Ahead of the Curve

November 9, 2018

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We expect Banxico to hike the reference rate 25bps to 8% on a deteriorated balance of risks for inflation

Monetary policy decision (November 15th). We expect Banxico to increase the reference rate 25bps to 8%. Our view is based on the following factors: (1) Higher upside risks to inflation and its expectations in spite of recent downward surprises, along the high likelihood that average inflation in 4Q18 will end above Banxico's forecast; (2) the recent deterioration in terms of market performance in a context of higher volatility, supporting the central bank to reaffirm its prudent stance; and (3) the Fed's hawkishness and expectation that the strategy of lifting rates gradually will stay in place, with the majority of Board members highlighting that the possibility of a more accelerated rate hike path in the US has increased.

Going forward, we think Banxico will remain more reluctant to continue with the hiking cycle given that the reference rate is already in restrictive territory and could weigh on growth. In this context, recent losses in MXN could not be followed by additional hikes, with the possibility that the central bank would allow for a real exchange rate depreciation in case of additional shocks to the economy and with an ample toolbox to deal with market volatility.

Mexico weekly calendar

DATE	TIME (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 13-Nov	10:00am	International reserves	Nov-9	US$ bn	--	--	173.6
Tue 13-Nov	12:30pm	Government weekly auction: 1-, 3-, and 6-month Cetes; 3y MBono (Dec'21); 3y Udibono (Jun'22)					
Thu 15-Nov	2:00pm	Banxico's monetary policy decision	Nov-15	%	8.00	8.00	7.75

Source: Banorte; Bloomberg

Proceeding in chronological order...

Weekly international reserves report. Last week, net international reserves increased US$50 million, amounting to US$173.6 billion. According to Banxico's report, this figure comes mainly from a positive valuation effect in central bank assets. In this context, the central bank's international reserves have grown by US$831 million during 2018 (please refer to the following table).

Banxico's foreign reserve accumulation detail
US$, million

	2017	Nov 1, 2018	Nov 1, 2018	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	172,802	173,633	50	831
(B) Gross international reserve	175,450	176,585	604	1,135
Pemex	--	--	291	-322
Federal government	--	--	228	483
Market operations	--	--	0	0
Other	--	--	84	974
(C) Short-term government's liabilities	2,648	2,952	553	304

Source: Banco de México

Weekly government bond auction. The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent–, will offer 3-year fixed-rate Mbonos (Dec'21), 3-year inflation-linked Udibonos (Jun'22), in addition to the "more traditional" 1-, 3-, and 6-month zero-coupon Cetes (please refer to the following table). As usual, results will be released at 12:30pm (ET).

Auction specifics (Tuesday, November 13th, 2018)

	Maturity	Coupon rate, %	To be auctioned[1]	Previous yield[2]
Cetes				
1m	13-Dec-18	- -	7,000	7.71
3m	14-Feb-19	- -	11,000	8.19
6m	09-May-19	- -	11,000	8.16
M Bono				
3y	09-Dec-21	7.25	9,000	7.91
Udibono				
3y	09-Jun-22	2.00	UDIS 1,000	3.67

Source: Banorte with data from Banco de México 1. Except for Udibonos, which are expressed in UDI million, everything else is expressed in MXN million. 2. Yield-to-maturity reported for Cetes, Mbonos and Udibonos

We expect Banxico to increase the reference rate 25bps to 8%. Moreover and even in this scenario, the risk of an additional rate hike in December remains alive, a situation we do not completely rule out. Our forecast is based on the following factors:

(1) *Higher upside risks to inflation.* In our view, these risks have increased since the last decision on October 4th, when Banxico kept the rate unchanged and Deputy Governor Manuel Ramos-Francia voted for a 25bps hike. First, it is highly likely that average inflation during 4Q18 will finish above Banxico's forecast of 4.2% yoy, as stated in its latest Quarterly Report. In this sense, we did a simple exercise assuming that monthly inflation in November and December equals the 5-year average at 0.82% and 0.5%, respectively, with October already known at 0.52%. Incorporating base-effects, this would result in average 4Q18 inflation of 4.73%, which is 53bps above Banxico's projection.

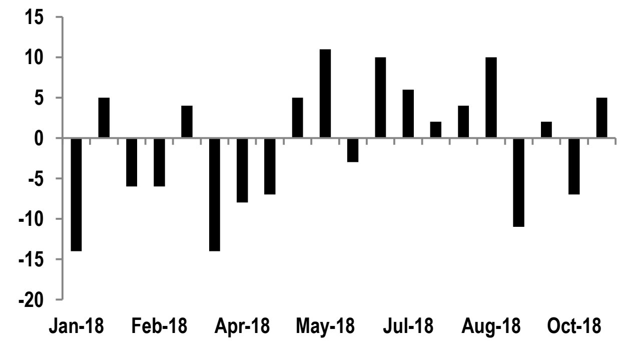
Based on our estimated trajectory, the same figure would be 4.8%, a spread of +60bps (see chart below to the left). In our view, this will carry more weight than recent downward surprises in bi-weekly prints, with 2 out of the 4 latest releases below consensus (chart below, right), mostly due to more modest pressures in agricultural and energy prices. It is our take that this potential deviation is enough to justify at least one more 25bps rate hike, more so considering that the central bank has already delayed the expected timeframe in which inflation will return to target from 2T19 to 2Q20.

Inflation forecasts
% yoy, simple average for the quarter

	2018		2019	
	III	IV	I	II
Headline				
Banxico	4.8	4.2	3.8	3.6
Banorte	4.9	4.7	4.4	3.9
Core				
Banxico	3.6	3.5	3.3	3.2
Banorte	3.6	3.5	3.5	3.4

Source: Banorte with data from Banxico

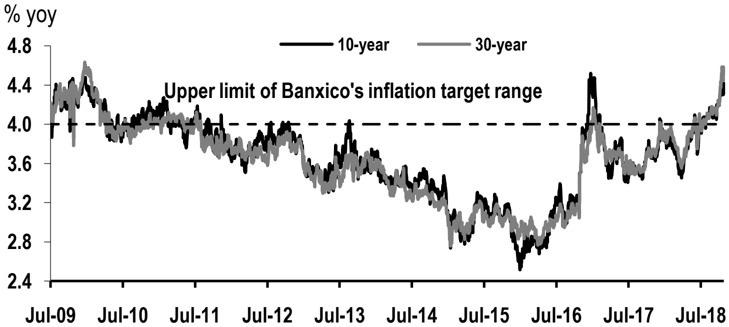
Headline inflation surprises
Bps based on bi-weekly data, spread between actual and estimated



Source: Banorte with data from Bloomberg

Even assuming a loose restriction stemming from Banxico's inflation forecast targeting regime, risks for inflation expectations have also increased. According to Banxico's survey, the headline forecast for year-end 2018 has increased from 3.94% as of the latest available report when they hiked the reference rate on June 21st, to 4.61% currently. The same figure for year-end 2019 has increased more modestly, while the adjustment for core inflation has been very modest. More relevant though, market expectations have surged, particularly for the long term. Breakeven inflations in all tenors (3-, 5-, 10-, and 30-years) oscillated around 4% at the end of June. As of yesterday's close, the first two had increased 21bps on average, trading around 4.2%. In the case of 10- and 30-year tenors the upward adjustment has been of 54bps, with the former going from .96% to 4.23% and the latter from 3.97% to 4.58%, both above Banxico's upper bound and close to highs not seen since the financial crisis (see chart below, left). Even if this has also been contaminated by the general adjustment in local rates, especially in nominal rates, we believe this will be an additional factor that could be of greater concern for the Board in terms of reaffirming the anchoring of inflation expectations.

Long-term inflation breakevens
% yoy

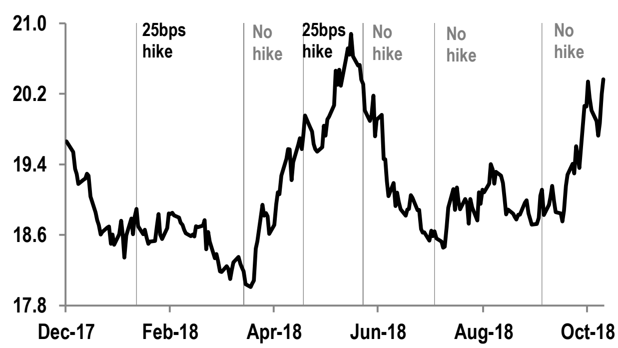


Source: Banorte with data from VALMER

(2) *Recent market performance*. Local assets' dynamics have strongly deteriorated, with the Mexican peso falling 6.2% since Banxico's latest policy meeting (see chart below, left). In this context, in the latest communique and minutes the Board reiterated that: "*…will continue to follow closely the potential pass-through of exchange rate fluctuations to prices, the monetary policy stance relative to that of the U.S. under an adverse external environment, and the conditions of slack in the Mexican economy…"*. On the other hand, we recently adjusted our FX forecasts significantly higher for the rest of the year and in 2019. For details, see: "*Mexico: Adjusting our USD/MXN projections amid a more challenging environment",* November 7, 2018, <pdf>.

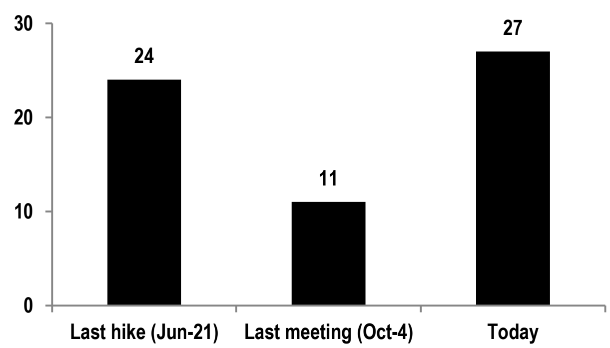
Regarding interest rates, the market is pricing-in accumulated rate hikes of 27bps through the end of this year and up to 61bps by mid-2019 (see chart below, right) as a result of a relative deterioration of the local and external outlook. It is our take that in a context of higher volatility along gradual rate hikes and draining of liquidity by the Fed, Banxico will reaffirm its prudent stance with an additional rate hike. In particular, in the minutes one member emphasized that: "*…the current monetary policy stance, prudent and defensive –both domestic and relative to the United States– has contributed to the recent favorable evolution of the Mexican financial markets…"*.

USD/MXN
Pesos per dollar



Source: Bloomberg

Cumulative implicit movements in reference rates
Bps, using interest rate futures



Source: Banorte with data from Bloomberg

(3) *A hawkish Fed*. Last Thursday, the Federal Reserve left is interest rate range unchanged at 2-2.25%, in line with expectations. Although the communique was mostly unchanged the tone remained hawkish, reinforcing expectations that the strategy of lifting rates gradually will stay in place. The market is assigning a probability of 74.9% of an additional 25bps rate hike in December 18-19, which we also expect. In our view, Banxico's Board is increasingly watchful of the Fed as the possibility of a more accelerated rate hike path has increased. In this respect, the minutes showed most members highlighting that: "… *in the event of inflationary surprises in the U.S., there is a risk of a faster-than-expected process of monetary policy normalization in that country…"*. Some tentative signs have emerged in favor of this thesis, such as the upward surprise in wages in the October labor report at 3.1% yoy, a post-crisis high.

Although the outlook for prices remains very uncertain, we believe the Fed is convinced of maintaining its strategy of gradual rate hikes at least for the rest of 2018 and in 2019. Coupled with a more difficult local and external conditions, our base case assumes that Banxico will remain prudent and will hike the reference rate at least once more this year (at this meeting), without ruling out an additional move in December.

In conclusion, we believe higher upside risks for inflation coupled with a more complicated local and external environment will prompt Banxico to hike the reference rate 25bps to 8%. Moreover, we do not completely rule out an additional increase in December. Going forward, we think Banxico will remain reluctant to continue with the hiking cycle given that the reference rate is already in restrictive territory and could weigh on growth. In this context, recent losses in MXN could not be necessarily followed by additional hikes. First, it is likely that Banxico would allow for a real exchange rate depreciation as an adjustment mechanism in case of additional shocks to the economy. Lastly, we should remember that authorities have an ample toolbox to deal with volatility and lower liquidity in the FX market, which could be deployed in case of a disorderly adjustment.

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	Reference
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HOLD	*When the share expected performance is similar to the MEXBOL estimated performance.*
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