

## Banxico– Talk dovish, act hawkish

May 18, 2017

- Banxico increased its reference rate by 25bp from 6.5% to 6.75% (Banorte-Ixe: 6.5%; consensus: 6.5%)
- While the Central Bank had maintained a dovish rhetoric in its speeches -suggesting the possibility of hiking in tandem with the Fed-, the statement today clearly shows a hawkish tone
- In our opinion, the decision to increase the reference rate comes as a result of:
  - (1) The upward trajectory of inflation, on the back of higher pass-through from increases in energy prices and the depreciation of the currency;
  - (2) The absence of slack in the labor market and the lower probability of a tail-risk event materializing in the Mexican economy; and
  - (3) The fact that conditions in domestic financial markets continued to improve
- We now expect another 75bps increase in the reference rate in 2017
- It is worth mentioning that our outlook is subject to the central bank's assessment of inflation in its next *Quarterly Inflation Report (QIR)* to be published next May 31, as well as the actions and rhetoric from the U.S. Fed, both in terms of rates and its balance sheet
- In this context, we expect Banxico to hike 25bps at its next meeting (June 22)
- The minutes of this meeting will be published on the 1<sup>st</sup> of June and the next monetary policy announcement will take place on the 22<sup>nd</sup> of June
- We acknowledge several risks embedded in local rate and the MXN in the aftermath of recent geopolitical events in the U.S. and Brazil in tandem with Banxico's communiqué today

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**Unexpected 25bps rate hike.** Banxico just released its monetary policy decision, in which the board decided to increase by 25bps the reference rate to 6.75%, vs consensus and our own expectation that the monetary authority would remain on hold. Banxico had maintained a dovish rhetoric in recent presentations by several Board Members. However, the *communiqué* published today clearly shows a hawkish tone, highlighting the main factors behind today's decision: (1) The upward trending inflation, on the back of higher pass-through effect coming from increases in energy prices along with the depreciation of the Mexican currency; (2) the absence of slack in the labor market and the lower probability of a tail-risk event materializing in the Mexican economy; and (3) the fact that conditions in domestic financial markets continued to improve.

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**The balance of risks for inflation has deteriorated.** Simultaneous temporary shocks, including higher energy prices and recent increases in the prices of some agricultural products, have pushed inflation above Banxico's target range. Nevertheless, the board of governors emphasized that medium and long-term inflation expectations have remained relatively stable. In this context, they predict that during 2017 inflation will be "... *considerably above the upper limit of the range...*", but anticipate that it will resume a path of convergence towards the 3% target in 2018. According to the communiqué, risks to the upside include: (1) Higher probability of second round effects on inflation; (2) as a result, inflation expectations could increase; (3) an additional depreciation of the exchange rate; (4) pressures on prices of agricultural goods; and (5) pressures on unit labor costs resulting from a smaller margin of slack in labor market conditions. Among the downside risks they mention: (1) An appreciation of the MXN; (2) a decrease in energy prices; and (3) a larger than expected deceleration of economic activity.

**Stable growth outlook.** Banxico highlighted in the statement that the Mexican economy continued to expand at 4Q16 rates. In this context, they also mentioned that there seems to be no slack left in the labor market. In addition, while the central bank considers that the balance of risks for the Mexican economy has deteriorated, they consider that "... *there is the perception that the probability of tail risks materializing has diminished...*".

**Financial conditions improving.** The central bank said that domestic markets improved, highlighting the appreciation of the Mexican currency on the back of a sharp reduction in volatility levels. Regarding the spread between Mexico and the US, the monetary authority commented that it remained relatively stable.

**We now expect another 75bps increase in the reference rate in 2017.** The central bank reiterated in its statement that among the factors they monitor closely are: (1) The pass-through effect of the depreciation of the Mexican peso and the increases in energy prices; (2) the relative monetary stance between Mexico and the US; and (3) the evolution of the output gap. In the first case, even though we believe that the probability of bouts of volatility in global financial markets persists, we expect that exchange rate movements will be relatively limited given Banxico's hiking cycle (375bp from December 2015 and 100bp so far in 2017), the US dollar auctions mechanisms and other instruments in the authorities' toolkit. However, we cannot rule out abrupt movements of the currency in the event of tail-risk events, particularly regarding geopolitical issues, both on a domestic level and globally. In addition, we expect the US Fed to hike the Fed funds rate by at least 50bp in the remainder of 2017. It is worth mentioning that our outlook is subject to the central bank's assessment of inflation in its next *Quarterly Inflation Report (QIR)* to be published May 31, as well as the actions and rhetoric of the Fed, both in terms of rates and its balance sheet. In this context, we expect Banxico to hike 25bp at its next meeting on June 22.

*From our fixed income and FX strategy team*

**We acknowledge several risks embedded in local rate and the MXN in the aftermath of recent geopolitical events in the U.S. and Brazil in tandem with Banxico's communiqué today.** Banxico released today its third policy decision of 2017. Following the 50bps hike on February 9<sup>th</sup> and the 25bps increase on March 30<sup>th</sup>, the central bank decided this Thursday to deliver a 25bps hike accompanied by a hawkish communiqué amid strong concerns about inflation. The market was pricing in 11bps for this event, resulting in a 12bps sell-off in the short-end, while mid- and long-term securities depreciated 8bps. Overall we hold our negative view on rates considering the current backdrop and a strong likelihood of additional rate adjustments within market expectations. Additional details in our publication "*Fixed-Income and FX Weekly*" <[pdf](#)>, published on May 15<sup>th</sup>, 2017. In addition, we have to take into account additional events that pose a significant risk to the risk premia embedded in local assets (*e.g.* bonds and FX) coming from the political turmoil in the U.S. and Brazil. In terms of strategy, we acknowledge and attractive relative valuation in 5- and 10-year Mbonos, however we prefer waiting for better conditions for long directional strategies.

In the FX market, the Mexican peso gained from 18.90 to 18.76 per dollar as it strongest intraday level, stabilizing around 18.85. We maintain our cautious stance and recommendation to buy USD/MXN on dips given the in the short-term backdrop described above and less favorable technicals. Under these circumstances, we still believe that the 18.45-18.50 support zone is attractive as an entry for long trading positions. Nevertheless, our economists' forecasts change in terms of Banxico's monetary policy path inserts downside risks to our year-end forecast of 19.50. If it materializes, the currency is likely to gain an additional edge to the one already in place in terms of the carry trade as it would imply a still higher spread to US rates but also when compared to other EM currencies.

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