Banxico minutes – Hawkish tone, reaffirming the need of additional tightening

- **Banxico published the minutes of the decision held on September 29th, in which they hiked the reference rate by 75bps unanimously, to 9.25%**
- **In our view, the document reaffirms the hawkish tone, still with concerns over inflation dynamics (and its expectations), similar to the last statement**
- **The debate remains centered on the magnitude of the upcoming hike, although also with comments over the terminal rate and actions after reaching it. Specifically, we highlight:**
  (1) The need to continue with rate hikes, albeit with differences between more defined actions and waiting for more information;
  (2) Greater concerns given more challenging conditions and with higher volatility in markets; and
  (3) The possible level of the terminal rate relative to the ex-ante real rate and the moment when it will be reached
- **In this context, all members agree that the inflationary backdrop has turned more difficult, requiring a restrictive monetary stance**
- **Taking into account our call for the Fed and more challenging conditions for inflation –among other factors–, we still expect +75bps in November, with the rate by year-end at 10.50% and a terminal level of 11.00% at the end of 1Q23**
- **Markets are pricing a terminal rate of 10.91% in 1Q23**

Banxico's minutes more hawkish at the margin. In our opinion, the document has very relevant information about the view of Board members and the factors that will drive upcoming decisions. Although we noted only slight changes in the last statement, we think that the minutes have a more hawkish bias, with greater concerns on inflation and its expectations. We perceived that, for most, following decisions will depend on prevailing conditions at said moment. It seems that some divergence among members persists over the magnitude of the next adjustment, although in our opinion, with a lower risk of an immediate change relative to previous minutes considering the more restrictive tone. In our opinion, Irene Espinosa and Jonathan Heath would call for at least maintaining the current pace –if not accelerating it if conditions deteriorate–, while Victoria Rodríguez and Galia Borja seem to prefer waiting for additional information. Finally, we believe that Gerardo Esquivel could push to reduce the pace as soon as November. Another relevant debate was over the terminal rate, where there are contrasting opinions over which will be its level and when will it be reached, albeit with agreement that it must be determined relative to the real ex-ante rate. In addition, Irene Espinosa was clear in that she thinks that the rate must remain in restrictive territory for the remainder of the forecast horizon. In this context, we keep expecting +75bps in November, with the rate by year-end at 10.50%. Tightening would continue in 2023, with the terminal rate at 11.00% by the end of 1Q23.

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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	+75bps
November 10	--
December 15	--

Source: Banxico

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Some differences regarding the size of the next adjustment remain. We believe that opinions have not changed significantly from those of the previous meeting, although there are signs that some of the more hawkish members (Jonathan Heath and Irene Espinosa) might consider a larger hike if circumstances call for it. This is clear when considering that it was likely Heath who talked about the benefits and costs of a 100bps hike. However, it seems that the costs would be greater, at least for now. Meanwhile, Espinosa does not seem to have ruled out that adverse conditions and uncertainty could lead to an adjustment in the pace –which for us would translate into larger increases. Meanwhile, we think Victoria Rodríguez and Galia Borja maintained their position, considering that the adjustments should be made based on prevailing circumstances and available information, although both agreeing with a deterioration in current conditions. Lastly, we believe that Gerardo Esquivel was clearer regarding moves vs. the Fed, arguing that they could be decouple as soon as in the next decision –this in a context in which the expectations of most market participants point to +75bp by said institution. Below, we present a table with our assessment of the main comments of each one:

Banorte's assessment **on Board member's comments** in the September 29th minutes

Bias	Member	Order in the minutes	Relevant comments
Hawkish	Jonathan Heath 	4	*"…it is not possible to implement a hike lower than that of the Federal Reserve…"* *"…an increase of 75 basis points is barely enough to bring the ex-ante real interest rate further into restrictive territory, and thus any fears about reaching an excessively restrictive monetary policy stance, which affects the rate of growth of economic activity, may be ruled out…"* *"…it should be communicated that it is very likely that the same pace of adjustment will continue in the next decision, adding that higher increases should not be ruled out…"*
	Irene Espinosa 	2	*"…it will be necessary for the monetary policy stance to remain restrictive within the forecast horizon…"* *"…more adverse global conditions, in an environment of greater uncertainty, could lead the Governing Board to consider modifying the pace of adjustment…"* *"…it will be necessary to continue increasing the reference rate, and that it should remain in a more restrictive level…"*
	Victoria Rodríguez 	1	*"…it is essential to act decisively to avoid an unanchoring process…"* *"…a prudent monetary policy is required to avoid possible negative effects on financial markets…"* *"…the hiking cycle must continue and pointed out that the magnitude of subsequent increases should be discussed based on the evolution of inflation and its determinants…"*
	Galia Borja 	5	*"…each decision must be carefully calibrated, determining the appropriate monetary stance…"* *"…the stance should be adjusted so that the central bank inflation forecast reflects a more neutral and symmetric balance of risks…"* *"…provide certainty that markets, and the financial system will adjust in an orderly manner…"*
Dovish	Gerardo Esquivel 	3	*"…that decoupling from the (Federal Reserve) pace interest rate hikes could be feasible as of the next policy decision…"* *"…it desirable for the hiking cycle to conclude by the end of 2022 and that the restrictive monetary policy stance is maintained throughout 2023…"* *"…a possible terminal level of such rate in this cycle could be between 4.5 and 5%..."*

Source: Banorte with information from Banxico

More discussions over the terminal rate of this hiking cycle, with diverging opinions. In the arguments of these minutes, we find two clear and somewhat opposite postures regarding which could be the terminal rate for this tightening cycle. In our opinion, Heath would have signaled that the ex-ante real rate should stand at a level close to 6.0%, higher than what the market forecasts. This, as a result of more complex inflation conditions, the pace of the Fed's hiking cycle, and higher risk aversion in financial markets. On the other hand, we believe that Esquivel is the one who estimates that a possible terminal level between 4.5% and 5.0%, and that it could be reached by the end of 2022 –maintaining a restrictive stance throughout 2023. According to our estimates, currently the ex-ante real rate stands at 3.88%.

Assuming that the 12-month inflation expectation remains constant at 5.17% (taken from Banxico's survey for September), our nominal terminal level of 11.00% implies a real rate of 5.54%, which seems reasonable to us and is in line with the previous comments. Finally, and regarding the duration of the rate in restrictive territory, Irene Espinosa emphasized in her dissent that "*…the monetary policy statement should mention explicitly and clearly that, in order to converge to the 3% target, the monetary policy stance must remain restrictive during the entire forecast horizon…*".

The balance of risks for inflation continues with a considerable upward bias. The Board remains focused on current inflation levels. Although they mention that these are partly due to a global phenomenon –with imbalances between supply and demand– they recognize that at s local level there are generalized pressures, both in the core and in the non-core components, with an emphasis on food and in the growing increases in services. Concerns also fall on the medium- and long-term inflation expectations. Most members mentioned that higher-than-expected shocks and the view that their effects will last longer, have led to an upward revision of both the headline and the core inflation in the remainder of the forecast horizon, placing the convergence in 3Q24. In this sense, a member pointed out that it cannot be ruled out that inflationary shocks will worsen, or that new pressures will materialize. Among the risks identified, most recognize both the persistence of core inflation and external inflationary pressures. Lastly, two members added the increases in minimum wages as a possible risk, while one ruled it out.

Tightening will continue in a very challenging environment. Considering that all members of the Board are still concerned about inflation, and that the Fed continues to be one of the factors considered, we believe that the increases will continue. Furthermore, it is not possible to completely rule out an even high pace in the short-term, although it is not our base case. On prices, our expectation is more adverse than that from the central bank, anticipating higher pressures in the core component –both in magnitude and duration–, with our average estimate for 4Q22 at 8.9% (vs. 8.6% of Banxico). Regarding the relative monetary stance, we are aligned with market expectations on the Fed, with futures discounting +75bps in November with almost 100% probability, consolidating after still negative inflation results in that country. Another factor that could contribute to this is the higher volatility in financial markets. In this sense, it is worth noting that local assets, such as the exchange rate have shown some stability. We think that an important reason behind this is that Banxico will continue to prioritize caution and prudence. In this backdrop, costs from decoupling from the Fed could be high, which is why we believe that they will continue to be linked for the remainder of this year and for much of 2023. Considering the latter, we reaffirm our expectation of +75bps on November 10th and +50pbs in December, with the rate by the end of the year at 10.50%. Hikes would continue in 1Q23, anticipating two +25bps adjustments which will take us to a terminal level of 11.00%.

From our Fixed income and FX strategy team

Markets are pricing a terminal rate of 10.91% in 1Q23. Local rates reflected few changes after the minutes. However, it is worth noting that the session was characterized by strong pressures in bonds, led by Treasuries. The negative surprise in US report caused the curve to lose up to 22bps at the short-end. Similarly, the Mbonos' curve flattened given losses of up to 10bps in the short-end and few changes at the long-end. Meanwhile, TIIE-28 swaps retained losses of 7bps, on average. After this, the market now sees a terminal rate for Banxico of 10.91% in 1Q23 from 10.75% a week ago. This scenario is still a bit lower than our view of 11.00% at the end of the same period. In terms of strategy, longer-term Mbonos have increased their relative value, mainly Nov'38 and Nov'42. However, given the unusual volatility and the current shape of the yield curve, we keep avoiding directional positions. In this regard, we still prefer relative value strategies, maintaining our trade idea to pay TIIE-IRS (26x1) and receive 2-year SOFR. In the FX market, the Mexican peso weakened after US CPI report, the standing at its 100-day MA at 20.15 per dollar. However, after Banxico's minutes, MXN advanced slightly, partially diluting its losses to 20.05 per dollar (-0.3%). We believe that the peso has limited room for an additional appreciation given an overvaluation above 10% according to our models. In technical terms, there is still space for further net short positioning. Moreover, it is our take that USD gains are not over yet due to Fed's determination to curb inflation. In this sense, we see levels below 20.00 as attractive to buy USD.

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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, Leslie Thalía Orozco Vélez, Hugo Armando Gómez Solís, Yazmín Selene Pérez Enríquez, Cintia Gisela Nava Roa, 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, 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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