Banxico's monetary policy decision

Reference rate ends the year at 8.25%

December 20, 2018

www.banorte.com
@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

Juan Carlos Alderete, CFA
Senior Economist, Mexico
juan.alderete.macal@banorte.com

Francisco Flores
Economist, Mexico
francisco.flores.serrano@banorte.com

Fixed income and FX Strategy

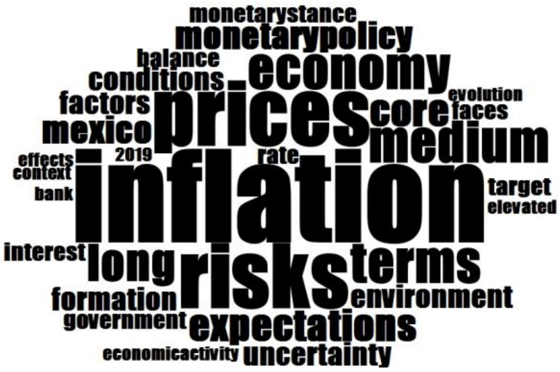
Alejandro Padilla
Head Strategist - Fixed-Income and FX
alejandro.padilla@banorte.com

Santiago Leal
Strategist Fixed Income and FX
santiago.leal@banorte.com

Leslie Orozco
Fixed Income and FX Strategist
leslie.orozco.velez@banorte.com

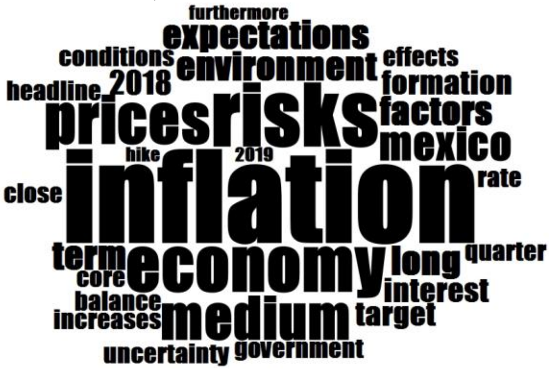
- **Banxico's board announced today its unanimous decision to increase the reference rate by 25bps to 8.25%**
- **In our opinion, the statement continues to show a hawkish bias, largely in line with the previous communiqué**
- **We believe that the monetary authority has left the door open to further increases, but we maintain our view that Banxico will remain on hold in 2019 and will only hike if necessary**
- **The linguistic analysis of the statement showed an increase in the word "*long*" relative to the previous decision. We also noted the appearance of the word "*elevated*" referencing both inflation and risks. On the contrary, the relative weight of "*risks*" and "*medium*" were slightly lower**
- **Local rates and the MXN are acknowledging that Banxico is leaving the door open for an additional hike if needed, although with less conviction**

December 20, 2018 Statement Word Cloud



Source Banorte

November 15, 2018 Statement Word Cloud



Source Banorte

As expected, Banxico decided to increase the reference rate by 25bps to 8.25%. This decision was in line with both our expectations and the market. In contrast with the last decision in which Irene Espinosa voted for a 50bps rate hike, in this occasion there was unanimity for hiking the reference rate. We maintain our view that Banxico will remain on hold during 2019, but cannot rule out the possibility of another rate hike in case that conditions warrant an action in this direction.

Inflation expectations take the spotlight. In our opinion, the statement continues to show a hawkish bias, largely in line with the previous communiqué. In our view, the focus is stronger on the deterioration of inflation expectations, with the recent improvement in inflation and downside risks for economic activity taking a backseat. In this context, we believe that previous communiqués had not stressed as forcefully the concern over the increase in inflation expectations. In fact, the main argument for today's hike was that "*…the environment of high uncertainty, in which the balance of risks for inflation is biased to the upside and some of the risks that might affect it in both the short and long terms have materialized, and in view of the possibility that medium- and long-term inflation expectations may be affected…*".

The risk of an above-average minimum wage increase has materialized. In recent days, the CONASAMI announced an increase to minimum wages (for details see: "*The National Commission for Minimum Wages agreed on a 16.2% increase for 2019*", December 17th, 2018, <pdf>). Banxico considered that such measure "*…in addition to their possible direct impact, there is the risk that these bring about wage revisions that exceed productivity gains and create cost pressures, affecting formal employment and prices…*". Moreover they advised that in order to sustainably increase the purchasing power of wages other policies must be considered, in particular fostering market competition in those sectors in which the poorest segments of the population concentrate their consumption basket

Risks from structural changes in the price formation process remain. Once again, Banxico emphasized the risks to inflation in the medium- and long-term due to policy changes. In particular, even though they considered that the government's budget for 2019 used a prudent macroeconomic framework –and recognized the favorable reaction of local markets–, they stressed the need to effectively deliver on fiscal goals. Moreover, they repeated that the current backdrop presents medium and long-term risks that could affect the country's macroeconomic conditions, its capacity to grow and the price formation process.

Nevertheless, there could be some wiggle room in terms of lower growth and global monetary conditions, particularly from the US Fed. For the Mexican economy, they considered that slack conditions continue to be more ample than at the beginning of the year, with economic activity moderating in 4Q18. In this respect, the balance of risks for growth remains on the downside and has further deteriorated. Moreover, global growth is also slowing down, probably more than expected. The inflation outlook seems to have improved, at least globally, as a result of the recent plunge in oil prices. In this context, they noted that financial conditions could keep tightening, although at a slower pace than previously anticipated.

We maintain our view that Banxico will remain on hold in 2019. In our view, the reference rate is already quite high and on restrictive territory in the midst of a deteriorated outlook for local and global growth. Moreover, the US Fed is likely to continue tightening monetary policy, although at a slower pace. In fact, we now see only two hikes in 2019 in the *Fed funds rate* (vs. three before yesterday's decision). In terms of inflation, we maintain our forecast that it will keep trending downwards to 3.5%yoy by year-end 2019, below market expectations. Nevertheless, we believe that Banxico has left the door open for additional rate hikes and is biased to keep increasing the reference rate, if needed, particularly if the anchoring of medium- and long-term inflation expectations is at risk. Lastly, we do not see a rate cut in the foreseeable future, despite economic and inflation conditions in 2019 that could help build the case for this scenario.

From our fixed-income and FX strategy team

Local rates and the MXN are acknowledging that Banxico is leaving the door open for an additional hike if needed, although with less conviction

The flattening of the Mexican yield curve in December continues (following the strong steepening bias last month) supported by today's highly expected rate hike (+25bps) from Banco de México, with a policy communiqué that remains leaned to the hawkish side. The central bank stressed out several factors that could derail the CPI convergence path towards its goal, coming from external and internal risks. In this regard, despite acknowledging lower inflation readings recently, board members set once again the balance of risks for inflation tilted to the upside. Despite this, the yield curve is pricing in slightly less than one rate hike in 1H19 as Banxico also highlighted the effect of slack in the economy and is aware that the Federal Reserve will be more gradual regarding its policy normalization strategy next year. All in all, market participants are recognizing that the central bank is leaving the door open for an additional rate hike if needed, however with less conviction, especially when the spread between Mexican and U.S. short-term ex-ante real rates continues widening, currently at 471bps, granting Banxico leeway against additional normalization from the Fed. As a result, the fixed-income market observed a modest reaction, holding the earlier rally of 10bps, especially in mid- and long-term rates. Given these dynamics we expect the recent appreciation of Mbonos to moderate and hold our trade recommendation of long positions in floating-rate securities. In the FX market, the peso continues trading below the psychological barrier of USD/MXN 20.00, relatively stable after Banxico's decision. In our view, current market conditions and valuation are appropriate for long USD positions as a short-term tactical trade.

Analyst Certification.

We, Gabriel Casillas Olvera, 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, Leslie Thalía Orozco Vélez, and Jorge Antonio Izquierdo Lobato 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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	Reference
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HOLD	*When the share expected performance is similar to the MEXBOL estimated performance.*
SELL	*When the share expected performance is lower than the MEXBOL estimated performance.*

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Research and Strategy

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	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
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Juan Carlos Alderete Macal, CFA	Senior Economist, Mexico	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Miguel Alejandro Calvo Domínguez	Economist, Regional	miguel.calvo@banorte.com	(55) 1670 - 2220
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

Fixed income and FX Strategy

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Santiago Leal Singer	FX Senior Strategist	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Fixed Income and FX Strategist	leslie.orozco.velez@banorte.com	(55) 5268 - 1698

Equity Strategy

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Technical Analysis	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Equity Research – Conglomerates / Financials/ Mining / Petrochemicals	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research – Airlines / Airports / Cement / Infrastructure / REITs	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Francisco Duarte Alcocer	Analyst	francisco.duarte.alcocer@banorte.com	(55) 1103 4000 x 2707
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@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	Senior, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@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	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Asset Management	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Corporate Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454