

Banxico minutes – Another confirmation that Banxico will move in tandem with the Fed

- Banxico published today the minutes of its monetary policy meeting held back in March 26, in which the board unanimously decided to leave the reference rate on hold at 3%
- In our view, the most important issues discussed were:
 - (1) The balance of risks for growth in Mexico has deteriorated;
 - (2) The balance of risks for inflation remains the same, but looks promising (inflation will fluctuate around 3%); and
 - (3) Market’s perception regarding the Fed’s next hike could be delayed
- In our opinion, the minutes kept the *dovish* tone we perceived in the last *communiqué* amid concerns about the uncertainty regarding the Fed’s hiking cycle, and the inherent risks for Banxico if they begin restricting their monetary policy before the Fed
- In this context, we continue to believe that Banxico’s next movement will be a rate hike (July 2015), immediately after the Fed increases its own reference rate (June 2015)
- Market participants acknowledging that Banxico will likely tighten monetary conditions in tandem with Fed, and the later could delay its decision

Minutes kept a *dovish* tone. Banco de Mexico just published the minutes of its monetary policy meeting held back in March 26, in which the board unanimously decided to leave the reference rate on hold at 3%. In our opinion, the minutes kept the *dovish* tone we perceived in the last *communiqué*. In this context, we highlight that the most important issues discussed were: (1) The balance of risks for growth and inflation in Mexico has deteriorated; (2) The balance of risks for inflation remains the same, but looks promising (inflation will fluctuate around 3%); and (3) Market’s perception regarding the Fed’s next hike could be delayed.

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The balance of risks for growth in Mexico has deteriorated. Most members of board commented that the balance of risks for the Mexican economy has deteriorated. While most members recognized that private consumption has shown a visible growth, which has been reflected in the most recent retail sales reports, investment has shown a moderate recovery derived from the downward trend capital goods imports. Moreover, industrial production has been hampered by the reduction in the Mexico's oil production. Similarly, most members commented on the slack in economic activity. In this regard, *“a board member mentioned that the persistent low growth can affect Mexico's potential GDP and stressed out that it is important to acknowledge if the current weak economy is explained by a lower potential growth or is only a cyclical phenomenon...”*. Additionally, most members concurred that *“the balance of risks for growth has deteriorated. In this regard, some members mentioned that they can't rule out further declines in oil production, and that the uncertainty about the implications of the Fed's monetary policy still persists. One of them mentioned that the downward trend of real wages in 2015 could hamper the recovery of private consumption, and that the recent fiscal consolidation efforts could have a negative impact on domestic demand...”*.

The balance of risks for inflation remains unchanged, but it's promising. With regard to inflation, although most members agreed that the balance of risk has remained stable regarding the last monetary policy statement, we highlight that: *“...most of Banxico's board members confirmed that headline inflation will remain around 3% yoy in the short term, and that it will end the year slightly below this level. Concerning core inflation, the board reiterated its view that it'll remain below 3% throughout 2015. By 2016, most of the members considered that headline and core inflation will hover around 3%.”*

The Fed's monetary policy normalization will probably begin later than it was expected a few months ago. With regard to the beginning of U.S. interest rate hiking cycle, most of Banxico's board members agreed that *“... the information provided in the past Fed's communiqué, along with the lower projections of the Fed's board members regarding economic growth and inflation suggest that the U.S. interest rate hiking cycle will be at a slower pace than was initially anticipated”*. Additionally most of them agreed that: *“... there is still uncertainty about the date in which the Federal Reserve will begin its hiking cycle, and the pace at which it'll take place, so they cannot rule out a surprise within market participants regarding the implementation of the Fed's normalization policy”*.

Low likelihood to act before the Fed. While one member highlighted the need to anticipate the Fed's hiking cycle given the possibility that in the future, volatility in international financial markets could increase, and that this will have an impact on the exchange rate, especially given the prospect of the US Fed's hiking cycle in 2015, two members agreed that: *"... given the current conditions that Mexico's monetary policy is facing, in which inflation is well behaved, expectations are firmly anchored, a well-behaved increase in interest rates along the yield curve, and Mexico is facing a weak economic cycle, Banxico would not gain much in anticipating the Fed's monetary policy actions, and could even be a mistake given the current cyclical position of the economy. Additionally there's a big uncertainty regarding the Fed's next hike could be delayed"*.

Banxico will begin a hiking cycle in July 2015. We maintain our view that Banxico's next move will be a rate hike. In our view, such movement will take place in tandem with Fed's first rate increase in June 2015 (Banxico could hike in July 2015). Moreover, we expect a tightening cycle of 100bps this year, so that the reference rate will end the year at 4%. Beyond 2015, there is a high degree of uncertainty about whether the Fed will only hold a "normalization" process and not a "monetary restriction", so it is difficult to predict what Banxico might do in year 2016. Nevertheless, we believe that the long-term equilibrium monetary policy rate in Mexico -incorporating the impact of structural reforms-, is 7%.

From our fixed income and FX strategy team:

Market participants acknowledging that Banxico will likely tighten monetary conditions in tandem with Fed, and the later could delay its decision. Banxico's minutes from its decision on March 26th portrayed a dovish bias, highlighting the effect of slack in the labor market and the economy overall within a likely scenario of low inflation along the year. Recent speeches from Board members together with today's minutes confirm the likely strategy to be followed in coming months: hiking rates in tandem with the Federal Reserve. The key factor will be assessing the probability of the beginning of policy normalization in the U.S. in the following meetings. In this regard, market is pricing in cumulative implied increases in the reference rates of 7bps in 3Q15 and 23bps in 4Q15 for the Fed funds rate and 13bps in 3Q15 and 39bps in 4Q15 for Banxico's reference rate. In our view the short-end of the curve is fairly valued in Mexico and depicts an overoptimistic scenario in the U.S. This suggests the possibility of further flattening of the yield curves in both countries. As a result, we hold a positive view in 20-year Mbonos (May'31 and Nov'34), tenors that continue portraying an appealing valuation in terms of the shape of the curve and the country risk premia embedded in these securities.

The Mexican peso accelerated losses since the inflation report published earlier, when it went from 14.90 to 15.00 per dollar, creeping higher to 15.08 at the time of writing in the aftermath of the minutes. As a result, the currency has lost 1.2% on the day. In our view, the reaction to both drivers is consistent with the idea that Mexico's monetary policy is unlikely to be supportive for the peso at least for the time being, which we have highlighted as one of the reasons to stay defensive. As evidence of the latter we point that, according to the minutes: (1) Currency losses are at least partially justified as the real exchange rate needed to adjust given changes in macro fundamentals, particularly the potential impact of lower oil prices on aggregate demand. This suggests that the peso's potential undervaluation would be less than simple models that compare the actual real exchange rate to historical averages; (2) the Foreign Exchange Commission measures have helped stabilize the market, although additional volatility cannot be discarded; (3) the Board seems to be biased to begin hiking rates after the Fed normalization process, as some argued that gains from hiking earlier would be limited and uncertainty about its timing is still very high; and (4) pass-through effects from peso losses have been moderate, arguing in favor of waiting for the Fed as the growth outlook has deteriorated. In conclusion, we maintain our long USD/MXN position (entry: 14.98; target: 15.50; stop-loss: 14.60) opened on March 20, which has recovered from recent losses after today's strong upward move.

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