

Banxico – Hawkish tone suggests a rate hike in September

- Banxico just announced its monetary policy decision, in which the board decided to remain on hold, as it was widely expected
- In our view, the *communiqué* maintained a hawkish tone because:
 - (1) Banxico recognized the higher probability of financial volatility on the back of geopolitical risks including the US elections and the normalization of the Fed's monetary policy
 - (2) The balance of risks for inflation in the horizon in which monetary policy operates remained unchanged, on the back of June's 50bps hike
- However, we believe that the *communiqué's* hawkish tone was limited by the comments regarding Mexico's slower economic growth, which is why we believe that Banxico will wait until September to hike again
- Looking ahead, we continue to believe that the central bank will increase the reference rate 50bps in September, and then again in December, leaving it at 5.25% by year-end, as we are still forecasting a highly volatile USD/MXN
- The minutes of this meeting will be published on August 25, and the next monetary policy announcement will take place on the 29th of September

A hawkish stance. Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 4.25%, as it was widely expected. In our view, the central bank maintained a hawkish stance, because: (1) Banxico recognized the higher probability of financial volatility on the back of geopolitical risks including the US elections and the normalization of the Fed's monetary policy; and (2) the balance of risks for inflation in the horizon in which monetary policy operates remained unchanged, on the back of June's 50bps rate hike. However, we believe that the *communiqué's* hawkish tone was limited by the comments made regarding Mexico's slower economic growth, which is why we believe that Banxico will wait until September to hike again the reference rate.

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FX volatility and inflation expectations. Banxico highlighted the higher volatility of domestic financial markets, as a result of the recent geopolitical events –including Brexit–. However, the *communiqué* also refers to the efforts made by the central bank to limit the negative impact of these events on local financial markets, like the 50bps rate hike in June that resulted in the appreciation of the Mexican currency. In this context, Banxico’s Board warned that: “...*Looking ahead we cannot rule out other episodes of increased volatility in financial markets, on the back of geopolitical risks including the US elections, and the normalization of the Fed’s monetary policy...*”. In this context, and considering that the central bank has already made reference to the effect of the depreciation of the Mexican currency on inflation expectations, Banxico also mentioned in their statement that: “...*the central bank will adjust its monetary stance with flexibility, in an effort to keep inflation and inflation expectations well-anchored, which in turn will contribute to greater financial stability...*”.

The balance of risks for inflation remained unchanged. Banxico said that inflation still remains below the 3% target. However, core inflation is still showing an upward on the back of the adjustment of relative prices as a result of the depreciation of the exchange rate. In the coming months, the central bank estimates that inflation will likely end the year close to 3% yoy, as a result of the changes made by the government to the formula to determine energy prices. The monetary authority said that “*Taking into account the increase of 50bps in the reference rate last June the balance of risks to inflation –in the horizon over which monetary policy takes effect-, remained unchanged...*”. In this regard, once again Banxico commented that one of the main risks to the inflation outlook is a larger-than-expected pass-through from the FX depreciation, particularly in the core index. Meanwhile, in the non-core index, the main risk comes from the upward trend observed in energy prices.

The balance of risks for growth deteriorated. According to the *communiqué*, the balance of risks for growth deteriorated over the intermeeting period. In particular, Banxico said that the outlook for global growth continued to deteriorate, while US economic activity in 2Q16 was lower than anticipated. In Mexico, Banxico said the contraction of economic activity in the second quarter was explained by the reduction in industrial output and null growth in services activities. In this context, the central bank said that “... *during the second quarter the output gap seems to have remained negative ...*”

We maintain our view that Banxico will hike again in September. The statement suggests that the central bank believes that preemptive measures – such as the one taken in June-, could be useful to improve the balance of risks for inflation. In this context, looking ahead we continue to forecast a highly volatile exchange market that could affect the performance of inflation in the horizon over which monetary policy takes effect, so we anticipate that the central bank will increase the reference rate by 50bps again in September, and then again in December. In addition, it is worth noting that September’s meeting will be the last before the US election, an event that could be particularly volatile for the Mexican exchange rate market. The minutes of this meeting will be published on August 25, and the next monetary policy announcement will take place on the 29th of September.

From our fixed income and FX team

Today’s communiqué positive for our trade ideas in short-term securities. Banxico’s policy decision came in line with our expectations, with no change in its reference rate and a neutral communiqué tilted with a slightly hawkish rhetoric. In the aftermath of Banxico’s assessment on current conditions, short- and mid-term securities rallied 5-8bps, as market priced in nearly 66bps of implied cumulative hikes for year-end and 97pbs for the 12-month ahead period previous to the release of the monetary decision. Overall, we hold our trade idea regarding long positions on Mbono Jun’21 and Udibono Jun’19 given the current pricing of these securities. More details in our research note “*Mexico Trade Idea: Buy Udibono Jun’19 and Mbono Jun’21*” <pdf>, published on July 13th, 2016. In the FX market, the Mexican peso reacted with marginal weakness to the release, going from 18.18 to about 18.20 per dollar but still gaining 1.2% on the day, the second strongest in emerging markets only behind COP. We believe today’s appreciation has been driven mostly by the surge in oil (WTI +4.1% at the time of writing) and high appetite for carry trades, (as suggested by the negative yielding JPY weakening 0.7%, S&P500 at new highs) which have lifted all EM. We do not see enough reasons in the communique to change our short-term view on the currency. As a result, we believe the current level is attractive for long USD/MXN positions ahead of Fed events (minutes next week and Yellen’s Jackson Hole speech on August 26), with the cross near oversold levels after this week’s run and virtually at its post-Brexit support of 18.21 per dollar.

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