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Banxico Watch

Will Banxico signal that the end of the rate-hiking cycle may be in sight?

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Banxico will stick to its resolve to bring inflation down with a 25bp hike but might hint future decisions are more uncertain

- **Last week, The Fed, in a context of bank failures and significant uncertainty around the sector, delivered a dovish hike.** It raised the fed funds rate by 25 bps to a 4.75-5.00% target range but struck a more dovish tone. **The "dot plot"** kept the terminal rate unchanged at 5.1% in 2023, which together with the more dovish tone, tighter financial conditions, and lingering risks, **points to just one more 25bp rate hike ahead.** Yet, with tighter financial conditions and its uncertain impact on the economy, which according to Chair Powell can be "[...] the equivalent of a rate hike, or perhaps more than that", markets now think that the odds of another hike and a pause in May are roughly equal. **Overall, the Fed paved the way to wrap up the rate-hiking cycle soon.** For now, we continue to expect one more 25bp rate hike to a 5.00-5.25% target range and a pause afterwards through year-end, although some analysts are forecasting rate cuts as soon as this summer (for more see). **A more dovish Fed** on the back of higher risks to growth amid bank-related risks **is a new development that was not present at the time of the last Banxico meeting in February.**

- **In Mexico,** after rebounding temporarily in January (to 7.9% YoY), **headline inflation resumed its downward trend in February, declining 0.3 pp to 7.6% YoY, and eased further in the first half of March to 7.1% YoY**. We expect the slowdown will be more pronounced during the next two quarters (Q2 and Q3). So far, the slowdown has been driven to a greater extent by lower non-core inflation, which declined 5 pp, from 10.6% to 5.6% YoY, between August 2022 and February this year, and dropped down further to 4.2% in the first fortnight of March. On the other hand, **core inflation has shown it remains sticky to the downside**. The January-February average (8.4% YoY) is the same as in Q4 22. **Yet, in the first half of March it eased to 8.1% YoY.** This stickines has been explained by a slow decline in core goods inflation that has been mostly offset by the continued rise in core services inflation. Thus, although goods inflation has started to slow and decelerated 0.7 pp between November 2022 and February this year (from 11.3% to 10.6% YoY) and eased further to 10.3% in the first two weeks of March, it continues to be very high, largely explained by high processed food inflation (13.2% YoY in the first fortnight of March) which remains significantly higher than non-food goods inflation (6.9%). **Core services inflation still shows no signs of slowing down**, and in fact has had an additional increase during the first five fortnights of the year, and its current level (of 5.7% YoY) is 0.4 pp higher than the average during Q4 22.

- **Despite this core inflation persistence, its seasonally-adjusted trend[1] points to a downward pathway in the coming months that will break the recent stickiness** (see figure 1). This trend measure that anticipates a decline in the pace of core inflation is consistent with the path forecast in our baseline scenario and also with Banxico's forecasts (that could be revised slightly to the upside this Thursday). Thus, **going forward, we**

[1] Calculated by seasonally adjusting the index and annualizing monthly increases

anticipate a marked slowdown in both headline and core inflation. By the end of this year, we anticipate levels of 4.8% YoY and 4.7% YoY, respectively. The downward trend in annual inflation will be driven not only by lower increases in monthly terms, but also by positive baseline effects, which will be more pronounced during the second and third quarters. This trend will be driven by the disinflationary process that is occurring in the United States and that will be more pronounced with tighter credit conditions, the easing in global supply chains and slower growth both globally and in Mexico. Thus, **in September, headline and core inflation could already be below 5.0% and 6.0% YoY, respectively.** Nevertheless, we anticipate that inflation will remain above Banxico's target range throughout 2023, and that it will not be below 4.0% YoY until Q2 24. This represents a similar trend to that forecast by Banxico for both inflation rates during 2023, but more positive than the consensus forecast, which anticipates that both headline and core inflation will close 2023 at levels above 5.0% YoY (of 5.3% and 5.3% YoY, respectively).

- **In a backdrop of slowly easing inflation with a continued risecore services inflation, and with Banxico fixated on keeping a wide interest rate spread against the fed funds rate, we expect it to** stick with its resolve to bring down inflation and **deliver a 25bp hike to bring the monetary policy rate to 11.25%.** We also anticipate that it will remain hawkish and will make an additional increase of the same size at the May meeting to conclude the hiking cycle with the monetary policy rate at 11.50%. However, with inflation slowing and the elevated level of the reference rate, the monetary policy stance will become increasingly restrictive in a context of lower risks to inflation and higher risks to growth. Therefore, we expect that Banxico will maintain a pause at 11.50% for an extended period before embarking in a rapid rate-cutting cycle in 1Q24. We anticipate that Banxico will cut the policy rate by 300 bp during 2024 to a level of 8.50% by the end of next year in order to prevent real ex ante rates from becoming excessively high, which will be unwarranted with falling inflation. In fact, we think current levels are already unwarranted considering that real rates are set to increase sharply (to levels beyond 7.0%). Given that even after these expected cuts the real rate would remain very high (see figure 2), we have a downward bias for this forecast.

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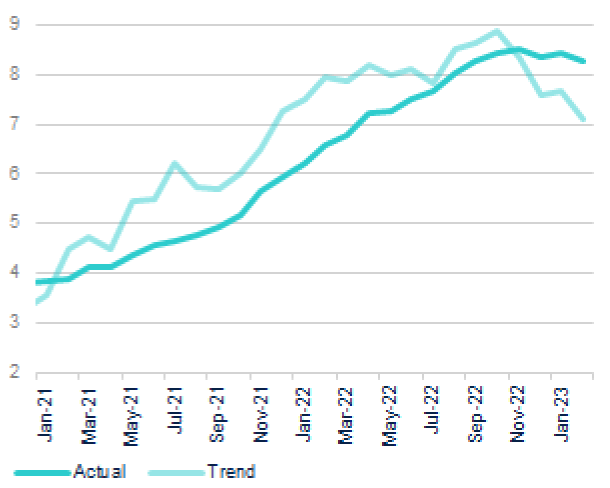
Core inflation is likely set to ease markedly in the coming months…

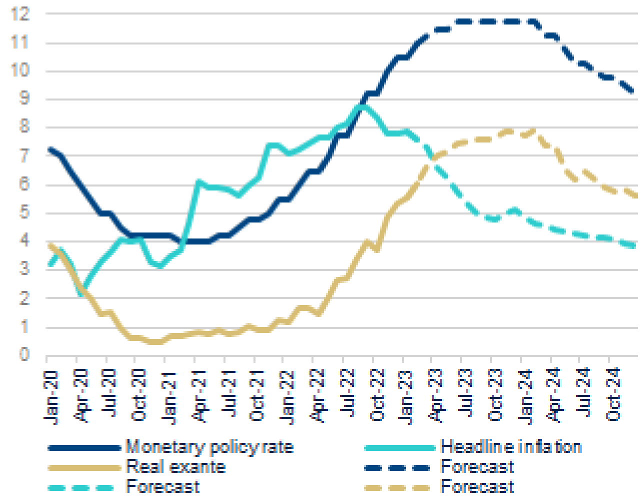
Figure 1. **CORE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



Source: BBVA Research based on data by INEGI.
*Own calculations.

… while the monetary policy stance is set to rise sharply with 50 bp worth of hikes in the pipeline

Figure 2. **MONETARY POLICY RATE & STANCE OUTLOOK**
(%)



Source: BBVA Research based on data by Banxico & INEGI.
*For expected inflation we add 0.3pp to our projected path to bring it closer to the consensus path.

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