BBVA Research

Mexico Economic Outlook

March 2023

Creating Opportunities

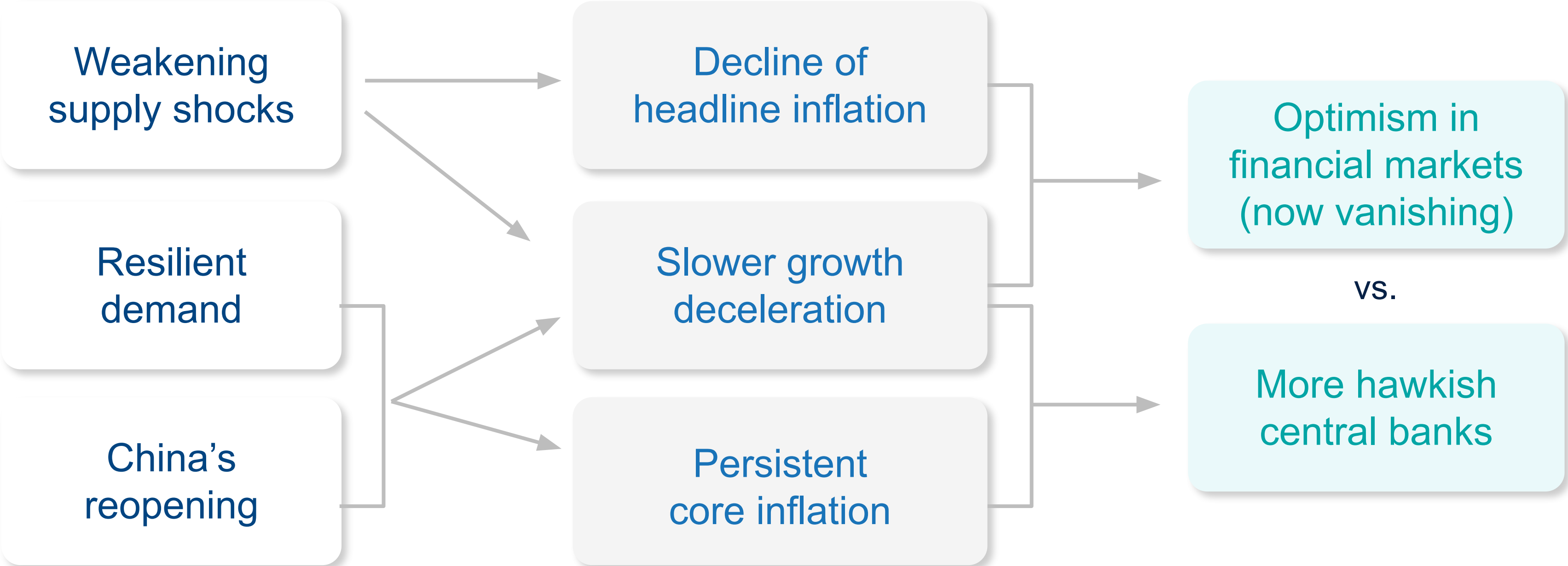
BBVA Research

01

Global Economic Outlook

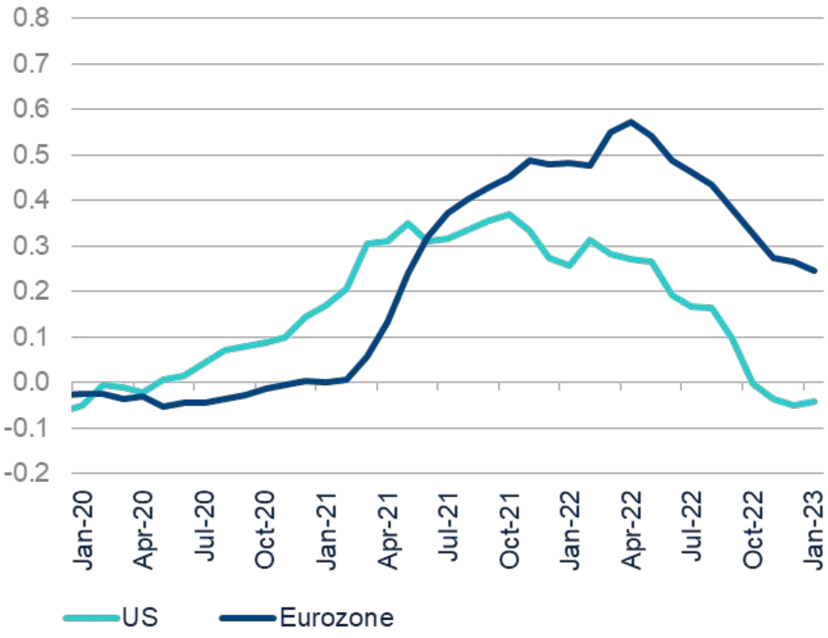
Weakening supply shocks, resilient demand and China's reopening back growth, but also inflation fears despite the recent drop in headline measures

RECENT DEVELOPMENTS IN THE WORLD ECONOMY



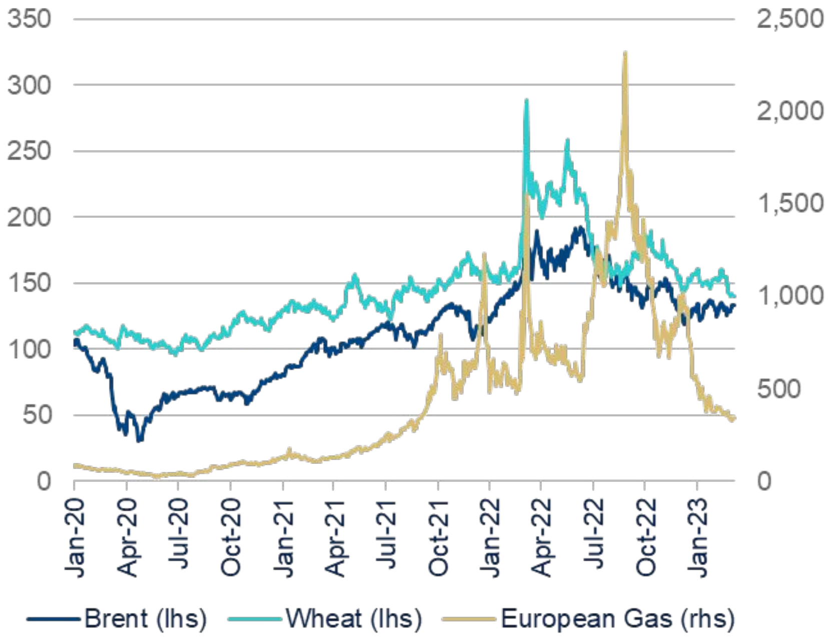
Weakening supply shocks: bottlenecks and commodity prices have eased; mild weather and healthy storage have helped to push gas prices down

BBVA RESEARCH BOTTLENECK INDEX
(INDEX: AVERAGE SINCE 2003 = 0)



Source: BBVA Research.

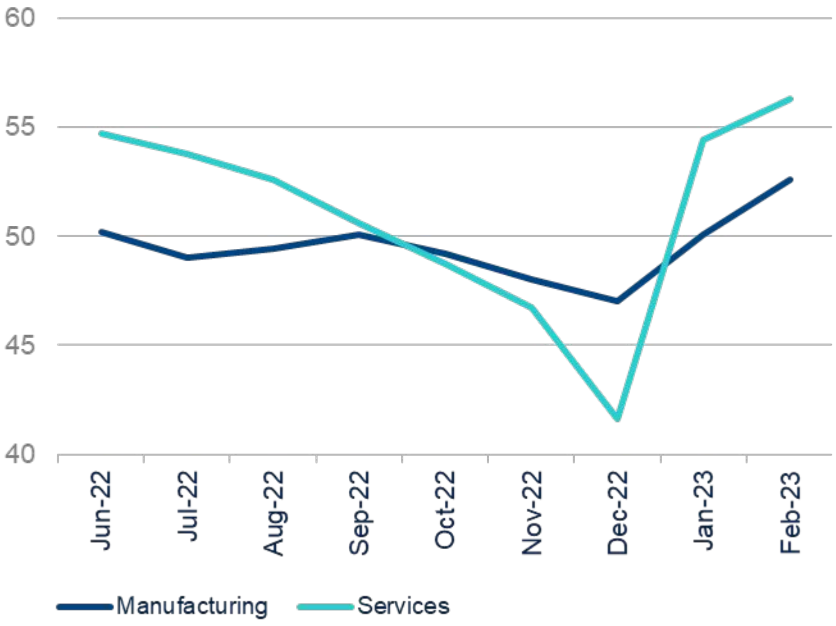
COMMODITY PRICES
(INDEX: 2019 AVERAGE = 100)



Source: BBVA Research based on data from Bloomberg.

China's reopening: after an initial negative impact on activity, unexpected easing of COVID restrictions has boosted economic activity

CHINA PMI INDICATORS
(MORE THAN 50: EXPANSION; LESS THAN 50: CONTRACTION)

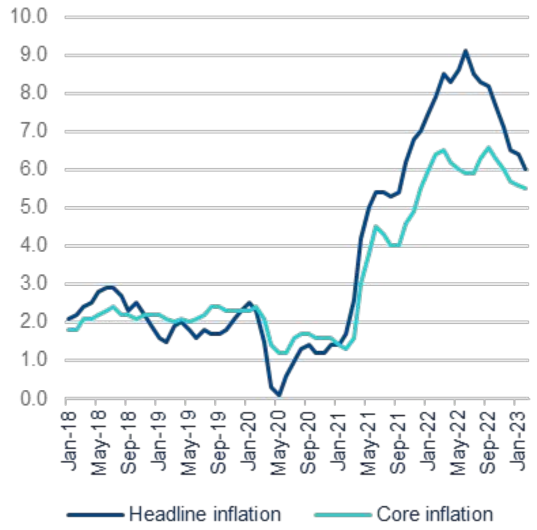


Source: BBVA Research based on data from Haver.

- China's flexibilization of COVID policies was faster than expected; together with the measures to stabilize the real estate sector, it suggests that the focus is now on growth.
- The reopening initially drove infections up, contributing to the sharp downward surprise of 4Q22 GDP.
- But a solid recovery is now underway according to more recent data.
- The demand recovery pace compared to the rhythm of supply normalization, in a protectionist context, will be key for global activity and inflation dynamics.

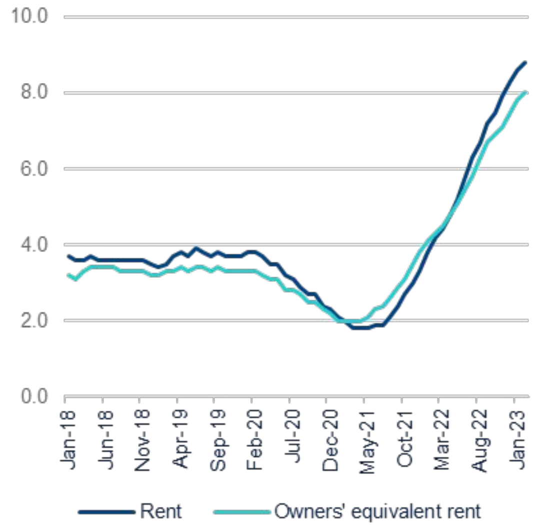
Headline inflation continues to fall in the US, but core inflation shows more stickiness

CPI INFLATION
(YoY %)



CORE INFLATION BY CATEGORY
(YoY %)

RENT AND OWNERS' EQUIVALENT RENT INFLATION (YoY %)

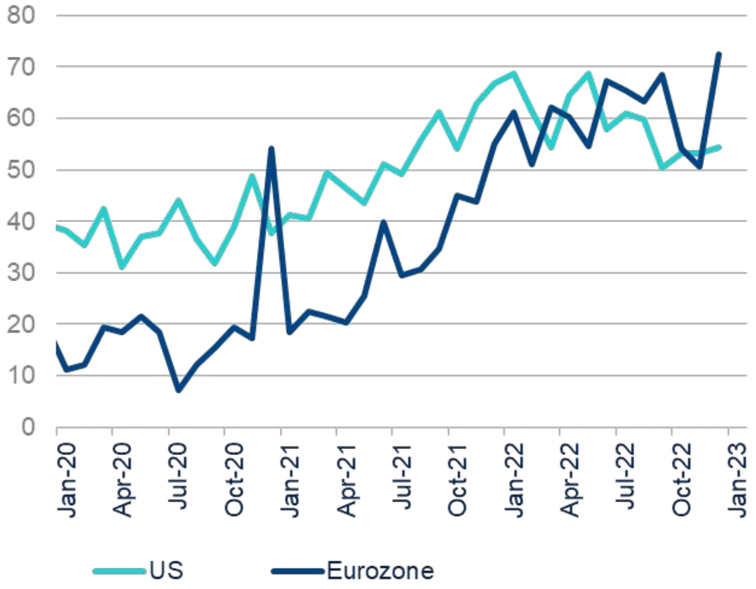


Source: BBVA Research based on data from Haver.

Price adjustments have become less widespread and frequent in the US, but there are no clear signs yet of improvement in the Eurozone

ITEMS OF THE CPI BASKET WITH ANNUALIZED MONTHLY INFLATION HIGHER THAN 4%

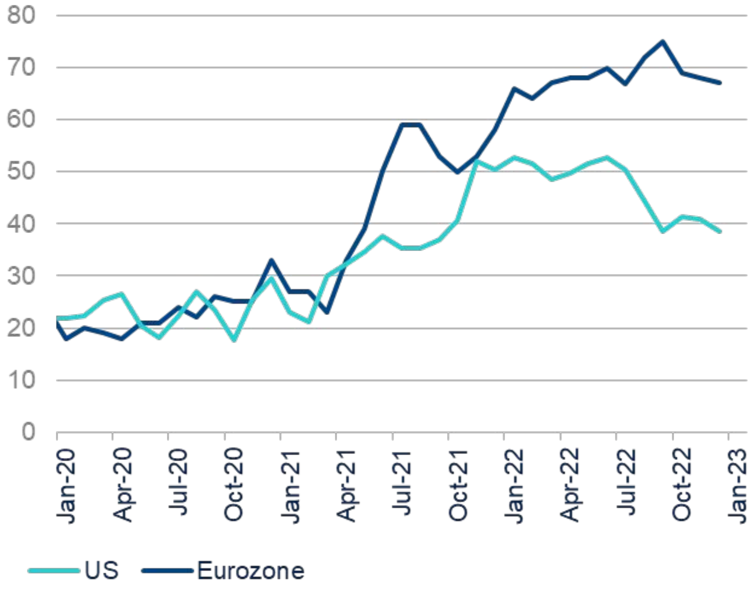
(SHARE OF TOTAL 2-DIGIT CPI ITEMS)



Source: BBVA Research based on local statistics.

ITEMS OF THE CPI BASKET WITH THREE CONSECUTIVE MONTHLY PRICE RISES

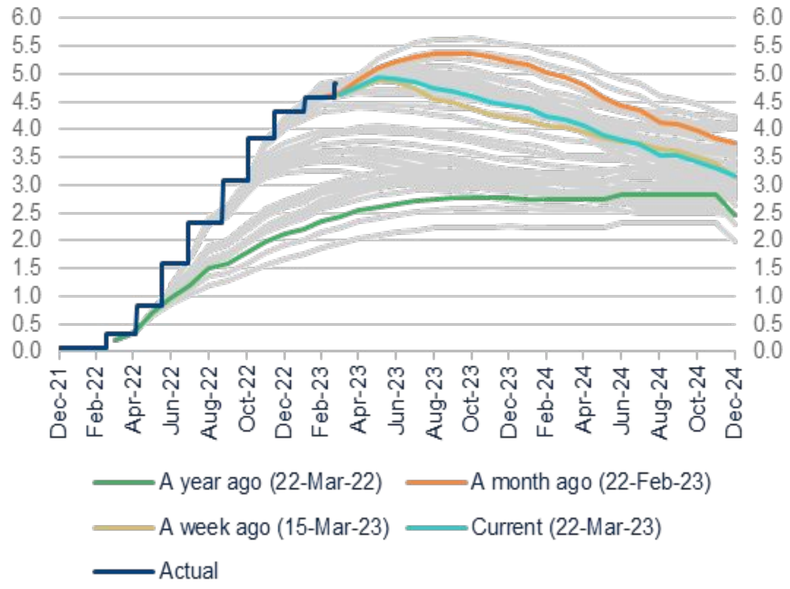
(SHARE OF TOTAL 2-DIGIT CPI ITEMS)



Source: BBVA Research based on local statistics.

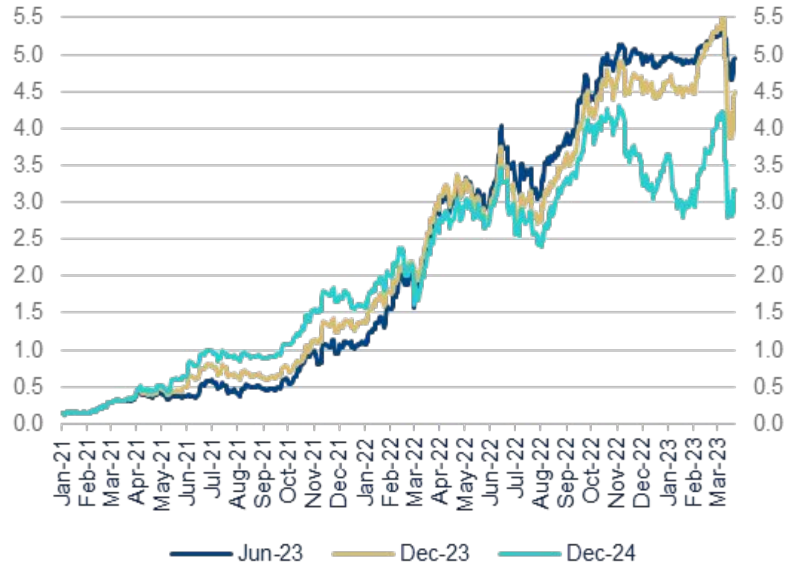
Central banks face a dilemma in their fight against inflation after recent (isolated) events in the banking system

IMPLIED RATE IN 30-DAY FED FUNDS FUTURES
(%)



Source: BBVA Research based on data from Bloomberg.

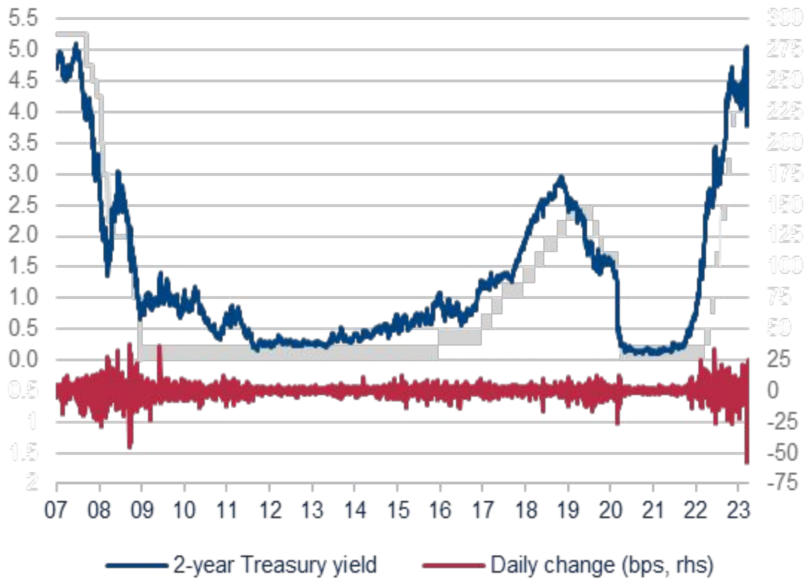
IMPLIED RATE IN 30-DAY FED FUNDS FUTURES
(%)



Source: BBVA Research based on data from Bloomberg.

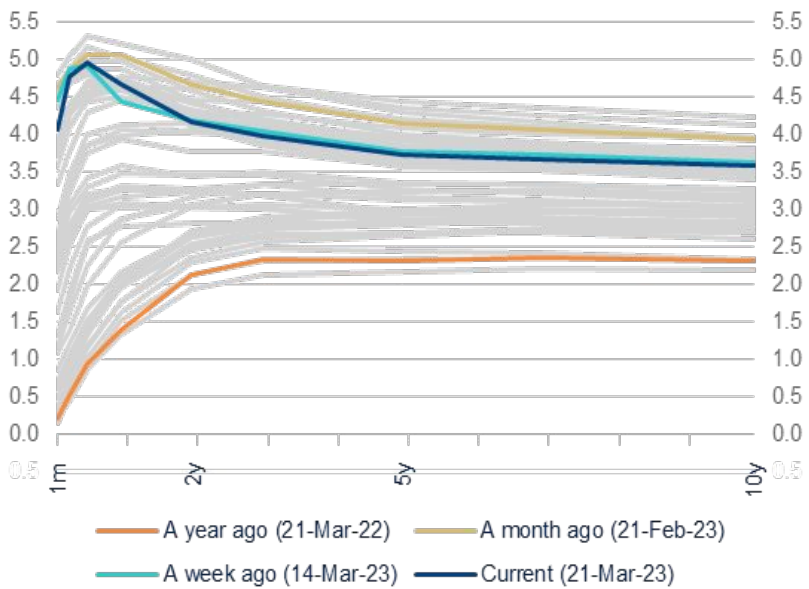
This uncertainty was reflected in episodes of high volatility in the financial markets; authorities' response contributed to contain it

2-YEAR TREASURY YIELD DAILY CHANGE
(% AND BPS)



Source: BBVA Research based on data from Haver.

TREASURY YIELD CURVE
(%)

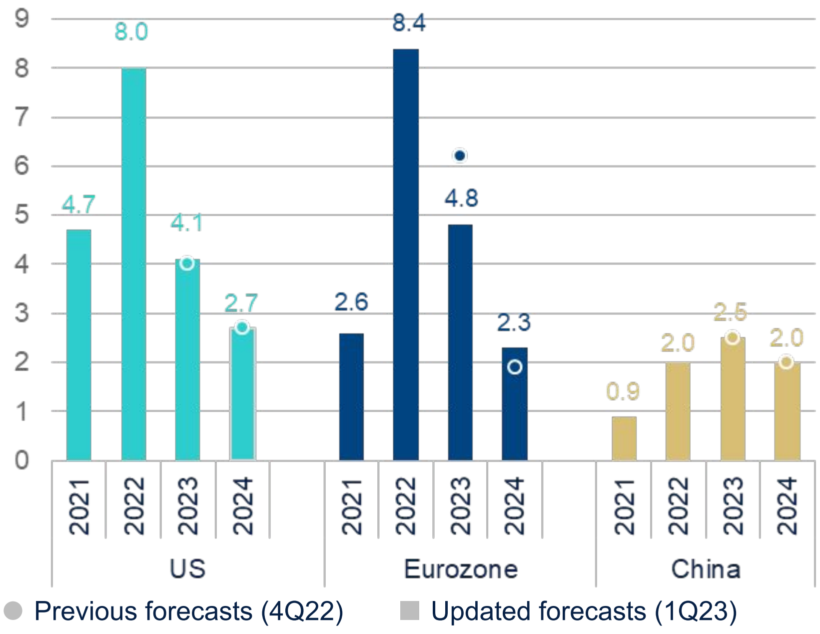


Source: BBVA Research based on data from Haver.

Inflation will continue trending downwards, but slower demand deceleration will prevent it from converging to the target over the next two years

INFLATION:CPI

(Y/Y %, PERIOD AVERAGE)



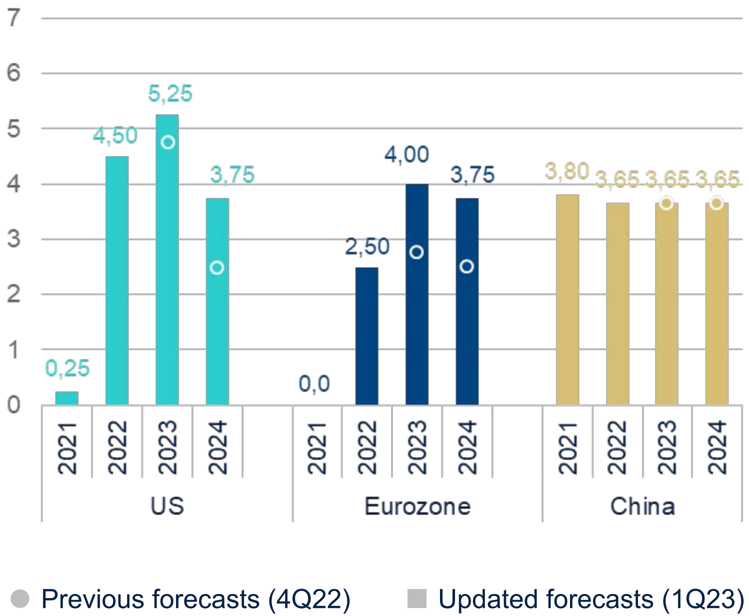
Source: BBVA Research.

- Downward surprises in headline inflation pave the way for lower-than-expected price pressures in the short-run, both in the US and the EZ.
- Still, sticky core prices amid more resilient labor markets as well as scarcer room for further falls in energy prices will keep inflation high for longer than expected.
- In China, inflation will probably remain under control, but the risk is that higher domestic demand coupled with the impact of protectionist measures more than offset the effects from the supply normalization, which would add to inflation pressures.

Central banks will remain focused on inflation: interest rates will rise more and will be kept higher for longer than expected

MONETARY POLICY INTEREST RATES(*)

(%, END OF PERIOD)

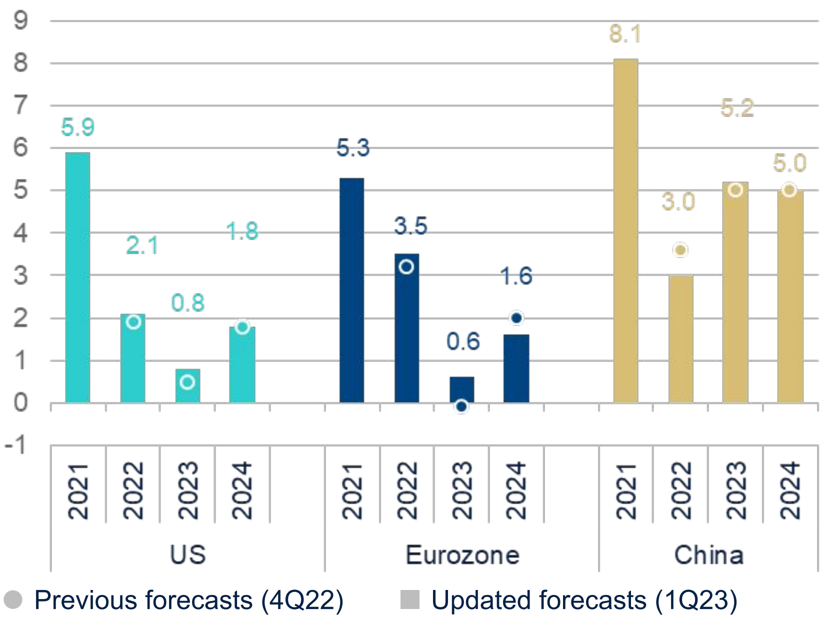


(*) In the case of the Eurozone, interest rates on refinancing operations.
Source: BBVA Research based on Bloomberg data.

- Terminal interest rate will be higher than expected, but uncertainty on the timing and the magnitude is large due to the volatile inflation dynamics, the unexpected resiliency of demand and doubts about the power of monetary policy in this context.
- One option is to accelerate quantitative tightening in exchange for smaller additional rate hikes, which could increase the risk of financial instability.
- The most likely is that interest rates soon reach 5.00%-5.25% in the US and 4.00%-4.25% in the Eurozone.
- High rates can be expected for longer, given the slow process of disinflation.

Better growth prospects for 2023: a softer deceleration in both the US and the Eurozone, and a stronger rebound in China

GDP: ANNUAL GROWTH IN REAL TERMS (*)
(%)



(*) Previous forecasts: 0.5% in 2023 and 1.8% in 2024 in the US, -0.1% in 2023 and 2.0% in 2024 in the Eurozone, 5.0% en 2023 and 5.0% in 2024 in China.
Source: BBVA Research.

- Global GDP is expected to grow 2.8% (0.5pp higher than forecast) in 2023 and 3.3% (0.0pp) in 2024, after having grown 3.2% in 2022.
- 2023 forecasts have been revised up in the US and the EZ on positive incoming data (resilient demand) and lower energy prices.
- Upward revision in 2023 GDP also in China: the reopening will support consumption and supply-side normalization; policy stimuli will back investment.
- Deceleration prospects remain in place due to monetary tightening and high inflation, but some factors (private sector's balance sheets, NGEU in Europe) will be supportive and a deep recession will likely be avoided.

Global turmoil in the banking sector: facts and impact

Trigger: specific problems in some entities

The **failures of SVB** and **Signature Bank**. Both banks neglected their A&L management and incurred on a large unhedged interest rate and liquidity risk. They were niche banks with a concentrated and volatile deposit base

Takeover of Credit Suisse
Systemic entity with problems, import outflows in the last 2 years The trigger of this transaction has been threefold: a) Financial turbulences originated by US mid-sized banks; b) Material weaknesses in internal controls; c) SNB, important stakeholder refused to invest more capital in CS.

Quick public and private response

(i) the guarantee of all deposits for both institutions and (ii) Fed launched a new Funding Program (BTFP) to cope with potential liquidity problems. In addition, the 9 largest US banks provided USD30bn to First Republic bank

- UBS agrees to buy CS for CHF3bn
- CHF 200bn liquidity support from the SNB for UBS and CS
- CHF 9bn of government guarantees for UBS losses (which endured first loss tranche of CHF 5bn) on certain assets
- CHF 16bn CS AT1 written down
- Coordinated CB action to enhance the provision of USD liquidity

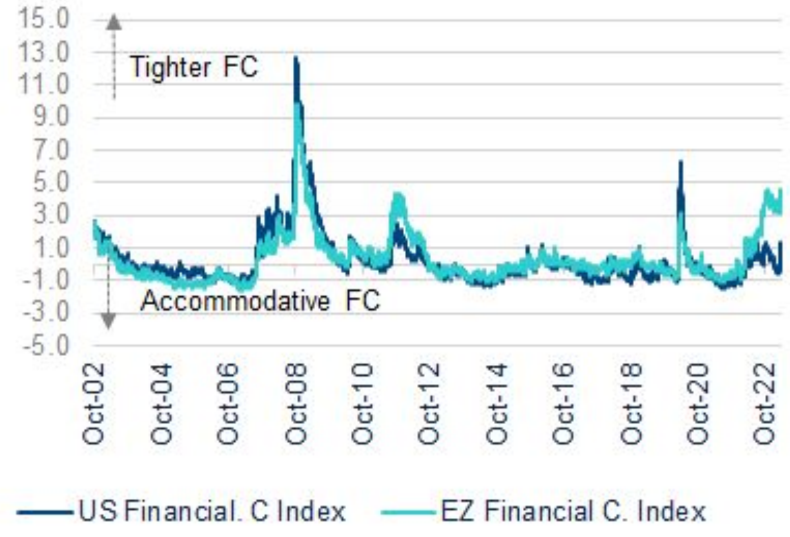
Markets
Some contagion, but limited in the financial sector due to decisive action of authorities and on more robust banking sectors than in 2008. Nonetheless sentiment continues to remain fragile and volatility is high

Monetary policy
CB have continued to fight inflation by raising rates and financial stability is being addressed with liquidity facilities. We expect CBs to exercise greater gradualism, but without relinquishing the need for high nominal interest rates to control inflation

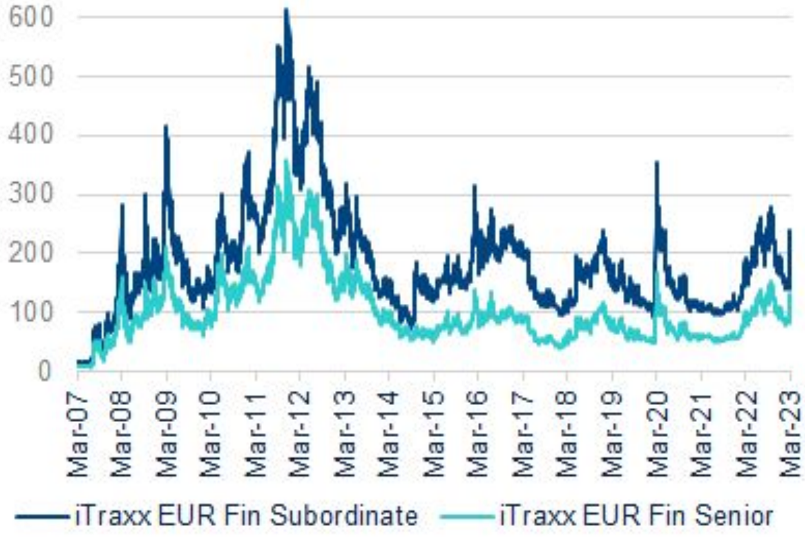
Implications for the economic outlook
Impact in credit provision and activity through traditional channels: the wealth channel, high capital costs and balance sheet reduction by banks. But such effects are likely to be minor in principle

Increased financial tensions could lead central banks to be more cautious if the stress spreads and increases

FINANCIAL TENSIONS INDEXES
(STANDARD DEVIATION FROM THE MEAN)



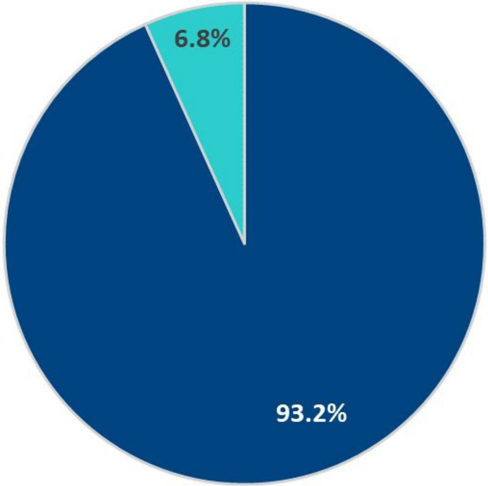
EUROPEAN BANKS' CDS
(BPS)



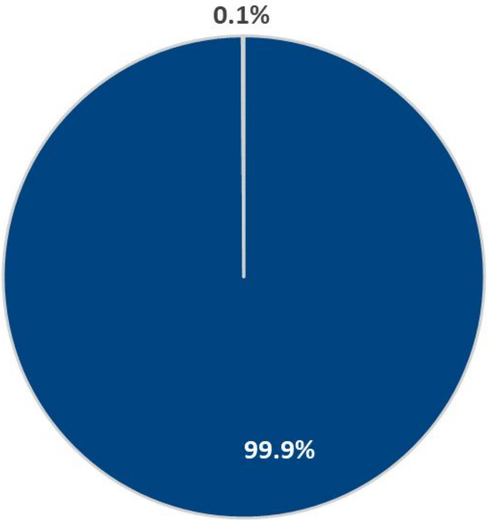
Source: BBVA Research, Bloomberg

Mexico: The amount of obligations guaranteed by the IPAB* is equivalent to 93.2% of the traditional deposits of commercial banks

GUARANTEED OBLIGATIONS AND TRADITIONAL DEPOSITS (%)



GUARANTEED ACCOUNTS (%)



Source: BBVA Research with data from CNBV and the IPAB.
IPAB = Instituto para la Protección al Ahorro Bancario (Institute for the Protection of Bank Savings)

*

Moreover, 99.9% of accounts are fully guaranteed (259.5 million of 259.7 million), while 0.1% of them are partially guaranteed.

Mexico: In January 2023, the multiple banking capitalization index was 19.7%, achieving a new all-time maximum

CAPITALIZATION INDEX (%)

Source: BBVA Research with data from CNBV.

The highest quality capital (tier 1 capital) is equivalent to 84.3% of net capital and represents 16.6% of total assets at risk.

Mexico: As of January 23, investment in government securities represented 17.5% of commercial bank assets.

FEDERAL GOVERNMENT BONDS AS A % OF TOTAL ASSETS

Source: BBVA Research with data from Banxico.

Long-term bonds (more than one year to maturity) represent 13.7% of such assets.

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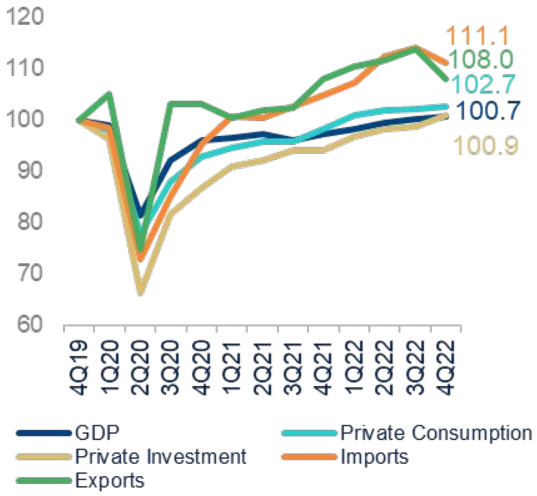
02

Domestic demand will mitigate the slowdown in manufacturing;

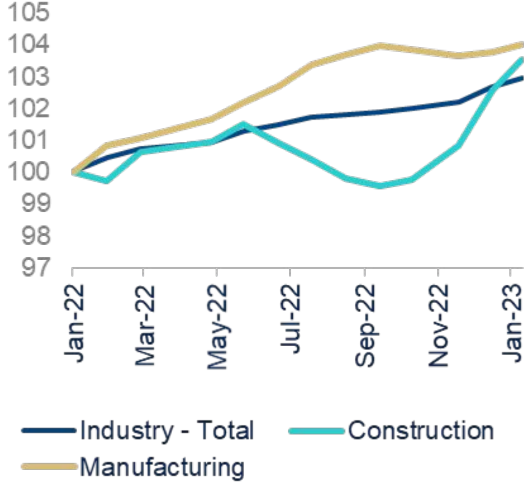
upward revision to our 2023 growth forecast

GDP grew 3.1% in 2022 with manufacturing and consumption resilience; private spending will continue to show dynamism in 2023

GDP COMPONENTS
(INDEX 4Q19=100)



INDUSTRY: SELECTED COMPONENTS (MOVING AVG. 3 MONTHS, INDEX JAN/2022=100)



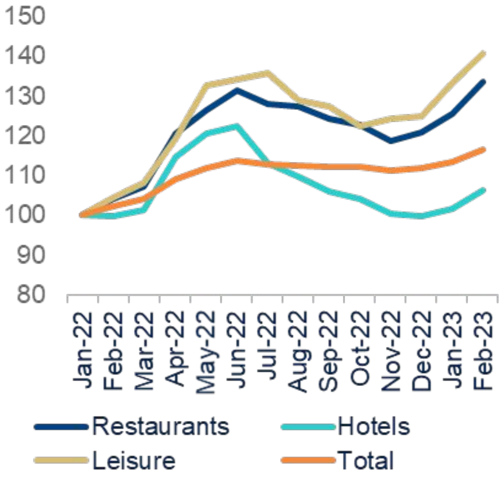
TERTIARY SECTOR: SELECTED COMPONENTS (MOVING AVG. 3 MONTHS, INDEX JAN/2022=100)

Source: BBVA Research/INEGI.

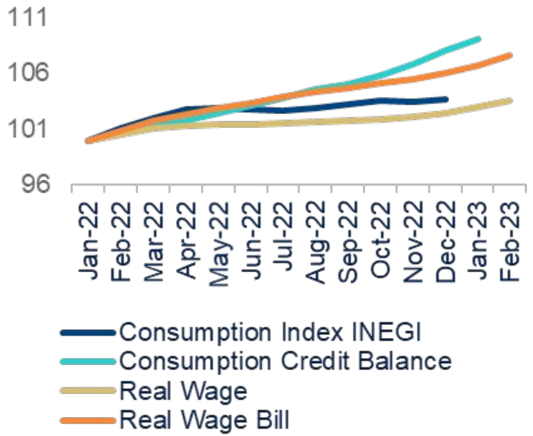
The sectors linked to external demand shower higher growth in 2022 driven by external demand

Improvements in formal employment and real wage have driven private consumption resilience; +momentum in remittances and credit recovery

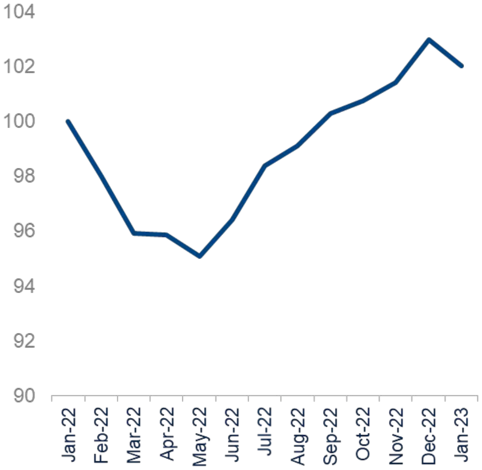
BBVA CONSUMPTION INDICATOR
(MOVING AVG. 3 MONTHS, INDEX JAN/2022=100)



INEGI CONSUMPTION INDEX, CONSUMPTION CREDIT, REAL WAGE & REAL WAGE BILL
(MOVING AVG. 3 MONTHS, INDEX JAN/2022=100)



REMITTANCES
(MOVING AVG. 3 MONTHS, INDEX JAN/2022=100, PESOS)

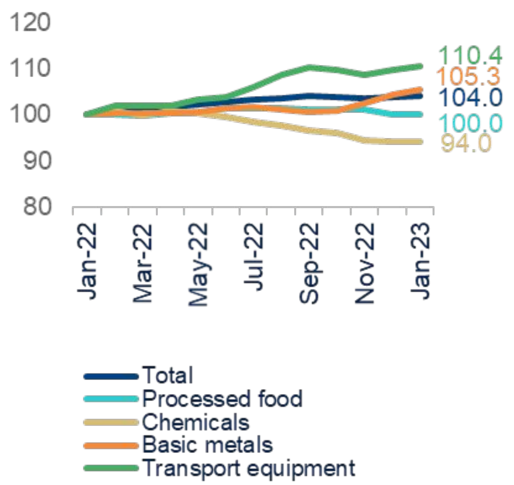


Source: BBVA Research/INEGI

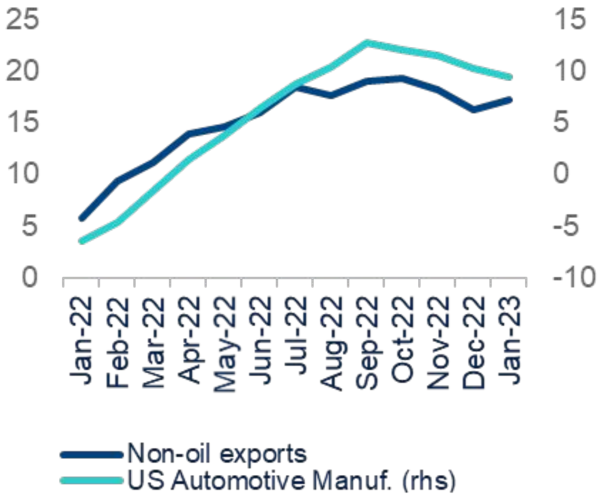
Households have gradually increase their level of leverage, but it is still 5% its pre-pandemic level

The eventual weakening of external demand for durable goods will slowdown manufacturing production

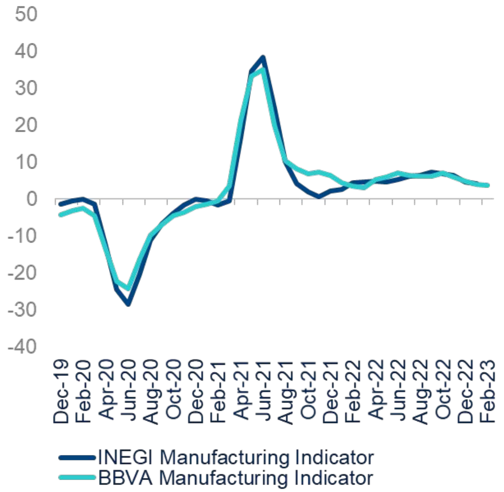
MANUFACTURING: SELECTED SECTORS (MOVING AVG. 3 MONTHS, INDEX JAN/2022=100)



NON-OIL EXPORTS & US AUTOMOTIVE MANUFACTURING (Y/Y%, MOVING AVG. 6 MONTHS)



MANUFACTURING: INEGI VS BBVA INDICATOR (Y/Y%, MOVING AVG. 3 MONTHS)

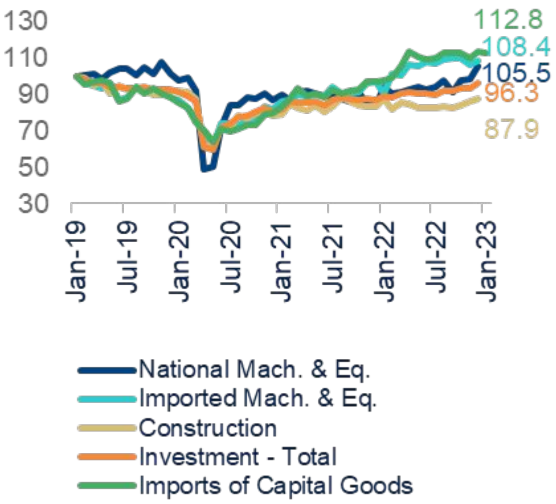


Source: BBVA Research/INEGI

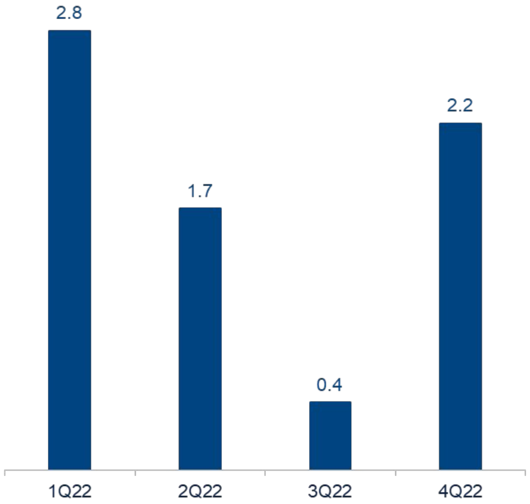
In February, the BBVA Manufacturing Indicator showed the lowest year-on-year variation since the end of 2021

Investment: the machinery and equipment segment shows high dynamism due to nearshoring; more certainty would potentiate it

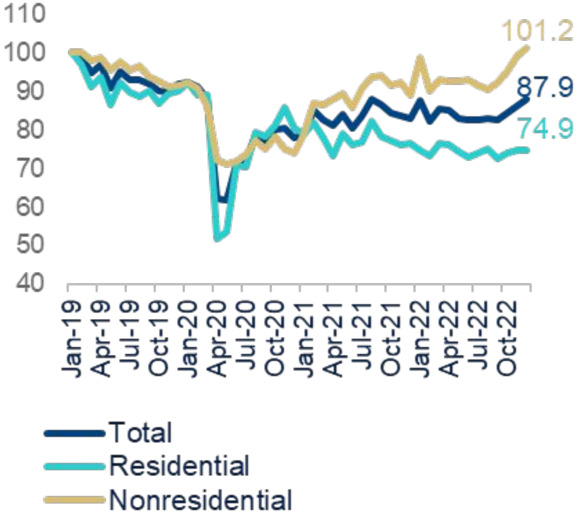
GROSS FIXED INVESTMENT & IMPORTS OF CAPITAL GOODS
(INDEX JAN/2019=100)



PRIVATE INVESTMENT
(Q/Q%)



CONSTRUCTION: COMPONENTS
(INDEX JAN/2019 =100)

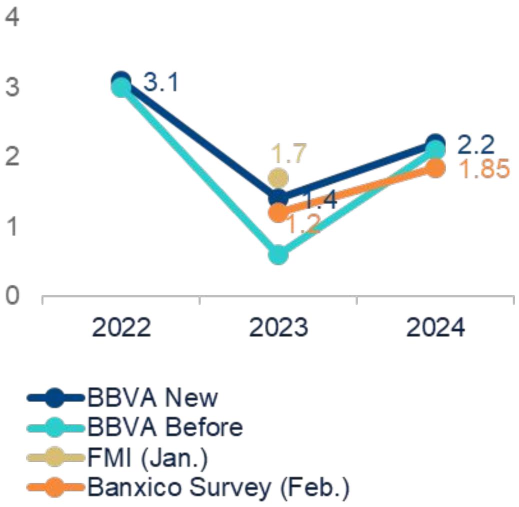


Source: BBVA Research, INEGI

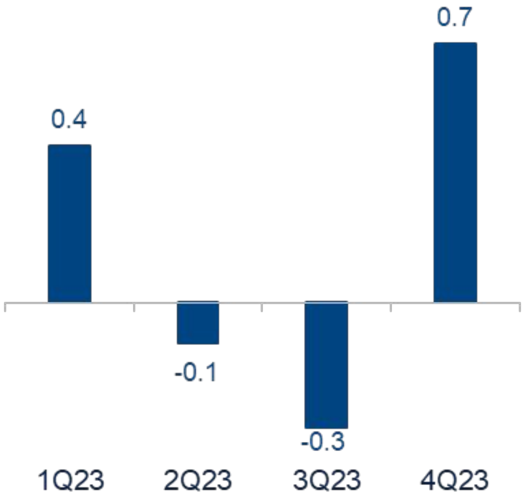
Construction is 12% below its Jan-19 level, keeping total investment 4% below that same threshold

Upward revision to our 2023 GDP growth forecast to 1.4% (0.6% before); domestic demand and US resilience as main drivers

GDP
(ANNUAL % CHANGE)



GDP
(Q/Q%)



OUTPUT GAP: BANXICO ESTIMATE
(% OF POTENTIAL GDP)

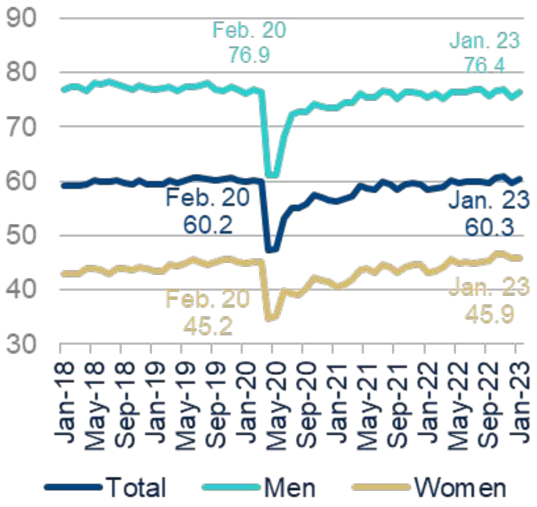
Source: BBVA Research, INEGI.

The economy is currently 1.5% below potential

Labor participation has recovered to pre-pandemic levels; however, the unemployment rate remains at historically low levels

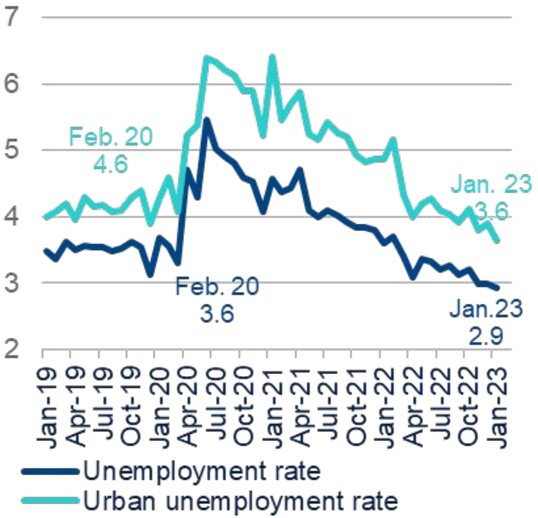
LABOR FORCE

(% EAP)



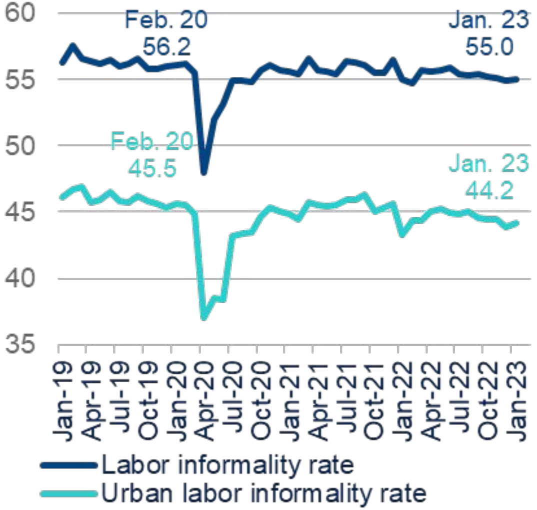
UNEMPLOYMENT RATE

(% OF EAP, SA)



LABOR INFORMALITY RATE

(% EMPLOYED, SA)

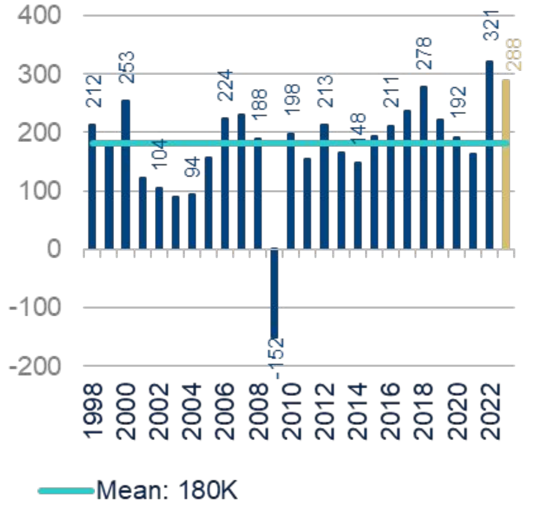


Source: BBVA Research, INEGI

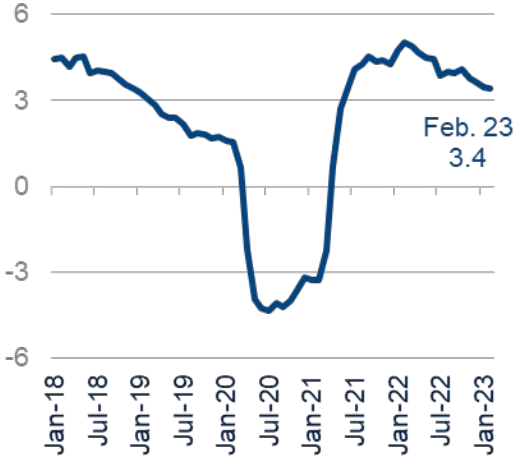
Labor informality continues without significant changes in the trend and is below the pre-pandemic level.

Formal employment shows strength at the beginning of the year, but we expect moderation in the coming months

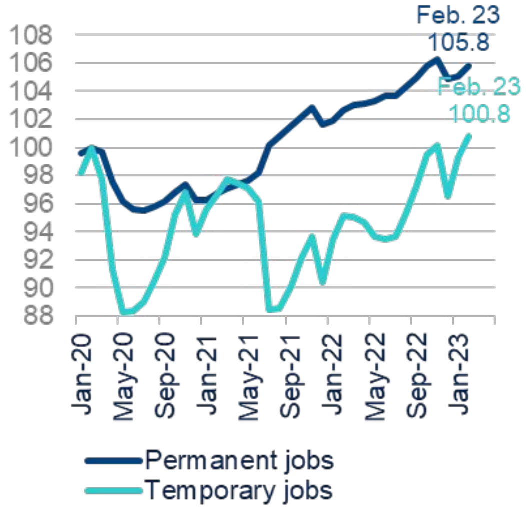
JOBS AFFILIATED WITH THE IMSS
(CUM. JAN-FEB, THOUSANDS)



JOBS AFFILIATED WITH THE IMSS
(ANNUAL CHANGE, %)



JOBS AFFILIATED WITH THE IMSS BY TYPE (INDEX, FEB-20=100)

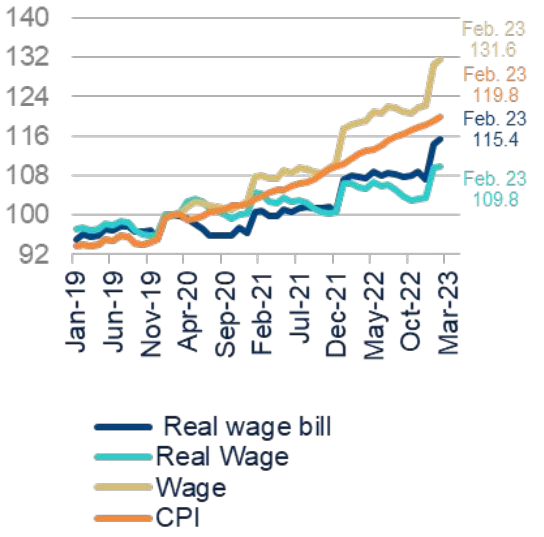


Source: BBVA Research,IMSS.

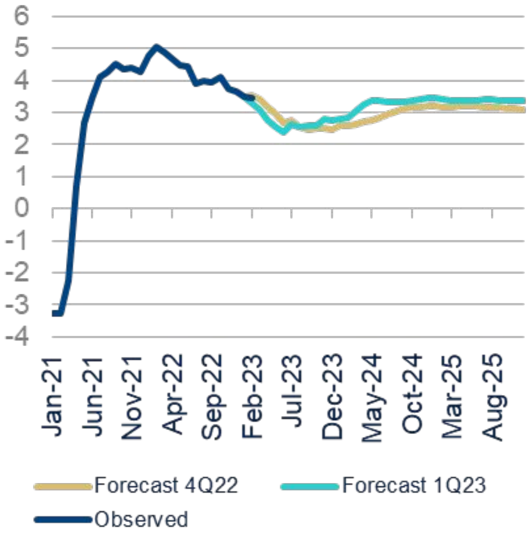
Permanent employment explains 73.9% of job creation in February, presenting an interannual variation of 3.0%, a level lower than that of February of the previous year, which was 6.2%, reinforcing this moderation in employment growth.

In 2023 we expect a more moderate employment growth compared to the previous year, in line with the expected growth of the economy

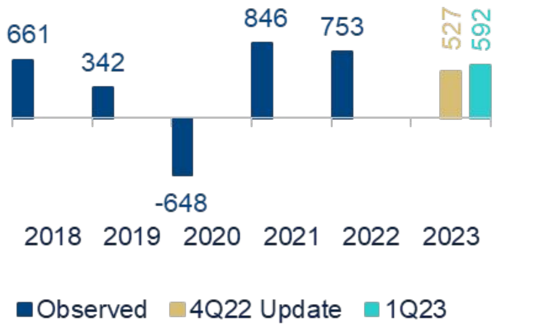
REAL WAGE AND TOTAL REAL WAGE BILL, IMSS (FEB-20 INDEX=100)



JOBS AFFILIATED WITH THE IMSS (ANNUAL CHANGE, %)



JOBS AFFILIATED WITH THE IMSS (ANNUAL CHANGE EOP, THOUSANDS)



Forecast	2023	2024	2025
THOUSANDS, EOP			
1Q23	592	753	764
4Q22 Update	527	700	702
ANNUAL CHANGE, % EOP			
1Q23	2.8	3.4	3.4
4Q22 Update	2.5	3.2	3.1

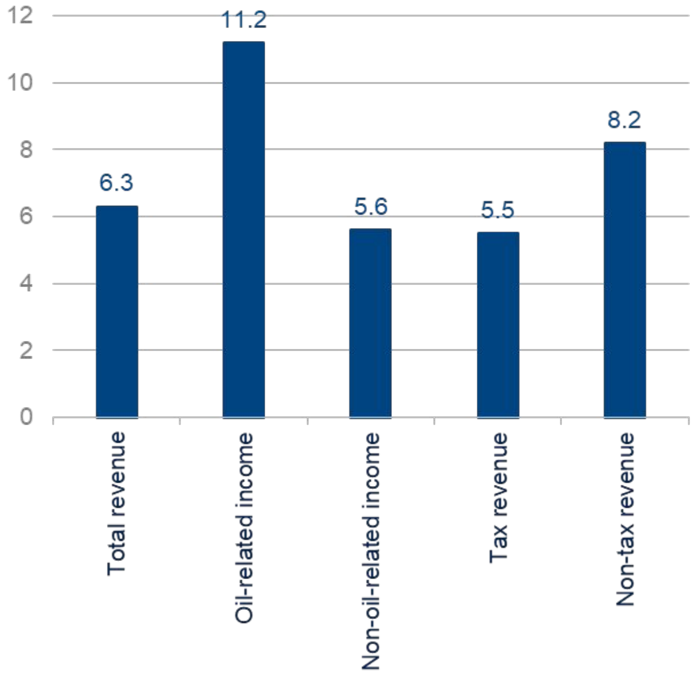
Source: BBVA Research,IMSS.

Wage reviews and job creation will be key to supporting the wage bill during 2023 and household consumption.

Public revenue in January 2023 was supported by all sorts of income; discretionary spending compensated the sizable increase in debt servicing

PUBLIC REVENUE AND MAIN COMPONENTS IN JANUARY 2023

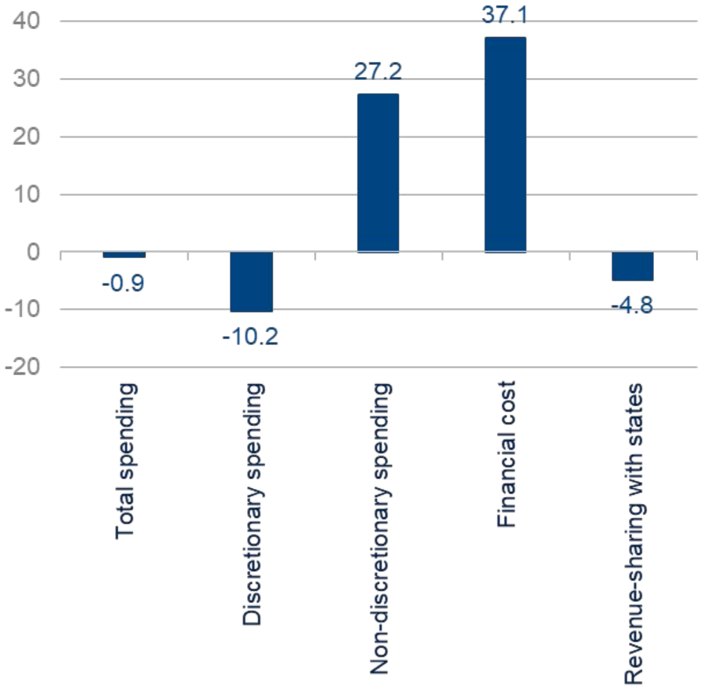
(REAL YOY %)



Source: BBVA Research / SHCP

PUBLIC SPENDING AND MAIN COMPONENTS IN JANUARY 2023

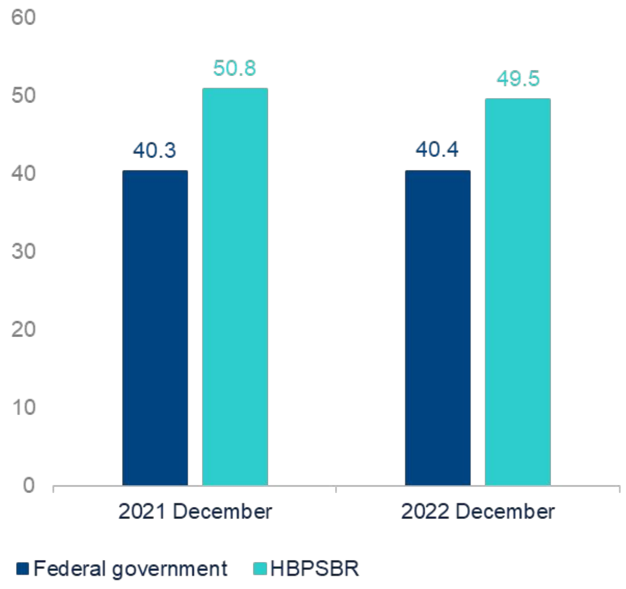
(REAL YOY %)



Source: BBVA Research / SHCP

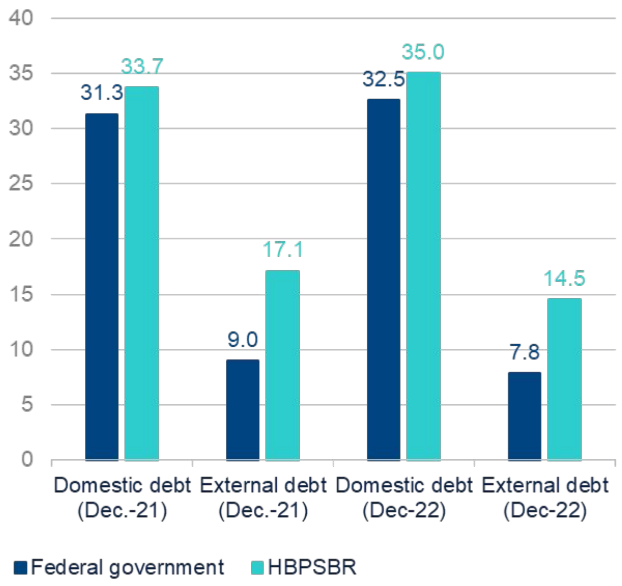
The reduction of 2.6 pp in the external component of the Historical Balance of PSBR (% of GDP) contributed to the fall of such balance

PUBLIC DEBT
(% OF GDP)



Source: BBVA Research / SHCP.

COMPONENTS OF PUBLIC DEBT
(% OF GDP)

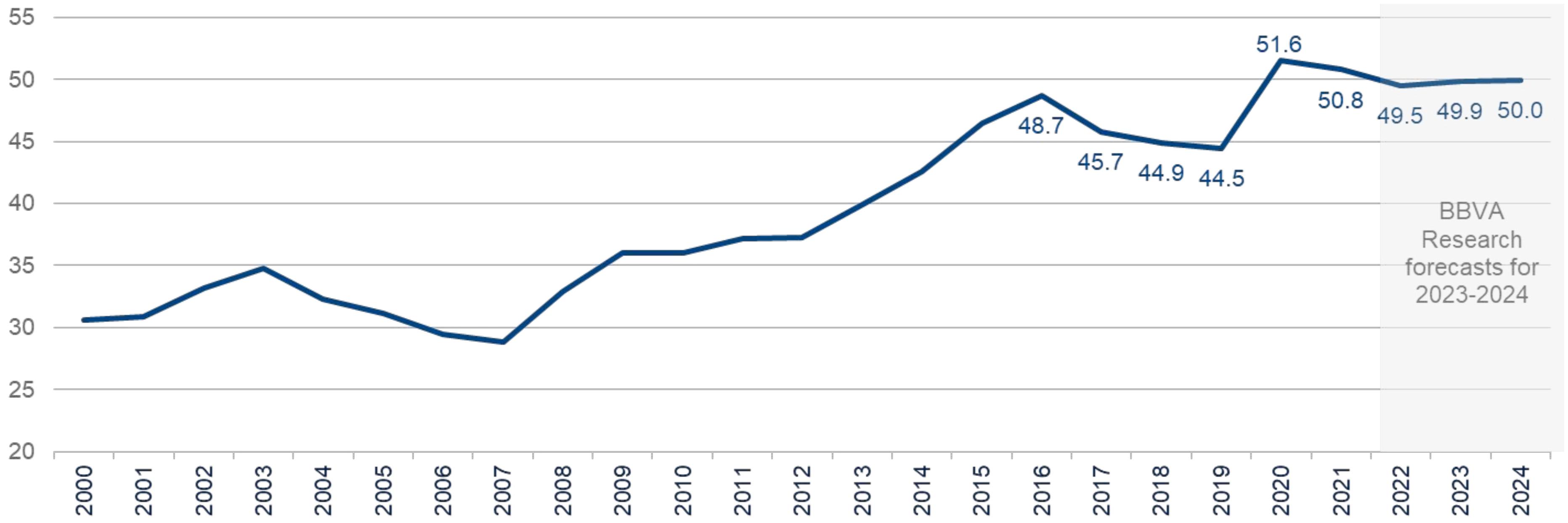


Source: BBVA Research / SHCP.

Public debt (% of GDP) will remain stable for the rest of AMLO's government and for this reason the risk of Mexico losing the investment grade is quite limited

HISTORICAL BALANCE OF PUBLIC SECTOR BORROWING REQUIREMENTS

(% OF GDP)



Source: BBVA Research / SHCP

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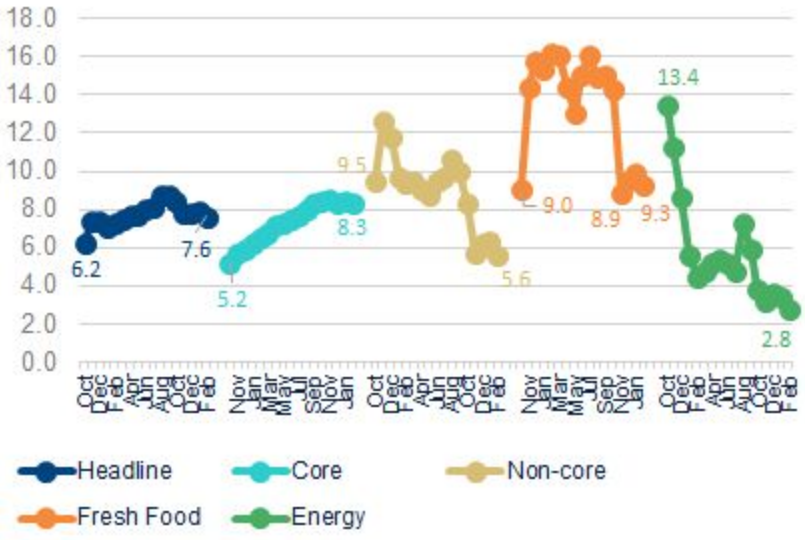
03

Rates will peak at 11.50%;

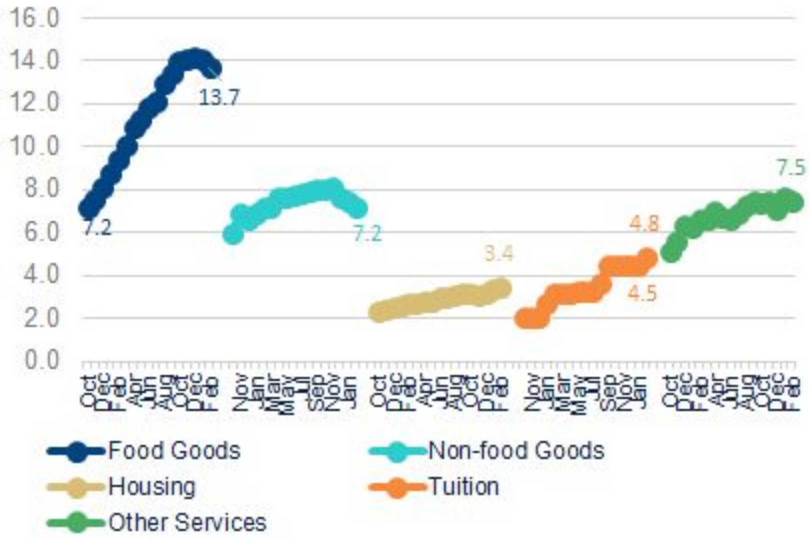
we expect a rapid rate-cut cycle in 2024

Inflation is falling mainly driven by lower non-core inflation…

HEADLINE INFLATION BREAKDOWN
(YOY % CHANGE)



CORE INFLATION BREAKDOWN
(YOY % CHANGE)



Source: BBVA Research, INEGI..

… but the seasonally-adjusted core inflation trend points to a more pronounced slowdown in the coming months…

HEADLINE INFLATION: ACTUAL & SA TREND*

(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)

* Own calculations
Source: BBVA Research con datos de INEGI.

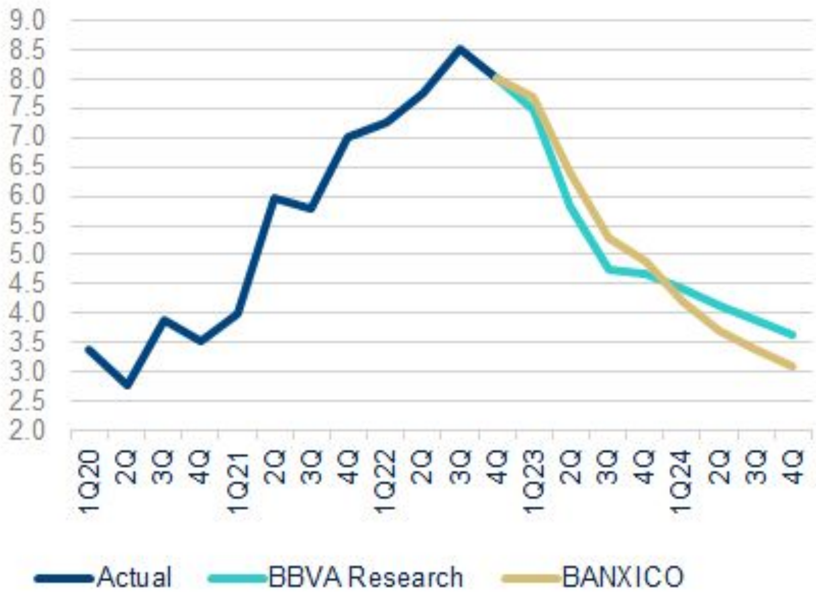
CORE INFLATION: ACTUAL & SA TREND*

(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)

* Own calculations.
Source: BBVA Research con datos de INEGI.

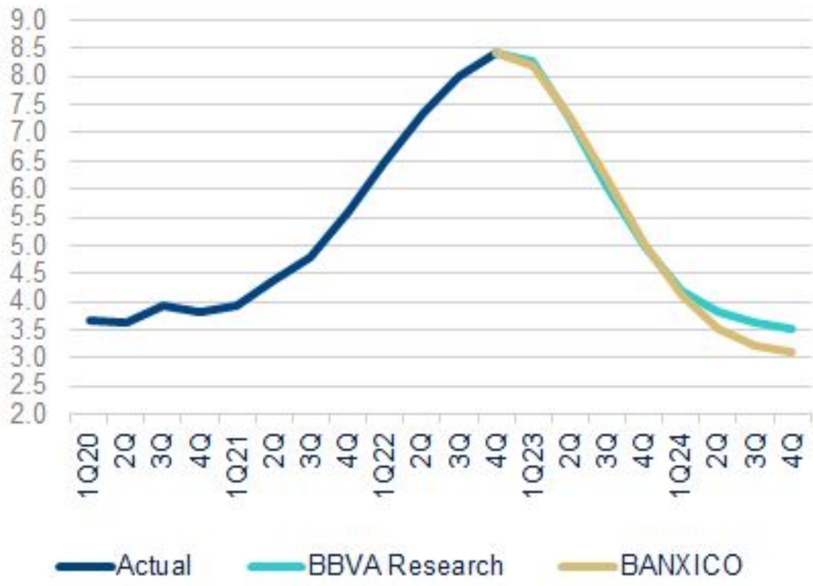
… as we foresee in our baseline scenario, and as Banxico also anticipates

HEADLINE INFLATION OUTLOOK
(YOY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research, INEGI, BANXICO.

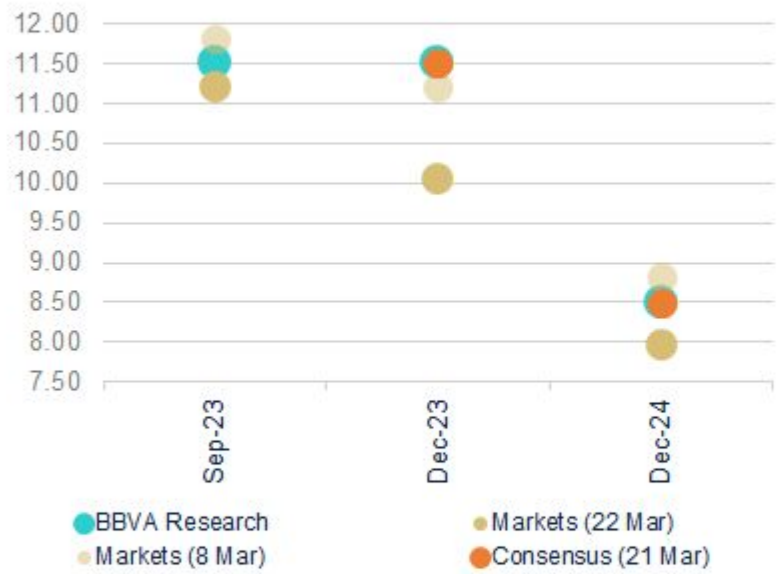
CORE INFLATION OUTLOOK
(YOY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research, INEGI, BANXICO

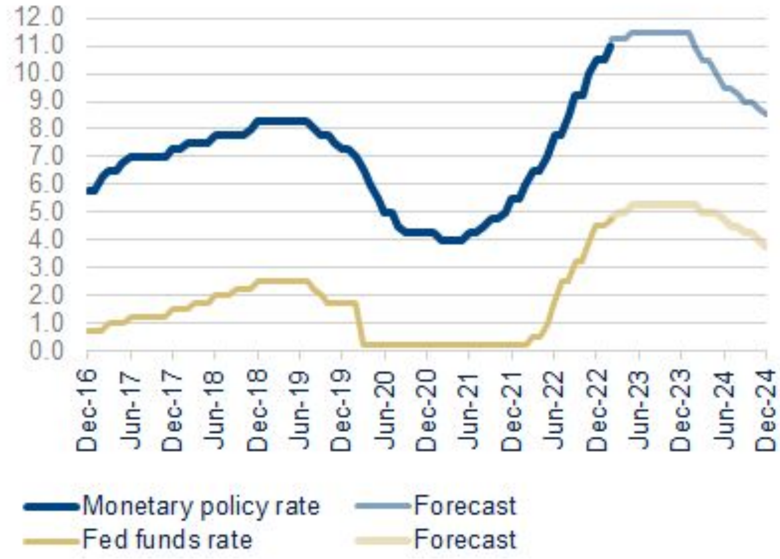
We anticipate that Banxico will bring the policy rate to 11.50%, but that, with lower inflation, it will implement a rapid rate-cut cycle during 2024...

MONETARY POLICY RATE OUTLOOK: BBVA RESEARCH VS MARKET AND CONSENSUS (%)



Latest data: 22 Mar for market expectations and 21 Mar for consensus expectations (latest available Banamex Survey). Source: BBVA Research, Banamex Surveys, Bloomberg.

MONETARY POLICY RATE OUTLOOK (%)

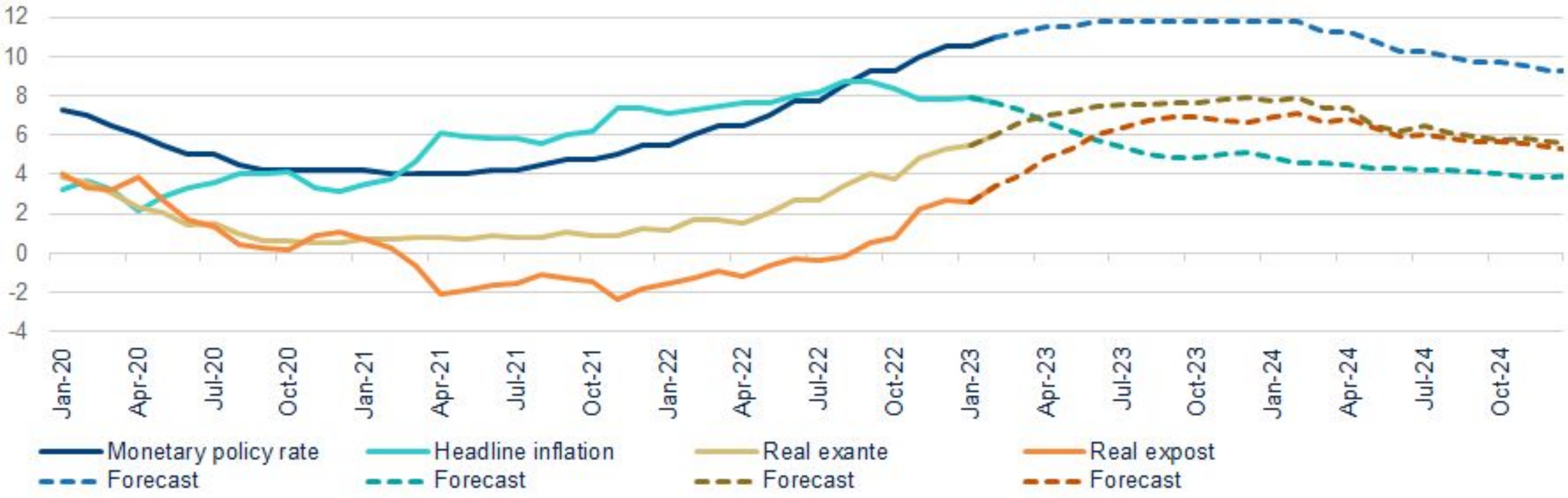


Source: BBVA Research, BANXICO, Bloomberg.

…to avoid unnecessary further tightening of the monetary stance with falling inflation

MONETARY POLICY RATE OUTLOOK

(%)

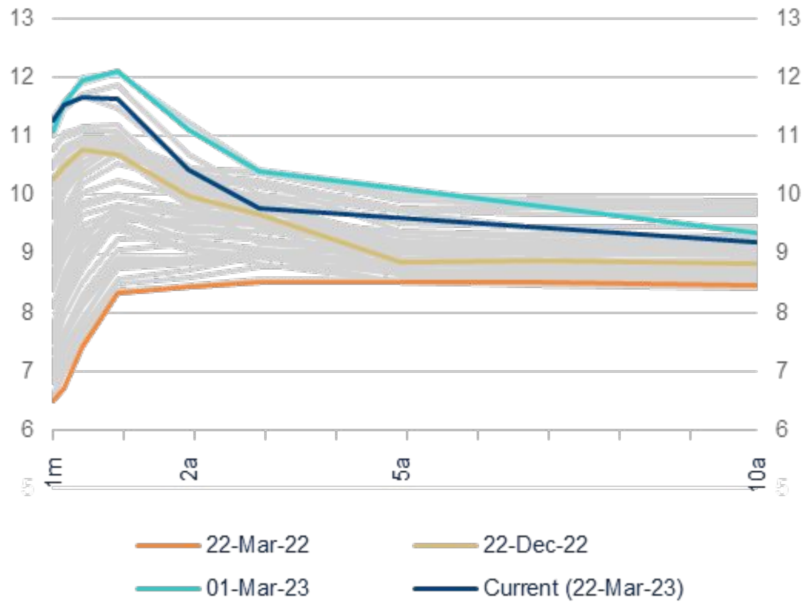


Source: BBVA Research, BANXICO & INEGI.

The yield curve shifted down amid recent turbulence caused by the vulnerability of some banks in the US

MX SOVEREIGN YIELD CURVE

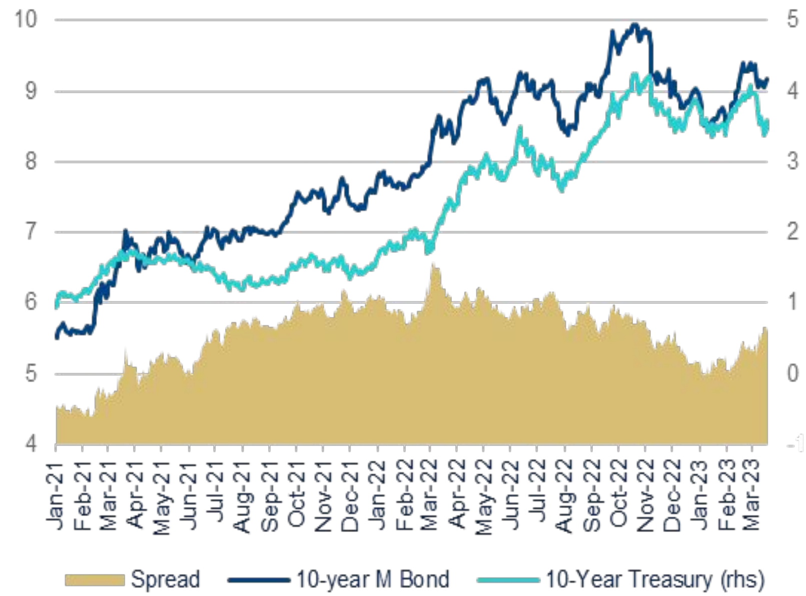
(%)



The gray lines show weekly yield curves over the last 12 months.
Source: BBVA Research based on data by Bloomberg.

MX AND US 10-YEAR YIELDS

(%)

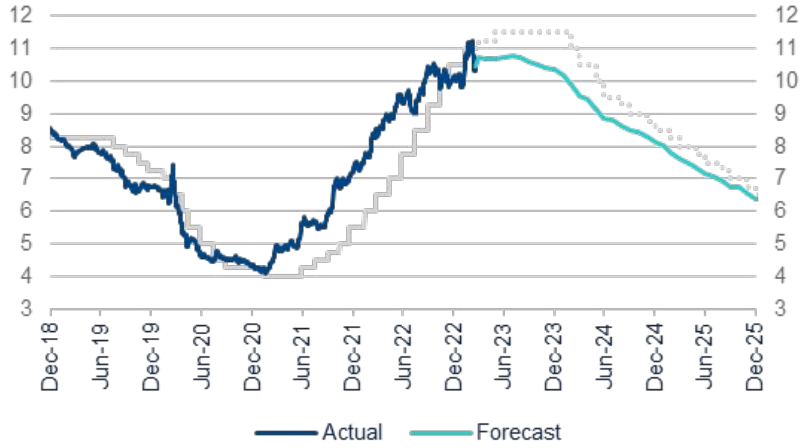


Source: BBVA Research based on data by Bloomberg and Haver Analytics.

Recent concerns on signs of global financial instability reinforce our view that long-term rates are past their peak

2-YEAR M BOND YIELD OUTLOOK

(%)

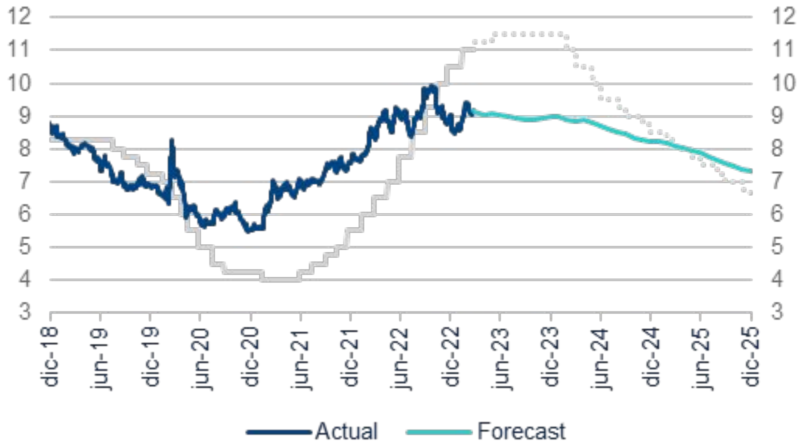


2-year M Bond	23	24	25
Forecast	10.4	8.1	6.4

Source: BBVA Research based on data by Bloomberg and Haver Analytics.
The gray solid (actual) and dotted (forecast) line indicates Banxico's overnight target rate.

10-YEAR M BOND YIELD OUTLOOK

(%)

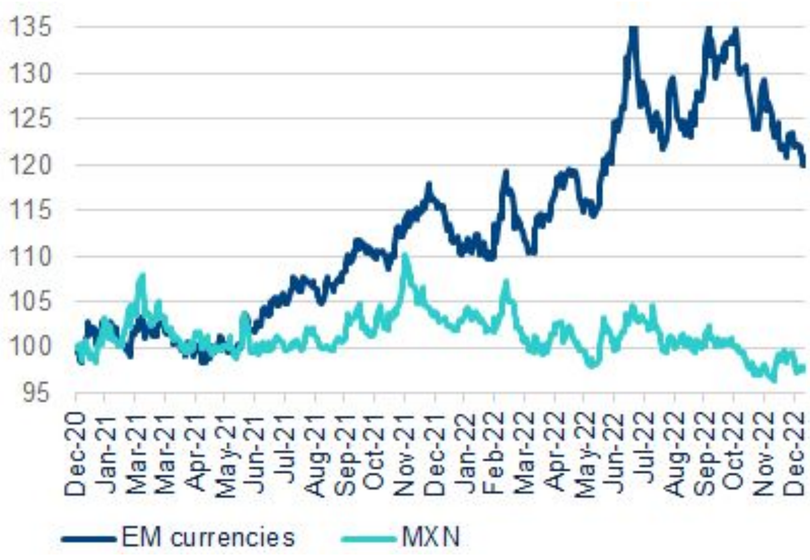


10-year M Bond	23	24	25
Forecast	9.0	8.2	7.3

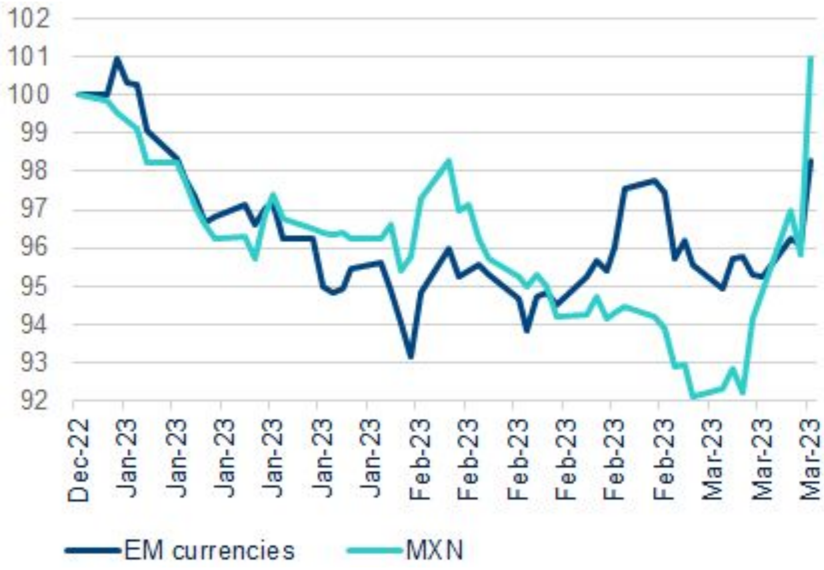
Source: BBVA Research based on data by Bloomberg and Haver Analytics.
The gray solid (actual) and dotted (forecast) line indicates Banxico's overnight target rate.

Wide rate differential, capital inflows, and fiscal soundness explain the better relative performance of the peso, but it is vulnerable to risk-off episodes

MXN & EM CURRENCIES RELATIVE PERFORMANCE[1] 2021-22
(INDEX, 31 DEC 2020=100)



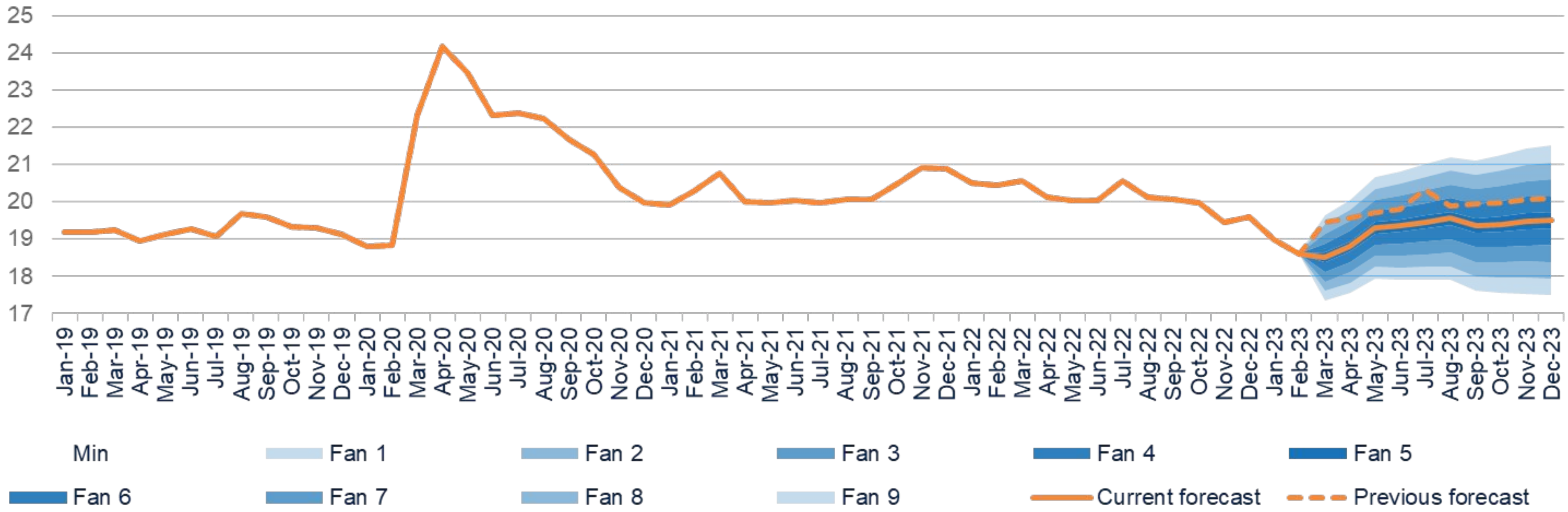
MXN & EM CURRENCIES RELATIVE PERFORMANCE[1] 2023
(INDEX, 31 DEC 2022=100)



1 Based on a reweighting of the JP Morgan EM Currency Index after removing the MXN.
Source: BBVA Research, Bloomberg.

We now expect the ER to reach 19.5 ppd by the end of 2023 and anticipate a gradual depreciation path driven by higher inflation in Mexico vs. US

EXCHANGE RATE
(PESOS/USD)



Source: BBVA Research, Bloomberg.

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04

Main messages & forecasts summary

Main messages

Recent developments

The failures of Silicon Valley Bank and Signature Bank in the US prompted decisive action by central banks to provide liquidity to the banking system. Both banks neglected their A&L management and incurred large unhedged interest rate and liquidity risk. In Europe, the Credit Suisse crisis was resolved with the acquisition by UBS, but uncertainty about the creditor hierarchy increased.

Growth estimate

Upward revision to our 2023 GDP growth forecast to 1.4% (0.6% before); 2.2% in 2024

- Private spending will boost growth this year and mitigate the slowdown in manufacturing given the deceleration in external demand.
- Gains in real wages and employment will drive private consumption; the recovery of consumption credit and the positive evolution of remittances will contribute to households' spending resilience.
- Manufacturing will lose ground on lower demand for durable goods in US.
- In investment, the machinery and equipment segment has shown dynamism boosted by nearshoring; construction remains 12% below its pre-COVID level.

In 2023 we expect lower growth in formal employment compared to the previous year. Wage reviews and the expectation of lower inflation will be key to maintaining the growth rate of real wages and the wage bill, which will benefit household consumption.

Main messages

Inflation & Monetary Policy

We expect Banxico to keep a very restrictive stance during 2023-24, but in a backdrop of easing inflation, a rapid rate-cut cycle will be needed to avoid an unwarranted increase in real rates.

- We anticipate that Banxico will bring the policy rate to an 11.50% peak, but that with lower inflation it will implement a rapid rate-cut cycle during 2024
    - The seasonally-adjusted core inflation trend points to a marked slowdown in the coming months…
    - … as we foresee in our baseline scenario, and as Banxico also anticipates. We anticipate headline and core inflation to reach 4.8% and 4.7% by year-end, respectively

Exchange rate

We now expect the ER to reach 19.5 ppd (with a downward bias) by the end of 2023, anticipating a gradual depreciation path driven by higher inflation in Mexico vs. US

Forecasts summary

		2020	2021	2022	2023	2024
GDP (Annual % change)	nuevo	-8.2	4.9	3.1	**1.4**	**2.2**
	anterior				0.6	1.8
Employment (%, eop)	new	-3.2	4.3	3.7	**2.8**	**3.4**
	previous				2.5	3.2
Inflation (%, eop)	new	3.2	7.4	7.8	**4.8**	**3.6**
	previous				4.3	3.5
Policy rate (%, eop)	new	4.25	5.50	10.50	**11.50**	**8.50**
	previous				11.25	8.75
Exchange rate (ppd, eop)	new	20.0	20.9	19.6	**19.5**	**19.7**
	previous				20.1	20.3
M10 (%, eop)	new	5.5	7.6	9.0	**9.0**	**8.2**
	previous				8.8	8.3
Fiscal balance (% of GDP)	new	-2.9	-2.9	-3.4	**-3.6**	**-2.5**
	previous				-3.6	-2.5
Current account (% of GDP)	new	2.3	-0.4	-1.0	**-0.6**	**-0.8**
	previous				-0.8	-1.5

Disclaimer

BBVA Research

Mexico Economic Outlook

March 2023

Creating Opportunities