Banxico minutes – High for long

- **Banxico published the minutes of the meeting held on February 7th, in which the Board decided to keep the reference rate at 8.25%**
- **In our opinion, the tone of the minutes is consistent with our take of a less hawkish bias in the last statement, particularly because of a more challenging backdrop for both global and local growth**
- **However, the central bank keeps emphasizing the need for maintaining a prudent stance, especially considering high uncertainty in the outlook for inflation, with risks still skewed to the upside**
- **Considering these, we maintain our forecast that the central bank will leave the reference rate unchanged at 8.25% during the rest of the year**
- **Further ahead, we see a higher probability of a rate cut in 2020**
- **Local markets sensed the dovish essence in Banxico's minutes**

In our opinion, the tone of the minutes is consistent with a less hawkish bias, in line with the last statement. Banxico published the minutes of the meeting held on February 7th, in which the Board decided unanimously to keep the reference rate at 8.25%. Recall that this was the first meeting with the votes of the two recently appointed Deputy Governors, Jonathan Heath and Gerardo Esquivel, who we believe are more focused on growth issues, which were reflected in some comments throughout the document. In particular, the central bank provided additional details about the factors behind the deceleration in global and local growth, with risks clearly skewed to the downside. Nevertheless, it is our take that the central bank maintains a prudent stance because of high uncertainty about inflation, with risks still tilted to the upside.

A challenging backdrop for global and local growth. In line with our expectations, there was a lengthy discussion about the outlook for economic activity. Globally, the majority stated that: "*…it is significantly biased to the downside and one pointed out that it has deteriorated...".* Among the factors highlighted, they mentioned: (1) An escalation in trade tensions; (2) lower than expected growth of the Chinese economy; and (3) political, geopolitical, and idiosyncratic factors. As a result, GDP forecasts for this year and 2020 have been revised lower. Additionally, one member stated that the probability of a US recession in the next twelve months has increased, while others added that some financial variables suggest this possibility. Domestically, the Board acknowledged that economic activity in 4Q18 decelerated strongly, with some comments regarding the possibility of extending to the first months of the year. Nevertheless, the conclusion was that it is still too soon to tell as there is not enough information available yet. In addition, they showed some concern over the possible adverse impact that the delay in fuel distribution, railway blockades, and strikes in Tamaulipas, among others, could have in activity. In this context, the majority highlighted the downward revisions in GDP forecasts for 2019, with one member adding that "*...a negative growth rate for the first quarter of 2019 would not be surprising…*", while other reminded that "*...the most worrying concern is the deteriorating prospects for growth…*".

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Among the main risk factors, they included: (1) Obstacles in the USMCA ratification process; (2) greater domestic uncertainty and less confidence in the outlook for the Mexican economy; and (3) delays in the execution of public spending. Regarding mid- and long-term risks, the majority of members highlighted: "…*Pemex's financial fragility and outlook, and, in particular, an additional downgrade to its credit rating as it could have an impact on the federal government's financial cost and, in general, on the country's conditions for accessing external financing…*". In conclusion, all members said that the balance of risks for growth remains to the downside, with some considering that it worsened further.

Despite the improvement in headline inflation, the Board remains cautious. The Board noted that, from November to January, headline inflation decreased from 4.72% yoy to 4.37%, mainly due to the reduction in non-core inflation. Nonetheless, one member warned that the decrease in January was influenced by one-off adjustments such as the VAT reduction in the Northern Border. Additionally, all members still agree that core inflation has stubbornly remained around 3.6% during the last ten months. This is a source of concern considering that core inflation is a more adequate indicator to gauge fundamental price pressures and the one that should respond more forcefully to monetary policy actions.

Another factor highlighted was the mixed performance of inflation expectations, as those for headline improved, but those for core inflation did not. Moreover, some members said that the persistence of core inflation has contaminated expectations. Among the risks, the majority mentioned the possibility of pressures in the peso exchange rate, while also including: (1) Renewed pressures in energy and/or agricultural prices; (2) the possibility of an escalation in protectionist measures; and (3) a deterioration of public finances. Some said transitory shocks observed in the first months of 2019 were also an upside risk, while everybody agreed that the magnitude of the minimum wage increase could result in both direct- and indirect- effects on prices. In this respect, most members: "…*considered that the balance of risks with regards to the expected path of inflation continues to be biased to the upside, in an environment of marked uncertainty…".*

***Hawks* vs. *Doves*.** Throughout the minutes we observed some comments with a clear easing bias, while the bulk of opinions with a more restrictive tone were located at the end of the document. On the dovish side, one that grabbed our attention was related to the central bank's stance going forward, arguing: "…*that the central bank should remain vigilant to the conditions prevailing in Mexico's economy so that a very restrictive monetary policy stance is not in place for too long, in case the economy's slack conditions continue to widen significantly*…". By contrast, another said that: "…*the central bank message should not reflect an easing of monetary policy stance given the weakening of economic activity, but rather convey the persistence of risks to inflation, thus strengthening monetary policy's credibility…".*

We maintain our forecast that the Banxico will leave the reference rate unchanged at 8.25% in 2019. In the overall balance, we believe that Banxico's board is more concerned about upside risks to inflation, justifying the need to maintain a prudent stance. In particular, they remain vigilant because of the high degree of uncertainty and consider that the recent fall in inflation has been driven by the decline in the non-core component, while core inflation remains stubbornly high. Nevertheless, we believe the minutes confirm our previous assessment that the Board is less hawkish due to lower growth prospects, both globally and domestically, which is likely to result in higher slack in terms of the output gap. Considering all these factors, coupled with our outlook for growth, inflation and global monetary policy, we maintain our view that the central bank will remain on hold at 8.25% for the rest of the year. Further ahead, we see a higher probability of a rate cut in 2020.

From our fixed income and FX strategy team

Local markets sensed the dovish essence in Banxico's minutes. Banxico's minutes released this Thursday came dovish in essence, but holding a cautious stance regarding its monetary policy management strategy, a situation broadly expected by the market. As a result, the yield curve depicted few variations, with a mild profit taking following a positive performance throughout this week. Disaggregating the information within the minutes, on the one hand they highlighted dovish comments regarding the current growth backdrop, supporting the recent flattening of the yield curve (2- *vs* 10-year tenors) to 25bps, after picking up from 14bps to 36bps in January. However, it is worth singling the possible deterioration in longer-term securities due to the credit risk component. In this sense, rate spreads against U.S. Treasuries have recently stabilized, a reflection of investors acknowledging at these levels a consistent risk premium with the current Mexican profile.

On the other hand, Banxico's Board members took some neutral allusions in respect to CPI dynamics, recognizing the headline inflation improvement *vis-à-vis* the previous monetary policy communiqué, but granting a balance of risks which is still upwardly biased, with the core component finding strong resistance for a faster convergence to its objective during the last 10 months, a factor that could affect inflation dynamics going forward, as well as mid- and long-term expectations which are still away from the target. In this sense, 3- and 5-year inflation breakevens trade at 3.76%, below the 12-month median at 3.92% and 3.95%, respectively. Moreover, implied expectations in the 10- and 30-year readings locate at 4.05% and 4.19%, with a more limited premium with respect to previous weeks. This suggests a still expensive relative value for Udibonos *vs* Mbonos. Broadly speaking, this argues for greater stability in interest rates on the back of the high spread against the U.S., which implies a very attractive carry in Mexican tenors. Specifically, the short-term ex ante rate spread is holding high at 442bps. However, this will be conditioned to the drivers of the risk premium embed in Mexican interest rates.

Considering these factors, we see appropriate waiting for better entry levels in directional long positions in the belly of the Mbonos curve, after the profit taking strategy in Mbonos Jun’22 and Dec’23 last week.

In the FX market, the reaction after the minutes’ release was modest with MXN holding levels close to 19.24 per dollar, equivalent to a 0.2% sell-off in respect to yesterday’s close. However, the currency has moved toward USD/MXN 19.30 recently. Within the document, we highlight the references regarding the important adjustment recently seen in the real exchange rate, derived from the crude-oil trade balance weakening and lower availability of foreign resources. Expressed as a higher real exchange rate, it is also important to comment on the competitiveness effects resulting from current inflation dynamics, and specifically due to the core component persistence. According to our REER model, the Mexican peso has as of today a fair value close to 18.98 per dollar. On the back of current conditions, this situation suggests a short-term trading range limited to a floor close to these levels. Consistent with the latter, USD/MXN performance has found a strong resistance at the 18.88 region (January’s lows) and difficulty breaking the 19.00 barrier. We do not rule out price action again around these ranges, where we would evaluate re-opening long USD recommendations, reaffirming our view of an expensive valuation at these levels.

Analyst Certification

We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Francisco Duarte Alcocer, Jorge Antonio Izquierdo Lobato and Leslie Thalía Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. de C.V for the provision of our services.

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HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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