



# Banxico's monetary policy decision

*Less hawkish, but not as much as the market expected*

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- Banxico's board announced today its unanimous decision to maintain the reference rate at 8.25%, in line with both our and market expectations
- In our opinion, the tone was less hawkish when compared to the previous communiqué, albeit still showing that Banxico maintains a prudent stance
- We highlight that this was the first meeting in which Deputy Governors Gerardo Esquivel and Jonathan Heath participated
- Regarding growth, the central bank acknowledged downside risks both external and domestic, with slack conditions widening and the possibility that the deceleration in 4Q18 extends to 2019
- The assessment of inflation showed no further deterioration in the balance of risks, adding downside factors such as lower prices in some goods in the non-core component and the possibility of higher slack in the economy
- The linguistic analysis supports our view of a less hawkish tone, considering the lower relative weight of both "risks" and "uncertainty", while adding more focus on external factors, with the mention of words like "United States" and "global"
- We now believe that Banxico will keep the reference rate unchanged at 8.25% for 2019 instead of at least until the first half of the year
- Local assets reacted to a policy communiqué that wasn't as dovish as market expectations

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February 7, 2019 Statement Word Cloud

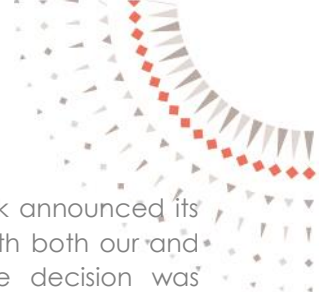


Source Banorte

December 20, 2018 Statement Word Cloud



Source Banorte



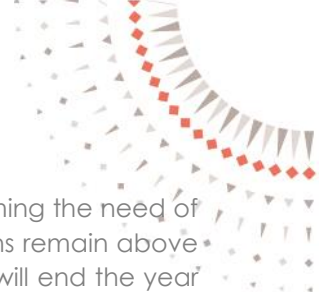
**Reference rate unchanged at 8.25%, as expected.** The central bank announced its decision to keep the reference rate unchanged at 8.25%, in line with both our and the market expectations. Such as in the previous meeting, the decision was unanimous. Additionally, we highlight that this was the first meeting in which Deputy Governors Gerardo Esquivel and Jonathan Heath participated.

**Banxico acknowledged changes in the global backdrop.** The Board acknowledged that global growth faces more headwinds, even referencing an economic slowdown in 4Q18. In this context, the Board noted additional sources of risks, such as the possibility of a further deceleration in the United States and the risks stemming from *Brexit*. In this context, they highlighted the modification in the Fed's communiqué showing more willingness to be patient in its normalization process. It is worth highlighting that the central bank maintained the relative monetary stance with the US as the second factor to watch in its decision-making process, adding that risks remain in the external backdrop.

**Positive reaction of local financial markets to domestic issues but prudence is still needed.** Considering that a large part of this was explained by the less hawkish stance of the Fed which translated in lower interest rates and a weaker dollar, there were some favorable events in the domestic front. Among them, the central bank stated the approval of a prudent fiscal budget as well as measures regarding the buyback of Mexico City Airport bonds. In contrast, they also noted that “...in view of *Pemex's* challenges, *Fitch* downgraded its credit rating, which will imply greater financing costs for Mexico's state-owned oil company...”. The monetary authority considered that the current scenario presents important risks, both in the medium and long term, thus leading them to continue to implement a prudent and firm monetary policy.

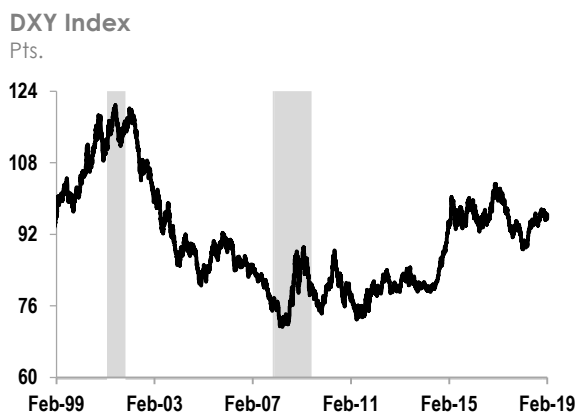
**Downside risks to growth.** The Board recognized that economic activity showed an important deceleration in 4Q18 relative to the previous quarter, with GDP at 0.3% q/q according to the preliminary print. Moreover, they suggested this deceleration is likely to continue at the start of 2019. Among the reasons supporting this expectation, they noted weaker global economic conditions and internal demand, with a specific and transitory impact in growth during the first quarter as a result of factors such as delays in fuel distribution and railway blockades. Although the Board did not state explicitly that the balance of risks for growth had deteriorated further, they said it remains skewed to the downside and that slack conditions have relaxed at the margin. We agree with this assessment, which should result in lowering some of the risk of demand-side pressures for inflation.

**No further deterioration in the balance of risks for inflation.** Following recent downward surprises, particularly in January, Banxico eliminated the phrase stating that risks for inflation had deteriorated. In terms of upside risks to prices the statement was broadly unchanged. The central bank maintained, among them; (1) The possibility of exchange rate pressures; (2) potential pass-through effects from the recent increase in the minimum wage; (3) new pressures in energy and agricultural prices; (4) an escalation of trade protectionist measures; and (5) deterioration in public finances. On the contrary, and in contrast with the previous communiqué, they restored some downside risks, including the possibility of more modest variations in prices of goods at the non-core component and that slack conditions widen more than expected. Regarding the former, it is our take that this comment is mainly due to the possibility of an extension lower in gasoline prices. In particular, the potential lagged effect in local gasoline prices due to the fall in international oil prices (coupled with recent MXN strength) but also the pricing policy of the new administration, which has an implied cap in terms of possible pressures in retail prices.

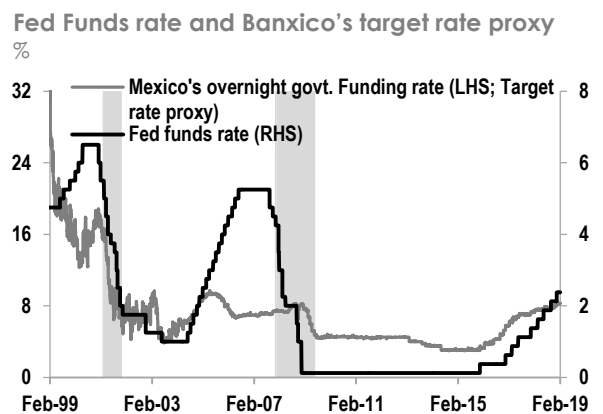


In our view, these changes insert a less hawkish bias in spite of reaffirming the need of maintaining a prudent and firm stance and that inflation expectations remain above the 3% target. In this context, we reiterate our forecast that inflation will end the year at 3.5% yoy, lower than consensus at 3.9%, which should provide additional room to the central bank to maintain the reference rate unchanged.

**We now believe that Banxico will maintain the reference rate unchanged at 8.25% throughout 2019, and not only in the first half.** Even though we think that there could be a strong case for a rate cut, we believe that a highly uncertain scenario will prevent the central bank to do so this year. Among others, it is our take that the factors that could favor a rate cut are: (1) Our expectation that annual inflation will maintain its downward trend, to end at 3.5% in 2019 from 4.4% currently; (2) the more dovish tone of the Fed, expecting no rate hikes this year, which has translated into boarder dollar weakness (as seen in the lower left hand side chart) even though we expect it to rebound later in the year; (3) the fact that Banxico's hiking cycle has been more aggressive than the Fed's since December 2015 (525bps vs. 225bps, see lower right hand side chart), along with other central banks turning dovish; (4) the deceleration of the Mexican economy, due to the typical slowdown in the first year of a new Federal administration, but also on the back of several transitory factors impacting short-term economic dynamism; and (5) our view that Banxico's Board has at least two members with a dovish bias.



Note: Shaded areas note a recession  
Source Bloomberg



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Source Bloomberg, Banxico

We believe that the probability of a rate cut cycle as soon as this year has increased but remains relatively low. First and foremost, the central bank maintains its conviction of the need for a prudent and firm stance to ensure that inflation converges to the 3% target. Moreover, our forecasts still include a weaker peso going forward, particularly in 4Q19. Other relevant risks include the possibility that the approval of the USMCA in the US is delayed further given the renewed leadership of the Democratic Party in the Lower House, and that Canada will hold general elections in October. Lastly, concerns regarding the financial position of Pemex, including its recent downgrade by Fitch, which could be a headwind for the sovereign and the risk premium embedded in local assets.



*From our fixed-income and FX strategy team*

**Local assets reacted to a policy communiqué that wasn't as dovish as market expectations**

Banxico stayed put, delivering a less hawkish communiqué. Nevertheless, the yield curve depicted a negative reaction as market participants discounted a more dovish tilt vis-à-vis the observed bias. As a result, Mbonos and TIE-IRS erased earlier gains following the better-than-expected January inflation report. For more details please refer to "Annual inflation reaches its lowest level in two years" [pdf](#), released this morning. We hold our trade idea of long positions in Mbonos Jun'22 and Dec'23 opened on January 9<sup>th</sup>. We acknowledge the limited room for additional appreciation for these securities given the current assessment of Banxico's announcement. Nevertheless, we are waiting for a new announcement in coming days from the federal government in terms of Pemex's current financial situation that could be supportive for the actual valuation of country risk premium. Regarding the FX market, the Mexican peso locates at 19.13 per dollar (-0.1%) reflecting a moderate reaction to Banxico's decision, with Thursday's price action partially contaminated by weaker risk appetite in global markets coupled with the USD strengthening for the sixth consecutive session. In broad terms, the peso has recently traded sideways, within a range defined by USD/MXN 18.88 and 19.21, unable to breach the 19.00 psychological level throughout this week. In this sense, we hold our trade idea of long positions in USD below USD/MXN 19.00, opened on January 15<sup>th</sup>.

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