

# Banxico – Surprise hike marks the start of the tightening cycle

- In a majority decision, Banxico decided today to hike the reference rate by 25bps to 4.25%, contrasting with both consensus and our call of staying unchanged
- In our view, the statement was more hawkish, with increasing concerns about inflation and the possibility of a sooner-than-expected withdrawal of monetary stimulus in developed economies
- Within the statement, we highlight:
  - (1) The updated forecasts for both headline and core inflation are higher relative to the ones published in the last *Quarterly Report*;
  - (2) The delayed estimated timeframe for the convergence of inflation to the 3% target, to 3Q22 from 2Q22; and
  - (3) The addition of pressures on agricultural prices due to the drought as an upside risk
- We now expect reference rate hikes of 25bps in the four scheduled meetings of this year, closing at 5.25% (previous: 4.50%)
- With better market conditions, we see value in positions favoring a greater flattening

**Banxico surprises with 25bps rate hike to 4.25%.** All analysts believed they would maintain the rate unchanged at 4.00%. In this sense, the decision was not unanimous, with two members favoring the latter scenario. The statement was more hawkish, with greater concerns about inflation and the possibility of a sooner-than-expected withdrawal of monetary stimulus in developed economies. Therefore, “...it was deemed necessary to strengthen the monetary policy stance in order to avoid adverse effects on inflation expectations, attain an orderly adjustment of relative prices, and enable the convergence of inflation to the 3% target...”. Given today’s surprise, our call that upside risks prevail for inflation (see chart below, left) and a scenario of a less accommodative stance globally, we adjust our monetary policy call. Specifically, it is our take that a hiking cycle has started. We now expect reference rate hikes of 25bps in the four scheduled meetings of this year, closing at 5.25% (see chart below, right).

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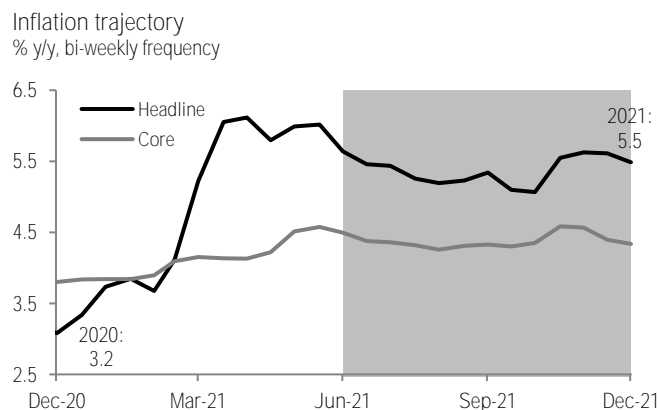
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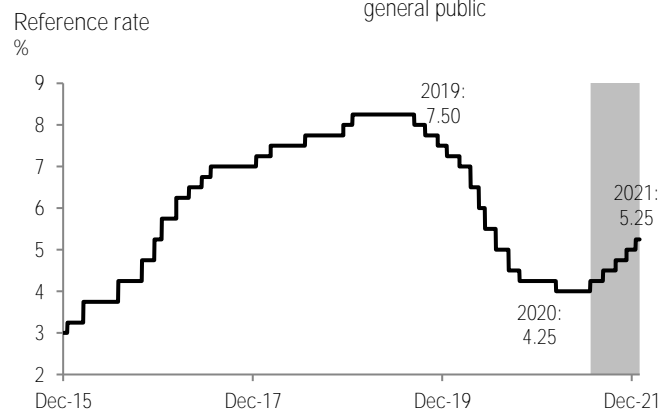
Banxico's 2021 policy decisions	
Date	Decision
<a href="#">February 11</a>	-25bps
<a href="#">March 25</a>	0bps
<a href="#">May 13</a>	0bps
June 24	+25bps
August 12	--
September 30	--
November 11	--
December 16	--

Source: Banxico

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Source: INEGI, Banorte



Source: Banxico, Banorte

**Additional deterioration on inflation, with a hawkish tone.** In the statement, we observed several changes about the outlook for prices, with the central bank much more concerned. In this sense, they stated that supply chains and productive processes of several goods and services continue to be affected by the pandemic. Moreover, although they still consider that shocks that have weighed on inflation are transitory, “...*given their variety, magnitude, and the extended time frame in which they have been affecting inflation, they may pose a risk to the price formation process...*”. Related to this, Banxico mentioned that they now see the convergence of inflation to the target in 3Q22, when as soon as in [the latest Quarterly Report](#) they expected this to happen in the second quarter of said year. They also anticipate inflation forecasts in the next few quarters to be higher, [as we said earlier today](#). The balance of risks remains skewed to the upside, adding as an additional factor in this direction that the drought can pressure agricultural prices even more.

**Cautiousness also due to the withdrawal of stimulus globally.** On the international stage, we highlight comments about higher global inflation, especially in the US as it reached 5% y/y in May. In this backdrop they note the risk of a sooner-than-expected withdrawal of monetary stimulus in developed economies. Among them, the Fed stands out as it also showed a more *hawkish* tone last week. However, we have also seen adjustments in this direction in some EMs (*e.g.* Brazil, Chile, Russia, Czech Republic, Turkey, among others). This is also important for Banxico’s relative monetary stance. On growth, adjustments were more modest, with an equilibrated balance of risks and seeing slack conditions for the economy as a whole.

**We believe this hike marks the start of a tightening cycle.** We think the statement does not signal a potential path for the reference rate going forward, with Banxico remaining highly data dependent, especially regarding the path of inflation and its expectations. However, it is our take that this surprise increase marks the start of a tightening cycle. Our view is especially grounded on our inflation forecasts for the remainder of the year, believing that pressures will continue in the short-term. Specifically, we see that the persistence of high core inflation as persistent, failing to breach 4.3% to the downside for the rest of 2021, a level which is above the upper bound around Banxico’s target. On top of the latter, the global backdrop will likely turn increasingly more challenging as we approach the Fed’s tapering. We still anticipate clear signs of this on the September 22<sup>nd</sup> meeting, with the reduction in the pace of asset purchases starting formally in January 2022. Given this scenario, we now expect reference rate hikes of 25bps in the four scheduled meetings of this year, closing at 5.25%. Previously, we anticipated only two 25bps increases, in November and December of this year. For 2022, there are further challenges, with Banxico adjusting its stance depending on several factors. Specifically, we think that at least three will be key: (1) The evolution of inflation, especially in terms of its composition and if it keeps or not surprising to the upside; (2) the market reaction, capital flow dynamics and risk premium adjustments to the Fed’s tapering; and (3) the possible effect of upcoming changes in the composition of the central bank’s Board.

*From our fixed income and FX strategy team*

**With better market conditions, we see value in positions favoring a greater flattening.** Banxico's surprise decision triggered a substantial sell-off in local rates, adding to an already pressured session in the aftermath of June's first biweekly local CPI print. The Mbonos' yield curve closed the session with pressures of 30bps in short- and mid-term tenors, which from the 10-year benchmark onwards observed pressures of 6bps. The sharp flattening resulted in a spread between 2- and 10-year TIEE-28 swaps compressing 30bps to 106bps, its lowest since the end of last year and consistent with a market that has acknowledged Banxico's hawkish tone and priced-in a more aggressive tightening scenario. As result, the yield curve depicts implied hikes by year end of slightly above 100bps, a fair valuation in our view, considering the central bank's bias and our new estimate of a reference rate closing 2021 at 5.25%. Among other movements the spread between 10-year Mbonos and Treasuries increased to its highest since May 2020, trading at 556bps while the 3-year breakeven closed at 4.95%, a fresh high since January 2010. Given current uncertainty we prefer to wait for better market conditions for directional strategies, although we see value in positions favoring a further flattening of the yield curve in alternatives such as the 2s10s spread in TIEE IRS.

In the FX market, the Mexican peso rallied more than 2% in the intraday basis to levels as strong as 19.71 per dollar, from which it picked-up again for a daily close at 19.84 (+1.7%). Carry will support the MXN in short-term, although we hold a cautious view for the currency with a relevant short-term floor at 19.50.

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We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalia Orozco Vélez, Gerardo Daniel Valle Trujillo, Eridani Ruibal Ortega and Juan Barbier Arizmendi, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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