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Banxico set to pause as it weighs inflation and growth risks

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We expect unchanged forward guidance and revised inflation forecasts to signal that March would be too soon to resume the easing cycle

Last week, the Fed kept the target range for the fed funds rate unchanged at 3.50-3.75% amid strong economic growth and signs of stabilization in the labor market. The assessment of economic conditions underscored a "solid" pace of growth through 4Q25 and an unemployment rate that "has shown some signs of stabilization." The judgment that "downside risks to employment rose in recent months" was removed, but forward guidance was left unchanged and continued to emphasize a data-dependent approach that leaves the door open to additional easing. In his Q&A, Powell noted that while upside risks to inflation and downside risks to employment remain, both have diminished, allowing for a wait-and-see approach. He acknowledged that inflation excluding tariffs is close to target, but also warned that the outlook faces latent upside risks: "a lot of companies in the middle [of value chains] are pretty committed to passing" tariff-related cost increases on to consumer prices. Overall, the decision reinforced our view that the Fed is comfortably settled into a pause that is likely to extend through 1H26 (Figure 1). Looking further ahead, we continue to expect that conditions will allow the Fed to deliver two additional rate cuts in 2H26, bringing the policy rate to a 3.00-3.25% terminal range (click here and here for additional details on last week's FOMC meeting). The Fed's decision should leave Banxico comfortable in following through with its well-signaled plan to pause the easing cycle.

In Mexico, GDP rebounded in 4Q amid strong external demand and resilient services, but the outlook for domestic demand continues to look uneven. According to INEGI's provisional estimate, GDP expanded by 0.8% q/q in 4Q25 (Figure 2), bringing full-year growth to 0.7%. The quarterly expansion was driven by industry and services, both of which grew by 0.9% q/q, pointing to a gradual recovery in manufacturing alongside continued resilience in the services sector (click here for more details). Consistent with this, the trade balance posted a USD 2.4bn surplus in December, highlighting the strength of external demand explained by the fact that Mexico currently faces one of the lowest levels of protectionism to export to the US. Export-oriented manufacturing has likely continued to benefit from solid US demand for computing and communications equipment amid the ongoing AI buildout, as well as from gradually improving US demand for vehicles and auto parts. That said, economic momentum remains uneven and domestic demand conditions are still weak. Private consumption has shown only modest growth, despite some support from services, while fixed investment

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continues to contract sharply, down 7.1% y/y as of October, amid persistent domestic and external uncertainty. One positive development comes from the construction sector, which appears to have reached a trough as a drag on growth, with early signs of stabilization pointing to an end of the negative base effects from the strong 2023-24 expansion. Overall, the improvement in activity in 4Q25 is likely to further reduce the urgency among the most dovish Board members to push for additional monetary easing in the near term. Still persistent investment weakness may continue to weigh on growth, and despite the improvement in 4Q25 growth, both a still negative output gap and a strong MXN leave the door open to additional easing later in the year.

As expected, inflation began to pick up in the first half of January, reflecting one-off fiscal-related price pressures that warrant a cautious pause in the easing cycle. Headline inflation averaged 3.8% y/y in 2025 and ended the year at 3.7%, close to its long-term equilibrium level. In the first half of January, headline inflation edged up to 3.8%, while core inflation increased to 4.5% from 4.3% in December. As was anticipated, the main culprit was core goods prices, which rose sharply to 6.1% y/y (its highest level in two years) following the IEPS tax increase that came into effect this year on selected food-related items such as cigarettes and soda, although the outturn was somewhat more benign than anticipated. At the same time, core services inflation inched slightly up to 4.4%, underscoring the puzzling persistence of services inflation despite weak domestic demand. However, the pickup in core goods inflation is widely anticipated to be a one-off. We think that the expected fading of fiscal-related shocks and the continued weakness of domestic demand should allow both headline and core inflation to resume a gradual downward trend from 2Q26 onward. In this context, while near-term inflation dynamics justify Banxico remaining on hold in the coming meetings in order to confirm that the temporary increase on prices does not have an effect on inflation expectations, the Board will likely continue to keep the door open to renewed easing later in the year once risks of second-round effects are ruled out. Consistent with this view, we continue to believe that a negative output gap will limit demand-side pressures and facilitate further disinflation in services.

Since the December meeting, financial markets have reflected peso strength and volatile yields; minutes showed ample support for a wait-and-see stance. The Mexican peso closed 2025 at around MXN 18.0 per dollar, posting a cumulative appreciation of 12.7% over the year. So far in 2026, it has continued to strengthen, gaining more than 4% to around MXN 17.2 (Figure 3), supported by a weaker USD, sustained optimism around the outlook for a successful USMCA review, the fiscal consolidation carried out by the government, and by a relatively attractive carry-adjusted-for-risk profile. The latter has been underpinned in part by expectations that Banxico is entering a pause in its easing cycle. Long-term government bond yields have been volatile since the December meeting. The 10-year M-bond yield rose to around 9.1% by late December, but has since declined by around 30 bps, despite some upward pressure on the US 10-year Treasury yield so far this year (Figure 4). Banxico's December meeting minutes showed unanimous support for a pause in the rate-cutting cycle. One member argued that "looking ahead, the cycle should proceed with greater gradualism and caution," while another stressed that "monetary policy will require greater caution and gradualism," and a third noted that "a wait-and-see approach will need to be adopted." The most dovish member of

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the board, Omar Mejía, considered it appropriate to pursue “a more gradual pace” rate adjustments during 1H26.” Even so, he remains as the strongest advocate of the view that “the rate-cutting cycle has not concluded.”

We expect Banxico to leave the policy rate unchanged at 7.00% this week and to continue to stress downside risks to growth despite near-term inflation risks. Banxico is unlikely to materially upgrade its assessment of the economic activity outlook following the rebound in 4Q25 GDP. Instead, it will likely continue to emphasize domestic weakness and external risks, particularly the uncertainty surrounding the upcoming USMCA review. At the same time, with the monetary policy stance now—appropriately in our view—within the estimated neutral range, the Board is expected to stress a cautious approach as it gathers more information on the one-off inflationary impact stemming from recent tax changes (IEPS) and new tariffs. After explicitly stating that it would “evaluate updating the inflation forecast to reflect the effects associated with said measures more accurately,” we expect Banxico to revise its inflation forecasts upward, delaying convergence to the 3% target beyond the currently projected 3Q26 horizon, which in our view is overly optimistic. We think the forward guidance is likely to remain unchanged (“the Board will evaluate the timing of additional adjustments to the reference rate,”) thus signaling that March would be too soon to resume the easing cycle.

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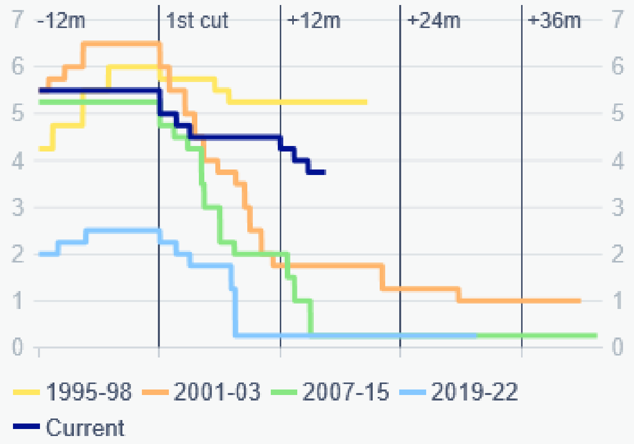
The Fed is comfortably settled into a pause that is likely to extend through 1H26

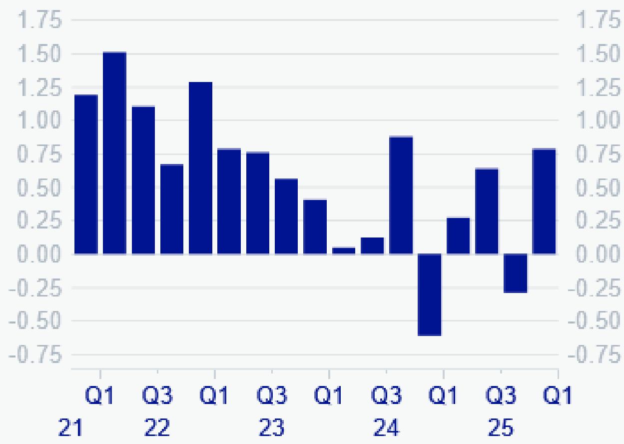
FIGURE 1. FED FUNDS RATE IN EASING CYCLES (%)



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

In Mexico, GDP expanded by 0.8% q/q in 4Q25, bringing full-year growth to 0.7%

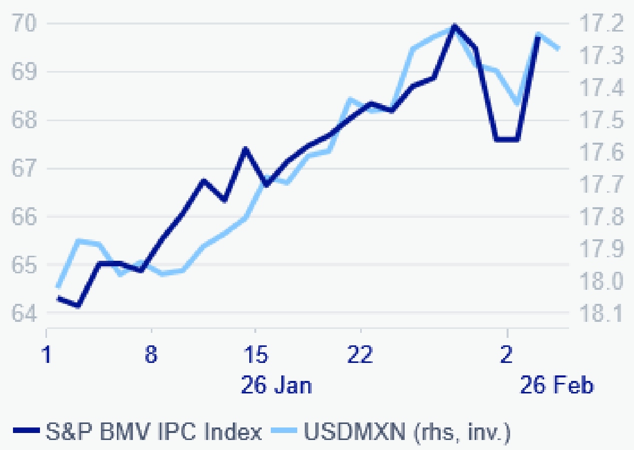
FIGURE 2. REAL GDP (Q/Q%)



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

So far in 2026, the Mexican peso has continued to strengthen, gaining more than 4%

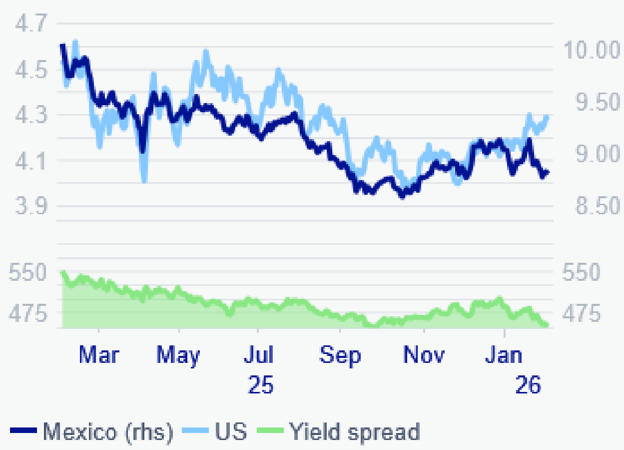
FIGURE 3. S&P BMV IPC INDEX AND USDMXN (THOUSAND INDEX PTS. AND PPD)



Source: BBVA Research / BMV / Macrobond

The 10-year yield rose to around 9.1% by late Dec, but has since declined by around 30 bps

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



Source: BBVA Research / Macrobond / Treasury Dept.

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