

## Ahead of the Curve

### Banxico minutes to focus on external uncertainty and upside risks to inflation

- Banxico's minutes (October).** Next Thursday at 10:00am (ET), Banxico will publish the minutes of its October 4th meeting, in which the Board maintained the reference rate at 7.75%, albeit in our opinion, showing a more hawkish bias. We believe the discussion was centered on: (1) The persistence of upside risks to inflation; (2) risks from Fed monetary policy; (3) emerging market volatility amid local stability; and (4) reduced uncertainty that could help economic activity. Given the prevailing risks at both the domestic and external fronts, we argued after the decision that the central bank is ready to increase the reference rate once more (+25bps), to end the year at 8.00%.

October 12, 2018

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#### Mexico weekly calendar

DATE	HOUR (ET)	EVENT	PERIOD	UNIT	BANORTE	CONSENSUS	PREVIOUS
Tue 16-Oct	10:00am	International reserves	Oct-12	US\$ bn	--	--	173.4
Tue 16-Oct	12:30pm	Government weekly auction: 1-, 3-, 6-month CETES; 3y Mbono (Dec'21); 3y Udibonos (Jun'22)					
Thu 18-Oct	10:00am	Banxico's minutes	October				

Source: Banorte; Bloomberg

## Proceeding in chronological order...

**Weekly international reserves report.** Last week, net international reserves decreased US\$175 million, amounting to US\$173.4 billion. According to Banxico's report, this figure comes mainly from a negative valuation effect in central bank assets. In this context, the central bank's international reserves have increased US\$589 million during 2018 (please refer to the following table).

### Banxico's foreign reserve accumulation detail US\$, million

	2017	Oct 5, 2018	Oct 5, 2018	Year-to-date
	Balance		Flows	
International reserves (B)-(C)	172,802	173,391	-175	589
(B) Gross international reserve	175,450	176,610	-430	1,160
Pemex	--	--	-79	-628
Federal government	--	--	-115	674
Market operations	--	--	0	0
Other	--	--	-235	1,114
(C) Short-term government's liabilities	2,648	3,219	-255	571

Source: Banco de México

**Weekly government bond auction.** The Ministry of Finance (MoF) –via Banco de Mexico as its financial agent–, will offer 3-year fixed-rate Mbonos (Dec'21), 3-year inflation-linked Udibonos (Jun'22), in addition to the “more traditional” 1-, 3-, and 6-month zero-coupon Cetes (please refer to the following table). As usual, results will be released at 12:30pm (ET).

### Auction specifics (Tuesday, October 16<sup>th</sup>, 2018)

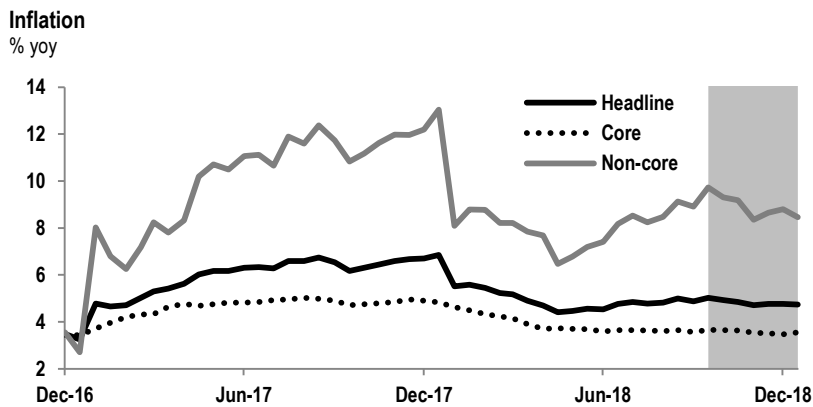
	Maturity	Coupon rate, %	To be auctioned <sup>1</sup>	Previous yield <sup>2</sup>
<b>Cetes</b>				
1m	15-Nov-18	--	7,000	7.70
3m	17-Jan-19	--	11,000	7.88
6m	11-Apr-19	--	11,000	8.07
<b>M Bono</b>				
3y	09-Dec-21	7.25	9,000	7.96
<b>Udibonos</b>				
3y	09-Jun-22	2.00	UDIS 1,000	3.78

Source: Banorte with data from Banco de México 1. Except for Udibonos, which are expressed in UDI million, everything else is expressed in MXN million. 2. Yield-to-maturity reported for Cetes, Mbonos and Udibonos

**Banxico's minutes (October).** Next Thursday at 10:00am (ET), Banxico will publish the minutes of its October 4<sup>th</sup> meeting, in which the Board maintained the reference rate at 7.75%, albeit in our opinion, showing a more hawkish bias. Given the prevailing risks at both the domestic and external fronts, we argued after the decision that the central bank is ready to increase the reference rate once more (+25bps), to end the year at 8.00%. In this regard, 7 out of 21 economists (surveyed by *Citibanamex* on October 5<sup>th</sup>) also expect one additional rate hike. We believe the discussion was centered on:

(1) *The persistence of upside risks to inflation.* In the communiqué, the Board argued that pressures on non-core inflation are impacting core prices, delaying inflation’s convergence toward the central bank’s target. While inflation for the first half of September –the most recent at the time of the decision– seemed to show a slight improvement, the next report was higher than expected, in particular at the core component, likely supporting Banxico’s thesis. For details see: “*Inflation in September slightly above consensus as core surprises to the upside*”, October 9<sup>th</sup>, 2018 <[pdf](#)>.

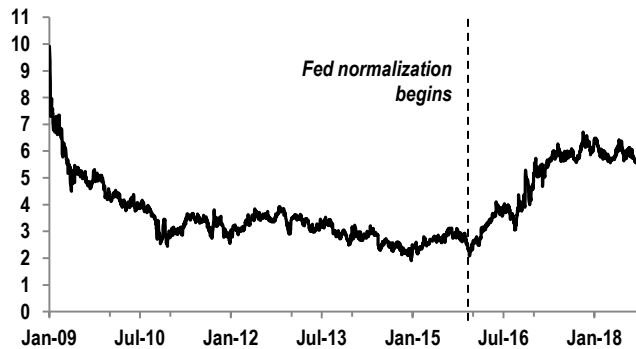
We also highlight the addition of a higher public spending as a risk factor on the back of some proposals of the incoming administration. Our view is that members of the new government have repeatedly shown a commitment to preserve healthy public finances, so it will be hard for this risk to materialize. We expect the discussion on inflation to be very relevant to evaluate the Board’s bias. Looking ahead, we believe main upside risks for inflation include additional pressures on energy prices, an increase in protectionist measures, and a possible adjustment in the Mexican peso in a still uncertain scenario.



Source: INEGI, Banorte

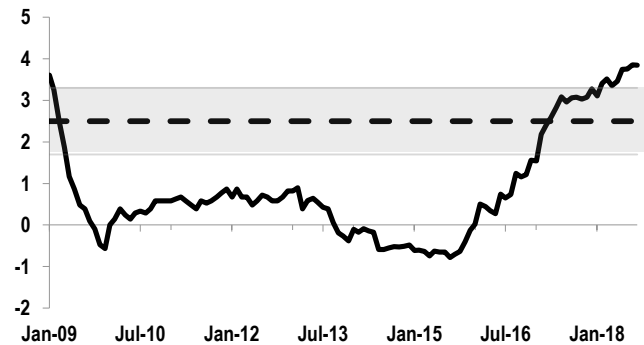
(2) *Risks from Fed monetary policy.* Since the US started its normalization back in December 2015, this is the first time that Banxico did not follow a Fed rate hike. This occurred despite maintaining the relative monetary stance between Mexico and the US as one of its main deciding factors. We believe the decision to decouple was explained to a great extent by: (a) An already high nominal rate spread, going from close to 300bps at the start of the normalization process to nearly 575bps currently, which helped shield the MXN in terms of carry (see chart below on the left); and (b) a short-term, real ex-ante interest rate of 3.85%, in restrictive territory relative to Banxico’s range estimate of the neutral rate ( $r^*$ ) between 1.7% and 3.3% (see chart below on the right). In this regard, we will search carefully for the likely discussion about the room that the Mexican monetary authority could have to absorb a potential decrease in the spread if they keep decoupling from the Fed. We believe this margin is limited given local and external conditions, which might be one of the factors that could lead Banxico to adjust once again higher its reference rate before year-end.

**MXN implicit carry against the dollar in 3-month FX forwards\***  
%, annualized rate



\* Positivo means a net carry gain of long MXN against USD  
Source: Bloomberg, Banorte

**Short-term, real ex-ante interest rate in Mexico**  
% annual rate

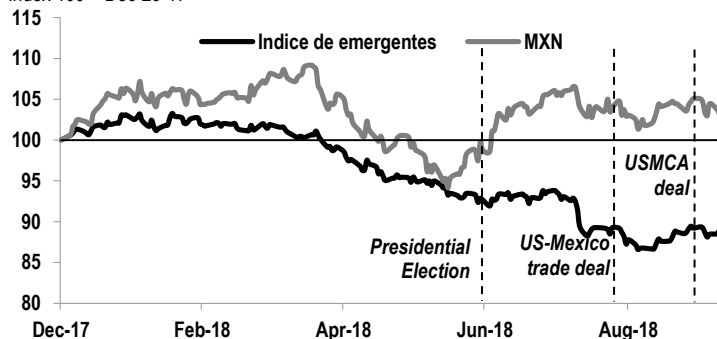


Note: The dotted line is the midpoint of Banxico's estimated range of the neutral, short-term interest rate estimated by Banco de Mexico  
Source: Banxico, Bloomberg, Banorte

(3) *Emerging market volatility but local stability.* In our view, Board members discussed the most appropriate policy stance in the face of a highly uncertain global outlook in between geopolitical risks, trade tensions, and more restrictive financial conditions, among others. In particular, the communiqué warned about EM volatility driving local asset prices lower. Typical volatility indices such as VIX (equities) and MOVE (rates) have been pushed to highs not seen since at least June, increasing the relevance of this discussion. In contrast, they also recognized the positive impact of idiosyncratic factors such as news in trade renegotiations with Canada and the US. The latter has supported the Mexican peso, relatively stronger than other EM currencies (see chart below) and helping contain a potential pass-through effect to prices and inflation expectations. Nevertheless, as the Board recognized higher volatility and its potential impact on the currency, the tone of this discussion should provide valuable information about its tolerance to a more adverse scenario in international markets.

**EM FX performance against the US dollar\***

Index 100 = Dec-29-17



\* Increase means appreciation against the dollar  
Source: Bloomberg, Banorte

(4) *Reduced uncertainty would help economic activity.* One of the positive drivers flagged by the central bank was recent developments in trade, lowering uncertainty and improving the balance of risks for the economy at the margin. In this context, we have observed better indicators at the start of 3Q18, in particular the 0.4% m/m increase in economic activity in July's IGAE (from a 0.1% fall the previous month and -0.2% q/q GDP in 2Q18). According to Banxico, slack was similar to the previous quarter, meaning more relaxed conditions. Nevertheless and in case that stronger activity is confirmed in upcoming data, the output gap could have not kept sliding further into negative territory. Coupled with higher wages, this could suggest better aggregate demand conditions for another rate hike in spite of Banxico's assessment, even if they have not yet translated into higher prices.

In our view, the current backdrop made this decision particularly difficult for Banxico. In this respect, we highlight two additional factors. First, the central bank stressed that in order to achieve inflation's convergence to target, they would not only maintain but *possibly strengthen* the current monetary policy stance, a hawkish signal when compared to recent communications. In second place, the decision was not unanimous, with one member voting for increasing the rate by 25bps. It is worth remembering that this is the first split decision since the change in the bank's communication strategy on April 30<sup>th</sup>. Taking into account the factors discussed, our inflation and exchange rate forecasts, we believe Banxico will hike the reference rate by 25bps before year-end to 8.00%, followed by a period of stability during the first half of 2019.

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