Central Banks

The latest inflation reading will likely keep the majority of the Board in a tightening mode

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Banxico will likely hike the policy rate by 25bp to 4.75% but looking ahead, we stick with our more dovish view

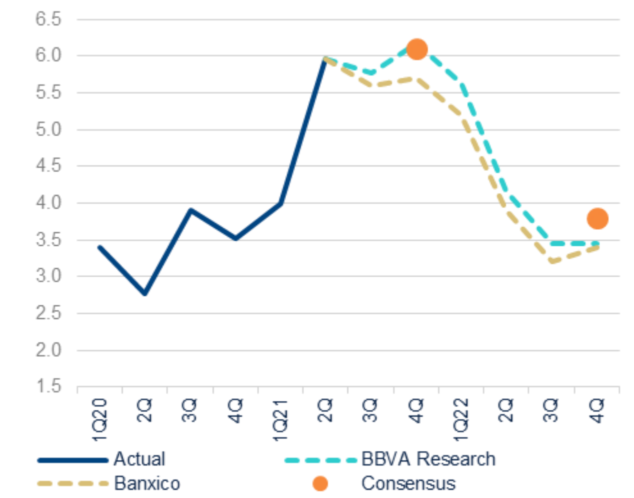
- **Continued inflation pressures point to another 25bp rate hike to 4.75% this Thursday.** Inflation was higher than our above-consensus forecasts in the first half of September: the headline rose 0.42% FoF (BBVA: 0.38%, consensus: 0.28%), 5.87% YoY, while core increased 0.31% FoF (BBVA: 0.27%, consensus: 0.24%), 4.92% YoY. The recent increase in oil prices along with the surge in natural gas prices will keep energy inflation high through year-end. We now expect headline inflation to close the year at 6.4% (up from our previous 6.2% forecast), and 0.5pp more to our 5.9% expectation for September. Core inflation is likely to continue on an upward trend until November when we expect it to reach 5.1%, before easing somewhat to 4.9% by year-end. This expected trajectory implies that Banxico will likely upwardly revise its expected headline inflation path in the short term, probably bringing it close to our expected path (see chart 1). In contrast, albeit core inflation keeps trending upwards, Banxico's latest forecasts already incorporated higher levels. In fact, Banxico thinks that the upward trend will continue through 1Q22 (see chart 2). Thus, we are not expecting any significant changes to the expected core inflation path. Together, higher core inflation, higher-than-anticipated headline inflation and a likely revision to headline inflation forecasts will likely keep the majority of the Board in a tightening mode. We anticipate another split decision, with a 3-2 vote for the third pre-emptive hike in a row.

- **However, the latest minutes open the door to interpretations that the majority of the Board could soon lean to put an end to the current hiking cycle**. Discussion about the last two hikes during the last meeting show that one member, likely Mr. Heath, the swing voter, could soon lean to put an end to the current hiking cycle. This member labeled the last two hikes as pre-emptive, arguing that a reinforcement of the monetary policy stance was needed, "but that this does not necessarily imply an accelerated cycle of increases." He / she also said that "market overreactions should be avoided insofar as it could anticipate aggressive rises […]." Even more importantly, he pointed out that, "given the slack, the inflationary outlook and the transitory shocks, it would seem that the new monetary stance [i.e., 4.50%] could be sufficient for the moment and that further adjustments to the rate will be exclusively dependent on the data." Considering that Banxico will likely revise to the upside its headline inflation forecasts, we think that this member, again likely Mr. Heath, will lean to vote for one more 25bp rate hike. Higher-than-previously expected headline inflation in the short term should not lead this member to change its view on the inflation outlook, particularly if as we expect, Banxico does not revise further to the upside the expected core inflation trajectory. However, recent data might lead this member to vote again for a rate hike to reinforce the monetary policy stance and that is why we think that there is still an outsize chance that Mr. Heath leans to the dovish side of the Board this Thursday something that would result on a 3-2 vote for a pause.. Looking ahead, another hike in November will likely be dependent on the data: if observed inflation does not grant a further upward revision of Banxico's expected path, we think that this member will no longer vote for a hike.

- Thus, **our bias now is that Banxico will not take the policy rate to 5.0% by year end and we are sticking with a more dovish expectation for 2022 (5.0% vs. 5.38% consensus and 6.09% markets) as we expect inflation to ease in 2022 and Banxico´s board to turn to more dovish with the new governor**. We think that the current balanced Board with two hawkish members, one swing voter and two dovish members will shift to a more dovish one with the new governor. Besides, the expected inflation trajectory increases the odds that Mr. Heath leans to avoid an unwanted tightening of the monetary policy stance during 2022. Twelve-month inflation expectations will likely adjust to the downside in 1Q22, as soon as inflation starts to ease, but even if we are not correct and they remain close to the current 3.7% levels (see chart 3), the ex-ante monetary policy rate will surpass 1.0% this Thursday, a relatively high level considering the degree of slack in the economy. Moreover, as Banxico has acknowledged, long-term inflation expectations have remained stable. With inflation easing, the absence of demand-side pressures and with risks contained in a context of negative output gap, a further tightening of the monetary policy stance in 2022 would be unwelcomed and unwarranted. Thus, we stick with a more dovish view on the monetary policy rate for 2022.

Banxico will likely revise to the upside its short-term headline inflation forecasts…

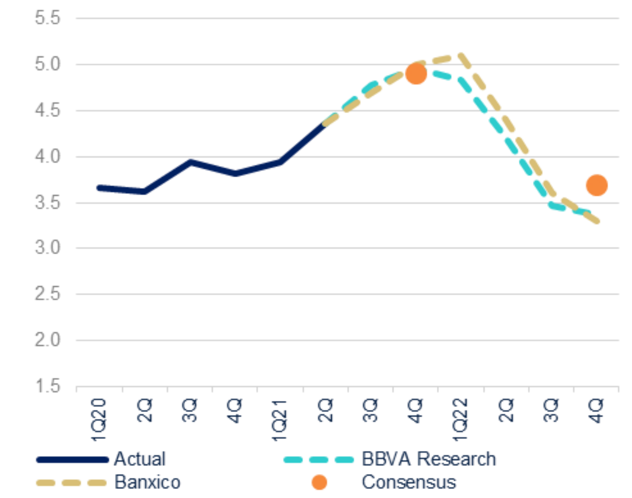
Figure 1. **HEADLINE INFLATION OUTLOOK** (YoY % CHANGE)



Source: BBVA Research / Banxico / Bloomberg / Banamex Surveys

… but will likely keep the core inflation ones broadly unchanged

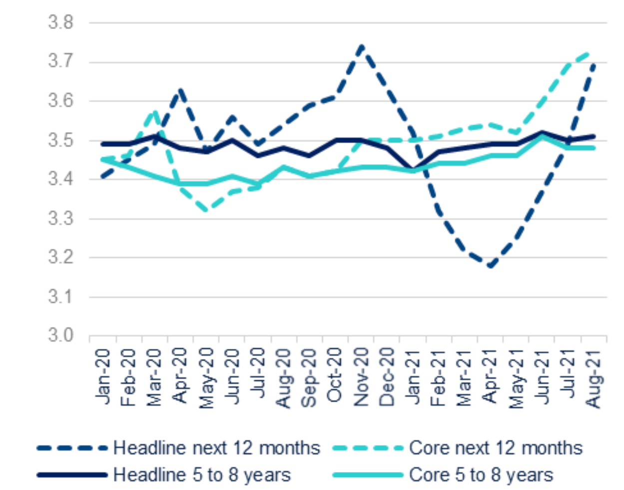
Figure 2. **CORE INFLATION OUTLOOK** (YoY % CHANGE)



Source: BBVA Research / Banxico / Bloomberg / Banamex Surveys

Long-term inflation expectations are stable, while short-term ones will decline in early 2022

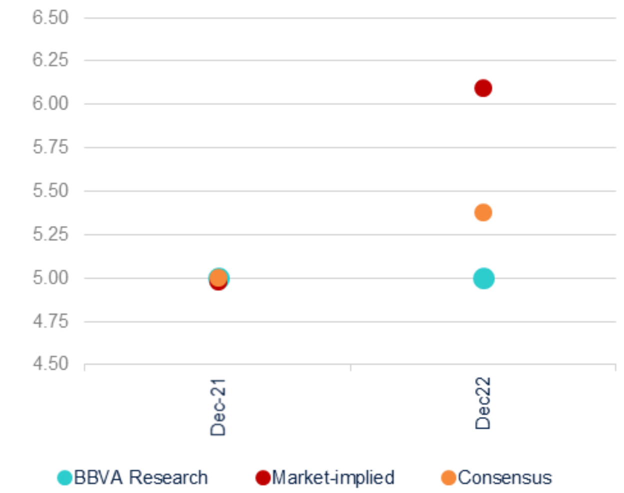
Figure 3. **INFLATION EXPECTATIONS** (%)



Source: BBVA Research / Banxico

We think that market and consensus monetary policy rate expectations will gradually adjust to the downside

Figure 4. **MONETARY POLICY RATE OUTLOOK** (%, EOP)



Source: BBVA Research / Banamex Survey / Bloomberg

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