BBVA Research

Banxico Watch

Banxico is set to hold the policy rate steady…

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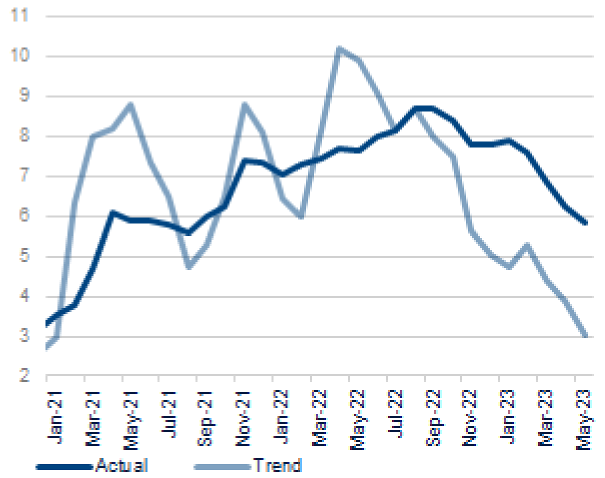
… but with falling inflation, it should -and we think it will- start a rate cut cycle in 4Q23

- Last week, **the Fed skipped a rate rise but hinted that it is set to hike again in July.** Most FOMC participants agreed on the need of "some further rate increases". In a hawkish shift, the updated "dot plot" showed the median projected fed funds rate rising to 5.6% by year-end, signaling that 50bp worth of additional hikes might come. **The Fed seems set to hike again in July, but we only expect one more increase.** With the risks of "overdoing it and underdoing it closer to being in balance" after hiking in July, the Fed would likely skip again in September. We expect that by November, softer core inflation will convince the FOMC to extend the pause.
- **How will Banxico react?** The spread between the policy rate in Mexico and the fed funds rate fell back to 600 bp in March (from 625 bp following Banxico's surprising 50 bp hike in early February) and seems now set to fall somewhat further in July (to 575 bp). Markets are pricing in a c. 80% odds that the Fed will lift rates again in July. At the same time, markets are not anticipating Banxico to follow Fed's footsteps and are pricing in that it will stay on the sidelines in the short term. Up to now, the still very wide interest rate differential (the average in the decade previous to the pandemic was 425 bps) and the expectation that it will narrow somewhat but remain very large continues to support the peso. In the intermeeting period (since March 30), the Mexican peso has strengthened further (4.9%). It has remained strong despite the Fed signaling last week that more hikes might come. That is, **Banxico will feel comfortable with peso's strength even as expectations of some narrowing in the interest rate spread have built up.** Members of the Board, including the governor, have recently mentioned that their policy decisions can now be more focused on domestic factors independently of what the Fed does.
- The Board can focus on the evolution of **inflation,** which **is set to decline fast in 2Q-3Q and has performed better than what Banxico forecasted in the previous meeting. Since then**, **headline inflation has come down 1.5 pp** (from 7.1% YoY in the first half of March to 5.7% in the second half of May). Although most of the decline has been driven by lower non-core inflation, **the pace of core inflation slowdown has also gained traction, dropping (-)0.8 pp** in the same period (from 8.1% YoY to 7.3% in the last five fortnights). Also, supercore inflation has been declining for three months in a row. Importantly, **trend measures continue to point to a more pronounced slowdown in the coming months (see Figures 1 and 2), as we foresee in our baseline scenario and as Banxico also anticipates (see Figures 3 and 4).** What about inflation expectations? Since late March, year-end headline inflation consensus expectations have eased from 5.25% YoY to 4.91%, coming closer to our below-consensus 4.6% YoY forecast. 12-month expectations have fallen (-)0.2 pp and although core inflation expectations have stayed mostly unchanged over the same period (at 5.3% YoY) we think that they will fall soon. We expect Banxico to slightly revise down its 2Q-3Q inflation forecasts to bring them closer to our projected path, and to keep the expected core inflation downward trend mostly unchanged.
- **With falling inflation and a strong peso, we expect Banxico to start a rate cut cycle in 4Q23 to avoid an additional increase in the already very high ex-ante real rate** which is set to hover around 7.0% in the next few months. Given that the peso strengthening has brought monetary conditions to restrictive territory, in a backdrop of falling inflation, after extending the pause during 2Q and 3Q Banxico should start a rate cut cycle in 4Q to avoid a further tightening of the monetary policy stance, even if the Fed is still in a pause. A signal is not likely in the short term, but we continue to expect that Banxico will start to cut rates as soon as in November.

A sharper drop in both headline and core inflation is in store…

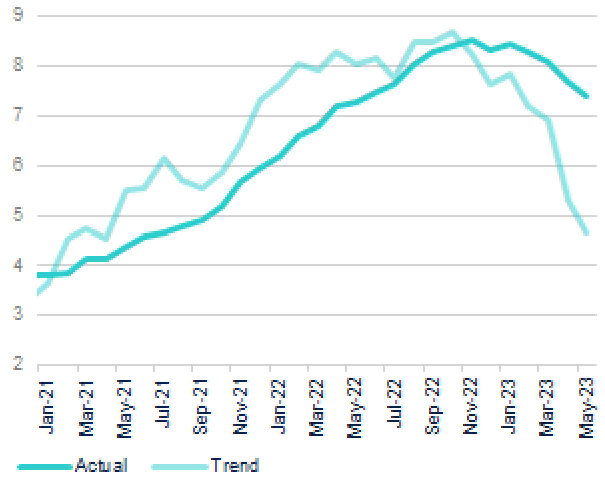
Figure 1. **HEADLINE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



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

… as suggested by trend measures

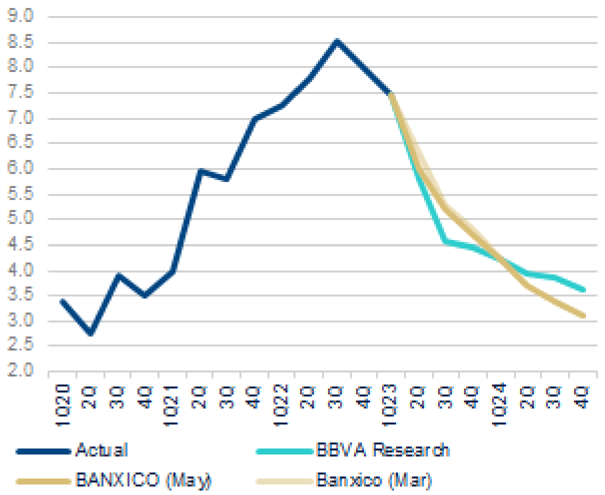
Figure 2. **CORE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



Source: BBVA Research based on data byINEGI
*Own calculations.

Headline inflation has eased more rapidly than projected by Banxico…

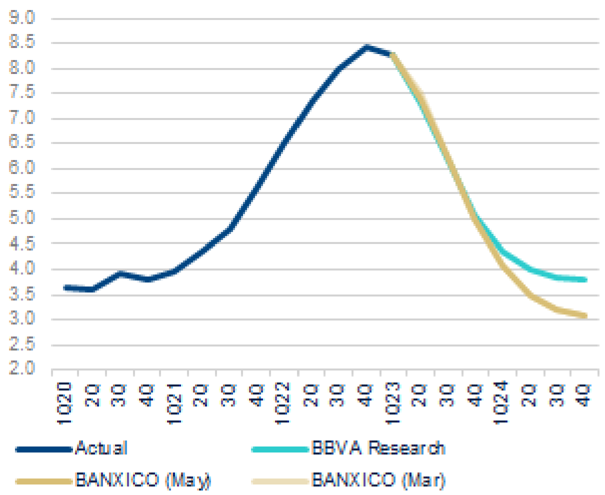
Figure 3. **HEADLINE INFLATION OUTLOOK**
(YOY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research based on data byBANXICO & INEGI.

… and core inflation has come down somewhat more compared to Banxico's expected path

Figure 4. **CORE INFLATION OUTLOOK**
(YOY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research based on data byBANXICO & INEGI.

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