Banxico minutes – Hawkish tone highlighting a higher pass-through

October 13, 2016

www.banorte.com
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@analisis_fundam

Gabriel Casillas
Chief Economist and Head of Research
gabriel.casillas@banorte.com

Delia Paredes
Executive Director of Economic Analysis
delia.paredes@banorte.com

Alejandro Cervantes
Senior Economist, Mexico
alejandro.cervantes@banorte.com

Fixed income and FX Strategy

Alejandro Padilla
Head Strategist - Fixed-Income and FX
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA
FX Strategist
juan.alderete.macal@banorte.com

- **Banxico published today the minutes of its monetary policy meeting held back on September 29, in which the board decided unanimously to increase the reference rate to 4.75% from 4.25%**
- **The discussions focused on the following topics:**
  - **(1) Banxico increased the reference rate in order to counteract inflationary pressures arising from the depreciation of the Mexican currency;**
  - **(2) Banxico's monetary policy will continue to be subordinated to the Fed's monetary policy**
  - **(3) Core inflation has maintained an upward trend as a result of the exchange rate depreciation, which implies that the balance of risks for inflation has deteriorated; and**
  - **(4) Even though the balance of risks for growth deteriorated over the previous meeting, several members highlighted the possibility of greater demand-side pressures;**
- **Looking ahead, we continue to forecast a highly volatile exchange rate market, amid geopolitical risks in 4Q16**
- **We maintain our view that Banxico will increase the reference rate by 25bps in December, leaving it at 5% by year-end**

Minutes with a *hawkish* bias. Banxico released today the minutes of the monetary policy meeting held two weeks ago (September 29), in which the board unanimously decided to increase the reference rate to 4.75% from 4.25%. The discussions focused on the following topics: (1) Banxico increased the reference rate in order to counteract inflationary pressures arising from the depreciation of the Mexican currency; (2) Banxico's monetary policy will continue to be subordinated to the US Fed own monetary policy; (3) Core inflation has maintained an upward trend as a result of the exchange rate depreciation, which implies that the balance of risks for inflation has deteriorated; and (4) even though the balance of risks for growth deteriorated over the intermeeting period, several members highlighted the possibility of greater demand-side pressures.

Banxico increased the reference rate in order to counteract inflationary pressures arising from exchange rate pass-through. Within Banxico's monetary policy minutes, the majority of the board mentioned that even though the Mexican economy decelerated in the first half of the year and inflation remains below target, the balance of risks for inflation has deteriorated as a result of the depreciation of the Mexican peso. In this context, all members of Banxico's Board agreed that: *"… as a result of higher inflationary pressures, we considered necessary to adjust the monetary policy in order to counteract them and keep inflation expectations well anchored…".*

Looking ahead, Banxico's monetary policy will continue to be subordinated to the Fed's monetary policy. In this regard some members commented on the difficulty of assessing the Banxico's future monetary stance. In particular, one member commented that *"... taking into account the close relationship between the two economies (Mexico and the US) and the degree of openness of the Mexican economy to national and international financial markets, an adjustment of the reference rate in the United States without a response of Mexico's monetary policy could lead to disorderly capital outflows with consequent risks to inflation and financial stability ...".* In this regard, another member highlighted that: *"… monetary policy should facilitate an orderly adjustment in interest rates, especially before the decompression process of the term premium that accompanies the process of the Fed's monetary policy normalization process, although the perception that the long-run rate in the United States might be significantly lower gives leeway to Banxico's monetary stance…".*

Short-term deterioration of the balance of risks for inflation. Most members highlighted that the balance of risks for inflation in the short-term deteriorated in the intermeeting period. Most members said that *"...exchange rate pass-through to merchandise prices has become more evident in recent weeks, with annual rates close to 4%...".* In addition, most members emphasized that *"…given the uncertainty associated with the external backdrop, an additional depreciation of the exchange rate could affect inflation expectations …".* The board agreed that the main upside risk to inflation is the exchange rate.

Increased demand-side pressures on prices. While the central bank felt that the balance of risks to economic growth deteriorated over the intermeeting period, some members commented on the uncertainty that persists in assessing the degree of slack in the Mexican economy. In particular, one member commented that *"…under the current circumstances, it has become very complicated to assess the economic cycle, not only because of the uncertainty surrounding the measurement of potential output, but also because of the phase of the cycle itself, with the output gap probably now very close to zero…".* In this regard another member alluded to widening of the current account deficit, which also represents a risk to the inflation outlook.

We expect a 25bps rate hike in December. As we mentioned in our previous publication, looking ahead, we continue to forecast a highly volatile exchange rate market, given: (1) The US elections; (2) the volatility in oil prices; and (3) the expectation of a 25bps hike in the Fed's fund rate in December. Regarding the US election, our base case scenario is that Hillary Clinton will win the elections, thus we believe that Banxico will increase by 25bps the reference rate in December to 5% (vs our previous 50bps hike call). However, if Donald Trump wins the election, we believe that Banxico will probably increase by 75bps the reference rate at its November, and then again at December's meeting to 6.25%. If the US election yields a controversial result for any of the presidential candidates, we believe that Banxico will probably wait until December to adjust the monetary policy.

From our fixed income and FX strategy team:

Banxico aware of the risk factors surrounding the peso and its likely effect on CPI. Banxico's minutes depicted a hawkish bias, paying close attention to the combination of external and internal factors that could bang up the performance of the Mexican peso and therefore result in second order effects on inflation. The central bank's assessment on inflation and growth suggests that the short-end is fairly price in, with an implied cumulative rate hike of 16bps by year-end and 37bps in the 6-month ahead. On the other hand, current conditions support the thesis that yield curves in the US and Mexico could remain in a steeper trend. As a result, we hold our trade idea of a 5y10y steepener in the TIIE-IRS curve with entry level of 35bps, target of 50bps, stop-loss of 25bps and currently trading at 47bps. Additional details in our research note "*Trade idea: 5y10y TIIE-IRS steepener*" <pdf>, published on October 5th, 2016. In the FX market, the MXN is 0.7% weaker on the day to 19.05 per dollar, impacted along EM (except Europe) and extending its losses modestly after the release. We highlight the Board's comments that peso weakness has also been driven by internal drivers, particularly concerns over the fiscal position. Since Tuesday we have recommended buying USD/MXN when it was trading around 18.90, a stance we reiterate as we maintain a cautious approach before the US election as we see limited room for a further leg down on the back of expectations of higher volatility in the short term.

GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy			
Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Economic Analysis			
Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Juan Carlos García Viejo	Economist, International	juan.garcia.viejo@banorte.com	(55) 1670 - 2252
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Fixed income and FX Strategy			
Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal, CFA	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144
Equity Strategy			
Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates / Financials/ Mining / Chemistry	marissa.garza@banorte.com	(55) 1670 - 1719
Marisol Huerta Mondragón	Equity Research Analyst – Food / Beverages / Specialized Commerce	marisol.huerta.mondragon@banorte.com	(55) 1670 - 1746
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research Analyst – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Eugenia Ivonne Arias Medina	Analyst	eugenia.arias.medina@banorte.com	(55) 1670 - 2251
Corporate Debt			
Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 1670 - 2248
Wholesale Banking			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Asset Management	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Corporate Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454