MoF and Banxico reinforce macroeconomic framework

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- **Mexican economic authorities have just announced three policy decisions aiming to reinforce the macroeconomic framework:**
  - **(1) Banxico announced its decision to hike the reference rate by 50bps to 3.75%**
  - **(2) The Ministry of Finance announced preemptive spending cuts for MXN132. 3bn (~US$7.2bn) in 2016; and**
  - **(3) The *Exchange Rate Commission* suspended dollar auctions**
- **In this context, we revised down our GDP growth forecast for 2016 to 2.3% from 2.7%**
- **Looking ahead, we believe that today's decision will allow the central bank to continue following the Fed's monetary policy normalization, hiking again in June**
- **In our view, the measures taken today show once again the government's deep commitment to maintaining macroeconomic stability**
- **Strong reaction in local markets following the announcements from MoF, Banxico and FEC**

Banxico announced its decision of hiking the reference rate in 50pbs. In an extraordinary meeting, Banxico's board of governors decided unanimously to increase to 3.75%. The central bank argued that the increased volatility in financial markets along with a very adverse external environment in which oil prices continue to decline, could have a negative effect on inflation expectations. Nevertheless, the monetary authority stressed that this measure *"...does not start a monetary tightening cycle..."*.

At the same time, the Ministry of Finance announced a preemptive spending cut for MXN132.3bn (~US$7.2bn). This amount is equivalent to 0.7% of GDP, and it also aims to deal with the deterioration of global conditions. From this amount, the federal government will reduce current expenses by MXN32.3bn (~US$1.8bn), without affecting security or social programs. The rest of the adjustment will come from *Petróleos Mexicanos*, with the details to be announced later on.

Finally, the *Exchange Rate Commission* suspended dollar auctions. Nevertheless, they kept open the option of intervening on a discretionary basis if needed. It is worth highlighting that decisions in terms of FX policy are made by a joint commission formed by the Ministry of Finance and the central bank.

In this context, we revised down our GDP growth forecast for 2016 to 2.3% from 2.7%. While the measures taken today by the MoF amount to 0.7% of GDP, we believe their negative impact on economic growth could be of around 0.3%-pts taking into account the multiplier effect of government spending. We expect another percentage point to be subtracted as a result of the slowdown in intermediate manufacturing output on the back of the slowdown observed in this same sector in the United States. Nevertheless, recent figures suggest that private consumption continue to strengthen driven by higher levels of job creations, contained inflation and credit expansion. Here it is important to highlight that we do not expect the increase in interest rates to have an immediate impact on banking credit trends as there are other forces in favor such as an increased competition in the sector. Finally, we expect external demand continue driving the economy through increased demand for Mexican manufacturing final goods.

In our view, the measures taken today show once again the government's deep commitment to maintaining macroeconomic stability. Local financial markets performance had not fully reflected the country's fundamentals in the past few weeks amid the renewed wave of high volatility in global markets. We believe that the measures adopted today show that the government is prepared to deal with an adverse global backdrop and that they are fully committed with macroeconomic stability. In terms of monetary policy, we expect Banxico to continue being tied to the U.S. Fed raising rates again in June.

From our fixed income and FX strategy team

Strong reaction in local markets following the announcements from MoF, Banxico and FEC. The Mexican yield curve observed a bear flattening bias in tandem with a sharp appreciation of the local currency in the aftermath of Banxico's decision to hike its reference rate by 50bps (from 3.25% to 3.75%), and reacting to the MoF's announcement of reducing spending and the Federal Exchange Commission to suspend the dollar auction mechanism after intervening discretionally along today's session.

The yield curve flattened as a result of short-term securities portraying higher rates (15-30bps), the mid-end observing a 5-10pb upward adjustment and long-duration instruments remaining flat (even with minor gains in few tenors). Derivatives curve observed a similar performance, while Udibonos curve was more defensive. The rationale behind these dynamics lies in the pricing of future implied hikes along the yield curve, especially in the mid- and long-ends, which show a policy normalization process in accordance to actual conditions. Moreover, the spreads between Mexican bonds and their U.S. peers, mainly in longer tenors, remain elevated, as a result of global uncertainty and risk aversion but not consistent with the fundamentals of the Mexican economy. We consider appropriate waiting for better conditions to increase directional positions in the local yield curve, mainly in mid- and long-term securities.

In the FX market the peso had a very strong reaction, gaining up to 80 cents from 18.80 to a minimum of 18.00 per dollar on an intraday basis and currently trading around 18.27. As a result, the currency accumulates a 3.3% appreciation on the day, the highest among emerging markets. The elimination of “minimum-price” auctions with the possibility of discretionary sales, coupled with the 50bps interest rate increase, could have at least two positive effects in the currency: (1) It provides more flexibility to Banxico in terms of the potential amount of daily dollar sales in the market to improve liquidity conditions during bouts of volatility; and (2) it increases the cost of short peso positions given its use as a proxy-hedge to exposure in other emerging markets given the increase in the short-term interest rate spread to the US, potentially weakening the negative effect of higher risk aversion and demand for safe haven assets. All in all, we do not discard USD/MXN trending towards the 18.00 psychological level in the short term, with the market rebalancing their positions (such as speculators, which are net short in futures). Nevertheless, external risks remain high and could continue affecting the peso despite these announcements, particularly lingering uncertainty about China, crude oil price dynamics, and Fed monetary policy. All in all, we reiterate our year-end 2016 forecast of USD/MXN 17.60, still seeing a trajectory with high volatility influenced by a plethora of risks, particularly in external markets.

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