

Banxico Minutes – The easing cycle has begun, despite some lingering risks

- Banxico published the minutes of the meeting held on August 15th, in which the Board of Governors cut the reference rate by 25bps, to 8.00% in a majority decision
- The dissenting vote at the meeting was cast by Deputy Governor Javier Guzmán. Among the reasons, he highlighted:
 - (1) A prolonged period of elevated core inflation;
 - (2) Lack of information about fiscal policy in 2020;
 - (3) Cutting the reference rate would surprise the market; and
 - (4) The risk of financial volatility given a higher country risk premium
- In our view, the tone was dovish, similar to the communique and confirmed by yesterday's 2Q19 *Quarterly Report*
- Overall, we believe opinions on growth were markedly more dovish, with a more comfortable stance on inflation despite recognizing an uncertain outlook
- We highlight ample comments about financial stability risks, such as Pemex's financial position and public finances, which remain important for policy decision going forward
- There was also a very relevant discussion on whether this is the start of an easing cycle, with mixed opinions on the matter
- In our view, recent communications of the central bank support our view of two additional 25bps cuts for the remainder of the year, with the first in September and the second in December
- Dovish bias in Banxico's minutes supports our trade idea in long-term Mbonos

Banxico more dovish on lower growth and inflation, while debating about some risks. Banxico just published the minutes of the meeting held on August 15th, in which the Board of Governors cut the reference rate by 25bps to 8.00%, in a majority vote (4-1). In our view the tone is dovish, similar to the communique and yesterday's *Quarterly Report* (QR), in which we observed a significant decrease in growth and inflation forecasts, particularly for this year. For details, see: "*Banxico QR – New estimates match the recent dovish shift*", <[pdf](#)>. On the dovish side, we highlight discussions about the worsening outlook for global and local growth, and more details about the more comfortable stance about inflation going forward. By contrast, we saw an ample discussion about some risks in a context of elevated uncertainty. In this respect, we maintain that financial stability concerns remain key for Banxico's decision-making process, with an interesting debate of whether cutting the interest rate in this meeting was the start of an easing cycle or not.

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Deputy Governor Javier Guzmán was the dissenter. Expanding on the reasons behind his vote –to maintain the reference rate unchanged– he stated that: (1) The 3% target refers to headline inflation, but due to the volatility of the non-core component, it is critical to analyze carefully the behavior of core inflation. In this respect, the latter has been elevated during a prolonged period and has not shown signs of moderating; (2) the Board did not have information about fiscal policy in 2020 –with the budget proposal to be delivered no later than September 8th– which is critical for the assessment of monetary policy; and (3) a rate cut surprising the market (which expected the rate on hold), which “...creates the risk of an adverse reaction and of making the central bank’s communication policy confusing...”. Throughout the document, he also said inflation expectations for all tenors remained above the 3% target despite the economic deceleration, that the credibility of inflation projections was at stake in part because of higher-than-expected core inflation, and that the positive effect on the exchange rate of a wider spread with the US had been more than compensated by other economic and political shocks.

Despite preferring to leave the reference rate unchanged, he supported to “...simultaneously signal that as some uncertainty factors dissipate and a more favorable balance of risks is attained, which is a likely scenario, the central bank would have more solid bases to take advantage of the consequent margins of maneuver, even in the very short term...”. In our view, he would have preferred to cut until at least the publication of the *2020 Budget*, while shifting to a very dovish bias to reinforce the signal to the market, as we had anticipated for the meeting.

Risks for global growth worsened. The Board acknowledged that recent dynamics, coupled with an escalation of trade tensions between the US and other partners –especially China– resulted in a deteriorated growth outlook. The latter, coupled with muted inflationary pressures, led to a wave of central bank easing. In this context, they noted the recent 25bps cut by the Federal Reserve, which was one of the main arguments to ease monetary conditions in the same magnitude, along the signal of more easing in the short term by the ECB, among others.

Domestic output stagnates. Some members noted that the deceleration was greater than anticipated, with broad weakness in all components of aggregate demand. In this regard, they pointed to the slowdown in consumption and the contraction in investment. The majority stated that the latter has been affected by both external and domestic factors, highlighting “...the persistence of an environment of uncertainty that has affected private investment, and which has stemmed from the public policy decisions taken by the new administration and by concerns over insecurity and corruption...”. In addition, some members pointed out that local dynamics seem to be more worrisome as the economy is underperforming global trends, especially in a context of higher-than-potential growth in the US. All in all, and despite the Board not explicitly stating that the balance of risks for growth deteriorated further, we believe the perception is that it has indeed worsened, with one member stating so.

The Board is more comfortable with the inflation outlook. On the back of a significant improvement in headline dynamics –driven by the non-core component–, the Board seemed more optimistic about the future path of inflation. Most members said they expect core inflation to start to decline, which previously seemed to be one of the main points of concern. On this point, they argued that: (1) The pass-through of higher energy prices to other categories (such as processed foods, vegetables and some services) has faded away; (2) greater economic slack should reduce demand-side pressures; and (3) businesses in highly competitive markets have low pricing power to pass on higher labor costs to the consumer, with evidence so far of limited contagion. Moreover, the outlook for energy prices is more favorable given the slowdown of global growth, with one member saying that such prices are no longer a key factor in light of the government’s new price policy, with both of these very relevant also for our below-market expectation for year-end inflation at 3.3% yoy.

Regarding risks, the minutes showed in detail the assessment of all members. In our view, two seem to have tilted towards a more favorable outlook, with one arguing that “...risks have decreased substantially as compared to those present in December 2018...”. Another mentioned that “...the balance of risks for inflation is now slightly tilted to the downside...”. The remaining three seemed to be sitting on the fence as they acknowledged very high uncertainty. We believe the skew to the downside has been reinforced by the most recent inflation prints, as reflected in the QR and very likely to be stated in the communique of the next meeting.

Pemex is still an important risk... In contrast with yesterday’s QR, the Board judged that Pemex’s new business plan “...has failed to reestablish confidence in its financial outlook due to doubts regarding the viability of increasing crude oil production...”. Most members noted that the increase in risk premium in the company’s financial assets has not diminished, still reflecting the possibility of an additional cut in its credit rating. This could result in volatility episodes putting pressure on the exchange rate, due to events such as a downgrade of the sovereign rating and Pemex’s loss of investment-grade status by a second agency. In this context, the Board reaffirmed that “...Pemex’s situation may affect public finances and Mexico’s sovereign debt rating...”. All in all, Banxico restated that there needs to be an effort by the Federal Government to revert conditions that led to the credit downgrade. Moreover, one member stated that there should be caution on this, as he/she judged that “...such rescue program demands, in the short- and medium terms, the continued and essential support of the federal government, which is in an overly constrained fiscal position...”.

...along public finances. The majority alerted about the vulnerability of public finances. One said that tax revenues are currently below budget and that this situation could worsen in the next three years due to Pemex support. He highlighted that this is a challenge as lower revenues would need to be compensated by a decrease in expenditures, more revenues, and the use of the *Stabilization Fund* this year. Some said that it is very important to take into account the challenges derived from using these resources in a context characterized by other important risks (in our view related to the outlook for the global economy).

As a result, it is critical that fiscal policy complies with the Federal Government goal of achieving a primary balance surplus. Overall, heightened concerns about the strength of public finances would generate higher uncertainty, impacting economic activity.

Is this the start of an easing cycle? We identified two different views on the matter. On the one hand, we believe that Deputy Governor Guzmán considers that conditions are not yet set for the start of a series of rate cuts. On the other hand, another member stated that “...*an analysis of the underlying risk factors leads to the conclusion that an accommodative cycle should begin...*”. Moreover, there were two more moderate comments from each side, with one mentioning that “...*inflation is controlled, which allows for monetary policy easing in order to attain the convergence of inflation to its target in an effective way with the lowest costs for economic activity ...*”, but another said “...*that this monetary policy action must not be interpreted as the start of an easing cycle, since future monetary policy decisions will depend on the development of inflation vis-à-vis its forecasted trajectory...*”.

In this context, we believe that at the time of the meeting, the board was almost evenly split between starting an easing cycle or not, reflected in an accurate manner by this comment: “...*Banco de México should act gradually and follow closely the available information on the economy’s cyclical position, and on all inflation determinants as well as on their balance of risks...*”. This latter point was also stressed by Governor Diaz de Leon in the presentation of the QR, as well as in other forums. In this respect, we believe that the Board is in a ‘data-and-events dependency’ mode. We believe that current developments, as well as our expectations about the future performance of the Mexican economy and overall risks, do call for the start of an easing cycle.

We maintain our expectation that Banxico will cut the reference rate to 7.50% by year-end. Broadly speaking, we believe communications from the central bank this week –both the QR and minutes–, support our call that Banxico will cut the reference rate by 25bps in September 26th, followed by a reduction of the same magnitude in December 19th. As a result, the reference rate would end this year at 7.50%. For 2020, we expect additional cuts between 50 and 75bps, within an easing cycle that we have previously argued could total between 125-200bps. In addition, some of the comments today support our belief that the main risk to our call is that the central bank cuts only by an additional 25bps this year, which in our view could materialize if financial stability risks, both external and domestic, increase significantly, as evidenced by the concerns on trade tensions, Pemex and the sovereign’s credit ratings and the fulfillment of fiscal goals among others.

From our Fixed income and FX strategy team

Dovish bias in Banxico's minutes supports our trade idea in long-term Mbonos . The minutes of Banxico's last monetary policy decision, in which the repo rate was lowered from 8.25% to 8.00% under a split vote reflected a Board that acknowledges that a diminishing of restrictive conditions is appropriate for the current inflation and growth local backdrop, in the midst of an ample process in which other central banks around the world are also lowering rates. However, the minutes exposed a profound debate around the risks derived, both from the local and foreign context, which have materialized into marked uncertainty regarding forward outlook. Incorporating this information to the most recent communication including the August 15th communiqué, comments from Board members, and yesterday's quarterly report, the monetary policy execution bias holds in the dovish side. The local fixed-income market did not react in a relevant fashion to the minutes release this Thursday. Its price action has been more influenced by U.S. Treasuries' dynamics somewhat pressured due to a partial risk appetite improvement on the back of optimism on the U.S.-China trade conflict. In this sense, after closing yesterday's session averaging a 5bps rally, the Mbonos curve registers a 2bps sell-off. Considering Banxico's general tone and a lower-rates global scene, we consider as appropriate to hold our trade recommendation in long-term Mbonos, started on August 16th, and highlighting a more attractive relative valuation in the Nov'38 and Nov'42 tenors. In this sense, the market is currently pricing-in implied cuts for Banxico's repo rate at a magnitude of -56bps for the 4Q19 and -174bps for 4Q20, revealing few variations vs yesterday.

In the FX market, the Mexican peso is still being object of a broad weakening in global currencies where concerns on deceleration and trade wars have been joined by specific stories such as the Argentinian case adding negative factors to the EM asset class. The peso trades around USD/MXN 20.10, mostly unchanged in respect to yesterday's close and, similar to the rates' performance, with muted reaction to Banxico's minutes. Though, the pair has bounced back from intraday lows at 20.26. These levels are the weakest since mid-December and the peso is now registering a 4.9% sell-off during August. In our view, the pesos' dynamics will remain mostly short-term stirred by a global structure under a notably fragile risk appetite. In case of a more substantive improvement in the latter, we do not rule out a recovery for the peso heading to USD/MXN 19.80, a level which we would see as attractive to evaluate a USD long repositioning looking for technical supports at 20.15, followed by 20.30. Despite the expectation about a lower repo rate from Banxico going forward, the parallel activity from other central banks will hold Mexican rate differentials attractive, reason why the currency's implied carry should not erode significantly, for now. We reaffirm our year-end forecast at USD/MXN 20.30, which is higher than current consensus at 19.69 in the last survey from Banco de México.

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