

Banxico – Sufficiently *dovish* to be able to wait for the Fed

- **Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected by most economists**
- **In our view, the tone of Banxico’s post-meeting statement was slightly more *dovish* than market expectations given that:**
 - (1) The board stated that market’s perception regarding the next hike in the Fed’s fund rate could be delayed; and**
 - (2) The balance of risks for economic growth has deteriorated**
- **Nevertheless, Banxico stressed out that the most relevant factors to consider regarding their monetary policy stance will be:**
 - (1) Mexico’s relative monetary conditions, particularly with respect to the U.S.; and**
 - (2) The performance of the exchange rate**
- **Looking ahead, we continue to believe Banxico will begin a hiking cycle in July 2015, immediately after the Fed starts its own normalization process in June**

Monetary policy decision - Rate unchanged, but *dovish* tone. Today, Banxico held its second monetary policy meeting of the year. The board decided to leave the reference rate unchanged at 3%, as it was widely expected. However, in our view, the tone of the *communiqué* was slightly more *dovish* than market expectations given that: (1) The board stated that market’s perception regarding the next hike in the Fed’s fund rate could be delayed; and (2) the balance of risks for economic growth has deteriorated.

Possible delay in Fed’s hiking cycle. While Banxico mentioned that market’s perception of a tighter monetary policy stance by the United States persists, the Board stressed out that given the last monetary policy statement issued by the Fed, the market now considers it more likely that the initial upward movement in the Fed’s fund rate could be delayed.

Dovish tone in terms of economic growth... In terms of economic growth, we believe that Banxico’s tone was more *dovish* than in the last statement. Even though the Board considers that the balance of risks for global economic growth has remained stable, the Board now considers that the balance for growth in Mexico has deteriorated. In particular, they highlighted that: *“The Mexican economy has had a rather weak performance. Mexico’s oil production platform continues to fall, which has contributed to a slower growth in industrial production... Considering the above-mentioned factors, we believe that the balance of risks for growth has deteriorated ...”*

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Fed's monetary policy and FX performance in the spotlight. Banxico stressed out that “...the Board will remain attentive to the evolution of all the inflation determinants, and market's expectations for medium- and long-term, but particularly they will be focused in Mexico's relative monetary conditions, particularly with respect to the U.S. as well as the performance of the exchange rate.” As we have mentioned throughout our publications, Banxico does not manage the reference rate in absolute terms but, given the global influence of the U.S. monetary policy, it only sets the spread between Mexico's rate and the U.S. federal funds rate. Thus, if the Federal Reserve decides to hike its rate in June, almost independently of Mexico's economic cycle and inflation, Banco de Mexico “will have to maintain” the differential between the interest rates in both countries. Particularly given that not doing it could trigger a significant depreciation of the Mexican peso against the dollar.

We maintain our expectations that Banxico's next move will be a rate hike in mid-2015. Given that economic activity in Mexico will expand at a higher rate this year (*vis-à-vis* last year), and that the Fed will raise the federal funds rate (probably in June), we consider it highly likely that Banxico will also start a hiking cycle (in July), even though inflation in Mexico will be around its 3% target. In this regard, we believe that the hiking cycle will be supported by: (1) A much more optimistic outlook for the U.S. economy, especially in light of the recent economic data, and growth momentum given the lower gasoline prices (in that country); (b) greater concern for the pass-through effect of the depreciation of the peso against the dollar to inflation; and (c) Banxico's board will probably be more empathic in the next monetary policy announcements about Mexico's relative monetary conditions, in particular to the U.S., given that it is a key factor to decide Mexico's reference rate path. In this context, we acknowledge that given the global deflationary environment, there is a chance that the U.S. Fed might postpone the beginning of its hiking cycle. If this is the case, then we would change our Banxico monetary policy call as well. The minutes of this meeting will be published on April 9.

From our fixed income and FX strategy team

Local assets remained pressured following global drivers and with a muted reaction to Banxico's different rhetoric. Banxico depicted a slightly *dovish* bias vis-à-vis the last communiqué released back on January 29th (with a hawkish tone at that time). Local rates observed a muted reaction following today's decision despite the different rhetoric, as market valuation already prices in a gradual hiking cycle in the 2H15 (60-75bps of implied increases in this period), but investors' concerns continue focused on external drivers, with possible adjustment of risk and term premiums in coming days on the back of a higher degree of uncertainty surrounding future Fed's decisions (and Banxico hinting a movement in tandem with the Federal Reserve). In this regard, BLS employment report to be published next week and FOMC's minutes on April 8th will be of extreme relevance for investors and could bring additional volatility to markets in coming days. Forward rates already incorporate a gradual normalization process in Mexico (2y/2y hovering around 6% and 5y/5y at 6.60%), arguing in favor of a better valuation in longer tenors along the yield curve. Taking into consideration the spreads between Mexican and US debt (10-year currently at 388bps, above mid-term equilibrium of 360bps and 12-month media around 349bps) and the slope of the curve we hold a positive view regarding the valuation of long-term Mbonos, especially the 20-year segment (May'31 and Nov'34). However, we think that better entry levels for directional trades could be reached in coming days as the profit taking process could continue ahead of the events described previously.

In the FX market the peso weakened from 15.08 up to 15.15 per dollar given the unexpected change in the tone relative to market expectations. Going forward, support for the currency from a potential widening of short-term interest rate differentials should be limited for the time being, with all eyes on the Fed outlook as the Board reiterated its strong vigilance of relative monetary conditions to the US and exchange rate dynamics for future decisions. Moreover, we stress that despite acknowledging that the dollar's uptrend has moderated since the latest FOMC decision, the Board warned that external volatility could return once again and hurt the currency. In this respect, we believe the peso remains vulnerable to a worsening of external conditions, one of the main drivers behind our long USD/MXN recommendation opened back on March 20 (entry: 14.98, target: 15.50; stop-loss: 14.60). We maintain this position, which has benefitted today from generalized risk aversion and Banxico's *communiqué*.

Disclaimer

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