Banxico – A slightly more hawkish stance, with an eye on

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- **Banxico just announced its monetary policy decision, in which the board decided to remain on hold, as it was widely expected**
- **We highlight that this was the first monetary policy meeting after Banxico's Board of Governors decided to increase by 50bps the reference rate in an extraordinary meeting held back in February 17**
- **In our view, the tone of the *communiqué* was slightly more *hawkish* with respect to previous release (February 4th) because:**
  (1) Even though Banxico acknowledged the favorable impact that their decision to hike rates –back in February 17th-, has had on domestic markets, they cannot rule out other episodes of increased volatility;
  (2) They consider that short-term inflation balance of risks has deteriorated, paying particular attention to FX pass-through; however
  (3) Even though they think that the balance of risks for growth remained unchanged, they perceive some signals of moderation, in particular in household spending
- **We maintain our view that Banxico is likely hike in tandem with the U.S. Fed, who we expect will hike twice this year (25bps in June, and another 25bps in September or December)**
- **Despite the above, we do not rule out the possibility of Banxico hiking more than twice this year, if there is strong evidence of FX pass-through on inflation and/or there is a new episode of high volatility**
- **The minutes of this meeting will be published on the 1st of April, and the next monetary policy announcement will take place on the 5th of May**
- **We expect the Mexican yield curve to continue flattening**

A slightly more *hawkish* stance. Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3.75%, as it was widely expected. In our view, the central bank has become slightly more *hawkish*, because: (1) Even though Banxico acknowledges the favorable impact that their decision to hike rates –back in February 17th-, has had on domestic markets, they cannot rule out other episodes of increased volatility; (2) they consider that short-term inflation balance of risks has deteriorated, paying particular attention to FX pass-through; however (3), even though they think that the balance of risks for growth remained unchanged, they perceive some signals of moderation, in particular in household spending.

The balance of risks for growth remained unchanged. According to Banxico's communiqué, the balance of risks for global growth remained unchanged, with activity in the U.S. firming in 1Q16 and the ECB and the BoJ continue with an accommodative monetary policy stance. Activity in emerging markets remains weak while China still poses a risk for global growth and financial stability. In Mexico, economic activity has moderated, particularly in terms of private consumption, while exports have been stagnant. However, the central bank *"...does not expect demand-side pressures on prices...."* and considers that there is still slack in the economy.

Exchange rate and volatility, key to inflation. Banxico explains that inflation recently reached 2.8%yoy –after touching historical minimums of 2.1% at the end of 2015-, on the back of an increase in agricultural prices and increases in merchandise prices, as a result of exchange rate depreciation. They expect inflation to end the year around 3%yoy, yet they mention pass-through as one of the main risks not only for inflation in the short-term but also for anchoring inflation expectations in the medium and long term.

We continue to believe that Banxico will follow the Fed, but with the possibility of hiking more than twice in 2016. Last FOMC meeting was slightly more dovish than expected, among others, because the *dot plot* suggested only two 25bps hikes in 2016 vs. four hikes estimated back in December 2015. We agree with the view that the Fed will hike twice this year, 25bps in June and another 25bps in September or December depending on economic conditions. In this context, we believe that Banxico's next move will be a 25bps rate hike in June 30th, right after the Fed does so in its FOMC meeting of June 15. Nevertheless, we do not rule out the possibility of Banxico hiking more than twice this year, if there is strong evidence of FX pass-through on inflation and/or there is a new episode of high volatility

From our fixed income and FX team

We expect the Mexican yield curve to continue flattening. Local rates registered a modest reaction to Banxico's communiqué, with self-effacing increases previous to a week characterized by lower liquidity. However, the weekly balance has been positive for Mexican bonds, mainly in the mid- and long-end of the curve. Investors have digested a dovish rhetoric from the Federal Reserve on Wednesday in tandem with looser monetary conditions from other central banks such as the ECB, BoJ and PBoC. In Mexico, the curve continues discounting nearly 50bps of cumulative implied hikes this year, which we still see as attainable. Nevertheless, we do not rule out a possible shift lower in between 25-50bps in case global central banks perpetuate an environment of higher lassitude and the peso extends its recent rally. On the other hand, the 5y5y forward rate stands at 6.62% from 7.02% a month ago, suggesting more limited gains in this section of the curve as opposed to the 10- and 20-year zone, especially given a higher slope.

Taking into consideration technical and fundamentals, we observe an attractive relative valuation in 10- and 20-year Mbonos, especially Jun'22, Dec'24, Mar'26 and May'31 tenors. In addition, we expect Udibonos to recover going forward as inflation dynamics could improve the embedded carry in the 2H16, and valuation remains attractive. In this regards, inflation breakevens, especially in the mid-end of the Udibonos curve are appealing for long positions, hovering around 2.8%, below Banxico's target of 3%. However, investors will remain cautious as depicted in recent auctions. Taking into consideration our CPI forecasts, the annualized carry for UDI-linked securities until 2Q16 could be of -2.7% annualized, but in the second half of 2016 the potential carry is of nearly 5.1%. Overall, the tenor of the Udibonos curve with the most attractive valuation is the 10-year security; however we suggest waiting for better entry levels.

In the FX market, the Mexican peso did not react meaningfully to the report, trading with a small 0.2% loss on the day of 17.34 per dollar after surging 3.2% in the two days following the Fed meeting. If any, the most important thing for the currency is the suggestion that another disorderly appreciation of the currency is a special factor that Banxico will keep an eye on due to the risk of a potentially higher pass-through to inflation. In our view, this gives a very moderate hawkish undertone to the communiqué, albeit balanced with the explicit comment that a downside risk for prices would be a greater appreciation of the currency. As we have already mentioned, we believe that there are at least two necessary conditions that could potentially trigger a response from the authorities (either selling USD or hiking rates): (1) A rapid and strong depreciation not only in absolute terms, but relative to other EM; and (2) that the latter were coupled with a deterioration in liquidity conditions, such as significantly higher bid-ask spreads. In terms of strategy, we have upgraded our short-term and trading stance on the peso after the Fed's decision (with a more dovish stance than expected), which could impact the dollar at least in three ways: (1) The fall in short-term US rates and implied probabilities of the next rate hike by June –which remains our base case- strips support of higher interest rate differentials; (2) the dovish signal was provided despite relatively good economic data in the US, placing risk markets in a "sweet spot" as recession expectations have waned but stimulus by the Fed is still hoped to be very ample, at least in the short-term; and (3) apart from other important central banks that eased in recent weeks (e.g. PBoC, ECB, BoJ, RBNZ, BoE), market volatility has plunged in the aftermath of the decision, helping investors to be more confident in adding risk to their portfolios and carry trades. As a result, we now favor USD/MXN short positions for trading purposes and believe that the peso could test its immediate support at 17.20 (last year's close), followed by 17.10 (Fibonacci level) and even up to the psychological level of 17.00 in coming weeks.

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