

## Banxico preview – Uncomfortably numb

- **Banxico will announce its monetary policy decision this week (June 4) at 2:00pm (EDT)**
- **We expect the monetary authority to keep the reference rate unchanged at 3%**
- **We believe that Banxico will maintain the tone of the last *communiqué* in which the main message was that in the absence of inflationary pressures and moderate growth, the board will focus on the time when the Fed will start its hiking cycle**
- **It is our take that the tone of the statement will provide support to our call (and consensus) that Banxico will begin a hiking cycle in October...**
- **...nevertheless, we do not rule out an intra-meeting rate hike, given the significant time gap between the FOMC and Banxico meetings going forward**
- **The minutes of this meeting will be published on June 18, and the next monetary policy announcement will take place on July 23**

**Same interest rate, same message.** This week, Banxico will hold its fourth monetary policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (June 4) at 2:00pm (EDT). We believe that board members will decide to leave the reference rate at 3%, as it is widely expected. Nonetheless, we believe that Banxico will maintain the tone of the last *communiqué* in which the main message was that in the absence of inflationary pressures and moderate growth, the board will focus on the time when the Fed will start its hiking cycle.

**When in doubt, wait.** While the Fed's minutes of the last monetary policy meeting denoted a clear division between the FOMC members about the normalization process, many participants: "...*thought it unlikely that the data available in June would provide sufficient confirmation that the conditions for raising the target range for the federal funds rate had been satisfied, although they generally did not rule out this possibility...*". While the Fed's minutes make it clear that the decision is very data dependent –and that it will be determined on a meeting-by-meeting basis–, the Fed seems not to rule out June completely. However, the most recent economic activity indicators, coupled with the fact that inflation remains well below the 2% target, lead us to believe that the Fed would like to wait until September's FOMC meeting. We believe that this "*bias to wait*" by several FOMC members will be taken into account in Banxico's next monetary policy decision.

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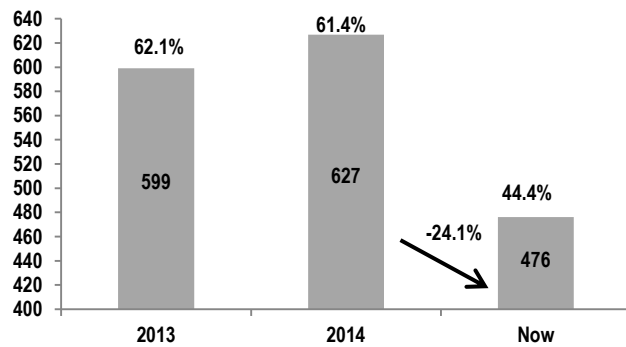
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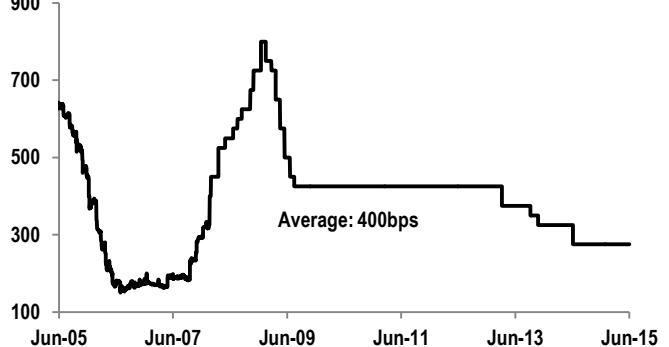
**Rate hike in Mexico, despite sluggish activity and low inflation.** In our view, a rate hike in the U.S. will trigger a similar action from Banxico (current reference rate is at 3% since March 2014). In fact, we believe that an increase in the U.S. reference rate is a sufficient condition to trigger a rate hike in Mexico – despite the fact that economic activity has been sluggish and that inflation could converge to the 3% target this year-, given that the holdings of foreign investors in the short-end of the curve is elevated (refer to the following chart on the left), making even more relevant the spread between Mexico’s reference rate and the *Fed funds* rate, as shown in the chart on the right. Moreover, in the last monetary policy minutes published in May 14, most board members agreed that taking into account the recent fiscal adjustments and given that inflation expectations are well anchored, acting ahead of the Federal Reserve would have more costs than benefits to Mexico’s economic recovery.

**Holdings of foreign investors in the short-end of the curve**  
MXN billions, %



Source: Banorte-Ixe, Banco de Mexico

**Spread between Fed and Banxico reference rates**  
bps



Source: Banorte-Ixe with data from Bloomberg

**Time gap between the FOMC and Banxico meeting schedules.** Banxico’s last monetary policy statement was published one day after the Fed’s announcement (*i.e.* Fed’s announcement took place in April 29, while Banxico’s *communiqué* was published on April 30). As we have mentioned throughout our publications, the central bank is in no hurry to raise the reference rate, given Mexico’s moderate growth, inflation stands below 3%, and with no inflationary pressures on the horizon. If Banxico intends to “*follow the Fed*”, it would be convenient for Banxico to “*pay-to-see the Fed’s hand*”. However, Banxico’s monetary policy meetings will take place between four and five weeks after the Fed meetings, which could qualify as a long term gap for fixed-income and derivatives traders (refer to the table below). We believe that this could be a decisive factor that could trigger Banxico to raise rates in an intra-meeting fashion. Moreover, if the Fed begins to hike in December, Banxico will no longer have a regular monetary policy meeting scheduled this year after the Fed meeting.

In this regard, in the last monetary policy minutes, at least 4 board members agreed that given the greater volatility generated in anticipation of the Fed's decision, the monetary policy stance in Mexico would also have to anticipate the Fed's decision. Even though we believe that the Banxico's reference rate hike will take place immediately after the Fed's hike in September (*i.e.* Banxico's hike will begin in October 2015), these comments open the possibility that Banxico could act preemptively anticipating the Fed's decision, if and only if the central bank perceives strong risks to inflation and/or financial stability.

**Dates of the upcoming monetary policy decisions**

	FOMC	Banxico	Difference (in days)
1	--	Thu 4-Jun	--
2	Wed 17-Jun	Thu 23-Jul	36
3	Wed 29-Jul	Thu 3-Sep	36
4	Thu 17-Sep	Thu 15-Oct	28
5	Wed 28-Oct	Thu 3-Dec	36
6	Wed 16-Dec	--	--

Source: US Fed and Banco de México

**To sum up...** Since our call for the Fed's first rate hike stands in September, we are penciling Banxico's first move to be a rate hike of 25bps at October 15 meeting, which is the first one to take place after the FOMC meets in September 16-17. Nevertheless, we do not rule out an intra-meeting rate hike, given the above mentioned significant time gap between the FOMC and Banxico meetings going forward. In addition, we continue to believe that the Mexican monetary authority will hike 25bps at each of its meetings until the end of the year. This implies a 50bps increase in the reference rate vs. the 100bps previously forecasted. Beyond 2015, there is a high degree of uncertainty about whether the Fed will hold only a process of "*normalization*" and not monetary "*restriction*", so it is difficult to predict what Banxico could do in this period. Nevertheless, we consider that the long-term monetary policy reference rate in Mexico, incorporating the impact of structural reforms, stands at 7%.

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