Central Banks

Banxico will continue their rate cut cycle with a larger 50bp rate cut on Thursday

A 50bp rate cut would mark the beginning of a long overdue easing cycle

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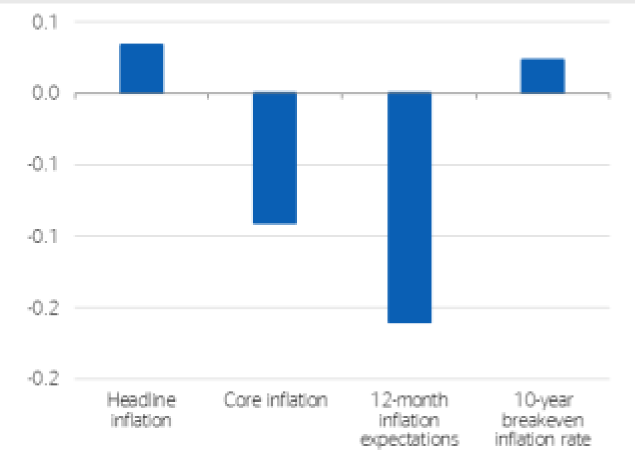
- **All members will vote for a rate cut, we expect a split vote again but now with a third Board member joining the two members that already saw the need for a faster pace of easing in September's meeting**
- **A 50bp would not take the markets by surprise at all since one third of the analysts surveyed by Bloomberg are expecting a larger cut and the swap curve is pricing in a bit more than 50bp of easing for the rest of 2019**
- **Although given the lag with which monetary policy operates and the current unwarranted restrictive stance Banxico is well behind the curve in the easing cycle, it has shown extreme caution and a smaller 25bp rate cut has a 40% chance in our view**
- **Following the dovish shift in the previous statement, we now expect a clear dovish forward guidance in Thursday's monetary policy decision accompanying statement**
- **We continue to expect the policy rate to reach 7.0% by year-end and 6.0% by June 2020; a faster easing pace and a looser monetary policy stance are warranted but we expect Banxico to remain cautious**

The case for a faster easing pace became stronger in the intermeeting period; the current restrictive stance is unwarranted

The case for a larger 50bp cut became stronger in the intermeeting period. Following the previous monetary policy decision we argued that the size of the rate cut in Thursday's meeting would ultimately depend on core inflation's performance and expected trajectory as opposed to Banxico's forecasts. Core inflation has now slowed four months in a row (-0.2pp) and edged down -0.1pp in the intermeeting period (see graph 1). Although gradually, it is clearly slowing down and a weakening economy / widening negative output gap points to a faster slowing pace in coming months. Besides, its recent performance and most likely trajectory going forward will be consistent with Banxico's expected trajectory. Moreover, risks are now biased to a faster slowing pace than currently expected by the central bank as a further weakening of the economy and a stronger MXN will likely put downward pressure on core inflation over the coming months. In our view, the core stickiness argument to keep the monetary policy stance as restrictive as it currently is, no longer holds.

Besides, headline inflation remained at 3.0% in the intermeeting period (see graph 1) and will most likely end the year well below 3.0% (we expect it to reach 2.7% by year-end). Headline inflation is likely to slow markedly in Nov-Dec on a slowing core inflation, as the global slowdown continues to put downward pressure on energy prices and on a favorable base effect as fresh food prices are likely to increase much less than in Nov-Dec 2018. As we expected, 12-month inflation expectations have declined sharply (see graph 1) while market-based long-term inflation expectations have moved in a narrow range close to 3.5% following a sharp drop in line with MXN strength. The MXN continues to outperform emerging-market currencies (see graph 2) and has appreciated around 2.5% since the start of Banxico's gradual easing cycle, certainly easing concerns on the effect of a less restrictive stance on the MXN. Besides, a possible USMCA ratification by the US Congress in the near-term would likely further boost the Peso. As we have argued before, concerns on the effect of a less restrictive stance on the exchange rate, inflation and inflation expectations are overdone.

Graph 1. **Change since last monetary policy meeting for selected inflation and inflation expectations measures** (Pp)



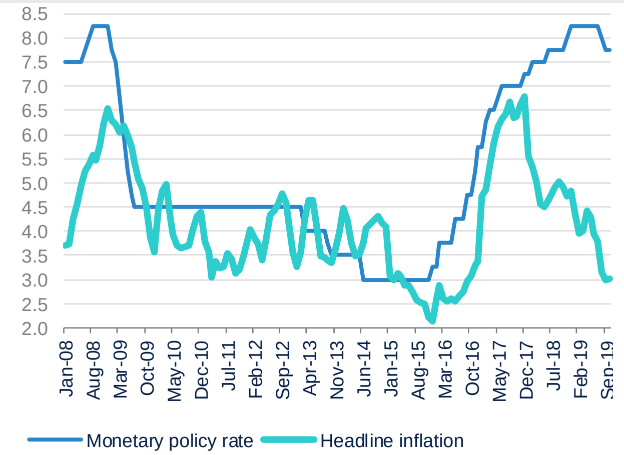
Source: BBVA Research / Banxico / INEGI / Bloomberg

Graph 2. **MXN vs other EM currencies* since the start of Banxico's rate cut cycle**
(Index 15 Aug 2019 = 100)

*Based on a reweighting of the JP Morgan after taking out the MXN; own calculations
Source: BBVA Research / Bloomberg

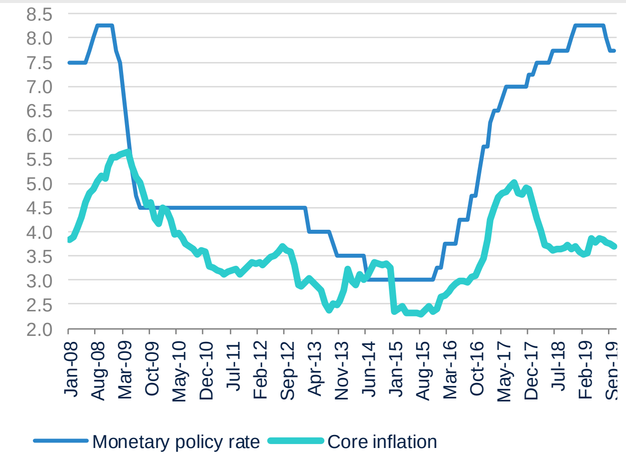
Not only does the case for a larger rate cut has become stronger since the last meeting where two members already voted for a 50bp cut, the need for a faster easing pace also has. With an economy at the edge of recession, a widening output gap, low headline inflation (on target now and below target as soon as next month), softer core inflation that will further decline in the remainder of the year, and lower inflation risks, the current restrictive stance is unwarranted. The rate cut cycle has much further to run and a faster easing pace is warranted. Banxico has not kept such a high monetary policy rate with headline inflation this low (see graph 3) and with a slowing core inflation (see graph 4). Moreover, the restrictive stance has not even eased anything following the two 25bp rate cuts since 12-month inflation expectations have eased more than 0.5pp and is not consistent with core inflation and inflation expectations slowing trends (see graphs 5 and 6). In other words, even with core inflation slowing down following its stickiness, with headline inflation on target and with lower inflation expectations and risks, Banxico has not yet eased the monetary policy, which remains excessively restrictive, is weighing on growth and, more importantly, is not consistent with the inflation, growth and risks backdrop. Banxico should feel comfortable embarking in a long overdue easing cycle.

Graph 3. **Nominal monetary policy rate and headline inflation** (%)



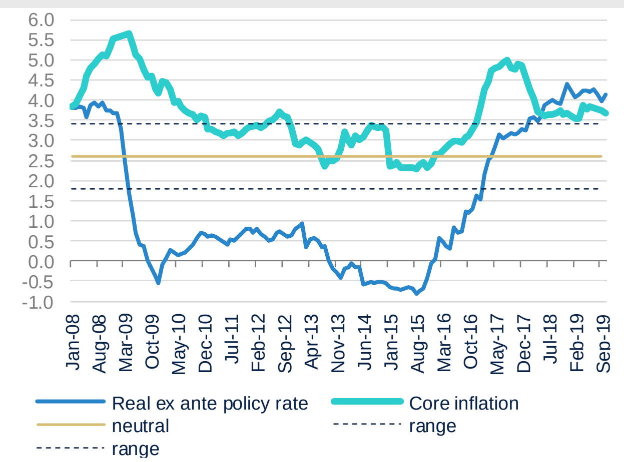
Source: BBVA Research / Banxico

Graph 4. **Nominal monetary policy rate and core inflation** (%)



Source: BBVA Research / Banxico / INEGI

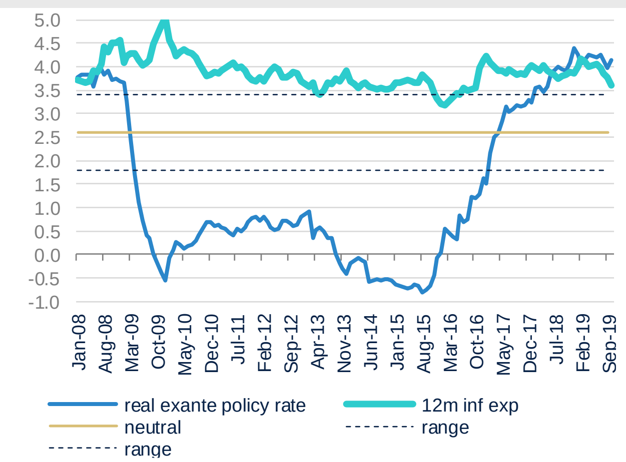
Graph 5. **Real exante monetary policy rate and core inflation** (%)



* Calculated with12-month inflation expecations using Banxico's Analyst Surveys for observed data and our projected inflation path for forecasted rate. The neutral rate (2.6%) and range (min, max: 1.8%-3.4%) are Banxico's estimates

Source: BBVA Research / Banxico / INEGI

Graph 6. **Real ex-ante monetary policy rate and 12-month inflation expectations** (%)



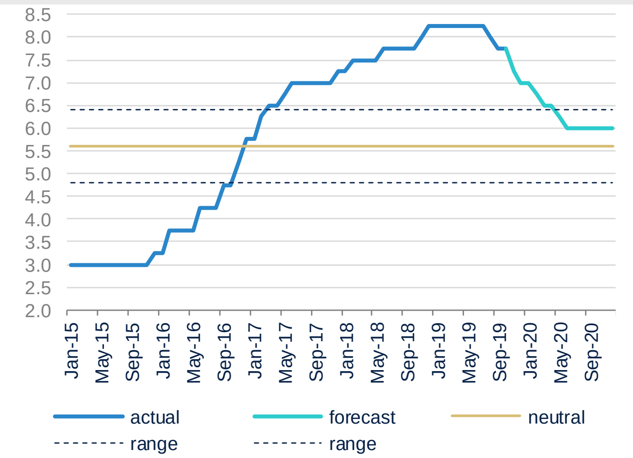
* Calculated with12-month inflation expecations using Banxico's Analyst Surveys for observed data and our projected inflation path for forecasted rate. The neutral rate (2.6%) and range (min, max: 1.8%-3.4%) are Banxico's estimates

Source: BBVA Research / Banxico / INEGI

Thus, in our view, a larger cut will be consistent with Banxico cautiousness. It will simply mark the start of a long overdue easing cycle. Besides, a 50bp would not take the markets by surprise at all since one third of the analysts surveyed by Bloomberg (us among them) are expecting a larger cut and the swap curve is pricing in a bit more than 50bp of easing for the rest of 2019. Following the dovish shift in the previous statement, we now expect a clear dovish forward guidance in Thursday's monetary policy decision accompanying statement and that Banxico will be finally willing to characterize inflation risks as biased to the downside. Overall, a more dovish tone is warranted; a better forward guidance will be welcomed.

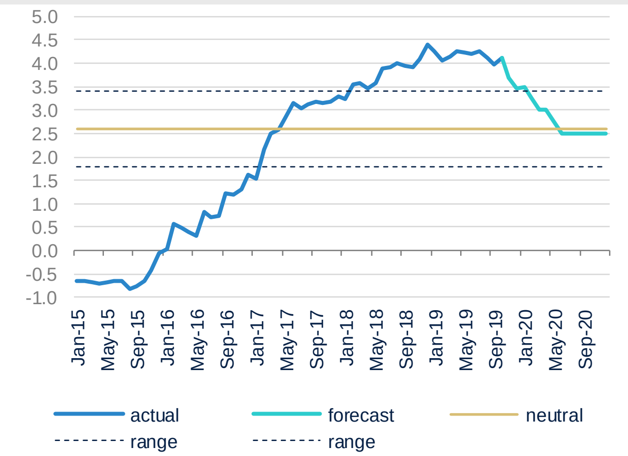
Looking ahead, we continue to expect the policy rate to reach 7.0% by year-end and 6.0% by June 2020. Such a gradual easing pace would only take the nominal policy rate to a neutral range by 2Q20 (see graph 7) and monetary policy to a neutral stance at the same time (see graph 8), in a context where, form a cyclical perspective, going below neutral would make sense. The spread between Banxico's monetary policy rate and the fed funds rate would remain at historically high levels (5.5%) following the 50bp cut, if confirmed. Morevoer, with the relative Peso strength and stability and with central banks among the emerging market world easing their policy at a faster pace than Banxico (and from much less restrictive stances and in many cases with higher inflation rates). MXN's risk-adjusted carry-trade, which is now among the highest (see graph 9), will remain well above the emerging market currencies average (see graph 10). A faster easing pace is warranted and a looser stance would be more appropriate than a neutral stance but we expect Banxico to remain extremely cautious.

Graph 7. **Nominal monetary policy rate: actual and forecast**** (%)



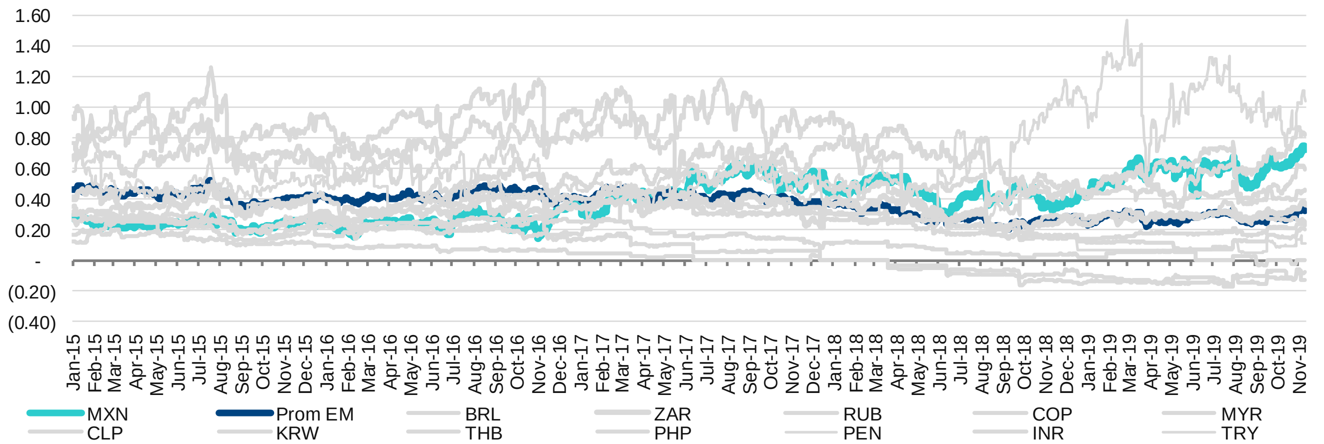
* The neutral rate (5.6%) and range (min, max: 4.8%-6.4%) are Banxico's estimates; **BBVA Research forecast
Source: BBVA Research / Banxico

Graph 8. **Real ex-ante monetary policy rate: actual and forecast**** (%)



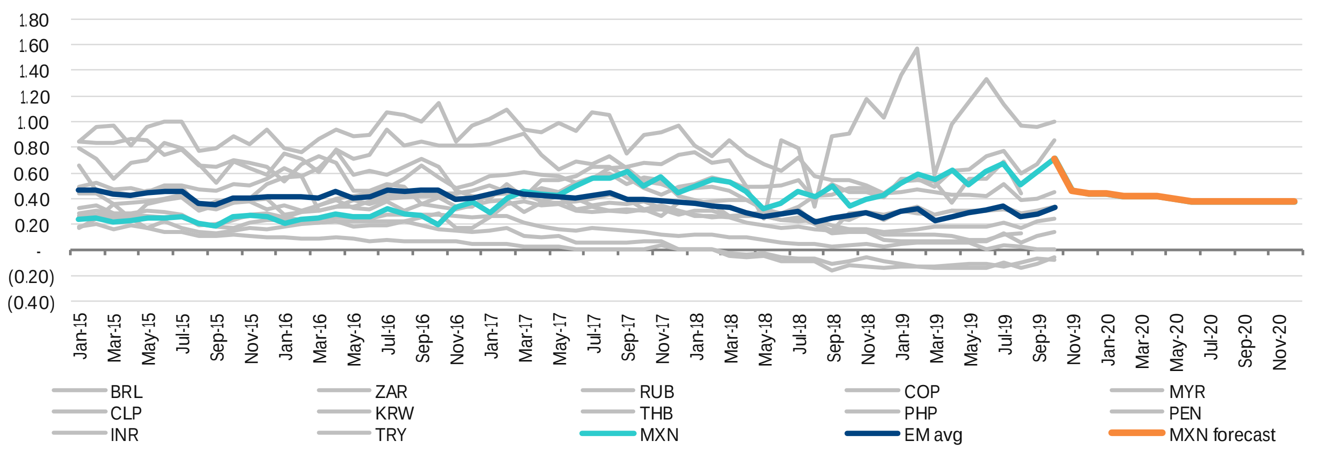
* Calculated with12-month inflation expecations using Banxico's Analyst Surveys for observed data and our projected inflation path for forecasted rate. The neutral rate (2.6%) and range (min, max: 1.8%-3.4%) are Banxico's estimates; ** Based on our own nominal monetary policy rate forecasts. Source: BBVA Research / Banxico / INEGI

Graph 9. **Risk-adjusted carry-trade**
(Pp)



Source: BBVA Research / Bloomberg

Graph 10. **Risk-adjusted carry-trade: actual and forecast***
(Monthly averages, pp)



* Based on our own fed funds, Banxico's monetary policy rate and MXN implicit volatility forecasts
Source: BBVA Research / Bloomberg

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