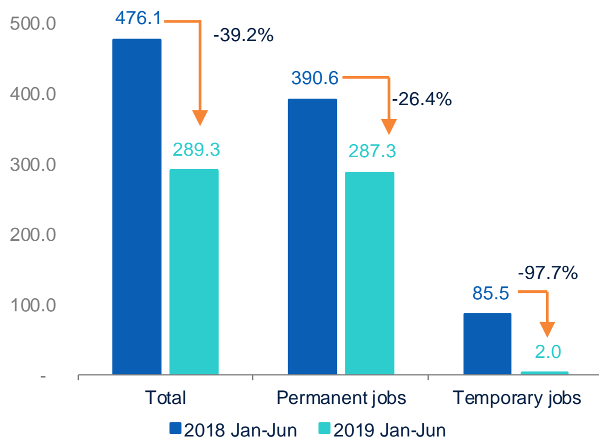


Source: BBVA Research based on data from the Mexican Institute of Social Security (IMSS)

In absolute terms, 289.3 thousand jobs were created in the first six months of 2019, representing a decrease of 39.2% compared to 2018 (186 thousand fewer jobs), which has been linked to low levels of economic activity, the fall in public investment, and stagnating private investment.

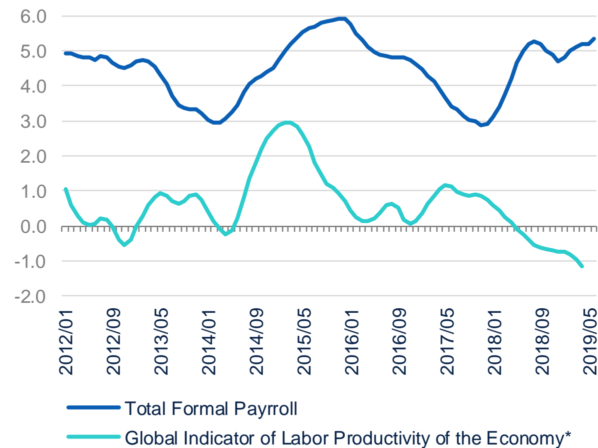
On the other hand, IMSS figures indicate that during the first six months of 2019, workers' base salary contribution was MXN 374.4 and in 2018 it was MXN 350.6, representing a 6.8% growth in nominal terms and 2.5% in real terms. Together with positive inflation performance, this increase has contributed to maintaining the purchasing power of wages. As a consequence, the total wage bill has shown an upturn, with an annual growth rate of 5.4% in real terms from January to June 2019. It is important to note that the increase has not been accompanied by an increase in productivity. According to the National Statistics Geography and Informatics Institute (INEGI, by its acronym in Spanish) the IGPLE (Indicador Global de Productividad Laboral de la Economía — Global Indicator of Labor Productivity in the Economy) based on employed personnel, of which we have information up to the first quarter of 2019, there have been negative annual quarterly variations since June 2018.

Figure 3.16 **INSURED PERSONS ASSOCIATED WITH EMPLOYMENT AFFILIATED TO IMSS BY TYPE OF EMPLOYMENT,** (THOUSANDS, % ANNUAL VARIATION)



Source: BBVA Research based on data from the Mexican Institute of Social Security (IMSS)

Figure 3.17 **REAL TOTAL WAGE BILL AND GLOBAL LABOR PRODUCTIVITY INDICATOR OF THE ECONOMY*,** (% ANNUAL VARIATION, PM6M)



Source: BBVA Research based on data from the Mexican Institute of Social Security (IMSS) and INEGI
*Series based on monthly personnel employed estimated by interpolation

Regard to the unemployment, the figures from INEGI's National Survey of Occupation and Employment (ENOE) indicated that the unemployment rate was 3.4% during the first quarter of 2019, i.e. 0.2 pp higher than the rate of the first quarter of last year. By the close of the second quarter of 2019, the gap is expected to remain, indicating a slight increase in the level of unemployment in relative terms. As a result, unemployment levels are expected to remain close to an average of 3.3% at year-end.

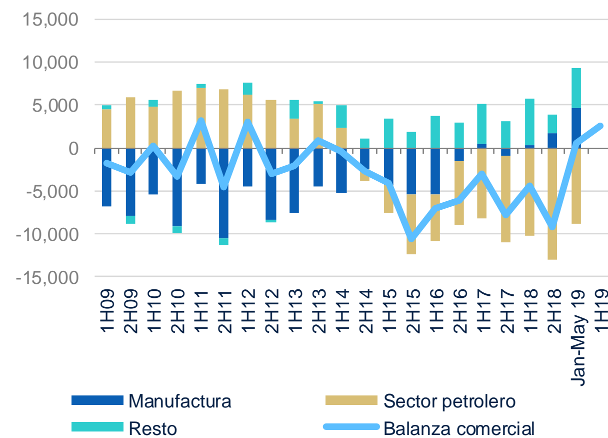
On the other hand, we anticipate that as a result of low economic growth at the end of the year and the slow recovery in investment, there will be a gradual recovery in employment generation at the end of the year and improved performance for 2020. In this sense, job creation will continue to show average growth rates of around 2.4% by the close of the year and real wages will grow by approximately 1.8%.

The trade balance recorded a surplus of USD 2.561 billion during the first half of 2019 vs. a deficit of USD 4.469 billion in the same period of 2018

With regard to the trade balance, the lower economic dynamism during the first half of the year was reflected in a trade surplus of USD 2.561 billion (Figure 1). This positive trade balance can be explained primarily by the surplus in the non-oil trade balance, which was USD 13.147 billion vs. a surplus of USD 5.704 billion in the same period of the previous year. For 2019, we estimate that the trade deficit will stand at USD 3.86 billion.

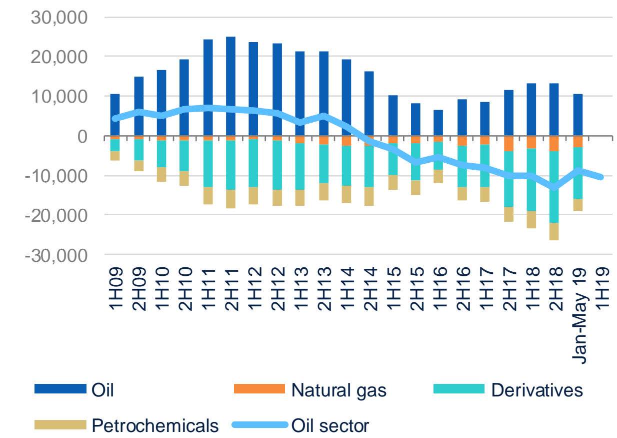
It is worth mentioning that the trade balance in crude oil, natural gas, and derivatives has been in deficit since the second half of 2014 (in the past this balance had been in surplus). In the first half of 2019, the oil trade balance showed a deficit of USD 10.586 billion vs. a deficit of USD 10.173 billion in the same period of 2018 (Figure 2). This annual increase in the oil trade deficit was due to the fact that oil exports fell 9.5% in annual terms, while oil imports showed an annual fall of 4.1%.

Figure 3.18 **TRADE BALANCE AND PRINCIPAL COMPONENTS** (MILLION USD)



Source: BBVA Research based on data from INEGI

Figure 3.19 **OIL SECTOR COMMERCIAL BALANCES** (MILLION USD)



Source: BBVA Research based on data from INEGI

Public finances: total public revenues in the first half of 2019 recorded a real annual increase of 0.6%, while total net spending showed a real annual decrease of 4.5% for the same period

The total public sector budget revenue showed a real annual increase of 0.6% in the period of January to June 2019. In the breakdown of total budgetary revenues into components, non-tax income (including the federal government's petroleum revenue) reported a real annual decrease of 9.6% in the same period. For its part, tax revenue showed a real annual increase of 4.4% in the first half of 2019. Although the IEPS contributed by 3.7 pp to the real annual variation in tax revenue, this positive contribution was offset by the negative 0.1 pp contribution of VAT to the dynamism of tax revenues. Income tax (ISR) also made a positive contribution of 0.8 pp to tax revenue dynamism. With regard to import taxes, these added 0.2 pp to the real annual growth of tax revenues.

Income tax is an important component of tax revenue due to its weight within its structure (accounting for 54.7% in the period from January to June 2019). It is worth noting that income tax showed a real annual variation of 1.5% in this period, which compares favorably to 0.6% of the real annual increase corresponding to the period from January to June 2018.

Public sector oil revenues accounted for 15.7% of total budget revenues in the period from January to June 2019 (19.0% during the same period in 2018). It is important to note that this revenue item posted a real annual drop of 16.7% in the period from January to June 2019.

Table 3.1 **TOTAL PUBLIC SECTOR BUDGET REVENUE JANUARY-JUNE** (BILLION MXN)

	2018	2019	Real % var.	% Struc.
Total	2502.0	2622.6	0.6	100.0
Federal Government	1927.1	2041.8	1.7	77.9
Tax	1558.1	1694.1	4.4	64.6
Income tax	876.8	926.7	1.5	35.3
VAT	460.9	477.9	-0.4	18.2
Non-tax	369.0	347.7	-9.6	13.3
Budget controlled agencies and companies	193.3	206.5	2.5	7.9
State-owned production enterprises	381.6	374.4	-5.8	14.3
Pemex	210.3	179.2	-18.2	6.8
CFE (state-owned electric utility)	171.3	195.2	9.4	7.4
Total	2502.0	2622.6	0.6	100.0
Oil revenue	475.7	412.6	-16.7	15.7
Non-oil revenue	2026.3	2210.0	4.7	84.3

Source: BBVA Research based on data from the Ministry of Finance and Public Credit (SHCP)

Table 3.2 **NET PUBLIC SECTOR EXPENDITURE JANUARY-JUNE** (BILLION MXN)

	2018	2019	Real % var.	% Struc.
Total	2789.2	2775.7	-4.5	100.0
Discretionary expenditure	1956.7	1924.0	-5.6	69.3
Current expenditure	1629.8	1608.5	-5.2	57.9
Capital expenditure	326.9	315.6	-7.3	11.4
Non-discretionary	832.5	851.7	-1.8	30.7
Funding for States	436.3	476.7	4.9	17.2
Borrowing cost	331.8	361.9	4.7	13.0
Adefas* and other	64.4	13.0	-80.6	0.5

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

Regarding net public sector expenditure in the period of January to June 2019, a real annual fall of 4.5% was recorded. This was largely due to the discretionary expenditure item (which represented 69.3% of total net public sector expenditure during the period from January to June 2019), with a real annual reduction of 5.6% in that period. It is worth noting that, within this expenditure, 78.0% of the reduction is explained by cuts to current expenditure. Non-discretionary expenditure showed a real annual decline of 1.8% in the first half of 2019.

It is important to recognize that federal funding, public pensions, and the cost of public borrowing continued to put pressure on public finances in the period from January to June 2019. Nevertheless, our calculations show that without financial investment and the aforementioned expenditure items, the remaining expenditure experienced a larger decrease with a real annual decrease of 13.1% during that period.

The larger 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 on the items that fall more directly under its control. The federal government will have to continue its spending containment efforts during the period of July to December 2019 to meet the target of MXN 240.2 billion or 1.0% of GDP for the primary surplus.

In the period from January to June 2019, the primary balance of the public sector recorded an amount of MXN 228.1 billion vs. MXN 126.9 billion in the same period of 2018. The primary surplus was largely due to the positive balance of MXN 135.2 billion from the federal government, which was offset by the negative balance of MXN 73.7 billion from agencies and companies.

Table 3.3 **INDICATORS OF PUBLIC EXPENDITURE JANUARY-JUNE**
(BILLION MXN)

	2018	2019		
	Nominal	**Nominal**	**Real**	**Real % var.**
Total net expenditure	2789.2	2775.7	2664.9	-4.5
Without financial investment	2778.8	2732.8	2623.7	-5.6
Without financial investment and state funding	2342.5	2256.1	2166.0	-7.5
Without financial investment, state funding and pensions	1952.0	1828.7	1755.7	-10.1
Without financial investment, state funding, pensions & cost of borrowing	1620.3	1466.7	1408.1	-13.1

Source: BBVA Research based on data from the Ministry of Finance and Public Credit (SHCP)

Table 3.4 **FINANCIAL POSITION OF THE PUBLIC SECTOR JANUARY-JUNE**
(BILLION MXN)

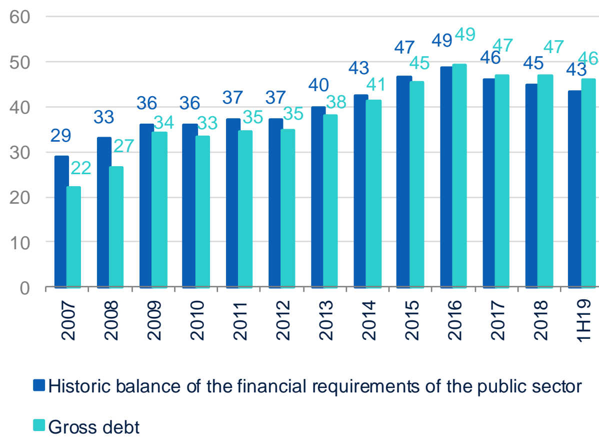
	2018	2019	Real % var.
Public balance	-206.7	-119.9	-44.3
Public balance without prod. invt.	107.1	152.1	36.3
Budget balance	-287.2	-153.1	-48.8
Budget revenue	2502.0	2622.6	0.6
Net budget expenditure	2789.2	2775.7	-4.5
Federal Government balance	-273.4	-157.5	-44.7
Bal. Agencies and Companies	-13.7	4.4	n.s.
Primary balance	126.9	228.1	72.6
Budget balance	44.6	208.8	349.5
Federal Government	-21.4	135.2	n.s.
Agencies and companies	66.0	73.7	7.2
Pemex	19.4	-13.4	n.s.
Other institutions	46.6	87.1	79.3
Indirectly-controlled institutions	82.3	19.3	-77.5

n.s. non-significant
Source: BBVA Research based on data from SHCP

Gross public debt stood at 45.9% of GDP in the first half of 2019. The debt level is 0.9 pp lower than the ratio of public debt to GDP seen at the close of 2018. As regards to the breakdown of this debt into domestic and external components, external debt fell from 36.1% at the close of 2018 to 35.8% at the close of the first half of 2019.

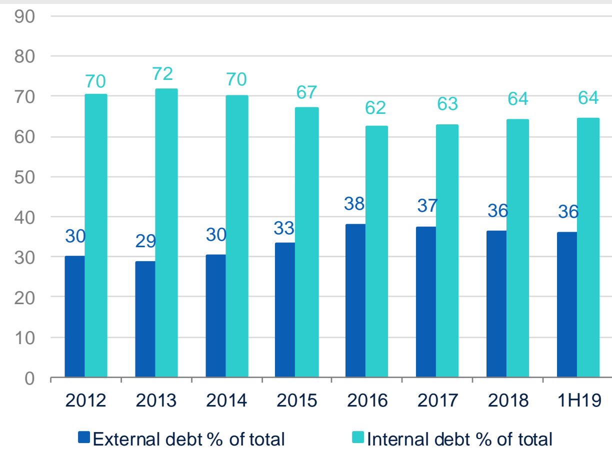
At the end of 2019, the historical balance of the public sector borrowing requirements (SHRFSP) was 16.0 pp of GDP higher than its level in 2007. This broad indicator of public debt stood at 43.4% of GDP in the first half of 2019. We anticipate that the SHRFSP will close 2019 at 45.5% of GDP.

Figure 3.20 **GROSS DEBT AND HISTORICAL BALANCE OF PUBLIC SECTOR BORROWING REQUIREMENTS** (% OF GDP)



Source: BBVA Research based on data from the Ministry of Finance and Public Credit (SHCP)

Figure 3.21 **PERCENTAGE STRUCTURE OF INTERNAL AND EXTERNAL PUBLIC SECTOR DEBT** (% OF TOTAL DEBT)

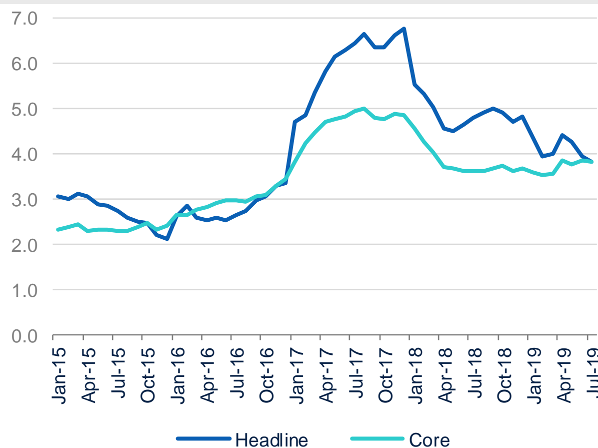


Source: BBVA Research based on data from the Ministry of Finance and Public Credit (SHCP)

4. In line with expectations, inflation regained its downward trend in May, after reaching its peak of the year in April, and is already below 4.0%.

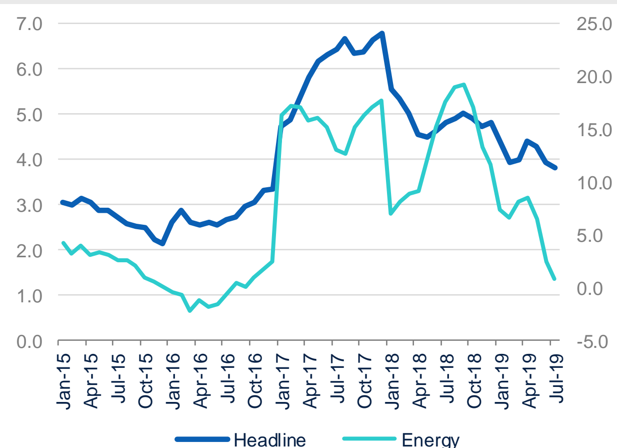
Following a transitional increase in headline inflation in the second quarter of 2019, which was largely due to an acceleration in the rate of increase in core prices (see Figure 4.1), it has resumed its downward trend, mainly driven by the continued decline in energy prices (see Figure 4.2). As a result, following an average decrease of (-)0.7 pp in the first quarter of the year (from 4.8% in 4Q18 to 4.1% in 1Q19), headline inflation picked up temporarily in the second quarter (to 4.2%), reaching what we expect to be its highest level in the year in April (4.4%). The transitional increase during the second quarter can be explained mainly by an increase of 0.3 pp in the core inflation average (from 3.56% in 1Q19 to 3.83% in 2Q19), and by the acceleration of the inflation of agricultural products.

Figure 4.1 **HEADLINE AND CORE INFLATION*** (ANNUAL % CHANGE)



* The July figure is a forecast, but is based on the data available for the first half of the month.
Source: BBVA Research/INEGI

Figure 4.2 **HEADLINE AND ENERGY PRICE INFLATION*** (ANNUAL % CHANGE)



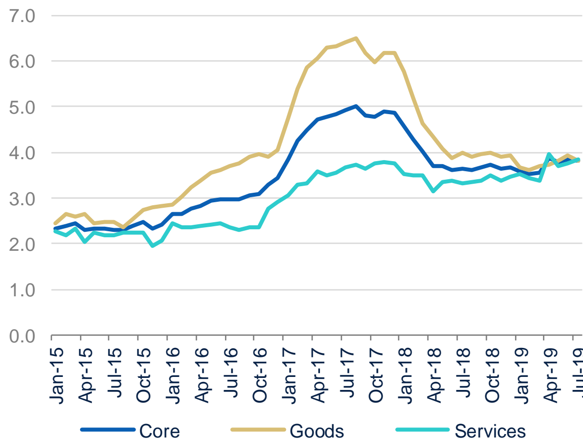
* The July figure is a forecast, but is based on the data available for the first half of the month.
Source: BBVA Research/INEGI

In line with expectations, headline inflation regained its downward trend in May and is already below 4.0%, after reaching 3.84% in the first half of July. For the month of July we expect it to remain at 3.8%, and decrease to 3.6% in August-September. As such, we expect that it will decrease by an average of (-)0.5 pp in the third quarter (from 4.2% in the second quarter, down to 3.7%). This decrease can be explained by a gentle moderation of 0.1 pp in core inflation (from 3.85% at the close of the second quarter to 3.73% at the close of the third quarter) and by the favorable base effect of non-core prices, mainly from the energy sector, which will stand at 1% in July compared to 8.6% in April. As a result, the supply shocks in energy prices seen in 3Q18 (at an annual rate, the inflation of the energy sector exceeded 19% at the end of 3Q18) will continue to ease and promote the development of headline inflation. Regarding core inflation, we anticipate that the gradual downward trend expected for the third quarter will accelerate in the fourth

quarter, in part favored by a base effect as a result of a substantial average rate of increase during the fourth quarter of 2018 (0.34% each month).

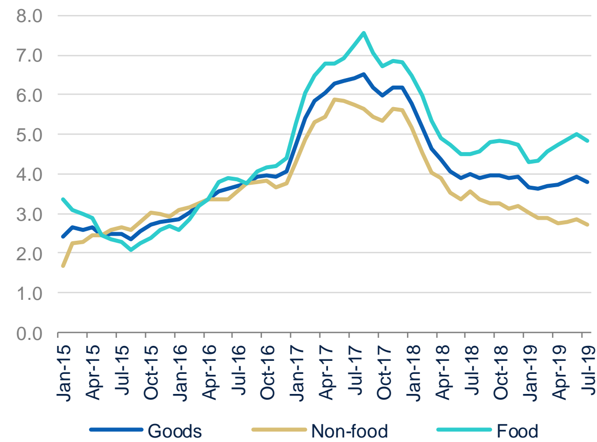
As such, following the rapid decrease in headline inflation (-0.8 pp to 4.0%) and the moderation of core inflation (-0.1 pp to 3.6%) in the first three months of the year, the second quarter closed with headline inflation at the same level (4.0%) while core inflation stood at 3.8%. By the end of the third quarter, we expect headline inflation to fall (-)0.2 pp to 3.6% and core inflation (-)0.1 pp to 3.7%, thereby returning to the narrow range of 3.6-3.7% in which it fluctuated for a year (from 2Q18 to 1Q19) before experiencing the transitional increase described above. Both core inflation's resistance to decrease during that period and its moderate transitional increase during 2Q19 can be mainly explained by an increase in service prices (the inflation of this subindex increased from 3.4% at the close of 1Q19 to 3.8% in 2Q19) and an increase of 0.2 pp (from 3.7% to 3.9%) in merchandise inflation for the same period (see Figure 4.3). The increase in service prices was mainly due to indirect effects on transport services resulting from the energy supply shocks observed in the second half of 2018, a higher rate of increase in tourist services driven by higher air fare prices (in part driven by higher taxes), and an unfavorable base effect on discontinuing price reductions for telecommunication services during 2019.

Figure 4.3 **CORE INFLATION AND COMPONENTS*** (ANNUAL % CHANGE)



* The July figure is a forecast, but is based on the data available for the first half of the month.
Source: BBVA Research/INEGI

Figure 4.4 **CORE INFLATION OF GOODS AND COMPONENTS*** (ANNUAL % CHANGE)



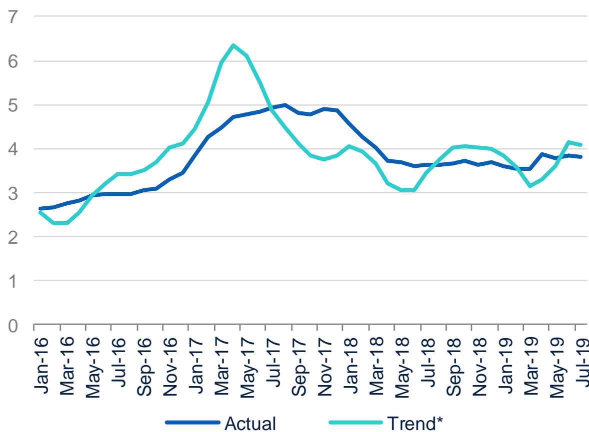
* The July figure is a forecast, but is based on the data available for the first half of the month.
Source: BBVA Research/INEGI

The higher rate of increase in merchandise can be explained by a transitional rebound in the inflation of processed foods, which was also due to indirect effects from the sharp increases observed in perishable food prices in the second half of last year. This was only partially offset by the continued favorable development of the sub-index of non-food merchandise, which is increasing at a rate of 2.8% per year at the end of the second quarter (see Figure 4.4). From our perspective, it is noteworthy that, despite increases in real wages and the indirect effects of various supply shocks, core inflation has remained relatively stable. The recent moderate increase is not a cause for concern, as it can be explained by cost factors as opposed to demand pressures. The change in weightings in July last year that increased the relative weight of processed foods has also had a negative effect, but this effect will begin to subside in the third quarter of the year.

Nevertheless, inflation performed well in the first half of 2019: the cumulative 0.7 pp increase forecast from January to July will be the lowest since 2015-2016, in which inflation reached historic lows of 2.7% and 2.8%, respectively

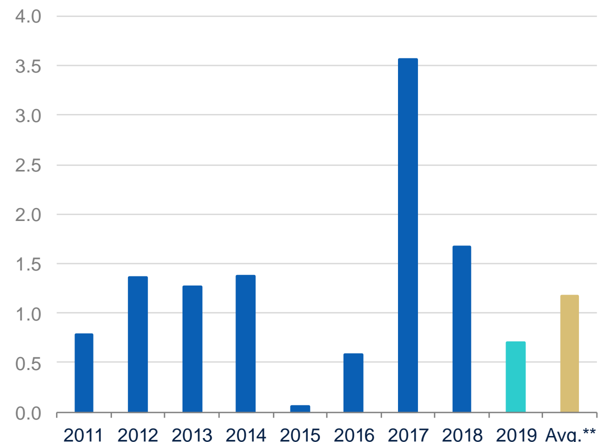
Despite the downward resistance of core inflation (see Figure 4.5), headline inflation has performed very well in the first seven months of the year. The cumulative increase of 0.7 pp from January to July is the third lowest increase in the last nine years. It is similar to the 0.6% increase observed in 2016, the second lowest in this period, and significantly less than the average 1.2% observed during the period 2011–2018, excluding 2015 (when cumulative inflation until July was the lowest in history, due to the favorable effects of the telecommunications reform and the elimination of certain charges such as long distance tariffs) and 2017 (when cumulative inflation until July was very high due to the shift to higher exchange rates on the prices of goods following Trump's rise to power). It is worth noting that, despite the downward resistance of core inflation, the cumulative increase in headline inflation as of July is (-)0.4 pp lower than the typical average for this decade.

Figure 4.5 **CORE INFLATION: ACTUAL AND TREND*** (ANNUAL % CHANGE AND ANNUALIZED 3M/3M % VAR.)



* Own calculations based on the deseasonalization of the headline inflation index; the July data is a forecast, but is based on the data available for the first half of the month.
Source: BBVA Research/INEGI

Figure 4.6 **HEADLINE INFLATION: ACCUMULATED JANUARY-JULY BY YEAR*** (PERCENTAGE POINTS)



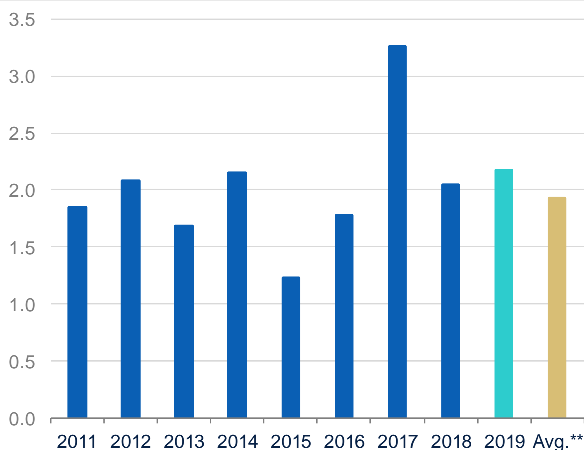
* The July figure is a forecast, but is based on the data available for the first half of the month.
** The average excludes 2015 and 2017.
Source: BBVA Research/INEGI

In contrast, the evolution of inflation has been less favorable, however, we cannot overlook the indirect effects described above derived from supply shocks i.e., from cost factors as opposed to demand pressures. The cumulative increase of 2.2 pp from January to July is similar to the 1.9% average observed during 2011-2018, if we exclude 2015 and 2017 from the calculation once again.

We expect inflation to continue to progress favorably; our forecasts for 2019 and 2020 remain unchanged

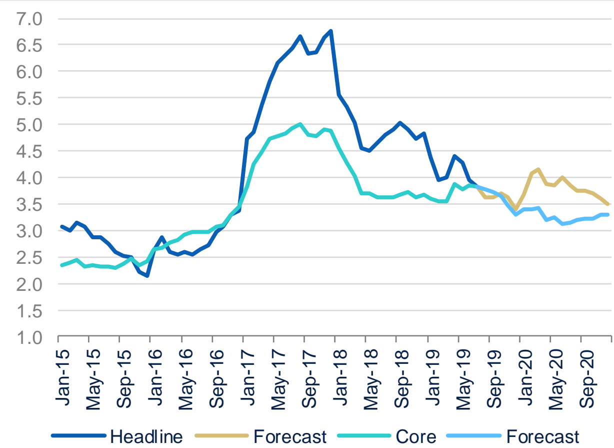
Recent trends in headline and core inflation suggest that both will decrease in the coming months, although core inflation will fall at a slower rate (see Figures 4.7 and 4.8). We continue to anticipate that headline inflation will close the year at 3.4% and core inflation at 3.3%. Our forecasts for the close of 2020 remain at 3.5% and 3.3%, respectively.

Figure 4.7 **CORE INFLATION: ACCUMULATED JANUARY-JULY BY YEAR***
(PERCENTAGE POINTS)



* The July figure is a forecast, but is based on the data available for the first half of the month.
** The average excludes 2015 and 2017.
Source: BBVA Research/INEGI

Figure 4.8 **OUTLOOK FOR HEADLINE AND CORE INFLATION**
(ANNUAL % CHANGE)



Source: BBVA Research/INEGI

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

Our forecasts for inflation are subject to both downward and upward risks; in our opinion, the balance of risk has improved and is more in proportion. 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 upward. 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 and the USA-China trade war, as well as internal fears about a possible further deterioration in the Pemex situation that could affect the exchange rate if it is perceived that it would eventually result in a deterioration of public finances. In addition to these upside risks associated with the exchange rate, pressures on energy prices (low probability) and/or fruit and vegetable prices could resurface, resulting in new supply shocks. In our opinion, the increase in the minimum wage does not represent an upside risk since only 3% of workers in the formal sector receive it, and in the 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 significant transfer of this increase to other wages.

The main downside risks continue to be associated with the weakness of the economy, which is widening the 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 energy 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.

Monetary policy: the beginning of the downward cycle is near...

After the Governing Board of the Bank of Mexico (the Board) decided to take preventative action by increasing the monetary rate by 25 bp to 8.25% at the last two meetings in 2018 (November and December), in the first three of the four meetings that have been held this year, the Board unanimously agreed to maintain the rate unchanged at that level. In the fourth meeting it kept the rate unchanged with one dissenting vote from Deputy Governor Gerardo Esquivel, who would have preferred (as we would have) for the Governing Board to have opted for a 25 bp cut to 8.0% of the monetary rate.

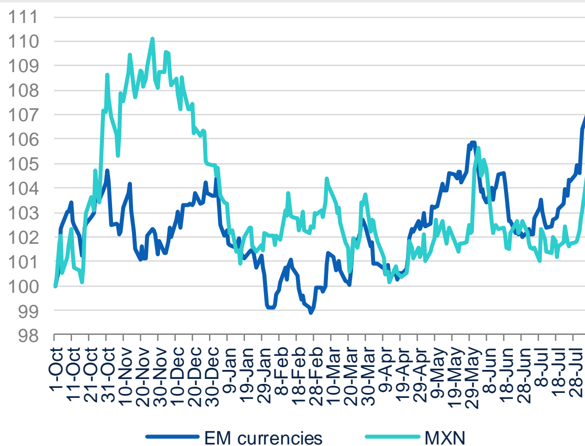
While the language of Banxico's latest monetary policy statement maintained a restrictive, hawkish tone, it is softer than that of previous releases and, in our opinion, both this and Esquivel's dissident vote support our forecast of an early beginning of a downward cycle. This moderation in tone suggests that the central bank is no longer open to possible additional precautionary increases and gives an indication that, in the absence of a deterioration in the balance of risk for inflation, and after a long monetary pause, the most likely scenario for the coming months is the beginning of a cycle of monetary easing that will gradually move monetary positions away from the historically restrictive level they currently hold, in a context of falling inflation with a weak economy and no demand pressures. Banxico's more balanced tone is reflected by several changes in its language. It states that the downward inclination of the balance of risks for growth “has increased." As regards inflation risks, it implicitly states that the risks are more balanced. In short, Banxico acknowledges, albeit in a tentative manner, the improved context for inflation and has taken the first step toward softening its tone and increasing flexibility for upcoming monetary rate adjustments. Thus, as we had anticipated, Banxico has shifted from a preventive approach (with possible additional preventive increases in the monetary rate), to a cautious approach of waiting and observing the evolution of the balance of risk for inflation, and then gradually prepare the ground for the beginning of a downward cycle. We believe that in June Banxico moved slightly closer to the start of an early relaxation of its monetary stance. We continue to anticipate a drop of 50 basis points (bp) in the monetary rate (to 7.75% at year-end), beginning with -25 bp in September. For 2020, we continue to foresee an additional cumulative cut of 100 bp to 6.75%.

The changes in Banxico's tone indicate greater flexibility and a better characterization of the recent evolution of inflation and its most likely future performance (the continuation of a downward trend). Although it is important that one member has already voted to start relaxing the existing restrictive monetary stance, the change in tone is even more significant as it shows greater flexibility and more clearly reflects the context of weak growth and falling inflation. We believe that Banxico will most likely shift its approach to a gradual easing of the monetary stance sooner rather than later. In fact, this may occur in the meeting in August, where it could announce that lower interest rates are imminent. There are several reasons for this: i) the Federal Reserve cut its reference rate in July and made it clear that it will not return to a cycle of rises for at least the remainder of the year; this has further widened the high interest rate differential between Mexico and the USA ii) the exchange rate is relatively stable despite risks and the recent increase

(accumulated depreciation of 3% due to trade tensions and global risk aversion); iii) as we anticipated, headline inflation is already below 4.0% and will maintain a downward trend for the rest of the year; core inflation will resume a clearer downward trend in the fourth quarter but in the third quarter it is expected to return to the narrow range in which it fluctuated between 2Q18 and 1Q19; iv) the economy is showing clear signs of weakness (GDP growth of just 0.1% QoQ in 2Q19 after contracting (-)0.1% QoQ in 1Q19) and, consequently, the increased weakness of the cyclical position of the economy is translating into an increase in the output gap, not only limiting the possible upside risks but tilting them downward; and v) the monetary position is highly restrictive: the real ex-ante monetary policy rate stands at over 4.0% (at 4.3% in July), an elevated level by historic standards, and significantly higher than the estimate of 2.0% of the neutral rate.

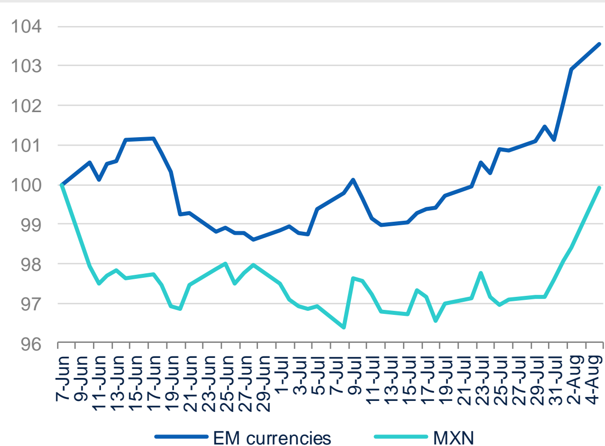
In this context, we believe that the case for a less restrictive monetary policy stance is growing ever stronger. We believe that Banxico will significantly relax its communication in August and gradually and cautiously begin to ease its monetary stance in September.

Figure 4.9 **MXN VS. EMERGING CURRENCIES* (OCT 1, 2018 INDEX =100)**



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

Figure 4.10 **MXN VS. EMERGING CURRENCIES* (JUNE 7, 2019 INDEX =100)**



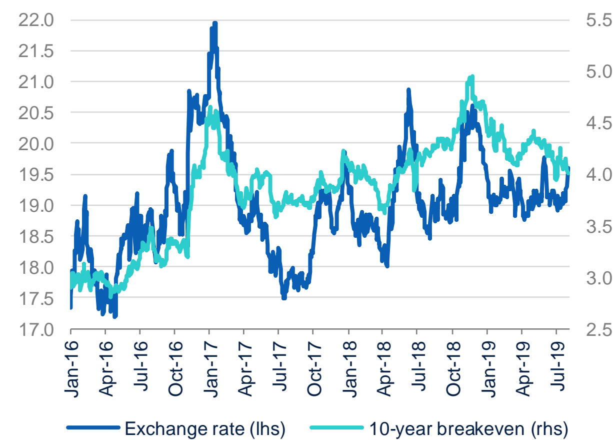
*Own calculations based on a reweighing of the JP Emerging Markets Currency Index after removing MXN
Source: BBVA Research/Bloomberg

… We anticipate that Banxico will begin reducing rates in September

The balance of risks for inflation continues to improve, together with the good performance of inflation, relative exchange rate stability, and lower inflation expectations. Inflation already fell to 3.8% in the first half of July and by the September meeting the August figure will be known, for which we expect inflation to drop further to 3.6%. As regards core inflation, we anticipate that by this time it will have slowed to 3.7%, from the 3.9% peak reached this year. Although the exchange rate is currently affected by the recent significant increase in global risk aversion, its evolution does not present a negative differentiation (see Figures 4.9 and 4.10) and we expect that, should this aversion subside, it would return to slightly more moderate levels. Indeed, since June 7, when the risk of possible tariffs on

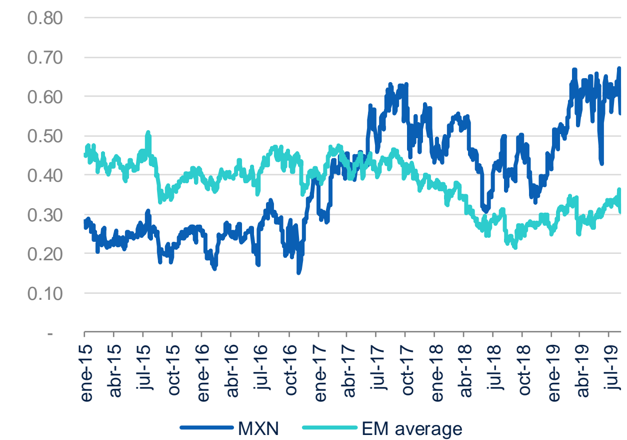
exports from Mexico to the USA lifted, the peso has performed better than other emerging currencies (see figure 4.10). It is important to reiterate that risks to the peso continue to skew upward, and are mainly related to Pemex (the government still needs to address Pemex's problems in a credible way), 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, the context for emerging currencies will improve when trade tensions between the USA and China calm. In addition, long-term market-based inflation expectations have dropped recently from 4.3% to 4.0% (see Figure 4.11) and analysts' consensus expectations have also dropped: in June, the consensus for the close of 2019 and 2020 fell from 3.8% and 3.7%, respectively, to 3.6% in both years (compared to 3.4% and 3.5%, as predicted by BBVA Research) and compared to the year-end inflation of 4.0% at the beginning of 2019.

Figure 4.11 **LONG-TERM INFLATION EXPECTATIONS DERIVED FROM MARKET INSTRUMENTS* AND EXCHANGE RATE** (% AND PPD)



* 10-year Breakeven
Source: BBVA Research/Bloomberg

Figure 4.12 **RISK-ADJUSTED CARRY-TRADE*** (%)

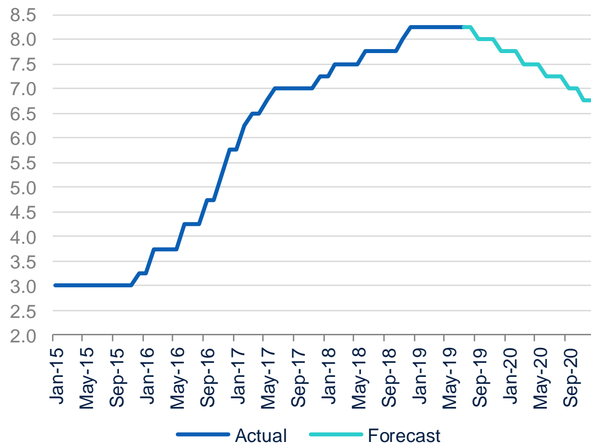


* Own calculations based on the monetary rate differential and adjusted with one-month implied volatility for each currency
Source: BBVA Research/Bloomberg

The Federal Reserve is likely to make an additional cut in the benchmark rate due to increased risks from the US-China trade war. It has been difficult for Banxico to begin to cut rates with a cycle of hikes by the Fed and inflation above 4.0%, but with a less favorable outlook for the US economy and intensifying headwinds, the Fed cut rates in July and is expected to do so again before the end of the year. In this context, Banxico should have fewer concerns about the relative position of monetary policy, even if it begins to cut rates, as the risk-adjusted MXN carry trade remains very attractive (see Figure 4.12).

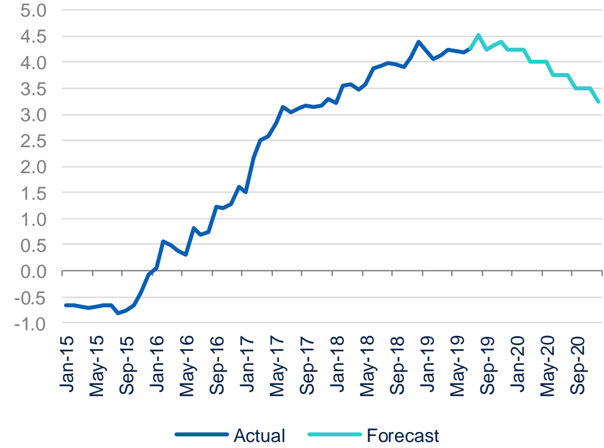
The marked slowdown in economic activity during 4Q18–2Q19 implies a much weaker cyclical position. As a result, it is foreseeable that the absence of demand pressures will continue with the widening of the output gap and that downward risks for inflation will have intensified.

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 inflation expectations 12 months after the Banxico survey. For estimates we use our inflation forecasts.
Source: BBVA Research/INEGI/Banxico

5. Forecasts

Table 5.1 **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	1.9	1.1	1.2
Germany	2.2	2.5	1.5	0.8	1.2
France	1.0	2.4	1.7	1.3	1.5
Italy	1.2	1.8	0.7	0.0	0.4
Spain	3.2	3.0	2.6	2.3	1.9
United Kingdom	1.8	1.8	1.4	1.1	1.2
Latin America*	-0.2	1.8	1.5	1.0	2.2
Mexico	2.6	2.4	2.0	0.7	1.8
Brazil	-3.3	1.1	1.1	0.9	1.8
Eagles**	5.3	5.4	5.2	4.7	4.9
Turkey	3.2	7.4	2.6	0.3	2.5
Asia-Pacific	5.6	5.6	5.6	5.3	5.1
Japan	0.6	1.9	0.8	0.7	0.4
China	6.7	6.8	6.6	6.0	5.8
Asia (exc. China)	4.7	4.6	4.7	4.6	4.4
World	3.4	3.7	3.7	3.3	3.3

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, Egypt, Philippines, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Pakistan, Russia, Turkey and Vietnam.
Forecasts closing date: July 12, 2019.
Source: BBVA Research

Table 5.2 **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	1.9	2.0	1.9	1.8
Personal consumption (real % change)	2.5	**2.6**	**2.8**	**2.1**	3.1	2.5	2.1	2.2	1.8	1.8	1.6	1.8
Govmnt. consumption (real % change)	-0.1	**1.5**	**1.6**	**0.7**	2.0	1.6	1.2	0.8	0.1	0.0	0.2	0.1
Gross fixed investment (real % change)	4.8	**6.0**	**5.2**	**4.0**	2.7	6.0	5.2	1.2	4.7	5.6	4.7	4.4
Construction[1]	3.3	**-0.2**	**-1.2**	**1.2**	-2.2	1.2	1.8	1.2	1.0	1.5	1.6	1.5
Industrial prod. (real annual % change)	1.6	**4.0**	**2.6**	**2.4**	0.4	2.5	2.4	1.8	3.4	3.3	2.9	2.2
Current account balance (% of GDP)	-2.3	**-2.3**	**-2.8**	**-2.9**	-2.7	-2.8	-2.8	-2.9	-3.0	-3.0	-3.0	-3.0
Final annual inflation	2.1	**1.9**	**2.2**	**1.9**	1.4	2.4	2.4	2.4	2.0	2.2	2.1	2.1
Average annual inflation	2.1	**2.4**	**1.7**	**2.1**	0.6	2.4	2.4	2.4	2.1	2.1	2.1	2.2
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	-4.3	-4.3

1: Residential investment
2: Fiscal balance (% of GDP)
Source: BBVA Research with Census Bureau, Federal Reserve, Labor Statistics Bureau

Table 5.3 **MEXICO INDICATORS AND FORECASTS**

	2017	2018	2019	2020	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
GDP (seasonally-adjusted)												
Real annual % change	2.4	2.0	0.7	1.8	0.1	0.7	0.7	1.0	1.7	2.0	1.7	1.9
Per inhabitant (US dollars)	9,432	9,753	10,173	10,629	10,029	10,191	10,246	10,363	10,525	10,593	10,721	10,834
US$ billions	1,169	1,220	1,285	1,356	1,258	1,282	1,292	1,310	1,333	1,345	1,365	1,382
Inflation (average, %)												
Headline	6.04	4.90	3.90	3.81	4.10	4.21	3.69	3.57	3.96	3.91	3.78	3.60
Core	4.68	3.82	3.66	3.26	3.56	3.83	3.78	3.47	3.40	3.19	3.18	3.27
Financial Markets (%, average)												
Interest rates												
Bank funding	6.75	7.69	8.15	7.29	8.25	8.25	8.17	7.92	7.67	7.42	7.17	6.92
28-day Cetes	6.69	7.62	7.96	7.24	7.97	8.03	8.05	7.81	7.58	7.39	7.09	6.89
28-day TIIE	7.12	8.06	8.45	7.63	8.56	8.51	8.49	8.25	8.00	7.75	7.50	7.25
10-year Bond	7.18	7.97	7.67	6.95	8.19	7.89	7.42	7.18	7.00	6.95	6.92	6.95
Exchange rate (average)												
Pesos per dollar	18.8	19.3	19.2	19.2	19.2	19.1	19.2	19.3	19.3	19.2	19.1	19.2
Public Finances*												
FRPS (% of GDP)	-1.1	-2.2	-2.9	-2.4				-2.9				-2.4
External Sector[1]												
Trade balance (US$ billions)	-11.0	-13.6	-3.9	-15.2	-1.8	5.0	-5.9	-1.1	-3.5	-1.9	-7.4	-2.4
Current account (US$ billions)	-19.4	-21.6	-11.0	-27.6	-5.6	4.7	-7.0	-3.1	-8.3	-4.4	-6.3	-8.6
Current account (% of GDP)	-1.8	-1.8	-0.9	-2.0	-1.8	1.5	-2.2	-0.9	-2.4	-1.3	-1.8	-2.4
Employment												
Formal Private (YoY % chge.)	4.3	3.6	2.4	3.4	3.1	2.4	2.3	2.4	2.4	3.0	3.3	3.4
OUR (% active population)	3.3	3.3	3.2	3.1	3.4	3.5	3.5	3.2	3.1	3.3	3.4	3.1

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

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

This document is provided in the United Kingdom solely to those persons to whom it may be addressed according to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and it is not to be directly or indirectly delivered to or distributed among any other type of persons or entities. In particular, this document is only aimed at and can be delivered to the following persons or entities (i) those outside the United Kingdom, (ii) those with expertise regarding investments as mentioned under Section 19(5) of Order 2001, (iii) high net worth entities and any other person or entity under Section 49(1) of Order 2001 to whom the contents hereof can be legally revealed.

The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA Bancomer and the rest of BBVA Group who are not members of FINRA (Financial Industry Regulatory Authority), are not subject to the rules of disclosure for these members.

"BBVA Bancomer, BBVA and its subsidiaries, among which is BBVA Global Markets Research, are subject to the Corporate Policy Group in the field of BBVA Securities Markets. In each jurisdiction in which BBVA is active in the Securities Markets, the policy is complemented by an Internal Code of Conduct which complements the policy and guidelines in conjunction with other established guidelines to prevent and avoid conflicts of interest with respect to recommendations issued by analysts among which is the separation of areas. Corporate Policy is available at: www.bbva.com / Corporate Governance / Conduct in Securities Markets".

BBVA Research

Creating Opportunities

This report has been produced by:

Chief Economist
Carlos Serrano
carlos.serrano@bbva.com

Javier Amador
javier.amadord@bbva.com

David Cervantes
david.cervantes@bbva.com

Arnulfo Rodríguez
arnulfo.rodriguez@bbva.com

Saidé A. Salazar
saidearanzazu.salazar@bbva.com

CONTACT DETAILS:
BBVA Research – BBVA: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico
bbvaresearch@bbva.com www.bbvaresearch.com