

## Banxico – Completely bound to the Fed

- Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected
- In our view, the tone of Banxico’s post-meeting statement was in line with the last *communiqué* given that:
  - (1) The balance of risks for economic growth continues to be deteriorated, and there isn’t any concerns regarding inflation
  - (2) They will be attentive to Mexico’s relative monetary conditions, particularly with respect to the U.S.; and
  - (3) The board stated again that market’s perception regarding the next hike in the Fed’s fund rate could be delayed;
- Looking ahead, we continue to believe Banxico will begin a hiking cycle in July 2015, immediately after the Fed starts its own normalization process in June

**Monetary policy decision - Rate and tone unchanged.** Today, Banxico held its third monetary policy meeting of the year. The board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our view, the tone of the statement was in line with the last *communiqué* given that: (1) The balance of risks for economic growth continues to be deteriorated and there isn’t any concerns regarding inflation; (2) the will focused on Mexico’s relative monetary conditions, particularly with respect to the U.S.; and (3) the board stated again that market participants are pricing that the next Fed rate hike could be delayed.

**Dovish tone in terms of economic growth...** In terms of economic growth, we believe that Banxico’s tone was in line with the last statement. Even though the Board considers that the balance of risks for global economic growth has remained stable, the Board now considers that the balance for growth in Mexico continues to be weak. In particular, they highlighted that: *“The Mexican economy continued to show a moderate growth... Considering the above-mentioned factors, we believe that the balance of risks for growth still tilted to the downside ...”*

**Fed’s monetary policy and FX performance in the spotlight.** Banxico stressed out that *“...given that Mexico’s economy is highly integrated to the Global economy, in particular to the U.S., the Fed’s monetary policy could have a significant impact on the exchange rate, inflation expectations, and therefore the overall price dynamics in Mexico. Taking the above-mentioned factors into account, the Board will remain focused... on Mexico’s relative monetary conditions, particularly with respect to the US, as well as the performance of the exchange rate.”*

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**Mundell-Fleming world.** As we have mentioned earlier, Banxico does not manage the reference rate in absolute terms but, given the global influence of the U.S. monetary policy, it only sets the spread between Mexico's rate and the U.S. federal funds rate. Thus, if the Federal Reserve decides to hike its rate in June, almost independently of Mexico's economic cycle and inflation, Banco de Mexico "*will have to at least maintain*" the differential between the interest rates in both countries. Particularly given that not doing it could trigger a significant depreciation of the Mexican peso against the dollar.

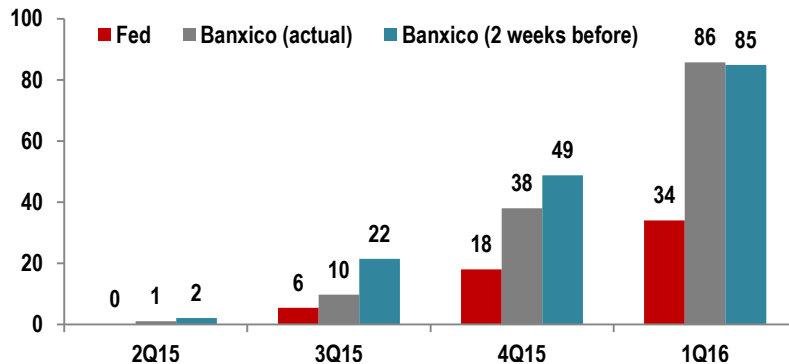
**We maintain our expectations that Banxico's next move will be a rate hike in mid-2015.** Given that economic activity in Mexico will expand at a higher rate this year (*vis-à-vis* last year), and that the Fed will raise the federal funds rate (probably in June), we consider it highly likely that Banxico will also start a hiking cycle (in July), even though inflation in Mexico will be around its 3% target. In this regard, we believe that the hiking cycle will be supported by: (1) Greater concern for the pass-through effect of the depreciation of the peso against the dollar to inflation; and (2) the board will probably be more empathic in the next monetary policy announcements about Mexico's relative monetary conditions, in particular to the U.S., given that it is a key factor to decide Mexico's reference rate path. In this context, we acknowledge that given the global deflationary environment, there is a chance that the U.S. Fed might postpone the beginning of its hiking cycle. If this is the case, then we would change our Banxico monetary policy call as well. The minutes of this meeting will be published on May 14.

*From our fixed income and FX strategy team*

**Investors modified their expected scenario for Banxico's future policy path, now pricing in a hiking cycle in tandem with the Federal Reserve.** Market adjusted its expectations on Banxico's future policy path embedded in short-term rates after a combination of a dovish bias in terms of the economy and a neutral perspective on inflation dynamics portrayed at today's *communiqué*. Short-term interest rate swaps in Mexico have observed an important correction in the previous two weeks, depicting currently a similar scenario to the one observed in their counterparts in the U.S. As a result, local rates are pricing in a situation in which Banxico will start hiking rates in tandem with the Federal Reserve and not before, despite any concerns regarding a weaker currency. As observed in the following chart, market priced in implied cumulative hikes of 22bps by 3Q15 and 49bps by 4Q15 two weeks ago, which represented a more aggressive scenario in terms of monetary policy restriction in Mexico *vis-à-vis* the U.S. However, as of today, the market is pricing in a more gradual hiking cycle in Mexico, with implied cumulative hikes of only 10bps by 3Q15 and 38bps by 4Q15, situation that is in line with the scenario priced in the U.S. market.

### Cumulative implied movements in reference rates

Basis points, using interest rate futures



Source: Source: Banorte-Ixe with data from Bloomberg

In terms of long-term securities, market observed a muted reaction following Banxico's *communiqué*, as investors continue acknowledging several global risks that could undermine the performance of sovereign bonds worldwide. In our view, valuation of the Mexican yield curve remains attractive, mainly in 20-year Mbonos such as May'31 and Nov'34. However, we acquiesce in the strong likelihood that the current sell-off could extend for the following sessions as the uncertainty surrounding Fed future actions and important economic data next week could result in higher risk premia globally. Nevertheless, we consider appropriate to wait for better entry levels in coming days for long directional strategies. Losses could prevail despite an attractive valuation in terms of the shape of the Mbonos curve in addition to spreads to U.S. Treasuries that are not reflecting Mexico's fundamentals. Specifically, the 10-year spread is currently trading at 381bps, higher than the mid-term equilibrium of 360bps and the 12-month mean at 352bps.

### **The peso did not react to the release and reaffirms our view that support from higher local interest rates should be limited in the foreseeable future.**

The Mexican peso had a similar dynamic, broadly unchanged at 15.36 per dollar after the *communiqué* following the selloff earlier today. Changes were minor, with the Board maintaining a strong vigilance of the currency's trend and relative monetary conditions to the US as a top priority for potential interest rate changes. The latter is consistent with our view that currency support from short-term interest rate differentials should be limited in the foreseeable future, more so considering rate hikes by other flow competitors (e.g. Brazil) that reduce its appeal among EM. In addition to a relatively high beta and liquidity when compared to other emerging markets, this suggests that the peso is still vulnerable to higher market volatility due to its efficiency as a proxy hedge to exposure in these types of assets. We reiterate our neutral stance on the peso and believe that it could trade between 15.00/15.10 to 15.50/15.56 in the short-term in the absence of local catalysts to counter for uncertainty in global markets. This expectation considers the possibility that the USD continues correcting lower given prospects of a potential delay in the timing for the Fed's liftoff and more positive news about a possible short-term deal between Greece and its creditors, which could result in a more benign environment for carry trades.

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