Banxico to keep rates on hold this week, despite the economic slowdown and relatively stable MXN.

Inflation edged higher in April; hawkish members of the board will continue to push for a cautious tone.

The disinflation trend will resume soon and slowing economic activity will support the case for rate cuts.

Poor Data in Mexico are Gradually Setting the Stage for Rate Cuts

External and domestic shocks in Mexico over the last two years, including the "gasolinazo", NAFTA renegotiation and the presidential election, have put the country's financial metrics under severe stress and pushed inflation to cyclical highs. This has forced Banxico to adopt a hawkish monetary policy stance. But as inflation drops to its lowest rate since 2016—despite a temporary rebound in early Q2 due to Easter distortions and statistical quirks—and economic activity slows, the case for policy easing inevitably will strengthen over the next three-to-six months. *Our long-standing view is that Banxico will start to cut rates in late Q3 or Q4, and data released last week reinforce our view.*

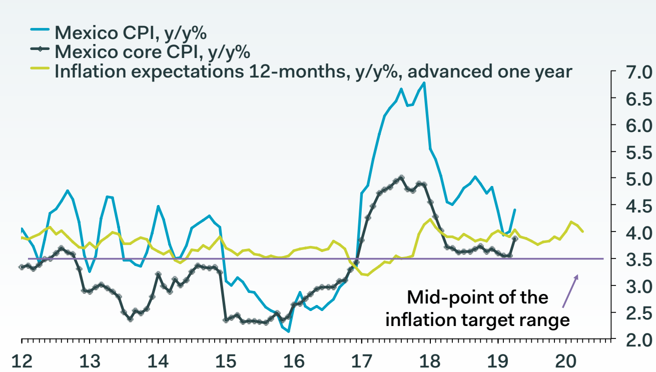
We doubt Banxico will adopt a particularly dovish tone at Thursday's meeting, though, given the recent inflation rebound and increased U.S.-China trade tensions. *But we think the conditions preparing the ground for rate cuts will start to develop sooner than markets expect.* Consumer prices rose 0.1% month-to-month unadjusted in April, in line with market expectations. Inflation rose to 4.4% year-over-year, up from 4.0% in March, but underlying forces are tame.

The modest month-to-month CPI increase was driven by the core component, which rose 0.5%, more than the 0.2% increase in March last year. Both services and goods drove the core component higher, rising 0.6% and 0.4% respectively. Higher prices for holiday-related services and airfares were the primary drivers, due to the late timing of Easter. These pressures eased in the second half of April. The year-over-year core rate edged higher to 3.9%, from 3.6% in Q1. *Even excluding the more volatile components at this time of year, services inflation edged up only to 3.9% from 3.8% in March, and the trend is stable.*

The non-core component, meanwhile, fell 1.2% month-to-month, chiefly due to lower energy tariffs, driven by government subsidies. This helped to offset the modest 0.5% gain in non-processed food prices. The year-over-year non-core rate increased by 0.6 percentage points, to 6.1%. This is slightly higher than we were expecting, but it was mainly due to the lower weighting of electricity prices within the index compared to last year, down to 1.5%, from 2.8% previously. We expect the non-core downtrend to resume soon.

Overall, inflation has pushed higher since February, but we think that the disinflation trend will resume, especially towards the end of the year. In total, the combined effect of the subpar economic recovery, favourable base effects, and a relatively stable MXN year-to-date will help to bring inflation down towards 3.5% by year end. This supports our case for rate cuts by the end of the year. Inflation expectations remain relatively high, which will be an ongoing source of concern for policymakers, ensuring

INFLATION EXPECTATIONS WILL START TO EASE SOON



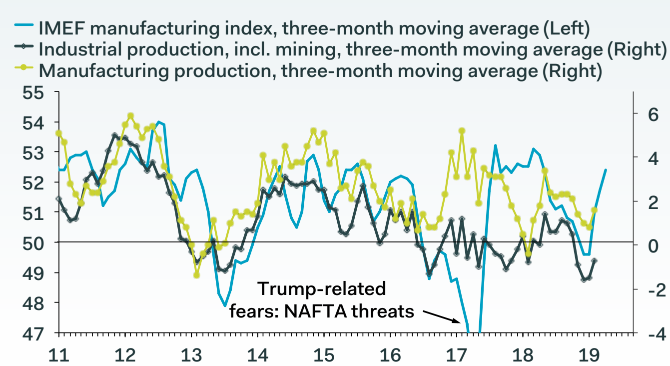
a cautious approach in the very near term. But if inflation converges to the target during the second half, as we foresee, expectations likely will start to fall consistently, easing Banxico's fears.

The growth data released last week, meanwhile, were very disappointing, in line with falling market expectations for economic activity in recent months. This downbeat sentiment is still in contrast to robust—albeit recently declining—consumer sentiment, and the downtrend has intensified since AMLO was elected President. *Recent data, including industrial production, retail sales, capex, unemployment and credit conditions, have deteriorated, confirming these downbeat expectations.*

According to March's industrial report, released on Friday, output plunged 1.3% month-to-month, wiping out the 0.4% increase in February and the 0.5% gain in January. Most importantly, a modest 0.3% increase in manufacturing production, was offset by weakness elsewhere. Construction output plunged 3.4% month-to-month, the biggest drop since March 2017. Infrastructure spending usually slows at the start of a new government, but the recent weakness is significant. Activity in the mining/oil sector, meanwhile, remains a drag, falling 1.5%, but due mainly to weakness in services related to the sector. Oil output seems to be stabilizing, at last.

Overall, the year-over-year rate of output growth fell to -2.6% in March, from -1.2% in February. The underlying trend, however, looks to be turning *up* with total output falling 0.4% quarter-on-quarter in Q1, following a 3.0% drop in Q4. That said, the sharp month-to-month contraction in March highlights

INDUSTRIAL ACTIVITY IS STABILIZIING, BUT THREATS LOOM



that the industrial sector is still very weak, even after eliminating the effect of temporary shocks including strikes, stoppages or the effect of a new administration on public spending. Mexico's industrial activity will continue to be held back by weak mining output and the effect of soft external demand in manufacturing. The latter will start to do slightly better over the second half, but global tensions remain a threat.

This is also evident in the gross fixed investment report released last week. GFI fell 2.5% month-to-month in February, following an unsustainable 8.0% leap in January and a 0.9% drop in December. The year-over-year rate fell 2.4% in February, trivially up from -2.5% in the previous three months. Total purchases of machinery and equipment plunged 2.0% month-to-month, with spending on imported equipment as the main drag, dropping 3.1% and overshadowing a 0.6% increase in domestic machinery investment.

We think that ongoing fears of populist policies, the lack of a clear policy on foreign investment by the new government, and the ongoing USMCA uncertainty is still persuading companies to keep capex projects on hold. Construction capex, meanwhile, fell 2.3% month-to-month in February, hurt by both weak residential and public infrastructure spending. But we still believe that the sector will do well this year, as fiscal and monetary drags start to ease.

Overall, the activity reports released last week confirm the weakness shown in other key hard data and the Q1 GDP report. The economy has come under strain due to trade-related risk, uncertainty about AMLO's policies, and stifling interest rates. Still, we expect a gradual improvement this year as these drags ease, public investment starts to pick up, and Banxico start easing rates. *Banxico will cut rates gradually, and will need to maintain a decent U.S.-Mexico rate differential to keep the MXN under control.* Moreover, the U.S. presidential election is around the corner and some businesses will prefer to wait until the political story becomes clear before advancing on their investment projects. Growth, therefore, will remain unexciting.

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, May 13

• Colombia Trade Balance (3)/10:00 Local
The unadjusted trade deficit likely rose to **USD0.8B** in March, from USD0.4B a year ago. **Consensus: USD0.8B.**

Tuesday, May 14

• Colombia Retail Sales (3)/10:00 Local
We look for a **6.0%** year-over-year increase, up from 5.7% in February. The COP's modest rebound in recent months, and improving retail confidence, suggest that the sector will do well. **Consensus: 5.5%.**

• Colombia Industrial Production (3)/10:00 Local
Industrial output likely rose **4.0%** year-over-year, accelerating from 2.8% in March. Improving fundamentals and better external conditions will help the industrial sector in the near term. **Consensus: 3.5%.**

Wednesday, May 15

• Colombia GDP (Q1)/11:00 Local
GDP likely increased by **3.0%** year-over-year, up from 2.8% in Q4. Services, commerce, and construction were the main drivers of Q4 growth, offsetting a modest drag from the mining/oil sector. **Consensus: 3.0%.**

• Argentina Consumer Prices (4)/16:00 Local
We think the index rose **4.1%** month-to-month in April, due to regulated price increases and the effect of the recent ARS sell-off. The year-over-year rate should have risen to **56.8%**, from 54.7% in March. Inflation pressures will start to ease in the second half. **Consensus: 4.0%.**

• Peru Economic Activity Index (3)/No set time
The index likely increased **2.8%** year-over-year in March, up from 2.1% in February. **Consensus: 3.0%.**

• Peru Unemployment Rate (4)/No set time
The unadjusted jobless rate likely fell to **6.7%** in April, from 7.0% in April 2018. **Consensus: N/A.**

Thursday, May 16

• Brazil Economic Activity Index (3)/No set time
The activity index likely will fall **2.2%** year-over-year, down from 2.5% in February. The underlying trend is deteriorating and confidence is easing. The economy will remain weak this year. **Consensus: -2.2%.**

• Mexico Overnight Rate /13:00 Local
We expect Banxico to keep interest rates on hold at **8.25%**. The MXN has stabilized this year due to reduced political risk and inflation pressures remain tame despite a modest rebound in Q1 and Q2. Our base case that Banxico will leave rates on hold over the next three-to-six months, as demand-related inflation pressures are very limited, and the economy will slow. But the door for rate cuts likely will be open in Q4, assuming favourable external conditions and a market-friendly AMLO. **Consensus: 8.25%.**

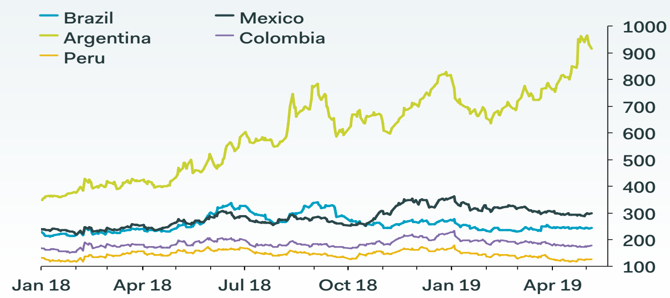
Friday, May 17

• Colombia Consumer Confidence (4)/No set time
We look for the confidence index to plunge to **-10** in April, from +1.2 in March; thanks mainly to the recent COP sell-off, despite low inflation. **Consensus: 3.3.**

PANTHEON'S LATAM FINANCIAL CONDITIONS DASHBOARD

	Currency			Benchmark Stock index		
	Value	Week, %	YTD, %	Value	Week, %	YTD, %
Argentina	44.83	-0.8	-16.0	33,394	3.0	10.2
Brazil	3.96	-0.4	-1.9	94,258	-1.8	7.2
Chile	686.5	-1.2	1.1	5,051	-1.6	-1.1
Colombia	3,274	-1.1	-0.6	12,662	0.7	13.6
Mexico	19.10	-1.0	2.9	43,382	-2.0	4.2
Peru	3.32	-0.5	1.6	20,160	-3.1	4.2
Venezuela	--	--	--	16,554	-0.5	931.2

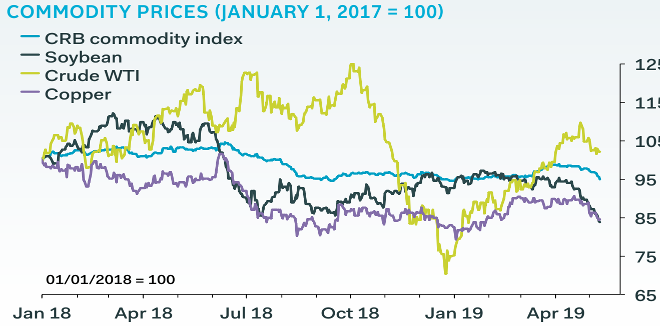
INDEX EMBIG SPREAD LATAM HISTORY



PANTHEON'S ECONOMIC FORECASTS

	Real GDP, y/y%		Inflation, Avg.		Interest rate, Q4	
	2018	2019	2018	2019	2018	2019
Argentina	-2.8	-1.0	33.8	39.0	59.25	50.00
Brazil	1.1	1.2	3.7	3.8	6.50	6.50
Chile	4.0	3.0	2.4	2.6	2.75	3.50
Colombia	2.7	3.0	3.2	3.1	4.25	4.75
Mexico	2.0	1.1	4.9	4.0	8.25	7.75
Peru	4.0	4.2	1.3	2.5	2.75	3.25
Venezuela	-17.0	-20.0	1.3M	25M	--	--

COMMODITY PRICES (JANUARY 1, 2017 = 100)



PANTHEON'S FINANCIAL FORECASTS

	Currency			Benchmark Stock index		
	Q2F	Q3F	Q4F	Q2F	Q3F	Q4F
Argentina	44.2	44.5	45.2	33,400	32,100	37,300
Brazil	3.75	3.45	3.67	98,100	101,500	103,200
Chile	674	667	648	5,240	5,380	5,460
Colombia	3,080	3,010	3,005	1,610	1,680	1,720
Mexico	19.2	19.4	19.3	43,500	44,300	45,600
Peru	3.25	3.23	3.24	21,200	22,500	23,800
Venezuela	--	--	--	--	--	