Banxico minutes – The central bank hints the possibility of decoupling from the Fed

- **Banxico published today the minutes of its monetary policy meeting held back in December 17, in which the board decided to increase the reference rate by 25bps leaving it at 3.25%, as it was widely expected**
- **We highlight the following features of the meeting:**
  (1) The decision to hike the reference rate was unanimous;
  (2) The Minister of Finance, Luis Videgaray, was at the monetary policy committee in question
- **In our view, the most important issues discussed were:**
  (1) The balance of risks for growth improved regarding the last monetary policy announcement;
  (2) The balance of risks for inflation improved in the short run, but remained unchanged for the medium term;
  (3) Banxico's rate hike was motivated by the Fed's hike; but
  (4) The central bank signaled the market that Banxico's hiking cycle will not necessarily replicate the Fed's monetary policy
- **In our opinion, the minutes kept the same tone we perceived in the last *communiqué* given that Banxico will adequate its monetary policy to Mexico's business cycle, and will not necessarily follow the Fed in 2016**
- **As a result, we continue to believe that the Fed to hike 75bps in 2016, while Banxico will do only 50bps, with the reference rate ending next year at 3.75%**
- **Mexico's yield curve portrays an attractive valuation as Banxico could normalize its policy stance gradually while the peso remains vulnerable to the external environment**

Monetary policy decision – 25bps hike driven by the Fed. Banco de Mexico just published the minutes of its monetary policy meeting held back in December 17, in which the board unanimously decided to increase the reference rate by 25bps, leaving it at 3.25%, as it was widely expected. We highlight that Luis Videgaray, Minister of Finance, was as at the meeting. In this regard for the past six years, a member of the Ministry of Finance is invited to Banxico's monetary policy meetings. Normally, the Minister of Finance, Luis Videgaray, appears once a year. However, this is the fourth time that Mr. Videgaray has attended Banxico's meetings in 2015.

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Higher growth, low inflation and Mexico's relative monetary stance. In our opinion, the minutes kept the same tone we perceived in the last *communiqué*. In this context, we highlight that the most important issues discussed were: (1) The balance of risks for growth improved regarding the last monetary policy announcement; (2) the balance of risks for inflation improved in the short run, but remained unchanged for the medium term; (3) Banxico's rate hike was motivated by the Fed's hike; but (4) the central bank signaled the market that Banxico's hiking cycle will not necessarily replicate the Fed's monetary policy

The balance of risks for growth improved. All board members agreed that the balance of risks for the Mexican economy improved regarding the last monetary policy meeting. Most members recognized that private consumption improved given the higher growth in Mexico's labor market, the recovery of private lending, and the downward trend inflation. Similarly, the Board members also recognized that private investment has recovered significantly. However, they also acknowledged that manufacturing production and exports still showed a lower performance. In this context, most of the members emphasized that: *"...the balance of risks for growth has improved over the previous monetary policy decision…"*.

The balance of risks for inflation also improved in the short term. Most board members agreed that the balance of risk for inflation also improved in the short run from the previous meeting. In particular, all members agreed that the pass-through effect from the depreciation of the Mexican currency to prices has been limited. They also acknowledge that the recent downward trend in inflation was explained by: *"…Banxico's monetary policy stance, the slack in the economy, and the additional reductions in input prices given the implicit benefits of the structural reforms, such as the energy and telecommunications service….".* The members of the Board also emphasized that the inflation expectations for 2016 and 2017 have moved closer to 3%. Most of the members mentioned that: *"... the balance of risks for inflation has improved in the short run, while in the medium term remained unchanged from the previous monetary policy meeting…".*

Banxico's rate hike motivated by the Fed's decision. All members agreed that the Fed's rate hike had important implications for Banxico's monetary policy decision in December. In particular, most members agreed that *"... while domestic conditions seem to suggest the desirability for keeping the reference rate unchanged, the Fed's reference rate hike and the decision of not adjusting Mexico's reference rate could generate an additional and disorganized MXN depreciation that could affect inflation and its expectations…".* Another member also mentioned that *"... [the decision of not adjusting Mexico's reference rate] could also affect financial stability and argued that given the Banxico's communication efforts, markets already expected an increase in Mexico's reference rate, after the increase in the federal funds rate, so the decision of not adjusting Mexico's reference rate could generate higher risks of disorderly movements in markets and could affect the credibility of the Central Institute…".*

Banxico hints a possible decoupling from the Fed. Although the Board justified that this rate hike was driven by the Fed's own increase in the federal funds rate, several members mentioned the convenience of decoupling from the Fed in future decisions. In particular, one member said that: *"…going forward and given the strong macroeconomic framework, if market nervousness about future interest rate increases of the federal funds rate is lower than the one observed around the first hike, Mexico's monetary policy would have more room to respond with additional flexibility to internal and external requirements…".* As a result of the latter, it is our take that Banxico is providing the market with a signal that the future movements in the reference rate will not necessarily follow the decisions made by the Federal Reserve.

We maintain our view that the Fed to hike 75bps in 2016, while Banxico will do only 50bps, with the reference rate ending next year at 3.75%. 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:

Mexico's yield curve portrays an attractive valuation as Banxico could normalize its policy stance gradually, while the peso remains vulnerable to the external environment. Today's minutes were in line with our expectations, reaffirming the need to act after the Federal Reserve despite domestic conditions of tamed inflation and economic slack (with a negative output gap) that signal an absence of demand-side pressures to prices. In our view, Banxico could continue hiking rates in tandem with the Federal Reserve at the beginning of 2016. Nevertheless, the restrictive cycle could be halted by mid-year, with realized cumulative hikes for the following 12 months maybe lower *vis-à-vis* the 82bps currently priced in the yield curve. The key factor will be the performance of the Mexican peso.

Mexican rates are trading in a low-volume environment with gains of 5bps on average in short-term tenors and 7bps in the long end, with the Mbono Dec'24 at 6.08% (-5bps on the day). We characterize the immediate reaction as modest. Ubidonos are mostly unchanged, also affected by low market turnover. Taking into consideration the variables mentioned above, we hold a positive view in terms of the belly of the Mbonos curve, especially 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 3.94%. For further details, 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.

The Mexican peso is gaining 0.6% on the day, going from 17.38 to 17.28 per dollar and the best performer in EM. In our view, the reaction can be explained by two factors: (1) Low liquidity that amplifies movements; and (2) comments reinforcing that Banxico is likely to follow the Fed at least in the first stage of normalization. Since December 16 we recommended long USD/MXN positions at or below 17.00 per dollar. We now suggest taking profits around current levels, with a 1.6% gain excluding a (slightly negative) carry. As liquidity is expected to return on Monday, some investors could sell dollars given the adjustment in the past two weeks. Nevertheless, we maintain our overall cautious stance on the MXN and short bias. We believe that uncertainty on various fronts (Fed pace of normalization, oil prices and China) still suggest a relatively high likelihood of elevated volatility at least during 1Q16, affecting the peso's performance given low interest rate differentials to the US relative to other EM's and concerns over a possible deceleration in foreign flows in a complicated external environment, in which we expect the dollar to remain bid.

BANORTE IXE

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