

Banxico – Slowly cooking a rate cut

June 27, 2019

- Banxico’s Board announced its decision to maintain the reference rate at 8.25%, as it was widely expected
- The decision was not unanimous, with one member in favor of cutting the reference rate by 25bps.
- We believe it is highly likely that Deputy Governor, Gerardo Esquivel, voted for a cut, given that he had already voted against the tone of the communiqué in the past two meetings
- In our view, the tone of the communiqué was slightly dovish as the balance of risks for growth was skewed further to the downside while the Board shows more conviction that inflation will converge to target
- Nevertheless, the central bank remains prudent and cautious on uncertainty about financial stability risks, particularly credit ratings and the approval of USMCA in the US
- In this regard, the linguistic analysis shows a considerable decrease in the relative weight of “inflation” although it remains as the most mentioned word, thus making the rest of the words appear larger
- We maintain our call of a 25bps rate cut in November’s meeting, with higher conviction after today’s decision. In our view, the central bank is waiting for uncertainty to diminish in order to take any step
- Despite of the latter, we cannot rule that a rate cut takes place at an earlier date, especially if uncertainty surrounding Pemex is drastically reduced
- The minutes of this meeting will be released on July 11th
- Banxico validates the market’s pricing of a more lax stance going forward

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June 27th, 2019 Statement Word Cloud



Source: Banorte with data from Banxico

May 16th, 2019 Statement Word Cloud



Source: Banorte with data from Banxico

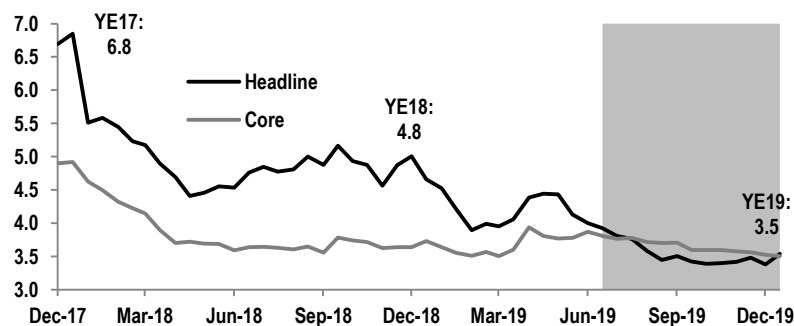
Reference rate unchanged at 8.25%. The decision was in line with our and the market’s expectations. Nevertheless, it was not unanimous, with one member in favor of cutting the reference rate by 25bps. We believe it is highly likely that Deputy Governor, Gerardo Esquivel, voted for a cut as he had already disagreed twice on the tone of the communiqué. In our view, the tone was slightly dovish as the as the balance of risks for growth was skewed further to the downside while the Board showed more conviction that inflation will converge to target. Nevertheless, the central bank remains prudent and cautious on uncertainty about financial stability risks. In particular, the monetary authority gave further comments on credit ratings (both the sovereign and Pemex), trade tensions with the US, and uncertainty about the ratification of USMCA in the latter country. The minutes of this meeting will be released on July 11th.

Prospects regarding economic growth continue to deteriorate. On the global backdrop, Banxico echoed the messages from other central banks, as inflation remains relatively low and economic activity keeps decelerating. Thus, the balance of risks is still biased to the downside. On the domestic front, the central bank mentioned that activity during April was only just higher than March, mostly due to weakness in the services sector, resulting in a further widening of the output gap. In addition, and most importantly, they stressed that the balance of risks has grown more uncertain, amplifying further the skew to the downside.

The outlook for inflation has become more balanced. Banxico highlighted that recent dynamics in the headline index, standing at 4.00% in 1H-June, have become more favorable, mainly due to a better performance in the non-core component. Nevertheless, within the core index, they noted the pickup in processed foods while services have come down slightly. Regarding the balance of risks, they added, to the upside, possible pressures if the US imposes tariffs on Mexican imports and countermeasures are deployed. To the downside, and taking into account the more dovish stance of central banks around the world, they noted the possibility of an additional appreciation of the MXN. All in all, the Board mentioned that some of the risks have diminished while others gained more relevance. In this sense, the statements now states that “...*high uncertainty persists regarding the risks that might affect inflation...*”, albeit eliminating that it is skewed to the upside. Considering the latter, we believe that the central bank’s view about inflation is starting to ours, with our year-end forecast at 3.5% yoy (see chart below).

Inflation forecasts 2019

% yoy, bi-weekly frequency

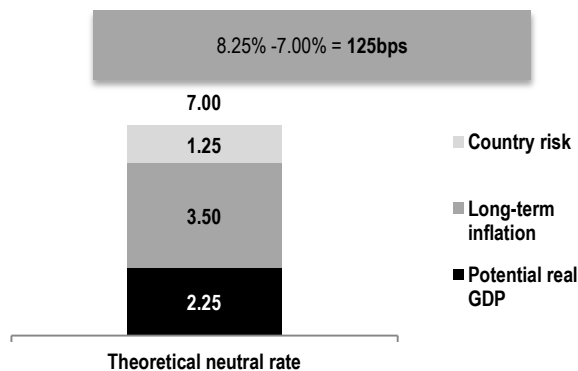


Source: INEGI, Banorte

Cautiousness prevails on high uncertainty, focused on risks to financial stability. We highlight that the Board added the phrase that: “...addressing the deterioration of both the sovereign’s and Pemex’s credit ratings (...) are necessary...” as the current environment continues to pose medium- and long-term risks that could affect the country’s economic conditions, its potential growth, and the economy’s price formation process. In this respect, we believe that authorities and market participants are waiting for the presentation of Pemex’s business plan, expected to be unveiled in the following two weeks. Additionally, the document stressed the more recent risk of an imposition of tariffs to all Mexican exports by the US, stating that in case of materializing this would likely result in the adoption of compensatory measures. Although this has been mitigated by a recent agreement, it has not been fully eliminated yet. Moreover, the approval process of the USMCA in the US is still uncertain, especially given the political backdrop in that country. On the contrary and as already mentioned, a positive development was the more dovish bias of global central banks, particularly the Fed. All in all, the Board continues seeing risks that could deteriorate the performance of financial assets in our country.

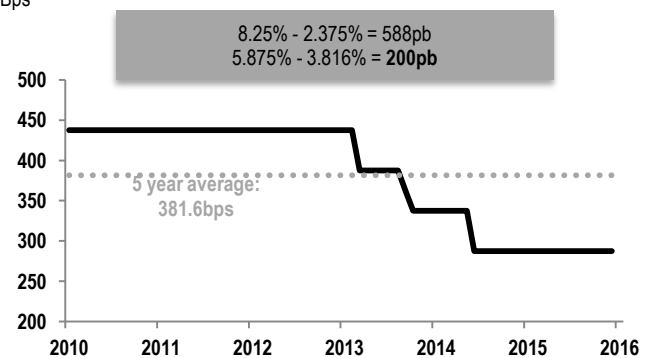
We maintain our call of a 25bps rate cut in November’s meeting, with slightly higher conviction. We think that Banxico will maintain a prudent and cautious stance for now, mainly because of the need for more information regarding some risk factors for financial stability. Nevertheless, the tone on both growth and inflation has increased our conviction that the central bank is slowly cooking a rate cut. As a result of our expectation that some of these risks will diminish gradually, in tandem with the more dovish stance by the Fed (with our view that a 25bps rate will materialize on July 31st), and that inflation will reestablish its downward trend in a context of muted growth, we maintain our call that Banxico will have room to cut the reference rate by 25bps at the November 14th meeting. Moreover, we cannot rule out this to happen sooner than expected if these risks unravel at an earlier date. Last but not least, we reiterate our call that this rate cut could kick-start an easing cycle, which we estimate could result in an accumulated reduction between 125-200bps (see charts below for further details about our estimates).

Theoretical “neutral” reference rate
%



Source: Banorte

Spread between the mid-point of the Fed funds rate and Banxico’s reference rate
Bps



Source: Federal Reserve, Banco de México

From our fixed income and FX strategy team

Banxico validates the market's pricing of a more lax stance going forward.

Banxico's split decision came with a member leaning in favor of a 25bps rate cut, together with a number of firm arguments about complex local and foreign conditions. The tone depicted a dovish bias, but somewhat uncertain with a hawkish tilt in respect to inflation and rather cautious on the back of risk factors stressing global growth, the geopolitical front (*e.g.* trade uncertainty with the U.S.), and risks for the sovereign and Pemex's credit profile. As a consequence of this tone, local rates adjusted with a 10bps rally in nominal tenors and up to 13bps in TIIIE-28 IRS, although with a market holding a pricing of around 33bps of accumulated implied cuts for 4Q19 (up to -123bps for 4Q20). In our view, this positioning is aligned with the central bank's reach throughout this year, reaffirming our call on a 25bps rate cut in November.

Local rates and other local securities have been supported by a relatively more favorable short-term view about the risk horizon (mainly as a migratory/trade agreement was reached with the U.S.) and reflecting the widespread rally in sovereign bonds worldwide given the more dovish rhetoric from developed central banks, including the Federal Reserve. Although investors acknowledge that local bonds could continue benefiting from the international backdrop, we see a current risk premium not reflecting Mexican idiosyncratic risks. In this sense, we are favoring liquidity, especially with attractive short-term rates in Mexico (in comparison with the rest of EM) and waiting for better valuations, after profit taking in the tactical long strategies in Mbonos Nov'36 and Nov'38.

In the FX market, the Mexican peso saw a moderate reaction to the decision, holding a slightly weaker performance during the session although within a very limited range. The currency trades close to 19.15 per dollar, a 0.1% depreciation with respect to yesterday's close, reaching up to intraday 19.19 per dollar earlier in the session. After the strong pressures witnessed between May and June following the U.S. commercial threats, MXN has resumed a relatively sideways performance, within a range defined by the 19.37 region (close to the 200-day MA) and 18.89, its strongest level reached just a week ago. Along with the temporal withdrawal of the premium associated with the Mexico-U.S. bilateral relationship, MXN has also been favored by the support that risky assets have experienced through the more accommodative tone from developed central banks. We hold our view that the main anchoring for the peso is its high carry derived from Banxico's rate. In this sense, despite a more dovish tone in today's communiqués, we believe the potential dilution of this factor will be short-term, only at the margin, and even lower when considering other EM central banks joining their developed pairs, highlighting Mexican rates' attractiveness. However, we hold a vision about a more complex 2H19, combining local and foreign risk factors, reinforcing our view on USD/MXN year-end at 20.30. In this sense, we will be active in looking for suggestive levels for USD directional longs, especially when downwardly breaching the 18.90 area.

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SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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