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# Banxico set to reiterate preference for a prolonged pause

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## A more hawkish Fed and sticky services inflation leave Banxico comfortably on hold despite persistent economic slack

**Last week, the Fed left rates unchanged at 3.50-3.75% and removed not only the easing bias, as expected, but also all explicit forward guidance.** The absence of guidance in the statement was effectively replaced by the updated economic projections, which delivered the signal Governor Warsh likely wanted to avoid. Headline PCE inflation for 2026 was revised up to 3.6% from 2.7%, while core PCE inflation was raised sharply to 3.3%, six-tenths above the March projection. The dot plot turned decisively more hawkish: eight participants now project no change in rates this year and only one still expects a cut. Of the remaining nine participants, three project one hike, five project two hikes, and one projects three (Figure 1). The median projection rose to 3.8%, practically halfway between holding rates steady and delivering a hike. Thus, the hurdle for additional easing is now considerably higher than earlier this year. Future rate hikes can no longer be ruled out if inflation fails to resume its path toward target. Although the balance of risks has shifted to the upside, we continue to expect the Fed to remain on hold through year-end. A sustained reopening of the Strait of Hormuz would likely put further downward pressure on oil prices, removing an important obstacle to further disinflation and reducing concerns about potential second-round effects among the more hawkish participants.

**In Mexico, recent activity data suggest that the economy began 2Q26 on a somewhat firmer footing, although underlying demand conditions remain weak.** Following the 0.6% q/q contraction in 1Q26 (Figure 2), economic activity rebounded in April, with the IGAE rising 1.2% m/m, supported by gains in both industry and services. The improvement was largely driven by a sharp increase in construction activity and stronger wholesale trade, likely reflecting World Cup-related spending and infrastructure projects. This should provide a temporary lift to activity, but will likely prove insufficient to fully offset the weakness recorded at the start of the year. Private consumption fell 0.8% q/q in 1Q26, while gross fixed investment remained 3.0% below its year-earlier level in March. Despite record-high FDI inflows in 1Q26, domestic investment remains subdued amid persistent uncertainty surrounding local Rule of Law concerns, U.S. trade policy, and the future of the USMCA. Labor market conditions also remain soft. Formal employment declined in May and cumulative job creation has changed little relative to the same period last year. That said, while economic slack remains significant, Banxico is unlikely to place much weight on weak activity now that the policy rate has reached neutral. Instead, the Board will likely prefer to convey that it will remain on hold while monitoring sticky services inflation, particularly given its recent assessment that the current monetary stance is consistent with inflation converging to target.

**The recent decline in inflation should allow Banxico to focus on ensuring that core inflation continues to converge toward target rather than reconsidering its policy stance.** Headline inflation fell from 4.5% y/y in April to 3.9% in May and eased further to 3.6% in the first half of June. The decline was largely driven by a sharp moderation in non-core inflation, reflecting the continued unwinding of earlier agricultural price shocks, as we had anticipated. Core inflation also edged lower, from 4.2% in May to 4.1% in the first half of June, reflecting easing goods prices. Services inflation, however, remained elevated at 4.6%. Crucially, it did not accelerate in the first half of June despite the economic boost from the World Cup, alleviating concerns that stronger demand could delay its easing (Figure 3). As a result, and in a context of still-weak domestic demand, both headline and core inflation should continue to ease gradually over the coming quarters. A still-negative output gap and soft labor market conditions should help contain demand-side pressures and support core services disinflation despite its persistent stickiness. With the policy rate now at the midpoint of the neutral range, the Board is unlikely to feel compelled to preemptively hike rates any time soon. This holds true despite persistent stickiness in services inflation and the risk that the Fed could hike in the coming months—an action that would narrow the interest rate spread. Instead, Banxico will likely signal it will hold steady while monitoring services inflation.

**Orderly financial market conditions and Banxico's latest meeting minutes suggest that the Board will keep the policy rate unchanged.** The Mexican peso has remained broadly stable since the last meeting, behaving largely in line with other emerging market currencies despite lingering global uncertainty and the Fed's more hawkish tone. At the same time, the 10-year M Bond yield has declined below 9.0% in recent days as FX risk premia have eased, even while the 10-year Treasury yield continues to hover around 4.5%, suggesting that domestic financial conditions have not tightened despite the shift in Fed communications. More importantly, Banxico's May meeting minutes revealed a broad consensus that the easing cycle has ended and that the current policy stance should remain in place for an extended period. Two of the three members who voted to cut rates argued that monetary conditions remain restrictive despite the policy rate standing near the midpoint of the neutral range, while Heath, the most hawkish member of the Board, indicated that the current level should remain unchanged until there is clear and sustained evidence of inflation converging to target. Taken together, market developments and Board communications suggest that Banxico is comfortable maintaining a prolonged pause while monitoring inflation dynamics and external risks.

**We expect Banxico to keep the policy rate unchanged at 6.50% this week and to reiterate its message that the current stance will remain in place for an extended period.** The gradual nature of the disinflation process in core services and the upside risks to headline inflation stemming from still-volatile energy prices linked to the Middle East conflict justify maintaining the current pause. At the same time, Mexico's monetary policy differential with the Fed has narrowed to levels last seen in 2014-15, limiting the scope for further compression in

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the absence of Fed easing[1]. But with markets increasingly assigning greater probability to additional Fed tightening than to renewed easing, the current level of the differential is unlikely to be a source of concern for Banxico in the near term. With the policy rate now at the midpoint of the neutral range rather than in expansionary territory, Banxico faces little pressure to act preemptively in either direction.

[1] Even so, the current differential should not be viewed as excessively narrow. Mexico's favorable macroeconomic fundamentals suggest that the economy could eventually sustain a smaller differential without generating significant pressure on the peso.

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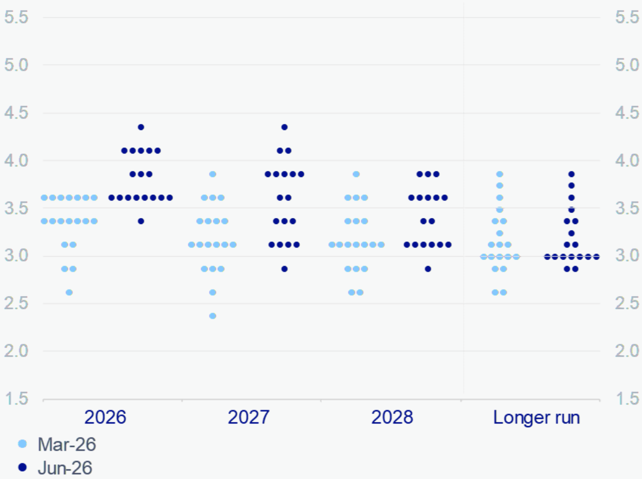
The absence of Fed's forward guidance was replaced by the dot plot, which turned hawkish

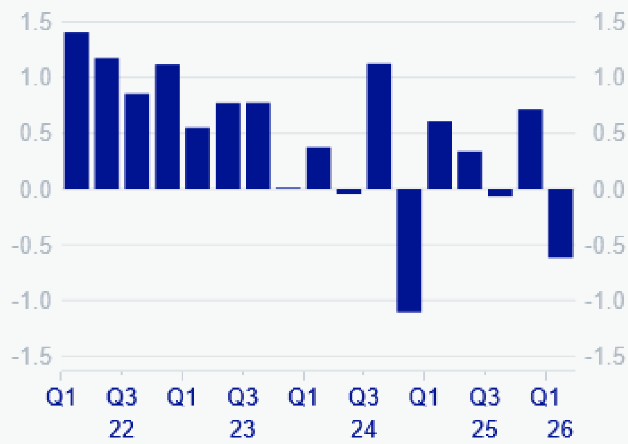
## FIGURE 1. FOMC PARTICIPANTS' DOT PLOT (%)




Source: BBVA Research, Fed

According to INEGI's second estimate, 1Q26 real GDP contracted by 0.6%

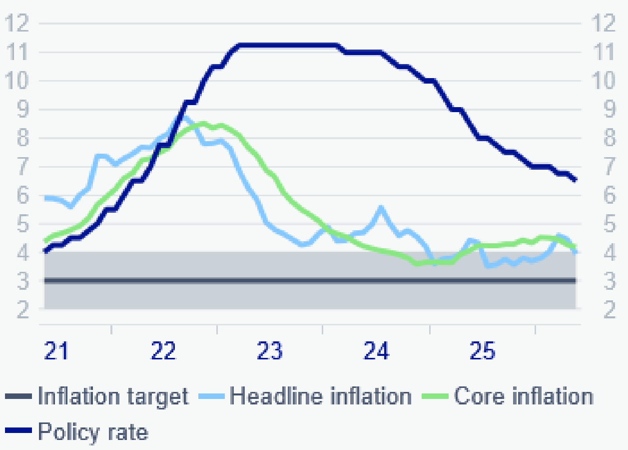
## FIGURE 2. MEXICO REAL GDP (Q/Q%)




Source: BBVA Research, INEGI

Headline and core inflation should continue to ease gradually over the coming quarters

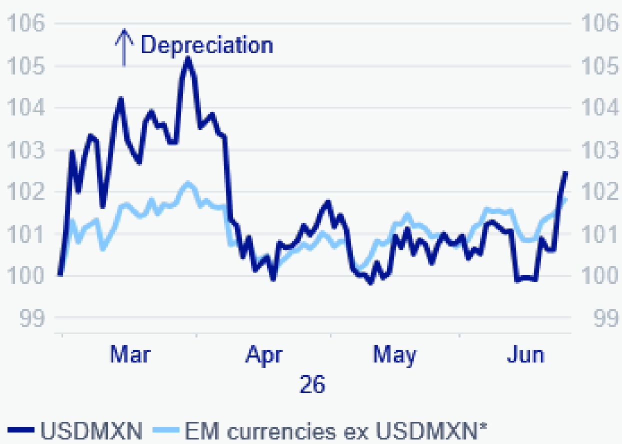
## FIGURE 3. INFLATION AND BANXICO POLICY RATE (%)




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

The Mexican peso continues to move broadly 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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