Banxico –We now see a faster hiking pace in the next two meetings

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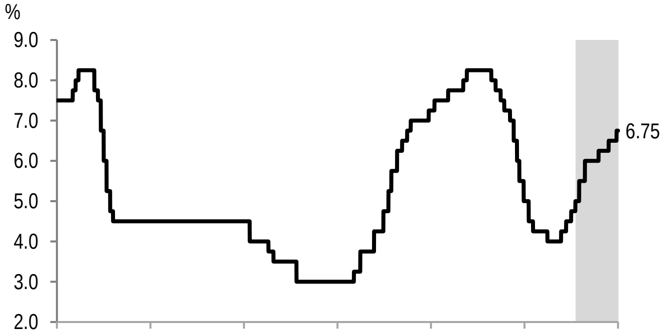
- **We adjust our call for the expected path of Banxico's reference rate, with the central bank front-loading hikes after recent developments**
- **Specifically, we now expect a 50bps hike on December 16th (previous: +25bps), taking the rate to 5.50% by year-end. For 2022, we still estimate 125bps of accumulated rate increases, but would happen in February (+50bps), June (+25bps), September (+25bps) and December (25bps). With this, the rate would reach 6.75% by the end of the year (previous: 6.50%)**
- **In our view, three main factors argue in favor of our call:**
  (1) The Fed's more hawkish bias, likely resulting in an accelerated tapering and more rate hikes in 2022;
  (2) Higher-than-expected inflation and recent signals from two Board members about the convenience of accelerating the hiking cycle; and
  (3) A weaker MXN, both in absolute terms and relative to other EMs, as well as deteriorated technicals, heightening risks for prices
- **Decisions will remain difficult and likely without unanimity. However, we cannot rule out that the 'Omicron' variant, and its potential effect on activity, convinces some members of maintaining the current pace**
- **On the other hand, new restrictions due to the pandemic may exacerbate price pressures due to its effect on global aggregate supply, strengthening the case for further actions**
- **Our call of 175bps in accumulated rate hikes by the end of 2022 is below the current market pricing of around 225bps**

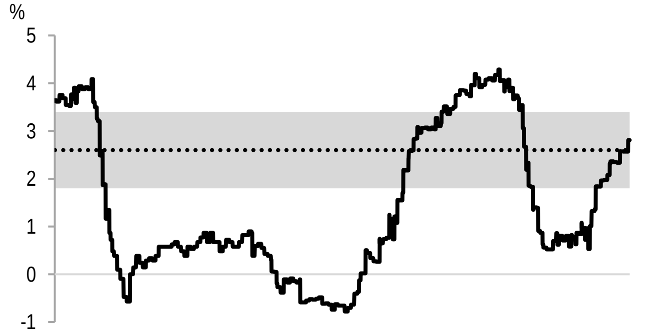
Banxico will continue hiking, but at a faster pace. After today's jobs report in the US –below expectations on job creation, but with a much lower unemployment rate– and recent global and local developments explained below, we adjust our estimated path for the reference rate. Overall, we believe these have resulted in an even more difficult scenario for monetary policy, justifying a faster hiking pace. Hence, we now expect a +50bps on December 16th from +25bps previously. For 2022, we still see 125bps of accumulated increases, but would happen in February (+50bps), June (+25bps), September (25bps) and December (25bps), with the rate at 6.75% by year-end (previous: 6.50%).

Banxico reference rate*
%



* Shaded area represents our forecasts
Source: Banorte with data from Banxico

Real short-term interest rate (ex-ante)
%



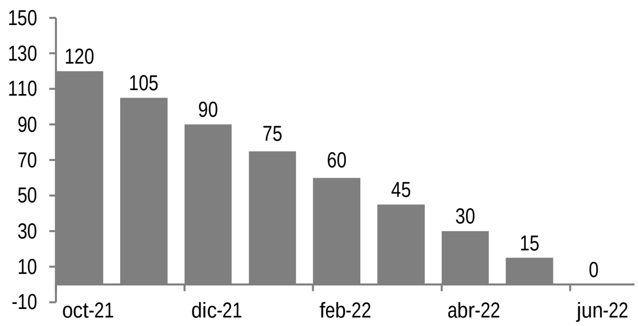
* Shaded area represents our forecasts. Calculated with our 12-month ahead inflation estimates
Source: Banorte with data from Banxico

Three main factors drive our revision. These are: (1) The Fed's more hawkish bias, likely resulting in an accelerated tapering and more rate hikes in 2022; (2) higher-than-expected inflation and recent signals from two Board members about the convenience of accelerating the hiking cycle; and; (3) a weaker MXN, both in absolute terms and relative to other EM, as well as deteriorated technicals, heightening risks for prices.

Faster tapering on persistently high inflation. Inflationary pressures continue and appear increasingly persistent. In the minutes of the last FOMC meeting, it was observed that, in general, members continued to perceive the current high level of inflation "mainly" because of transitory factors. However, pressures could take longer to subside than they had assessed previously, and some noted that price increases had become more widespread. In his remarks to Congress this week, Powell said the factors driving higher inflation are more persistent. In this context, he argued that it is time to withdraw the word "transitory" when referring to high inflation as there are several meanings for this word. To the central bank, it means something that is not permanent, while most people understand it as something that is short-lived. In this scenario, he explained that the policy implemented has adapted to that and will continue to do so.

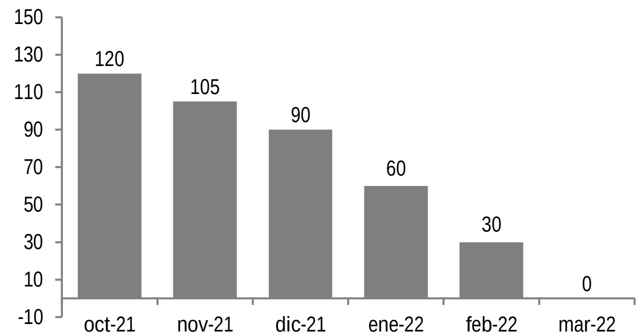
The asset purchase program that the Fed had been implementing included purchases of US$80 billion in Treasuries and US$40 billion of MBS per month. In the last decision held in early November, it was explained that tapering would begin that month with a rate of reduction of US$10 billion in the former and $5 billion in the latter. At this rate, the Fed would finish the process in 8 months, in June 2022 (see graph below). Following that announcement, different price indicators kept showing significant pressure, while members' comments have turned hawkish, opening the door to a faster rate of reduction in asset purchases. Among these, Powell's words this week in Congress stand out saying that they will discuss whether it is convenient to accelerate the pace of reduction in December. Sharing the same view, Clarida stated that it will likely be appropriate to have such a discussion. Bullard explained that he believes the FOMC should move in a more hawkish direction in the next couple of meetings to properly manage inflation risks. Quarles, who will step down this month, said he would support the committee's decision to bring the end of the tapering forward. Also, Bostic and Daly have reiterated that it may be appropriate to reduce purchases at a faster pace. Given this scenario, we expect that the FOMC to announce in December an acceleration of the tapering starting on January, doubling the amount from US$15 billion to USS30 billion. At this pace, the Fed would finish the process in March, instead of June (see graphs below).

Tapering at a US$15 billion pace
US$ billion



Source: Banorte with data from the Federal Reserve

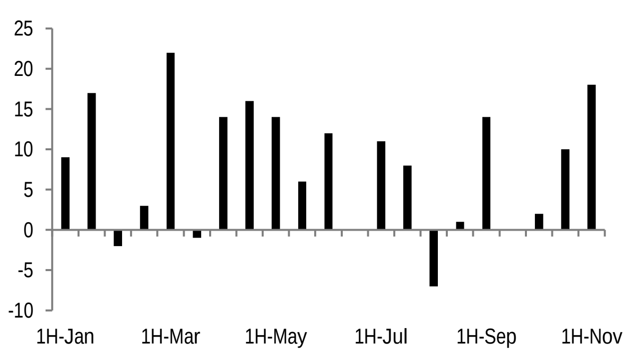
Tapering a at a $30 billion pace starting in January*
US$ billion



* Note: The US$30 billion pace starting on January corresponds to Banorte's forecast
Source: Banorte with data from the Federal Reserve

Upward inflation surprises in Mexico… In this backdrop, our estimate for inflation in the 2H-Nov, to be published on December 9th, is at 0.22% 2w/2w. In monthly terms, it is consistent with 1.00% m/m, highest since 2017 –in the aftermath of a sizable increase in gasoline prices at the beginning of the year– for a comparable period. Annual headline and core inflation would increase again, to 7.2% and 5.6%, respectively. Based on our December forecasts, quarterly average inflation in 4Q21 would be 6.9% and 5.5%, with the former once again higher (by 10bps) than Banxico's current estimates. Relative to market expectations, inflation could very well keep surprising higher (see chart below). In addition, the minimum wage in 2022 will increase by 22%, above our expectations. Our base case is that the 'lighthouse effect' will be limited, but we cannot rule out that companies will be forced to adjust prices more strongly as they have faced cost pressures in several fronts. Regarding COVID-19, we are looking closely at restrictions imposed in several countries due to the 'Omicron' variant. Although too early to tell, one potential problem that may arise is that it exacerbates already strained supply chains. Our year-end 2022 inflation forecast is 4.4%, above consensus (4.0%), although we believe these factors add some upward risks to prices.

Inflation surprises*
Bps, bi-weekly frequency



* Calculated as the difference between actual inflation and analysts' consensus according to Bloomberg
Source: Banorte with data from INEGI and Bloomberg

…and a hawkish tone by two Banxico Board members. The most relevant piece of information in the latest minutes was the debate about whether it would be convenient to accelerate the pace of the hiking cycle. As mentioned at the time, we think these comments were made by Deputy Governors Irene Espinosa and Jonathan Heath.

Ms. Espinosa seems to have more conviction, explicitly mentioning that monetary stimulus should have been cut by 50bps. Mr. Heath did not say anything about the magnitude and warned that caution is needed, arguing that an eventual increase in the speed of adjustment should be of a determined duration to rule out an aggressive and prolonged cycle. Given the Fed's shift, as well as these members' highly data-dependent approach (particularly from Mr. Heath), we believe they will have enough reasons to vote for a 50bps hike. We also think that, at least, Governor Díaz de León will vote in the same direction. Specifically, he is also probably more concerned about recent market volatility, so a faster pace should foster a more orderly adjustment in financial markets and the economy.

Higher market volatility and a weaker peso increase risks to the price outlook. As risk appetite has deteriorated in recent weeks, the Mexican peso has followed a trend change in line with greater global financial stress, mainly as a result of the Fed's more hawkish tone and higher premiums associated with the pandemic. Volatility has increased substantially across practically all asset classes and for the Mexican peso. Given its market depth, the MXN has experienced a more noticeable effect given its use as an EM proxy. In this context, last week the peso reached new lows in this year against the US dollar as at 22.15, from where it has recovered to 21.25 currently. However, it shows a 4.5% depreciation since November 8th. Since then, the MXN's performance has reflected a notorious widening in its ranges, resulting in a spot deviation above 1.5σ in all sessions relative to its 90-day average.

Technical deterioration could induce greater currency vulnerability. The surge in realized volatility has permeated significantly into the MXN technical space, with the implied volatility curve inverting as a result of a new regime at sharply higher levels that match those observed in March, for short-term maturities. This situation weakens the attractiveness of the currency's carry, with these strategies requiring a more stable backdrop. In addition, the potential positive effect of a greater hike from to Banxico's reference rate could be limited, as this is already partially priced in the short-end of the local yield curve. Meanwhile, we consider that the Fed's stance will continue to result in a USD strengthening bias in the coming months. In this sense, the speculative position in the IMM for the USD remains net long and with room to increase, including net shorts for the MXN that do not yet appear markedly stretched. As of November 23rd, these stand at US$ 1.2 billion, short bets against the MXN since May and close to their highest level since 2017, a phase in which they reached as high as US$ 2.3 billion. All in all, we see these factors resulting in a space of increased vulnerability for the currency. As such, we have adjusted our forecast for USD/MXN to 21.10 from 20.50 by the end of this year and to 21.80 from 21.20 by 2022 year-end. Our estimates consider levels close to 20.50 by the 2Q22 and pressures reaching up to 22.10 by the 4Q22.

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We, Alejandro Padilla Santana, 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, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez and Gerardo Daniel Valle Trujillo, 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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