

Banxico – Concerned about pass-through, but no preemptive hikes

- Banxico released today its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3.25%, as it was widely expected
- Although Banxico stressed that the balance of risks to growth deteriorated from the previous decision ...
- ...We perceived an increased concern about exchange rate pass-through amid the recent wave of volatility in international markets
- In our opinion, despite increased concern about the exchange rate, the central bank will continue to follow the Fed's monetary policy actions
- In this context, we expect Banxico to hike in June
- The minutes of this meeting will be published on February 18th, while the next meeting will take place on March 30
- Mixed performance in local rates, with Mexican linkers rallying on a less favorable assessment on inflation

Monetary stance unchanged, with some changes to the balance of risks. Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view, although the central bank's assessment of the balance of risks, both for external and domestic growth, is more *dovish*, we perceived an increased concern about recent exchange rate performance and the consequences that this could eventually have, not only on inflation in the short term, but also on inflation expectations, in a context of increased volatility conditions in global financial markets. Nevertheless, we do not think that this concern would necessarily trigger an action by the monetary authority before the U.S. Fed hikes rates again in June. We agree with Banxico in that the balance of risks to growth has deteriorated. Moreover, we continue to believe that exchange rate pass-through will be limited, with 12-inflation ending the year below Banxico's 3% target.

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The balance of risks for growth deteriorated from the previous meeting. In our view, the tone of the statement with respect to growth was negative. Although Banxico confirmed the strength shown by private consumption – supported by higher employment and low inflation-, the central bank highlighted that exports have lost momentum on the back of the slowdown in external demand. In addition, the central bank recognized that investment has slowed. In this context, Banxico “...*does not expect demand-side pressures on prices....*” and considers that “...*the balance of risks to growth has shown some deterioration compared to previous monetary policy decision...*”.

Exchange rate and volatility, key to inflation. The central bank concluded that cyclical conditions of the Mexican economy show weakness while the outlook for inflation in the short-term has deteriorated due to the base of comparison. Nevertheless, the monetary authority stresses that one of the main risks to the inflation scenario is the fact that “...*exchange rate depreciation could persist given the impact that global financial conditions has had on the exchange rate, contaminating inflation expectations and leading to increases in the prices of non-tradable goods ...*”.

Banxico will follow the Fed. In an interview for *Bloomberg* in Davos, Governor Agustin Carstens was questioned about whether the central bank may adopt a different monetary stance from the Fed. In this regard, Carstens highlighted the importance of distinguishing between economic external and internal factors. In the first case, the currency movement may destabilize inflation expectations and could motivate an increase in Banxico’s reference rate. However, the current dynamics of the Mexican economy, which has been characterized lately by moderate growth, is consistent with the monetary stance taken by Banxico. In this context, and considering that some of the exchange rate volatility is generated by the interest rate differential between Mexico and the US, Carstens said that “*it is essential to follow the Fed*”.

We maintain our view that Banxico will continue its hiking cycle right after the Fed’s hike in June. While Banxico’s central scenario seems to be of economic activity weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given this, we believe that Banxico will continue its hiking cycle right after the Fed’s hike in June.

From our fixed income and FX strategy team

Mixed performance in local rates, with Mexican linkers rallying on a less favorable assessment on inflation. Mexican rates finished with a mixed performance as investors acknowledged a complex scenario for Banxico going forward. Concerns on FX pass-through ahead and potential risks for the global economy and markets outweighed a dovish assessment in terms of local growth. As a result, nominal-rate Mbonos observed a 3bps sell-off, while real-rate Udibonos rallied between 5 and 15bps, with short-term linkers leading the gains. In our view, current conditions and the valuation of the yield curve continue to be supportive for our trade ideas, despite today's communiqué. We acknowledge a more attractive premium in securities maturing in Jun'21 and Jun'22 *vis-à-vis* Dec'24. Similarly, we continue recognizing an attractive valuation in the Dec'18 and Dec'19 securities, within the belly of the Mbonos curve. In this regard, we expect foreign investors to hold a strong exposure in Mexican bonds, albeit reducing duration taking advantage of current market dynamics. In addition, we hold our trade idea of receiving the short-end of the TIE-IRS curve with important carry and roll-down gains of 7bps per month in the 1-year tenor (13x1) and taking into consideration that the pricing of Banxico's policy path going forward still portrays attractive value. For further details regarding this recommendation please refer to "Trade Idea: Receive 1-year TIE-28 IRS (13x1), [pdf](#)" published on November 12th, 2015.

In FX, the Mexican peso weakened to a session-low of 18.33 per dollar after the release, from 18.28. In our view, the communicate shows more concern about a possible pass-through effect from accumulated currency losses to inflation, maintain it as a key factor for future decisions. Notwithstanding the latter, it is worth noting that: (1) The Board affirmed that second-round effects to non-tradable goods have not been observed; and (2) that although an impact is expected in some goods, they don't forecast a broad and negative effect in the price-formation process. Given this and even after considering these heightened concerns, we still believe that local conditions should prevent a preemptive hike for addressing the currency's weakness. Therefore, we reiterate our recommendation of buying USD/MXN with first support around 18.15-18.20 (which tried to break on the downside today) and the 18.00 psychological for directional positions, mainly due to the prevailing environment of high external volatility.

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