A hawkish calibration of our calls for the Fed and Banxico

- **The economy has reached levels that we see as consistent with the Fed's dual mandate, with inflation at 7.0% and the unemployment rate at 3.9%. This will allow the central bank to hike rates soon and has tilted its rhetoric increasingly *hawkish***
- **In this backdrop, we modify our call of *Fed funds* rate hikes for 2022. We now see 4 hikes of 25 bps each, in the March, June, September and December meetings. With this, the rate would close this year in a range between 1.00%-1.25%**
- **In addition, for 2023 we expect four more increases of the same magnitude, placing the rate between 2.00-2.25%, consistent with the central bank's estimate of neutrality**
- **As a result, we also adjust our expectations for Banxico, incorporating an additional 25bps hike in March**
- **Therefore, we expect an accumulated increase of 150bps in 2022, divided between a 50bps hike in February and four 25bps rises in March, June, September, and December. With this, the rate would close 2022 at 7.00%. Moreover, we expect a terminal rate in 2023 at 8.00%**
- **Apart from challenges in the inflation front, the Mexican central bank response would be influenced by the need to manage the relative monetary stance with the US because of its potential impact on capital flows and the exchange rate**

Economy consistent with the Fed's dual mandate… After implementing an aggressive accommodative policy because of the pandemic, the economy seems to have achieved conditions consistent with the Fed's dual mandate. On one hand, it has clearly exceeded its inflation target of 2% on average. Specifically, upward pressures have spread more than expected, with inflation closing last year at 7.0%. Recently, they removed the word 'transitory' when describing the nature of the factors that have affected price dynamics. Given persistent supply chains issues and the renewed spread of the pandemic, we believe that high inflation will continue, especially in the first semester (see graph below, left), with full-year 2022 inflation at 4.3% (consensus: 4.4%). On the other hand, the economy is already at maximum employment. In this sense, the December labor market report showed a more aggressive than anticipated drop in the unemployment rate, from 4.2% to 3.9%. This decline is key as the NAIRU is estimated at 4.0%.

…so Fed members have been increasingly *hawkish.* Faced with this situation, the rhetoric from several members of the central bank has become increasingly *hawkish.* We highlight Powell's comments yesterday before the Senate Banking Committee due to his confirmation hearing for a second term as central bank chair. He explained that they are trying to return policy to neutral, even perhaps to restrictive territory. He also assured that the central bank will raise rates more if needed to curb prices. In addition, we believe it was very important that he said it is very likely that they would start reducing the size of the balance sheet later in 2022.

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Fed's 2022 policy decisions

Date	Decision
January 26	--
March 16	--
May 4	--
June 15	--
July 27	--
September 21	--
November 2	--
December 14	--

Source: Federal Reserve

Banxico's 2022 policy decisions

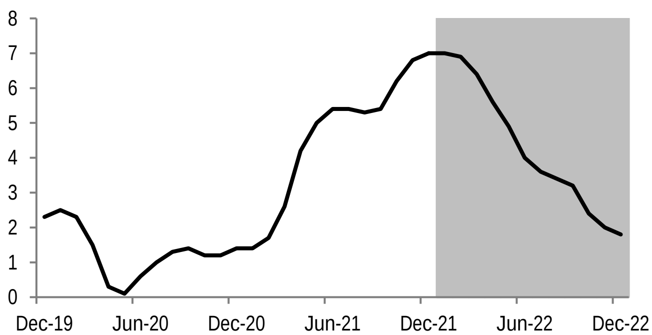
Date	Decision
February 10	--
March 24	--
May 12	--
June 23	--
August 11	--
September 29	--
November 10	--
December 15	--

Source: Banxico

All these comments reinforce the message of the latest FOMC minutes, in which it was agreed this process would begin after the rate hike cycle started. However, Powell was more specific about its possible timing. In addition, we have had relevant comments from other FOMC voting members this year, such as Mester (Cleveland) and George (Kansas City). The first said that, if current economic conditions prevail, she will support a March rate hike and anticipates three increases this year. With a very *hawkish* tone, the second stated that the current accommodative stance is not appropriate for the economic situation.

Markets already see the beginning of the hiking cycle. Given the above, markets are already pricing in a relatively more aggressive pace in the Fed's restrictive cycle. For the next 24 months, slightly more than 6 hikes of 25bps each are expected (graph below, right), which would lift the rate to a range between 1.50%-1.75% by January 2024. This would imply that the Fed would still be accommodative by then, as the neutral rate of 2.0% to 2.5% equates to a range between 8 and 10 hikes.

Inflation*
% y/y



* Note: The figures for 2022 correspond to Banorte´s estimates
Source: Banorte with data from Bloomberg

Market implied pace of rate hikes in the next 24 months*
Times

* Note: Total hikes, assuming each is of 25bps. Neutral rate of 2% to 2.5% equates to a range between 8-10 hikes. Source: Banorte with data from Bloomberg and Morgan Stanley

For the Fed, we expect 4 hikes per year in 2022 and 2023. Due to inflation, labor market performance, and the more *hawkish* stance of Fed members, we slightly modify our call of the *Fed funds* this year. We now see 4 hikes of 25bps (previously: 3 hikes). We estimate them in meetings with updates to the macro framework and *dot plot* (March, June, September and December). With this, the rate would stand between 1.00%-1.25% at the end of the year. Additionally, for 2023 we see four more increases in the same months, bringing the rate to a range between 2.00%-2.25%, that is, on neutral ground. Consequently, our view is of a slightly more *hawkish* stance than what the market currently anticipates. On the balance sheet, we see *tapering* ending in March and the beginning of the balance sheet runoff in 4Q22. The latter would be much earlier than in the last cycle, when they waited about a year and a half after the start of the hiking cycle.

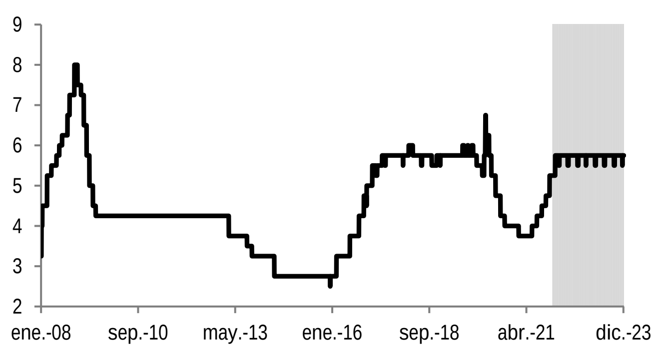
As a result, we marginally adjust our Banxico forecasts. In the very short-term, we believe domestic monetary policy will remain tied to a very adverse inflation outlook, with the core extending higher. Therefore, we maintain our view of a 50bps hike in February. After this and with a price outlook not quite favorable, Banxico will have to come along with the Fed's tightening cycle, following its four 25bps hikes with adjustments of the same magnitude in 2022.

With this, the reference rate would close this year at 7.00%. For 2023 we expect similar dynamics, with Banxico still following the Fed with an accumulated 100bps increase, to 8.00%. Our estimates are a little bit more aggressive than analysts' consensus, which contemplates a total increase in 2022 of 100 to 125bps (vs. our 150bps) and only of 25 to 50bps in 2023 (vs. our 100bps). On the other hand, the market is pricing a faster pace but a slightly lower terminal rate, with +213bps in 2022 and unchanged in 2023.

The importance of the relative monetary stance. One of the factors that Banxico has stressed as key in their decision-making process has always been the relative monetary stance, especially with the US. This is due to several factors. Among them, we highlight the currency's carry, which in turn influences capital flows, especially speculative in nature. In turn, this might influence the exchange rate and inflation. In this sense, only once Banxico has not matched (either with 25 or 50bps) the Fed's tightening since the reference rate was introduced, in 2008. This happened on September 2018, with the central bank correcting and matching this movement one meeting later. As we anticipate an additional hike by the Fed, we also expect an additional increase locally. On the magnitude, the average reference rate spread since 2008 has been around 450bps (maximum: 800bps; minimum: 275bps), with the current level at 525bps. Although the latter seems high, the spread stabilized at 575bps in the previous restrictive cycle (chart below, left), which equals the level that we expect to prevail until the end of 2023.

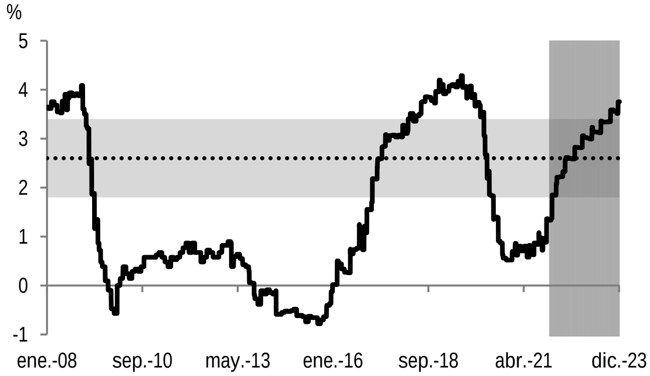
The real rate would enter restrictive territory in 2023. According to our estimates, the real ex-ante interest rate currently stands around 1.4% (chart below, right). This level is still accommodative based on the latest estimates by the central bank. With our projected hikes and a gradual downward path for inflation, we expect the rate to enter the neutral zone as soon as February 2022. We believe this is very important for the signal coming from monetary policy and to inflation expectations, issues on which we have perceived heightened concerns. Based on the remainder of our forecasts, the rate would reach restrictive territory in late 3Q23. Lastly, it would stand around 50bps below the high in the last tightening cycle (at 4.29% in August 2019) by the end of said year.

Reference rate spreads between Mexico and the US*
%



* Note: Target rate in Mexico minus the top of the Fed Funds range in the US
Source: Banxico, Federal Reserve, Banorte

Ex-ante real rate and estimated range of the short-term neutral rate *
%



* Note: Based on our inflation and reference rate forecasts starting in January 2022
Source: Banxico, INEGI, Banorte

Analyst Certification

We, Alejandro Padilla Santana, Juan Carlos Alderete Macal, Alejandro Cervantes Llamas, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Francisco José Flores Serrano, Katia Celina Goya Ostos, 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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