Central Banks

Banxico to signal that it is not yet ready to change its stance but recent developments warrant a less hawkish tone

Banxico is likely to remain on hold for the next three meetings

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- **The case for a rate cut is not strong yet, but a less hawkish wording seems warranted**
- **Banxico will likely signal patience**
- **We expect the easing cycle to begin in August**

Banxico to signal that it is too early for the beginning of an easing cycle

On the last meeting (February 7), the Board signaled that further tightening was unlikely, but at the same time, it stayed hawkish and kept a cautious wait-and-see approach in the near-term. In our view, the wording was more hawkish than warranted. The statement signaled a pause, not an end, in the tightening cycle. We expect Banxico to go one-step further in this meeting and signal an end in the tightening cycle. We think that the wording will cautiously begin to pave the way for the beginning of an easing cycle later this year, but also to signal that Banxico thinks that it is too early to start cutting rates in the short term. Briefly, we think the wording is likely to signal patience. In our view, the statement should incorporate several recent positive developments to reflect that although the case for a rate cut is still not that strong, the bias is gradually leaning towards rate cuts, not pre-emptive hikes. We expect Banxico to keep rates unchanged at 8.25% and the decision to be unanimous.

Reasons why we expect Banxico to start cutting rates this year…

1. Risks to inflation have continued to ease. Inflation has fallen more than expected in 1Q, giving Banxico less reasons to be concerned with the inflation trend, after the supply-shock driven rebound seen during 4Q18 (see chart 1). The peso is now relatively stable reflecting lower concerns on Mexico and it has fully recovered from the sharp negative differentiation seen during Oct-Nov 2018 after the NAIM cancelation (see chart 2). Risks remain, mainly related to PEMEX (the government still needs to address PEMEX's problems in a credible manner), the sovereign rating, 2019 budget execution and fiscal pressures going forward, and the pending approval of the USMCA in the US Congress, but with the Fed effectively on the sidelines and lower concerns on Mexico, the backdrop for EM currencies and the MXN has improved. Besides, long-term market based inflation expectations have fallen back following peso's rally (see chart 3) and analysts' consensus expectations have also decreased (analysts' consensus now expects 3.7% headline inflation by year-end compared to 3.9% prior to February's meeting and 4.0% at the beginning of the year).

2. The Fed is now likely to remain on the sidelines. It was difficult to envision Banxico to start cutting rates with the Fed hiking and with inflation above 4.0%, but with a weaker US outlook, there is increasing probability of no more rate increases in 2019. In fact, the Fed signaled no more hikes in its last statement[1]. In the absence of higher inflationary

1: "The data that we are seeing is not currently sending a signal which suggest moving in either direction from here" pressures in the US (our base case), the Fed would be comfortable with keeping rates unchanged. Moreover, if economic conditions were to deteriorate significantly, the Fed could begin to consider potential rate cuts (see). In this context, Banxico should have fewer concerns on the relative monetary policy position even if it starts to cut rates later this year as the MXN risk-adjusted carry trade would remain very attractive (see chart 4).

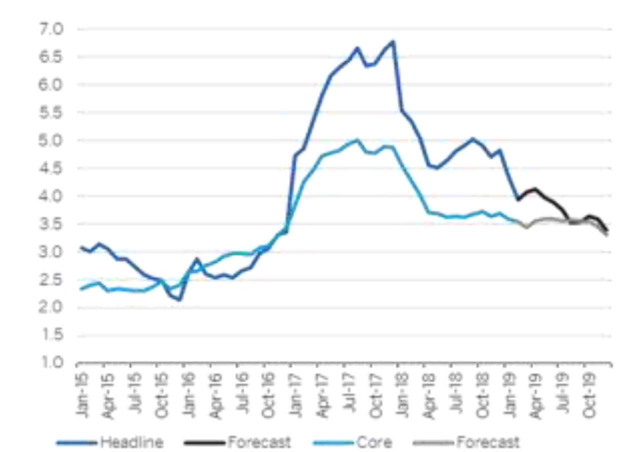
… but not until 3Q

Inflation is likely to rebound in 2Q. Headline inflation has surprised to the downside in the first five fortnights of the year, pushing annual inflation down to 3.9% from 4.8% in December. Core inflation has edged down to 3.5% from 3.7% at the end of last year, and the narrow 3.6-3.7% range in which it moved from April 2018 to January 2019. However, the strong decline in headline inflation is mainly explained by the sharp drop in fruits and vegetable prices (-12.0% from the first half of January to the second half of February). Annual headline inflation is likely to rebound in Q2 and to stay above 4.0% at least until June (see chart 1). Meanwhile, core inflation is unlikely to move further down until Q4 and thus, Banxico will likely continue to point out that core inflation is showing signs of stickiness.

In addition, recent speeches and interviews by Governor Diaz de Leon, suggest that the Central Bank is still concerned with the risk that the Pemex situation represents and with the increase in the country´s risk premium. He has stated: "monetary policy will not react only to the cyclical position".

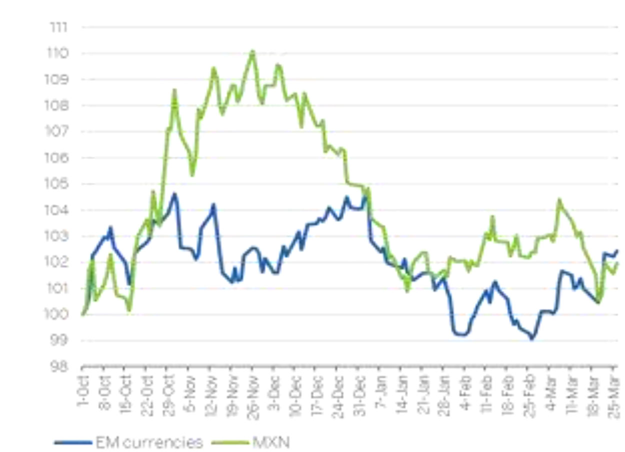
Bottom-line. We think that with the Fed on the sidelines, a stable MXN, headline inflation below 4.0% from the Summer onwards, a stable core, a negative output gap and a real ex-ante monetary policy rate above 4.0%, the case for an easing cycle will be strong. We thus think Banxico will start easing its monetary stance in August and we anticipate two 25bp rate cuts this year (in August and November) bringing down the policy rate to 7.75% by year-end. We expect 100bp of rate cuts next year, i.e 6.75% by December 2020.

Chart 1. Inflation Outlook
(YoY % change)



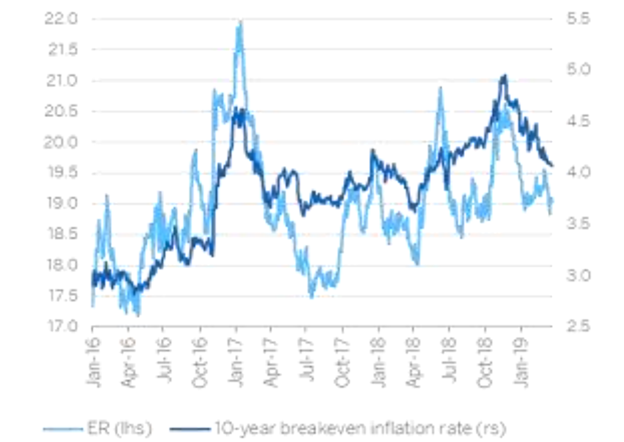
Source: BBVA Research / INEGI

Chart 2. MXN vs EM currencies*
(% and ppd)



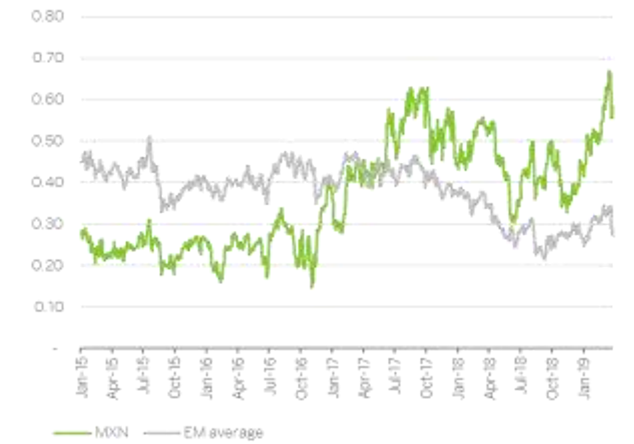
*Own calculations based on a reweighting of the JP Morgan Emerging Markets Currency Index after taking out the MXN
Source: BBVA Research / Bloomberg

Chart 3. Long-term market based-inflation expectations and exchange rate (% and ppd)



Source: BBVA Research / Bloomberg

Chart 4. Risk-adjusted carry-trade (%)



Source: BBVA Research / Bloomberg

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