Central Banks

Banxico is likely to cut the policy rate by a further 25bp to 4.00%

We continue to think that Banxico will move in 25bp steps from here until the policy rate reaches 3.0% (in May 2021)

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- **There is scope for further rate cuts as inflation comes down**
- **In the intermeeting period inflation showed signs of stabilizing and the peso rallied**
- **Inflation concerns are overdone: in spite of the current change in relative prices, there will not be any demand-side pressures in the coming quarters, giving Banxico room to further cut rates**
- **We continue to think that the policy rate will reach 3.75% by year end and 3.0% by May 2021**

We continue to expect that Banxico will slash rates further than currently expected, as Banxico keeps them close to 0% in real terms

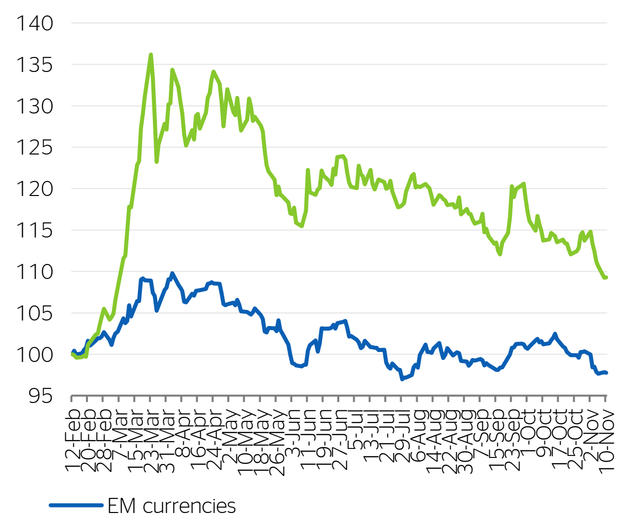
Banxico opted to slow its easing cycle in its last meeting in September. In our view, looking ahead, Banxico will attempt to keep the real rate around 0.0% in coming meetings. If as, we expect, inflation comes down after recently stabilizing, Banxico would need to continue with its 25bp rate cuts in the coming meetings to keep the monetary policy stance unchanged. Therefore, we continue to expect Banxico to cut the policy rate to 4.0% tomorrow and to 3.75% in December, and to cut it further to 3.0% in 2021 with inflation converging with the 3.0% target.

In the intermeeting period, inflation remained sticky to the downside with core inflation remaining at 4.0% and headline inflation inching further to the upside to 4.1%. Yet, this mainly continues to reflect underlying food price pressures, which nonetheless are already showing signs of subsiding. Not only core food goods annual inflation is stabilizing but also its most recent print (-0.03% FoF in the second fortnight of October, its first bi-weekly decline in more than four years) points to a turning point going forward. With this, core goods inflation stabilized over the past five fortnights in a narrow range around 5.4% while core services inflation edged down in October to 2.4% from 2.5% in August and September. We expect core inflation to ease to 3.7% by year-end and more importantly to gradually converge to 3.0% in 2021. As we anticipated, October's print supports our view that core inflation likely peaked in Aug-Sep and is set to gradually come down with continued demand weakness, a faster recovery on the supply side, a large negative output gap, subsiding food price pressures and a strengthening peso. This brings us to the second reason for which Banxico is likely to find comfort: the recent rally in the peso.

As can be seen in graphs 1 and 2, the peso has continued to recently outperform other emerging market currencies and has appreciated 7.5% since the date of the last meeting with the exchange rate (ER) coming down to 20.5 from 22.2ppd. We expect further appreciation of the peso when it becomes even clearer that the outcome of the US election will not change and when more companies announce a successful conclusion of phase 3 vaccine trials. Positive inflation signs in spite of the stickiness alongside the peso rally will lean the balance to another 25bp rate cut. This in a context in which the expected 3Q rebound in economic activity significantly lost momentum towards the end of the quarter and economic activity will remain a much greater concern that inflation in a backdrop of peso strength and a likely increase in global risk appetite following the recent positive developments in vaccine trials.

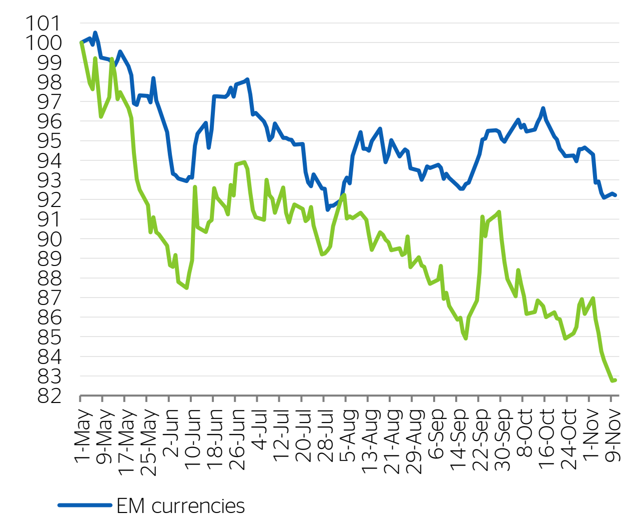
Summing up, in the current backdrop, inflation worries will remain overdone as both headline and core inflation likely peaked and will most likely ease towards the end of the year and more significantly in 2021. Going forward, the most likely scenario is that inflation will stop being mainly driven by supply-side factors –which were behind the increase observed before the recent stabilization– and will start to be mainly driven by (weak) demand. Thus, inflation will likely gradually come down to 3.0% in coming months. If during this trend Banxico decided to pause, it would restrict the monetary policy in a context of economic weakness, inflation deceleration, peso strength and a more positive global backdrop. In addition, one of the most hawkish members of the board will leave after the end of the year (he cannot be reappointed because he exceeds the age limit) and will most likely be replaced with a more dovish member. We do not expect that to be the case and that is why, contrary to consensus expectations, we continue to expect further cuts after tomorrow's policy rate decision. We continue to expect that Banxico will slash rates much further than currently expected, until they are around 0% in real terms, but we now expect Banxico to slow the rate cut cycle (to 3.75% by year-end). We continue to think that the policy rate will reach 3.0% (now in May 2021).

Graph 1. **MXN RELATIVE PERFORMANCE TO OTHER EM CURRENCIES* AFTER THE SPIKE IN GLOBAL RISK-AVERSION**
(INDEX, FEB 12, 2020 = 100)



Source. BBVA Research / Bloomberg.
*Weighted liquidity average and compared to trade based on a new weighting by JP Morgan after removing the Mexican peso; own calculations.

Graph 2. **MXN RELATIVE PERFORMANCE TO OTHER EM CURRENCIES* SINCE THE START OF MAY**
(INDEX, MAY 1, 2020 = 100)



Source: BBVA Research / Bloomberg
*Weighted liquidity average and compared to trade based on a new weighting by JP Morgan after removing the Mexican peso; own calculations.

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