Banxico's hiking cycle comes to an end

- **Banxico just announced its monetary policy decision, in which the board decided to increase the reference rate by 25bps to 7%, in line with our and consensus forecast**
- **We highlight that one Board member voted in favor of maintaining the current reference rate**
- **We believe that Banxico's 25bps rate hike was mainly explained by the Fed's 25bps hike in June**
- **However, the central bank did significantly modified the tone of the *communiqué* showing a dovish bias, where they stressed that: *"... taking into account the transitory nature of the recent inflationary shocks, the time horizon in which the transmission channels of the monetary policy work, as well as the current forecasts for the Mexican economy, the actual level of the reference rate is compatible with the process of efficient convergence of inflation to the 3% target …"***
- **Banxico acknowledged that the balance of risk for inflation didn't show a further deterioration, and highlighted:**
  (1) The restrictive monetary policy implemented since 2015 will continue to influence the behavior of inflation;
  (2) Inflationary pressures derived from the pass-through effect of the depreciation of the Mexican currency to prices, as well as the increase in the prices of energy will fade away in the short run; and
  (3) The negative output gap, as a result of the downward trend in investment
- **Even though we believe that inflation will maintain an upward, albeit a softer trend and will reach a maximum in August (6.5% yoy), we believe that it will converge towards our 5.7% year-end forecast (refer to the chart on the following page)**
- **Since Banxico's Board considers that the impact of the above-mentioned inflationary shocks is temporary, and the current level of the reference rate is consistent with the convergence of inflation to its 3% target, we now consider that the monetary authority will maintain the reference rate at 7% throughout the year**
- **We also believe that the monetary authority will be able to initiate an easing cycle in 2018, given that inflation will be converging towards the 3% target, as the above-mentioned inflationary shocks fade**
- **The minutes of today's meeting will be published on July 6, and the next monetary policy announcement will be published in August 10**
- **Local rates extended today's rally following a dovish rate hike from Banxico this afternoon trading 17bps lower *vis-à-vis* yesterday's closing level, with market participants currently pricing in the possibility of the central bank easing conditions as soon as December**

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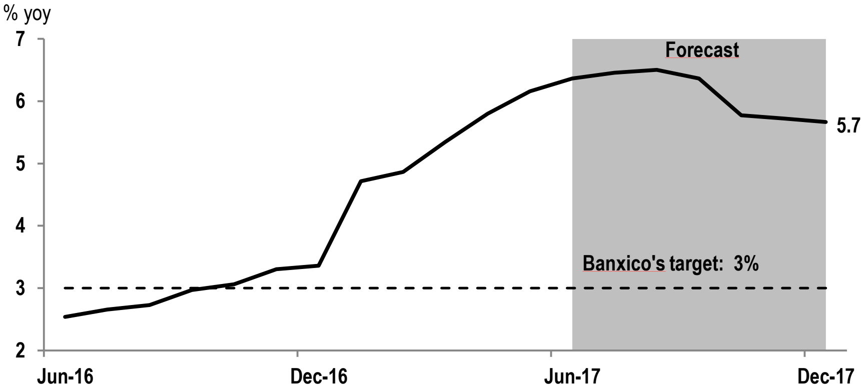
- **We believe that the easing cycle will depend on three factors: (1) Continuation of the Fed's monetary policy cycle; (2) the perceived risks with respect to the presidential election of June 2018; and (3) the bias of Banxico's new Governor, who will replace Agustin Carstens in November 30**

- **Taking into account current conditions we recommend long positions in 3- and 5-year Mbonos Jun'20 and Jun'22, despite a flatter curve, but with an attractive country risk premia (532bps and 504bps spread against U.S. Treasuries, respectively) and embedded policy outlook (*e.g.* 5y5y forward rate at 7.02%)**
- **The Mexican peso strengthened from 18.10 to 18.03 per dollar as an immediate reaction despite the dovish tone, albeit now gaining 0.8% on the day to the former level. Nevertheless, we highlight that forward points along the curve diminished significantly, with the implied carry of MXN/USD longs at the one-year maturity from 5.50% to 5.34%, low since April 14th when the spread against the fed funds rate was 25bps lower, and below short-term tenors (*e.g.* one-month at 5.68% annualized). This signals the possibility of a lower interest rate advantage for Mexico in the near future, which could limit the currency's current pace of appreciation**
- **We maintain a positive bias on MXN for tactical trading purposes, with the peso still resilient due to attractive carry and low volatilities that keep supporting portfolio inflows. Technically, we see 18.00 as an immediate support, believing that another test of the 17.87-17.90 zone is likely. We reiterate our preference for waiting better entry levels to enter new directional positions**

Banorte-Ixe inflation forecast

% yoy



Source: Banorte-Ixe with data from INEGI

Disclaimer

The information contained in this document is illustrative and informative so it should not be considered as an advice and/or recommendation of any kind. BANORTE is not part of any party or political trend.

BANORTE IXE

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