



Banxico's monetary policy decision

Ready to hike, but with no real willingness to do it

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- Banxico's board announced today its decision to increase the reference rate by 25bps to 8.00% in a split decision for the second time in a row
- In this respect, it is worth noting that the dissenter voted for a 50bps hike
- In our opinion, the statement showed a more hawkish bias, maintaining the possibility that further rate hikes could materialize going forward
- Nevertheless, we maintain our view that the reference rate will end the year at the current level of 8.00%. In spite of the latter, we recognize the risk of additional rate hikes given a complex domestic and external environment
- In this respect, our view is supported by: (1) Our expectation that the 2019 Budget will reaffirm the commitment of healthy public finances; (2) that Mexico maintains very solid fundamentals; and (3) that the real rate is already in restrictive territory
- Within the *communiqué*, we highlight that according to the Board, the balance of risks for inflation has deteriorated significantly, both in the short- and medium-term
- Reaffirming the latter, the linguistic analysis of the statement showed a considerable increase in the word "medium" relative to the previous decision. In addition, the highly complex scenario gained more importance, as suggested by the increase in the relative weight of the words "risks", "uncertainty", and "prices"
- Banxico's hawkish hike supportive for our trade recommendation on floating-rate securities and buying USD in dips

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November 15, 2018 Statement Word Cloud




Source Banorte

October 2, 2018 Statement Word Cloud



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As expected, Banxico increased the reference rate by 25bps to 8.00%, with a split decision for a second time in a row. The central bank announced its decision to increase the reference rate by 25bps to 8.00%, in line with both our expectations and the market. In contrast with the last decision, in this occasion there was an agreement for hiking the reference rate, even with one member voting in favor of a 50bps rate hike. Nevertheless, we maintain our view that the reference rate will end the year at the current level of 8.00%. In spite of the latter, we recognize the risk of additional rate hikes given a complex domestic and external environment.

A more hawkish tone as the overall outlook has become more challenging, both from external and domestic factors. We perceived a hawkish tone in the *communiqué*, with the monetary authority concerned about recent events. In particular, they highlighted the peso's important depreciation, affected by external factors but also by: "...the announcement about the intention of cancelling the New Mexico City International Airport project and, in general, by markets' concerns regarding both the incoming administration's policies and some legislative initiatives...". In turn, Banxico alluded that this led to a sizable increase in risk premium that investors demand for holding domestic assets. More importantly, they stated that this entails significant medium- and long-term risks for the country's macroeconomic conditions, growth potential and the economy's price formation process.

Increased concerns over inflation. In our view, several statements suggest that the Board is more concerned over inflation, not just in the short- but also in the medium-term. First, they said that inflation "...faces significant risks related to the possible adoption of policies that could structurally affect the economy's price formation process...". Moreover, "...the balance of risks to the forecasted trajectory of inflation has deteriorated and exhibits a significant upward bias...", even after this hike and more in line with our expectations. Last but not least, we noted that the *communiqué* did not include an explicit reference to the downside risks for inflation, which contrasts with previous decisions. Considering the latter, we believe that it will be very important to watch the central bank's updated inflation forecasts in their next Quarterly Report, to be published on November 28th.

Stronger growth, but the balance of risks has deteriorated. Banxico notes that the economy expanded during 3Q18 after the slight contraction observed in the previous quarter. Despite of slightly less slack as a result of the latter, the Board said that from a cyclical perspective the balance of risks was still biased to the downside and deteriorated at the margin. In particular, the central bank noted that forecasts for global growth have been revised slightly downwards and financial conditions have tightened further, which makes the external environment more challenging, apart from the uncertainty stemming from domestic factors.

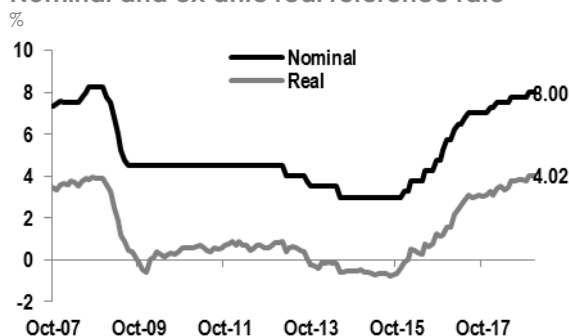
Despite the more hawkish *communiqué*, we maintain our view that Banxico will keep the reference rate at 8.00% by the end of the year. Moreover, we believe that the reference rate will remain unchanged at least during the first half of 2019, albeit recognizing higher risks of further hikes. In our opinion, this is supported by:

(1) *Responsible Budget in 2019.* In our view, the incoming administration will continue with fiscal consolidation efforts, proposing a primary surplus between 0.5-0.8% of GDP and an overall deficit around 2.5% of GDP. In this respect, the Budget Proposal, to be released on December 15th at the latest, will help reassure investors of the commitment to healthy public finances and the strategy of gradually reducing Government Debt as a share of GDP. In this respect, it is our take that market volatility could wane after this release.

(2) *Healthy macro fundamentals.* It is worth remembering that the Mexican economy is in a very strong position to weather additional shocks. Although the domestic balance of risks has deteriorated, macro fundamentals are in a better shape when compared to recent historical periods when the reference rate was at a similar level than today. In this respect, key market indicators such as the 5-year CDS, currently at 149bps, is well below the 357bps observed in 4Q08, when the reference rate was at 8.25%. Moreover, Mexico's fiscal dependence on oil revenues meant that the country was in a more vulnerable position as they represented 44% of total federal revenue, above the 17% figure at the end of 2017. In terms of government debt, the average duration has lengthened, extending from 3.5 to 5.0 years in the same period. Last but not least, international reserves (including the IMF's Flexible Credit Line) have increased meaningfully, going from around US\$152.5 to 260.0 billion (see table below). This contrasts with the level of Mexico's EMBI+, which has surged to 227bps and is close to the 231bps high also reached in June 2008.

(3) *The real rate is already in restrictive territory.* According to Banxico's latest estimates, the short-term equilibrium real interest rate is located at 1%, while the long-term estimated range is at 1.7-3.3%, with a mid-point of 2.5%. After this rate hike, the ex-ante real interest rate has reached 4.0%, significantly higher than equilibrium. Additionally, the current nominal rate at 8.00% is only 25bps below the maximum of 8.25% observed since the central bank adopted the reference rate as its main monetary policy instrument (see chart below).

Nominal and ex ante real reference rate



Source Banorte with data from Bloomberg, Banxico

Mexico's macroeconomic indicators

Indicator	4Q08	Current
5-year CDS (bps)	357	149
EMBI+ Mexico (bps)	231	227
International Reserves (US\$ billion)*	152.5	260.0
Government debt duration (years)	3.5	5.0
Oil-related govt. revenues (% of total)	44	17

* Including the IMF's Flexible Credit Line

Source Bloomberg, Banxico and JPM,

Going into 2019, we expect the reference rate to remain on hold at least during the first half of the year, although we recognize that the balance of risks for additional rate hikes has increased due to both domestic and external factors. In this respect, Banxico highlighted once again the need to maintain a prudent monetary stance in the face of a challenging backdrop. Moreover and even after this hike, they maintained that "...the Governing Board will take the necessary actions, specifically, maintaining or possibly strengthening the current monetary policy stance, so that headline inflation converges to Banco de Mexico's target within monetary policy's period of influence...".

In spite of the latter, we believe that Banxico remains reluctant to continue with the hiking cycle given that growth is likely to moderate in 2019 (as suggested by the historical behavior of GDP during the first year of a new Federal Administration), and that core inflation has maintained a downward trend and will keep converging towards the target, in addition to the abovementioned factors.



From our fixed-income and FX strategy team

Banxico's hawkish hike supportive for our trade recommendations on floating-rate securities and buying USD in dips.

This Thursday, Banco de Mexico decided to increase the reference rate by 25bps to 8.00%, in line with our forecast and consensus, and in a split decision (one member voting for 50bps hike). Judging by the *communiqué's* tone, the central bank remained firmly in the hawkish side, pointing out to a deteriorated balance of risks for inflation, with an upward bias. By the end of the session and after Banxico's decision, the short-end and the belly gained between 4-7bps, while the longer-end was pressured between 2-6bps. The 10-year benchmark closed at 8.99% from 9.04%. It is worth mentioning that this security is 12bps above October's close, a month in which it sold-off 95bps as it moved to 8.87% from 7.92%. As a consequence of today's decision, the curve is holding 28bps of implicit rate hikes for the remainder of 4Q18, 60bps for 1Q19, and 71bps for 2Q19, exhibiting marginal variations with respect to the levels before the decision. In this respect, the hawkish bias already priced-in by the market was mostly unchanged. Moreover, we highlight the relevance of the next Quarterly Report to be delivered on November 28th, in which some adjustments in the central bank's forecasts are expected.

Given this scenario, we hold our trade recommendation favoring defensive positions in floating rates. Regarding the FX market, the Mexican peso depicted a positive reaction to Banxico's decision, trading at USD/MXN 20.28 and equivalent to a 0.64% rally when compared to yesterday's close. We believe that the key technical space will find a short-term range at the 19.90-20.60 area. Additionally, last week we reviewed our forecasts for this cross expecting 20.50 per dollar for year-end 2018 and 22.50 for 2019. For details please refer to: "*Adjusting USD/MXN projections amid a more challenging environment*", [pdf](#), published on November 7th. In this sense, we consider as a prudent strategy to hold a USD buying bias in dips.

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