Banxico's Minutes – Lower uncertainty is key for a rate cut

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- **Banxico published the minutes of the meeting held on May 16th, in which the Board of Governors maintained the reference rate unchanged at 8.25%**
- **We highlight that, even though the rate decision was unanimous, Gerardo Esquivel did not agree with the tone communiqué for a second consecutive time**
- **In our opinion, the tone of the minutes is relatively hawkish, similar to the one seen on both the communiqué and the *Quarterly Report,* which was published yesterday**
- **However, we perceived a high degree of uncertainty and ample debate over the outlook regarding future monetary policy decisions**
- **We still expect Banxico to cut the reference rate by 25bps to 8.00% in the November 14th meeting**
- **Pressures in Mexican bonds in the aftermath of hawkish minutes from Banxico**

Unanimous decision, with one dissenter about the tone once again. Banxico published the minutes of the meeting held on May 16th, in which the Board of Governors maintained the reference rate unchanged at 8.25%. Although the decision was unanimous, Deputy Governor Gerardo Esquivel did not agree with the tone communiqué for a second time in a row. Once again, he does not concur with both the restrictive tone of the statement as well as the balance of risks for inflation, which remains tilted to the upside. Besides the arguments outlined previously, he added his concern that inflation expectations and the inflation risk premium have increased despite a relatively favorable performance of inflation in 2019. In this regard, he highlighted that *"…It is not totally unlikely that such expectations are being affected by the central bank's communication…"*. He does not agree with the emphasis on the minimum wage hike as an upside risk for inflation, adding that five months after this increase there is no convincing evidence that this is actually occurring.

Risks to global growth remain to the downside, with a higher impact from geopolitical factors. The tone about global growth is in line with the *Quarterly Report* published yesterday (see: "*Banxico QR – Slower growth, convergent inflation, but FX risks",* <pdf>). On recent events, a member mentioned that the increase in protectionist measures between the US and China has dampened investors' risk appetite and could trigger a more pronounced economic deceleration. Additionally, some highlighted risks about the possibility of a no-deal Brexit, increased tensions related to North Korea, and conflicts in the Persian Gulf. One of the main concerns in this front is the possibility that these events trigger higher volatility, with a member stating that financial channels could amplify the economic deceleration. Most members noted that recently, markets have suffered from the escalation in trade tensions, with investors seeking safe-haven assets while capital flows to EMs have moderated.

For the Mexican economy, the document is also consistent with lower growth estimates in yesterday's QR, with most members mentioning that the outlook deteriorated after the 0.2% q/q contraction of GDP in 1Q19. Regarding the balance of risks, one member added others such as (1) That austerity measures from the new government generate a higher slowdown of activity to the one already seen; (2) that the real exchange rate appreciates and impacts negatively non-oil exports; (3) remittances growth start to decelerate; and (4) in the medium term, the possibility of an economic recession in the US.

Discussion on the impact from the increase in minimum wages… One member stated that it is somewhat ironic that in an environment of economic weakness several indicators of wage pressures have increased, mainly due to salary increases above productivity gains. As mentioned yesterday, this is one of the main concerns of the central bank due to its potential pressures on inflation, particularly at the core component. Said member argued that the natural result is the fall in formal employment and a higher unemployment rate, lessened to some extent by higher employment in the informal sector. In addition, the contraction in employment has been steeper in the northern part of the country, where higher wage revisions have been observed, and even contrasting markedly with neighboring counties were these adjustments didn't take place. On the other hand, some signaled that a potential source of wage pressures are the labor commitments embedded in the USMCA agreement.

…and signals stemming from inflation dynamics. In our opinion, the debate about the recent path of inflation was very interesting. One member argued that accumulated headline inflation in 1Q19 was the lowest for a quarter since the creation of the CPI, with a very low January due to the reduction in VAT at the northern border. However, another member said that core inflation in the December-April period was above the same period of last year and the second-highest in the last five years. Despite of the differences in interpretation, most members highlighted that the recent increase in headline inflation was driven by both of its major components, but that *"…the core inflation component contributed in greater measure to such an increase…"*. In our opinion, some of the most relevant factors justifying the more cautious and prudent stance about inflation of the central bank are: (1) Uncertainty regarding the driving factors behind the increase in both inflation components; and (2) if this effect will fade away in the near future.

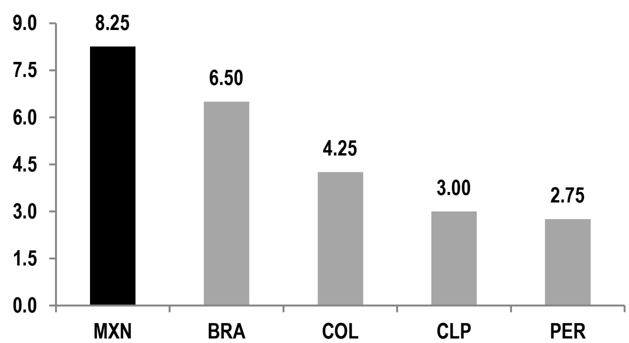
Uncertainty about future policy decisions. The document shows that most members are concerned about the risks of easing monetary policy prematurely. In particular, given an environment that: (1) Both headline and core inflation have increased; (2) the future path of both indices takes into account additional pressures –as it was confirmed with the upward revisions for 2019 and 2020–, and that it has become more uncertain. In this sense, some said that under this circumstances, and on top of an environment of supply-side shocks and recent wage dynamics, an *"…easing of the monetary policy stance or a premature message in this direction would validate the abovementioned inflation expectations, would call into question the commitment to the inflation target and would affect the central bank's credibility…"*.

In this context, most members considered that the institution must be prepared to respond as needed in order to achieve the convergence of inflation towards the target, maintaining a firm and cautious stance as local and external uncertainty remains high.

On the contrary, some members argued that they should be vigilant about economic dynamics in order to prevent maintaining a restrictive stance for too long. In particular, one member (which we assume is Deputy Governor Esquivel) said that this situation could widen economic slack, strengthen excessively the real exchange rate (impacting exporters) and attract volatile short-term capital inflows that could increase the vulnerability of the FX market. In this respect, this member considered that the hiking cycle should be put to an end unless something extraordinary takes place.

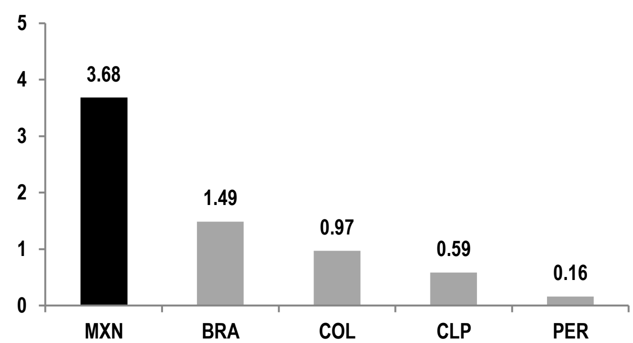
It is important to say that the reference rate is currently very high when compared to EM peers in the region, both in nominal and real terms (see chart below). Additionally, we believe there is consensus among the Board about the economic deceleration and the more accommodative stance of DM central banks. As a result, we believe that the relatively more restrictive stance of our country suggests that the central bank's bias in case of an additional rate move is clearly skewed to the downside.

Nominal reference rate in selected countries
%



Source: Bloomberg

Real reference rate in selected countries
%

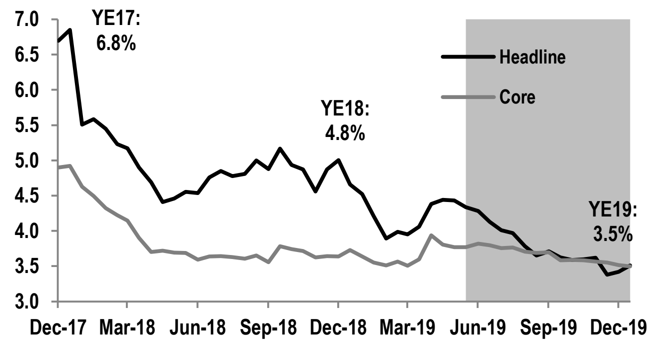


Source: Bloomberg

We maintain our expectation that Banxico will cut the reference rate by 25bps in November 14th. In our view, the most relevant section of the minutes was the debate around recent signs and reasons behind the pickup in inflation. We consider that the central bank maintains a cautious stance mainly due to the uncertainty over this dynamic. In this context, we reiterate our year-end inflation forecast at 3.5%, lower than the 3.7% median in the latest Banxico Survey. In addition, growth estimates continue to be modest and it is not possible to rule out a further deterioration. Taking into account the latter scenario, we maintain our expectation of a 25bps reference rate cut in November 14th. Moreover, we also think that a cut could materialize earlier than we currently expect.

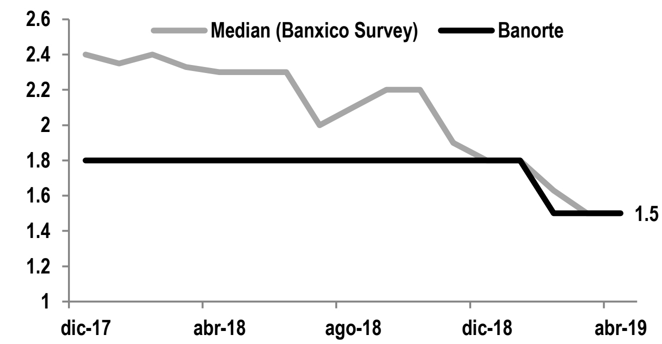
Specific conditions that would increase the probability of the latter scenario include: (1) A further deterioration of economic activity; (2) better inflation dynamics than those currently estimated by the central bank, a situation we believe could materialize by 4Q19;, and/or (3) a reduction in local uncertainty, particularly regarding the financial situation of Pemex including its potential effect on both its own and the sovereign credit rating.

Inflation forecasts
% yoy, bi-weekly frequency



Source: INEGI, Banorte

2019 GDP forecasts
% yoy



Source: Banxico, Banorte

From our Fixed income and FX strategy team

Pressures in Mexican bonds in the aftermath of hawkish minutes from Banxico. Local rates are selling off nearly 3bps on average following Banxico´s hawkish assessment in terms of inflation, while holding a downside tilt regarding the Mexican economy balance of risks, portraying a relevant dovish argument. Investors acknowledged that the majority of the members remain concerned about the degree of deceleration of the global economy. Moreover, they assimilated Deputy Governor Esquivel´s dissenting views in terms of the tone of the communiqué, delivering a more dovish approach about the current state of CPI and not considering the increase in the minimum wage as an upward risk for this factor. As result, the yield curve is pricing in -28bps of cumulative implied cuts by 2019-end and -107bps by the end of 2020. Although we acknowledge that the Mexican yield curve could benefit from the dovish inertia from several central banks combined with an attractive carry, we hold a cautious stance for long directional trade ideas. We continue observing a more attractive relative valuation in Mbonos Nov’36 and Nov’38, nevertheless we suggest waiting for better market conditions and entry levels for new long positions.

USD/MXN reacted with a positive tone to this Thursday’s minutes, trading at 19.08 (+0.3%) following a previous session in which Banxico’s Quarterly Report contributed to a 0.3% rally. The peso’s dynamics are still holding amid narrow ranges, as has been the case of the latest weeks, a context that in our view will linger in the short-term. Looking forward, we acknowledge a more complex second half of the year, although taking into account Banxico’s recent communications; the currency’s embedded carry will remain as a key support. Capturing this view, we suggest waiting for more attractive levels for USD long positions, especially when trading close to 18.80 per dollar.

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SELL	*When the share expected performance is lower than the MEXBOL estimated performance.*

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