Central Banks

Banxico resumes its easing cycle with a 25 bp rate cut, to 4.00%

A dovish statement with forward-looking tweaks suggests that additional rate cuts in the coming meetings are likely

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- **Banxico resumes the easing cycle even after acknowledging that headline inflation is set to rise**
- **The Board seems to be less concerned about this expected jump in inflation**
- **If that implies a more forward-looking Board, it will constitute a very welcome development**
- **Given this, along with a dovish mood and an economy that is set to weaken further by the time of the next meeting, we think that the odds of a rate cut next meeting have increased**

A dovish Banxico leaves the door open for additional cuts even after acknowledging that headline inflation is set to temporarily rise in the near-term

Banxico resumes its easing cycle with a 25 bp rate cut, to 4.00%, after "pausing" it in the previous two meetings. Most analysts, including us, expected the cut. The focus, in a backdrop of a headline inflation set to increase, was going to be on the voting within the Board, the wording of the statement, and the forward-guidance –if any. All three elements suggest that additional rate cuts in the coming meetings are likely.

Our baseline scenario anticipated that Banxico was going to cut the policy rate in the first three meetings of the year; however, in the back of rising energy prices, headline inflation is now set to jump temporarily to around 4.0% in March and slightly above 4.5% in April. We argued, in our note anticipating today's rate cut (see here), that with a backward-looking central bank, rising headline inflation made consecutive rate cuts less likely, but the door for additional cuts would likely open again in late 2Q (June) once headline inflation began to decline following the base-effect driven temporary increase. Following today's decision and dovish statement, we think that additional consecutive rate cuts are now more likely: Moreover, if the temporary jump in headline inflation makes Banxico "pause" the easing cycle again, we think that it will resume in June once May's inflation print confirms that headline inflation has fallen below 4.0%. In short, not only we think that Banxico is going to cut more than what markets and consensus are anticipating (to 3.75% vs. our expectation of 3.5% with bias towards possibly another 25bp rate cut), we now think that the odds of Banxico cutting the policy rate in the next two meetings have increased.

It was very likely that the Balance of the Board was going to shift towards the doves after the appointment of Galia Borja to replace the most hawkish member of the previous Board. We expect a 3 to 2 vote for the rate cut. The vote was unanimous. We will need to wait for the discussion in the Minutes to see what changed the vote of the two hawks (Alejandro Díaz de León and Irene Espinoza) which voted to keep the rate unchanged in the last two meetings. It could be argued that headline inflation fell back below 4.0%, but it was already below 4.0% in the November print, which was known by the date of the last meeting. It could also be argued that the near-term economic outlook has recently darkening, but economic activity was already showing clear signs of slowing by the time of December's meeting, and, more importantly, Banxico's easing cycle has been much more slow than that of most central banks in a context of a weaker economy with a grimmer recovery outlook. What then could have made them change their vote? It is unclear and perhaps the minutes will bring light to this; yet, what seems clear is that the dovish shift within the Board is most significant than previously thought. In our view, this is a welcome change, particularly in the current context.

The wording of the statement is dovish and leaves the door open for additional cuts. Although Banxico repeats that the inflation outlook is uncertain, it acknowledges that core inflation's recent stickiness responds to a change in relative prices, with core goods prices pushing up core inflation but services prices pulling it down. Banxico anticipates core inflation to be around 3.0% from 3Q onwards. It also explicitly indicates that the jump in headline inflation, which we expect will cause it to rise to levels above 4.0% in late Q1 and above 4.5% in April, will be "mainly associated with the arithmetic effects of the reduction in energy prices last year", and will prove temporary. Thus, the Board expects, as we also do, a "downward trend as of the second semester". We think that this thorough and clear description of its inflation outlook is a small step towards forward guidance considering that even after acknowledging that headline inflation is set to rise temporarily in the near-term, the Board went ahead with the resumption of the easing cycle and left the door open for additional rate cuts. It is soon to tell if the Board is not only more dovish but also less backward-looking, but there are signals that it may be the case.

Given the dovish shift, the temporary nature of the jump in inflation in the months ahead, and with the economy likely to weaken further by the time of the next meeting, the odds of a second consecutive rate cut in March have increased. Lower inflation together with the need of more stimulus in a backdrop of a more dovish Board supports our view that Banxico will take the policy rate down to 3.5% this year. We think that after today, the odds of the rate reaching 3.5% by May have increased.