

Fed in September; Banxico in October

May 20, 2015

- **The FOMC has just published the minutes of the 28-29 April meeting**
- **In our opinion, the tone of the minutes was more dovish than the one we perceived in the monetary policy statement back in April**
- **Discussions revolved around the timing for monetary policy normalization, in which June seems now very unlikely**
- **Recent data for economic activity in April and May suggests a weaker than expected recovery**
- **In this context, we see now September as the time for the first hike in the *Fed fund* rate**
- **In line with this change, we also change our call for Banxico, where we now expect the first rate hike to take place in October**

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Dovish minutes and significant changes in FOMC views. The FOMC has just published the minutes of their 28-29 April meeting. In our opinion, the tone of the minutes was more dovish than the one we perceived in the monetary policy statement back in April. In our opinion, the main difference between this minutes and the ones from the March meeting is a change in the sentiment of FOMC participants regarding the timing for normalization. While in the minutes of the meeting that took place in March 17-18, they stated that: “...*Several participants judged that the economic data and outlook were likely to warrant beginning normalization at the June meeting...*”; in today’s minutes they said that: “...*Many participants, however, thought it unlikely that the data available in June would provide sufficient confirmation that the conditions for raising the target range for the federal funds rate had been satisfied, although they generally did not rule out this possibility...*”.

Fixed income and FX Strategy

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Economic data published after April’s FOMC meeting show that economic recovery is being weaker than expected. It is likely that GDP in 1Q15 observed a negative rate of expansion largely due to adverse weather conditions, which will be transitory. Nevertheless, even though 2Q15 data suggests a recovery, the rebound over the period in question will be moderate.

In this context, we now believe that the beginning of the normalization process will be delayed until September. While the minutes make it clear that the decision is very data dependent –and that it will be determined on a meeting-by-meeting basis–, the Fed seems not to rule out June completely. Nevertheless, as we have argued above, recent economic activity indicators, coupled with the fact that inflation remains well below the 2% target, lead us to believe that the Fed would like to wait until September’s FOMC meeting. Nonetheless, we maintain our view that the process of normalization will be very gradual.

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We also maintain our view that Banxico's next move will be a rate hike, in tandem with the U.S. Fed. However, since we have changed our call for the Fed's first rate hike to September, as discussed above, we have also adjusted our expectations regarding the date of Banxico's first move and we are now penciling in a rate hike of 25bps at October 15 meeting, which is the first one to take place after the FOMC meets in September 16-17. In addition, we continue to believe that the Mexican monetary authority will hike 25bps at each of its meetings until the end of the year. This implies a 50bps increase in the reference rate vs. the 100bps previously forecasted. Beyond 2015, there is a high degree of uncertainty about whether the Fed will hold only a process of "normalization" and not monetary "restriction", so it is difficult to predict what Banxico could do in this period. Nevertheless, we consider that the long-term monetary policy reference rate in Mexico, incorporating the impact of structural reforms, stands at 7%.

From our fixed income and FX strategy team:

The Federal Reserve confirmed market valuation on rates. Broad discussions within Fed's minutes released this afternoon confirmed the scenario priced in rates, in which investors have assessed a strong implied probability of observing the liftoff in 4T15, especially after a faint-hearted BLS labor report for March (published April 4th) and weaker data regarding 2Q15 afterwards. Fed funds futures discount implied cumulative hikes of 7bps for the September 17th policy decision and 21bps for the December 16th meeting. Similarly, Mexican rates price in implied cumulative hikes of 19bps for Sep. 3rd policy decision, 32bps for Oct. 15th and 47bps for Dec 3rd. In the aftermath of today's minutes the market reaction was muted, as investors have been preparing (acknowledging) this scenario after the release of weaker than expected economic data for 2Q15.

We hold a neutral stance on local rates, suggesting waiting for better market conditions to open long directional positions. Investors are aware of the prevailing risks at the global level that are likely to generate an additional sell-off in sovereign bonds worldwide (European bonds' adjustments, uncertainty about the Fed, and Greek's credit *impasse*). In our view, there is an attractive valuation in the Mexican yield curve, mainly in 20-year Mbonos such as May'31 and Nov'34. However, we acquiesce in the strong likelihood that the sell-off registered in the last days could endure given the uncertainty surrounding the Fed's future actions, waiting for more definition in the economic front. In this sense, we believe patience should keep paying off, waiting for better entry levels for long directional strategies. It is likely that this situation continues despite an attractive Mbonos curve slope and a spread between US rates and local bonds that does not reflect Mexico's fundamentals. Specifically, the 10-year spread is currently trading at 363bps, higher than the mid-term equilibrium of 360bps and the 12-month mean at 354bps.

In terms of the FX market, we maintain a cautious stance on the MXN and avoid chasing the rally observed in recent weeks (even after the correction since last Friday). We recommend trading the ranges as we expect them to remain wide given the persistence of high volatility in global markets and the lack of local catalysts. In our view, the peso's higher correlation with US rates will limit a stronger appreciation past 15.00 per dollar as a relevant technical support, in which we could continue seeing higher appetite for long USD positions. On the contrary, interest in peso longs could increase above 15.40 per dollar, particularly if risk premiums in Mexican bonds to US rates in the long-end are high.

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