

Banxico – No easing until the dust settles

- Banxico’s Board announced its decision to maintain the reference rate at 8.25%, as it was widely expected
- In our view, the tone was more hawkish when compared to the previous communiqué, particularly in terms of the inflation outlook, outweighing dimmer growth prospects for the Mexican economy
- On inflation, we highlight the board’s concern on recent wage negotiations and that wider slack could not translate into a some relief of core inflation pressures
- Moreover, they consider that global uncertainty could trigger portfolio adjustments, while at the domestic level investors remain cautious on both Pemex and the sovereign’s credit outlook
- They added cost pressures as one of the main factors in their decision-making process going forward
- In this regard, the linguistic analysis shows a considerable increase in the relative weight of the word “core” alluding to inflation, while the word “risks” remains relevant
- As a result, we change our call to a 25bp rate cut in November’s meeting, instead of a 25bp rate cut as soon as June, due to the heightened degree of concern about the inflation outlook reflected in today’s communiqué
- Despite of the latter, we cannot rule that a rate cut could take place at an earlier date, especially if uncertainty surrounding Pemex is drastically reduced
- In this context, the next key events to follow in the agenda are:
 - (1) Upcoming announcement on further measures to support Pemex (May 27th);
 - (2) The central bank’s *Quarterly Report* (May 29th); and
 - (3) Pemex business plan, which should be presented to its Board of Directors on June 15th
- The minutes of this meeting will be released on May 30th
- Market participants acknowledged a less dovish rhetoric from Banxico

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May 16th, 2019 Statement Word Cloud



Source: Banorte with data from Banxico

March 28th, 2019 Statement Word Cloud



Source: Banorte with data from Banxico

Reference rate unanimously unchanged at 8.25%. The decision was widely expected, although we did not rule out the possibility of a dissenter as Deputy Governor Gerardo Esquivel voted against the last communiqué, arguing that he diverged from its restrictive tone as well as from the conclusions on the balance of risks for inflation. In our view, the tone of the communiqué turned more hawkish vs. the previous one, particularly in terms of the inflation outlook, outweighing dimmer growth prospects for the Mexican economy. In addition, they are concerned about possible portfolio adjustments triggered by global uncertainty, while at the domestic level investors remain cautious on both Pemex and the sovereign's credit outlook. Moreover, they added cost pressures as one of the main factors in their decision-making process, along with possible second-round effects from FX to prices, relative monetary policy stance vs. the US and slack conditions in the economy. The minutes of this meeting will be released on May 29th, one day after the *Quarterly Report* is published.

Dimmer domestic growth prospects amid downside risks for the global economy. Banxico recognized that global growth in advanced improved in the first quarter of the year, but risks remain tilted to the downside. With no significant inflation pressures, they expect central banks to adopt a more accommodative stance. In terms of the Mexican economy, they believe that slack has widened in the first few months of the year, with growth affected by temporary shocks, both external and domestic. All in all, they believe that the balance of risks for growth is now more uncertain while remaining biased to the downside.

Possible upward pressures on inflation as some risks have intensified. The monetary authority acknowledged that the recent pick-up in services inflation was partly explained by a calendar effect. Nevertheless, the annual rate increased even after adjusting for this effect. Apart from the usual upside risks to inflation (*i.e.* energy and agricultural prices, public finance deterioration), they considered that the increase in the minimum wage could add upward pressures to other wage revisions throughout the economy. They even stated that some of the recent increases have already exceeded productivity gains, helping explain the relatively high levels of core inflation. In addition, they are also concerned on the possibility greater economic slack would not necessarily translate into lower inflationary pressures, taking into account the particular elements within the core component that have experienced increases. In this context, Banxico seems to be concerned that the persistence of high core inflation could translate into medium- and long-term inflation expectations remaining stubbornly above the target, as has been the case for some time.

Global financial markets remain highly uncertain, while investors are cautious on both Pemex and the sovereign's credit outlook. The central bank considers that the global backdrop is still very uncertain, with the risk of an escalation of trade wars and economic growth, among other geopolitical risks. These increase the probability of renewed episodes of elevated volatility. On the domestic front, and even though the Mexican peso has appreciated, it has shown higher volatility.

In this context, global uncertainty could eventually trigger portfolio adjustments, while investors' attention on Pemex and the sovereign, as we already mentioned.

We change our call to a 25bps rate cut in November's meeting, instead of a 25bp rate cut as soon as June. This change comes on the back of the heightened degree of concern that the central bank showed in today's communiqué. In our view, the central bank's attention remains on the three issues we have been mentioning throughout our publications: (1) The outlook for economic growth; (2) the path of inflation; and (3) the financial stance of Pemex and its implications for both the company and the sovereign credit rating.

In the first case, we continue believing that growth will moderate in 2019 on the back of the usual deceleration associated with the first year of a new federal administration, along with the temporary shocks experienced during first few months of the year. We reiterate our GDP forecast for 2019 at 1.5% yoy, with downside risks. In terms of inflation, we remain confident that, despite recent pickup in the annual comparison, CPI will converge to our long-held 3.5% year-end forecast, supported in part by the government's energy policy.

Although these two factors would be enough to start cutting rates sooner than November, lingering concerns, regarding both Pemex and the sovereign's credit outlook, are likely to make the central bank delay this decision. Two events on this front will be key to judge the next steps for both the government and Pemex. First, the upcoming announcement on additional help that the federal government will provide to the state-owned company, which is expected to take place on May 27th. Second, the presentation of the company's business plan, which should be unveiled to its Board of Directors on June 15th. We anticipate a favorable outcome from both events, which could eventually give Banxico room to cut the reference rate earlier in 2H19 if uncertainty is drastically reduced.

From our fixed income and FX strategy team

Market participants acknowledged a less dovish rhetoric from Banxico.

Local rates are selling off nearly 3bps following Banxico's policy decision. As expected, the central bank stood pat, leaving its reference rate unchanged at 8.25%. The more relevant aspect of today's decision came with the board's assessment on inflation, growth, MXN, and the current backdrop. Banxico held a dovish approach in terms of the current state of the economy. However, this rhetoric was strongly dampened by a balance of risks for inflation with a significant upward bias. In addition, Banco de México stressed out the relevance of holding appropriate monetary conditions to anchor the Mexican peso (via an attractive carry) and inflation expectations. As of today, the short-term ex ante real-rate is trading with a 420bps spread against the U.S., which has been extremely relevant in terms of the peso performance. This situation could be a key aspect given several geopolitical risks in the global landscape. In our view, these arguments are supportive for the current pricing of the short-end of the yield curve, discounting -27bps of implied cuts in the repo rate in 2019 and -61bps in a 12-month horizon. In terms of strategy, we remain cautious about the current valuation of the yield curve, waiting for better entry points or market conditions for new directional long positions in the long-end of the Mbonos curve, observing a better relative valuation in the Nov'36 and Nov'38 securities.

In the FX market, the Mexican peso depicted a fairly limited reaction to Banxico's monetary policy decision holding a price action close to 19.08 per dollar, trading at the end of the session at 19.11 (-0.3%). In the last two trading days the currency has performed more favorably on the back of some attenuation in the trade tensions affecting the market, following the stressed backdrop seen the previous week which push it up to levels at 19.32. Moreover, news regarding specific Mexican steel and aluminum themes have provided additional intraday support. In broad terms, the currency's carry has been the main anchoring factor for the peso, with a year-to-date performance printing +3.1%, the second stronger return amid other EM pairs. In our view, price action will hold relatively defensive in the short-term, acknowledging a relevant floor at the 18.75 region where we identify few space for further appreciation. Looking ahead, we expect a more challenging second half for 2019 reason why we suggest USD/MXN longs below 19.00 holding a year-end forecast at 20.30. For more details in terms of our MXN trajectory and views please refer to "*Fixed-Income, FX, and Commodities - 2Q19 Outlook*" <[pdf](#)>, published on April 10th, 2019.

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We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Francisco Duarte Alcocer, Jorge Antonio Izquierdo Lobato and Leslie Thalia Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. de C.V for the provision of our services.

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