

GDP contraction and softer core inflation bolster the case for a final cut

Javier Amador, Iván Fernández, Carlos Serrano

Easing core inflation at the start of 2Q and negative GDP growth in 1Q should reinforce Banxico's confidence in looking through recent supply shocks

Last week, the Fed left rates unchanged at 3.50-3.75% and paved the way for a potential removal of its easing bias should higher energy prices persist. While the easing bias of the policy statement was left unchanged, three FOMC members did not back the inclusion of such guidance at this time, signaling a growing view within the Committee that the scope to resume rate cuts this year is becoming increasingly limited. During his last Q&A as Chair, Powell reiterated that the current stance remains well positioned, although he added that such assessment could shift as soon as the next meeting if warranted: “of course we will move to a hiking bias if we want to hike and we’ll move to a neutral bias before that.” Absent a definitive ceasefire between the U.S., Israel, and Iran, and in an effort to safeguard the anchoring of medium- and long-term inflation expectations, the Fed will likely begin soon to convey more balanced probabilities of cutting or hiking the policy rate. Such a shift would be consistent with an economy that continues to expand at a solid pace ([Figure 1](#)), while the labor market, although fragile, remains broadly stable. Another key topic in Powell’s press conference was his decision to continue as a Board Governor after his term as Chair expires next month. He framed his choice around concerns about recent and potential future “attacks on the Fed which threaten [its] ability to conduct monetary policy without considering political factors” (click [here](#) and [here](#) for additional details on last week’s FOMC meeting).

In Mexico, GDP data likely reinforced most Board members’ case for completing the easing cycle this week, bringing the policy rate closer to neutral without delay. According to INEGI’s preliminary estimate, 1Q26 real GDP contracted by 0.8% q/q ([Figure 2](#)), with all three main sectors contributing to the decline. Industrial activity fell by 1.1%, extending the volatile performance observed since 2024. Services—having averaged quarterly growth of 0.7% between 2022 and 2025—declined by 0.6%, marking their first contraction since 4Q24 (-0.1%) and the steepest since 3Q21 (-1.3%). The agricultural sector contracted for a second consecutive quarter, falling by 1.4% (-1.5% in 4Q25). The quarterly real GDP contraction largely reversed the momentum seen in 4Q25—when the Mexican economy expanded by 0.9%—bringing annual growth down to just 0.2% from 1.8% in 4Q25. The outlook for 2026 has

therefore deteriorated. Weak domestic growth continues to reflect a persistent environment of uncertainty around local Rule of Law doubts and U.S. trade policy and the outlook for oil prices amid the unresolved Middle East conflict, weighing on investment decisions (click [here](#) for additional details on GDP growth). This is also reflected in the continued weakness of formal job creation, which remained subdued in March, with only a modest monthly increase in March (+30,000 formal jobs) equivalent to 1.2% y/y growth, or just 0.5% when excluding digital platform workers. This is compounded by the fact that, since December 2022, over 49,000 micro and small formal firms have shut down, underscoring an unfavorable environment for formal business activity and a growing shift toward informality in a context where the minimum wage is around 77% of the median wage and is now a burden for SMEs (click [here](#) for additional details on the labor market). That said, some tailwinds remain in place for real activity, including resilient consumption supported by continued real wage gains, a gradual recovery in fixed investment—underpinned by a likely successful USMCA review and a possible pipeline of mixed infrastructure projects—and less restrictive fiscal and monetary policy stances. The upcoming World Cup could also provide a temporary boost to activity in 2Q26, particularly in trade and services, although this effect is expected to be limited and insufficient to offset the contraction at the start of the year. Overall, weak demand conditions strengthen the case for a 25bp rate cut at Banxico’s upcoming meeting.

The most recent biweekly core CPI figure favors Banxico’s assessment that the uptick in inflation is driven by one-off supply shocks rather than demand-side pressures. Headline inflation rose by just 0.11% m/m and edged down to 4.5% y/y in the first half of April, slightly below expectations. This was driven by easing core inflation, which slowed to 4.3% y/y from 4.4% in the previous fortnight, despite a slightly firmer biweekly print (+0.18% f/f). The decline in the annual rate was broad-based, with core goods inflation easing to 4.1% y/y (from 4.3%) and core services to 4.4% (from 4.5%), while services excluding housing and tuition moderated to 5.1% (from 5.3%), its lowest level this year. Above-target inflation continues to reflect the impact of three supply shocks: the January IEPS adjustment, unusually high fruit and vegetable prices, and higher global energy prices, which pushed headline inflation to around 4.6% in recent months. We continue to think that most Board members are likely to view these shocks as transitory and consistent with the absence of second-round effects. As a result, and amid still weak domestic demand, both headline and core inflation should resume a gradual downward trend from 2Q26 onward. The still-negative output gap and the weakness in the labor market should help contain demand-side pressures and support further disinflation in core services, despite its persistent stickiness. In this context, easing core inflation at the start of the quarter should reinforce Banxico’s confidence in looking through recent shocks and following through on its guidance of wrapping up the easing cycle this week.

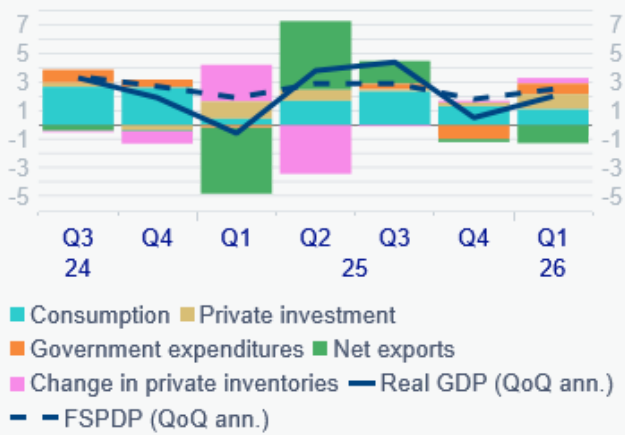
Weak domestic demand and the orderly behavior of the peso will likely lead Banxico to deliver the final rate cut despite persistent global uncertainty. Domestic long-term government yields eased somewhat in recent weeks but remain volatile, with 10-year M Bond yields still hovering above 9% ([Figure 3](#)), reflecting both elevated U.S. Treasury yields and persistent currency risk premia. The decline in key country risk measures like the CDS and the USD-bond-denominated yield spread suggests that markets are not pricing a deterioration in Mexico’s macro fundamentals. The Mexican peso has recently behaved more in line with other

EM currencies, having been significantly affected during the bout of global risk aversion in early March as a result of being a very liquid currency ([Figure 4](#)). Banxico's March meeting minutes showed that most Board members anticipate limited effects on the Mexican economy from the Middle East conflict. The majority stated that the impact on inflation from higher international energy prices "would be limited," given "the price cap policy implemented by the federal government." Omar Mejía maintained his dovish tone, noting that "going forward, there is room for a further adjustment," suggesting support for a final cut in this week's meeting, as "failing to adjust the policy stance would contribute to further widening slack conditions in the economy, and that it will occur once the shock has dissipated." The other two members were more ambiguous on timing, with their remarks signaling a strong dependence on the evolution of the conflict and its impact on domestic inflation and financial markets. But Governor Victoria Rodríguez dovish comments last week during her hearings at the Senate, suggest that she is aligned with delivering a final rate cut.

We expect Banxico to wrap up the easing cycle this week with a 25bp rate cut, taking the rate to 6.50%, followed by a prolonged pause lasting at least through the rest of the year. While Banxico will continue to express caution amid global risks and high oil prices, our view is that most Board members will conclude they can look through these shocks and stay the course toward the midpoint of the neutral rate, with a 4-1 vote likely, as Galia Borja joins the three members who voted to cut rates in March. Consensus has decisively shifted toward a rate cut, now anticipated by 32 of 35 analysts in the Citi Survey, following last Friday's weak GDP print. The Board will continue to highlight domestic weakness following the 1Q26 GDP data, which will most likely lead to a downward revision of Banxico's staff 1.6% growth forecast for 2026. Still-tight financial conditions, driven by higher long-term yields, reduce the need for additional restraint, while the relative strength of the peso points to limited FX risks. Banxico will likely convey that it will take some time to assess the cumulative effects of the easing cycle. Looking further ahead, as core inflation converges toward 3.5% and the Fed potentially resumes easing, Banxico could consider additional adjustments, bringing the policy rate closer to 6.0% next year.

Fed is likely to remain on hold for longer amid global uncertainty and solid economic growth

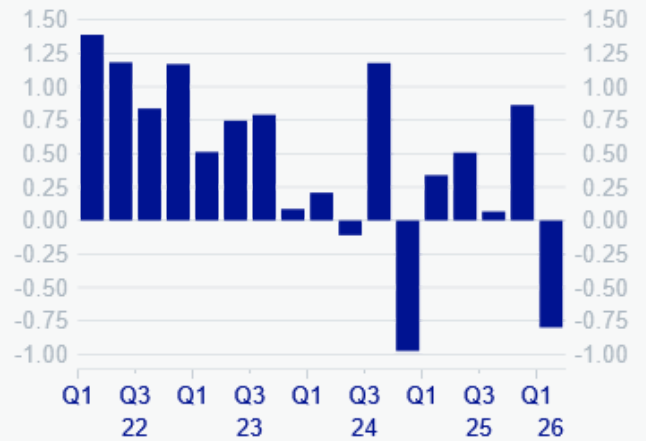
FIGURE 1. US REAL GDP GROWTH (%)



Source: BBVA Research, BEA

According to INEGI's preliminary estimate, 1Q26 real GDP contracted by 0.8%

FIGURE 2. MEXICO REAL GDP (Q/Q%)



Source: BBVA Research, INEGI

10-year M Bond yields still hovering above 9%, reflecting elevated US yields and currency risk

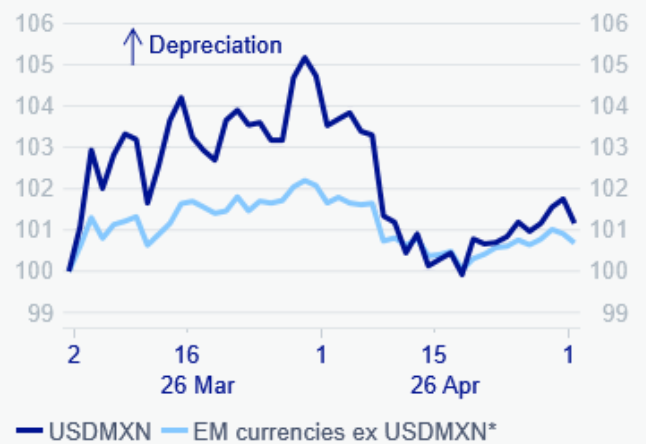
FIGURE 3. 10-YEAR GOVERNMENT YIELDS AND YIELD SPREAD (% AND BPS)



Source: BBVA Research, Macrobond, Treasury Dept.

The Mexican peso has recently behaved more in line with other EM currencies

FIGURE 4. USDMXN RELATIVE PERFORMANCE (28-FEB-26=100)



* Reweighted version of the Fed's Emerging Market Economies (EME) Dollar Index. Source: BBVA Research, Fed, Macrobond

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