

Banxico's QIR – Monetary stance tied to the U.S. Fed

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- Banxico published today its *Quarterly Inflation Report (QIR)* for 1Q16
- We highlight the following issues:
 - (1) Measures taken during 1Q16, which included an unexpected rate hike on February 17 –as part of a coordinated action with the Ministry of Finance-, had the expected results;
 - (2) Growth forecasts for 2016 remained unchanged (between 2% and 3%) while the central bank lowered their expectation for 2017 to 2.3%-3.3% from a 2.5%-3.5% range;
 - (3) The output gap will remain in negative territory until the end of 2017;
 - (4) Inflation in 2016 will remain below 3% in the coming months, although at the end of the year will close around this level; and
 - (5) The inflation outlook remains favorable, so that the 12-month rate of inflation will remain hovering around the 3% target
- In the traditional “grey” boxes Banxico’s researchers tackle the following topics:
 - (1) Recent developments in Mexico’s terms of trade; and
 - (2) Recent changes in the transmission mechanism of monetary policy in Mexico
- We maintain our view that Banxico will hike the interest rates after the U.S. Fed in June

Lower growth ahead but inflation under control. The monetary authority released its *Quarterly Inflation Report (QIR)* for 1Q16. The release was accompanied by a press conference led by Governor Carstens. We highlight the following issues discussed in the document: (1) Measures taken during 1Q16, which included an unexpected rate hike on February 17 –as part of a coordinated action with the Ministry of Finance-, had the expected results; (2) growth forecasts for 2016 remained unchanged (between 2% and 3%) while the central bank lowered their expectation for 2017 to 2.3%-3.3% from a 2.5%-3.5% range; (3) the output gap will remain in negative territory until the end of 2017; (4) inflation in 2016 will remain below 3% in the coming months, although at the end of the year will close around this level; and (5) the inflation outlook remains favorable, so that the 12-month rate of inflation will remain hovering around the 3% target. In our opinion, Banxico’s *QIR* suggests that the central bank is tied to the U.S. Fed actions, even though they would be ready to act in case of extreme conditions, which are not currently present.

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Satisfied with emergency measures taken. Governor Carstens noted in his presentation that the measures taken during 1Q16, which included an unexpected rate hike on February 17 –as part of a coordinated action with the Ministry of Finance–, had the expected result. In this context, a considerable appreciation of the currency was observed, while interest rates in short-end of the curve increased with the ones in the long end came down, which implied a desired flattening of the yield curve.

A more dynamic economic growth in the first quarter. The report highlights that the performance of the Mexican economy during the first quarter of 2016 was better than the one at the end of last year, as a result of the dynamics observed in private consumption, while investment remained subdued and external demand expanded at a more moderate pace. According to the report, the pickup in consumption levels is explained by higher levels of employment and real wage gains, along with the implementation of structural reforms and a better dynamic of banking credit, among others. In this context, even though there is still some slack in the economy, this is reducing very gradually, although they expect the output gap remains negative until the end of 2017.

They expect growth in 2016 between 2% and 3%, and a less dynamic 2017. Banxico did not change its growth target for 2016, although it revised down its previous estimate for economic growth next year to a range between 2.3% and 3.3% from 2.5%-3.5% previously (refer the box below). Among the factors that could affect the economic dynamism, the central bank highlighted: (1) A slowdown in the global economy, U.S. industrial activity in particular; and (2) a more complex international backdrop with more stringent financial conditions that could impact investment plans. On the positive side, they underscored the possibility that the improvement in the labor market and expansion in the amount and the access to credit could lead to more dynamic private consumption. Moreover, they consider that the implementation of structural reforms could have more favorable and in a shorter period than anticipated effects on the economy.

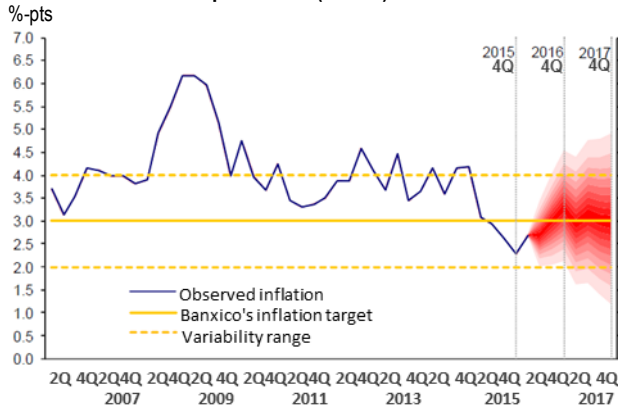
Banxico's Forecast Recent			Banxico's Forecast Previous Quarterly Report		
	2016	2017		2016	2017
GDP (%)	2.0 - 3.0	2.3 - 3.3	GDP (%)	2.0 - 3.0	2.5 - 3.5
Employment (thousands)	590 - 690	630 - 730	Employment (thousands)	610 - 710	650 - 750
Trade balance (bn)	-15.4 (1.4, %GDP)	-15.1 (1.3, %GDP)	Trade balance (bn)	-12 (1.2, %GDP)	-13.1 (1.2, %GDP)
Current account (bn)	-34.4 (3.1, %GDP)	-36.7 (3.1, %GDP)	Current account (bn)	-30.3 (2.9, %GDP)	-33.5 (2.9, %GDP)
Inflation			Inflation		
Headline	Transiently exceeds 3%	Around the permanent inflation target	Headline	Near 3%	Around the permanent inflation target
Core	Near 3%	Around the permanent inflation target	Core	Near 3%	Around the permanent inflation target

Source: Banxico

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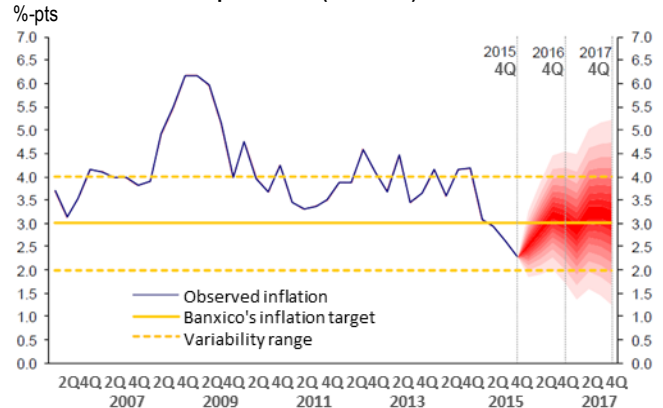
Banxico considers that inflation will be about 3% this year. The central bank said headline inflation will remain at levels below 3% in the coming months temporarily exceeding this figure in the last quarter, but finally closing the year at target levels. For 2017, Banxico expects that inflation levels will remain around the target. With respect to risks, they consider that structural reforms will continue to push down the price of some widespread used inputs, such as telecommunication services and energy items, while the dynamism of economic activity could be lower than anticipated. By contrast, an adverse external backdrop could trigger a disorderly depreciation of the exchange rate. In addition, they cannot rule out increases in the prices of agricultural products, although their impact on inflation would tend to be transitory.

Fan chart: Inflation expectations (Actual)



Source: Banco de México, 1Q16 QIR

Fan chart: Inflation expectations (Previous)



Source: Banco de México, 4Q15 QIR

The recent evolution of the terms of trade in Mexico has been positive. In the first “grey” box, Banxico’s research team shows that prices of Mexican non-oil imports, which are mostly of intermediate products, have fallen markedly, while the price of non-oil exports have remained stable. This implies an improvement in the terms of trade, in contrast to the terms of oil trade, which have deteriorated on the back of the reduction in crude oil prices. It concludes that while sluggish global demand continues to suggest risks to the Mexican external sector, it appears that the demand of consumer goods by the U.S. has maintained its dynamism, and therefore its price has not changed much. In this context, they suggest that Mexico should continue to allocate its resources towards production sectors that are highly demanded by the U.S.

Recent changes in the transmission mechanism of monetary policy in Mexico. The second “grey” box becomes more important amid current exchange rate depreciation trend and given market’s expectation that Banxico could hike rates, even before the Fed does so again. The box analyzes, after establishing that the main channel through which monetary policy operates is the expectations channel, the response of the economy to various economic shocks and the accordingly monetary policy response in each case. They conclude that the response of inflation to an exchange rate shock has been reduced and the responsiveness of this variable to return to the initial state is much faster than in the past, highlighting the strengthening of expectations channel. This implies that, since agents anticipate better the response of the central bank, the monetary policy stance could be less aggressive than in the past in order to mitigate the effects of such shocks, possibly due to the strengthening of expectations channel and the credibility that the central bank has been gaining.

We maintain our view that the central bank will probably hike rates in tandem with the Fed. Nevertheless, we cannot rule out the possibility that the monetary authority could increase the reference rate more than twice this year. Our base-case scenario for the Fed is that the FOMC will hike the Fed funds rate twice this year (25bps in June, and other 25bps in September or December). In this context, we believe that the next move by Banxico is a rate hike: 25bps on 30 June, after the Fed does the same at its meeting on June 15. Nevertheless, we cannot rule out the possibility that the monetary authority hikes more than 50bps this year, in case there is strong evidence of pass-through of exchange rate depreciation to inflation and/or there is a new episode of high volatility in international financial markets.

From our fixed income and FX strategy team

Relief rally in local rates in the aftermath of a less hawkish QIR. Mexican securities have observed a 3-4bps rally throughout the entire yield curve amid the release of Banxico’s QIR this afternoon, which was characterized by a less hawkish tilt *vis-à-vis* last week’s minutes and market expectations. Investors have acknowledge several factors commented previously in this research note suggesting the willingness of Banxico to be patient and stay put awaiting Fed’s decision, despite a significant deterioration in FX dynamics in May. In our view, conditions in the local fixed-income market could change in the aftermath of today’s information released by Banxico, with a valuation that has turned notably attractive following the sell-off started last week, in which the market priced in 100bps of implied cumulative hikes for this year. Despite the relief rally of the last two sessions and more appealing prices, we hold a cautious stance in terms of the local fixed-income market, waiting for the Federal Reserve in June, especially after the hawkish bias depicted by several FOMC members in recent days. As a result, we suggest waiting for better entry levels in the long belly of the Mbonos curve.

In the FX market, the peso is gaining 0.4% on the day at 18.42 per dollar. Nevertheless, it had a tight correlation with oil prices all day, lagging to them as Carstens's comments began. In our view, this was mainly because of the signal of a significantly low probability of discretionary USD sales. Specifically, he said that interventions were intended only in "really exceptional circumstances" and, unlike February, there was no evidence of a speculative attack against the currency. Considering these factors and a better relative behavior since the beginning of the past week (when analysts raised strongly their concerns about this possibility), we now believe it is much more unlikely to see an intervention in the short term. We reiterate our recommendation to buy USD/MXN on dips for trading purposes and attractiveness for directional longs in case of a fall towards the 17.90-18.00 zone.

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