

## Banxico's minutes – Bias towards higher rates

- Banxico just published the minutes of the meeting held on October 4<sup>th</sup>, in which the board decided to remain on hold, keeping the reference rate at 7.75%
- In our view, the tone of the minutes reaffirms the hawkish tone of the statement, highlight discussions on upward risks for inflation, particularly in the core index, along with pressures on energy prices
- In our opinion, information published today supports our call for an additional 25bps rate hike before the end of the year, taking the reference rate to 8.00% and remaining on hold at least until the first half of 2019
- Moreover, the Board of Governors mentioned the positive effect of the NAFTA 2.0 (USMCA) agreement, which we believe was key to October's decision
- Discussions on the relative monetary policy stance and new government's public policies also took place
- Market participants are ready for another rate hike in Mexico in 4Q18

**In our opinion, the tone of the minutes reaffirms the hawkish tone of the statement.** Some of the main discussions revealed in the document: (1) The upward risks for inflation on the back of higher energy prices, which if they were to continue could lead to second-round effects on core inflation; (2) the positive effect of the NAFTA 2.0 (USMCA) agreement; (3) the possibility of upside surprises in US inflation and a more restrictive stance from the Fed; (4) risks stemming from some public policy proposals from the new government; and (5) the dissident vote from Manuel Ramos-Francia as a result of persistently high core inflation and the low probability that headline inflation will reach Banxico's forecast. Considering these factors, as well as a complex domestic and external environment, we believe that the information published today supports our call for an additional 25bps rate hike before the year-end, taking the reference rate to 8.00%, followed by a pause at least until the first half of 2019.

**Core inflation will be a key indicator in the coming months.** We highlight the main focus of discussions that took place were around the risks for inflation, with a special focus on higher energy prices and their impact, not only on headline inflation, but also on the potential second-round effects on the core component. Most participants considered that, given a complex backdrop in which both internal and external risks abound, the monetary authority should monitor those factors that could result in additional pressures on prices, which could eventually divert the convergence to the target.

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In our view, this is in line with the hawkish tone perceived in the communiqué. In particular, “...*the majority of the members highlighted that core inflation – the component that responds more clearly to the monetary policy stance– has evolved, in general, as anticipated, and is expected to continue to decrease, although some of them pointed out that at a lower rate and subject to greater risks. In this regard, one member emphasized that such component has exhibited a significant degree of persistence...*”. Among the risks observed we highlight the possibility of additional pressures on the Mexican currency given both domestic –e.g. wage negotiations that do not reflect productivity gains-, and external factors, such as an increase in global protectionism, among others.

**A more restrictive Fed and upside inflation surprises in the US support a prudent stance from the central bank.** Particularly, they mentioned the risk of a faster-than-expected pace in US monetary policy normalization if inflation surprises on the upside. Among the main risks for this scenario, they highlighted a possible pass-through of tariffs to final prices, and relatively low slack in the economy which could in turn translate into demand-side pressures. In this context, we forecast a 25bps hike in the *Fed funds* range in December, followed by an accumulated 75bps throughout 2019 on the back of a favorable assessment of economic conditions and inflation slightly above the 2% target. Finally, one member argued that current prudent and defensive monetary stance –both in absolute as well as in relative terms-, has contributed to an improvement in local financial markets.

**The positive effect of the NAFTA 2.0 (USMCA) agreement was key to maintaining the reference rate at 7.75%.** Board members agreed that the reduction in uncertainty after the agreement bolstered the resiliency of the MXN, particularly amid a difficult backdrop for EM currencies. One member argued that this mitigates some of the risks for inflation; while another one commented that it gives Mexico’s monetary policy some leeway considering the expected path for US Fed monetary policy going forwards. All in all, they considered that the agreement could have favorable consequences for the market and the exchange rate.

**Interesting discussion on some public policies suggested by the new government.** They discussed, among others, the ones that have to do with the fiscal stance and its implications for central bank independence and inflation. Among them, the recent proposal of using international reserves for financing public expenditures, including investment outlays or other type of expenses, as these are not a source of net wealth given that they need to be financed with higher central bank liabilities. One member emphasized that “...*emphasized the implementation of such proposals would directly jeopardize the central bank’s independence and its main statutory mandate, leading to a situation of fiscal dominance over monetary policy. The same member argued that, in the best case, implementing some of these measures would generate a greater inflationary bias, besides the one the Mexican economy already has...*”. Moreover, some members warned about the risk of higher-than-expected public spending, with one of them stressing that this could reduce the speed of convergence of core inflation towards its target.

**Manuel Ramos-Francia, the dissenting voter.** This is the first split decision since the change in the bank's communication strategy back on April 30<sup>th</sup>, with Manuel Ramos-Francia arguing that: "...inflation has been subject to a complex environment characterized by both cyclical and structural factors. This situation is evident as shown by long-term inflation expectations, which have remained around 3.5 percent for several years, regardless of the stage of the business cycle the 9 Mexican economy is undergoing...". Moreover, he said that Banxico has already adjusted on several occasions its estimates for the expected time horizon needed for inflation to converge to its target. Coupled with the current inflation forecast targeting framework for monetary policy and the factors driving core inflation (in addition to its higher persistence), he considered that not acting with a 25bps hike could be very costly for the Banxico's credibility.

**We believe Banxico has not ended with the hiking cycle, and remains ready to pull the trigger.** As already mentioned, we still expect an additional 25bps rate hike in the reference rate to end this year at 8.00%, followed by a period of stability at least during the first half of 2019. We agree with the central bank's assessment about upside risks to prices as we estimate that headline inflation will close the year at 4.8% yoy, higher than the current median analysts' consensus of 4.5%. Moreover, there are several risks going forward that could have an adverse impact in local activity and markets. On the domestic front, there is still some uncertainty on the policies of the new administration, such as the consultation on Mexico City's new airport and the presentation of the fiscal budget for next year, in which we expect the new administration to confirm its commitment to healthy public finances. Externally, we highlight US mid-term elections, upcoming decisions by the Fed considering its more hawkish bias, trade tensions between US and China, and emerging market volatility, among others.

*From our fixed income and FX strategy team*

**Market participants are ready for another rate hike in Mexico in 4Q18.** Banxico released the minutes from its latest policy meeting on October 4, in which the board decided to stay put (leaving its reference rate unchanged at 7.75%) with a split decision and a hawkish message. The concerns about the complex global landscape in tandem with a more restrictive stance from the Federal Reserve and a challenging backdrop for inflation were the key takeaways from today's minutes. The concerns about inflation were also stressed out by Governor Díaz de León earlier today in a *Reuters* interview, highlighting the difficult dynamics for energy prices worldwide and its likely effect on the CPI. The market reaction was modestly negative (+3bps), confirming the recent adjustment. As of today, the yield curve is pricing in +10bps of implied movements in Banxico's repo rate by year-end, while only discounting +1bps in 2019. Overall it seems that the risks stressed out by the central bank are consistent with the risk off mode from global investors, supporting our defensive trade ideas of long positions in the CPI-linked Udibono Jun'22 and buying USD in dips with an 18.70 entry point.

More details about the current valuation of local markets and our short-term tactical trade recommendations in our "*Fixed-Income and FX Weekly*" <[pdf](#)>, published last Monday.

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We, Gabriel Casillas Olivera, 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 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. of C.V for the provision of our services.

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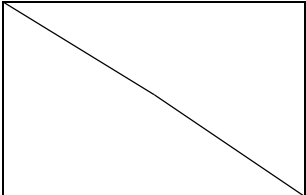
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