

Banxico – A rate cut is closer than it looks

- We now estimate Banxico to cut the reference rate by 25bps to 8.00% in the September 26th meeting, vs. our previous expectation of a reduction of the same magnitude in November 14th
- Moreover, we now expect the total easing in 2019 to be 50bps vs. only 25bps previously
- We have been arguing that recent inflation dynamics, economic activity, and the relative monetary stance with the US, have provided enough leeway for the central bank to cut the reference rate sooner than we expected, with today’s Fed decision as the final driver behind our call change
- In our opinion, concerns expressed in recent communications about core inflation and financial stability risks will make Banxico’s Board to use the August meeting to pave the way for a rate cut in their next decision
- The market has priced in a scenario in which Banxico will join the dovish inertia worldwide sooner than expected

We now expect Banxico to cut the reference rate by 25bps in September. This view differs from our previous expectation for a rate cut in the November 14th meeting. In addition, we forecast that easing in 2019 will total 50bps, 25 more than our previous estimate. We believe that recent dynamics of inflation, economic activity, and the relative monetary stance vs. the US, have provided enough leeway for the central bank to cut the reference rate sooner than we previously expected. It should be noted that this scenario is more dovish than current analysts’ expectations, which see only a 25bps rate cut (see chart below on the left). Moreover, the market is already discounting a similar scenario as ours (see chart below on the right), with an expected easing of 12bps by the end of 3Q18 and accumulated cuts of 53bps by year-end.

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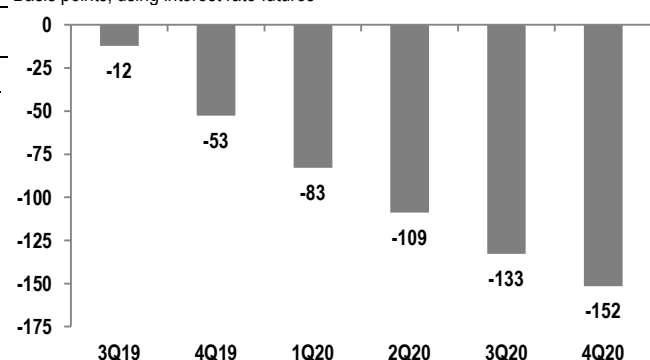
2019-2020 Macroeconomic forecasts

	GDP Growth		Inflation		Banxico's rate		Fed Funds rate	
	2019	2020	2019	2020	2019	2020	2019	2020
	% yoy, %							
Banorte	0.8	1.4	3.5	3.5	7.75	7.00	1.875	1.875
Banxico Survey	1.1	1.7	3.7	3.6	8.00	7.50	--	--
Citibanamex Survey	0.9	1.5	3.7	3.6	8.00	7.50	--	--
IMEF	0.9	1.5	3.8	3.7	8.25	7.50	--	--

Source: Banorte, Banxico, Citibanamex, IMEF

Cumulative implied movements in reference rates

Basis points, using interest rate futures

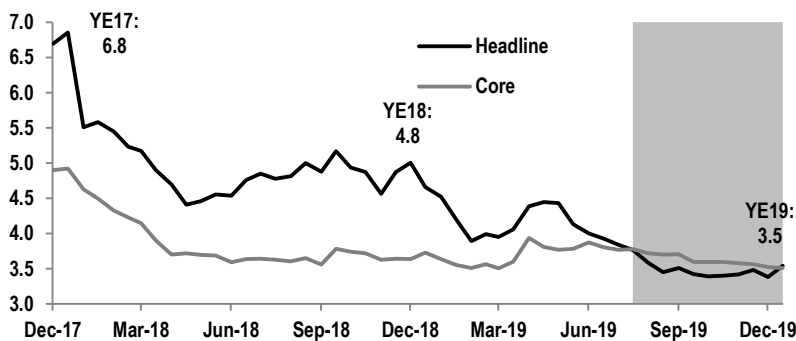


Source: Bloomberg

Inflation is converging to target... After annual inflation climbed to 6.8% at the end of 2017, it resumed its downward trajectory towards the central bank’s target, albeit at a slower pace than expected, finishing 2018 at 4.8%. However, year-to-date dynamics have been more favorable, with non-core inflation playing a key role in driving the headline down to 3.84% in the first half of July (latest data available). This component has fallen from 8.4% in December 2018 to 3.92% in 1H-Jul, on the back of lower energy prices. We have observed some stickiness to the downside within the core component, which has climbed from 3.68% to 3.81% during the same period, a situation that has been flagged for some time now by Banxico’s Board. In spite of this, we remain confident that headline inflation will continue declining gradually to reach our year-end forecast of 3.5% (see chart below), which is lower than current market expectations hovering around 3.6-3.7%.

Inflation forecasts

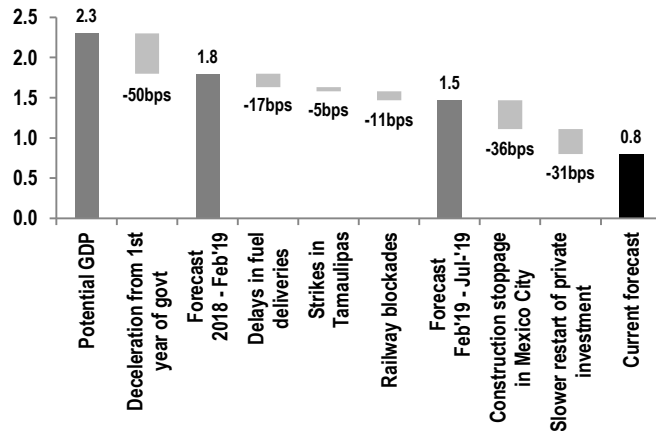
% yoy, bi-weekly frequency



Source: Banorte

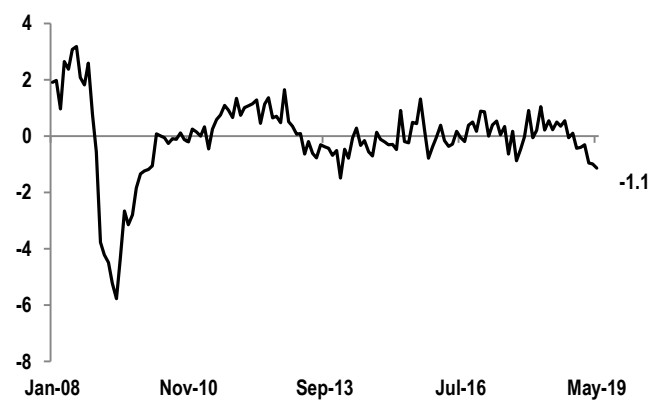
...while economic activity has slowed down significantly. This morning, INEGI announced that GDP in 2Q19 declined 0.7% yoy, after growing 1.2% in 1Q19 (for further details, see: “2Q19 GDP – The Mexican economy continues to decelerate, but avoided a ‘technical recession’” <[pdf](#)>). Using seasonally-adjusted data, growth looks to have stagnated since the last quarter of 2018 (4Q18: 0.0% q/q; 1Q19: -0.2%; 2Q19: +0.1%). In this context, it is worth mentioning that growth declined from 2.9% yoy in 2016 to 2% in 2018, with our estimates pointing to an additional downshift for full-year 2019 towards 0.8%. Even though some of this deceleration was already expected given that we are in the first year of a new federal administration –when an economic slowdown due to government spending is usually observed–, such behavior has been exacerbated by a series of transitory shocks, as depicted in the chart below on the left. In this context, we believe growth will pick-up to 1.4% in 2020 as these factors fade away and social programs by the government consolidate, among other factors. Nevertheless, it is our take that slack will remain relatively high, with our current estimate of the output gap at -1.1% of potential GDP according to the monthly-proxy IGAE (see chart below, right), likely staying in negative territory in coming quarters.

2019 GDP growth forecast
% and contribution in bps



Source: Banorte

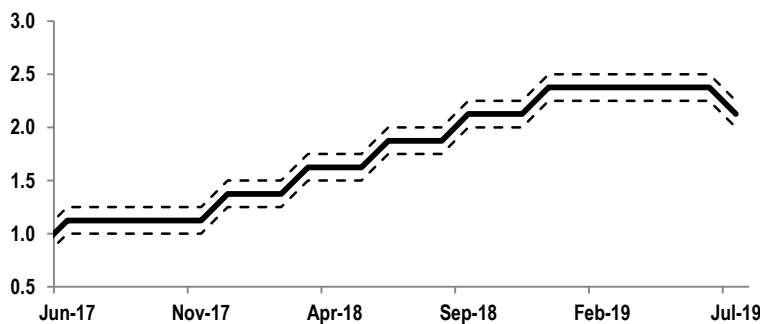
Output gap
% of potential GDP



Source: Banorte with data from INEGI

Relative monetary stance vs. U.S.: The Fed cuts the Fed funds rate. Also today, the FOMC decided to cut the Fed funds rate by 25bps, to 2.125% (see chart below). In our view, the Committee sent a message that was slightly less dovish than expected, albeit still warranting another 25bps rate cut in 2019. For details, see “*Decisión del FOMC – El Fed recorta tasas, pero no abre la puerta a un ciclo de relajación monetaria*”, [pdf](#), published today, (available only in Spanish). In this respect, we believe today’s decision gives Banxico additional degrees of freedom to cut the reference rate soon, particularly given that the central bank has persistently stressed: (1) The importance of the relative monetary policy stance against the US as a key driver for its decisions; and (2) Mexican peso dynamics in terms of the risks for inflation, with a more dovish Fed helping to anchor the currency at a stronger level.

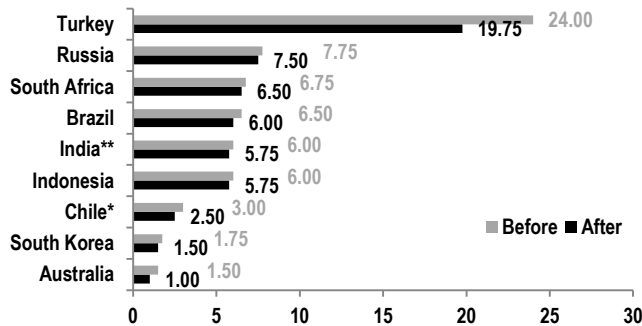
Fed Funds rate
%



Source: Federal Reserve

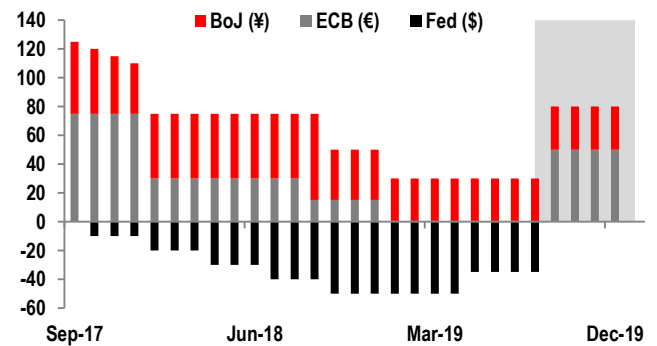
Riding the global dovish wave. It should be noted that easing has not only been done by the Fed, with many central banks, including peers in emerging markets, starting to cut their respective reference rates. In this context, some countries that have recently taken these measures include Turkey, Russia, South Africa, India, Indonesia, Chile, South Korea, Australia and Brazil (see chart below on the left). Additionally, central banks in advanced economies have signaled a higher willingness to ease. In particular the ECB has set the table for a rate cut and even to restart QE. The BoJ showed a dovish tone in its latest communication, which could signal further actions from the institution.

Reference rates in EM at the beginning of the year and its current level %



*Previously, they hiked 25bps at the beginning of the year. **Three 25bps cuts in 2019.
Source: Bloomberg

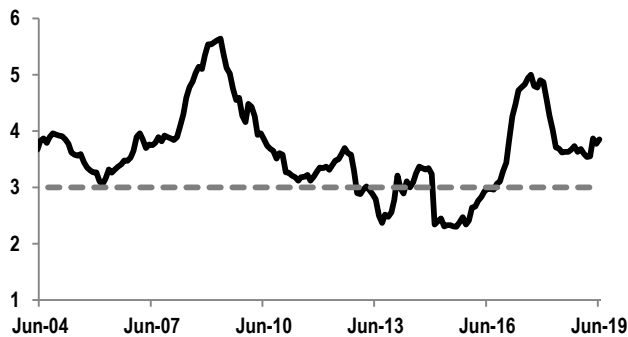
Monthly asset purchases by central banks in advanced economies* Billion, local currency



Source: Bloomberg

We do not expect a rate cut in August. Markets are still incorporating with some probability a possible reduction of the reference rate at the upcoming meeting to be held on August 15th. Nevertheless, taking into consideration the central bank's recent communications (*i.e.* monetary policy statement, minutes of the meeting, Quarterly Report, among others), we consider it is unlikely that the monetary authority will take such action at said meeting. Banxico has expressed concerns about the stickiness in core inflation (see chart below on the left), as well as some financial stability issues. In particular, the monetary authority has referred to Mexico's public finances sustainability, with pending credit rating actions from *Moody's* and *S&P Global*, while maintaining a 'negative' outlook for both the sovereign and Pemex (see table below, right).

Core inflation % yoy



Source: Banorte

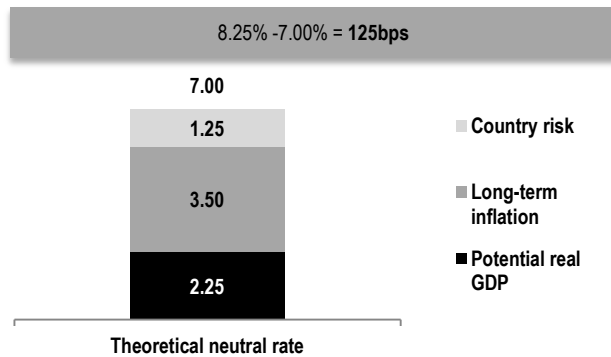
Credit ratings

Fitch Ratings	S&P Global	Moody's Investors Service
A-	A-	A3 (Sovereign)
BBB+	BBB+ (Sovereign and Pemex)	Baa1
BBB (Sovereign)	BBB	Baa2
BBB-	BBB-	Baa3 (Pemex)
BB+ (Pemex)	BB+	Ba1

Source: S&P Global, Fitch Ratings, Moody's Investors Service

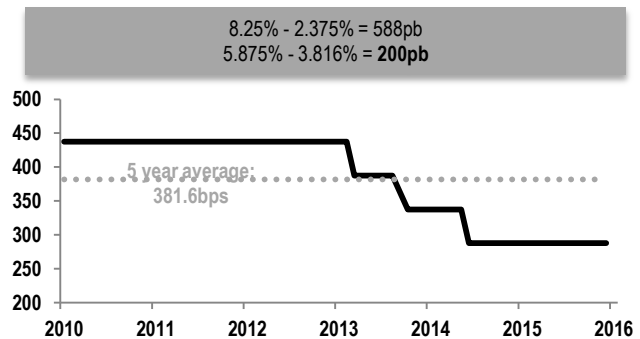
We now believe that Banxico is closer to cutting the reference rate. With inflation converging to target, a significant deceleration of economic activity that is actually tracking below potential, and a global wave of monetary easing led by the Fed, we continue arguing that Banxico's Board has more ample room to cut the reference rate. In our opinion, Banxico will cut the reference rate in the September 26th meeting, against our previous expectation of a reduction of the same magnitude in November 14th. This, in a context in which we see room to ease in a cycle which could be between 125 and 200bps of accumulated cuts, with the reference rate ending between 6.25% and 7% (see graphs below).

Theoretical “neutral” reference rate
%



Source: Banorte

Spread between the mid-point of the Fed funds rate and Banxico's reference rate
Bps



Source: Federal Reserve, Banco de México

From our Fixed Income and FX strategy team

The market has priced in a scenario in which Banxico will join the dovish inertia worldwide sooner than expected. The Federal Reserve and several central banks have started to ease monetary conditions to offset the current economic slowdown. This coordinated dovish strategy has put Mexico into a more restrictive relative monetary stance, as the country has one of the most attractive interest rates on a risk-adjusted basis. Moreover, the spread of ex ante short-term real rates between Mexico and the U.S. is depicting an additional 135bps premium in comparison to equilibrium levels. Although Banxico has been cautious about several risks (external and domestic) that could undermine the convergence of inflation towards its target, along and financial stability, the combination of a deeper economic deceleration and more benign inflation could support the case for a rate cut sooner than previously anticipated.

The Mexican yield curve has already anticipated this backdrop, pricing in -53bps of implied rate cuts this year and -152bps until 2020-end. In terms of strategy, we acknowledge the international landscape (*e.g.* lower rates) could be supportive for Mexican bonds; however, we acknowledge that idiosyncratic factors could affect the risk premium embedded in local assets. We hold our more benign view in short-term securities, which are depicting more attractive carry gains due to an inverted yield curve. On the other hand, we prefer waiting for better market conditions and valuation in longer tenors. Overall this strategy proved to be accurate last week. Regarding the Mexican peso, a Banxico rate cut should not build, in our view, significant carry erosion in the short-term. This factor has been key to understanding the currency's defensiveness throughout the year. Our view is mainly supported by parallel movements by other central banks, both in EM and by the Federal Reserve, holding Mexican rates attractive. However, we see a weaker path for the peso going forward into 2019, averaging this quarter 19.40 for a closing level of 19.68, and averaging 20.14 in 4Q19 for a year-end at 20.30 per dollar. Considering the latter, we suggest taking advantage of attractive levels below USD/MXN 19.00 for long USD positions.

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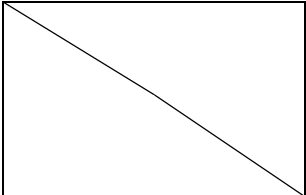
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