THE WEEKLY **LATAM** ECONOMIC MONITOR

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Banxico adopts a less hawkish tone, but its credibility remains intact despite new Board members.

Inflation started the year well under control; it will fall further, opening the door for rate cuts in late Q3.

The economy is slowing and AMLO is market-friendly, for now; no need to leave rates this high.

Banxico Dials Down its Hawkish Tone; but no Rate Cuts Until late Q3

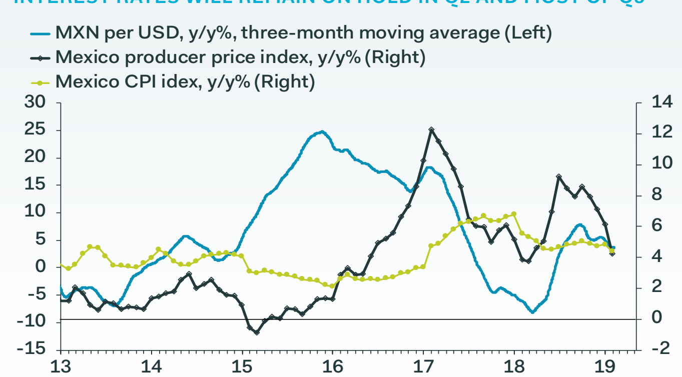
Banxico's monetary policy meeting on Thursday was the first to be attended by the two new deputy governors, Jonathan Heath and Gerardo Esquivel, economists appointed by AMLO. Market participants breathed a sigh of relief at the sight of renewed signs of policy continuity. Any indication of AMLO-driven dovishness would have put financial metrics under severe stress and damaged Banxico's credibility and perceived independence.

Banxico stuck to the script and left the reference rate at 8.25%. The Bank had increased rates by 25bp at each of its previous two meetings, in November and December, forced by rising inflation, deteriorating inflation expectations and volatility in the wake of the airport saga. This time, however, improved domestic financial conditions in recent months and the slowing economy, coupled with a "patient" Fed, prompted policymakers to adopt less hawkish rhetoric. The threats provoked by the global trade war have also pushed policymakers to scale back their rhetoric.

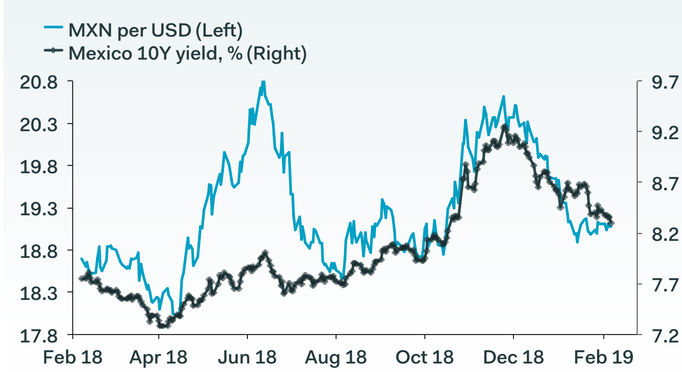
In the statement, Banxico highlighted that the MXN has performed well recently—the peso has rebounded 3% this year—and volatility has eased, with sovereign risk premia and interest rates for the medium and long terms falling, though they still remain relatively high. The Bank noted that long-term interest rates in the U.S. have fallen and the USD has weakened, contributing to the better performance of Mexican markets. The 2019 Budget and the resolution of the airport bond dispute also helped to keep financial metrics under control. But policymakers said that risks remain, with the Pemex situation a key concern. Not surprisingly, AMLO said last week that his government will announce fresh fiscal measures for the state-owned oil company.

The Board did not revise its assessment of the balance of risks to growth and inflation, but regards economic risks as no longer deteriorating. On the inflation front, policymakers believe risks are still biased to the upside, in an environment of high uncertainty. The Bank said it will closely monitor exchange rate pass-through, Fed policy, and the output gap, as

INTEREST RATES WILL REMAIN ON HOLD IN Q2 AND MOST OF Q3



FINANCIAL METRICS ARE IMPROVING; GOOD NEWS FOR BANXICO



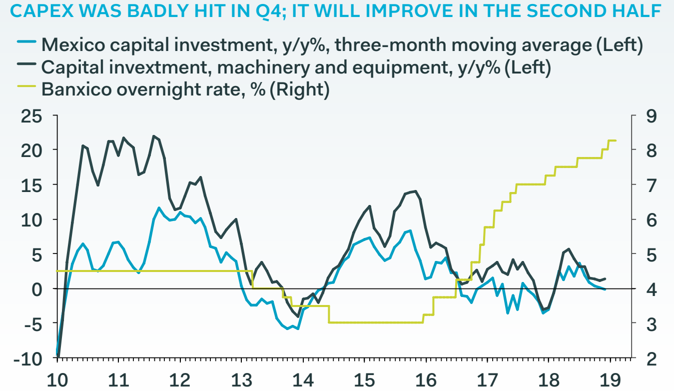
usual. This all suggests that interest rates will remain on hold for the foreseeable future and markets shouldn't price-in any rate cuts in the near term.

It is essential for the Mexican economy and financial markets that the Board demonstrates coherence in decisions that are unbiased by political pressures, and are based solely on their assessment of the economic and financial factors. So a unanimous decision, with no dovish dissents, especially from the new members, was reassuring. But rate hikes will come only if financial conditions deteriorate and inflation expectations overshoot.

The Board said it will act "in a timely and firm manner" to push headline inflation down to its 3% target and keep a lid on inflation expectations. *We think Banxico will leave rates on hold over the coming quarters, as demand-related inflation pressures are very limited, and the economy will slow, at the margin.* If we are right, and AMLO and his team go on reassuring investors, the MXN and financial risks metrics will continue to improve. We expect risks related to the USMCA and Pemex to remain under control. As such, we stick to our base case that the door for rate cuts likely will open gradually in late Q3 or Q4.

Data released last week underscored that the economy is under pressure and inflation is falling consistently; these factors underscore that more rate hikes will be catastrophic. Gross fixed investment plunged 3.1% month-to-month in November, the biggest drop since April 2017, pushing the year-over-year rate down to -2.1%, from 1.8% and a modest 0.5% increase in Q3. The underlying trend has been

CAPEX WAS BADLY HIT IN Q4; IT WILL IMPROVE IN THE SECOND HALF



falling rapidly since April, adding to the case for keeping interest rates on hold.

Consumer prices, meanwhile, rose 0.1% month-to-month in January, below market expectations and much less than the 0.5% increase a year ago, and the 1.7% "gasolinazo" leap in January 2017. Inflation fell to 4.4% year-over-year in January, from 4.8% in December, hitting the lowest rate since December 2016. The main driver of the modest month-to-month increase in January this year was the 0.2% rise in the core. This increase was driven by goods prices, rising a modest 0.3% month-to-month. Non-food goods prices rose 0.1%, in line with their recent trend, constrained by the recent MXN rebound.

Meanwhile, the services index rose just 0.1% in January, after a 0.6% increase in December, driven by falls in airfares and tourist packages, which are normal at this time of year. But the key issue here is that the effects on the services components of the minimum wage increase early this month and inertia have been limited, which will continue to ease some of Banxico's fears. The year-over-year core rate eased to 3.6% from 3.7% in December.

Prices in the non-core group, meanwhile, fell 0.3% month-to-month. Fresh food prices rose 0.4%, but the increase was fully offset by a 0.7% drop in energy prices. Non-core inflation plunged to 6.8% year-over-year, from 8.4% in December. This is a good start to the year as this sub-index has been the main headache for policymakers in the current cycle.

Mexico's inflation is starting to fall consistently, and we expect the underlying trend to ease gradually towards Banxico's 3% target throughout the year. Domestic inflation pressures will remain subdued this year, with little evidence of pass-through effects. The MXN rebound in December through mid-January and its recent stability will help to keep underlying pressures tame. Moreover, AMLO's decision to reduce gasoline prices and VAT in northern states has also helped, and the downside on the CPI has been stronger than we expected. The effect of recent fuel shortages has been modest, at least for now, but will be the main factor to watch in the near term.

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THIS WEEK IN BRIEF

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

Monday, February 11

- **D: Mexico Industrial Production (12)/8:00 Local**
Industrial production likely fell **0.3%** month-to-month, pushing the year-over-year rate down to **-1.5%** in December, from -1.3% in November. We expect the manufacturing sector to improve, once the trade war eases and the USMCA agreement is ratified. **Consensus: -1.6%.**

Tuesday, February 12

- **No significant data released.**

Wednesday, February 13

- **D: Brazil Retail Sales (12)/9:00 Local**
We expect retail sales to fall **0.1%** month-to-month in December, pushing the year-over-year rate up to **4.6%**, from 4.4% in November. Consumption is still resilient, thanks to low inflation, interest rates and the modest recovery in the labour market. **Consensus: 4.0.**

Thursday, February 14

- **Colombia Retail Sales (12)/10:00 Local**
We look for a **6.8%** year-over-year increase, down from 10.8% in November. We expect the retail sector to remain strong, but downside risks loom. The COP's rebound in recent weeks, and improving consumer confidence, suggest that the sector will do well. **Consensus: 6.8%.**
- **Colombia Industrial Production (12)/10:00 Local**
Industrial output should rise **5.1%** year-over-year, accelerating from 4.7% in November. Improving economic fundamentals and favourable external conditions for Colombia's main exports, particularly oil, are helping. We expect oil prices to improve gradually and the trade war to ease, boosting Colombia's prospects. A resolution of the Venezuelan crisis would also help; we remain cautiously optimistic on this front. **Consensus: 4.3%.**
- **Argentina Consumer Prices (1)/16:00 Local**
The index should rise **2.5%** month-to-month in January, due to regulated price increases and the lagged effect of the ARS sell-off last year. The year-over-year rate should fall slightly to **48.7%**, from 47.6% in December. Inflation pressures are starting to ease gradually and this eventually will boost President Macri's chances of re-election in October. **Consensus: 2.5%.**

Friday, February 15

- **Brazil Economic Activity Index (12)/8:30 Local**
The index likely will increase **1.0%** year-over-year, down from 1.9% in October. Relatively healthy private consumption will be partially offset by weak industrial activity. Looking ahead, we expect a modest acceleration this year, helped by low inflation, low interest rates, and a gradual recovery of the labour market. External woes are a risk, due to the trade war. **Consensus: 0.2%.**
- **Peru Economic Activity Index (12)/No set time**
The index likely increased **5.1%** year-over-year in December, down from 5.3% in November. **Consensus: 5.0%.**

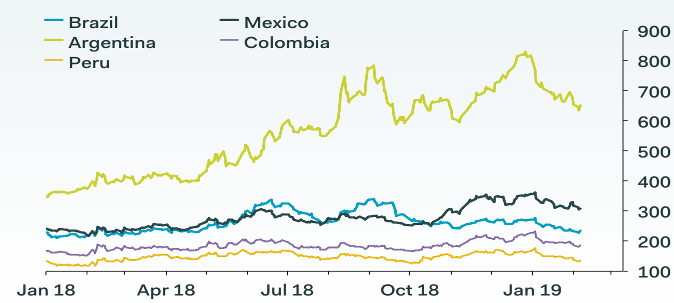
Expected During the Week

- **Brazil Formal Job Creation (1)/No specific time**
We look for **99K** job gains in January, unadjusted, after a 77K increase in the same month last year. The labour market is recovering, and low interest rates will help to consolidate the rebound. **Consensus: 88K.**

PANTHEON'S LATAM FINANCIAL CONDITIONS DASHBOARD

	Currency			Benchmark Stock index		
	Value	Week, %	YTD, %	Value	Week, %	YTD, %
Argentina	37.84	-1.8	-0.4	36,664	0.2	21.0
Brazil	3.73	-2.0	4.0	95,343	-2.6	8.5
Chile	658.9	-1.0	5.3	5,379	-1.4	5.4
Colombia	3,116	-0.8	4.4	11,896	-0.3	6.7
Mexico	19.08	0.1	3.0	43,180	-1.8	3.7
Peru	3.32	0.2	1.4	20,315	0.1	5.0
Venezuela	--	--	--	5,525	4.5	244.2

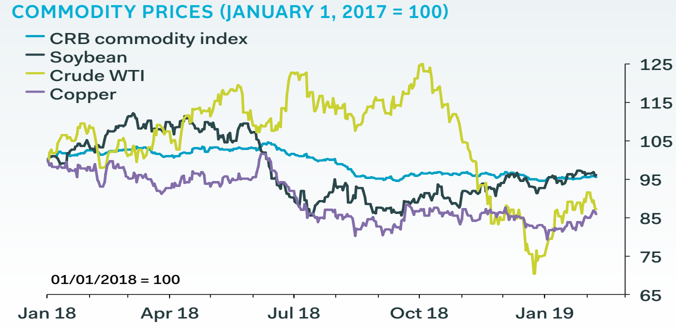
INDEX EMBIG SPREAD LATAM HISTORY



PANTHEON'S ECONOMIC FORECASTS

	Real GDP, y/y%		Inflation, Avg.		Interest rate, Q4	
	2018	2019	2018	2019	2018	2019
Argentina	-2.4	-0.4	33.8	35.0	59.25	30.00
Brazil	1.4	2.4	3.7	3.7	6.50	6.50
Chile	4.0	3.4	2.4	2.8	2.75	3.50
Colombia	2.6	3.1	3.2	3.2	4.25	4.75
Mexico	2.0	2.0	4.9	4.2	8.25	8.00
Peru	3.8	4.1	1.3	2.5	2.75	3.25
Venezuela	-17.0	-20.0	1.3M	20M	--	--

COMMODITY PRICES (JANUARY 1, 2017 = 100)



PANTHEON'S FINANCIAL FORECASTS

	Currency			Benchmark Stock index		
	Q1F	Q2F	Q3F	Q1F	Q2F	Q3F
Argentina	38.5	39.1	39.8	32,100	32,900	33,100
Brazil	3.79	3.67	3.65	88,100	89,200	89,500
Chile	680	676	672	5,120	5,240	5,480
Colombia	3,130	3,080	3,010	1,320	1,480	1,510
Mexico	19.5	19.2	19.0	42,310	43,500	44,300
Peru	3.34	3.28	3.25	20,050	21,200	22,500
Venezuela	--	--	--	--	--	