

Banxico minutes – 50bps hike as a response to the uncertainty around the Mexican economy

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- Banxico published today the minutes of its monetary policy meeting held back on November 17, in which the board decided unanimously to increase the reference rate by 50bps to 5.25%
- The discussions focused on the following topics:
 - (1) Banxico's 50bps hike occurred in an environment of high uncertainty, in which the central bank decided to maintain a balance between exercising caution, but avoiding lagging behind the prevailing situation
 - (2) 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;
 - (3) Even though Mexico's economic growth was higher in 3Q16, the balance of risks for growth deteriorated, as a result of the uncertainty surrounding the impact of Donald Trump's policies to the Mexican economy; and
 - (4) The fiscal actions acquire special relevance to strengthen Mexico's macroeconomic framework
- We maintain our view that Banxico will increase the reference rate by 25bps in December, immediately after the Fed

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Preventive 50bps hike. Banxico released today the minutes of the monetary policy meeting held two weeks ago (November 17), in which the board unanimously decided to increase the reference rate by 50bps to 5.25%. The discussions focused on the following topics: (1) Banxico's 50bps hike occurred in an environment of high uncertainty, in which the central bank decided to maintain a balance between exercising caution, but avoiding lagging behind the prevailing situation; (2) 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; (3) even though Mexico's economic growth was higher in 3Q16, the balance of risks for growth deteriorated over the previous meeting, as a result of the uncertainty surrounding the impact of Donald Trump's policies to the Mexican economy; and (4) the fiscal actions acquire special relevance to strengthen Mexico's macroeconomic framework

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Banxico increased the reference rate in order to counteract inflationary pressures arising from exchange rate pass-through. Within Banxico's monetary policy minutes, the central bank highlighted that given the uncertainty prevailing around the Mexican economy, the 50bps hike in the reference rate was a precautionary measure to counteract external shocks. In particular, one member commented that: *"... in this environment of high uncertainty, a balance must be maintained between being cautious but avoiding lagging behind the prevailing situation, and taking hasty measures that may not be justified."* In this context, several members of the central bank's Governing Board emphasized that monetary policy adjustment should: *"... reinforce the anchoring of inflation expectations, focus on narrowing the pass-through effect of the exchange rate to prices, and generate an orderly process of the decompression of term premia, which is even more relevant given the phase of the cycle in which the Mexican economy stands."*

The balance of risks for inflation has deteriorated. Most members highlighted that the balance of risks for inflation has deteriorated in the intermeeting period. Several members said that: *"...the main risk for inflation is that given the uncertainty associated with the external backdrop, an additional depreciation of the exchange rate could contaminate inflation expectations..."*. Most members also highlighted that the risk of a greater pass-through effect of the exchange rate to prices has increased, which some have associated with the fact that the exchange rate shock may be of a permanent nature".

Lower growth prospects. Within the minutes, several Board members emphasized that the balance of risks for economic growth also deteriorated in the intermeeting period. While the Mexican economy posted a better performance during the third quarter of the year, the minutes show that: *"...Among the downside risks, the majority of members highlighted the protectionist policies that may be implemented in the United States, since it is our principal trading partner. One member pointed out also the lower growth of remittances inflows and the possibility that the uncertainty surrounding the current situation is already affecting some investment decisions, while another member also highlighted that the current economic environment is less conducive to foreign investments in the country."*

Fiscal adjustments to strengthen Mexico's macroeconomic framework. The majority of the Board emphasized the need to adopt the necessary fiscal measures to strengthen Mexico's macroeconomic framework. In particular, several members commented that: *"...given the recent concern regarding the evolution of Mexico's public finances, fiscal actions are particularly important. One member stressed out that: "...the perception of sovereign credit risk has increased, even at levels comparable to those of economies with a lower credit rating. For this reason, carrying out an additional fiscal adjustment can not only prevent a reduction in Mexico's credit rating, but could boost an improvement, by favorably surprising the market and even helping to lay the correct foundations for any negotiation with the new US government."*

We expect a 25bps hike in the reference rate in December. Looking ahead, we continue to forecast a highly volatile exchange rate market, given: (1) If Trump's fiscal stimulus does materialize, inflation might be higher and the Fed's hiking cycle could be faster than our base-case scenario; (2) Trump's future comments regarding *NAFTA* and the bilateral trade relation; and (3) Oil price volatility. Moreover, we expect a 25bps hike from the Fed in December. In this context, we believe that Banxico will increase the reference rate by 25bps in their next monetary policy meeting on December. However, we do not rule out a 50bps hike if FX volatility increases in the coming weeks.

From our fixed income and FX strategy team:

Banxico is likely to align its strategy to Fed's future actions, but still aware of FX dynamics. Today's minutes concurred with last week's Quarterly Inflation Report, highlighting a shift of a strategy that will be likely align with the policy path of the Federal Reserve in coming months. Banxico stressed out the risks on inflation and growth associated with current global conditions, starring the outcome of U.S. elections. However, it seems that monetary policy has a limited space going forward. Taking into consideration these conditions, we acknowledge that the short-end of the yield curve is depicting an overshooting in terms of implied rate hikes priced in. The market is discounting 132bps of cumulative increases in the 12 months ahead. On the other hand, current inflation dynamics could have important implications in 2017. Recent polls have depicted important forecast adjustments for next year to levels close to 4.0%yoy from a previous 3.2%-3.4% range. Even Banxico has increased its expected inflation for the next year inside the Quarterly Inflation Report published yesterday. The market is pricing inflation breakevens hovering around 3.8% in every tenor from 3.3% a month ago. Taking into consideration current conditions, we suggest reducing exposure in Mbonos and increasing their positions in CPI-linked Udibonos, as a defensive relative value strategy. The Udibonos with the most attractive pricing are the ones maturing on Jun'19, Dec'20 and Jun'22. In the FX market, the Mexican peso is falling 0.9% on the day to 20.76 per dollar. It is worth noting that the loss was mainly a reaction to the surprise announcement of the resignation of Banxico's Governor Agustín Carstens, effective on July 1st, 2017. In our view, this further adds to the already high degree of uncertainty faced by our country. On the other hand, we believe that the minutes are consistent with the recent message that a real exchange rate depreciation is necessary after the result of the US election. Coupled with comments about the persistent uncertainty faced by the economy due to this event, we maintain our view that appetite for MXN longs will stay low at least until next year, with higher risk premiums and a low likelihood of a significant reversal until we have more information about the possible changes in the relationship between Mexico and the US. In this context, we reiterate our preference for USD/MXN longs, with a strong support that was unable to break in the last days at 20.50 which we see as attractive to re-engage in dollar purchases, seeing also a modest probability of a strong peso appreciation beyond 20.00 per dollar on a mid-term horizon.

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