Central Banks

It is a close call but we expect Banxico to cut the policy rate 25bp to 4.00%

We continue to expect that Banxico will take the policy rate to 3.50% this year

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- **Core inflation is set to weaken from 2Q onwards**
- **The near-term economic outlook is darkening and demand is set to remain weak in the foreseeable future**
- **Recent increases in inflation are mainly explained by rises in global energy prices**
- **The balance of the Board appears to have shifted to the doves**
- **We think that the policy rate will reach 3.50% this year but it could by 3Q instead of 2Q**

With a backward-looking central bank, rising headline inflation makes consecutive rate cuts less likely, but the door for additional cuts should open again in late 2Q

Banxico opted to remain on the sidelines in the last two meetings despite a deteriorating near-term outlook. Yet, the statements have been dovish and have left the door open for further rate cuts. They have repeated that the decisions were a “pause”, not an end, to the easing cycle. Banxico seems to be waiting for clearer signs that inflation is set to weaken. Recent evidence suggests that core price pressures are set to gradually soften even if headline inflation is set to accelerate.

The monthly falls in headline prices in March-April of last year will drop out of the year-on-year comparison and thus, headline inflation will pick up sharply in the following months. Banxico knows that this base effect will be temporary and that in the summer headline inflation will decline sharply after the rebound seen last year also drops out of the year-on-year comparison. That is, inflation will temporarily increase mainly driven by base effects. Analysts and markets know this. The temporary pick up is unlikely to have an effect on inflation expectations and thus, a tighter-than-warranted monetary policy stance will not have any effect. Another factor driving up inflation at the start of the year is the sharp increase in energy prices. In fact, gasoline and gas prices explain 0.5pp of the 0.86pp MoM January inflation. Energy prices are set to rise further in February. Yet, monetary policy can´t do anything to offset supply-related inflation pressures, especially of a global nature and that is not resulting in second order effects on other prices. Banxico disregarded the decline of headline inflation, from 4.0% during August-October to 3.3% in November. One reason is that even if to some extent softening core inflation contributed to the decline, the main driver was the fall in volatile prices. We think that the Board should do the same now, take the decision based on the expectations for core inflation disregarding changes in volatile prices.

Core inflation eased from 4.0% YoY in August-October to 3.8% over the last two months. Core services inflation has remained well below 3.0% over the last nine months, averaging 2.4% over that period, while core goods inflation should gradually weaken in the context of weakening demand, a dimming near-term economic outlook, and following the recent sharp strengthening of the peso. Although core inflation might remain sticky through 1Q21, we think that it is set to soften from Q2 onwards and will start to converge relatively fast to 3.0% in the second half of the year. The question is what will have more weight on Banxico's decision. The recent and expected upward trajectory of headline inflation or a backdrop that points to lower core inflation going forward.

Banxico's most recent statements on the dovish side along with the balance of the Board that appears to have shifted to the doves after the appointment of Galia Borja point to a 25bp rate cut to 4.00% but it is a closer-than-previously-expected call following January's inflation print and energy prices trend. We expect a 3 to 2 vote for the rate cut. We continue to expect Banxico to take the policy rate down to 3.5% this year, taking the real rate close to 0%, but the sharp temporary increase that headline inflation will have in coming months could delay the next cuts to the second quarter. We continue to think that a more accommodative policy stance is more than warranted.