

Banxico QR – Hiking cycle has not finished

- Banxico published today its *Quarterly Report (QR)* for 3Q18
- The release was accompanied by a press conference by Governor Alejandro Díaz de León
- In our opinion, the tone of the QR remains hawkish, as portrayed in the communique of the last monetary policy meeting on November 15th
- We highlight that Banxico modified both its inflation and growth estimates due to a highly uncertain environment, specifically:
 - (1) The inflation trajectory was revised upwards, particularly for the period up to the first three quarters of 2019
 - (2) Growth estimates were revised slightly down, to a range between 2%-2.4% from 2%-2.6% in 2018, and from 1.8%-2.8% to 1.7%-2.7% in 2019
- In terms of the traditional *grey boxes*, we noted:
 - (1) The study about the pass-through effect from high energy prices to core inflation;
 - (2) The potential effects stemming from wage indexation to inflation;
 - (3) Recent developments surrounding Mexico's credit rating and outlook
- Banxico also released its Calendar for 2019, in which monetary policy decisions are still closely aligned to those of the US Fed
- We modify our call for Banxico's next policy meeting on December 20th, expecting now a 25bps hike for the reference rate to finish 2018 at 8.25%

Quarterly Inflation maintains a cautious stance, in line with the last monetary policy decision. Banxico published today its *Quarterly Report (QR)* for 3Q18. The release was accompanied by a press conference led by Governor Alejandro Díaz de León. In our opinion, the tone of the QR was very similar to the one observed in the last monetary policy decision on November 15th, with a *hawkish* bias amid a highly uncertain backdrop and deteriorated risks for inflation both in the short- and medium-term horizons.

Banxico revised upwards its inflation forecasts for 2018 and 2019.

According to the report, inflation during the year has been impacted by several factors that have delayed the convergence towards the target. Among them, they highlighted energy prices, not just because of its direct impact in the headline index but also due to second-round effects on core prices, particularly in services. Regarding the latter, they also pointed to pressures from the exchange rate and wages. Considering this, Banxico adjusted its quarterly point estimates significantly higher for both headline and core indices, front-loaded to a one year-ahead horizon (up to 3Q19) while leaving the forecasts for 2020 basically unchanged (see table below).

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The central bank did not change its view that inflation would stand near the target of 3.0% in 1H20 because of monetary policy actions already taken, and in spite of significant changes to the trajectory. In this respect, for the first time they estimated headline inflation would reach exactly 3.0% in 3Q20. Going to core prices, and consistent with the Board’s view of its higher resistance to maintain a downward trend, we also noted relevant changes, with a maximum adjustment of +40bps relative to the previous estimates in the second and third quarters of 2019.

As in the latest statement, Banxico removed risks to the downside for inflation. In this sense, among the main upside risks the Board maintained further pressures on the MXN, energy and agricultural prices, as well as protectionist measures and a possible deterioration of public finances. In addition, the central bank added a section on structural risks, noting a possible adjustment to the downside on potential output, structural weakness in public finances, and upward adjustments in medium and long-term inflation expectations, among others.

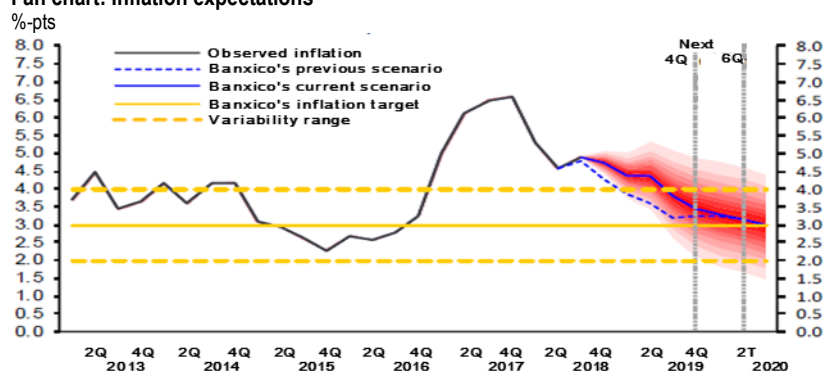
CPI forecasts

% yoy, quarterly average

	2018		2019				2020		
	III	IV	I	II	III	IV	I	II	III
CPI									
Current forecast	4.9*	4.7	4.4	4.4	3.8	3.4	3.3	3.1	3.0
Previous forecast	4.8	4.2	3.8	3.6	3.2	3.3	3.2	3.1	
Core									
Current forecast	3.6*	3.7	3.6	3.6	3.4	3.1	3.0	2.9	2.7
Previous forecast	3.6	3.5	3.3	3.2	3.0	2.9	3.0	2.9	

Source: Banco de México, 3Q18 QR; *Observed data

Fan chart: Inflation expectations



Source: Banco de Mexico; 3Q18 QR

Growth estimates revised modestly down. Contrary to our expectations of no changes despite downside risks, the central bank revised its forecasts lower for both 2018 and 2019. In the first, the estimated range fell from 2.0-2.6% to 2.0-2.4% (midpoint: 2.2%), marginally above the YTD growth rate up to 3Q18 at 2.1%. For next year, it was lowered from 1.8-2.8% to 1.7-2.7% (midpoint: 2.2%), stronger than our 1.8% forecast.

In terms of risks to the downside, they included: (1) That high uncertainty remains or even worsens, which could impact investment and consumption; (2) a potential delay in the approval of the USMCA trade agreement, given that it needs to be approved by legislative branches in the three countries; (3) heightened protectionist measures by the US; (4) bouts of volatility as a result of Fed tightening and/or contagion from other EM countries; and (5) a delay in the execution of public spending as a result of implementation challenges faced by the incoming administration. To the upside, they included that investment snaps back after trade announcements made by the US and Canada, upside in manufacturing due to strong industrial production in the US, and higher public spending than anticipated. Considering the latter, it is also worth mentioning that Banxico’s forecasts for 2019 and 2020 do not include the materialization of the risks mentioned above, as there is considerable uncertainty in the forecast horizon.

Last but not least, there were interesting comments about the risks for potential GDP included in a *grey box*. Among them, we highlight: “...that public policy decisions result in higher market concerns and a sustained loss of confidence in Mexico as an investment destination...”, apart from “the weakening or failure to implement structural actions aimed to increase the economy’s productivity levels...”. Moreover, Banxico stated that it is necessary to correct structural and institutional problems that deter investment and productivity growth, as higher productivity is the only way to generate better-paid employment opportunities. They also said that more competition is needed in order to foster the creation of value instead of rent-seeking behavior, investments in infrastructure, strengthen the rule of law, and fight insecurity and corruption.

Banxico’s Forecast
Recent Report (3Q18)

	2018	2019	2020
GDP (%)	2.0 – 2.4	1.7 – 2.7	2.0 – 3.0
Employment (thousands)	670 – 740	670 – 770	690 – 790
Trade Balance (bn)	-13.5 (1.1% of GDP)	-14.1 (1.1% of GDP)	-15.1 (1.1% of GDP)
Current account (bn)	-22.6 (1.9% of GDP)	-28.8 (2.3% of GDP)	-31.5 (2.3% of GDP)

Source: Banxico

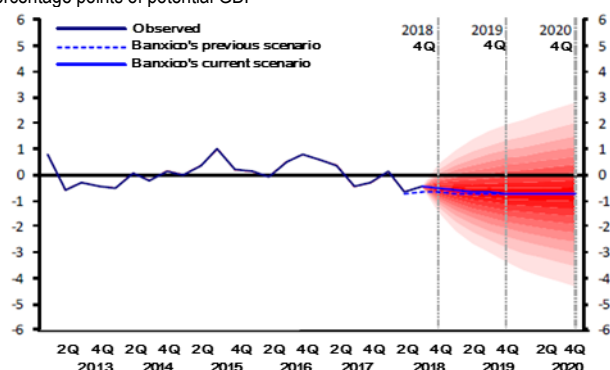
Banxico’s Forecast
Previous Quarterly Report (2Q18)

	2018	2019
GDP (%)	2.0 – 2.6	1.8 – 2.8
Employment (thousands)	670 – 770	670 – 770
Trade Balance (bn)	-13.4 (1.1% of GDP)	-14.1 (1.1% of GDP)
Current account (bn)	-23.7 (1.9% of GDP)	-27.9 (2.1% of GDP)

Source: Banxico

Output gap

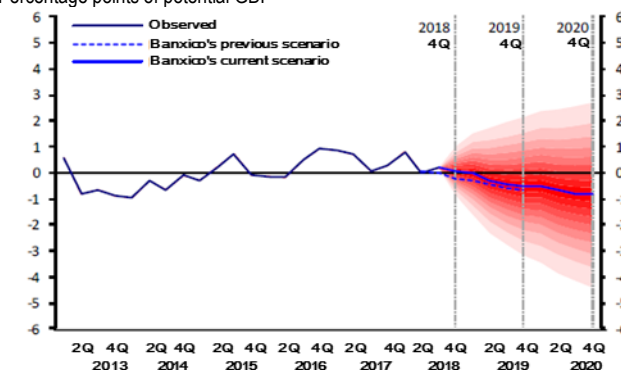
Percentage points of potential GDP



Source: Banco de Mexico; 3Q18 QR

Output gap ex oil production

Percentage points of potential GDP



Source: Banco de Mexico; 3Q18 QR

Banxico policy decisions in 2019 will still be closely aligned to the US Fed.

All of Banco de Mexico’s monetary policy meetings will take place with a lag no greater than two weeks from the Fed’s decisions (refer to the table below), relatively in line with 2018’s calendar, when the longest time span between meetings was three weeks due to the *Holy Week* holiday in Mexico. This is particularly relevant considering that, starting next year, all of the Fed’s meetings will be followed by a press conference by the chairman, thus making all of the meetings “live”. Last but not least, the Calendar also included the dates when the *Financial System Stability Report* will be released.

Monetary policy meetings

Month	Federal Reserve	Banxico
January	30	--
February	--	7
March	20	28
April	--	--
May	1	16
June	19	27
July	31	--
August	--	15
September	18	26
October	30	--
November	--	14
December	11	19

Source: Banxico, Federal Reserve

Banxico defends its mandate, and explains the rationale of recent decisions.

Included in a research note, Banxico reflected on its public policy goals, objectives, and limitations. In particular, they reaffirmed that, based on economic analysis and empirical studies, monetary policy cannot have a permanent effect on the course of economic activity. In particular, they said that consistently looser monetary policy does not lead a permanent shift in potential GDP but on high inflation. Given the costs associated with the latter scenario, the best contribution that the central bank can make to the economy is to focus its efforts on achieving price stability, as its mandate states. In this context, they also explained their rationale for recent decisions (August, October and November). In the first two, the Board maintained the reference rate unchanged at 7.75%, considering that inflation shocks were transitory and slack in the economy had increased. In contrast, in November they raised the reference rate by 25bps to 8.00%. Among the reasons, they highlighted the resistance of core inflation to decrease, staying at elevated levels, along risks for inflation that remained skewed to the upside and deteriorated, along the possibility of economic policies that could structurally affect the price formation process. This discussion suggests that Banxico already takes into account the effect of economic slack in the inflation outlook, but the latter is preeminent when taking policy actions, as stated in the central bank’s constitutional mandate.

In the traditional grey boxes, Banxico emphasized the impact of energy prices on core inflation... Considering the 20.6% and 9% YTD increases in the prices of low-grade gasoline and LP gas, respectively, as well as the resistance of core inflation to converge to target, the central bank analyzed the effect that energy prices have had in the latter. For the study, two components of core inflation were defined, one that reacts significantly to energy and a complementary index that does not. This methodology allowed Banxico to determine that there is evidence of a positive pass-through effect from energy to core prices, as evidenced by the statistical difference between both components. In addition, an exercise using a counterfactual scenario provided evidence that the convergence has also been delayed by adjustments in other variables, such as the exchange rate and wage dynamics.

...and potential effects from wage indexation to inflation. Within this research box, the central bank concludes that introducing schemes to index wages to inflation introduces rigidities into the labor market, which in turn makes it more difficult for the economy to absorb adverse effects. Moreover, these measures tend to increase the risks of inflationary spirals, particularly if the indexation is pegged to actual inflation vs. expectations. These negative effects were exemplified by Banxico with a historical and econometric analysis in both Brazil (wages in the late 70's and early 80's) and Mexico (basic goods in the late 80's) when this type of programs were implemented, which eventually translated into negative impacts to both economies.

Moreover, Banxico commented on the recent adjustments on the outlook for the credit rating of both Mexico and Pemex. Following the adjustment in the credit outlook from *HR Ratings* and *Fitch Ratings* in October 2018, as well as comments from *S&P* and *Moody's* in the same period, Banxico stated that in previous instances of similar actions, the Federal Government has acted to minimize the probability of risks materializing. This was evidenced by the actions undertaken in 2016 and 2017, which resulted in budget cuts in order to bolster confidence among market participants. In this regard, Banxico commented that: *"...the challenge for the new administration is to make decisions that lead to the strengthening of the country's institutional framework and generate certainty to all participants in the Mexican economy..."*.

We now expect Banxico's to hike the reference rate 25bps to 8.25% on December 20th. In our view, this is supported by: (1) The upward revision to inflation forecasts in the short- and mid-term, particularly as they stand above Banxico's target for all 2019; (2) the persistence of comments regarding the deteriorated outlook for prices, including resistance of core inflation to maintain its downward trend supported by the study that finds evidence of relevant pass-through of higher energy prices; (3) the discussion about risks for the price formation process in the short- and medium-term; and (4) a highly uncertain outlook, stemming from external and local factors.

Going into 2019, we believe Banxico will remain relatively reluctant to keep hiking rates, as the real ex-ante interest rate is already at highly restrictive territory, the new administration has committed to maintaining sound fundamentals, and the central bank expects slack in the economy to increase. Nevertheless, we recognize that risks remain tilted to the upside in terms of the terminal reference rate.

From our fixed income and FX strategy team

Banxico's QR reaffirmed the hawkish tilt, giving support to our negative view on Mbonos and arguing in favor of our trade idea in floating-rate securities. Banxico's QR depicted a similar hawkish bias with respect to the most recent policy announcement. The central bank stressed out several headwinds for FX and inflation, suggesting that additional rate hikes could be required in order to tackle the risks to the convergence of inflation towards its target. The market reaction was modest, as the yield curve is already pricing-in tighter monetary conditions ahead, with almost a 100% implied probability for a 25bps rate hike next month and +64bps of cumulative increases in a 6-month horizon. The 5-year forward rate continue portraying an upward trend, trading today at 9.86% (+6bps), as a result of higher term and risk premiums. Overall, today's document gives support to our negative view on Mbonos and argues in favor of our trade idea in floating-rate securities. In terms of the FX market, the negative assessment about current market conditions is also beneficial for our long USD trade recommendation. More details in "*Mexico: Fixed-Income and FX Weekly*", <[pdf](#)>, published on November 26th, 2018.

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