BBVA Research

Banxico Watch

Banxico likely to stay cautious

Javier Amador / Iván Fernández / Carlos Serrano

November 8, 2023

We are not expecting a shift in tone at this meeting

- **Continued progress on inflation and a gradually rebalancing labor market drove the Fed to skip a rate hike for a second consecutive meeting last week.** Although the Fed left the door wide open for another rate hike, in our view, Chair Powell could have been more hawkish given recent strong economic data, but instead started to pave the way for a dovish shift to signal the Fed has wrapped up the hiking cycle. We think the Fed will continue to gradually change its tone in the following meetings, in which a definitive pause will be clearly signaled, and the debate will start to shift to the length of the pause, especially following the October jobs report that signaled a labor market that keeps cooling, further reducing the probability of observing wage inflationary pressures ahead. In a nutshell, we think the Fed is done if conditions allow them to be done (for more see). Fed funds rate expectations and yields alongside the yield curve have eased somewhat over the past week following this less hawkish Fed tone alongside the modest job growth pace in October and signals that the services sector could be finally headed towards a deceleration in 4Q after the latest ISM services index showed less robust growth. Long-term rates in Mexico have also come down from recent hikes. However, they remain higher than a couple of months ago, tightening financial conditions and thus making another rate hike less necessary.
- **Banxico will remain cautious until it becomes more confident that core inflation is headed toward target and the Fed clearly signals a definitive pause (something we think will not happen this year).** Thus, Banxico will not feel compelled to signal that a rate-cut cycle is in store anytime soon, even amid high real interest rates and a gradual core disinflation process. In the intermeeting period, headline inflation eased much more than what Banxico was likely expecting according to its September forecasts. October's inflation will be released tomorrow before the decision. We expect headline inflation to have eased to 4.25% YoY, the lowest level in 32 months (Figure 1). In its last meeting, Banxico puzzlingly revised up its short-term headline inflation forecasts to 4.7% and 4.4% YoY on average in 4Q23 and 1Q24. With October's inflation set to fall to levels slightly below 4.3%, Banxico will likely revise down these forecasts. As to core inflation, we do not expect any meaningful changes in its forecasts. Core inflation likely eased to 5.5% YoY in October, down from 5.8% YoY in September (Figure 2). Although the annual rate would thus have fallen for ten straight months, and to its lowest level in 24 months, it remains above the headline rate and well above Banxico's target, mainly as core services inflation has remained more sticky recently. Looking ahead, driven by base effects, headline inflation will most likely edge up in Nov-Dec, before resuming its downward trend in 1Q24 (Figure 3) while core inflation will continue to come down steadily. Under this inflation backdrop, Banxico will likely be in no rush to change its tone and keep its very restrictive stance for longer.
- **Banxico is thus set to remain backward-looking in the short term and to keep its policy rate steady at 11.25% for at least this upcoming meeting and the following in December.** Core inflation has come down more slowly but also noticeably, likely (-)2.9 pp year to date in October, and it is set to drop further, but at the same time, it is not likely to fall to levels close to 4.0% until 2Q24 and below that threshold until 3Q24. What about inflation expectations? Since the last meeting, both 12-month headline and core inflation expectations

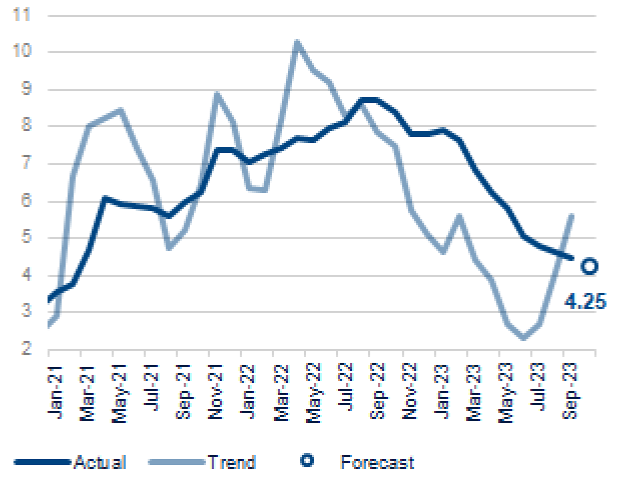
remained broadly stable at 4.2%. We continue to think they have room to come down further (our current 12-month expectations are 3.7% for both headline and core inflation). Thus, with inflation dropping back, the real ex-ante rate is not only set to remain very high but to most likely continue increasing in the coming months. Medium-term expectations remain well-anchored at levels close to the average inflation rate observed in the last fifteen years.

- **To sum up, we are not anticipating any major changes in Banxico's statement, tone, or forecasts.** Yet, even if Banxico is unlikely to signal the start of a rate cut cycle in the short term, we expect it to gradually start to shift its tone, as the Fed is already doing, to signal that even if it is not around the corner, the next move will mark the start of an easing cycle that gradually brings down the real ex-ante rate from its current extremely elevated levels. We continue to expect Banxico to join other countries such as Chile and Brazil, which have already embarked in gradually easing their restrictive stance and have started to cut nominal rates. Although we continue to expect a rate cut cycle in 1Q24 (as we think that will be warranted to avoid a further tightening of the monetary policy stance with falling inflation and real rate levels increasing further), we think that **Banxico's cautiousness and hawkishness are significantly tilting the risks towards a further delay in the start of this cycle.** Governor Heath, for example, conveyed a hawkish message a couple of weeks ago by stating that not only has the balance of risks for inflation remained skewed to the upside, but also that it has deteriorated recently (see).

BBVA Research

There is a bump in the road in store for headline inflation in Nov-Dec…

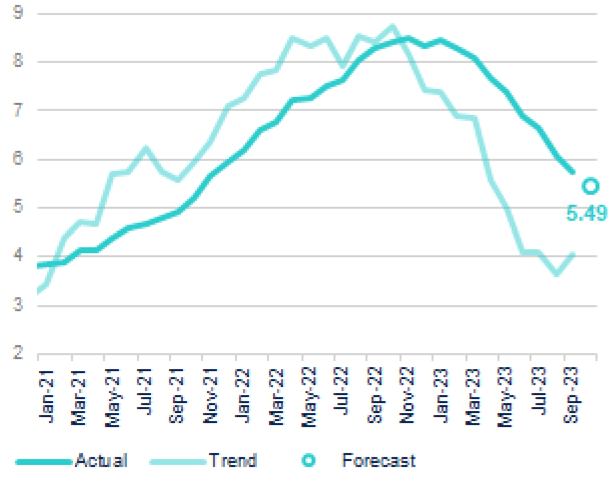
Figure 1. **HEADLINE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



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

… but core inflation is set to continue to steadily ease, as signaled by trend measures

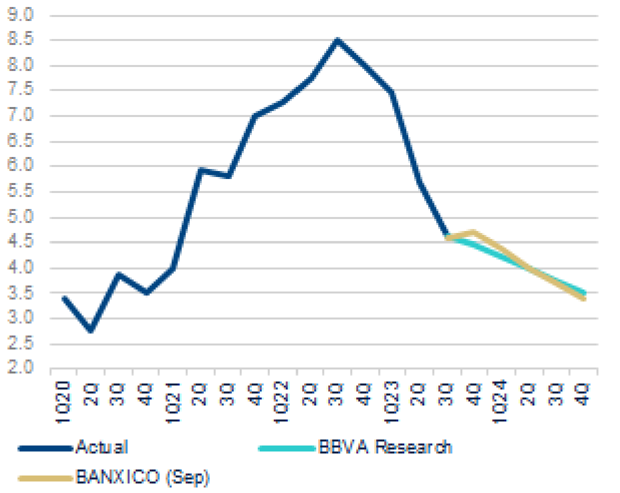
Figure 2. **CORE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



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

Banxico will likely revise down its short-term inflation forecasts, bringing them closer to ours

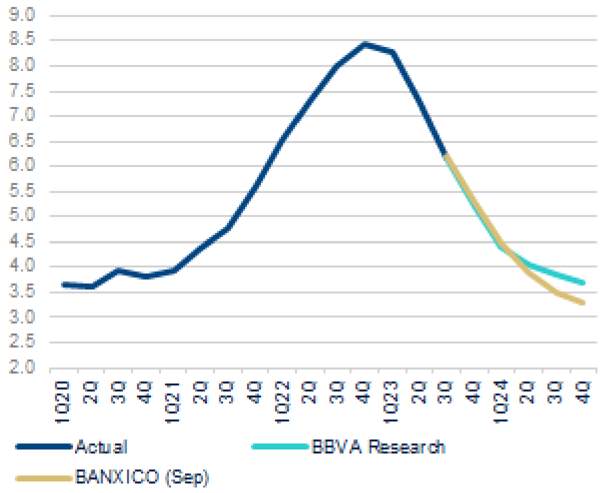
Figure 3. **HEADLINE INFLATION OUTLOOK**
(YOY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research based on data by Banxico and INEGI.

We are not anticipating any noticeable changes to its core inflation forecasts

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



Source: BBVA Research based on data by Banxico and 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.