

Banxico ready for higher volatility ahead

- Banxico just announced its monetary policy decision, in which the board decided to keep the rate on hold, as it was widely expected
- In our view, the tone of the *communiqué* was neutral with respect to previous release (March 18) because:
 - (1) Banxico recognized that the Mexican economy observed a higher growth in 1Q16, but they also acknowledged that the balance of risks for the global economy has deteriorated;
 - (2) They consider that the short and medium-term balance of risks for inflation has remained unchanged; and
 - (3) Banxico highlighted the embedded risks of the accommodative stance of several central banks to the financial system, and acknowledged that they cannot rule out other episodes of increased volatility
- We maintain our view that Banxico will likely hike in tandem with the U.S. Fed, who we expect will hike twice this year (25bps in June, and another 25bps in September or December)
- The minutes of this meeting will be published on May 19, and the next monetary policy announcement will take place on the 30th of June

A neutral stance. Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3.75%, as it was widely expected. In our view, the central bank maintained a neutral stance, because: (1) Banxico recognized that the Mexican economy observed a higher growth in 1Q16, but they also acknowledged that the balance of risks for the global economy has deteriorated; (2) the Board considers that the short and medium-term balance of risks for inflation has remained unchanged; and (3) Banxico highlighted the involved risks of the accommodative stance of several central banks to the financial system, and acknowledged that they cannot rule out other episodes of increased volatility.

The balance of risks for growth remained unchanged. According to Banxico's *communiqué*, the balance of risks for global growth deteriorated, with a lower growth in the U.S. despite the recovery of the labor market and the higher levels of consumer confidence. In the Eurozone and Japan, Banxico mentioned that the economy has observed a modest recovery despite the ECB and the BoJ's accommodative monetary policy stance. In Mexico, economic activity posted a higher growth in 1Q16. However, external demand continues to be stagnant, while gross domestic investment has shown a weak performance. In this context, the central bank "...does not expect demand-side pressures on prices...." and considers that there is still slack in the economy.

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Inflation and volatility. Banxico explains that inflation recently reached 2.6% yoy, where core inflation has maintained a moderate, but upward trend given the adjustment of relative prices as a result of the exchange rate depreciation. However, Banxico emphasized that the pass-through effect of the FX depreciation to prices has been limited, and they expect inflation to end the year around 3%yoy. Regarding the volatility of financial markets, the central bank highlighted that “... *the accommodative monetary stance implemented by several central banks in advanced economies [...] could pose significant risks to the stability of the international financial system*”. In this context, Banxico acknowledged that they cannot rule out other episodes of increased volatility.

We continue to believe that Banxico will follow the Fed. We continue to believe that Banxico’s next move will be a 25bps rate hike in June 30th, right after the Fed does so in its FOMC meeting of June 15. Nevertheless, we do not rule out the possibility of Banxico hiking more than twice this year, if there is strong evidence of FX pass-through on inflation and/or there is a new episode of high volatility. The minutes of this meeting will be published on May 19, and the next monetary policy announcement will take place on the 30th of June.

From our fixed income and FX team

50bps of rate hikes priced in for this year fairly valued despite neutral rhetoric inside Banxico's *communiqué*. Banxico's assessment on the balance of risks for inflation and growth in tandem with its view on global dynamics came in with a less hawkish bias vis-à-vis market expectations. However, it is our take that the 50bps of implied rate hikes embedded in the yield curve for the remainder of the year are fairly valued taking into consideration the uncertainty about Fed future actions and factors that could undermine the peso's recovery going forward. In the aftermath of today's policy decision local rates observed a muted reaction. In terms of trade ideas, we hold our view that the Mexican yield curve will continue flattening. However, we maintain our profit taking recommendation in mid- and long-term Mbonos as a tactical strategy. The rationale this view lies in a twofold argument: (1) likely adjustment in U.S. Treasuries, and (2) country risk spread compression reaching "fair value" levels. Taking into consideration actual valuation of the Mexican yield curve, we suggest waiting for better entry levels for long positions in the belly of the Mbonos curve, awaiting employment data in the U.S. tomorrow.

The Mexican peso weakened from 17.84 to 17.90 per dollar after the communiqué, a 0.5% loss on the day. In terms of market reaction, we note two things: (1) Oil was decreasing before but stabilized at the moment it was published, and even with a slight pick-up afterwards; and (2) MXN went from one of the best currencies in EM at the beginning of the session to being among the worst, while other oil-sensitive currencies such as RUB and COP are still up. We believe this suggests a more dovish interpretation relative to expectations. Nevertheless and given that the Board reiterated its strong vigilance to FX dynamics for policy decisions, we do not expect today's decision to have a strong or persistent effect on the currency.

For further details about our views on the market and forecasts please refer to our research note: "Fixed-Income, FX and Commodities Quarterly – 2Q16 Outlook" [pdf](#), published on April 19, 2016.

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