

Banxico draws a line between monetary and exchange rate policy

- Banxico released today its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected
- A few minutes after Banxico's decision, the *Foreign Exchange Commission* (FEC) modified its pre-announced US dollar auction mechanisms to a more aggressive stance
- In our opinion, the central bank remains "tied" to monetary policy decisions in the U.S., so this decision gives the monetary authority leeway to avoid having to raise rates before the Fed does so in September
- According to the policy statement, cyclical conditions of the Mexican economy show weakness, while inflation will remain below the 3% target in 2015
- Particularly, as board members warned that: "...any actions from the U.S. Fed could have additional repercussions on the Mexican exchange rate and inflation expectations..."
- However, it is our take that the tone of communiqué was a little bit more hawkish *vis-à-vis* the last one
- The minutes of today's meeting will be released on August 13, and next monetary policy announcement will take place on September 21
- Positive reaction in local assets following Banxico's communiqué and FEC's measures

Monetary policy decision – A slight change in the perception of the balance of risks. 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. In our opinion, Banxico continues viewing no need to move monetary policy under the current growth (with a more deteriorated balance of risks) and inflation (with a more favorable balance of risks) outlook. Nevertheless, the still uncertain beginning of the U.S. Fed normalization of monetary policy and its effect on the exchange rate is of particular concern given that: "...any actions from the U.S. Fed could have additional repercussions on the Mexican exchange rate and inflation expectations...". In this context, we continue to believe that Banxico remains "tied" to the actions of the monetary authority in the United States.

Fed's normalization process to start soon. We perceive a relative more hawkish stance of the monetary authority regarding U.S. Fed monetary policy, stressing that "...[the U.S. Fed] estimates that the first interest rate hike will take place in 2015, and that the pace of subsequent increases will be gradual...". This contrast with previous assessment of the moment of the Fed's first hike which Banxico considered could have been delayed.

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Downside risks on growth. In our opinion, the tone of the statement regarding the growth is marginally more negative than in June's statement. While the central bank considers that the balance of risks for the global economy has not changed since the last meeting, Banxico highlights that the non-car manufacturing sector, mining and construction performance is weak. Moreover, despite some pick up in domestic demand indicators, they consider that slack in the market is still large, so they do not expect demand-side pressures on prices.

Relative monetary conditions and exchange rate remain the most important factors in Banxico's decision making process. The monetary authority concludes that cyclical conditions of the Mexican economy show weakness while inflation will remain below the target in 2015. However, as it was abovementioned, board members warned that: "...the Fed's actions could have additional repercussions on the exchange rate and inflation expectations...". In this context, Banxico's board of governors will pay particular attention to "... the evolution of the exchange rate, the relative monetary conditions between Mexico and the United States, and the evolution of the slack in the economy..."

We maintain our view that the central bank's next move will be a hike, immediately after the Fed. While Banxico's central scenario seems to be of economic activity weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given this, we believe that Banxico's next move will be a rate hike, immediately after the Fed starts its normalization of monetary policy in September 16-17. This implies that the central bank could be raising rates at its next regular meeting on September 21. Recent measures taken by the *Foreign Exchange Commission* give Banxico some leeway to wait for the Fed to hike rates, instead of increasing Mexico's own reference rate ahead of the decision, as it has been the case in some other emerging economies (*e.g.* Brazil).

The FEC takes further actions against a volatile FX market. The Foreign Exchange Commission (FEC) announced two changes to their existing measures in the FX market: (1) An increase in the amount of the US daily auction without minimum price from US\$ 52 to 200 million at least until September 30; and (2) a reduction of the trigger in the US\$ 200 million daily auction without minimum price, from 1.5% to 1% of the previous day's fixing rate, keeping the amount unchanged. It is also worth noting that the open-ended nature of this latter measure announced back on December 2014 was modified to also expire on September 30, 2015. Lastly, the FEC reiterated that it will continue to monitor market conditions and could take additional measures if they are needed.

We see these changes as significant, surpassing our and (most likely) the market's expectations even though it was highly likely that new measures would be announced (see: "*Mexican peso: Cheap, but stuck between a rock and a hard place*", <[pdf](#)>, and "*USD/MXN – The Foreign Exchange Commission could act again soon*", <[pdf](#)>). Considering only the higher amount in daily auctions without minimum price, expected sales beginning tomorrow and until September 30 (from September 29 before) will be scaled up by US\$ 6.5 billion, going from US\$ 2.2 to 8.6 billion, or +294%.

For reference, the accumulated amount sold through this mechanism since its reintroduction back on March 11, 2015 and up until today stands at US\$ 5.1 billion.

According to past comunicués, Banxico's expected amount of reserves accumulation for the next twelve months is hovering around US\$ 12.6 billion. Given that expected total sales are about US\$ 8.6 billion and the program will last at least the next two months, this amount implies a reduction of international reserves in the tune of US\$ 6.5 billion (assuming constant accumulations per month) during the same period. Despite of the latter and considering the overall healthy level of international reserves US\$ 190.7 billion and the IMF's flexible credit line at around US\$ 70 billion, it is our take that the implied reduction in international reserves will not result in any meaningful worsening of Mexico's fundamentals, and that FX reserves are actually being used in a correct way given the challenging external scenario.

As a result, we change our short-term stance on MXN from neutral to positive. Despite gains after the announcement, we see further room for peso appreciation in the short-term as dollar liquidity will increase in local markets. Moreover, it is our take that these measures serve as a stronger signal that authorities are determined to respond efficiently to risks from peso depreciation that could spill into other variables, while also reaffirming their commitment to favoring rules-as opposed to discretionary-based measures. In particular, we believe USD/MXN could trend towards 16.00 per dollar and could open tomorrow with a gap lower as Asian and European markets react to the news. Technically, main supports stand at 16.14/16.16 (this week's low and 10-day MA, respectively) and at 16.04, with its most significant resistance at today's high and newest historical of 16.50 per dollar.

From our fixed income and FX strategy team

Positive reaction in local assets following Banxico's communiqué and FEC's measures. Concerns regarding the strong MXN depreciation against the USD in July (3.6%) were partially eased after Banxico released a hawkish communiqué and the Foreign Exchange Commission (*FEC*) announced new measures in order to provide liquidity to the FX market. Local assets were pricing an aggressive scenario in terms of monetary policy restriction in Mexico early this session (more than a single 25bps hike for September), but immediately aligned towards a more gradual pace following this announcements. In the aftermath of today's news, Mexican bonds observed gains of 4-5bps in short-term instruments and 2-3bps in longer tenors. In our view, local rates will remain defensive as market valuation portrays appealing risk premia embedded in the slope of the yield curve, spread vs U.S. Treasuries and forward rates. In the FX market, the peso reacted with a 1% relief rally following both statements, moving from USD/MXN 16.45 to 16.28 (even reaching 16.20).

Disclaimer

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Track of the latest fixed-income trade recommendations

Trade idea	Entry	Target	Stop-loss	Closed	Status	P/L	Initial date	End date
Spread TIE 2/10 yrs (flattening)	230pb	200pb	250pb	200pb	Closed	Profit	26-Jun-15	29-Jul-15
Long Mbono Dec'24	6.12%	5.89%	6.27%	5.83%	Closed	Profit	13-Mar-15	19-Mar-15
Relative-value trade, long 10-year Mbono (Dec'24) / flattening of the curve					Closed	Profit	22-Dec-14	6-Feb-15
Pay 3-month TIE-IRS (3x1)	3.24%	3.32%	3.20%	3.30%	Closed	Profit	29-Jan-15	29-Jan-15
Pay 9-month TIE-IRS (9x1)	3.28%	3.38%	3.20%	3.38%	Closed	Profit	29-Jan-15	29-Jan-15
Pay 5-year TIE-IRS (65x1)	5.25%	5.39%	5.14%	5.14%	Closed	Loss	4-Nov-14	14-Nov-14
Long Udibono Dec'17	0.66%	0.45%	0.82%	0.82%	Closed	Loss	4-Jul-14	26-Sep-14
Relative-value trade, long Mbonos 5-to-10-year					Closed	Profit	5-May-14	26-Sep-14
Receive 2-year TIE-IRS (26x1)	3.75%	3.55%	3.90%	3.90%	Closed	Loss	11-Jul-14	10-Sep-14
Receive 1-year TIE-IRS (13x1)	4.04%	3.85%	4.20%	3.85%	Closed	Profit	6-Feb-14	10-Apr-14
Long Udibono Jun'16	0.70%	0.45%	0.90%	0.90%	Closed	Loss	6-Jan-14	4-Feb-14
Long Mbono Jun'16	4.47%	3.90%	4.67%	4.06%	Closed	Profit	7-Jun-13	21-Nov-13
Receive 6-month TIE-IRS (6x1)	3.83%	3.65%	4.00%	3.81%	Closed	Profit	10-Oct-13	25-Oct-13
Receive 1-year TIE-IRS (13x1)	3.85%	3.55%	4.00%	3.85%	Closed	Flat	10-Oct-13	25-Oct-13
Long Udibono Dec'17	1.13%	0.95%	1.28%	1.35%	Closed	Loss	9-Aug-13	10-Sep-13
Receive 9-month TIE-IRS (9x1)	4.50%	4.32%	4.65%	4.31%	Closed	Profit	21-Jun-13	12-Jul-13
Spread TIE-Libor (10-year)	390bps	365bps	410bps	412bps	Closed	Loss	7-Jun-13	11-Jun-13
Receive 1-year TIE-IRS (13x1)	4.22%	4.00%	4.30%	4.30%	Closed	Loss	19-Apr-13	31-May-13
Long Udibono Jun'22	1.40%	1.20%	1.55%	0.97%	Closed	Profit	15-Mar-13	3-May-13
Receive 1-year TIE-IRS (13x1)	4.60%	4.45%	4.70%	4.45%	Closed	Profit	1-Feb-13	7-Mar-13
Long Mbono Nov'42	6.22%	5.97%	6.40%	5.89%	Closed	Profit	1-Feb-13	7-Mar-13
Long Udibono Dec'13	1.21%	0.80%	1.40%	1.40%	Closed	Loss	1-Feb-13	15-Apr-13
Receive 1-year TIE-IRS (13x1)	4.87%	4.70%	5.00%	4.69%	Closed	Profit	11-Jan-13	24-Jan-13
Receive TIE Pay Mbono (10-year)	46bps	35bps	54bps	54bps	Closed	Loss	19-Oct-12	8-Mar-13
Spread TIE-Libor (10-year)	410bps	385bps	430bps	342bps	Closed	Profit	21-Sep-13	8-Mar-13
Long Udibono Dec'12	+0.97%	-1.50%	+1.20%	-6.50%	Closed	Profit	1-May-12	27-Nov-12
Long Udibono Dec'13	+1.06%	0.90%	+1.35%	0.90%	Closed	Profit	1-May-12	14-Dec-12

Track of the latest FX trade recommendations*

Trade Idea	Entry	Target	Stop-loss	Closed	Status	P/L*	Initial Date	End date
Long USD/MXN	14.98	15.50	14.60	15.43	Closed	Profit	20-Mar-15	20-Apr-15
Short EUR/MXN	17.70	n.a.	n.a.	16.90	Closed	Profit	5-Jan-15	15-Jan-15
Tactical trade: Long USD/MXN	14.40	n.a.	n.a.	14.85	Closed	Profit	15-Dec-14	5-Jan-15
Tactical trade: Long USD/MXN	13.62	n.a.	n.a.	14.11	Closed	Profit	21-Nov-14	3-Dec-14
Short USD/MXN	13.21	n.a.	n.a.	13.64	Closed	Loss	10-Sep-14	26-Sep-14
Tactical trade: Short EUR/MXN	17.20	n.a.	n.a.	17.03	Closed	Profit	27-Aug-14	4-Sep-14
USD/MXN call spread**	12.99	13.30	n.a.	13.02	Closed	Loss	6-May-14	13-Jun-14
Directional short USD/MXN	13.00	12.70	13.25	13.28	Closed	Loss	31-Oct-13	8-Nov-13
Limit short USD/MXN	13.25	12.90	13.46	--	Cancelled	--	11-Oct-13	17-Oct-13
Speculative short USD/MXN	12.70	12.50	13.00	13.00	Closed	Loss	26-Jul-13	21-Aug-13
Short EUR/MXN	16.05	15.70	16.40	15.69	Closed	Profit	29-Apr-13	9-May-13
Long USD/MXN	12.60	12.90	12.40	12.40	Closed	Loss	11-Mar-13	13-Mar-13
Long USD/MXN	12.60	12.90	12.40	12.85	Closed	Profit	11-Jan-13	27-Feb-13
Tactical limit short USD/MXN	12.90	12.75	13.05	--	Cancelled	--	10-Dec-12	17-Dec-12

* Total return does not consider carry gain/losses

** Low strike (long call) at 13.00, high strike (short call) at 13.30 for a premium of 0.718% of notional amount

Source: Banorte-Ixe

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