# Banxico – Monetary stance reaches restrictive territory, but the hiking cycle will continue

- **Today, Banxico's Board raised the reference rate by 75bps to 8.50% with a unanimous vote, in line with our call and consensus**
- **The tone of the statement remains hawkish. We highlight that:**
  **(1) Inflation forecasts were adjusted upwards again, although the convergence to the target is still estimated by 1Q24;**
  **(2) Regarding the magnitude of the increase, they removed the phrase *"…on this occasion…"*. In addition, they modified the guide that they *"...will evaluate taking the same forceful measures if conditions so require..."*;**
  **(3) Specifically, now they will assess the magnitude of the next upward adjustments according to "prevailing circumstances", alluding to greater data dependency and the relative monetary stance with the Fed; and**
  **(4) The balance of risks for inflation remains "significantly" biased to the upside**
- **We reiterate our call that the reference rate will reach 10% by the end of the year. Particularly, we anticipate a 75bps increase in September, with Banxico following the Fed**
- **After this, we continue to believe the central bank could start cutting rates towards the end of 2023**
- **The market expects a more modest hiking pace for the rest of the year**

**Banxico hikes 75bps, in line with expectations.** In line with our view and consensus, the central bank raised the reference rate again by 75bps (see table to the right), taking the rate to 8.50%. The decision was unanimous, just as in June. In our opinion, this is largely due to: (1) The Fed rising by the same magnitude on July 27th, with the majority considering it necessary to move hand-in-hand with this institution in the latest minutes; and (2) core inflation remaining under pressure and well above target, with no clear signs of a moderation yet. With this adjustment, the ex-ante real rate –based on the median of the twelve-month ahead inflation forecast in Banxico's survey– has reached restrictive territory, at 4.6%. We believe the latter helps explain some changes in the statement. Among them, the most relevant is that, in the forward guidance, the phrase that they *"…will evaluate taking the same forceful measures if conditions so require…"* was modified. While this could be interpreted as less hawkish, we think it points to higher data dependency and the relative monetary stance. Instead, they mentioned that they *"…will assess the magnitude of the upward adjustments […] based on the prevailing conditions…"*. Considering the statement, our short-term inflation expectations (and the upward revision in Banxico's estimates) and our outlook for the Fed, we reiterate our call that the reference rate will reach 10% by the end of the year. Specifically, we anticipate an 75bps increase in September to 9.25%, in line with the decision that we expect from the Fed in the same month. Lasty, we continue to believe that Banxico could start cutting rates towards the end of 2023.

August 11, 2022

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**Banxico's 2022 policy decisions**

| Date | Decision |
|---|---|
| February 10 | +50bps |
| March 24 | +50bps |
| May 12 | +50bps |
| June 23 | +75bps |
| August 11* | +75bps |
| September 29 | -- |
| November 10 | -- |
| December 15 | -- |

*Minutes of the decision to be released on August 25th
Source: Banxico

**The balance of risks for inflation remains "significantly" biased to the upside.** The broad determinants of inflation remain the same, with the annual metric –both for the headline and the core– at two-decade highs. In this backdrop, the balance of risks is still characterized as "significantly" biased to the upside. This is important despite the inclusion of a new risk to the downside, namely, a stronger-than-expected deceleration of global activity, with each of the remaining drivers pushed one notch lower in the list. Risk factors to the upside remained unchanged vs. the previous statement. Another concern is analysts' inflation expectations, especially noting the upward adjustments to the core, including in the long term. On the other hand, their inflation forecasts were revised higher again (see table below), in line with our view. For the headline, the average increase for the rest of 2022 was +50bps, with the last quarter (at 8.1%) now quite close to our forecast for the same period, at 8.2%. Changes for 2023 were mostly in the first half, increasing by 60bps in each quarter. For the core, the revisions were more substantial, with the average adjustment for 2H22 at +65bps and at +80bps for 1H23. Despite of this, we think the estimate for 4Q22 remains quite optimistic at 7.6%, compared with our 7.9% forecast.

CPI forecasts
% y/y, quarterly average

| | 1Q22 | 2Q22 | 3Q22 | 4Q22 | 1Q23 | 2Q23 | 3Q23 | 4Q23 | 1Q24 | 2Q24 |
|---|---|---|---|---|---|---|---|---|---|---|
| CPI | | | | | | | | | | |
| Current | 7.3* | 7.8* | 8.5 | 8.1 | 7.1 | 5.0 | 3.7 | 3.2 | 3.1 | 3.1 |
| Previous | 7.3* | 7.8* | 8.1 | 7.5 | 6.5 | 4.4 | 3.5 | 3.2 | 3.1 | 3.1 |
| Difference (bps) | -- | -- | 40 | 60 | 60 | 60 | 20 | 0 | 0 | 0 |
| Core | | | | | | | | | | |
| Current | 6.5* | 7.3* | 7.9 | 7.6 | 6.5 | 5.1 | 3.8 | 3.2 | 3.1 | 3.0 |
| Previous | 6.5* | 7.3* | 7.4 | 6.8 | 5.7 | 4.3 | 3.5 | 3.2 | 3.1 | 3.1 |
| Difference (bps) | -- | -- | 50 | 80 | 80 | 80 | 30 | 0 | 0 | -10 |

Source: Banco de México. *Observed data

**We reiterate our call of a 10% reference rate by year-end.** As already mentioned, the statement maintained a hawkish tone. Banxico will keep hiking, with uncertainty centered more around the pace and the level of the terminal rate. In our view, concerns about inflation remain high, including about mid- and long-term expectations. With the rate already in restrictive territory, we believe the statement signals more strongly the dependency to incoming data and the relative policy stance, especially against the Fed. It is our take that it has been a positive development the fact that they have communicated more clearly the importance of this latter factor in their own reaction function, having favorable results at least through two channels: (1) It has been heeded by the market, with local interest rates fully pricing-in a move of the same magnitude which was seen today, with remarkable stability; and (2) the defensiveness of the MXN relative to other EM currencies without the need of further measures (*e.g.* dollar auctions, outright sales, more NDFs, etc.). Both support a more orderly adjustment of the economy and financial markets, on top of containing the increase in inflation expectations.

Specifically, we do not see an immediate need for Banxico to "decouple" from the Fed. In their last meeting, the latter stated that upcoming decisions will be made on a meeting-by-meeting basis as they have already reached neutrality. Meanwhile, several Fed members have warned that it will be necessary to keep hiking rates and market expectations of cuts next year seem premature.

With a still relatively robust US economy –and after warning that it is costlier to increase rates less than needed, than overshooting–, we believe most FOMC members will want to continue with the front-loading of the cycle. Therefore, we expect a 75bps hike in September, with the Fed funds range reaching 3.75% - 4.00% by the end of this year. For Banxico, we believe they will follow the actions of the US monetary authority, with moves of the same magnitude in upcoming meetings. With this, the spread between Mexico and the US would remain at the current level of 600bps (when using the upper bound of the range), which we see as adequate at least until the start of the next easing cycle, which we anticipate could start in late 2023.

*From our Fixed Income and FX strategy team*

**The market expects a more modest hiking pace for the rest of the year.** The initial reaction in rates was quite modest given the lack of surprises. Both Mbonos and TIIE swaps showed few changes, maintaining session gains of 3bps and 2bps, on average, respectively. However, after the revision of inflation forecasts, rates diluted gains and were slightly pressures by 2bps, on average. Nevertheless, market expectations continue to reflect a moderation in the tightening cycle, with a terminal rate around 9.60%. This implies +50bps hikes in each of the decisions in September and November. This is below our call of a year-end rate at 10.00%. Hence, in terms of strategy, we believe short-term rates still have room for additional pressures. We see an expensive valuation in Mbonos Mar'23, Nov'23 and Sep'24, as well as at in the short-end of TIIE swaps curve, up to the 1-year tenor (13x1). We expect curves to extend their flattening bias, with higher relative value in Mbonos vs real rates. Meanwhile, CPI-linked bonds (Udibonos) begin to show higher relative value after the compression in *breakevens* below their 12-month averages, except for short-term securities. We highlight the 5-year tenor at 4.49%. However, we believe they are not attractive enough yet to start new positions at these entry levels.

In FX, the dollar started the session on the downside and remained negative, with slight adjustments in the DXY and BBDXY indices of 0.1%. The Mexican peso managed to break lower the 20.00 psychological level, reaching its best intraday level since the end of June at 19.90. After the decision, the currency returned to 19.96, equivalent to a 0.4% appreciation and scoring four positive days in a row. The MXN has been resilient, and we believe it will continue to be supported in the short-term because of: (1) Banxico's high rates; (2) lower implied volatility relative to EM peers, especially vs. Latam; (3) its proximity to the US through exports, remittances, and tourism; and (4) a more stable macroeconomic framework vs. EM peers. However, we also recognize limited room for further appreciation, so we see USD buying attractive below 20.00 pesos per dollar.

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**We, Alejandro Padilla Santana, Juan Carlos Alderete Macal, Alejandro Cervantes Llamas, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Katia Celina Goya Ostos, Francisco José Flores Serrano, José Luis García Casales, Víctor Hugo Cortes Castro, José Itzamna Espitia Hernández, Carlos Hernández García, David Alejandro Arenas Sánchez, Leslie Thalía Orozco Vélez, Hugo Armando Gómez Solís, Yazmín Selene Pérez Enríquez, Miguel Alejandro Calvo Domínguez, Daniela Olea Suárez, José De Jesús Ramírez Martínez, Gerardo Daniel Valle Trujillo, Luis Leopoldo López Salinas, Isaías Rodríguez Sobrino, Paola Soto Leal, Oscar Rodolfo Olivos Ortiz, Daniel Sebastián Sosa Aguilar and Salvador Austria Valencia 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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