

Banxico QR – At least one more 50bps hike given a very challenging backdrop

- Banxico published today its 4Q21 *Quarterly Report* (QR). The release was accompanied by a press conference led by Governor Victoria Rodríguez
- GDP for this year was revised down by 80bps, to 2.4% from 3.2%. This is in line with our call. For 2023, growth is expected at 2.9% (previous: 2.7%). Inflation estimates were unchanged relative to the [last statement](#)
- We continue seeing a hawkish bias. On prices, we noted:
 - (1) A greater importance of the persistence of core inflation at high levels as a risk for the forecasted path;
 - (2) The balance of risks continues to be skewed to the upside, and has even deteriorated, highlighting pressures on commodity prices due to the conflict in Ukraine; and
 - (3) To the downside, given higher slack, that higher costs and wages do not pressure prices
- On top of this, questions and comments were focused on the potential implications of the conflict in Ukraine and upcoming Fed normalization
- There were eight *grey boxes*. We focused on the analysis of the persistence of inflation and the historical evolution of monetary policy in Mexico in the face of rate cycles in the US
- We modify our monetary policy call, now seeing a 50bp hike in March (previous: +25bps) and a year-end level of 7.50% (previous: 7.25%)
- We reaffirm our trade idea of paying 2-year TIE-IRS

Banxico remains hawkish, with an even more challenging backdrop. In our opinion, the *Quarterly Report* (QR) for 4Q21 provided important information on several fronts. On top of being the first led by Governor Victoria Rodríguez, we highlight the questions and comments on the potential implications of the conflict in Ukraine and the upcoming normalization of the Fed. Regarding the first, it was mentioned that it is still too early to talk about its impact, although this will depend on its duration. On the latter, it was reaffirmed that the Fed's decisions are important, although they are only one of the elements that the Board considers. In our view, most members believe that these events have made the outlook even more complex. In this backdrop, estimated GDP for this year was revised lower, from 3.2% to 2.4% –in line with our forecast–, while inflation estimates remained unchanged, although with the balance of risks deteriorating. The tone remains hawkish, suggesting that the hiking cycle will continue. Furthermore, it points to at least a +50bps hike in March, so now we anticipate this scenario (previous: +25bps). For the rest of the year, we see +25bps each in May, June, September, and December, taking the rate to 7.50% (previous 7.25%). For 2023, we anticipate a closing rate of 8.50%.

Inflation forecasts unchanged, albeit with adjustments in the balance of risks. As in the two previous reports, the central bank [maintained the estimates of the previous meeting](#).

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Banxico's 2022 policy decisions

Date	Decision
February 10	+50bps
March 24	--
May 12	--
June 23	--
August 11	--
September 29	--
November 10	--
December 15	--

Source: Banxico

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Nevertheless, there were relevant adjustments in the balance of risks. On top of still being to the upside, they included once again that it had ‘deteriorated’ after eliminating this in the previous statement. In addition, on risks to the upside we noted: (1) Greater relative importance of persistent core inflation at high levels, even explained in one of the *grey boxes* (see below); (2) external pressures related to the pandemic and measures to contain it, which used to occupy the first spot; (3) that the geopolitical conflict drives energy and commodities higher, which has been materializing. The last two, unchanged, were: (4) episodes of FX depreciation; and (5) cost pressures due to supply chain disruptions or higher wages, which used to be in second place. To the downside, we only noted that the first place is now occupied by economic slack (wider at the margin), so cost and labor hiring conditions could not pressure prices. Despite of this, the tone did not change much. All of this leads us to believe that it is very likely that Banxico will adjust its forecasts higher once again in its upcoming meeting, on March 24th.

CPI forecasts

% y/y, quarterly average

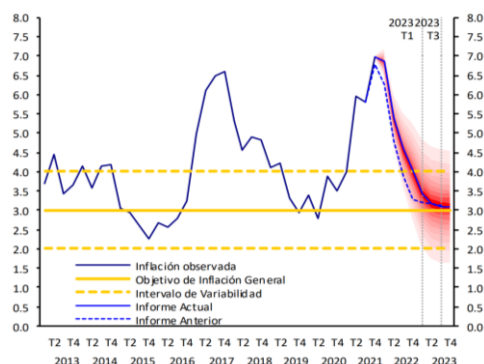
	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23
Headline	7.0*	6.9	5.4	4.6	4.0	3.4	3.2	3.1	3.1
Core	5.6*	6.4	6.1	5.1	4.3	3.3	2.9	2.7	2.7

Note: Comparisons to the previous QR are not presented because forecasts have been updated in tandem with policy decisions

Source: Banco de México. *Observed data

Fan chart: Headline inflation*

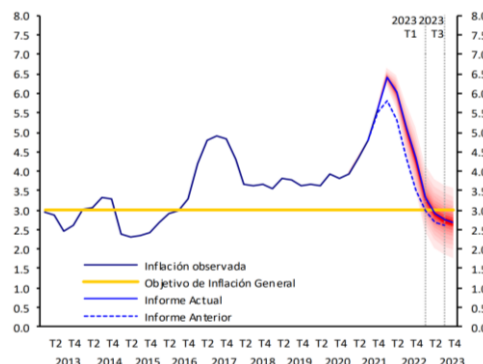
% y/y



Source: Extracted directly from Banxico's 4Q21 Quarterly Report, only available in Spanish

Fan chart: Core inflation*

% y/y

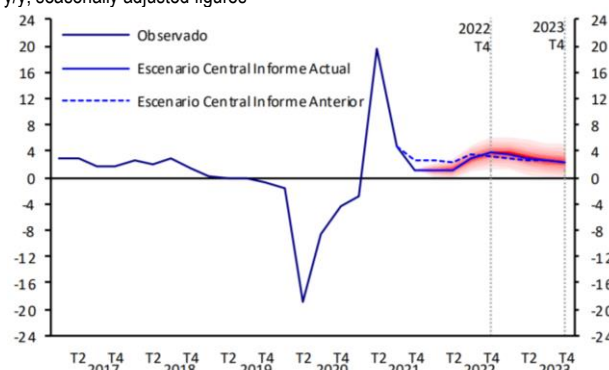


Source: Extracted directly from Banxico's 4Q21 Quarterly Report, only available in Spanish

Downward revision in 2022's GDP. As expected, the central bank trimmed its estimate for this year, with the mid-point slipping from 3.2% to 2.4% (range: 1.6% to 3.2%), matching our forecast. They mentioned that the revision was mainly on a lower inertial boost given [weakness in activity at the end of 2021](#). Although they expect a sequential increase in 1Q22, there might be an impact from the ‘Omicron’ wave. After this, activity will be boosted both by external and domestic demand, albeit with the overall trend still tied to the pandemic. If progress close to the mid-point is achieved, activity would reach pre-pandemic levels (4Q19) in 4Q22, pushing it back one quarter vs. the previous QR. For 2023, there was a +20bps move in the forecast to 2.9% (range: 1.9% to 3.9%) due to a more favorable base effect, with Banxico stating that the path for quarterly moves was mostly unchanged. As a result, the degree of slack would be higher in the short-term, although gradually picking up through the forecast horizon, closing it by late 2023. Risks remain tilted to the downside, noting: (1) Persistence of the pandemic; (2) extension of supply bottlenecks; (3) new episodes of financial volatility; and (4) a slow recovery of fixed investment.

GDP forecasts

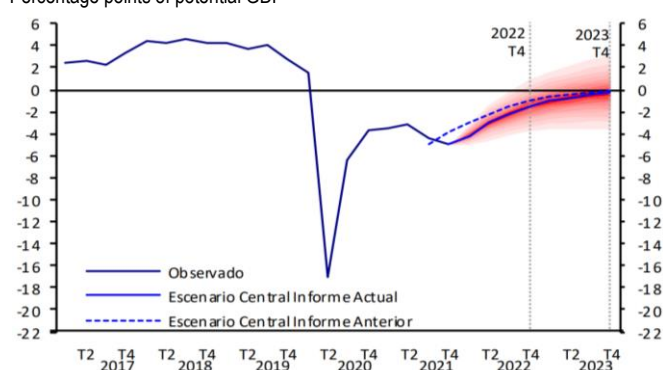
% y/y, seasonally adjusted figures



Source: Extracted directly from Banxico's 4Q21 Quarterly Report, only available in Spanish

Output gap

Percentage points of potential GDP



Source: Extracted directly from Banxico's 3Q21 Quarterly Report, only available in Spanish

Modest changes in other estimates. Despite lower growth in 2022 –and marginally higher for 2023–, Banxico kept its estimates for IMSS affiliated job creation unchanged for this and next year, based on the available data. On external accounts, changes were modest. Specifically, the trade deficit for both years could be tighter; the current account would show a lower deficit in 2022, although increasing in 2023. For more details, see the tables below.

Banxico's Forecasts

Current Report (4Q21)

	2022	2023
GDP (% y/y)		
Central scenario	2.4	2.9
Range	1.6 to 3.2	1.9 to 3.9
Employment (thousands)	560 to 760	510 to 710
Trade Balance (bn)	-15.0 to -9.0	-17.8 to -9.8
	(-1.1% to -0.6% of GDP)	(-1.2% to -0.6% of GDP)
Current account (bn)	-8.2 to 1.8	-10.1 to 1.9
	(-0.6% to 0.1% of GDP)	(-0.7% to 0.1% of GDP)

Source: Banxico

Banxico's Forecasts

Previous Report (3Q21)

	2022	2023
GDP (% y/y)		
Central scenario	3.2	2.7
Range	2.2 to 4.2	1.7 to 3.7
Employment (thousands)	560 to 760	510 to 710
Trade Balance (bn)	-16.1 to -10.1	-18.6 to -10.6
	(-1.1% to -0.7% of GDP)	(-1.2% to -0.7% of GDP)
Current account (bn)	-8.5 to 1.5	-9.1 to 2.9
	(-0.6% to 0.1% of GDP)	(-0.6% to 0.2% of GDP)

Source: Banxico

Relevant topics in the traditional grey boxes, focused on inflationary pressures and monetary policy cycles. As usual, the central bank included a deep analysis of several important issues. In this occasion, they centered on factors related to inflationary pressures and monetary policy cycles. The eight boxes were: (1) The increase in transportation costs and its impact on international inflation; (2) International evidence of the correlation between average inflation and its persistence; (3) Recent recovery of IMSS affiliated jobs; (4) Trend measures for headline and core inflation; (5) Effects of inflation on labor poverty in Mexico; (6) Exchange rate volatility and its impact on capital flows to Mexico; (7) Relationship between the Fed funds rate and the evolution of Mexican financial markets; and (8) Banxico on cycles of adjustments in the Fed funds rate. Considering the persistence of inflation and risks from the next Fed restrictive cycle and other EM and DM markets, we will focus on boxes (2) and (8).

High inflation implies risks to going forward, indicating persistence. Based on historical data for emerging and advanced economies at times of high inflation (70's and 80's), they sought to determine if these levels implied a greater persistence for their cycle.

The methodology was based on the construction of: (1) Monthly seasonally adjusted inflation averages with moving windows (15 years); and (2) the persistence of inflation in said periods. With this and a non-parametric measure of probability, it was concluded that there is no evidence of a linear relationship for monthly inflation levels, but in the case of average inflation there is a positive and statistically significant correlation. The higher, the more persistent. In the case of Mexico, this coefficient is 0.77, similar to other emerging countries such as Chile (0.78) and Brazil (0.77), but lower than Colombia (0.40) and South Africa (0.48), among others. This is very important given the magnitude and duration of current global shocks. Given this high level of historical persistence, there is an elevated risk that high inflation will remain due to its high persistence. This partially explains why inflationary pressures have spread and that, without an appropriate policy response, there is a risk of a de-anchoring in expectations.

The behavior of the domestic reference rate given adjustments in the *Fed funds* rate. On the last four cycles (2 of hikes and 2 of cuts) of the *Fed funds* rate, they analyzed and described the behavior of Banxico's reference rate given said adjustments. Overall, moves in both rates during these episodes were in the same direction, but not necessarily of the same magnitude. Historically, decisions have been taken considering macroeconomic fundamentals, weighing the trend of monetary policy in the US as an additional factor and classifying it as relevant. Focusing on the current situation, the behavior of the target rate in Mexico during Fed tightening cycles rate would correspond, at least in the early stages, to moves in the same direction. In addition, we think these could be of a larger magnitude given local conditions. This reinforces and is in line with our view that Banxico will largely keep following the Fed.

Given a more complex scenario, we now expect a 50bps hike in March... This is higher than our previous call of +25bps, driven by the deterioration of the environment. The spotlight has been on Ukraine's invasion. First, upward risks for inflation have clearly increased because of this situation and given the rise in energy prices and other commodities. This is more important considering the high persistence of inflationary pressures, especially at the core, as well as the fact that price pressures in recent fortnights have already extended. Second, the possibility of an even more hawkish Fed, even with higher volatility because of the conflict and that it is highly likely that they hike only by 25bps on March 16th. Lastly, the need to reinforce financial market resiliency because of higher risk premia in local assets. Specifically, to maintain the MXN attractive with a high carry relative to the USD. In turn, this would reduce the risk of additional inflationary pressures given a volatility of higher volatility because of the global backdrop.

...after this, we are still expecting adjustments of 25bps in May, June, September, and December. These moves would be in tandem with the Fed, taking the reference rate to 7.50% by year-end (previous: 7.25%). Specifically, these steps, of a more modest size ahead, are mainly based on our expectations that inflationary pressures will start to recede at the margin starting on 1Q22. In this respect, we believe Banxico probably will not want to reach restrictive territory –as measured by the real, ex ante interest rate– very fast. Considering this, we also modify our rate call for the end of 2023, to 8.50% (previous: 8.25%).

From our Fixed income and FX strategy team

We reaffirm our trade idea of paying 2-year TIE-IRS. Local rates reacted modestly to the QR, in a session characterized by high volatility and strong losses in bonds of other regions. Mbonos gained 3bps, excluding short-term securities, pausing this week's sell-off. TIE-IRS were pressured by 4bps on average. Hence, the market's pricing of Banxico's next moves did not change materially, with implied hikes of +206bps for the rest of the year. It is worth noting that the market still bets for +50bps in the next policy decision. Moreover, uncertainty triggered by the crisis in Ukraine has strongly impacted local risk premia. In this regard, the 10-year spread between Mbonos and Treasuries reached up to 624bps yesterday, highs since the start of the pandemic. In the current backdrop and given our calibration of Banxico's rate, we reiterate our [recommendation of paying 2-year TIE-IRS \(26x1\)](#) with entry at 7.40% and target of 8.10%. This security closed today at 7.94% (+6bps); that is, $+2\sigma$ of its 90-day MA. The originally-planned investment horizon remains close to the next Fed's decision, on March 16th. In FX, the dollar moderated its recent rally, with DXY and BBDXY losing 0.1%. Meanwhile, the Mexican peso was very volatile, oscillating between 20.58 and 20.80 per dollar, closing at 20.62. We reiterate our view of additional USD strength ahead of the start of the Fed's hiking cycle in highly uncertain environment about inflation and geopolitical tensions.

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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 Luis García Casales, Yazmín Selene Pérez Enriquez, José Itzamna Espitia Hernández, Carlos Hernández García, Paola Soto Leal, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Daniela Olea Suárez, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo and Isaías Rodríguez Sobrino, 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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