

Banxico's warranted cut will move policy into neutral range

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Mexico's weak growth and stable financial markets leave room for Banxico to keep easing, even as the Fed turns more cautious

Last week, the Fed lowered the fed funds rate target range to 3.75-4.00% and warned that a third consecutive rate cut in December was not a “foregone conclusion.” Despite the official data blackout, the FOMC conveyed a slightly upbeat assessment of economic activity, yet emphasized that “job gains have slowed.” It continued to characterize inflation as “somewhat elevated.” Seeking to rein in expectations of a steady easing cycle ahead, Chair Powell struck a cautious tone and warned that a rate cut in December was not a “foregone conclusion” and, in fact, was “far from it.” Financial markets swiftly adjusted to the Fed's cautious messaging, scaling back easing bets: Treasury yields rose across the curve ([Figure 1](#)) and the Fed funds futures market now assigns a 35% chance of a pause next month (vs 5% earlier last week). Unless upcoming alternative data signal a material weakening in the labor market, the FOMC could move to the sidelines in the next meeting (click [here](#) and [here](#) for additional details on last week's FOMC meeting). We think Banxico's room to continue easing is unlikely to have been materially affected by the Fed's more cautious tone, as some Board members have indicated that a narrowing rate spread is not a binding constraint.

Mexico's economy contracted in Q3, as the temporary boost from net exports in the previous quarter faded and domestic demand likely remained in contraction. After posting a trade surplus of USD 1.7 billion in Q2, Mexico's trade balance recorded a cumulative deficit of USD 4.36 billion in Q3. In September alone, imports rose by 15.2% y/y, slightly outpacing the 13.8% increase in exports. This reversal likely contributed to the 0.3% q/q GDP contraction in Q3 ([Figure 2](#)), driven by a 1.5% drop in industrial activity (vs. 0.7% in Q2) and stagnation in services (0.1% vs. 0.8%). A rebound in the volatile primary sector (3.2% vs. -2.4%), a small contributor to overall GDP, was not enough to offset the broader weakness. On the labor market front, formal job creation was flat for a second consecutive month in September (0.05% m/m), capping a year characterized by minimal employment growth. The sectoral breakdown continues to reflect the lingering weakness in investment: manufacturing and services posted monthly job losses (-0.15% and -0.44%, respectively); construction jobs rose modestly (0.38%), but the sector is still contracting sharply in annual terms (-6.6% y/y). The real wage bill slowed to 3.7% y/y, pointing to a continued drag on private consumption. Overall, activity data continue to indicate that underlying domestic demand remains subdued. This will likely reinforce Banxico's view that the “weakness of economic activity” limits upside risks for the inflation outlook and supports the ongoing easing cycle.

Headline inflation remained within Banxico's target range in early October, as soft core goods prices and subdued non-core inflation offset still-sticky services prices. Headline inflation rose at a slightly below-expectations pace in the first half of October, bringing annual inflation down to 3.6% from 3.8%. The decline was largely due to a favorable base effect and a drop in agricultural prices, which partially offset the seasonal rise in electricity tariffs following the expiration of summer subsidies. This resulted in a net 0.6% increase in the non-core component, which nonetheless slowed to 1.6% y/y from 2.0% in the previous fortnight. Core inflation also surprised slightly to the downside, rising by just 0.18% on a biweekly basis and easing to 4.2% y/y (from 4.3% in late September). Core goods inflation moderated by 0.1 pp to 4.1% y/y—suggesting the uptrend seen since late 2024 has halted—while services remained puzzlingly sticky at 4.4% despite the continued weakness of economic activity. Headline inflation has thus remained within Banxico's 2-4% target range for four consecutive months and, combined with a still gloomy activity outlook, should keep the Board confident that the balance of risks continues to favor a normalization of the policy stance. The disinflation process in other services is taking longer than expected ([Figure 3](#)), but we continue to believe that very weak domestic demand will eventually bring it back toward historical averages. The persistence of services inflation may lead Deputy Governor Heath to maintain his dissent in favor of a pause, while the rest of the Board supports continuing the easing cycle.

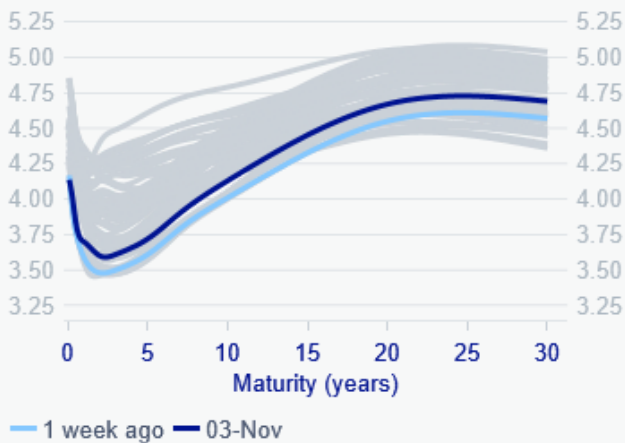
Supportive financial conditions continue to suggest the environment remains conducive to further easing, underpinning the Board's confidence in its easing approach. Since the last policy meeting, the peso has traded within a narrow range around MXN 18.4 per USD. The Fed's more hawkish tone late last week pushed it down by roughly 0.7%, but peso volatility has remained near its lowest levels since March 2024 and only slightly above those recorded in early 2020, before the pandemic-driven financial turmoil. During the year, MXN has appreciated around 10% giving Banxico another reason to proceed with the easing cycle. The downward shift in the middle and long segments of the yield curve appears to have paused, with Mexican yields resuming their usual correlation with US Treasuries. The 10-year yield, currently around 8.8%, reached a low of 8.6% in mid-October when the US 10-year Treasury yield briefly fell below 4% for the first time in a year ([Figure 4](#)). Sovereign risk (e.g., CDS spreads) has remained broadly stable, suggesting that markets have responded positively to the continuation of fiscal consolidation efforts outlined in the 2026 budget proposal presented in early September and to the fact that Mexico can continue to export a wide variety of goods to the US tariff-free. These developments indicate that Banxico continues to operate under favorable financial conditions to maintain its easing cycle—a view that was once again reflected in the minutes of the latest meeting. Three members explicitly signaled this view, noting that “the rate-cutting cycle could continue [...] under an approach of gradualism,” that “looking ahead, the adjustment of the target rate could continue gradually,” and that “there is space to continue with the rate-cutting cycle under an approach of gradualism.” A fourth member was more cautious and only stated “the possibility of adjusting the target rate once again.” However, even this member's reasoning ultimately pointed toward the case for further easing.

We expect Banxico to deliver another 25bp rate cut this week to 7.25%; as monetary policy moves to neutral, attention will turn to any signals of a less dovish tone. With this adjustment, the ex-ante real policy rate would stand around 3.35%, roughly 25bp below the

upper bound of Banxico's estimated neutral range (3.6%)—a level that implies the policy stance has now entered neutral territory. Our focus will be on whether this milestone leads to a more cautious tone in the statement, as the Board approaches the midpoint of its neutral range, estimated to be around 2.7%. After this week's cut, that midpoint will lie approximately 65bp below the policy rate, broadly in line with the three additional rate cuts we have penciled in our baseline scenario. A more balanced tone would signal growing caution within the Board about the potential risks of moving beyond neutrality. However, if Banxico keeps its communication and forward guidance broadly unchanged, it would reinforce our view that a majority of the Board is comfortable with taking rates slightly below its midpoint neutral estimate. Such a signal would strengthen our bias that risks to the policy rate path next year are tilted toward additional easing amid expectations of continued growth softness.

Financial markets swiftly adjusted to the Fed's cautious messaging, scaling back easing bets

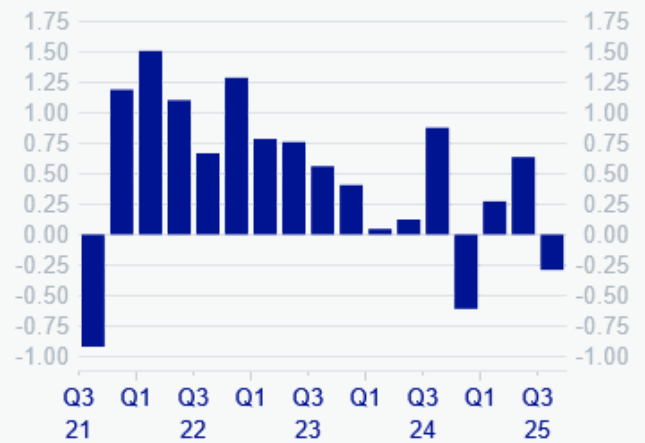
FIGURE 1. TREASURY YIELD CURVE (%)



The gray lines indicate weekly curves over the past year; intermediate rates calculated with natural cubic spline interpolation. Source: BBVA Research / Treasury Dept.

GDP contracted in Q3 driven by a drop in industrial activity and stagnation in services

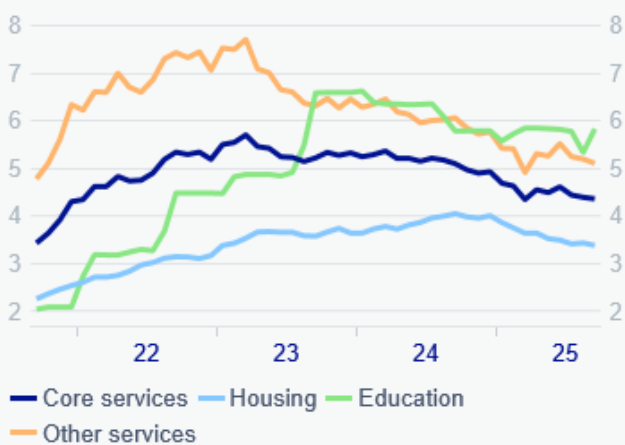
FIGURE 2. REAL GDP (Q/Q%)



Source: BBVA Research / INEGI

The disinflation process in other services is taking longer than expected

FIGURE 3. CORE SERVICES INFLATION (%)



Source: BBVA Research / INEGI

Mexican long-term yields have resumed their usual correlation with US Treasuries

FIGURE 4. 10-YEAR GOVERNMENT YIELDS AND YIELD SPREAD (% AND BPS)



Source: BBVA Research / Macrobond / Treasury Dept.

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