

Banxico's minutes – Prudent stance necessary in a highly risky scenario

- **Banxico just published the minutes of the meeting held on August 1st, in which the board of governors decided to remain on hold, keeping the reference rate at 7.75%**
- **In our opinion, the tone of the minutes does not deviate much from the one in the statement, detailing the central bank's rationale its decision**
- **Furthermore, they continue to argue in favor of our view that Banxico will remain on hold in the next 18 months, not ruling out the possibility of further increases if the inflation outlook deteriorates**
- **The combination of current valuations in the short-end and Banxico's assessment about inflation, growth and the FX remains positive for our trade idea in the CPI-linked Udibono Jun'22**

In our opinion, the tone of the minutes does not deviate much from the one in the communiqué, detailing the central bank's rationale. The board of governors justified their monetary policy decision -on hold at 7.75%- , arguing that: (1) The recent change in relative prices, on the back of higher than expected energy prices, is temporary; (2) both survey and market-based measures for medium and long-term expectations have remained relatively stable; (3) slack in the economy has increased, reducing the probability of demand-side pressures; and (4) core inflation continues to show a downward trend, which is expected to continue. Moreover, they recognized the appreciation of the Mexican peso in the inter-meeting period along with lower volatility in global financial markets.

Concern on a highly uncertain outlook. A constant word used by Banxico's board to depict the outlook ahead is "uncertainty". In terms of growth, they agreed that economic conditions have deteriorated and that, for 2018, it is possible that it will be closer to the lower-end of their 2%-3% forecast range, although most of them maintained that activity will pick up next year. Among the main risks for growth they mentioned: (1) An unfavorable outcome in terms of NAFTA renegotiation; (2) the possibility that oil output keeps underperforming; and (3) uncertainty regarding the new administration's economic policy strategy, particularly in terms of fiscal policy.

Balance of risks for inflation unchanged from previous meeting and still biased to the upside. As we mentioned above, Banxico considered that the recent pick-up in inflation will be temporary and that core inflation, which is the component that more clearly respond to monetary policy according to the board, has maintained a descending trend.

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Once again, they believed that the outlook is difficult to assess as the scenario remains highly uncertain, with some important risks: (1) There is the possibility of a backdrop of lower economic activity and inflation persistently above target; (2) further pressures on energy and agricultural prices; and (3) the new administration's economic policies -such as a change in the determination of the minimum wage-, as well as a possible deterioration in the fiscal stance.

A prudent monetary policy stance, but with the door clearly open to further hikes... The monetary authority seems to be comfortable with its current monetary policy stance having in mind that, in the case of a shock that requires an adjustment of the real exchange rate, they should only act in order to prevent second-round effects on prices to keep inflation expectations on check. For the time being, they considered that current pressures on inflation are supply-sided with no further ones observed from the demand side. Nevertheless, given the highly uncertain outlook, *"...some members mentioned that additional rises of the target rate cannot be ruled out..."*.

...But probably not jumping the gun soon. They argued that an inflation-targeting central bank should conduct monetary policy based on forecasts, with the board explaining in detail the reasons behind possible deviations from the target, in the absence of a monetary policy response. In particular, one member added that *"...even in the presence of shocks that would justify a change in the monetary policy stance, for instance, when there is evidence or a risk of second-round effects on prices, postponing the attainment of the inflation target can be justified, as long as the monetary policy response to these shocks is deemed appropriate, and consistent with the attainment of the inflation target, although in a reasonably longer period..."*. In our opinion, this discussion suggests Banxico is not going to hike further if it is not completely necessary, even if inflation misses their estimates and it takes longer to converge to the target. In this context, we agree with the board's views in terms of the communication strategy that they should follow in such a case, which should *"... provide guidance on how Banco de México responds to different types of shocks in order to re-optimizing its monetary policy stance so that it is consistent with the fulfillment of the target in the referred time frame..."*.

We maintain our view that Banxico will keep the rate at 7.75% in the next 18 months. We expect inflation to remain relatively elevated in coming months but still converge to our 4.3% by year-end. In terms of the FX, we believe the currency will remain well behaved in spite of current volatility, with our forecast still at USD/MXN18.60 for year end. Moreover, the new administration has pledged to maintain sound fiscal policies and solid macroeconomic fundamentals. Regarding the relative monetary policy stance vs. the U.S., it is worth mentioning that Banxico's next monetary policy decision is due one week after the FOMC holds its September meeting, at which we expect a 25pb rate hike. One member of the board stated that interest rate differentials with the U.S. remain at prudently high levels despite inflation differentials narrowing while term-premia has remained stable, which is in line with our view that Banxico has some leeway to decouple from the U.S.

Fed normalization process, at least for the time being. Nevertheless, we cannot rule out new episodes of high volatility due both to domestic and external factors, increasing the probability of Banxico hiking another 25bps before the year ends.

From our fixed income and FX strategy team

The combination of current valuations in the short-end and Banxico's assessment about inflation, growth and the FX remains positive for our trade idea in the CPI-linked Udibono Jun'22. Banxico's minutes portrayed a balanced assessment of risks, highlighting a hawkish tilt in terms of inflation, which was offset by a dovish bias with respect to growth. The document also stressed out the main drivers behind the FX performance in coming months, most of them global (*e.g.* topics related to geopolitics, tighter monetary conditions in the U.S. and the protectionists agenda from President Trump). Overall, the fixed income market depicted a mild reaction to the minutes of the central bank, with a yield curve pricing in 23bps of implied rate hikes for the remainder of 2018. When analyzing the spread between the 1-day ex ante real rate in Mexico and the U.S., the current 475bps differential suggests a 75bps buffer in terms of relative monetary policy between Banxico and the Federal Reserve. As a result, the risks associated to short-term securities are well contained after the correction observed in recent weeks. In this regard, we hold our trade idea of long positions in the CPI-linked Udibono Jun'22, which could benefit from current inflation dynamics, especially with the change of methodology to take place starting August 23rd. Taking into account our CPI forecasts, the expected carry for the remaining 137 days of 2018 is 2.43% (*i.e.* 6.39% annualized).

Regarding FX, today's session is depicting a null effect from Banxico's minutes as the market is still driven by the investors' risk perception worldwide. In this sense, geopolitical themes have dominated the global agenda as has been the case of the Turkish backdrop and trade dynamics. The Mexican peso is rallying today 0.86% to 18.97 per dollar, recovering some ground from yesterday's losses which printed a 1.35% sell-off reaching up to USD/MXN 19.30 following a number of sessions with sharp volatility. In this respect, since August 7th the Mexican peso has lost 2.7% vs a 3.2% depreciation of an EM currency basket. In the technical space, the 200-day MA at 19.04 will remain as a short-term relevant reference, as well as the 19.23 area where the 100-day MA converges to a Fibonacci level. Given the possibility of greater stress in EM, we still see the possibility of having a pressured peso in the short-term. However, we reiterate our year-end forecast at 18.60 per dollar. For more detail in our estimates for the remaining of the year please consult: "*Fixed-Income, FX, and Commodities - 3Q18 Outlook*" [<pdf>](#), released on July 24th, 2018.

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