

## Banxico minutes –Hawkish tone in line with our call for a 50bp hike in September

July 14, 2016

- Banxico published today the minutes of its monetary policy meeting held back on June 30<sup>th</sup>, in which the board of governors decided unanimously to increase by 50bp the reference rate
- The discussions of the board of governors focused on the following topics:
  - (1) The balance of risks for inflation in the horizon in which monetary policy operates has deteriorated, highlighting the upward trend in core inflation
  - (2) The decision to hike rates as a measure to prevent a disorderly depreciation of the Mexican currency –given the adverse effects on relative prices-, and the de-anchoring of inflation expectations;
  - (3) Growth prospects for the global economy have deteriorated given economic and financial uncertainty derived from the *Brexit* referendum;
  - (4) The probability of financial volatility given geopolitical risks including the US elections, China’s economic and financial situation, and the expectation of more monetary easing from advanced economies; and
  - (5) In Mexico, the current account deficit is increasing, and its financing structure is highly reliable on short-term capital flows
- Looking ahead, we continue to forecast a highly volatile exchange rate market, amid geopolitical risks in 2H16
- We maintain our view that Banxico will hike the reference rate by 50bps in September, and again by the same amount in December, leaving it at 5.25 % by year-end

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**Minutes with a hawkish bias.** Banxico released today the minutes of the monetary policy meeting held two weeks ago (June 30), in which the board of governors unanimously decided increase by 50bp the reference rate. The discussions of the board of governors focused on the following topics: (1) The balance of risks for inflation in the horizon in which monetary policy operates has deteriorated, highlighting the upward trend in core inflation; (2) the decision to hike rates as a measure to prevent a disorderly depreciation of the Mexican currency –given the adverse effects on relative prices-, and the de-anchoring of inflation expectations; (3) growth prospects for the global economy have deteriorated given economic and financial uncertainty derived from the Brexit referendum; (4) the probability of financial volatility given geopolitical risks including the US elections, China’s economic and financial situation, and the expectation of more monetary easing from advanced economies; and (5) in Mexico, the current account deficit is increasing, and its financing structure is highly reliable on short-term capital flows.

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**Inflation.** Most of the board members emphasized that the balance of risks for inflation has deteriorated. Regarding core inflation, most members highlighted: “... *the recent acceleration in the price of processed foods, reaching 3.8% (...) inflation in “other goods” sub-index also stands around 4%, and has maintained an upward trend that –given the behavior of the exchange rate–, is not likely to reverse in the coming months...*”. Among the upside risks, all members pointed out that “... *there is a possibility that the depreciation of the Mexican currency will exacerbate the growing trend of core inflation and could affect the trajectory of the non-core sub-index, through energy prices...*”.

**Exchange rate and the 50p hike in June.** Most board members agreed: “...*on the need to adjust the monetary policy stance, in order to prevent the further depreciation of the Mexican currency and the adjustment of relative prices, given that it could translate into a de-anchoring of inflation expectations...*”. In our view, Banxico has adopted a more defensive stance toward the disorderly behavior of the Mexican currency as most board members highlighted that: “...*the prospect of a prolonged period of uncertainty in international financial markets given recent events in the UK, with possible implications for the exchange rate, and ultimately on inflation expectations, a situation that could be accentuated with the electoral process in the United States...*”. Taking into consideration that Banxico made explicit references to possible geopolitical events that could increase the volatility of financial markets –including the US elections–, it is likely that the central bank will increase the reference rate again in September, given that this will be the last monetary policy meeting before the US elections.

**The balance of risks to global growth deteriorated.** According to the minutes of Banxico, growth prospects of the global economy deteriorated significantly derived from the UK’s *Brexit* referendum, and uncertainty about its economic and financial impact. In this regard, most board members commented that: “... *the external conditions for emerging countries have deteriorated since the events in the UK [...]. They added that emerging markets were significantly affected by continuing outflows of foreign portfolio investment, and by increasing market interest rates and other sovereign credit risk indicators...*” Similarly, the central bank warned that “...*there is a possibility that financial volatility is accentuated given some geopolitical risks, such as the electoral process in the United States. One member also highlighted the uncertainty about the economic and financial situation in China and the expectation of further monetary easing from advanced economies...*”.

**Lower growth in Mexico, but there's a risk of private consumption overheating.** Regarding Mexico's economic growth, Banxico mentioned that despite the rapid growth in the first quarter, the economic outlook for the second quarter is more negative. In particular, private consumption has maintained a higher growth, but industrial production has decelerated significantly, while overall investment remains subdued. Although most members agreed that they expect a deceleration in the Mexican economy, other members emphasized the risk involved in the higher current account deficit, given that its financing structure is highly dependant of short-term capital flows.

**We maintain our view that Banxico will hike the reference rate by 50bps rate in September.** As we mentioned in our previous publications, we believe that, after Banxico's rate hike in June, we expect that market participants will pressure Banxico to raise the reference rate in the event of a significant depreciation of the exchange rate, and in order to achieve any reaction in the local markets, from now on Banxico will need to hike 50bps. Looking ahead, we continue to forecast a highly volatile exchange rate market, given the geopolitical risks in the second half of the year. In this context, we anticipate that the central bank will increase the reference rate 50bps in September, and again in December, leaving it at 5.25% by year-end.

*From our fixed income and FX strategy team:*

**Markets acknowledged that Banxico is ready to stand up to any situation in the global context.** As expected, Banxico's minutes depicted a hawkish tilt, portraying an extensive analysis behind its decision to hike 50bps its reference rate to 4.25% on June 30<sup>th</sup>. The central bank expressed its concerns on the global context, the effect on the MXN and the likely consequences on a still well-anchored CPI. Despite the hawkish bias from Banxico, the pricing of the yield curve already prices in a strong likelihood of a more restrictive stance in coming months. The market has 57bps of implied cumulative hikes by year-end and 77bp for the coming 12 months. Given current dynamics, we started two new trade ideas yesterday: buying Udibono Jun'19 with entry of 1.95%, target of 1.65% and stop-loss of 2.10%, and Mbono Jun'21 with entry of 5.60%, target of 5.35% and stop-loss of 5.80%. The rationale behind these trading strategies is referred in our research note "*Mexico Trade Idea: Buy Udibono Jun'19 and Mbono Jun'21*" <[pdf](#)>, published on July 13th, 2016. No significant reaction in the local fixed-income market following Banxico's minutes. In the FX market, the Mexican peso lost part of its relative advantage since the beginning of local trading up to the release of the minutes, going from 18.21 to 18.33 per dollar albeit still winning 0.2% on the day. Discussions about the FX were abundant. In general terms, we think that the comments show that a great deal of the decision to hike rates was driven not only by worse conditions in international markets but also by an important series of local factors that help explain the peso's fall and higher risks to inflation dynamics. We highlight that most of the members considered that the peso's depreciation could reflect greater concerns about Mexico's economic fundamentals. Taking this into account, we are still convinced that higher local rates have had and are likely to have a limited effect in the currency, at least so far. We reiterate a defensive stance on the peso and recommendation to avoid chasing the recent rally in risk assets, seeing USD/MXN directional longs as highly attractive if the move extends downwards towards the 18.00-18.10 zone as entry levels in the short term.

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