BBVA Research

Banxico Watch

Banxico will remain hawkish and backward looking

Javier Amador / Iván Fernández

August 9, 2023

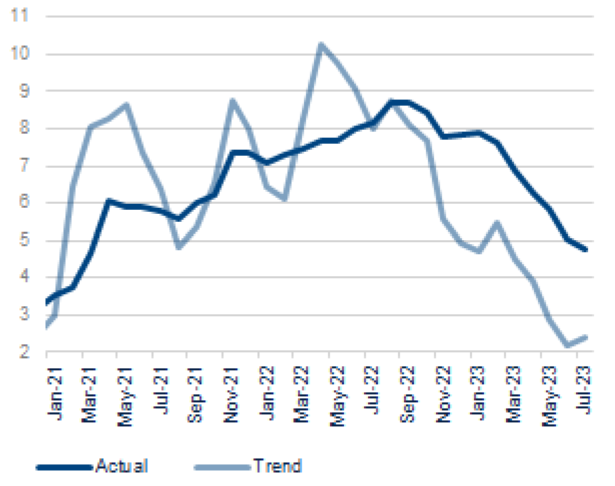
It will not open yet the door for the possibility of rate cuts

- **After raising the fed funds rate by 25bps to a 5.25-5.50% target range two weeks ago, the Fed is now set to take a meeting-by-meeting data-dependent approach.** Our baseline scenario is that US core inflation will have softened enough over July and August to persuade the Fed to skip in September, and will likely ease further before the November meeting. We think that the bar for a hike in September is high, and with data showing that the labor market is coming into better balance and core inflation is cooling down more markedly, **the Fed is probably done raising rates** (see). More so taking into account that Powell pointed out that "[the Fed is] coming to a place where there are risks on both sides." Thus, we do not expect the current 575 bps spread between Mexico and US's policy rates to fall back in coming months driven by Fed's actions.
- **Banxico's June meeting minutes showed members' agreement on the need for "caution" in the current disinflationary stage.** They emphasized the importance of maintaining the policy rate at its current level for an extended period. Two of them expressed discomfort with market expectations of rate cuts by the end of the year, with another considering it "prudent to refrain from taking actions that could [...] relax the monetary stance prematurely", likely in response to Jonathan Heath's early-June comments about a possible rate cut in November. More recently, amidst few signs of easing core services inflation, Heath dialed back somewhat his dovish tone by saying that Banxico will likely need to hold its current restrictive stance "for a while" and wait for it to take effect. He added that some adjustments could be made, if needed, in case inflation expectations decrease rapidly and cause an excessively restrictive stance. This echoes June minutes' revealed concerns from two members about an increasing ex-ante real interest rate ahead, with one of them warning that "the monetary stance must be prevented from becoming too restrictive."
- **Banxico is set to remain backward-looking in the short term and keep its policy rate steady for at least this upcoming meeting and the following in September.** Inflation in July came broadly in line with our forecasts. Headline inflation dropped back to 4.8% YoY, 3 percentage points (pp) below 2022's year-end 7.8% YoY. Core inflation has come down more slowly but also noticeably, to 6.6% YoY, (-)1.7 pp year to date. Both are set to continue to drop further (see Figures 1 and 2). Trend measures and our expected path suggests that headline inflation is going to slow down more markedly than currently expected by Banxico through the end of this quarter. We thus expect Banxico to fine tune its short-term headline inflation forecasts (see Figure 3). What about inflation expectations? Since the last meeting, 12-month headline and core inflation expectations have come down 0.3 and 0.4pp, to 4.4% and 4.3% respectively. We think that they will gradually come down further (our expectations are 4.0% and 3.8%, respectively). Thus, the real exante rate is set to remain very high with inflation dropping back and will likely increase somewhat further in the next months.
- **Sooner rather than later, Banxico is likely to join other countries such as Chile and Brazil which are already easing their restrictive stance.** What will it take for Banxico to start a rate cut cycle to avoid an unwarranted increase in the real exante rate? Despite a slight depreciation since its late-July lows, the peso has remained relatively strong in a context of increasing risk aversion over the past few weeks. Peso strengthening along with high real rates has brought monetary conditions to restrictive territory. We continue to think that in the backdrop of falling inflation, **Banxico should start a rate cut cycle in 4Q to avoid a further tightening of the monetary policy stance, even if the Fed ends up hiking rates one more time or is still holding rates steady**. **Some hints about the roadmap for the rate cut cycle will be useful, but seem unlikely in the short term.** Besides, there is a risk that with a strong economy and sticky services inflation, Banxico decides to remain backward looking and extend the very restrictive stance for longer.

BBVA Research

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

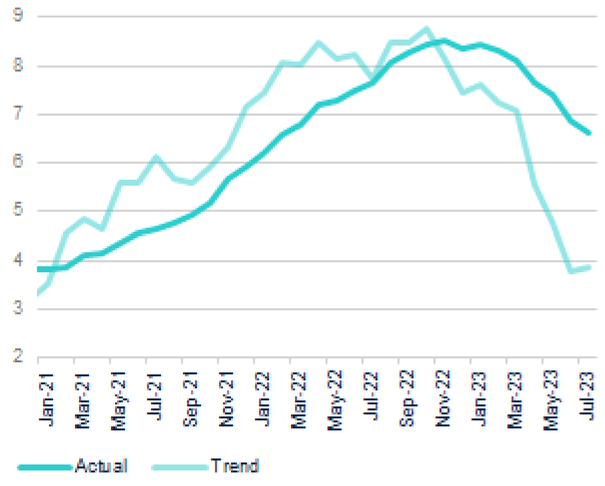
Figure 1. **HEADLINE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



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

… as suggested by trend measures

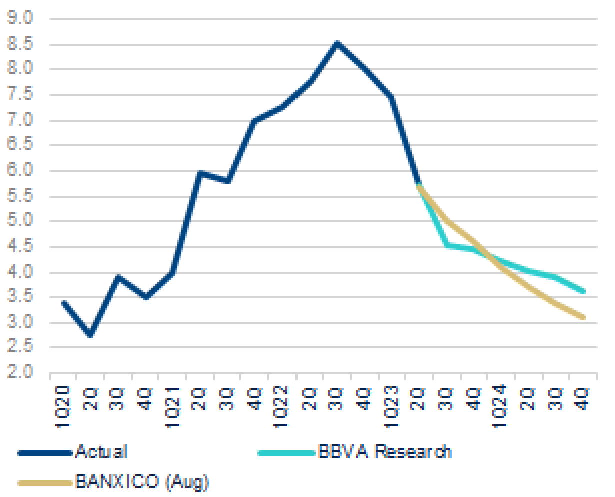
Figure 2. **CORE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



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

Headline inflation is set to ease more rapidly in 3Q23 than projected by Banxico…

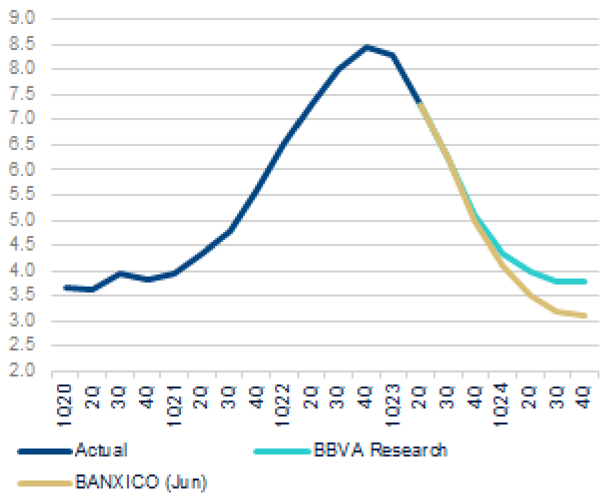
Figure 3. **HEADLINE INFLATION OUTLOOK**
(YOY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research based on data byBANXICO & INEGI.

… while core inflation will likely come down in line with Banxico's expected path

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



Source: BBVA Research based on data byBANXICO & INEGI.

BBVA Research

DISCLAIMER

The present document does not constitute an "Investment Recommendation", as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse ("MAR"). In particular, this document does not constitute "Investment Research" nor "Marketing Material", for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com