

Banxico Minutes – Financial stability concerns remain key to the central bank’s decisions

- Banxico published the minutes of the meeting held on June 27th, in which the Board of Governors maintained the reference rate unchanged at 8.25%
- In line with our expectations, the minutes confirmed that Deputy Governor Gerardo Esquivel voted against the decision. Among his reasons, he stated: (1) Better inflation dynamics; (2) a more dovish stance from global central banks; and (3) the deceleration of the Mexican economy
- In our opinion, the tone of the minutes was slightly dovish, similar to what we perceived in the communiqué, In particular, we observed heightened concerns about growth, with a better outlook for headline inflation
- However, there is still a high degree of uncertainty and ample debate over risks for financial stability, which included the credit rating for the sovereign and Pemex
- We believe that the minutes support our expectation that Banxico will cut the reference rate by 25bps to 8.00% in the November 14th meeting
- The market is positioned for a gradual approach towards lower rates

Minutes tone in line with the one we perceived in the communiqué. Banxico just published the minutes of the meeting held on June 27th, in which the Board of Governors maintained the reference rate unchanged at 8.25%. In line with our expectations, the tone resembles the one we perceived in the communiqué, with the monetary authority concerned about the outlook for both global and local growth. Nevertheless, comments about inflation were more mixed, particularly regarding the drivers and risks for core inflation. The document showed that ‘some members’ are still worried about the fact that this component remains stubbornly high despite a context of greater economic slack that should have already resulted in lower price pressures at the core level. More importantly, we observed several comments about recent credit rating downgrades of Mexico and Pemex, the risks such movements entail as well as their potential effects on public finances, the economy and financial markets, which lead us to believe that financial stability concerns remain key in Banxico’s decision-making process.

Deputy Governor Esquivel, the dissenter. As expected, Deputy Governor Gerardo Esquivel was against the decision, in favor of a 25bps rate cut. He argued that inflation has behaved better than forecasted in previous *Quarterly Reports* and is converging to target. Additionally, he said that accumulated inflation in 1H19 would be around 0.3% (actual, known after the decision: 0.37%), the second-lowest so far this century. For this particular point there were a lot of discussions about the drivers, with the majority considering declines in non-core prices as the main reason behind it.

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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

Fixed income and FX Strategy

Alejandro Padilla

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

Santiago Leal Singer

Fixed-Income and FX Strategist
santiago.leal@banorte.com

Leslie Orozco

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

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More importantly, he argued that inflation by year-end 2019 will be very close or even below 3.4% (Banorte: 3.5%). Also as we expected, he said that other reasons in favor of a rate cut were the loosening of monetary policy in advanced economies and the noticeable deceleration of the domestic economy. Moreover, we believe he was the member reiterating in the document that it cannot be ruled out that the pessimistic tone of recent communiqués has been one of the reasons behind the recent increase in inflation expectations.

Continuing concerns on global growth, with muted inflation pressures. The Board noted that risks for global growth remain biased to the downside, pressured by trade tensions –now adding overall conditions between the US and its trading partners, and not only with China–, volatility in financial markets, and geopolitical risks. On this last point, one member noted increased tensions that could impact energy markets, probably referring to recent developments in the Hormuz strait. Regarding global inflation, Banxico also noted that risks are biased to the downside, on the back of lower commodity prices. Considering these factors, they acknowledged that a more dovish stance from central banks across the world, with special focus on the US Fed, as they showed some willingness to ease their monetary stance, but also about the ECB; BoJ, and other developed- and emerging-countries.

Deteriorated outlook for domestic growth. All members agreed that economic activity has decelerated more than expected, with greater weakness in domestic demand due to lower private consumption, muted investment and low government spending. Looking at the supply-side, most said that there is a significant and unfavorable trend change in services, with one member highlighting this sector's importance in GDP. This has translated in greater slack on the output gap, also shown by the persistent slowdown in job creation. All in all, risks for growth have deteriorated further to the downside, with increased risks in both the external and domestic front. Regarding the former, Banxico added new threats from tariffs from the US, while also considering possible delays in USMCA ratification. On the domestic front, some members signaled the possible economic impact from additional reductions to both the Pemex and the sovereign credit rating.

Slight improvement in inflation risks. The board recognized that inflation has improved in recent fortnights, driven down by non-core items as a result of lower energy and agricultural prices. However, there are still concerns about the behavior of the core component, which remains stubbornly high. In this context, the evaluation for risks was broadly mixed. To the upside, we note the addition of possible impacts stemming from retaliatory measures if the US imposes tariffs on Mexican goods, while discussions on wage pressures were expanded. In contrast, pressures to the downside included greater slack conditions and the possibility of an appreciation of the Mexican peso, driven by looser global monetary conditions. All in all, the assessment was that there is a high degree of uncertainty, which we take to be an improvement vs. the previous decision, in which risks were clearly biased to the upside.

Possible response to Fed easing. Comments in this front were relevant in a context of a more dovish stance from the Fed. In this respect, a 25bps cut has already been discounted by the market for its next meeting (in line with our own expectation). It is worth noting that this factor is second in the list of drivers mentioned by the central bank as part of their decision-making process. Looking at individual opinions, one member –likely to be Deputy Governor Esquivel– stated that if the Fed reduces its reference rate, Banxico should match cuts in order to maintain the current spread, which stands at 575bps. Another member stated that if the Fed cut materializes, this would represent a challenge for local monetary policy, as it would imply a relative tightening in domestic conditions. All in all, most members signaled that this change in stance gives Banxico additional room to maneuver.

Lengthy discussions on credit ratings, especially Pemex. The document had several comments about the recent downgrade of the sovereign and Pemex credit ratings, with some members flagging as a domestic risk the possibility of additional reductions. These could impact the economy, public finances, and financial market performance and volatility. Importantly, at least one member also said that a similar situation could occur with the state-owned utility, CFE.

Regarding Pemex, the majority said that its risk premium has deteriorated significantly, but the impact to the sovereign’s financial costs has been limited. There was an interesting discussion about the potential impact if a second major rating agency downgrades the company below investment-grade. Some said the markets already discount this scenario, although it could lead to forced-selling by some investors, a process that may have started by now. Another said that Pemex’s loss of investment-grade would not necessarily lead to episodes of financial volatility since such risk is already discounted and portfolio adjustments may take place gradually. In this context, most members noted the importance of preventing an additional deterioration in the credit rating of Pemex’s debt. Specifically; “...*They noted that to improve the situation of the company, a clear and credible business plan is necessary, together with a medium and long-term strategy focused on value generation and that improves the company’s access to financial markets. (...) Some members mentioned that in case the actions taken to reactivate oil production and restore the health of Pemex’s finances are insufficient, this would have important implications for public finances and in general for the economy...*”.

We identified at least two members with a dovish bias. Apart from the dissent of Deputy Esquivel already described, another member stated that if inflation continues to converge towards the target, “...*the start of an easing cycle in the short term would be necessary...*”, although this decision “...*should be taken with caution and prudence...*”. In this respect, we identify at least two members in favor of a lower reference rate sooner rather than later. Nevertheless, ‘some’ members stated that given the complex backdrop, it would not be convenient to ease monetary conditions if inflation does not show a clear trend towards the 3% target.

We maintain our call of a 25bps rate cut in November's meeting. We believe that Banxico will maintain a prudent and cautious stance for now, mainly because of the need for more information regarding some risk factors for financial stability. In this respect, it was quite clear that members are uncertain about the possible outcome and effect of some lingering risks, such as additional credit rating actions (especially in Pemex), and the ratification of USMCA, among others.

In our view, Banxico will have room to cut the reference rate by 25bps at the November 14th meeting, when we expect some of the risks to have ebbed away, while inflation should have already started to converge to our 3.5% year-end forecast, amid a backdrop in which global central banks are likely to remain dovish. Nevertheless, we cannot rule out this to happen sooner than expected if these risks unravel at an earlier date, although nothing in the document makes us believe that this will be the case. Last but not least, we reiterate our call that this rate cut could kick-start an easing cycle, which we estimate could result in an accumulated reduction between 125-200bps.

From our Fixed income and FX strategy team

The market is positioned for a gradual approach towards lower rates. Banxico's minutes this morning were characterized by a clear dovish tilt, coming mainly from the board's view about the effect of slack in the Mexican economy. Nevertheless, the dissenting opinions hovered around inflation and conditions linked to financial stability. Some dovish arguments centered on the convergence of annual inflation towards Banxico's confidence range (2%-4%), stressing out that some of the risks for CPI have alleviated. In contrast, several members highlighted that the dynamics in the core component are less encouraging and that there are several risks coming from Pemex, fiscal accounts, growth and other factors enlisted by credit rating agencies recently that could result in a higher risk premia in local assets and cost pressures to the economy. Overall, Banxico's board will be cautious with the implementation of its monetary policy judging by the deep analysis about current conditions, suggesting that the leeway for easing monetary conditions is limited. Nevertheless, we have to acknowledge that a more dovish Fed, with a strong likelihood of reducing its Fed funds rate this year (on cut as soon as July 31st) could help Banxico to start a gradual easing cycle by year-end, especially when taking into account the spread in ex ante short-term real-rates between Mexico and the U.S., currently at 437bps. As of today, the yield curve is pricing in -47bps of implied rate cuts this year and a total amount of -139bps until 2020-end. In the aftermath of today's minutes, Mexican bonds observed a breather, rallying 2-3bps after the strong sell-off in the last two sessions. Regarding our recent tactical trade idea considering Mbono Nov'42, we recommend a stop loss action in order to limit a potential additional depreciation given the high degree of uncertainty in the current landscape that could affect the risk premium embedded in this security.

The Mexican peso experienced a limited reaction to Banxico's minutes this morning, holding a price action close to 19.15 per dollar (-0.1% in respect to yesterday's close). Recent performance has partially paired pressures which pushed the cross to levels as high as 19.36 on Tuesday, although it currently marks a weekly negative balance, broadly decoupling from EM and G10 currencies which have been favored by the Fed's dovish tone reflected in USD weakness. Particularly, the DXY scores a 0.3% loss in respect to last Friday's close, whereas the BBDXY has lost 0.1%.

In the same comparison, the EM complex prints a ~0.4% rally, contrasting with a 0.7% sell-off in the MXN. Regardless of this performance, the Mexican peso is still 2.7% stronger year-to-date, though giving up some positions in the outperformers' group (at this time as the 6th strongest). In spite of recent movements, we see a peso which is still not reflecting a consistent risk premium with the local and foreign idiosyncratic risks captured by the complex outlook described by Banxico in its minutes. In this sense, the peso's high carry, especially when compared to other EMs, is still holding as the main anchoring subject. Considering the latter, a prudent monetary vision from Banxico and a potential limited action space build up the case for this factor to extend in the following months. However, it is our take that this equilibrium could wane going forward, reason why we affirm our year-end forecast at USD/MXN 20.30. In strategy terms, we hold a negative bias for the currency, despite its attractive carry, acknowledging the next two key technical resistances at the USD/MXN 19.27 Fibonacci reading and the 19.38 200-day moving average.

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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
Francisco Duarte Alcocer	Analyst, Global Economist	francisco.duarte.alcocer@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 Thalia 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 Asset Management	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 Corporate Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454