

Banxico minutes – A more hawkish tone suggests at least two rate hikes in 2016

- Banxico published today the minutes of its monetary policy meeting held back on May 5th, in which the board of governors decided unanimously to maintain the reference rate at 3.75%, as it was widely expected
- The discussions of the board of governors focused on the following topics:
 - (1) Banxico recognized not only that the Mexican economy observed a higher rate of growth in 1Q16, but also acknowledged that the balance of risks for the global economy has deteriorated;
 - (2) The Board considers that the short and medium-term balance of risks for inflation has remained unchanged;
 - (3) Banxico highlighted the implicit risks of the accommodative stance of several central banks to the financial system, not ruling out other episodes of increased volatility; and
 - (4) The need to continue with fiscal consolidation measures to differentiate from other emerging economies
- In this context, the board of governors considered that, in addition to monitoring the relative stance of monetary policy vs. U.S., further adjustments in the reference rate could be warranted in the case of increased levels of uncertainty in global financial markets
- We maintain our view that Banxico is likely hike in tandem with the U.S. Fed, who we expect will hike twice this year (25bps in June, and another 25bps in September or December)
- Despite the above, we do not rule out the possibility of Banxico hiking more than twice this year, if there is strong evidence of FX pass-through on inflation and/or there is a new episode of high volatility

Minutes with a hawkish bias. Banxico released today the minutes of the monetary policy meeting held two weeks ago (May 5), in which the board of governors decided to keep the reference rate at 3.75%. The discussions of the board of governors focused on the following topics: (1) Banxico recognized not only that the Mexican economy observed a higher growth in 1Q16, but also acknowledged that the balance of risks for the global economy has deteriorated; (2) the Board considers that the short and medium-term balance of risks for inflation has remained unchanged; (3) Banxico highlighted the implicit risks of the accommodative stance of several central banks to the financial system, and acknowledged that they cannot rule out other episodes of increased volatility; and (4) the need to continue with fiscal consolidation measures to differentiate from other emerging economies.

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The balance of risks for growth remained unchanged. According to Banxico's minutes, the balance of risks for global growth during the first quarter of the year deteriorated given the lower growth of the overall global economy. In this regard, several members discussed the *secular stagnation* hypothesis, which refers to a lack of demand associated with a decline in the propensity to invest coupled with a higher propensity to save, generated by a lower rate of population growth, a lower TFP (total factor productivity), and a reduction in capital goods prices, among other factors. The Board also highlighted the lower economic growth in the U.S. despite the recovery of the labor market and the higher levels of consumer confidence. In Mexico, economic activity posted a higher growth in 1Q16. However, external demand continues to be stagnant, while gross domestic investment has shown a weak performance. In this context, the central bank "*...does not expect demand-side pressures on prices....*" and considers that there is still slack in the economy, although it is diminishing gradually.

Inflation and volatility. Banxico explains in the minutes that inflationary conditions continue to be favorable. Core inflation has maintained a moderate, but upward trend given the adjustment of relative prices as a result of the exchange rate depreciation. However, Banxico emphasized that the pass-through effect of the FX depreciation to prices has been limited, and they expect inflation to end the year around 3%yoy. Regarding the volatility of financial markets, the central bank highlighted that "*... the accommodative monetary stance implemented by several central banks in advanced economies [...] could pose significant risks to the stability of the international financial system...*". In this context, Banxico acknowledged that they cannot rule out other episodes of increased volatility.

Fiscal consolidation and PEMEX. The monetary authority is satisfied with the results of the fiscal measures undertaken this year that incorporate: (1) The Federal Government's fiscal cut announced in February 17; (2) the changes in Pemex's fiscal regime; (3) the fiscal cut announced for 2017; (4) the prepayment of outstanding debt issued by the Federal Government given Banxico's operational surplus transferred to the MoF; and (5) the reduction in the fiscal deficit during the first quarter of the year. However, the monetary authority continues to emphasize the need to "*...continue with the fiscal consolidation measures..*", among others because the strong fundamentals help increase confidence in Mexico and distinguishes it from other emerging economies.

We maintain our view that the central bank will probably hike rates in tandem with the Fed, although we cannot rule out the possibility that Banxico could increase the reference rate more than twice this year. Our base-case scenario for the Fed this year is that the FOMC will hike the Fed funds rate twice this year (25bp in June, and other 25bps in September or December). In this context, we believe that the next move by Banxico is a rate hike: 25bps on 30 June, after the Fed does the same at its meeting on June 15. Nevertheless, we cannot rule out the possibility that the monetary authority hikes more than 50bps this year, in case there is strong evidence of pass-through of exchange rate depreciation to inflation and/or there is a new episode of high volatility in international financial markets. The minutes released today confirmed our expectation after some members stressed that: “... *inflationary risks can be materialized regardless of the Federal Reserve’s actions. In this regard, Mexico’s monetary policy must be ready to act in a timely and flexible manner, in order to face any obstacles that could endanger the consolidation of inflation’s convergence to its permanent 3 percent target...*”.

From our fixed income and FX strategy team:

Hawkish tilt in Banxico's minutes supports our view for additional correction in local rates. As commented previously, today's minutes were characterized by a hawkish rhetoric, with an embedded concern about FX dynamics and acknowledging the possibility of additional rate hikes, front-running any Federal Reserve action if required, resembling the decision from February 17th. It is our take that the recent adjustment in the MXN should trigger an intervention in the FX market soon if deteriorated conditions in the FX market prevail. For further details refer to our research note "*Foreign Exchange Commission intervention warning*" <[pdf](#)>, published May 17th, 2016. In our view, there is a strong likelihood of observing an FX intervention before any change in the reference rate. However, Banxico is ready to act if necessary through the rate mechanism. In the aftermath of this event, local rates extended today the losses from previous sessions, observing a 10bps sell-off in short-term securities, and a depreciation of nearly 6bps in the long-end of the yield curve. We consider that the short-end will remain pressured in tandem with deteriorated dynamics in the FX market since the end of April and also considering the hawkish bias in the minutes released from the Federal Reserve yesterday. The 73bps of implied hikes priced in the curve for year-end are attainable, with low probability of decreasing going forward. On the other hand, we recommend as a tactical strategy holding an underweight stance in Mexican bonds and wait for better entry levels for long positions in the belly and long-end of the Mbonos curve. On the other hand, USD/MXN is trading around 18.50, its highest level since February 17th. The reaction to the minutes was muted, with the last leg up due to yesterday's Fed minutes. We recommend limiting losses in short positions for trading purposes, turning even more cautious. We believe that the prospect of possible FX intervention by the FEC makes risk/reward not attractive at the current level, but if this materializes and the exchange rate falls, we favor buying dollars at a better entry and attractive for structural longs around 17.90-18.00 per dollar.

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