

Banxico – Unchanged balance of risks and still tied to the U.S. Fed

- Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected
- In our opinion, the tone of the statement was very similar to the previous one as the board considered that the balance of risks for both growth and inflation has remained virtually unchanged
- According to the document, cyclical conditions of the Mexican economy show weakness while inflation will remain below the 3% target in 2015
- Nonetheless, board members warned that: “...any actions from the U.S. Fed could have repercussions on the Mexican exchange rate and inflation expectations...”
- In this context, we believe that Banxico remains "tied" to monetary policy decisions in the U.S.
- Today’s meeting minutes will be released on June 18, and next monetary policy announcement will take place on June 23
- Banxico’s communiqué brought no surprises for markets –a true nonevent– this Thursday

Monetary policy decision - Rate and tone unchanged. Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our opinion, the tone of the statement was very similar to the previous one as Banxico’s board considered that the balance of risks for both growth and inflation have remained virtually unchanged. In this context, the central bank acknowledged that the cyclical conditions of the Mexican economy show weakness while inflation will remain below the target in 2015. However, board members warned that: “...the Fed’s actions could have repercussions on the exchange rate and inflation expectations...”, which lead us to believe that Banxico remains "tied" to the actions of the monetary authority in the United States.

Potential delay in the Fed’s normalization process. While Banxico monetary policy board believes that market participants expect a more restrictive monetary stance from the U.S. Fed, they stressed that “... In response to weakness in economic activity [in the US] in the first quarter and to the revisions in growth expectations for this year, consensus agrees that the date of the first increase in the reference rate will be delayed and that the pace of subsequent increases will be gradual....”.

June 4, 2015

www.banorte.com
www.ixe.com.mx
@analisis_fundam

Gabriel Casillas

Chief Economist and Head of Research
gabriel.casillas@banorte.com

Delia Paredes

Executive Director of Economic Analysis
delia.paredes@banorte.com

Alejandro Cervantes

Senior Economist, Mexico
alejandro.cervantes@banorte.com

Fixed income and FX Strategy

Alejandro Padilla

Head Strategist - Fixed-Income and FX
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA

FX Strategist
juan.alderete.macal@banorte.com

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The slow recovery of the Mexican economy continues. In our opinion, the tone of the statement regarding the growth is marginally more positive than in the statement of April 30th. While the central bank considers that the balance of risks for both, global and the Mexican economy has not changed since the last meeting, Banxico highlights the improvement in non-oil exports and the fact that some indicators of consumption seem to be recovering. However, it notes that the recovery of investment levels have lost vigor while industrial output remain subdued as a result of lower levels of oil output.

Relative monetary conditions and exchange rate remain the most important factors in Banxico's decision making process. The monetary authority concludes that cyclical conditions of the Mexican economy show weakness while inflation will remain below the target in 2015. However, as it was abovementioned, board members warned that: "...*the Fed's actions could have repercussions on the exchange rate and inflation expectations...*". In this context, Banxico's board of governors will pay particular attention to "... *the relative monetary conditions between Mexico and the United States, the exchange rate and the evolution of the slack in the economy...*"

We maintain our view that the central bank's next move will be a hike, immediately after the Fed. While Banxico's central scenario seems to be of economic activity weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given this, we believe that Banxico's next move will be a rate hike, immediately after the Fed starts its normalization of monetary policy in September 16-17. This implies that the central bank could be raising rates at its next regular meeting on October 15th, four weeks after we expect the first hike from the U.S. Fed. Nevertheless, we cannot rule out that, since this four-week period could create a scenario of high volatility in domestic financial markets, there is the possibility that Banxico could act preemptively, if and only if, risks to inflation and/or perceived financial stability increase substantially.

From our fixed income and FX strategy team

Banxico's communiqué with no surprises for markets –nonevent– this Thursday. No market reaction following today's policy decision from Banxico, as the central authority reiterated their strategy of moving in tandem with the Federal Reserve in an environment of modest growth, no inflationary pressures and FX depreciation with no evidence of pass-through. Financial assets already priced in the beginning of the liftoff from both central banks by year-end: 22pb of implied cumulative hikes in December 2015 embedded in Fed funds futures and 55bps for Mexican 28-day TIE futures. Banxico reemphasized today that it will be strongly vigilant on FX dynamics on the back of important global risk factors that could increase risk premia in EM currencies ahead. Investors continue acknowledging several global risks that could undermine the performance of sovereign bonds worldwide (European bonds adjustments, uncertainty about Fed and Greek's credit *impasse*). In our view, valuation of the Mexican yield curve is attractive. However, we acquiesce in the strong likelihood that the current sell-off could extend as the uncertainty surrounding Fed future actions and important economic data tomorrow that could result in higher risk premia globally. We consider appropriate to wait for better entry levels in coming days for long directional strategies. Losses could prevail despite an attractive valuation in terms of the shape of the Mbonos curve in addition to spreads to U.S. Treasuries that are not reflecting Mexico's fundamentals.

In the FX market and as expected, there was no immediate reaction to Banxico's communiqué, with the peso trading 0.1% weaker on the day at 15.54 per dollar. With few changes in the outlook, we reiterate our views regarding the effects of relative monetary conditions for the currency. We do not expect greater support from higher short-term interest rate differentials in coming months. With global issues unresolved (with investor looking for a more definite trend in US data and tomorrow's labor report to gauge Fed expectations; Greek *impasse* with creditors), higher sensitivity to interest rates, and few local catalysts, we maintain a defensive stance on the peso despite a more attractive valuation after losses in the past three weeks (from 15.00 per dollar). We suggest avoiding strong directional positions, maintaining strong vigilance of global market dynamics to assess the attractiveness of a new directional trade recommendation at better entry levels.

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GRUPO FINANCIERO BANORTE S.A.B. de C.V.
Research and Strategy

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

Economic Analysis

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Livia Honsel	Economist, Europe	livia.honsel@banorte.com	(55) 1670 - 1883
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Rey Saúl Torres Olivares	Analyst	saul.torres@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972

Fixed income and FX Strategy

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal, CFA	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

Equity Strategy

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry	marissa.garza@banorte.com	(55) 1670 - 1717
Marisol Huerta Mondragón	Equity Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 1670 - 1746
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research Analyst	valentin.mendoza@banorte.com	(55) 1670 - 2250
María de la Paz Orozco García	Analyst	maripaz.rozco@banorte.com	(55) 1670 - 2251

Corporate Debt

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 1670 - 2248

Wholesale Banking

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Managing Director – Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Jorge de la Vega Grajales	Managing Director – Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Managing Director – Private Banking	lpietrini@ixe.com.mx	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Managing Director – Asset Management	pimentelr@ixe.com.mx	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Managing Director – International Banking	rvelazquez@ixe.com.mx	(55) 5268 - 9879
Victor Antonio Roldan Ferrer	Managing Director – Transactional Banking	vrolدان@ixe.com.mx	(55) 5004 - 1454