BBVA Research

Creating Opportunities

Mexico Economic Outlook

June 2024

Higher investment in 2024-2025 only with legal certainty

Javier Amador / David Cervantes / Iván Fernández / Arnulfo Rodríguez / Saidé Salazar / Carlos Serrano

June 2024

- **We will revise our growth forecasts for 2024 and 2025 once the reform of the judicial system is known, which could have significant impacts on investment.**
- **Consumption shows dynamism** driven by gains in real wages and total wage bill, as well as the advance of transfers from social programs during 1H24.
- **Investment shows a slowdown at the beginning of the year,** due to the lower growth of the non-residential segment, with declines in public and private sector spending.
- **Slow industrial growth in 2024,** with a sluggish manufacturing sector in view of weaker external demand.
- **The slowdown in formal job creation has been confirmed.** A slight rebound is expected during the third quarter, but the year will close at lower levels than the last three years.
- **Core inflation continues to decelerate** despite continued stickiness in services inflation.
- **We anticipate lower inflation and lower interest rates in the second half of 2024 and in 2025.** We expect headline inflation to fall to 4.2% by the end of this year and to 3.5% by the end of 2025.
- **There is substantial leeway to gradually normalize the monetary policy stance** but we anticipate that it will remain highly restrictive for the rest of this year and 2025 despite the gradual rate-cut cycle, which now against a backdrop of greater uncertainty about the judicial reform, we anticipate to be slower, bringing the policy rate to 10.50% by the end of this year and 8.50% by the end of 2025.
- **Higher risk premia due to political uncertainty and the delay of Banxico's easing cycle** entails a period of higher mid- and long-term interest rates than previously anticipated.
- **We estimate that public debt will increase to 51.3% by the end of 2024 vs. 46.8% of GDP in 2023** due to the higher public deficit and the higher estimated year-end exchange rate.

The economy would grow less in 2024 than in 2023 with resilience of private consumption

Economic activity showed sluggish dynamism during 1Q24, with growth of 0.3% q/q, following the stagnation recorded at the end of 2023. By segments, industry declined (-)0.6% q/q during the period, whereas the tertiary sector reported a variation of 0.6% q/q. Within the industrial sector, construction fell (-)0.7% q/q, 7.0 pp below the average recorded during the first three quarters of last year, while manufacturing contracted (-)0.3%, the second consecutive decline since 4Q23. While the first data for 2Q24 are more favorable, in an environment of higher public expenditure due to the presidential elections, we anticipate that the second half of the year will show more sluggishness, particularly in the industrial sector.

By demand components, private consumption showed the greatest dynamism, with a quarterly variation of 1.5%, 0.4 pp above the average variation registered during 2023. In line with the resilience that private spending has shown in recent months, the BBVA Research Big Data Consumption Indicator registered growth of 2.7% MoM in May (real, sa), the highest figure since February. Although the consumption of goods is already above its pre-pandemic trend, spending on services still has a gap with respect to the level it would have registered if the Covid-19 pandemic had not materialized, pointing to additional room for growth. Added to the above are the accumulated gains in real wages and real total wage bill (10.0% and 16.3%, respectively, since June 2022), and the advance of social program transfers during 1H24, which will continue to boost private consumption.

Regarding investment, the recently published data from INEGI indicate a slowdown at the beginning of the year, with a quarterly variation of 0.8% in 1Q24, 4.6 pp below the average growth observed during the period 1Q23-3Q23. According to INEGI's gross fixed investment indicator figures, non-residential investment in March was 2% lower than the level recorded in Dec-23, while the machinery and equipment segment exceeded the same threshold by 4.1%. Considering the March figures, both the construction and machinery and equipment segments exceeded their pre-pandemic trend by more than 20%, in view of the stimulus registered last year derived from the federal government's flagship works. We estimate that the momentum that the sector reported throughout 2023 will gradually dissipate in the following quarters, given the reductions in public and private investment and the high interest rate environment. At the end of March, private investment was 1.6% below its Dec-23 level, while public investment was 9.2% below.

We will revise our growth estimates for this year and 2025 once the reform of the judicial system and the type of fiscal adjustment to be implemented next year are known, as both factors may have significant impacts on aggregate demand.

The labor market continues to show resilience: although the slowdown in formal employment will continue, it is expected to gain a slight boost in the third quarter of the year.

According to the National Job and Employment Survey (ENOE), the unemployment rate again hit its lowest level in April, standing at 2.6% in seasonally adjusted (s.a.) figures, which had only been recorded in February this year. This rate is 1.5 percentage points (pp) below the historical average (2005-2023). At the urban level, which includes data from 32 cities, the unemployment rate is also at historic lows, 3.0% s.a. in March 2023 and 2024 and 3.1% s.a. in April this year. The labor informality rate increased 0.3 percentage points (pp) in April compared to the previous month, reaching 54.7% in seasonally adjusted figures. However, this rate is still 0.1 pp lower than in the same month of the previous year, which implies that the resilience of the labor market has not been accompanied by a significant increase in labor informality. Similarly, the trend in the informality rate also suggests that increases in the minimum wage have not resulted in increases in labor informality.

Regarding formal employment, data from the Mexican Social Security Institute show that job creation has presented atypical variations between March and May, largely due to the calendar effects of Holy Week. However, the gradual and steady slowdown trend is clear in seasonally adjusted figures. Employment grew 1.5% from the beginning of the year to May, a lower level compared to the 2.3% growth of the previous year, clearly reflecting the slowdown in job creation. The real wage of IMSS workers grew 4.6% annually in May, with a monthly variation of 1.5%, maintaining its strength. The wage bill also grew significantly, with an annual variation of 6.9% and a monthly variation of 1.3%. Both real wage and the total wage bill have shown a good performance so far this year, with a growth of 7.4% and 9.0%, respectively, as of May.

As a result, the labor market continues to show signs of resilience, although with a clear slowdown in the creation of formal employment. This slowdown is expected to be more gradual during the third quarter and even regain some strength due to seasonal factors. However, considering the job creation performance to date, we expect employment to close the year with a net job creation of 573,000 (vs. 617,000 previously forecast), representing an annual change of 2.6%, a decrease of 0.2 pp from our previous forecast (Figure 2).

Core inflation continues to slow despite the downward stickiness that services inflation continues to show

The disinflation process continues. While supply shocks so far this year have halted the decline in headline inflation, the decline in core inflation has continued. From the end of 2023 to May, headline inflation has not fallen (it stands at 4.69% y/y compared to 4.66% last December), but core inflation has fallen (-)0.9 percentage points (pp), from 5.1% y/y to 4.2%. Headline inflation experienced a transitory rebound during December and January due to a supply shock in the price of fruit and vegetables, then fell temporarily in February and March (4.4% y/y), but rose again in April and May. During April, the sharp increase in agricultural prices and energy prices other than electricity prevented monthly headline inflation from falling, as usual due to the seasonal start of subsidies to electricity prices in the season of high temperatures. The supply shock in agricultural products continued in May. In contrast, and more relevant, the annual pace of core inflation has slowed for 16 consecutive months, and is now at its lowest Level in three years (at 4.2% y/y). Looking ahead, we expect headline inflation to resume a downward trend from July onwards, but we expect it to remain above 4.0% y/y for the remainder of the year, closing December at 4.2% y/y. Meanwhile, we anticipate the downward trend in core inflation to continue for the rest of the year and to stand at 3.8% y/y in December.

It should be noted that since last August, non-core inflation has shown an upward trend from the minimum levels reached in July 2023 (of 0.7% y/y), and that therefore, (lower) core inflation, which had contributed consistently during this year to the disinflation process, has shown in the last ten months an increasing relative importance in this favorable dynamic. Initially, the disinflation process was mainly driven by non-core inflation, which declined 11.3 percentage points (pp), from 10.6% to -0.7% y/y, between August 2022 and July 2023. From that month through May of this year, it has increased 6.9 pp, to 6.2% y/y. For its part, core inflation, which decreased only (-)0.3 pp during the first quarter of 2023, in the second and third quarters slowed (-)1.2 pp and (-)1.1pp to 6.9% y/y and 5.8% y/y, respectively, and has continued to decline at a good pace, (-)0.7 pp to 5.1% y/y in the fourth quarter of last year, and (-)0.5pp to 4.6% y/y in the first quarter of this year, and has declined (-)0.4pp further to 4.2% in the first two months of this quarter. Moreover, we see elements for it to continue to decline steadily for the rest of the year, albeit at a somewhat slower pace, with goods inflation falling further and services inflation finally breaking its downward rigidity in a context of weaker domestic demand strength.

The slower pace of core inflation has continued to be mainly driven by lower goods inflation which is already close to 3.0% y/y (at 3.4% y/y in May), while services inflation still shows more resistance to decline and its current level of 5.2% y/y is similar to the average of the previous 12 months, and is only 0.5 pp lower than the peak reached in March 2023 of 5.7% y/y. Inflation in services other than housing and school fees has shown less downward stickiness than total services inflation, but has so far also shown a moderate slowdown of (-)1.6 pp from the peak in March 2023 (7.7%), and is currently still at a very high level of 6.1% y/y.

Going forward, we continue to expect inflation to gradually converge to Banxico's target of 3.0% y/y +/-1 pp. We anticipate that during 2H24 headline inflation will decline slightly to average 4.4% y/y in the second half of the year and that it will end the year at a level slightly above the upper end of the range for Banxico's 3% target, at 4.2% y/y (Graph 3). For its part, we anticipate that core will average 4.0% during 2H24 and that it will close the year at 3.8% y/y. This represents a less optimistic trend than that expected by Banxico for headline inflation and similar for core inflation.

There is ample room to gradually normalize the monetary policy stance

With respect to monetary policy, the real ex-ante rate remains very high (7.2%) and remains close to its maximum in the current tightening cycle (of 7.4%) against a background of gradual convergence of core inflation to the target range, with medium-term inflation expectations well anchored, with expectations that the Fed will start implementing an easing cycle soon (in September), and in a context of decelerating domestic demand, especially investment, Banxico could resume its rate-cut cycle as soon as this week's meeting. However, the likelihood of Banxico voting again to leave the rate unchanged increased after it emerged from the minutes of the May meeting that the two most hawkish members of the Board of Governors indicated that they were already determined to vote in favor of a pause this month. Since the results of the election, the exchange rate has risen by 9% but has now depreciated by 6% following the peso's recovery over the last week, while headline inflation developments imply that Banxico will revise upward its expected inflation path for this quarter and the next two quarters (see graph 3). Therefore, we believe that Banxico will keep the rate unchanged at 11.00% at the closing of the quarter. As a result, we now anticipate that the central bank will end up cutting the reference rate twice in the second half of this year and eight times next year. Nevertheless, should this scenario materialize, the high level of the real rate implies that, in the absence of an acceleration in the expected rate-cut cycle, the monetary stance will most likely remain very tight through 2024-25, with the ex-ante real rate above 3.4%, the upper end of the estimated range for the long-term neutral rate, over this entire horizon. In our scenario, the ex-ante real rate would be 7.0% at the end of this year and 5.0% at the end of next year. The real ex-ante rate is likely to average 7.2% for the rest of the year (i.e. not to decline from its current level for the rest of the year) and end next year close to 6.0% (5.9%) next year, a very restrictive stance. In 2H24, the rate cuts would simply avoid an additional and unnecessary tightening of the monetary policy stance, while in 2025, the easing cycle will also seek to gradually ease the monetary stance with lower inflation, already close to target, and a slowing economy, but we now anticipate that signals from Banxico imply that they will maintain a tighter than necessary stance for a prolonged period of time.

We expect cumulative rate cuts this year to be only 75 basis points (bps), bringing the monetary rate to 10.50% by year-end. We believe that the cycle could be faster, but Banxico continues to signal that it will proceed with too much caution (Graph 4). We expect the rate-cut cycle to extend through 2025 and 2026, with the rate declining to

8.50% by the end of next year and to 6.50% by the end of 2026. Going forward, given that we expect the Fed to conclude its easing cycle at a level of 3.0%, we anticipate that the end of the rate-cut cycle level in Mexico, which we do not believe will be reached now until 2027, will be 6.0%, an equilibrium level that we believe Banxico will maintain over the medium term.

Higher interest rates along the yield curve amid local political uncertainty

Recent data suggest that economic activity in the United States is slowing in the second quarter after a bumpy first quarter. However, with economic activity still expanding at a solid pace and inflation above target, the Fed decided at its meeting this month to keep the federal funds rate in the 5.25-5.50% target range, reiterating the need to see more good inflation data before it can begin an easing cycle. The updated economic projections showed that the median FOMC participant now expects a single rate cut this year (to 5.00-5.25%), followed by four additional reductions next year (to 4.00-4.25%).

Even though this delay in the beginning of the rate-cut cycle was already priced in by the market, the recent growth moderation, the consumer and producer inflation data for May, as well as the Fed's apparent confidence in the continuation of disinflation in the coming months, have favored a more optimistic outlook for inflation going forward. This is reflected in the recent decline in mid- and long-term Treasury yields. For example, the yield on the 10-year Treasury bond fell in recent days to 4.2%, after having reached a level of 4.7% at the end of April.

While government yields in Mexico mirrored the evolution of US Treasury yields during the first five months of the year, their behavior in June has been more linked to domestic developments related to the outcome of the recent electoral process in Mexico (Figure 5). At the short end of the yield curve, the 1- and 3-month Cetes have shown stability after Banxico's March cut and the expectation of a further extension of the pause in Banxico's monetary cycle. In contrast, the recent uncertainty surrounding the possible economic effects of the potential approval of Morena's constitutional reforms was reflected in higher risk compensation in mid- and long-term government bond yields, which increased significantly in recent weeks amid notable episodes of volatility, as shown by the significant shift in the yield curve (Figure 6). The 10-year M-Bond rose from 9.8% before the election to 10.4% in the middle of last week, its highest level since the global financial crisis in October 2008 (when it peaked at 11.3%). This week it decreased to levels around 9.9%.

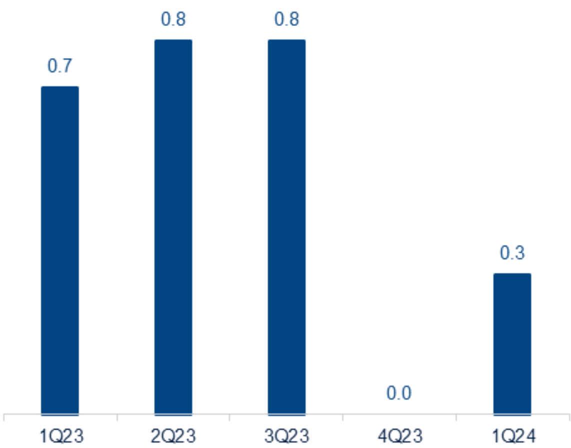
We anticipate continued volatility in the coming months, largely explained by the evolution of the local political context and, to a lesser extent, by the economic environment in the United States and how the Fed and Banxico's monetary policy expectations evolve. Later on, another factor to consider will be the U.S. presidential election (the first Tuesday in November). While higher risk premia and the delay in Banxico's easing cycle imply a period of higher mid- and long-term rates than previously anticipated, we continue to expect that rates along the yield curve will gradually decline in the medium term amid the eventual monetary easing cycles in the United States and Mexico, as well as a possible gradual easing of market concerns associated with political uncertainty.

The Historical Balance of the Public Sector Borrowing Requirements will rise to 51.3% in 2024 from 46.8% of GDP in 2023

We forecast that the Historical Balance of Public Sector Borrowing Requirements (SHRFSP) will be 51.3% of GDP by the end of 2024. This level does not represent a sustainability problem for Mexico's public debt (Figure 7) or for the sovereign credit rating. However, from 2025 onwards, public deficits of around 2.5% of GDP will be needed to keep this public debt ratio stable. Based on the most recent announcements by the Ministry of Finance and Public Credit, it is foreseeable that next year's fiscal consolidation will bring the public deficit to levels close to 3.0% vs. 5.0% of GDP in 2024 (the highest level in the last 35 years). Given the expected fragility of public finances in the coming years due to the depletion of contingency funds, increased pressures from social spending, economic support for Pemex, public pensions, debt service and the limited margin for tax revenue growth without a fiscal reform, the next federal government will most likely have to make adjustments to discretionary spending to prevent public debt (% of GDP) from resuming its upward trajectory.

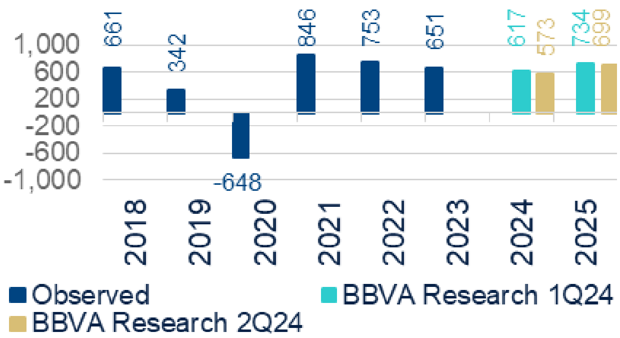
We anticipate that the Mexican peso will continue to show some volatility as it is subject to greater uncertainty than normal (due to the reform of the judiciary and the presidential elections in the US) in the remainder of the year. We expect the exchange rate to be around 19.0 pesos per dollar by year-end.

FIGURE 1. **GDP**
(Q/Q%, REAL, SA)



Source: BBVA Research / INEGI.

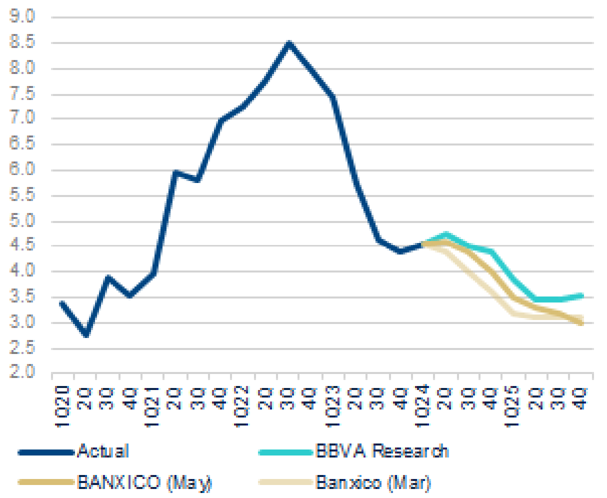
FIGURE 2. **JOBS AFFILIATED WITH THE IMSS**
(THOUSANDS AND Y/Y % CHG. EOP)



Forecast	2024	2025	2026
Thousands, Eop			
BBVA Research 2Q24	**573**	**699**	**745**
BBVA Research 1Q24	617	734	754
Annual Var., % Eop			
BBVA Research 2Q24	**2.6**	**3.1**	**3.2**
BBVA Research 1Q24	2.8	3.2	3.2

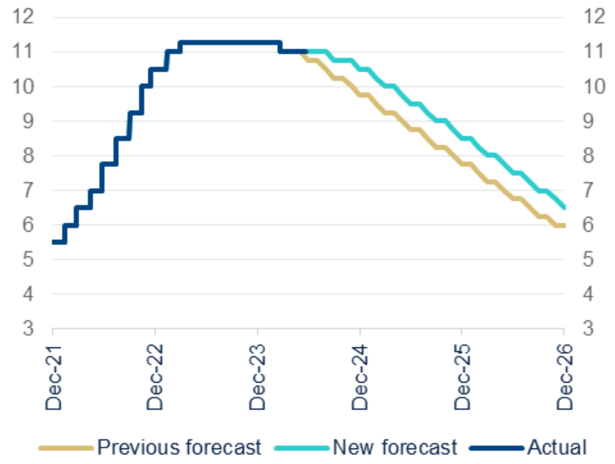
Source: BBVA Research / INEGI.

FIGURE 3. **HEADLINE INFLATION**
(Y/Y % CHANGE)



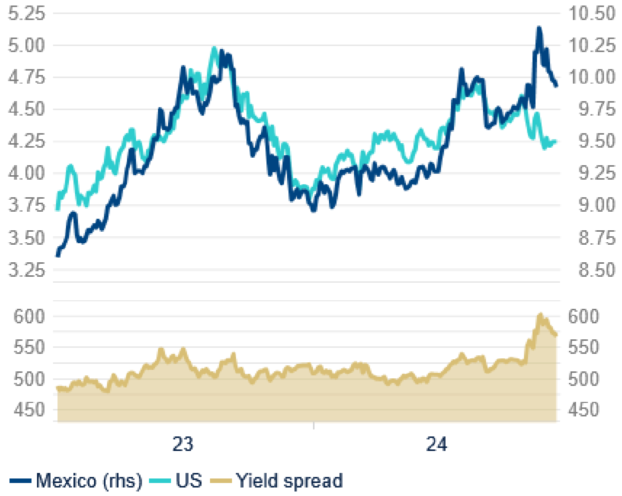
Source: BBVA Research / INEGI / Banxico.

FIGURE 4. **MONETARY POLICY RATE**
(%)



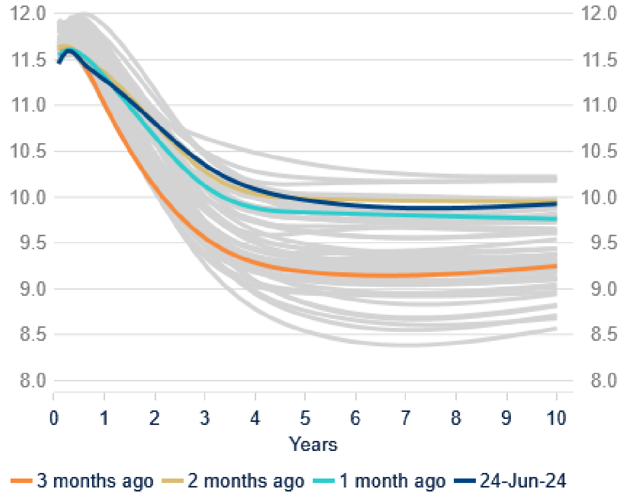
Source: BBVA Research / Bloomberg / Banxico.

FIGURE 5. **10-YEAR YIELDS IN MEXICO AND US**
(%)



Source: BBVA Research / Bloomberg / Haver

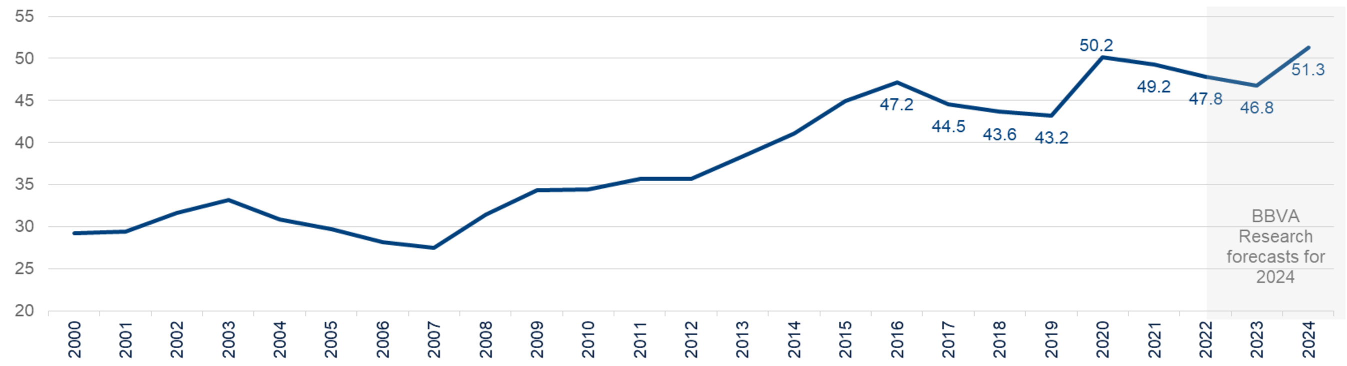
FIGURE 6. **SOVEREIGN YIELD CURVE**
(%)



The gray lines show the weekly yield curves for the last 12 months.

Source: BBVA Research / Bloomberg

FIGURE 7. **HISTORICAL BALANCE OF THE PUBLIC SECTOR BORROWING REQUIREMENTS** (% OF GDP)



Source: BBVA Research / SHCP.

BBVA Research

Creating Opportunities

DISCLAIMER

The present document does not constitute an "Investment Recommendation", as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse ("MAR"). In particular, this document does not constitute "Investment Research" nor "Marketing Material", for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com