Banxico ends easing cycle on concerns over inflation and market volatility

- **In a unanimous decision, Banxico decided today to keep the reference rate unchanged at 4.00%, in line with consensus but contrary to our call**
- **In our view, the statement was hawkish, mainly because of the details of the vote and the changes made to the inflation outlook. Moreover, they showed a more prudent stance because of higher market volatility**
- **Moreover, we highlight that:**
  (1) They added "*…the need to consolidate a downward trajectory for headline and core inflation to the 3% target…*";
  (2) The anticipated paths for headline and core inflation in the short term are slightly above those in the last *Quarterly Report*; and
  (3) The inclusion of external inflationary pressures among the risks to the upside for inflation
- **Given the shorter statement, our linguistic analysis showed a lower absolute weight of the word "*inflation*". However, we noted the appearance of (financial) "*conditions*" and a higher importance of "*goal*"**
- **We consider that Banxico has ended its easing cycle. We expect the next adjustment to be to the upside, although the timing of when it could happen is highly uncertain**
- **We wait for better entry levels for long positions in mid- and long-term Mbonos**

Banxico keeps the rate unchanged at 4.00%. The decision was in line with consensus but not with our call of a 25bps cut. We expected a very difficult decision, so the unanimous vote was somewhat surprising. The latter, on top of changes to the inflation outlook and its expectations, gives the statement a more hawkish bias. Moreover, we perceived a more prudent stance due to financial market dynamics. Therefore, we believe Banxico ended its easing cycle today, with an accumulated cut of 425bps since it started, on August 2019. We expect the next reference rate adjustment to be to the upside. Nevertheless, uncertainty about the timing is very high given: (1) Global market dynamics and their impact on inflation and its expectations; (2) the relative monetary stance to other EMs; and (3) the start of policy normalization by the Fed, among others, with Banxico reaffirming their data-dependency given this backdrop.

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Banxico's 2021 policy decisions

Date	Decision
February 11	-25bps
March 25	0bps
May 13	--
June 24	--
August 12	--
September 30	--
November 11	--
December 16	--

Source: Banxico

Document for distribution among the general public

March 25th, 2021 Statement Word Cloud

Source: Banorte with data from Banxico

February 11th, 2021 Statement Word Cloud

Source: Banorte with data from Banxico

A better outlook on growth, albeit with market volatility. Globally, the Board noted higher growth expectations after the approval of new fiscal stimulus in the US. Nevertheless, and in line with recent market volatility, they highlighted as a downside risk a greater tightening of financial conditions, alluding to pressures in the MXN and higher medium- and long-term interest rates both domestically and abroad. For Mexico, they recognized a deceleration in activity at the start of the year, albeit with a better scenario ahead, driven by external demand. Although they keep expecting ample levels of slack, we note that they removed the phrase regarding that the balance of risks for growth is skewed to the downside. Overall, the tone about the global and local outlook is more positive.

Greater concerns about inflation. The most relevant changes were in this front. They highlighted the recent increase in headline and core inflation, resulting in adjustments for short-term expectations (year-end 2021). Given this, they expect that the anticipated paths for both components in the short term will be above those in the 4Q20 Quarterly Report, albeit keeping the convergence to the 3% target unchanged in 2Q22. In this context, they added that there is "*…the need to consolidate a downward trajectory for headline and core inflation to the 3% target…*". This makes us think that the central bank is concerned not only about the inflation 'hump', but also of additional risks for the expected paths. This is also confirmed by adjustments on the risk factors, along changes on their relative order as they listed first those to the upside and then those to the downside. Within the former: (1) The effect from a rebalancing in spending was expanded to all components –not only the core–, along cost pressures; (2) they included global inflationary pressures –previously a downside risk–; and (3) they maintained the possibility of episodes of FX depreciation. Among those to the downside, we only highlight the separation of effects from economic slack to those stemming from social distancing as two different points. In this context, we think a very relevant signal is the fact that the balance of risks was not reaffirmed as uncertain, removing this line. Considering the latter and the more hawkish skew in the changes made to the inflation outlook, we believe most members now think that said balance is tilted to the upside.

Banxico ends easing cycle. The next rate movement to the upside. Since the start of the year, the outlook for growth, financial stability and global inflation have changed drastically, with Banxico reacting to this situation. In this backdrop, we think the central bank ended its easing cycle today –which started on August 2019 with the rate at 8.25%, accumulating cuts of 425bps– and that the next adjustment will be upwards. However, the timing of when this could happen is very uncertain, given: (1) Market dynamics and its impact on commodities (especially energy prices) and the exchange rate, impacting inflation, its expectations, and the path that prices could show after the 'hump' in 2Q21; (2) the moment in which the Fed starts to taper asset purchases and hike the *fed funds* rate, affecting the relative monetary stance to the US and other EMs; and (3) local factors like possible credit rating changes, the mid-term elections, and even a potential fiscal reform for 2022. Given this complex environment, Banxico reaffirmed its prudent stance and high dependency to incoming data and events.

From our fixed income and FX strategy team

Since mid-February, the Mexican yield curve has experienced a notable steepening bias, primary as a result of the correspondent adjustments in US Treasuries, capturing the expectation of the economic recovery process and greater inflation dynamics. More recently, the yield curve has also incorporated a more challenging inflation scenario in Mexico which has resulted in the less dovish bias from Banxico's board. In balance, the Mbonos' curve averages pressures of around 70bps during March and prices in implied hikes for Banxico by 30bps for the 3Q21 and of 65bps for the 4Q21. This pricing is excessive and has probably been contaminated by current local trading conditions that have worsened in terms of market depth and liquidity. However, it is consistent with our view of a more restrictive stance from the central bank going forward. In this sense, the yield curve experienced a modest adjustment after the announcement, adding pressures of ~2bps for shorter-term TIIE swaps. In terms of strategy, we wait for better entry levels for long positions in mid- and long-term Mbonos.

In the FX market, immediately after the decision the peso stented from USD/MXN 20.72 to 20.58, a reflection of the market acknowledging that the currency's carry erosion due to the easing cycle has concluded. Although this will be a factor favoring the peso amid hawkish stances from other flow competitors (e.g. Russia, Brazil), we believe the current global backdrop will still present volatility spaces and a challenging configuration for the whole EM universe, adding to a uneven global economic recovery and potential pressures due to the local electoral phase at the end of the next quarter.

Analyst Certification

We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo, Eridani Ruibal Ortega and Juan Barbier Arizmendi, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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