

## Banxico minutes – Hiking cycle not over due to heightened risks

- Banxico published the minutes of the meeting held on November 15<sup>th</sup>, in which the board decided to increase the reference rate 25bps to 8%
- In our view, the information published today supports our call of an additional 25bps rate hike at the December 20<sup>th</sup> meeting, taking the reference rate to 8.25%
- Irene Espinosa dissented in favor of a 50bps rate hike, arguing for the need of sending a strong signal for Banxico to fully comply with its constitutional mandate
- Moreover, Manuel Ramos Francia suggested the need of including some kind of forward guidance in monetary policy decisions
- In our opinion, the tone of the minutes is consistent with the hawkish bias of the statement and the *Quarterly Report*, highlighting discussions on both cyclical and structural upward risks for inflation
- There were deep discussions on uncertainty, both in the short and long term, stemming from external and domestic factors
- In a context of possible low growth and persistence of inflation pressures, the board argued that monetary policy management is complicated so responses should be taken if, for a variety of reasons, uncertainty increases considerably
- Market participants acknowledge the hawkish tilt from Banxico and a cautious stance given a challenging landscape

In our opinion, the tone of the minutes reaffirms the hawkish tone of the statement and the *Quarterly Report*. It is our take that the discussion was mainly focused on upside risks for inflation for the short- and medium-term, and due to possible changes in both cyclical and structural factors. In this respect, a great deal of the discussion was framed in the *Quarterly Report* published yesterday. For details, please refer to: “*Banxico QR – The hiking cycle has not finished*”, <[pdf](#)>.

**Structural challenges for the Mexican economy.** In the discussion about structural factors, the majority agreed that inflation faces important risks related to the possible adoption of policies that could affect the price formation process. In this respect, one member highlighted some risks that have been in place for several years and that have accelerated in recent months, with three of them emerging at an increasing speed and with the possibility of having strong and adverse effects on inflation and the economy in general. Specifically, these are: “...i) an adverse shock to potential growth; ii) a strong and fast deterioration in the conditions of access to international market financing; and iii) the possible unanchoring of inflation expectations that may even lead to a situation of fiscal dominance...”. In this context, this member expressed his/her concern about the materialization of such risks and how this would make the economy operate indefinitely with a higher inflationary bias and smaller growth.

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**Views on recent market developments.** The majority considered that national financial markets were subject to significant pressures due to both external and domestic factors since the last monetary policy meeting. In this respect, some members considered that domestic factors were the main ones affecting the recent evolution of markets, including the exchange rate, and medium- and long-term interest rates. Some members considered that trading conditions in the foreign exchange market remained stable during the period, but one said that there were significant effects in the fixed-income market, with abrupt movements under low liquidity conditions.

**Uncertainty is the name of the game.** Throughout the document, several comments were made about the challenging backdrop for the Mexican economy as it faces an unusual degree of uncertainty. In particular, most alluded that: “...an environment of greater uncertainty for the country’s macroeconomic framework has been generated...”, and therefore, “...the current environment of uncertainty presents risks for the nominal functioning of the economy...”. Moreover, most noted that monetary policy should have a measured response in case that economic uncertainty considerably. In particular, one member added that monetary policy plays a fundamental role in managing such uncertainty, which possibly implies acting even more prudently than Banxico has been doing up to now.

**One dissenter, several calls for action.** The minutes showed that Irene Espinosa was the dissenter, favoring a 50bps rate hike. Among the reasons supporting her call, she stated that the central bank had to send an unequivocal, timely and strong signal to fully comply with its constitutional mandate, particularly to achieve convergence of inflation towards the target. Additionally, another member said that: “...although it is convenient to modify the objective for the reference rate, currently a single 25bps increase is far from being sufficient to realign the expected trajectory of inflation to its target of 3% in general, not only within the forecast horizon...”. Lastly, another said that even considering higher risks of second-round effects to inflation, a deteriorated balance of risks, and market dynamics which would justify a 50bps rate hike, concluded that a 25bps rate hike was more convenient. The latter, taking into account the decline that inflation is showing and announcements on key decisions on fiscal and wage matters are pending, among others.

**We expect Banxico to hike the reference rate 25bps to 8.25% on December 20<sup>th</sup>.** As we mentioned yesterday with the *Quarterly Report*, we believe that another rate hike is justified after the upward revision to inflation forecasts, particularly as they stand above Banxico’s target for all 2019, coupled with a deteriorated balance of risks for prices in the short- and medium-term. In this respect, the minutes confirm our view that Banxico will maintain a very prudent stance in the face of higher uncertainty. Going into 2019, we believe Banxico will remain relatively reluctant to keep hiking rates, although we recognize that risks are still tilted to the upside in terms of the terminal reference rate.

*From our fixed income and FX strategy team*

**Market participants acknowledge the hawkish tilt from Banxico and a cautious stance given a challenging landscape.** Current conditions point towards a 25bps rate hike on December 20<sup>th</sup> by the Mexican central bank. Banxico's assessment inside today's minutes about the global landscape, in addition to the complex dynamics for the local currency and inflation and other local factor previously discussed, is consistent with the hawkish message previously outlined at yesterday's *Quarterly Report*. In addition, board members are acknowledging the adverse effects of this backdrop for market conditions, increasing the likelihood of higher term, inflationary and risk premiums embedded in local assets for the remainder of the year. In this context, the 2- and 5-year forward rates in Mexico are currently trading 8.89% and 9.74%, respectively, with a 139bps increase on a YTD basis, already reflected a high degree of risk aversion. At the same time, inflation breakevens are hovering around 4.1% in short-term securities (20bps higher from their fair values), and at 4.7% in longer tenors (+70bps) convey a deterioration of inflation expectations. In the same tenor, the spreads between Mexican Mbonos and U.S. Treasuries are operating 120bps above their 12-month means, approaching 2009 levels, while the peso has depreciated 8% this quarter, after breaching 3 standard deviations last month. Under this scenario we expect the *hawkish* tilt to remain for longer. Today's market reaction was limited in both, the fixed-income and FX markets, as investors has already priced in a rate hike in December and tighter monetary conditions in 2019 (+51bps in a 6-month horizon). However, we expect this challenging environment to continue affecting risk premia. In this regard, we hold our trade ideas of long positions in floating-rate bonds and USD.

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