# Banxico follows the Fed and hikes 25bps as expected

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- **Banxico released today its monetary policy decision, in which the board decided to increase the reference rate by 25bps leaving it at 3.25%, as it was widely expected**
- **According to Banxico statement, the risk balance for growth and inflation improved**
- **Nevertheless, the relative monetary conditions to the US and the inflationary effect of a possible divergence explained the 25bps hike in the reference rate**
- **We continue to believe that Banxico will adequate its monetary policy to Mexico's business cycle, and will not necessarily follow the Fed in 2016**
- **In this context, we expect the Fed to hike 75bps in 2016, while Banxico will do only 50bps, with the reference rate ending next year at 3.75%**
- **The minutes of today's meeting will be released on December 31, and the next monetary policy announcement will take place on February 4**
- **Attractive valuation in the Mexican curve as Banxico could moderate its normalization process**

**Monetary policy decision – 25bps hike driven by the Fed.** Banxico just released its monetary policy decision, in which the board decided to increase the reference rate by 25bps, leaving it at 3.25%, as it was widely expected. Banxico modified its monetary stance despite the current scenario of moderate growth and low inflation. However, the beginning of the Fed's normalization process and the implicit effects on the exchange rate was the main reason why the Board decided to increase the reference rate. We continue to believe that that the central bank will adequate its monetary policy to Mexico's business cycle during 2016, and will not necessarily follow the Fed in 2016. In this context, we expect the Fed to hike 75bps in 2016, while Banxico will do only 50bps, with the reference rate ending next year at 3.75%. The minutes of today's meeting will be released on December 31, and the next monetary policy announcement will take place on February 4.

**Better economic outlook**. In our opinion, the tone of Banxico's *communiqué* regarding Mexico's economic growth is more positive than in October's statement. In particular, the central bank considers that consumer spending is gaining momentum supported by higher employment and low inflation levels. However, exports have stalled given the weakness of the manufacturing sector in the U.S. and the fall in oil prices. Taking all these factors into account, the board considered that: *"…the slack in Mexico's economy and the labor market has diminished, but it will not translate into demand-side pressures on prices yet. The board now considers that the balance of risks for growth has improved compared to the previous monetary policy decision..."*.

**The balance of risks for inflation has improved.** Banxico mentioned that inflation has continued to show a downward trend, reaching historic lows as a result of the negative output gap, the positive effects of the structural reforms on prices of energy and telecommunications services. The monetary authority also commented on the moderate impact of the pass-through effect of the depreciation of the Mexican currency to prices. In response, the Board considered that: *"... the balance of risks for inflation has improved in the short term…"*.

**Relative monetary conditions and exchange rate remain the most important factors in Banxico's decision-making process**. The monetary authority concludes that despite that the recent behavior of inflation is consistent with medium and long-run target, the Board decided to increase the reference rate by 25bps. In particular, the statement shows that: *"…[Banxico's Board] acted in response to the 25bps increase in the fed funds rate, given that the absence of an adjustment in our reference rate could generate an additional and disorderly depreciation of the Mexican currency, affecting both inflation expectations and inflation itself…"*. However, the central bank also left the window open to adjust its monetary policy to Mexico's cyclical conditions given that *"...the Board will continue to monitor the evolution of all inflation determinants [...]. In order to be able to take additional and flexible measures required to consolidate the efficient convergence of inflation to the target of 3 percent…"*. We believe that another clear example that Banxico will also consider Mexico's economic cycle to adjust its monetary stance is the divergence between the scheduled monetary policy meetings between the central bank and the Fed (refer to the chart below).

**Fed and Banxico's Calendar 2016**

| Month | Banxico | Fed |
|---|---|---|
| January | | 26-27 |
| February | 4 | |
| March | 18** | 15-16* |
| April | | 26-27 |
| May | 5 | |
| June | 30 | 14-15* |
| July | | 26-27 |
| August | 11 | |
| September | 29 | 20-21* |
| October | | |
| November | 17 | 1-2 |
| December | 15 | 13-14* |

Source: Banorte-Ixe with data from Banxico and Federal Reserve
*Meetings with update of macroeconomic projections and press conference by chair Janet Yellen
**Friday, March 18, 2016

**In sum…** While Banxico's central scenario seems to be of moderate economic growth and inflation below target in 2016, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Looking ahead, we believe that Banxico will follow the Fed in its monetary tightening cycle, but Banxico's monetary stance could diverge from the Fed's if the business cycles between both countries show major differences. In this context, we expect the Fed to hike 75bps in 2016, while Banxico will do only 50bps, with the reference rate ending next year at 3.75%.

*From our fixed income and FX strategy team*

**Attractive valuation in the Mexican curve as Banxico could moderate its normalization process.** Today's 25bps hike in the reference rate came in line with expectations, especially after the Federal Reserve decided yesterday to deliver the first rate increase after the 2008/2009 crisis. Banxico's communiqué portrays a strong dovish sense (as the one observed in the previous document releases on October 29th) despite the beginning of the tightening cycle in the U.S., which could be supportive for a local rate with a very attractive valuation in terms of normalization of monetary conditions in both countries. Mexican bonds extended yesterday's gains following Banxico's announcement, with a rally of nearly 7bps along the yield curve, with a slight flattening bias. In our view, the monetary authority in Mexico could continue hiking rates in tandem with the Federal Reserve at the beginning of 2016. However, low inflation and an effect of slack in the economy could halt the restrictive cycle by mid-year, with realized cumulative hikes for the following 12 months maybe lower vis-à-vis the 91bps currently priced in the yield curve. The key factor will be the performance of the Mexican peso. Taking into consideration these variables we hold a positive view in term of the belly of the Mbonos curve, especially the tenors from the Dec'18 security to the Dec'24. In accordance with this view, we hold our trade idea opened on November 12th of receiving 1-year TIIE-28 IRS (13x1) with an entry level of 3.92%, target of 3.67%, stop-loss of 4.10%, and currently trading at 3.88%. For further details regarding this recommendation please refer to "Trade Idea: Receive 1-year TIIE-28 IRS (13x1), <pdf>.

On the other hand, we hold a pessimistic view on Mexican linkers despite a valuation that looks attractive for investments with long-term horizons. Current inflation dynamics are likely to undermine the demand for inflation-linked securities (e.g. Udibonos), which could extend the recent sell-off on the back of a positive assessment on inflation for 2016.

In the FX market, the currency gained from 17.08 to 17.00 per dollar after the decision, practically unchanged on the day. In our view, the reaction could be at least partially explained by the comment that not raising rates after the Fed "*could induce an additional and disorderly depreciation that could affect current inflation and inflation expectations*". Moreover, the Board is still warning about the possibility of a stronger pass-through effect despite being modest so far. Notwithstanding the latter, we still believe that Mexico's monetary policy will not be a supportive factor for the peso in the foreseeable future, more so with the latent possibility of Banxico decoupling from the Fed in the future. In this respect, we reiterate yesterday's recommendation suggested after the Fed's decision of buying USD/MXN below 17.00 per dollar, expecting higher appetite at current levels. Our cautious outlook for the currency is also based on the persistent pressures and high volatility observed in oil prices and lower seasonal liquidity until year-end, elements that we believe should limit the potential of a strong appreciation in the short-term.

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