

Banxico minutes – Hawkish tone highlighting possible demand-side pressures

- Banxico published today the minutes of its monetary policy meeting held back on August 11, in which the board of governors decided unanimously to maintain the reference rate at 4.25%
- The discussions focused on the following topics:
 - (1) Even though the balance of risks for growth deteriorated over the previous meeting, several members highlighted the possibility of greater demand-side pressures;
 - (2) Core inflation has maintained an upward trend, however the balance of risks for inflation in the horizon in which monetary policy operates remained unchanged, as a result of the 50bps rate hike in June;
 - (3) Banxico's monetary policy tightening in June helped to stabilize inflation expectations, which was reflected in the flattening of the yield curve; and
 - (4) The probability of higher financial volatility in local markets given geopolitical risks, including the US elections, lower oil prices, and the expectation of the normalization of the Fed's monetary policy
- Looking ahead, we continue to forecast a highly volatile exchange rate market, amid geopolitical risks in 2H16
- We maintain our view that Banxico will increase by 50bps the reference rate in September, and again by the same amount in December, leaving it at 5.25 % by year-end

Minutes with a hawkish bias. Banxico released today the minutes of the monetary policy meeting held two weeks ago (August 11), in which the board unanimously decided to maintain the reference rate at 4.25%. The discussions focused on the following topics: (1) Even though the balance of risks for growth deteriorated over the previous meeting, several members highlighted the possibility of greater demand-side pressures; (2) core inflation has maintained an upward trend, however the balance of risks for inflation in the horizon in which monetary policy operates remained unchanged, as a result of the 50bps rate hike in June; (3) banxico's monetary policy tightening in June helped to stabilize inflation expectations, which was reflected in the flattening of the yield curve; and (4) the probability of higher financial volatility in local markets given geopolitical risks, including the US elections, lower oil prices, and the expectation of the normalization of the Fed's monetary policy

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Higher demand-side pressures... Within Banxico's minutes, most of the board members agreed that the balance of risks for economic growth deteriorated over the previous decision. In particular, most members referred to the lower global economic growth explained by the sluggish global demand. Regarding Mexico's economic performance, several members mentioned the 0.2% q/q reduction in GDP was explained by the contraction in mining output, and the slowdown in the manufacturing industry, which had collateral effects on the services associated with this sector, such as trade and transport. However, one member mentioned that "*... the economic information is insufficient to accurately assess to what extent the recent evolution of Mexico's GDP responds to factors of a statistical nature or a weakening of economic activity. In particular, growth figures in the second quarter were affected by seasonal factors difficult to correct.*"

Uncertainty regarding Mexico's GDP output gap. While most board members agreed that the output gap remains negative, two members highlighted the uncertainty surrounding its estimation. In this regard, one member pointed out that: "*... in addition to possible measurement errors in Mexico's potential GDP, other economic indicators within the labor market, such as the lower unemployment rate and the recent trend in labor's unitary costs, raises questions about the degree of slack that effectively prevails in the economy.*" Moreover, this member also referred to the upward trend in the current account deficit. In this context, he explained that "*...despite the deceleration in [Mexico's] GDP, the imbalance between spending and national income has increased, which suggests that its recent evolution –particularly through the depreciation of the exchange rate– is already a source of demand-side pressures on prices.*"

Balance of risks for inflation remained unchanged. Most board members highlighted that the balance of risks for inflation remained unchanged from the previous meeting, as a result of the 50bps hike in Banxico's reference rate during June's meeting. However, some board members felt that the risk balance deteriorated, even though they did acknowledge the positive impact of Banxico's timely monetary policy adjustment on local financial markets. Among the upside risks, a member 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. Moreover, another risk factor is the emergence of potential aggregate demand pressures, considering the aforementioned uncertainty surrounding the slack in the economy.*"

Exchange rate, volatility, and monetary policy. Regarding the exchange rate, most board members agreed that: “...the Mexican currency displayed a higher volatility, depreciating after the Brexit referendum, and then appreciating to an even lower level.” Moreover, one member mentioned that “... the monetary policy decision taken by Banxico following the Brexit referendum contributed to the exchange rate appreciation.” In this context, most board members highlighted that the flattening of the yield curve after the 50bps hike reflects the stabilization of inflation expectations. Looking forward, most board members highlighted: “...the probability of higher financial volatility in local markets given geopolitical risks, including the US elections, lower oil prices, and the expectation of the normalization of the Fed’s monetary policy.”

We maintain our view that Banxico will increase by 50bps the reference rate in September. Banxico’s minutes suggest that the central bank believes that preemptive measures –such as the one taken in June–, could be useful to improve the balance of risks for inflation. Looking ahead we continue to forecast a highly volatile exchange market that could affect the performance of inflation in the horizon over which monetary policy takes effect, so we anticipate that the central bank will increase the reference rate by 50bps again in September, and then again in December. In addition, it is worth noting that September’s meeting will be the last before the US election, an event that could be particularly volatile for the Mexican exchange rate market. The next monetary policy announcement will take place on the 29th of September.

From our fixed income and FX strategy team:

Banxico's hawkish tone signals limited value in the short-end of the Mbonos curve, with particular attention to currency dynamics in coming months.

Similar to the response after Wednesday's inflation report, both Mbonos and Udibonos did not react meaningfully after the release of Banxico's minutes. In our view, this has more to do with low seasonal liquidity and conviction ahead of Yellen's speech tomorrow. Mbonos have been trading today about 3bps stronger all along the curve, while Udibonos are mostly unchanged. In spite of this and in line with our expectations, it is our take that the minutes were slightly more hawkish than the communique, particularly the opinion of some members about upside risks to inflation even after the 50bps hike in June. We still believe that valuations in the short-end are stretched, with implied accumulated rate hikes standing at 28bps by year-end and 66bps until 2Q17. We do not discard potential pressures ahead in this section of the curve, in particular if the Mexican peso depreciates significantly again. Passing to the FX market, we maintain a defensive stance on our currency. Although we have recommended waiting for Yellen's speech tomorrow to analyze the attractiveness of new, long USD/MXN positions, we still see the 18.00-17.95 zone as a strong technical support where appetite for dollar purchases should increase meaningfully. We expect renewed downward pressures for the peso as we get closer to the US election along other risk events (e.g. oil producers meeting in Algeria, Italian referendum in October, Mexico's budget approval process, the Fed meeting in September, among the most relevant).

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