

Banxico's minutes reinforce easing bias as expected

- **Banxico just released the minutes of its last monetary policy meeting in which the board decided to cut interest rates by 25bps**
- **Recall that this was not a unanimous decision with vice governors Gerardo Esquivel and Jonathan Heath voting in favor of a more aggressive action (-50bps)**
- **They recognized that even though the bias of monetary policy should be restrictive, conditions warrant lower interest rates**
- **As expected, the minutes show a *dovish* tone, highlighting the favorable inflation results and the downside risks to economic activity**
- **We maintain our view that the monetary authority started an easing cycle with two more rate cuts (of 25bps each) in 2019**
- **For 2020, we continue to see a 125bps cycle to get the reference rate to 6% at the end of next year**

Banxico minutes maintain *dovish* bias. The central bank just released the minutes of the meeting held on September 26th, when the Board cut the reference rate by 25bps to 7.75%. Nevertheless, this decision was not unanimous with two members, Gerardo Esquivel and Jonathan Heath, voting in favor of a more aggressive action (-50bps rate cut). In line with our expectations, we believe that the document maintained a *dovish* tone, as all members seemed to be biased to lower interest rates as a result of four factors: (1) The stagnation of economic activity; (2) the fall in headline inflation, hitting the central bank's target in September; (3) the global easing wave; and (4) the fact that domestic risks have ebbed away somewhat, even though they remain central for the outlook.

Arguments for a more aggressive rate cut. As we have already mentioned, vice governors Gerardo Esquivel and Jonathan Heath voted in favor of cutting the rate in 50bps instead of 25bps. Mr. Esquivel argued that inflation has behaved better than expected and that he expects both total and core inflation to converge to Banxico's target very soon. Moreover, global easing wave globally and Mexico's economic deceleration open the door to even a larger rate cut cycle than the one observed in the U.S. Fed. Meanwhile, Mr. Heath argued that while he believes that the bias of monetary policy should remain restrictive, current conditions warrant lower levels of interest rates as slack in the economy is increasing, inflation is converging to target, global easing cycle and lower risk aversion levels.

Banxico's board agrees that slack in the economy has widened. Even though some members believed that conditions could eventually show some recovery in the second half of the year, they still expect a negative output gap. Discussions on growth were focused on the low levels of investment, which could eventually affect growth rates going forward.

October 10, 2019

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In this context, one member considered that risks associated to maintaining high levels of interest rates longer than necessary should not be minimized. Regarding the balance of risks, on the downside all members named global factors, USMCA ratification, along with further reductions in government revenues and other domestic factors affecting confidence levels.

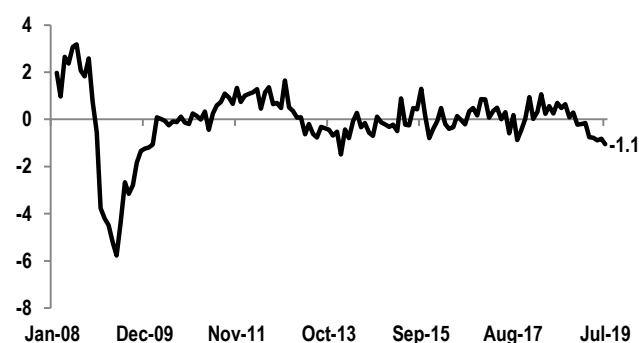
Extended discussions on inflation prospects. As we expected, discussions basically focused the prospects of core inflation, as it remains stubbornly above target levels. Most members were concerned because core inflation has not fallen in tandem with total CPI on the back of indirect effects of higher wages and energy prices in the second half of the year. Looking ahead, they expect inflation to converge to target levels, but they think that uncertainty surrounding the scenario is still very high. Among risks for higher inflation they mention: (1) The persistence of core inflation above target levels despite a widening output gap; (2) exchange rate pass-through, which they believe that even though is low, it is not negligible; (3) external risks related to higher tariffs; (4) weak public finances along with wage revisions above productivity gains. By contrast, they mentioned the possibility of an appreciation of the Mexican peso and lower variations of non-core prices as the main risks to lower inflation.

Lower domestic risks. Members agreed that risks premiums came down since the previous monetary policy meeting, in line with those from other EM but also on the back of the reduction of domestic risks as 2020 government budget and finance measures taken in Pemex were relatively well received by financial markets. Nevertheless, they still see these last two as the main risks to markets from a domestic point of view, while the relationship between Mexico and the U.S. is also a source of concern. In this sense, one member stressed that: “...it is particularly important that, along with a firm and prudent monetary policy stance, some other measures to boost confidence levels and a sustainable consolidation of public finance is necessary...”.

We maintain our view that the monetary authority started an easing cycle with two more rate cuts (of 25bps each) in 2019. These movements imply a 7.25% rate by year-end. Moreover, we still estimate that the cycle will continue in 2020, with 75 bps of cuts front-loaded to the first semester and an additional 50bps during the second half, resulting in a reference rate of 6% by the end of next year. This path implies 225bps of accumulated cuts from the 8.25% level just before the August decision. Apart from the fact that we expect the output gap to remain in negative territory (*see chart below on the left*), the most relevant support for our outlook is the fact that global central banks have started to cut simultaneously, providing Banxico with additional flexibility for more stimulus while at the same not reducing the short-term spread (both in nominal and real terms) with the US as significantly as if Banxico ‘goes solo’ or in a context of tighter global monetary conditions. It is worth noting that this argument is also supported by the minutes published today.

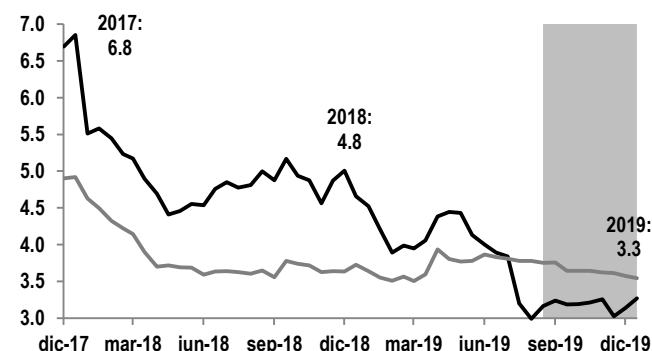
Moreover, behind our expectation also underlies the view that inflation will remain under control and close to target (*see chart below on the right*), recognizing that a relevant risk that could eventually result in more modest easing would be sizable increases in costs (including wages) that reinforce the resistance to the downside of the core component, along with a more noticeable effect in terms of higher mid- and long-term inflation expectations.

Output gap
% of potential GDP



Source: Banorte with INEGI data

Inflation forecast
% y/y



Source: INEGI, Banxico

From our Fixed income and FX strategy team

Banxico’s minutes confirmed that local assets are properly pricing in a gradual but extended easing cycle

Banxico released the minutes of its last policy decision on September 26th, in which it reduced its reference rate by 25bps, with no surprises (dovish bias but with a prudent approach). In line with market expectations, Jonathan Heath and Gerardo Esquivel were the dissenting votes (in favor of a 50bps reduction). Overall, these minutes were characterized by a dovish tilt, giving support to the expectations of additional rate cuts from Banxico for the rest of the year and in 2020. In this regard, the Mexican yield curve is pricing in -48bps of implied cuts for the rest of the year (with policy meetings on November 14th and December 19th), and a total of -176bps by 2020-end. The arguments of the dissenting members suggest that they will continue pushing for additional monetary stimulus, and most likely in a more aggressive way. However, these views could be offset by the arguments of the other members. In terms of growth, the minutes depicted strong concerns about current dynamics. When discussing the drivers behind inflation, Banxico’s board acknowledged the rapid convergence of the annual figure towards the 3% target, but holding a cautious view about core inflation. Banxico’s members are aware of a complex global landscape, in tandem with some challenges for Mexico, which could result in a gradual and prudent easing cycle, taking into account that the rest of the world continues easing monetary conditions. Based on this international context, Banxico could ease conditions in a larger magnitude *vis-à-vis* the Federal Reserve, taking into account the wide spread between short-term ex ante real rates between two countries, currently at 473bps, portraying a maximum level since August 2018.

This differential gives leeway to Banxico with an actual 125bps buffer from the long-term equilibrium. Local bonds are observing a 3bps selloff this morning, following the performance of other interest rates worldwide and with no additional traction coming from today's minutes. In our view, current conditions will remain favorable for interest rates worldwide, and this will also influence the Mexican market. However, we are waiting for better entry levels for new long strategies in Mbonos, especially in the 30-year tenor Nov'47. In the FX market, the peso is extending the early gains, within a context of USD weakness against G10 and EM currencies, trading 0.5% stronger at USD/MXN 19.47. Today's minutes are supporting the thesis that the embedded carry will remain as a key anchor in the short-term, with expected gradual erosion in coming quarters. In terms of strategy, we are waiting for better entry points (between 19.35 and 19.40) to start a new long USD tactical recommendation.

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