

## Banxico's Minutes – Unanimous decision, split communiqué

- Banxico just published the minutes of the meeting held on March 28th, in which the board of governors decided maintain the reference rate unchanged at 8.25%
- We highlight that, even though the rate decision was unanimous, one member of the board, Gerardo Esquivel, did not agree with the communiqué, which is unprecedented for Banxico
- The board agrees that there are downside risks to growth, while for inflation the balance is tilted on the upside
- A wide majority of the board considered that a prudent and firm stance is still required
- We maintain our view that Banxico is likely to cut interest rates in June
- Gains in Mexican bonds in the aftermath of more dovish minutes from Banxico

**Unanimous decision, but one dissenter in terms of the communiqué.** Banxico just published the minutes of the meeting held on March 28th, in which the board of governors decided maintain the reference rate unchanged at 8.25%. Although the decision was unanimous, deputy governor Gerardo Esquivel highlighted that he did not agree with the communiqué. This is unprecedented for Banxico after they decided to identify the direction of the vote of each member back on May 2018. Since then, we have observed dissenters in terms of the vote, but not on the communiqué. Mr. Esquivel argued that he differs both on the relatively hawkish tone as well as on the balance of risks for inflation. In the first case, he would have preferred to convey a more neutral tone, while he believes that, in terms of inflation, negative risks are enough to compensate other risks.

**Downside risks to growth amid lower global growth prospects.** The board of governors agreed that growth conditions have deteriorated so they do not expect central banks to restrict monetary conditions soon. For the Mexican economy, they expressed a concern on investment levels while they see moderation in other components of aggregate demand. Most of them argued that economic activity is resenting transitory shocks in 1Q19. Nevertheless, some of them are still uncertain if economic deceleration is transitory or not, as some indicators are pointing to a change in the economic cycle. All in all, they agreed that the balance of risks for growth is negative, mentioning, among others the risks that: (1) “...the current environment of uncertainty that has kept investment at low levels, and that may lead to lower levels of consumer expenditure, persists or deteriorates...”; (2) “...a downgrading in the credit rating of State-owned productive companies or of the sovereign itself materializes...”; (3) “...public spending is exercised with a longer delay than would normally occur at the beginning of an administration...”; (4) “...risks stemming from the ratification process of the new free-trade agreement with the U.S. and Canada...”; and (5)

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*“...the possibility of a slower-than-expected recovery in oil production...”*. Moreover, they added the possibility of lower than expected tax collection could limit public spending, along with the increased probability of a recession in the U.S., among others.

**Risks to inflation still on the upside side.** In terms of inflation, they considered that recent figures are in line with their own expected convergence to target. Nonetheless, they discussed at length the persistence of core inflation, which has remained above 3.5% for 53 consecutive fortnights, which could eventually lead to a deterioration of expectations. They conclude -except for Mr. Esquivel as we already mentioned-, that although there are some downside risks, upward pressures could eventually derail the expected trajectory of inflation.

**Other risks to the outlook.** The board also discussed other factors that could impact financial markets, such as Pemex financial situation, as many institutional investors in emerging markets hold a wide range of Mexican assets. They concluded that Pemex is facing significant financial challenges that could eventually represent a risk to macroeconomic stability, as they could lead to a downgrade not only of the company’s own rating but also the country’s credit rating.

**What’s next for monetary policy?** In our view, the minutes reveal some discussions on what the next steps for monetary policy would be, with the wide majority agreeing on a prudent and firm stance for the time being so that inflation expectations converge to the 3% target. Nevertheless, while the board agreed that slack in the economy is likely to widen in the next few quarters, only one member -probably Mr. Esquivel-, said that the monetary authority should not extend restrictive conditions further ahead as the balance of risks for growth is clearly negative while the inflation outlook is stable. Furthermore, he said that they should close the door to the hiking cycle. However, other member alerted that this could have implications for financial stability. Moreover, this member highlighted that the only mandate of the central bank is price stability and that they could influence on the cyclical behavior around the long-term growth trend but not in the trend itself.

**We maintain our view that Banxico will start an easing cycle on its June 27<sup>th</sup> meeting with a 25bps rate cut.** In our view, Banxico’s attention remains on three issues: (1) The outlook for economic growth; (2) the path of inflation; and (3) the financial stance of Pemex and its implications for both the company and the sovereign credit rating. On the first two factors our base-case contemplates a further moderation in economic activity, while price dynamics will continue to be favorable, particularly for the non-core index. In terms of growth, we expect that the impact from recent supply shocks will show in economic reports for the next few months. On top of this, the recent downturn in global economic activity supports our expectation that growth will be more moderate in comparison with 2018. On inflation, our forecast contemplates a downward path towards the target, ending the year at 3.5%. In this respect, the new energy pricing policy, aiming to maintain prices constant in real terms, is very relevant.

In this context, we have already seen the policy in action, with the renewed fiscal stimulus to fuel excise taxes (IEPS) starting in early March. With core inflation stable and headline inflation declining in a context of lower demand-side pressures due to the deceleration of growth, it is our take that price dynamics will also allow the central bank to cut rates.

*From our Fixed income and FX strategy team*

***Gains in Mexican bonds in the aftermath of more dovish minutes from Banxico.*** Local rates are rallying 2bps on average following a more dovish assessment of Banxico in terms of growth and inflation vis-à-vis market's interpretation of the communiqué. Investors are acknowledging that some members remain concerned about the degree of deceleration of the global economy and in doubt about the resilience of Mexico towards these external headwinds. However, board members are still cautious about inflation. Market participants are also reacting to deputy governor Esquivel's dissenting views in terms of the tone of the announcement, delivering a more dovish approach about the current state of the economy and prices. As result, the yield curve is pricing in -33bps of cumulative implied cuts by 2019-end and -100bps by the end of 2020. In terms of strategy we hold a positive view in terms of Mexican rates, as they will continue to benefit from the dovish inertia worldwide. However, we suggest waiting for better entry levels for a new directional long trade idea in 20-year Mbonos.

In the FX market, the Mexican peso's reaction was modest, yet it managed to revert weaker price action this Thursday with respect to the latest six sessions which have hold it below 19.00 per dollar steadily since Monday. It currently trades at USD/MXN 18.83 from around 18.88 before the minutes release, equivalent to a 0.1% daily depreciation, but fairly close to stronger levels seen in European hours that touched up to 18.81, its strongest reading since March 20<sup>th</sup>. In our view, the space for further appreciation is already limited, stressing out a fair value around 18.90 according to our REER model. In this sense, we assess interesting entry points for new USD longs.

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