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Banxico Watch

Mexico

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Banxico Delivers

Bottom line: Banxico cuts the fondeo rate by 50bp mainly on the grounds of a downward inflation perspective and structural improvements to abate inflation. However, we believe markets will be inclined to a dovish stance ahead, which means that another rate cut could be in the offing if the downward risks for US activity materialize. Overall, we believe it is probable that reforms will be implemented this year and therefore it would be a matter of time before rating agencies improve the outlook of Mexico and so we are still long flatteners at the long end and MXN. The 10Y spread against the UST could reach 250bp by year end.

The board finds its window of opportunity

In a highly expected meeting, Banco de México finally delivered a cut of 50bp to the fondeo rate. The board had expressed its willingness to cut rates in previous episodes and now it found its opportunity to seize it. The rate cut takes place after inflation slumped from 4.18% to 3.25% between November 2012 and January 2013 and also after Banxico stressed that inflationary pressures from February to April would not prevent the inflation from converging.

Banxico's rate cut decision is based on the following: i) The likelihood that inflation will decline towards 3.0% in the second half of the year, even if it climbs to a 4.0% peak in the next months; ii) the structural improvements to abate inflation, i.e., the reduction of inflation's level, volatility and persistence, as well as the absence of second order effects; iii) the weakness of global economic growth and, in particular, the downside risks to US growth. We note that the central bank added two new factors to its arguments for cutting the fondeo rate: the possibility that stronger foreign inflows could tighten the monetary conditions and the fact that a reduced public deficit, combined with the rate cut, would provide a more suitable policy to face foreign shocks.

A rate cut in unusual circumstances

We highlight that today's decision suggests a change in Banxico's behavior. For example, this is the first time since 2005 that a rate cut takes place in a context of an inflation rate above 3.5% and accelerating, and economic activity growth slightly above the potential GDP. We also find unusual that the central bank had cut rate barely 3 months after it considered a hike. Our perspective of a rate cut with 30% probability in March and 50% in April considered that given the uncertainty on the development of the avian flu and the future behavior of telephone prices could be positive to wait and evaluate how these risks developed. The rate cut in march indicates that Banxico assigns a low probability that these factors have relevant upward effect in inflation.

In its statement, Banxico explicitly said that this cut is not the beginning of an easing cycle and, therefore, we should not expect further easing in the near term. In fact, we expect the monetary policy rate to remain unchanged at 4.0% for a prolonged period. Nevertheless, we expect the markets to be inclined to a dovish stance ahead, in our view, and another rate could not be dismissed if the downward risks to US activity materialize. Firstly, Banxico downgraded an already negative scenario for economic activity. Secondly, as mentioned above, Banxico stresses in this occasion that there are some risks of unnecessary tightening of monetary conditions and increase in foreign inflows as other central banks keep easing their policy stance. Banxico therefore is referring to the real exchange rate. Clearly, a cut is not feasible within the next 6 months, and it is too soon to say whether growth risks will materialize (political uncertainty). The market could move in this direction, however, as the real exchange rate will probably continue to appreciate.

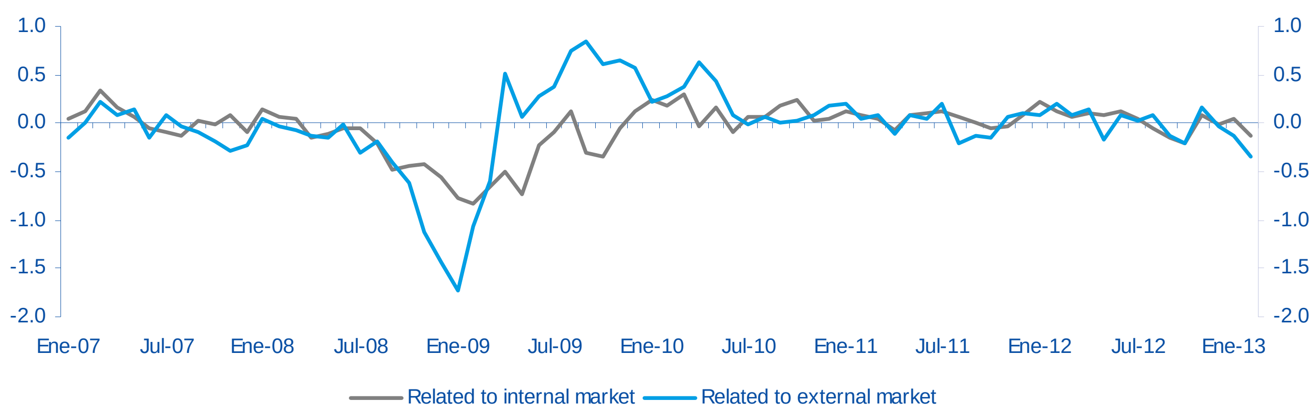
The curve experience profit taking, but we are still on

The MBono curve is undergoing losses at the time of writing this report. This price action is the result of slight profit-taking as a cut was widely expected and the losing streak in USTs following a series of US economic readings that surprised on the upside. However, we believe that the scope for gains, particularly in the short and long ends, will remain open. Firstly, as we noted in our March 6 report, "Banxico: What difference does this Friday make?", at that time the curve was pricing in a cut but not completely, and so there was scope for a shift to the downside if Banxico delivered. Secondly, as we pointed out above, Banxico stated that this is a one-off cut, but the bias will remain dovish ahead. The fact that central bank is again referring to foreign flows and the exchange rate will continue limiting the yields upside potential, especially as the global outlook is set to continue promoting the search for relative value strategies. Finally, we are certain that Banxico will at least not hike for long, which means that the local curves are still attractive in terms of valuation. Overall, we believe it is highly probable that reforms will be implemented this year and therefore it would be a matter of time before rating agencies improve the outlook of Mexico. Thus we are still long flatteners at the long end and MXN. The 10Y spread against the USD could reach 250 by year end (this is our new target).

MXN's almost muted as expected; support remains

The USDMXN saw a significant climb right after the cut was announced; however, almost immediately the currency resumed its higher sensitivity to the external front. We were expecting this kind of reaction function as the cut had been on the table since January, but the reaction to such "surprising" change of stance was short-lived. In our document titled "Banxico: What difference does this Friday make?" we noted that factors were aligned for MXN to continue strengthening notwithstanding a lower carry, and that the cut would only represent a near-term support level for USDMXN. Expectations for structural reforms to take place and the possibility of a credit rating upgrade will continue favoring MXN ahead. Still, the currency is being buttressed by a strong US employment report and for weeks has shrugged off the risks related to the US fiscal cliff and political factors in the EMU, now in the backstage. Liquidity is the main driver again and global central banks seem to be set to continue easing. The crossroads is precisely this: the factors behind MXN's broadly bullish stance remain in force, and Banxico seems to be somewhat concern about this. Therefore, the above-mentioned dovish bias in global markets will likely increase if MXN appreciates in a more significant manner. Hence, we believe that further easing should not be dismissed and will continue preventing MXN's breach of the 12.50 level in the short run.

Figure 1
Economic activity indicators (m/m% standarized)



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