

Banxico's minutes – Keeping options open amid a highly uncertain backdrop

- Banxico just published the minutes of the meeting held on June 21th, in which the board of governors decided to hike the reference rate in 25bps to 7.75%
- In our opinion, the minutes show hawkish rhetoric amid a highly uncertain and risky environment with Banxico keeping the door open to further rate increases
- As we expect favorable conditions for both inflation and FX, we maintain our view that Banxico will keep the rate at 7.75% in the next 18 months
- Nevertheless, we cannot rule out new episodes of high volatility due both to domestic and external factors, which could eventually increase the probability of another rate hike before the year ends
- The peso rally continues while rates remain stable following hawkish minutes from Banxico

In our opinion, the minutes detail the hawkish rhetoric we observed in the communiqué. They see deterioration in the balance of risks for inflation and a more aggressive normalization of monetary conditions in the United States. In addition, they consider that the scenario still has a high degree of uncertainty, stemming from both the renegotiation of NAFTA and the post-electoral process, in particular the future fiscal stance.

Inflation balance of risks has deteriorated. The board of governors agreed in that inflation prospects have an upward bias, derived from: (1) The fact that some of the risks have already materialized, such as a depreciation of the exchange rate and higher energy prices; (2) demand-side pressures could arise, given the cyclical conditions –with a narrowing slack–, and in particular as a result of rising unit labor cost; (3) they are worried that the depreciation of the FX could become permanent and increase the pass-through to prices; and to a lesser extent (4) there could be a negative effect from protectionist measures from Trump's administration, particularly if the list of products subject to retaliation from Mexico's government expands.

A more aggressive U.S. Fed. In addition, they highlighted the possibility of inflation shocks in advanced economies, particularly in the U.S., that could entail a more aggressive normalization process looking ahead. In this context, they highlighted the changed in the last Fed *dot-plot*, adding an additional hike in 2018. Considering this, Banxico explained that one of the main drivers of monetary policy decisions continues to be the relative monetary policy stance, with one member stating that “...*monetary policy must take into account that a narrowing of the short-term interest rate spread is not convenient...*”.

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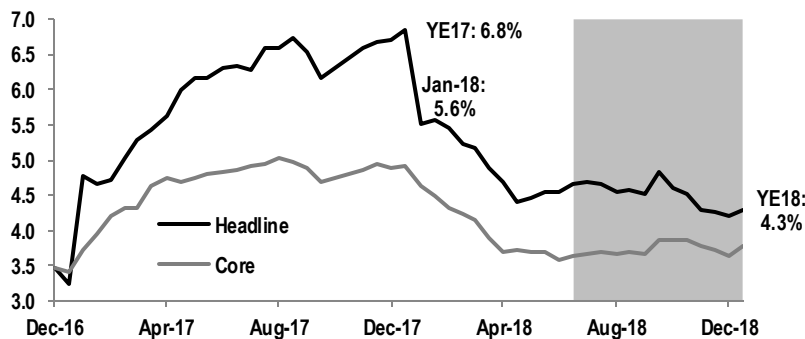
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Prudent and cautious stance to bolster economic confidence. Banxico reiterated that both sound fiscal and monetary policies are necessary to improve the resilience not only of the economy but also of the financial system amid a highly uncertain and risky backdrop. Nevertheless, they considered that the response from fiscal policy is currently limited and could deteriorate looking ahead. In this context, one board member stressed that “...for Banco de México to be able to fulfill completely its constitutional mandate of ensuring price stability, it is imperative that responsible and sustainable fiscal policy be implemented...”. In addition, some members mentioned also the importance of reducing corruption and impunity, which they believe is already affecting economic activities, and of improving the rule of law.

We maintain our view that Banxico will keep the rate at 7.75% in the next 18 months. We expect inflation to pick up in the next few months but still converge to our 4.3% by year-end. In terms of the FX, we believe that the Mexican peso will show an appreciation trend, as uncertainty ebbs away. Moreover, the new administration has pledged to maintain sound fiscal policies and solid macroeconomic fundamentals. 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.

Inflation forecast 2018

% yoy



Source: INEGI and Banorte

From our fixed income and FX strategy team

The peso rally continues while rates remain stable following hawkish minutes from Banxico. The yield curve is trading sidelines, with a modest positive bias, after a significant rally observed since mid-June, following the risk on effect in global markets and the rally in the Mexican peso. Market participants are acknowledging the hawkish tilt from Banxico at today’s minutes, endorsing a 21bps implied rate hike in the reference rate from the central bank in the 2H18, priced in the curve. In our view, Banxico’s hawkishness is positive for our trade idea in floating-rate securities (e.g. Bondes D). On the other hand, we hold our trade recommendation of long positions in long-term Mbonos, stressing out a more attractive relative valuation in the Mar’26 and Nov’47 tenors. Nevertheless, under a risk-reward assessment, we recognize that an additional rally is limited.

In the FX market, the MXN strengthened modestly after the release, albeit accumulating a 1.2% gain today at 19.23 per dollar, its strongest level since mid-May. In our view, Banxico's cautious stance is positive for the currency due to its effect on expectations about possible rate hikes in the near future, supporting the attractiveness of carry particularly as implied volatility decreases after the presidential election. In this context, we maintain our recommendation of long MXN positions against USD with an immediate target of 19.00 per dollar for risk-tolerant investors. The latter is stressed as trade uncertainty remains very high due to possible tariffs by the US to China tomorrow and with no additional news on NAFTA, which could keep pressuring EM countries that continue showing significant portfolio outflows.

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