

Banxico minutes – The monetary authority rules out acting before the Fed

June 18, 2015

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- Banxico published today the minutes of its monetary policy meeting held back in June 4, in which the board unanimously decided to leave the reference rate on hold at 3%
- In our view, the most important issues discussed were:
 - (1) The balance of risks for growth in Mexico, which remained the same over the inter-meeting period;
 - (2) The balance of risks for inflation that stood practically unchanged from previous meeting (inflation will fluctuate around 3%) but with upside risks; and
 - (3) The market perception regarding the possibility of a delay in the U.S. Fed normalization process
- In our opinion, the minutes kept the same tone we perceived in the last *communiqué* given that Banxico's monetary policy is "bound" to the Fed's decision
- We perceive a strong debate within Banxico's board members about the timing of the U.S. Fed's normalization process, and the inherent risks for its own monetary policy cycle, if they were to start hiking rates before the Fed does...
- Nevertheless, the majority of board members emphasized that the costs of anticipating any Fed action are far greater than the benefits
- As a result, we continue to believe that Banxico will start a hiking cycle right after the Fed...
- ...however, given the significant gap between the Fed's and Banxico's monetary policy meetings, Banxico could act preemptively even acting in an intra-meeting fashion

Minutes kept the same tone as the last *communiqué*. Banco de Mexico just published the minutes of its monetary policy meeting held back in June 4, in which the board unanimously decided to leave the reference rate on hold at 3%. In our opinion, the minutes kept the same tone we perceived in the last *communiqué*. In this context, we highlight that the most important issues discussed were: (1) The balance of risks for growth in Mexico, which remained the same over the inter-meeting period; (2) the balance of risks for inflation that stood practically unchanged from previous meeting (inflation will fluctuate around 3%) but with upside risks; and (3) the market perception regarding the possibility of a delay in the U.S. Fed normalization process.

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The balance of risks for growth in Mexico remains the same. Most board members mentioned that the balance of risks for the Mexican economy continues to be negative, but it has not deteriorated from previous meeting. While most of board members recognized that private consumption has shown a visible recovery –mainly reflected in the most recent retail sales and *ANTAD* sales reports-, GFI has shown a moderate recovery derived from the lower growth dynamics of the construction sector. Moreover, industrial production has been hampered by the reduction in Mexico’s oil production, and the temporary slowdown in the U.S. economy, which resulted in a lower performance of manufacturing exports. Similarly, the majority of the board mentioned that: *“...there is still slack in labor markets and the economy in general, so no generalized demand-sided pressures on prices are anticipated. In this regard, some members commented that the economy is expected to continue showing a negative output gap, and this situation should prevail at least until 2016 ...”*.

The balance of risks for inflation remains practically unchanged, but upward risks remain. In terms of inflation, most members agreed that the balance of risk has remained stable regarding the last monetary policy statement. We highlight that: *“...most of Banxico’s board members confirmed that headline inflation will remain below 3% yoy in 2015. For 2016, inflation will most likely remain around 3% throughout the year...”*. However, Banxico was very emphatic in highlighting the upside risks, as most of the Board members mentioned: *“...the possibility that the depreciation of the Mexican currency could contaminate inflation expectations. [...] As other factors to consider forward, a member said that the positive shocks on inflation in 2015 will not necessarily be repeated next year, plus next year’s inflation will not benefit from the disappearance of the positive base effect resulting from the tax reform in 2014. He added the possibility that demand-sided pressures could rise as economic recovery progresses...”*.

The Fed monetary policy normalization will probably begin later than it was expected a few months ago. With regard to the beginning of U.S. interest rate hiking cycle, most of Banxico’s board members agreed that *“... there is still uncertainty about the date in which the Federal Reserve will begin its hiking cycle, and the pace at which it will take place. Some board members highlighted that analysts prospects for the Fed’s first rate hike stand closer to September, however, market expectations implied from derivative instruments suggest that the first rate hike could take place until December or even at the beginning of next year...”*.

Higher costs of acting before the Fed. Even though two board members argued in favor of anticipating the Fed’s decision, most agreed that: *“... taking into account the recent fiscal adjustments and given that inflation expectations are well anchored, acting ahead of the Federal Reserve would have more costs than benefits, given that it could affect Mexico’s economic recovery...”*. Additionally, a board member was very emphatic in stating that *“... such action [acting ahead of the Fed] would operate through the channel of expectations and their impact on the economy would depend on the beliefs or perceptions of economic agents.*

In this context, he explained that there may be multiple equilibria. Indeed, one possibility in anticipating the Federal Reserve, -in an environment of weak economic activity, inflation and inflation expectations at historical lows-, could generate an unfavorable reaction of economic agents, and could detonate a disruptive behavior within local markets...”

Time gap between the FOMC and Banxico meeting schedules. As we have mentioned throughout our publications, the central bank is in no hurry to raise the reference rate, given Mexico’s moderate growth, inflation at 3%, and without any inflationary pressures on the horizon. If Banxico intends to “*follow the Fed*” it would be convenient for Banxico to keep a *wait and see* mode. However, Banxico’s monetary policy meetings will take place between four and five weeks after the Fed meetings, which could qualify as an “*eternal gap*” for fixed-income and derivatives traders (refer to the table below). We believe that this could be a decisive factor that could trigger Banxico to raise rates in an intra-meeting fashion. Moreover, if the Fed begins to hike in December, Banxico will no longer have a regular monetary policy meeting scheduled this year after the Fed’s meeting. We believe it would be advisable for the board to modify its calendar, so that the next monetary policy announcements could take place exactly one day after the FOMC. While this change could trigger some movements in the FX and TIIIE futures market, we believe that these movements will be non-disruptive, nor highly distortionary. Conversely, Banxico could remove a source of uncertainty.

Dates of the upcoming monetary policy decisions

	FOMC	Banxico	Difference (in days)
1	Wed 17-Jun	Thu 23-Jul	36
2	Wed 29-Jul	Thu 3-Sep	36
3	Thu 17-Sep	Thu 15-Oct	28
4	Wed 28-Oct	Thu 3-Dec	36
5	Wed 16-Dec	--	--

Source: US Fed and Banco de México

We maintain our view that the central bank's next move will be a hike, immediately after the Fed. While Banxico’s central scenario seems to be of economic weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to the exchange rate dynamics and inflation levels in Mexico. Given this, we believe that Banxico’s next move will be a rate hike, immediately after the Fed starts its hiking cycle in September 16-17. This implies that the central bank could be raising rates in the next regular meeting on October 15th, four weeks after the Fed’s first rate hike. Nevertheless, we cannot rule out that, since this four-week period could create a high volatility scenario in domestic financial markets, there is the possibility that Banxico could act preemptively, if and only if, the board perceives higher risks to inflation and/or financial stability.

From our fixed income and FX strategy team:

Banxico's minutes with no relevant info that could change market expectations on future policy path. Local assets with no reaction after Banxico released the minutes from its June 4th meeting. Discussions between the Board members on topics related to the economy, inflation and monetary conditions suggest that the central authority is likely to start liftoff in tandem with the Federal Reserve. The absence of FX pass-through effects and well-anchored inflation expectations will grant Banxico the opportunity to observe closely the strategy from the U.S. authority.

In fixed-income, financial assets already price-in the beginning of liftoff from both central banks by year-end: 13pb of implied cumulative hikes in December 2015 embedded in Fed funds futures and 33bps for Mexican 28-day TIE futures. Investors continue acknowledging several global risks that could undermine the performance of sovereign bonds worldwide (European bonds adjustments, uncertainty about Fed and Greek's credit impasse). In our view, valuation of the Mexican yield curve is attractive. However, we acquiesce the possibility of further volatility despite the rally observed in recent sessions. We consider appropriate to wait for better market conditions in coming days for long directional strategies, despite an attractive valuation in terms of the shape of the Mbonos curve in addition to spreads to U.S. Treasuries that do not adequately reflect Mexico's fundamentals. In terms of relative value, we expect better performance in 7- to 10-year tenors than other segments of the Mbonos curve.

In FX, the Mexican peso retraced earlier gains from a session-low around 15.17 per dollar around the time of the release to 15.25 currently. Nevertheless, we assign most of the responsibility for the move to better-than-expected US data as opposed to the minutes. We highlight some members' comments that providing liquidity to the FX market would be the first response to further and significant pressures in the currency due to the Fed's liftoff. We concur with the latter, reiterating our view that additional measures could be announced in case of a fast and/or disorderly depreciation towards 16.00 per dollar. In terms of strategy, yesterday we recommended to switch from a long to short peso bias following the Fed meeting and strong gains in the past three weeks. We keep trading ranges on an intraday basis, with the risk-reward profile not attractive enough for directional positions at the current level. In our view, USD/MXN will validate a strong technical support at 15.20 (100-day MA), with stronger appetite for dollars as the peso's valuation advantage has compressed significantly and the currency remains vulnerable to higher volatility and risk aversion, which could surge in the short-term due to the complicated backdrop in Greece.

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