

Banxico joins the global dovish wave

August 15, 2019

- Banxico unexpectedly decided to cut the reference rate by 25bps to 8.00%
- The decision was not unanimous, with one member in favor of maintaining the reference rate at 8.25%
- In our view, the tone of the communique was more dovish than the previous statement, given:
 - (1) The global dovish wave, as reflected by the recent decline in local and global yield curves at different tenors;
 - (2) More confidence about the outlook for inflation; and
 - (3) A wider than expected output gap
- Our linguistic analysis shows a similar skew, with “inflation” once again losing relative weight; “slack” gaining relevance along with the addition of the words “convergence” –related to the inflation target- and “weakness”, regarding growth
- We now expect an additional 50bps of rate cuts for the remainder of the year, with the first 25bps cut taking place in the September 26th meeting, followed by a cut of the same magnitude in December 19th
- Nevertheless, the risk to our call is that the monetary authority delivers just one additional rate cut instead of two, amid a highly uncertain scenario, particularly regarding the sovereign and Pemex’s credit rating
- The minutes of this meeting will be released on August 29th
- Rally in local assets amid a shift in Banxico’s monetary stance

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August 15th, 2019 Statement Word Cloud



Source: Banorte with data from Banxico

June 27th, 2019 Statement Word Cloud

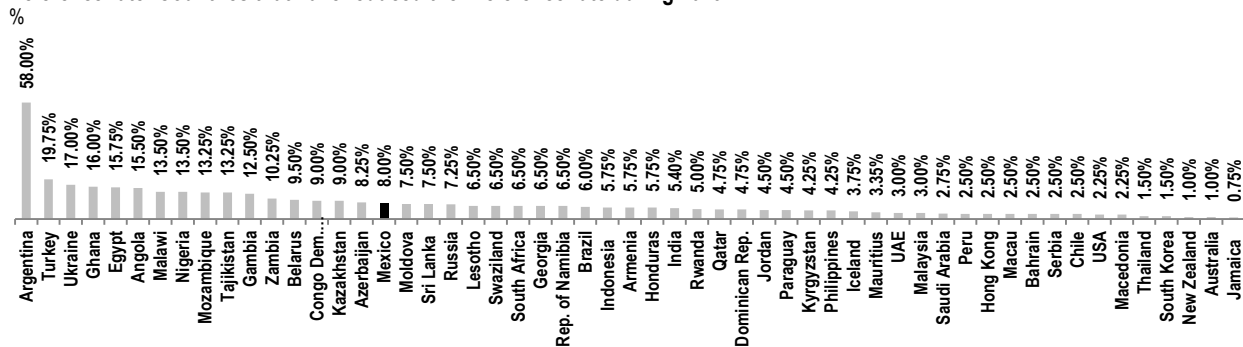


Source: Banorte with data from Banxico

Banxico cuts the reference rate by 25bps, to 8.00%. The decision was unexpected, and it was not unanimous, with one member in favor of maintaining the reference rate unchanged at 8.25%. In our view, the tone was more dovish than the previous communique, as the Board stressed: (1) A more difficult global economic growth backdrop, resulting in a global dovish wave; (2) relatively more confidence about the outlook for inflation (both at the headline and core level) and its convergence to target; and (3) risks for domestic activity still skewed to the downside. Nevertheless, Banxico reassured its prudent stance, given an environment characterized by a high degree of uncertainty. In this respect, we believe they remain focused on financial stability risks, such as the possibility of credit rating changes (both of the sovereign and Pemex), the outlook for fiscal accounts in an environment of more modest economic growth, and USMCA ratification in the US, among other factors.

Additional challenges for the global economy. As expected, the central bank argued that the outlook for the global economy has worsened. Among the reasons behind this they highlighted risks due to heightened trade tensions, the possibility of a no-deal *Brexit*, and a further deterioration of other geopolitical risks. Moreover, they stated that tensions between the US and other countries arose in trade, migration, and technological issues, along some aspects of exchange rate policy. As a result, a wide number of central banks around the world have adopted a more accommodative monetary policy stance, a situation dubbed as the global dovish wave. In this respect, 55 central banks have eased policy so far in 2019, including Banxico today, as shown in the chart below.

Reference rate: Countries that have reduced their reference rate during 2019*



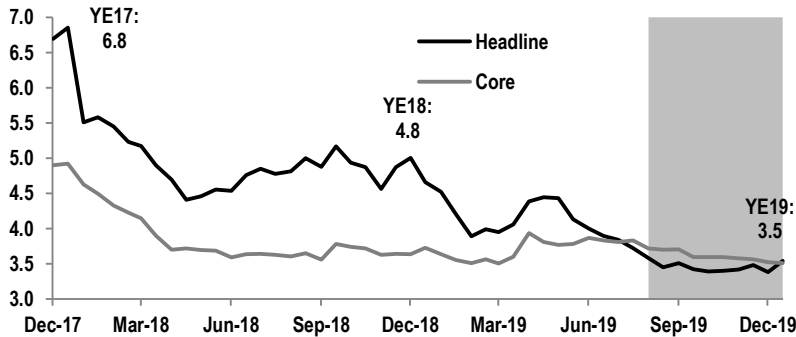
*Note: For the US, the reference rate shown in the upper bound of the Fed Funds range
Source: Bloomberg

More confident about the outlook for inflation, despite still elevated uncertainty. The monetary authority mentioned the recent decrease in headline inflation, on the back of lower pressures at the non-core level. Particularly, they highlighted the improvements in the prices of energy and fruits and vegetables, while meat and eggs remain under pressure. Overall, inflation seems not only to be largely in line with Banxico’s estimates (in 2Q19, average headline inflation was 4.2% yoy, below the central bank’s estimate of 4.3% in its latest *Quarterly Report*), but also firmly within the central bank’s target range in the last two months. Taking this into account, it should be noted that the Board stated that one of the driving forces behind the cut was “...that headline inflation has decreased, as foreseen by Banco de México...”.

More importantly due to the concerns expressed about the resistance to the downside of non-core inflation, we highlight the addition in the communique of some mitigating factors for this component going forward. Particularly, they flagged lower pass-through from energy and the effect of a widening output gap (see next paragraph). In our view, the central bank is signaling a more comfortable stance regarding the outlook for inflation, a situation that is closer to our below-market expectation for year-end inflation at 3.5% yoy (see chart below).

Inflation forecasts

% yoy, bi-weekly frequency

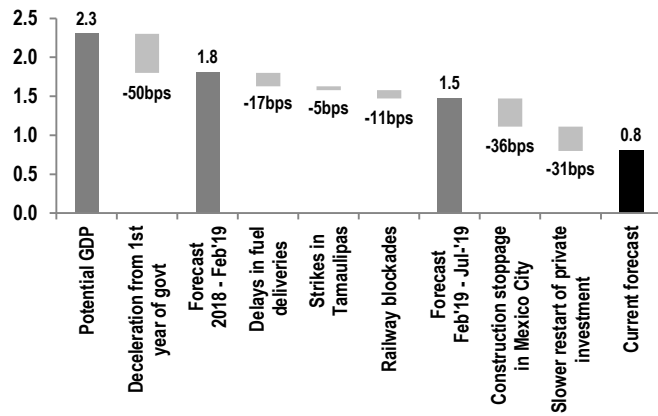


Source: INEGI, Banorte

The output gap widens more than expected. While Banxico did not elaborate much on recent developments in terms of activity, they mentioned that the preliminary estimate for 2Q19 GDP showed that the stagnation of the economy continued. As a result, slack increased further and at a faster than anticipated pace. Particularly, most recent data –June’s industrial production, among others–, gauge the possibility of a downward revision to 2Q19 GDP, from -0.7% to around -0.8% yoy. This is still consistent with our 2019 forecast of 0.8% (see chart below on the left), although we acknowledge that it represents an additional downside risk to our estimate. In turn, this could translate into an even wider output gap, which according to our estimates (using available data for *IGAE*), stands 1.1%-pts below potential, a situation we think could extend at least in the following quarters. Overall, we believe that information on this front supports our call for further easing from the central bank.

2019 GDP growth forecast

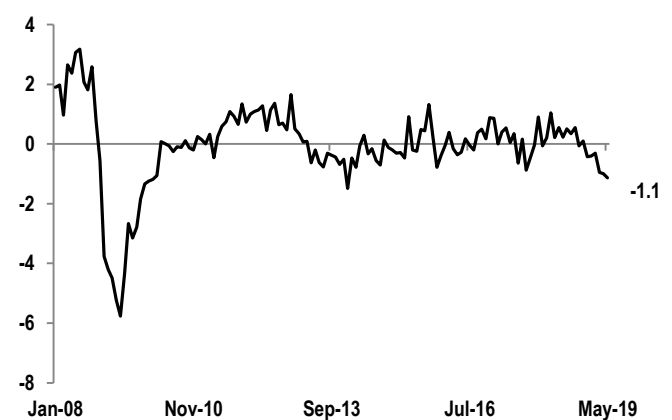
% and contribution in bps



Source: Banorte

Output gap

% of potential GDP



Source: Banorte with data from INEGI

We now expect an additional 50bps of cuts for the rest of 2019. In our view, Banxico will cut the reference rate by 25bps in September 26th, followed by a reduction of the same magnitude in December 19th. As a result, the reference rate would end this year at 7.50%, lower than our previous expectation of 7.75%. For 2020, we expect additional cuts between 50 and 75bps, within an easing cycle that we have previously argued could total between 125-200bps.

Finally, the main risk to our call is that the central bank cuts only by an additional 25bps this year. Banxico reiterated that it is necessary to address the deterioration of both the sovereign's and Pemex's credit rating and achieving the fiscal targets for 2019. More relevant though, they added that: "...*It is also important that the Economic Package for 2020 generates confidence...*", which must be presented to Congress no later than September 8th. In our view, this latest comment is likely linked to the potentially negative effect on tax revenues that could stem from an environment of lower economic growth, which would also increase the risk of additional credit actions by the major rating agencies. In this sense, *Moody's* recently stated that there is a higher risk that the Federal Government does not achieve its primary surplus goal for 2019 (1% of GDP). Although we recognize that this risk has increased, particularly as it could impact Pemex's rating to be downgraded below investment, it is our base-case scenario that the Federal Government will remain committed to sound fiscal accounts, with adjustments along the way in terms of spending in case of lower tax collection.

From our fixed income and FX strategy team

Rally in local assets amid a shift in Banxico's monetary stance. Banxico decided to deliver a 25bps rate cut today, accompanied with a dovish communiqué, suggesting additional adjustments in its monetary stance this year. This decision was not fully priced in by market participants, as the yield curve discounted an implied probability for a rate cut today of only 29.3% vs. 61.6% in the September meeting. The Mexican central bank is acknowledging that global monetary conditions have eased recently (*i.e.* 54 central banks have cut rates in 2019), putting the country in a more restrictive stance in a relative-valuation basis (*e.g.* 95bps of premium over the spread in short-term real rates with the U.S.). The world is entering a new paradigm in terms of interest rates, with Europe trading in negative territory in basically every tenor and a flatter yield curve in the U.S. (curve inversion between several tenors). This situation in tandem with better CPI dynamics and a weaker economy argues in favor of a lower repo rate going forward, as discounted by the yield curve with -36bps of implied cuts for the remainder this year and -140bps until 2020-end. Banxico eased monetary conditions this Thursday, despite the impairment of the global landscape given several geopolitical risks (*e.g.* concerns about trade tensions, possible contagion from the Argentinean sell-off, among others) and some idiosyncratic factors in Mexico that are not fully priced in the country risk premium. In the aftermath of today's policy decision, Mexican bonds depicted a 16bps rally in Mbonos. In terms of strategy, we acknowledge that the low-rates environment in the world will be supportive for Mexican bonds.

In the FX market, the Mexican peso registers a slightly more positive session, following the sharp risk aversion wave in recent days which pushed the cross up to 19.78 per dollar on Monday and broadly affected the EM asset class. The peso originally reacted in a negative fashion to Banxico's policy decision, moving up to 19.77 but currently trading at 19.61, equivalent to a 0.3% appreciation vs. yesterday's close. The peso's recent performance has reflected a greater sensibility to global drivers. In the first place, the Chinese yuan weakening as a reaction to greater protectionist threats from the U.S. has triggered an important adjustment in several EM currencies. Reflecting this situation and contrasting to previous risk aversion periods in the year where MXN performed more resiliently, betas against the renminbi have surged (*e.g.* today at 0.24 from 0.06 prior to the additional tariff announcement on August 1st). Moreover, as previously commented, fractures in Argentinian assets are similar events to the ones observed just a year ago, with the market evaluating if this context has become a systemic or idiosyncratic risk, as well as its contagion degree to EM assets. Amid this optic, MXN is currently under a more complex global backdrop which has been captured by sharp volatility during August. Meanwhile, although Banxico's validation on a lower repo rate this Thursday suggests a potential carry weakening for the currency, we do not expect short-term significant erosion given rate spreads that remain favorable for Mexico. Controlling by this effect, we expect a peso navigating a complex outlook for the remainder of 2019, averaging 19.40 for this quarter closing at 19.68 and averaging 20.14 in the 4Q19 for a year-end close at 20.30 per dollar.

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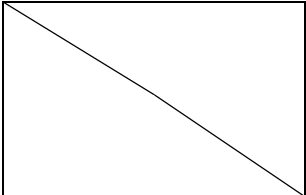
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