

Banxico preview – Waiting for the Fed’s next hike in June

- **Banxico will announce its monetary policy decision this week (February 4) at 3:00pm (EST)**
- **We expect the monetary authority to remain on hold**
- **We expect the communiqué to highlight that:**
 - (1) **The Mexican economy improved in 4Q15, but there are some downside risks to the outlook;**
 - (2) **The balance of risks for inflation remains positive; and**
 - (3) **The higher probability that the FOMC will decide to delay the its normalization process until June**
- **In addition, we expect the monetary authority to acknowledge the difficult start of the year in financial markets**
- **All in all, we continue to believe board members will reiterate that in the absence of inflationary pressures and moderate growth, the board will continue to monitor the relative monetary conditions vs. the U.S.**
- **It is our take that the tone of the statement will provide support to our call that Banxico will continue its hiking cycle after the Fed’s hike in June**
- **The minutes of this meeting will be published on February 18, and the next monetary policy announcement will take place on March 30**

A slightly more dovish stance. This week, Banxico will hold its first policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (February 4) at 2:00pm (EST). We believe that board members will remain on hold, leaving the reference rate at 3.25%. We expect the communiqué to highlight that: (1) The Mexican economy improved in 4Q15, but there are some downside risks to the outlook; (2) the balance of risks for inflation remains positive; and (3) the higher probability that the FOMC will decide to delay the its normalization process until June. In addition, we expect the monetary authority to acknowledge the difficult start of the year in financial markets. In this context, and taking into consideration recent comments from governor Carstens -who highlighted the need to follow the Fed-, we now expect Banxico to hike another 25bps in June, just after the Fed increases rates again.

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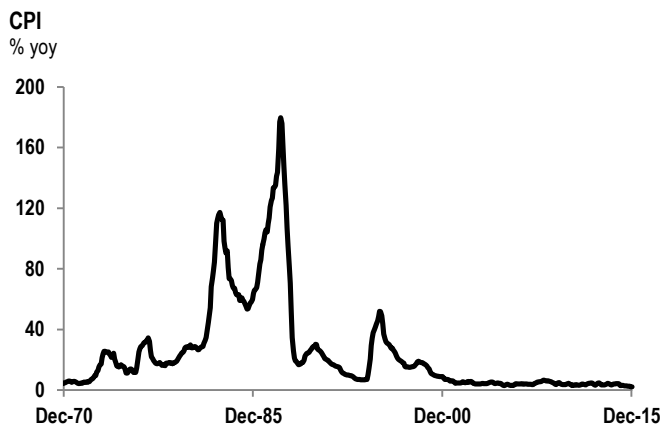
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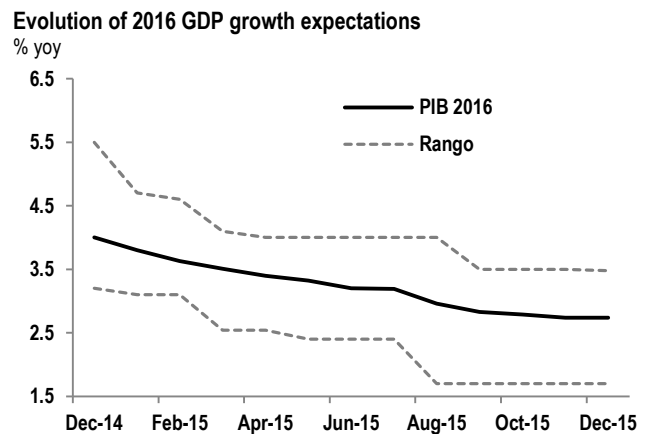
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Moderate growth and low inflation. Given Mexico’s slow economic growth, the absence of inflationary pressures and the Fed’s current monetary policy, common sense would dictate that Banxico should not raise the reference rate, until the Fed continues its hiking cycle. Inflation is at historically low levels (refer to the chart on the left), and even though Mexico's economic growth has been higher, growth expectations for 2016 have been continuously revised downwards (refer to chart on the right). Similarly, economic outlook is not that encouraging for 2016. The current situation of low crude oil prices given Mexico’s heavy dependence on oil revenue (~25%), the government's commitment to reduce the fiscal deficit to 0.5% of GDP in 2016, and the new fiscal regulations that will affect the accounts of Mexico’s federal entities and municipalities, will translate into a lower public spending, hindering 2016 GDP’s growth below 3%.



Source: INEGI



Source: Banxico Survey of Economic Expectations

The FOMC will wait until June to increase the reference rate again. The FOMC decided not to change its monetary stance in order to keep the Fed Funds rate between 0.25% and 0.50%. In the statement, we perceived a more dovish tone. While the Fed has been very clear that the hiking cycle will be “gradual,” it seems that the complex external environment, characterized by high volatility, the decline in oil prices, and the strong appreciation of the dollar will push the Fed to postpone the next rate hike at least until June.

Banxico will follow the Fed. In an interview for *Bloomberg* in Davos, Governor Agustín Carstens was questioned about whether the central bank may adopt a different monetary stance from the Fed. In this regard, Carstens highlighted the importance of distinguishing between economic external and internal factors. In the first case, the currency movement may destabilize inflation expectations and could motivate an increase in Banxico’s reference rate. However, the current dynamics of the Mexican economy, which has been characterized lately by moderate growth, is consistent with the monetary stance taken by Banxico. In this context, and considering that some of the exchange rate volatility is generated by the interest rate differential between Mexico and the US, Carstens said that “*it is essential to follow the Fed*”.

We maintain our view that Banxico will continue its hiking cycle right after the Fed's hike in June. While Banxico's central scenario seems to be of economic activity weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given this, we believe that Banxico will continue its hiking cycle right after the Fed's hike in June.

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