CENTRAL BANKS

The beginning of the end of the tightening cycle

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A 50 bp "dovish" hike aimed at minimizing the probabilities of second round effects and at setting the conditions for the end of the hiking cycle

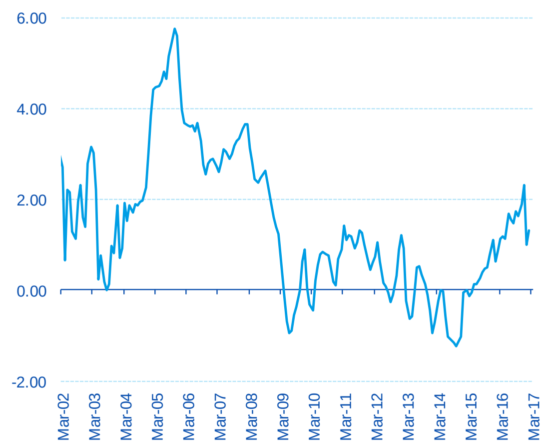
The economic outlook for Thursday's monetary policy meeting will be clearly less gloomy than at the beginning of the year. As the possibilities of a major disruption to the commercial relations between Mexico and the US diminish, the exchange rate has appreciated 8.5% since last meeting, while the volatility and liquidity conditions of the market have improved to similar levels last seen before the US election. Early indicators suggest that the economy will expand at a healthy pace in the first quarter of the year. In addition, oil price has dropped 7.6% since last meeting reducing the pressure on gasoline prices. All the latter has been boosted by a low risk aversion environment in the financial markets.

However, on the inflation front some risks are still lurking. Headline inflation is running at 5.3%, while core is at 4.3% and on an upward trend. It can be said that a great deal of these increases correspond to a change in relative prices but the magnitude of these changes keep alive some risks that cannot be dismissed. Core goods inflation accelerated again during the first fifteen days of March to 5.74% YoY, while the increase of 0.44% during the first fortnight of March lies on the worst 10% of the distribution since 1998. Besides, despite the stabilization of services inflation, they are running at 3.13% well above the median increase of the last five years and with an economy that seems to be doing better than what was expected in JanuaryRegarding the relative monetary stance with the US, the FED increased its benchmark rate by 0.25% and emphasized that the economy is doing well and that recent signals are consistent with further improvement. The FOMC dot projections points to two more rate hikes during 2017, a year with a fiscal reform in sight and in which some decisions about the process of reducing the balance sheet are expected to be made. It is worth considering that around 65% of total holdings of long term government bonds (Mbonds) are in hands of foreign investors. Increasing by more than the Fed would reduce to chances of seeing a sudden stop in such investments.

By considering the aforementioned factors, we expect Banxico to hike the policy rate by 50bp to 6.75% and to adopt a dovish tone reflecting the less gloomy outlook. We consider that the rate hike will be aimed at minimizing the risks of second-round effects from the further adjustment in relative prices and will constitute a clear signal of discomfort with current inflation levels, particularly as we expect inflation to peak until the summer. At 6.25%, the real rate is at around 1.3% well below other restrictive episodes (i.e. 2008) in which the central bank kept increasing rates just before inflation changed its trend; there is still room to act. This rate hike would be joined by a dovish tone that will reflect a less adverse balance of risks of inflation as exchange rate pressures waned and inflation expectations dropped. We think that the statement will continue to leave the door open for further tightening but at the same time will start to set the table for the end of the hiking cycle. In sum, we expect a 50bp this Thursday and a dovish tone that would be consistent with one more rate hike to end the year at 7.0%.

Chart 1

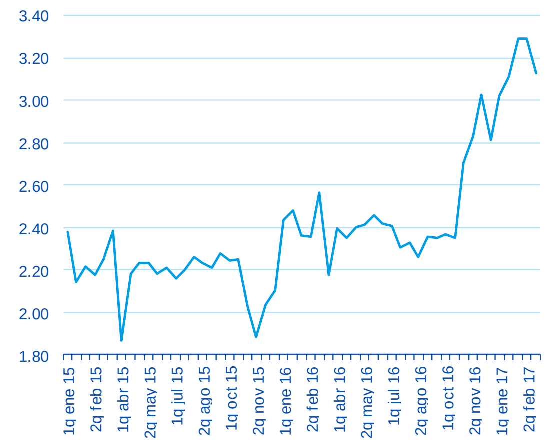
Real rate (% YoY)



Source: BBVA Research based and INEGI.

Chart 2

Services inflation (% YoY)



Source: BBVA Research based on INEGI data

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