

Banxico decision – Two doves, just a 25bps cut

- Banxico decided to cut the reference rate by 25bps to 7.75%, in line with our call and market expectations
- The decision was not unanimous, with two members in favor of cutting the reference rate by 50bps
- We believe the tone of the communique was slightly more dovish than the previous communique, highlighting:
 - (1) The balance of risks for global and domestic growth remains skewed to the downside, with the local economy still in stagnation;
 - (2) The recognition of the decline in headline inflation to the 3% target, despite the stickiness of core inflation
 - (3) The global dovish wave, with risks for the global economy still to the downside
- We noted that the balance of risks for both growth and inflation remained unchanged relative to the previous decision
- Nevertheless, our linguistic analysis showed that “inflation” is no longer the most mentioned word, replaced by “risks”. In addition, “prices” lost relative weight, while “convergence” gained
- We now expect a 25bps rate cut in each of the two remaining monetary policy meetings of 2019, with the reference rate at 7.25% by year-end
- In 2020, we expect the reference rate to end the year at 6.00%, with 75bps of easing taking place in the first semester
- The minutes of this meeting will be released on October 10th
- Strategy: Banxico delivered a dovish cut, reinforcing the pricing of the yield curve. We hold a positive view in terms of interest rates given Banxico’s expected strategy going forward and the possibility of further stimulus worldwide

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Recent votes by Banxico’s Board

Vote	Sep-19	Aug-19	Jun-19	May-19
Unchanged	--	1	4	5
-25bps	3	4	1	--
-50bps	2	--	--	--

Source: Banxico

Banxico cuts the reference rate by 25bps, to 7.75%. The decision was in line with our call and market expectations, with only a few participants anticipating a 50bps cut. Nevertheless, the decision was not unanimous, with two members in favor of cutting the reference rate by 50bps, to 7.50%. In our view, the tone was slightly more dovish than the previous communique, based on the fact that: (1) There were two dissenting votes, favoring more aggressive easing (-50bps); and (2) our linguistic assessment suggests that “*inflation*” is no longer the most mentioned word, replaced by “*risks*”. In addition, “*prices*” lost relative weight, while “*convergence*” gained, as shown below. This contrasts with the perception of relatively few changes as the Board maintained the skew in terms of the balance of risks for both growth and inflation

September 26th, 2019 Statement Word Cloud



Source: Banorte with data from Banxico

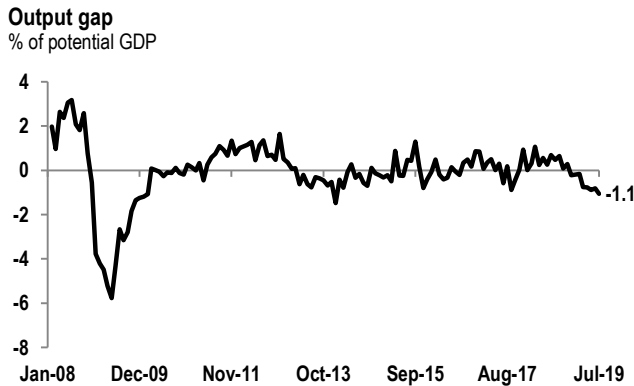
August 15th, 2019 Statement Word Cloud



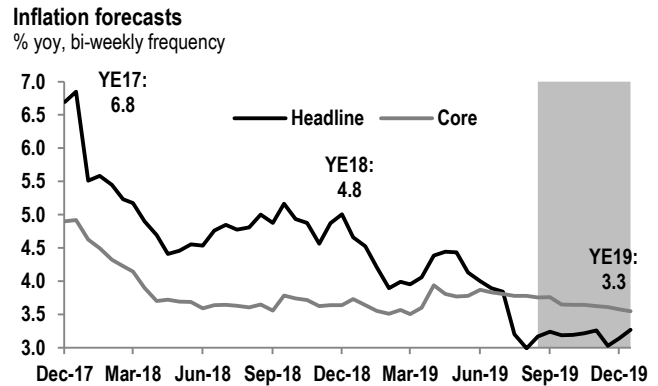
Source: Banorte with data from Banxico

The balance of risks, for both growth and inflation was unchanged from previous meeting. Regarding global conditions, Banxico once again acknowledged the rate cut in the US, while also noting looser monetary policy in other regions, such as the Eurozone. In addition, they still highlight trade tensions having an impact on growth, thus they left the risks for global growth tilted to the downside. Going into Mexico, they noted the stagnation in economic activity so far during the year until July, while mentioning for the first time that they expect a slight recovery in the remainder of the year, in line with our expectation (for further details see: “*IGAE – Stagnation persists, although positive signs start to emerge*” <[pdf](#)>). However, contrasting with our own calculations, they stated that slack conditions remain relatively unchanged with respect to the last decision. In particular, our latest estimate puts the output gap at -1.1% of potential GDP, 20bps lower than in the August meeting (see chart below on the left).

On inflation, the Board recognized the steep fall in the headline index, standing at 2.99% yoy. Nevertheless, they still stated that the core component continues to show resistance to the downside, near 3.8% yoy. We did not perceived significant changes to factors, both to the upside or downside, within the balance of risks, which was in our view confirmed by the final statement on this manner remaining the same as in August. This is consistent with our inflation forecast of 3.3% at the end of the year, which takes into account a slight moderation in the core component coupled with limited pressures from energy and agricultural goods (see chart below on the right).



Source: Banorte with data from INEGI



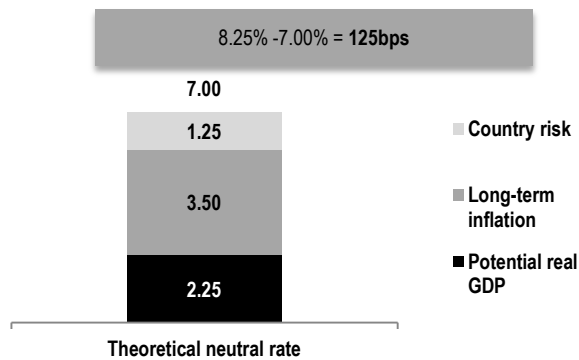
Source: INEGI, Banxico

We believe Banxico to cut the reference rate by 50bps before year end. In our view, the monetary authority is inclined to lower interest rates, particularly given the two dissenting votes in favor of a 50bps cut. Therefore, we now expect two additional 25bps rate cuts for the rest of the year, instead of only one. Specifically, we believe the central bank will cut the reference rate in the two remaining decisions of the year, in November 14th and December 19th. As a result, the reference rate would end this year at 7.25%, continuing with the easing cycle that started in August. We believe that some of the most immediate risks to financial stability have waned, which were the main reasons behind Banxico’s unchanged stance during the first half of the year. Among others, the *2020 Budget Proposal* continued to show a firm commitment with healthy public finances, while recent measures to bolster Pemex’s financial position and liquidity were favorably received by market participants.

The easing cycle will likely continue in 2020, with the rate by year-end at 6.00%. In particular, we expect the easing to be front loaded, with 75bps of cuts taking place in the first semester. In this respect, we have previously argued that Banxico’s easing cycle could total 125-200bps (see charts below). Considering the upper end of the range, this would result in a terminal rate of 6.25%. Nevertheless, we increase our conviction that the central bank will find slightly more room to cut than previously anticipated.

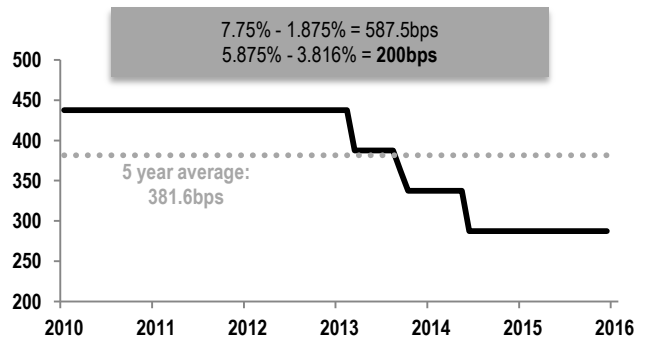
The most relevant driver behind this adjustment is the fact that global central banks have started to cut simultaneously. With global recession risks increasing and a muted inflation outlook worldwide, we believe this situation will likely continue in the foreseeable future. In our view, this global context provides the central bank with additional flexibility. In particular, this would allow Banxico to maintain a prudent stance (with its importance stressed again in today’s communique) and provide more stimulus at the same time, given that the relative attractiveness of Mexican assets –as measured by the short-term interest rate spread– does not compresses as much as if Banxico ‘goes solo’ or in a context of tighter monetary conditions globally. Additionally, the central bank’s latest estimate of the neutral rate stands at 2.6% in real terms (range: 1.8%-3.4%), which assuming 3% inflation, implies a 5.6% neutral nominal rate (range: 4.8%-6.4%). Thus, our projection of the terminal rate within the easing cycle would actually be 40bps above Banxico’s mid-point estimate of neutrality.

Theoretical “neutral” reference rate
%



Source: Banorte

Spread between the mid-point of the Fed funds rate and Banxico's reference rate
Bps



Source: Federal Reserve, Banco de México

We should still take into account that both global and domestic risks could result in a shallower easing cycle than our projections, particularly if there is a strong increase in financial market volatility. Some of the most relevant include the Brexit process, the US Election and a worsening situation in the geopolitical front. Domestically, we will remain focused on several issues, including the possibility of additional rating downgrades –both to the sovereign and Pemex– and fiscal challenges due to a low-growth environment that could eventually compromise the government’s targets, although not currently in our base case scenario.

From our fixed income and FX strategy team

Banxico delivered a dovish cut, reinforcing the pricing of the yield curve.

We hold a positive view in terms of interest rates given Banxico’s expected strategy going forward and the possibility of further stimulus worldwide. In line with our expectations, Banxico delivered another 25bps rate cut, accompanied by a dovish communiqué, stressing out that two Board members voted for a 50bps rate cut. The central bank’s assessment, combined with the global easing cycle, suggests that additional cuts are in the pipeline for this and next year, as priced in the yield curve with a cumulative implied rate reduction of 183bps by the end of 2020. This valuation is consistent with our forecast adjustment in regards to Banxico’s policy rate, calling for additional rate cuts of 50bps this year, as well as 125bps for 2020, distributed by 75bps in 2020 first half and 50bps in the second semester. In the aftermath of this decision, the Mexican yield curve extended a rally experienced throughout the session, partially supported by a favorable performance in global fixed-income, closing with a 6bps appreciation that captured the central bank’s dovish bias and in spite of short-term securities that discounted the possibility of a 50bps reduction. We acknowledge that the actual global landscape will remain supportive for fixed income assets, especially taking into account the expectations about additional rate cuts from Banxico and other central banks. Nevertheless, we recommended taking profits in our long strategy in Mbonos Nov’38 and Nov’42 last Tuesday, waiting for better valuations to start new trade ideas.

For further details please consult: “Profit taking in our Nov’38 & Nov’42 long Mbono trade idea”, <[pdf](#)>, published on September 24th.

In the FX market, the Mexican peso depicted as initial reaction to Banxico's decision a modest rally that later diluted to trade again close to the 19.65 handle, extending in around 0.5% yesterday's 0.6% sell-off. The peso's recent price action has been influenced by a new USD strengthening phase, which has led the American currency to test monthly highs. Although the local rates' relative position against other regions is still MXN supportive, we see the potentially more aggressive stance from Banxico as an additional pressure factor for the remaining of the year and 2020's performance, as a greater carry erosion combines with a global risk backdrop that holds highly unstable. In this sense, we reaffirm our 2019 and 2020 year-end forecasts at USD/MXN 20.30 and 21.30, respectively, holding a tactical trade recommendation in USD long positions with a strong floor at the 19.30 technical cluster.

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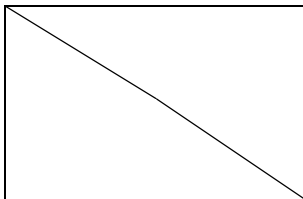
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	Reference
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