

Banxico – The easing cycle will continue, decoupling from the Fed

November 14, 2019

www.banorte.com
@analisis_fundam

Gabriel Casillas
Chief Economist and Head of Research
gabriel.casillas@banorte.com

Delia Paredes
Executive Director of Economic Analysis
delia.paredes@banorte.com

Juan Carlos Alderete, CFA
Senior Economist, Mexico
juan.alderete.macal@banorte.com

Francisco Flores
Economist, Mexico
francisco.flores.serrano@banorte.com

- Banxico decided today to cut the reference rate by 25bps to 7.50%, in line with our call and market expectations
- The decision was once again split, with two members voting in favor of a 50bps cut, as we expected
- In our view, the tone of the communicate was more dovish than the previous statement, given that:
 - (1) Banxico hinted that they will decouple from the Fed, continuing with the easing cycle;
 - (2) They kept pointing to weakness in activity, below their expectations and with the consequent widening of the output gap;
 - (3) The slight reduction in some financial stability risks, particularly after measures aimed to address risks to the credit rating of both the sovereign and Pemex
- Our linguistic analysis showed a diminished importance of “risks”, leaving the first place in terms of the most mentioned word, replaced once again by “inflation”. We also highlight that “recent” appeared, which we relate to the latest performance of growth and inflation
- We maintain our view of an additional 25bps rate cut in December 19th, taking the reference rate to 7.25%. For 2020, we also reiterate our expectation of an accumulated cut of 125bps, for a year-end rate of 6.00%
- The minutes of this meeting will be released on November 28th
- Banxico delivered a dovish cut, holding the market pricing for further stimulus. We hold our view on a global and domestic backdrop providing support for fixed-income securities

Fixed income and FX Strategy

Alejandro Padilla
Head Strategist - Fixed-Income and FX
alejandro.padilla@banorte.com

Santiago Leal
FX Senior Strategist
santiago.leal@banorte.com

Leslie Orozco
Fixed Income and FX Strategist
leslie.orozco.velez@banorte.com

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November 14th, 2019 Statement Word Cloud



Source: Banorte with data from Banxico

September 26th, 2019 Statement Word Cloud

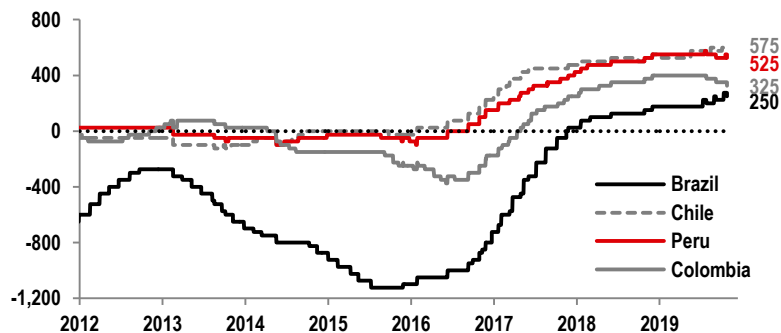


Source: Banorte with data from Banxico

Banxico cuts the reference rate by 25bps, to 7.50%. The decision was in line with our call and market expectations, despite some analysts anticipating a more aggressive action (50bps cut). This was certainly likely, as portrayed by today’s split decision with two dissenters favoring this scenario, in line with September’s outcome. We believe these votes were made, once again, by Deputy Governors Jonathan Heath and Gerardo Esquivel. In our view, the tone was more dovish than in the previous communique, as the Board: (1) Hinted that they will decouple from the Fed, continuing with the easing cycle; (2) kept pointing to economic weakness, signaling that GDP growth this year will be below their expectations, with the consequent widening of the output gap. The balance of risks remained tilted to the downside; and (3) a relative reduction in financial stability risks, particularly the outlook for the credit rating of both Pemex and the sovereign, with a higher likelihood of USMCA ratification in the US. Despite of this, it is our take that the central bank remains cautious as they keep seeing high uncertainty in various fronts, both external and domestic, preferring to wait for more information and to remain prudent despite low growth and headline inflation virtually at the 3% target.

Banxico signals that they will decouple from the Fed, continuing with the easing cycle. In the communique, the central bank acknowledged that the Fed cut the fed funds range again by 25bps on October 30th. More importantly though, they were careful also to point out that the Fed mentioned: “...in its communications that such range is appropriate considering the risks faced...”, in line with our view of a likely pause for the foreseeable future. In this respect, the key adjustment was in the factors to keep an eye on, changing from “...the monetary policy stance to that of the US...” in the previous communique, to “...Mexico’s relative monetary policy stance in an external environment that is still subject to risks...”. In our view, this signals that despite the pause of the Fed, the central bank will keep easing, while looking more closely to its position in comparison to other emerging markets, with ample room to cut at least against regional peers given that short-term interest rate spreads are very wide (see chart below).

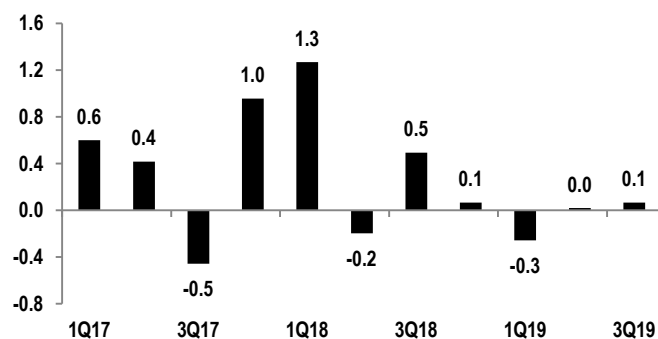
Reference rate spreads: Mexico - Latam
bps



Source: INEGI, Banorte

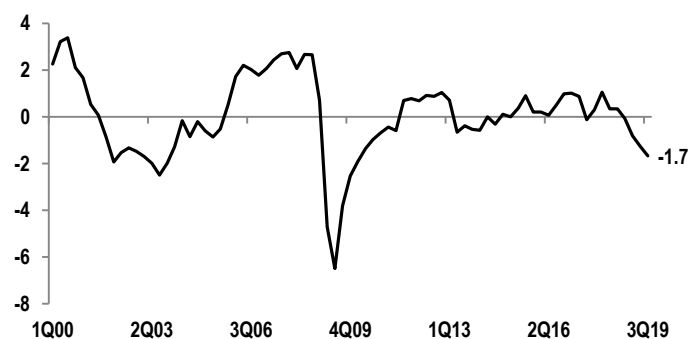
More dovish on growth, which has been lower than expected, with the consequent widening of the output gap. Regarding growth, it is our take that the central bank was significantly more dovish as it recognized that 3Q19 GDP (-0.4% yoy; +0.1% q/q), remains limited, a situation observed for several quarters (chart below, left). They also eliminated the phrase included in September that they expected a slight recovery in economic activity for the remainder of the year, anticipating a cut in their forecast range for GDP growth this year, at 0.2%-0.7%, and in 2020, currently at 1.5%-2.5%. The balance of risks for growth remains skewed to the downside. Moreover, they said that slack conditions “...have widened more than anticipated...”, contrasting with the previous statement stating that they were relatively unchanged. This is consistent with our own calculations, with the output gap as of 3Q19 (using preliminary GDP data) at -1.7%, below the -1.3% of the previous quarter (chart below, right).

GDP growth
% q/q, sa



Source: INEGI

Output gap
% of potential GDP



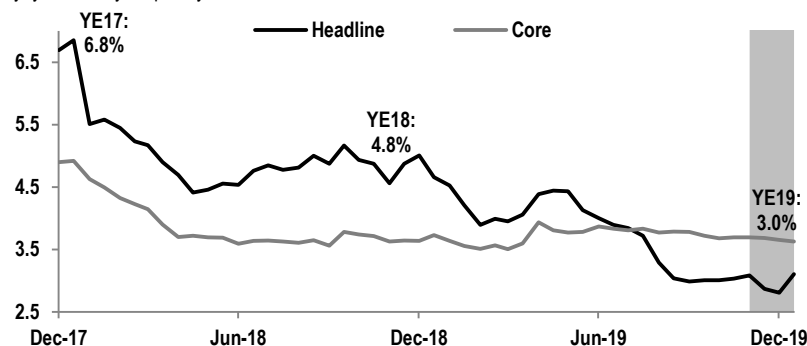
Source: Banorte with data from INEGI

Inflation still at the 3% target, with core inflation falling modestly. The headline index was broadly unchanged from the previous decision, from 2.99% in the 1st half of September to 3.02% in October. Nevertheless, we highlight that: (1) Core inflation was still described with resistance to the downside after falling modestly in recent months, going from 3.87% in April to 3.68%; and (2) they did not modify the balance of risks despite a better-than-expected performance of the headline and the hint of a slight reduction in their forecasts, at least for 4Q19, which stand at 3.2% for the headline and 3.5% for the core. Based on our expected path for the last two months of the year (see: “*We revise our year-end inflation forecast to 3.0% from 3.3%*” <[pdf](#)>), we believe Banxico could adjust the former modestly to the downside.

In our view, the most relevant change about core inflation was that, among the upside risks, the possibility of strong wage increases that could lead to cost pressures was placed as the second most important in the ranking, only behind the resistance to the downside, and higher relative to the previous decision. This signals that Banxico is keenly on watch and cautious about the announcement about the magnitude of the minimum wage (MW) increase for 2020, which is typically known between the end of November and the first weeks of December. On the other hand, downside risks were broadly unchanged, although they increased the relevance of slack conditions relative to lower variations in some components within the non-core index.

Inflation forecasts

% yoy, bi-weekly frequency



Source: INEGI, Banorte

A slight improvement in financial stability risks. We noted comments about lower trade tensions between the US and China, and that the probability of a disorderly *Brexit* process has diminished. Additionally, when talking about the rating of Pemex and the sovereign, they replaced the phrase “...to address the deterioration...” for “...strengthening the credit rating outlook...”, in our view recognizing recent measures taken with regards to the company, and the recently presented *2020 Budget*. Finally, they pointed to higher risk appetite and the possibility of USMCA ratification as downside risks for prices due to their potential effect in terms of an appreciation of the Mexican peso. In our view, these subtle modifications suggest that the Board sees a slight reduction in some short-term financial stability risks, allowing them to continue the easing cycle.

We reiterate our view of a 25bps rate cut in December, with the easing cycle continuing in 2020. The more dovish tone of the communiqué reaffirmed that the central bank is in the midst of an easing cycle. As mentioned above, we identified some elements to support our view that Banxico will continue reducing the reference rate, namely: (1) The signal that they will decouple from the Fed; (2) the widening of the output gap and a slightly better inflation outlook for the headline; and (3) the slight reduction of financial stability risks, both external (trade war, Brexit, USMCA) and domestic (Pemex and the sovereign credit rating). Although some of these point to the possibility of a more aggressive easing path (50bps cuts), we continue believing that the monetary authority will stay prudent, reducing the rate in 25bps steps.

This is mainly supported by two factors. First, the high level of core inflation and its resistance to the downside. In this respect, Banxico acknowledged that “...core inflation has persisted at high levels, albeit exhibiting a slight reduction...”, with some of the most important factors in the balance of risks focused in their impact on this component, including a possible depreciation of the MXN. We do not see a material change in its underlying dynamics in the short-term, which would justify Banxico’s prudent stance.

Second, the high likelihood of a significant increase in the minimum wage (MW). We see as highly relevant the reshuffling of this risk to the second most important place in the ranking. Given higher-than-average increases in the last three years, coupled with the preference for significant hikes by the new administration, we believe concerns will be focused on this front and won't dilute soon.

Going to 2020, we still expect an additional 125bps of easing, taking the reference rate to 6.00% by year-end, front-loaded at the first half of the year. The exact timing is still relatively uncertain given that: (1) The official calendar has not been released yet –expecting it to be included in the *3Q19 Quarterly Report*, to be published on November 27th–; and (2) a still uncertain scenario, both globally and domestically. Regarding this, some of the main risks we identify for next year include the US elections, with the possibility of an additional round of attacks from Donald Trump in an attempt to bolster his position with his electoral base. Other factors to keep track of include local elections in some states, and the possibility of a global recession. In our view, these could insert additional volatility to the MXN, which could be an additional source of pass-through to core inflation, particularly as the carry advantage of the currency erodes gradually.

From our fixed income and FX strategy team

Banxico delivered a dovish cut, holding the market pricing for further stimulus going forward. With only one monetary policy decision left in 2019, Banco de México reduced its benchmark rate 25bps to 7.50%, in line with our expectation and under a split decision with two Board members leaning for a 50bps rate cut. In our view, the tone was more dovish than the previous decision on September 26th, in light of the economic growth assessment and the decoupling signaling from the Federal Reserve in terms of the relative monetary policy stance. This situation confirms our vision about the execution of further easing going forward. Particularly, we expect an additional 25bps rate cut on December 19th and a total reduction of 125bps in 2020 distributed in 75bps for the 1H20 and 50bps in the 2H20, leaving the repo rate at 6.00%. In this sense, the market is currently pricing in 165bps of accumulated implied cuts for year-end 2020. In the aftermath of Banxico's decision, the local yield curve experienced a flattening bias, with short-term interest rates closing the session with an average adjustment of -2bps, while longer-term securities held a rally of about 6bps, though limiting stronger gains throughout the day. This performance took place with global markets depicting stronger appetite for sovereign bonds and other safe havens, under a cautious risk exposure. Local rates limited part of the pressures registered during this week that reached up to 16bps in the longer-end of the Mbonos curve as of yesterday, after a relevant rally since mid-September that pushed the local risk premium towards its lowest level since October 2018.

On the latter, the 10-year spread between Mbonos and U.S. Treasuries stood around 493bps since last week, a level from which it has bounced back towards 511bps today and with a 12-month median printing at 558bps. In spite of the pause signaled by the Federal Reserve in terms of its easing cycle, we see a global and domestic backdrop still supportive for fixed-income securities. In this regard, we hold our trade recommendation in long position on Mbono Nov'47 opened on October 25th, acknowledging the pressures this security has experienced in previous sessions pushing it to 7.44% as of yesterday's close, finishing this Thursday at 7.37%.

In the FX market, the Mexican peso has underperformed in latest sessions, mostly affected by a weaker scene in terms of several geopolitical premiums, including few definitions in the U.S.-China trade agreements and other specific themes such as Chile's political scene which has affected the EM FX space in broad terms. USD/MXN broke a consolidation channel defined between 19.02 and 19.26 registered since mid-October, reaching yesterday 19.53, its weakest intraday level since October 10th. It is worth mentioning the fact that the pair breached a number of technical barriers, among them the 19.26 area where the 200-day MA is currently located and 19.37 where the 100-day and 50-day MAs converge. The currency exposed a positive reaction to Banxico's decision, closing the session at 19.32 per dollar, equivalent to a 0.2% appreciation, falling from 19.49 at earliest stages of the day. In strategy terms, we hold our tactical recommendation on USD longs, identifying USD/MXN 19.50 as an attractive region for profit taking. We reiterate our estimate for year-end 2019 at 20.30 per dollar and 21.30 for 2020, integrating among the main factors weakening the peso, the currency's implied carry erosion as spreads against U.S. rates and other EMs tighten, together with a global geopolitical scene that we expect to feed greater risk aversion phases into next year, chiefly guided by the U.S. electoral agenda.

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GRUPO FINANCIERO BANORTE S.A.B. de C.V.
Research and Strategy

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

Economic Analysis

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Juan Carlos Alderete Macal, CFA	Senior Economist, Mexico	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Miguel Alejandro Calvo Domínguez	Economist, Regional	miguel.calvo@banorte.com	(55) 1670 - 2220
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Luis Leopoldo López Salinas	Analyst, Global Economist	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

Fixed income and FX Strategy

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Santiago Leal Singer	FX Senior Strategist	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Fixed Income and FX Strategist	leslie.orozco.velez@banorte.com	(55) 5268 - 1698

Equity Strategy

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Technical Analysis	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Equity Research – Conglomerates / Financials/ Mining / Petrochemicals	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research – Airlines / Airports / Cement / Infrastructure / REITs	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251

Corporate Debt

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Manager, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248

Wholesale Banking

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.cebillos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Victor Antonio Roldan Ferrer	Head of Commercial Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454