

## Banxico Minutes – Banxico’s hike still tied to the U.S. Fed

- Banxico published the minutes of its October 29<sup>th</sup> monetary policy meeting, in which the board left the reference rate unchanged at 3%
- In our view, minutes will confirm the monetary authority’s focus on the U.S. Fed’s hiking cycle
- The discussions of the Governing Board concentrated on the following topics:
  - (1) The balance of risks for growth which deteriorated in the inter-meeting period, while the balance of risks for inflation remained unchanged;
  - (2) The adjustment of financial markets in Mexico, amid recent episodes of volatility, liquidity provision mechanisms in the exchange market, in particular; and
  - (3) The preemptive or reactive bias of monetary policy, especially in case of a delay in the start of normalization in the US
- In our opinion, the document continues to show that Banxico is "tied" to the decisions of the U.S. Fed
- We maintain our view that the central bank's next move will be a rate hike (December 17), immediately after the Fed begins to raise the Fed funds rate (December 16)
- We recognize an attractive valuation in the short-end following Banxico’s recent assessment on inflation, growth and global environment

**Monetary policy unchanged.** Banxico released today the minutes from the monetary policy meeting held two weeks ago (October 29), in which the board of governors decided unanimously to keep the benchmark rate at 3%. In our opinion, the minutes kept the same tone of recent communications from the central bank, highlighting the following discussions: (1) The balance of risks for growth which deteriorated in the inter-meeting period, while the balance of risks for inflation remained unchanged; (2) the adjustment of financial markets in Mexico, amid recent episodes of volatility, liquidity provision mechanisms in the exchange market, in particular; and (3) the preemptive or reactive bias of monetary policy, especially in case of a delay in the normalization process in the United States.

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**The balance of risks for growth has deteriorated.** Board members agreed that the balance of risks for the Mexican economy deteriorated in the inter-meeting period. While most of the members recognized that private consumption has presented an improvement, they also acknowledged that other indicators such as those associated with the manufacturing and mining sectors continued to show a weak performance. In this context, most members emphasized that: *"... slack remains in the labor market and the economy as a whole, so that no generalized price pressures are anticipated... "*.

**Balance of risks to inflation remained unchanged.** With regard to inflation, most members agreed that the outlook has remained unchanged from the previous meeting. In particular, all members agreed that the exchange rate pass-through effect has been limited and that inflation will remain below 3% until year-end. In this context, they believe that the exchange rate pass-through has not only been limited, but also has not derived into second-round effects, while the change in relative prices due to the depreciation of the real exchange rate *"...is taking place in an orderly and gradual manner ..."*.

**Orderly adjustment of financial markets in Mexico.** Most members agreed that the market adjustment -given the recent episode of volatility- has been orderly and with lower costs than in other emerging economies. However, the discussion highlighted the need to continue *"... using and calibrating the mechanisms for providing liquidity to the foreign exchange market to reduce the risk premium ..."*. In this context, the central bank believes that the current period of relative calm could be transitory, with a high possibility of further episodes of volatility ahead. In addition to the liquidity-provision instruments, the monetary authority emphasized the need to maintain a stable macroeconomic framework, for which it is necessary for recent fiscal adjustment efforts to materialize while continuing implementing the structural reforms. In our opinion, this discussion could lead to some changes, as we have been arguing throughout our publications, in the dollar auction mechanisms. Nevertheless, recall that decisions on this issue are not the prerogative only of the monetary authority, but of the *Exchange Commission*, in which the Ministry of Finance is also involved.

**Acting before or after the Fed...that is the question.** Finally, we highlight the discussions on the need for monetary policy to be reactive or preventive, bearing in mind again that these discussions were carried out when there was a high level of uncertainty around the Fed's decision. In this context, a member considered that given the risk of capital movements and disorderly market adjustments *"... monetary policy should be adjusted in Mexico before it is adjusted in the United States ..."*. However, most members were emphatic that adjusting policy before the Fed would not be appropriate, since such a move would be inefficient and high-cost.

**We maintain our view that the central bank's next move will be a hike, immediately after the Fed in December.** While Banxico's central scenario seems to be of economic 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 these factors, we believe that Banxico's next move will be a rate hike, immediately after the Fed starts its normalization of monetary policy in December 15-16. This implies that the central bank could be raising rates at its next regular meeting on December 17. However, the central bank's more dovish stance in terms of growth relative to the Fed suggests that Banxico will adequate its monetary policy to Mexico's business cycle, and will not necessarily follow the Fed in 2016.

*From our fixed income and exchange rate strategy team*

**We recognize an attractive valuation in the short-end following Banxico's recent assessment on inflation, growth and global environment.** Today's minutes confirm market expectations that Banxico will start rate liftoff in tandem with the Federal Reserve, but taking into consideration a benign scenario for inflation and risks to economic recovery. Local rates are showing a mild reaction following Banxico's minutes as they have already priced in the balance of risks identified by the Board's members. In our view, the assessment inside the most recent documents suggests that the short-end of the Mexican yield curve has an attractive valuation. Earlier today we started a new trade recommendation in order to take advantage of these conditions. We recommend receiving 1-year TIE-IRS (13x1) with an entry level of 3.92%, target of 3.67% and stop-loss of 4.10%. This strategy has an expected gain of 7bps per month from carry and roll-down. The market has observed a significant adjustment during the last month as a result of a more hawkish rhetoric by several FOMC members, particularly in the days following the US labor report, with markets beginning to assimilate a new paradigm from the Fed. In this respect, the implied probability of a 25bps rate hike in December has surged from 37% one month ago to 66%. Mexico's short-end of the curve is more attractive vis-à-vis the U.S. For more details please refer to the research note "*Trade Idea: Receive 1-year TIE-28 IRS (13x1)*" [<pdf>](#) published today.

In the FX market, the Mexican peso is trading 0.2% weaker on the day at 16.76 per dollar, returning from a daily low of 16.82. In our view, this was mostly due to some profit taking in USD longs after Yellen passed to comment on monetary policy this morning and not because any new and significant information in the minutes. It is worth mentioning that several Board members see a high likelihood of an increase in volatility as the Fed's rate hike approaches. There was also a brief discussion about current liquidity measures in the FX market set to expire on November 30, with one member in favor of keeping them while other said that these should be evaluated after recent events, keeping in mind their cost in terms of reserve drainage. In this context, we have perceived less immediate concerns over a potentially high pass-through effect from peso weakness to prices in the short term. In our view this suggests that the brunt of the adjustment in case of expectations of a more aggressive Fed cycle and higher volatility could be in the currency as opposed to rates. Given the Fed's more hawkish stance, we keep a cautious outlook on the currency even after its recent depreciation, recommending buying USD/MXN on dips with a strong support at the 50-day MA around 16.70 and a potential drift towards the psychological resistance of 17.00 per dollar.

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