

Banxico minutes – Following the Fed, but...

May 14, 2015

- Banxico published today the minutes of its monetary policy meeting held back in April 30, in which the board unanimously decided to leave the reference rate on hold at 3%
- In our view, the most important issues discussed were:
 - (1) The balance of risks for growth in Mexico continues to be negative;
 - (2) The balance of risks for inflation remains the same (inflation will fluctuate around 3%); however, there are significant upside risks; and
 - (3) Market's perception regarding the Fed's next hike is that it could be delayed
- In our opinion, the minutes kept the same tone we perceived in the last *communiqué* amid concerns about the uncertainty regarding the Fed's hiking cycle, and the inherent risks for Banxico if they begin restricting their monetary policy before the Fed...
- ...But, despite the fact that Banxico's board emphasized that there are more costs than benefits associated to hiking before the Fed, they do not rule out completely the possibility that, in case of turbulence ahead of the actual start of the normalization process in the U.S., Banxico's own tightening cycle could have to be brought forward
- In this context, we continue to believe that Banxico's next movement will be a rate hike (July 2015), immediately after the Fed increases its own reference rate (June 2015)
- Banxico validates market expectations of a modest liftoff by year-end.

www.banorte.com
www.ixe.com.mx
@analisis_fundam

Gabriel Casillas

Chief Economist and Head of Research
gabriel.casillas@banorte.com

Delia Paredes

Executive Director of Economic Analysis
delia.paredes@banorte.com

Alejandro Cervantes

Senior Economist, Mexico
alejandro.cervantes@banorte.com

Fixed income and FX Strategy

Alejandro Padilla

Head Strategist - Fixed-Income and FX
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA

FX Strategist
juan.alderete.macal@banorte.com

Minutes kept the same tone as the last *communiqué*. Banco de Mexico just published the minutes of its monetary policy meeting held back in April 30, in which the board unanimously decided to leave the reference rate on hold at 3%. In our opinion, the minutes kept the same tone we perceived in the last *communiqué*. In this context, we highlight that the most important issues discussed were: (1) The balance of risks for growth in Mexico continues to be negative; (2) The balance of risks for inflation remains the same (inflation will fluctuate around 3%); however, there are significant upside risks; and (3) Market's perception that the Fed's next hike could be delayed.

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The balance of risks for growth in Mexico continues to be negative. Most members of board mentioned that the balance of risks for the Mexican economy continues to be negative, but has not deteriorated from the previous meeting. While most of the Board members recognized that private consumption has shown a visible recovery, mainly reflected in the most recent retail sales and consumer confidence reports, GFI has presented a moderate recovery derived from the lower growth dynamics of the construction sector. Moreover, industrial production has been hampered by the reduction in Mexico's oil production, and the temporary slowdown in the U.S. economy, which resulted in a lower performance of manufacturing exports. Similarly, most members mentioned that: *"...the balance of risks for Mexico's growth continues to be negative, but has not deteriorated from the previous meeting. [...] A Board member mentioned that if the recent slowdown in the U.S. economy continues, Mexico's economy would be affected, and that the U.S. interest rate hiking cycle could hamper Mexico's economic development. He also highlighted that the Board should not rule out the possibility that the recent fiscal tightening efforts could have a negative impact on domestic demand or that the recent slowdown in the construction sector could continue..."*

The balance of risks for inflation remains unchanged, but with some risks. With regard to inflation, most members agreed that the balance of risk remained stable *vis-à-vis* the previous monetary policy meeting. We highlight that: *"...most of Banxico's board members confirmed that headline inflation will remain around 3% yoy in the short-term, and that it will end the year slightly below this level..."*. However, the board was very emphatic regarding the risks, as most of the Board members mentioned that: *"... although the exchange rate pass-through effect to prices is currently low, the risk of a higher impact continues to increase as the economy recovers. Another member added that it's possible that the current depreciation could translate into a higher pass-through effect that could eventually develop second-order effects to prices. Some board members also highlighted the possibility of higher inflation given the large volatility of agricultural goods prices in the next months..."*

The Fed's monetary policy normalization will probably begin later than it was expected a few months ago. With regard to the beginning of U.S. interest rate hiking cycle, most of Banxico's board members agreed that *"... there is still uncertainty about the date in which the Federal Reserve will begin its hiking cycle, and the pace at which it'll take place. Some board members highlighted that market prospects for the Fed's first rate hike range from September to January of the following year, depending on which indicator is considered ..."*

Hiking before the Fed has more costs than benefits ... 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, given that it could affect Mexico’s economic recovery...*”.

...But, Banxico’s board does not rule out the possibility of hiking ahead of the Fed. 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. In particular, the minutes included the following comments: “...**one board member emphasized that there is a high probability that markets anticipate the Fed’s decision, and that a period of increased turbulence could take place prior to the actual hike. This member and others argued that the current monetary conditions -due to the depreciation of the exchange rate-, gives enough leeway to tighten Mexico’s monetary policy. Another member added that it would be rational for Banxico to act pre-emptively ahead of the Fed’s decision...**”.

Banxico will begin a hiking cycle in July 2015. We maintain our view that Banxico’s next move will be a rate hike. In our view, such movement will take place in tandem with Fed’s first rate increase in June 2015 (Banxico could hike in July 2015). Moreover, we expect a tightening cycle of 100bps this year, so that the reference rate will end the year at 4%. Beyond 2015, there is a high degree of uncertainty about whether the Fed will only hold a “*normalization*” process and not a “*monetary restriction*”, so it is difficult to predict what Banxico might do in year 2016. Nevertheless, we believe that the long-term equilibrium monetary policy rate in Mexico -incorporating the impact of structural reforms-, is 7%.

From our fixed income and FX strategy team:

Banxico validates market expectations of a modest liftoff by year-end. Today’s minutes have confirmed that Banxico is willing to stay put until further news from the Fed, increasing the likelihood of a gradual rate increase in tandem with its U.S. counterpart when economic and global conditions allow this situation. The Mexican authority has recognized that the economy continues portraying an effect of slack, while there are no inflationary pressures (no evidence of passthrough). However, the central bank will be strongly vigilant on FX dynamics on the back of important global risk factors that could increase risk premia in EM currencies. As a result, the market is pricing in high implied probabilities of the beginning of Fed’s liftoff in the 4Q15 and a scenario in which Banxico could start normalizing monetary conditions somewhere between 3Q15 and 4Q15. Implied cumulative hikes by year-end are standing at 18bps for Fed and 51bps for Banxico. In terms of long-term Mexican securities, market observed a muted reaction following Banxico’s minutes and observing a modest relief today following its U.S. peers.

Investors continue acknowledging several global risks that could undermine the performance of sovereign bonds worldwide (European bonds adjustments, uncertainty about Fed and Greek's credit impasse). In our view, valuation of the Mexican yield curve remains attractive, mainly in 20-year Mbonos such as May'31 and Nov'34. However, we acquiesce in the strong likelihood that the current sell-off could extend for the following sessions as the uncertainty surrounding Fed future actions and important economic data tomorrow that could result in higher risk premia globally. Nevertheless, we consider appropriate to wait for better entry levels in coming days for long directional strategies. Losses could prevail despite an attractive valuation in terms of the shape of the Mbonos curve in addition to spreads to U.S. Treasuries that are not reflecting Mexico's fundamentals. Specifically, the 10-year spread is currently trading at 377bps, higher than the mid-term equilibrium of 360bps and the 12-month mean at 352bps.

Regarding the FX and in tandem with the rates market the peso was mostly unchanged, trading currently 1% stronger to yesterday's close at 15.10 per dollar. In our view, the main highlight is the stronger conviction shown by the majority of Board members of the inconvenience to act ahead of the Fed, which for the peso should result in tight short-term spreads to US rates and contained carry levels, particularly with respect to other emerging markets. Hence, we believe that the peso's relative underperformance since the end of March could stay at least until mid-June, particularly in the midst of still high volatility (driven by other global risk factors). Moreover, we confirm our view that other measures by the Foreign Exchange Commission could be unveiled in case of disorderly peso depreciation (say, rapidly going to 16.00 per dollar), although concerns should be more limited now that the currency has appreciated from around 15.30 when the meeting was held. Despite recent gains driven by negative surprises in US data we reaffirm our neutral stance in the MXN and advise not to chase the rally, recommending trading in ranges. We believe intraday volatility will remain high, particularly if global rates continue adjusting upwards, with the peso likely trading in a wide range between 15.00/15.10 and 15.50 per dollar.

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GRUPO FINANCIERO BANORTE S.A.B. de C.V.
Research and Strategy

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

Economic Analysis

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Livia Honsel	Economist, Europe	livia.honsel@banorte.com	(55) 1670 - 1883
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Rey Saúl Torres Olivares	Analyst	saul.torres@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

Fixed income and FX Strategy

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal, CFA	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

Equity Strategy

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5004 - 1275
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 5004 - 1231
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry	marissa.garza@banorte.com	(55) 5004 - 1179
Marisol Huerta Mondragón	Equity Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 5004 - 1227
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 5004 - 1266
Valentín III Mendoza Balderas	Equity Research Analyst	valentin.mendoza@banorte.com	(55) 5268 - 9000 x 1267
María de la Paz Orozco García	Analyst	maripaz.orozco@banorte.com	(55) 5004 - 5262

Corporate Debt

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5004 - 1405
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 5004 - 1340
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 5004 - 1437

Wholesale Banking

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Managing Director – Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Jorge de la Vega Grajales	Managing Director – Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Managing Director – Private Banking	lpietrini@ixe.com.mx	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Managing Director – Asset Management	pimentelr@ixe.com.mx	(55) 5268 - 9004
Ricardo Velazquez Rodríguez	Managing Director – International Banking	rvelazquez@ixe.com.mx	(55) 5268 - 9879
Victor Antonio Roldan Ferrer	Managing Director – Transactional Banking	voldan@ixe.com.mx	(55) 5004 - 1454