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Banxico to deliver one last rate cut before moving to the sidelines

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It will convey more caution amid sticky core inflation and one-off inflation shocks, even as domestic demand remains very weak

Last week, the Fed delivered a third consecutive 25bp rate cut, to 3.50-3.75%, and signaled it will likely pause rate cuts at its next meeting in late January. The policy statement continued to emphasize that downside risks to employment had increased, but included a hawkish tweak in the forward guidance regarding the "extent and timing" of additional adjustments. The updated SEP showed a downward adjustment to the inflation median projection, suggesting growing confidence that tariff-related price pressures will remain limited. However, the dot plot revealed deepening divisions within the FOMC: seven participants see no need for further rate cuts through 2026, while four participants would support one cut (the median projection) and another four would support two cuts. Only three participants envision three or more rate cuts next year. In his press conference, Powell delivered a clear signal of an upcoming pause: the Fed is now "well positioned to wait to see how the economy evolves." This message reinforced our expectation that the Fed will take some time to assess the effects of the policy easing that has been delivered so far (Figure 1) before proceeding with two additional rate cuts in the second half of 2026 (click here and here for additional details on last week's FOMC meeting). Last week's Fed rate cut should leave Banxico comfortable in delivering another 25bp cut this week. However, the greater caution signaled by the US central bank regarding the policy path for 2026 is also likely to be reflected in Banxico's communication.

In Mexico, recent data continue to point to a marked weakening in domestic demand, which offsets the boost from a narrowing trade deficit. While INEGI's second estimate of 3Q25 GDP confirmed that output contracted by 0.3% q/q, growth in 1Q and 2Q was revised down to 0.2% and 0.4%, respectively (from initial estimates of 0.3% and 0.6%). This led Banxico to revise down its growth forecast for this year from 0.6% to 0.3% in its latest Quarterly Report. Private consumption stagnated in September in m/m terms, reflecting a 0.1% m/m decline in national goods consumption. Signs of weak household spending appear to have extended well into the final months of the year: in November, consumer confidence fell to 44.2 points, its lowest level since December 2022, while formal employment grew by just 0.04% m/m (s.a.), the third-weakest November reading since 2010. This led to a further deceleration in real wage bill growth, to 4.0% y/y. Similarly, gross fixed capital formation continued to contract in September (−0.3% m/m, −8.4% y/y). However, external demand has likely continued to provide a partial offset to weak domestic conditions through 4Q, preventing a sharper slowdown in overall activity. In October, exports grew by 14.2% y/y, outpacing the still-strong increase in imports (12.8% y/y), narrowing the cumulative trade deficit to USD 2.3bn year to date, well below the USD 19.7bn deficit recorded a year earlier. Overall, weak domestic demand should continue to limit demand-side inflationary pressures. However, Banxico's scope for further easing is likely to be tempered by a temporary inflation shock early next year, prompting a more cautious policy stance.

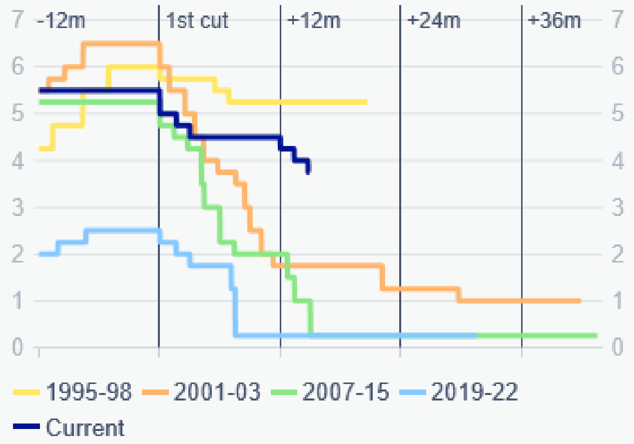
At 3.8%, headline inflation remained within Banxico's variability range for five straight months through November, but is set to face a one-off shock early next year. Last month's uptick in core inflation from 4.3% to 4.4% y/y was partly driven by softer-than-expected seasonal disinflation in core non-food goods (-0.10% m/m), which pushed core goods inflation to 4.4% y/y, its highest level in almost two years (Figure 2). Core services inflation also edged up for a second consecutive month to 4.5% y/y, after hovering around 4.4% throughout 3Q, reflecting persistent stickiness in other services inflation, despite clear signs of economic slack. Looking ahead, inflation will face a significant but likely temporary shock in early 2026, which is likely to push headline inflation up to around 4.2-4.3% y/y in January and 4.3% y/y on average in 1Q26, an expected development that we anticipate to be reflected in Banxico's updated inflation forecasts this week. This supply shock will stem both from changes to excise taxes on certain discretionary-spending items (IEPS) and from the implementation of recently approved tariffs on a wide range of imported goods, mainly from Asian countries with which Mexico has no trade agreement. According to estimates from the Ministry of Economy, the latter could add around 0.2 pp to headline inflation. And while we expect the former effect to unfold gradually through 2026, the impact of higher taxes—which we estimate at around 0.3 pp—is likely to be reflected in January. This is likely to be the main justification for Banxico signaling an upcoming pause in the easing cycle, even as the central bank has expressed confidence that these effects will remain a one-off. Consistent with this view, we continue to believe that a still-widening negative output gap will limit demand-side pressures and favor further disinflation in services in 2026.

Financial conditions have remained supportive overall, despite higher government bond yields, as the peso has continued to appreciate amid historically low volatility. In recent weeks, the Mexican peso continued to appreciate, breaking below MXN 18 per dollar and posting a c. 13% year-to-date gain (Figure 3), with volatility remaining at historically low levels. This performance has been supported by a still relatively attractive carry-adjusted-for-risk profile among major EM currencies and healthy external and fiscal accounts. Throughout the year, the peso has also benefited from the fact that Mexico has continued to export a wide variety of goods (more than 80%) to the US tariff-free, despite the broader reconfiguration of global trade policy under the Trump administration. At the same time, the local yield curve has shifted upward, influenced both by the rise in US Treasury yields and by growing expectations of a pause by Banxico. The US 10-year Treasury yield increased to around 4.2%, from 4.0% in late November, while the Mexican 10-year government bond yield has risen by nearly 25 bps to around 9.15% since Banxico's November meeting, when the central bank moderated the tone of its communication, signaling more limited room for further rate cuts next year. The meeting minutes confirmed this more cautious and data-dependent stance, highlighting that policy has now entered the estimated neutral range. While most Board members continued to acknowledge that a weak activity outlook provides room for additional easing next year, there was much less consensus on the pace at which rates should move further into neutral territory, with only one member explicitly stating that “the real interest rate should move further inside that [neutral] range.”

We expect Banxico to deliver another 25bp rate cut at this meeting, bringing the policy rate to 7.00%, while also conveying more limited room for further easing. Banxico moved the monetary policy stance into the neutral range at its previous decision, a significant milestone after three years of a markedly restrictive stance that had taken the nominal policy rate to a peak of 11.25% in March 2023. This week’s cut is likely to be accompanied by an even more cautious tone than in November. At this stage of the monetary policy cycle, the Board will likely refocus on the risks associated with the persistence of core inflation—particularly in services—and on the temporary inflation shock expected in early 2026, despite the significant weakness of the economy and the strength of the MXN. As a result, forward guidance is likely to become more data-dependent and less explicit, with no commitment to further easing. This shift will likely be interpreted as signaling a near-term pause, which would be consistent with our baseline scenario of two additional rate cuts in 2026, once the one-off inflation shock begins to fade.

The Fed will take some time to assess the effects of the policy easing delivered so far

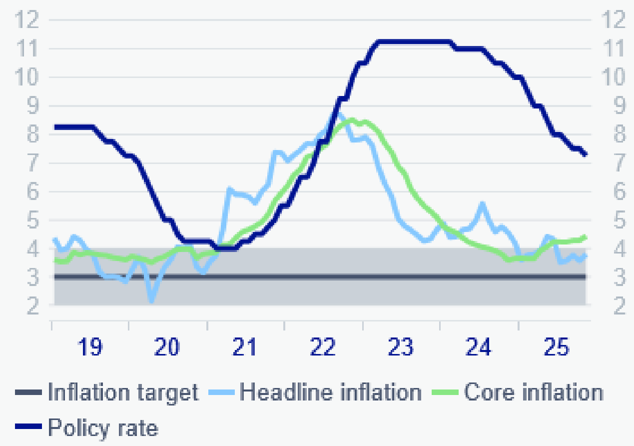
FIGURE 1. FED FUNDS RATE IN EASING CYCLES (%)



Target rate for the 1995-98, 2001-03, and 2007-15 (before 16-Dec-08) cycles; upper limit of the target rate range for the 2007-15 (after 16-Dec-08), 2019-22, and current cycles
Source: BBVA Research / Fed

Headline inflation has remained within Banxico variability range for five straight months

FIGURE 2. INFLATION AND BANXICO POLICY RATE (%)



The shaded area indicates the inflation target variability range
Source: BBVA Research / INEGI / Banxico

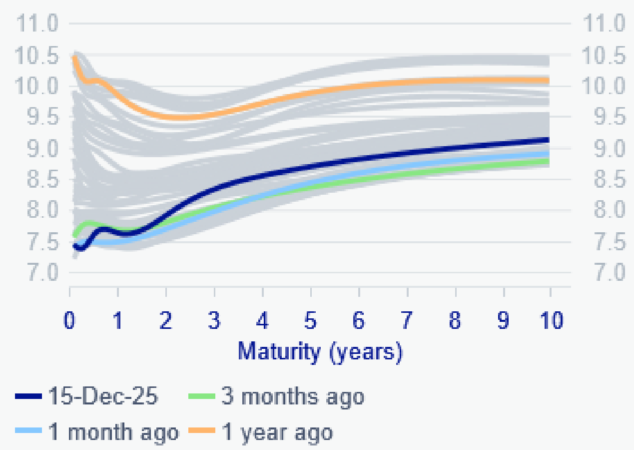
The Mexican peso continued to appreciate, posting a c. 13% year-to-date appreciation

FIGURE 3. USDMXN & S&P BMV IPC INDEX (THOUSAND INDEX PTS. AND PPD)

Source: BBVA Research / BMV / Macrobond

The yield curve shifted up driven by the rise in US yields and growing expectations of a pause

FIGURE 4. GOVERNMENT YIELD CURVE (%)



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

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