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A stronger 2Q26 is unlikely to shift Banxico's policy pause

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Easing core services inflation is encouraging, but Banxico likely needs further confirmation

Last week, the Fed left rates unchanged at 3.50-3.75%, while the 9-3 voting split underscored the Committee's increasingly hawkish internal debate. The policy statement remained virtually unchanged, leaving Chair Warsh's press conference as the main source of new policy signals. His introductory remarks were clearly hawkish, but his answers during the Q&A were considerably more ambiguous. He deliberately avoided providing explicit guidance on the timing of the next move, instead preserving policy optionality by emphasizing that the Committee will focus on "trends in the data" rather than individual data releases. He argued that removing forward guidance was intended to allow markets to transmit a more "unfiltered" signal about the outlook. In his view, the recent rise in long-term yields and the strengthening of the U.S. dollar are already contributing to tighter financial conditions (Figure 1). We continue to believe that the durability of the recent improvement in inflation will be the key determinant of the next policy move. At the same time, downside risks to activity remain elevated, including geopolitical tensions, a stable but fragile labor market, and uncertainty surrounding the sustainability of the AI-driven investment boom. Another pause in September remains, in our view, a plausible baseline scenario, although we continue to see the risks to our outlook as tilted to the upside (click here and here for additional details on last week's FOMC meeting).

Mexico's economy rebounded in 2Q26 after contracting in the first quarter, but weak underlying domestic demand casts doubt on a sustained recovery. Real GDP expanded 1.5% q/q following the 0.6% contraction in the first quarter (Figure 2), with industry and services growing 1.6% and 1.5% q/q, respectively. While the rebound appears to have been supported in part by the completion of infrastructure projects ahead of the FIFA World Cup, the implied June GDP growth contribution to the quarterly outturn suggests that the tournament's boost to activity was limited. We therefore continue to view the rebound as temporary, with underlying demand conditions likely to remain weak once these effects fade. Labor market conditions also continue to point to only a gradual recovery. Although formal employment growth accelerated to 2.0% y/y in June, much of the improvement reflected the incorporation of digital platform workers into the IMSS. Excluding those workers, effective employment growth was only 1.0% y/y (Figure 3), while cumulative job creation through June remained more than 40% below its historical average, suggesting that the prolonged weakness in underlying domestic demand still has ample room for improvement. Overall, stronger 2Q GDP data are unlikely to alter the Board's view that, while economic slack remains significant, it no longer justifies further easing with the policy rate at broadly neutral levels.

Recent inflation data support what most Board members signaled earlier this year—that a neutral stance is enough to bring disinflation across the finish line. Headline inflation rose just 0.05% in the first half of July, lowering the annual rate to 3.1%, helped by the continued moderation in non-core inflation. Meanwhile, core inflation remained unchanged at 3.9% y/y, as the monthly increase (0.16%) came in below market expectations. The most encouraging development was the moderation in core services inflation excluding housing and tuition—the measure most closely linked to the domestic economic cycle—which remained below 5.0% y/y for a second consecutive fortnight (Figure 4). This further confirms that weak domestic demand is gradually filtering into sticky inflation components. A negative output gap alongside weak labor conditions should limit demand-side pressures and keep core services disinflation on track. With the policy rate at the midpoint of neutral, the Board will likely resist preemptive hikes—even if the Fed tightens soon—given the divergent domestic demand cycles in Mexico and the US. Instead, Banxico will likely maintain its pause while assessing whether the recent moderation in services inflation proves durable.

Orderly financial market conditions continue to support Banxico's preference for remaining on hold. The Mexican peso has continued to trade broadly in line with other emerging market currencies despite renewed volatility surrounding the conflict in Iran, fluctuating within a narrow 17.3–17.6 range while FX volatility remained subdued. Although the 10-year M Bond yield increased following the Fed's hawkish shift in June and briefly reached 9.3% during the renewed escalation of the Middle East conflict, it has since retraced to around 9.1%. Importantly, the increase appears to have been driven primarily by higher U.S. Treasury yields rather than a deterioration in Mexico's risk premium. Sovereign CDS spreads have remained broadly stable, while the decline in FX risk premia has continued to exert downward pressure on long-term local yields. Banxico's June meeting minutes also reinforced the case for an extended pause, revealing broad agreement that the current policy stance remains appropriate given the absence of demand-side pressures, the strength of the peso, and the persistence of services inflation. Even Jonathan Heath's traditionally hawkish remarks focused on defending an extended pause rather than opening the discussion on rate hikes, arguing that a potential Fed hike would merely reduce the room for additional easing.

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. Recent data continue to validate the Board's assessment that the policy rate has reached a level consistent with inflation converging to target without additional policy easing. We think the likely temporary nature of the strong 2Q26 GDP rebound and the lingering labor market weakness will prevent the Board from adopting any hawkish tone. At the same time, the June meeting minutes suggested that the debate within the Board has shifted away from whether additional easing is warranted toward how long the current stance should be maintained. Even the more dovish members acknowledged that the current stance is "well-suited" and "sufficiently robust," while the more hawkish members argued that a potential Fed rate hike would reduce the room for additional easing rather than require Banxico to tighten. For now, we continue to expect the policy rate to remain at 6.50% at least through year-end.

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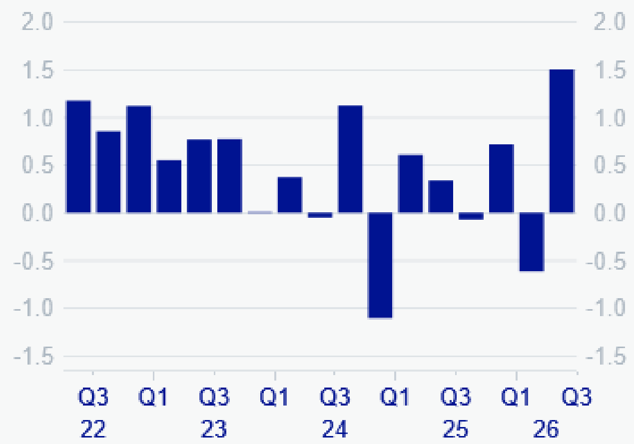
Warsh argued that the rise in long-term yields is contributing to tighter financial conditions

FIGURE 1. 10-YEAR TREASURY YIELD & DXY INDEX (% & INDEX POINTS)

Source: BBVA Research, ICE, Treasury Dept.

2Q26 real GDP expanded 1.5% q/q following the 0.6% contraction in the first quarter

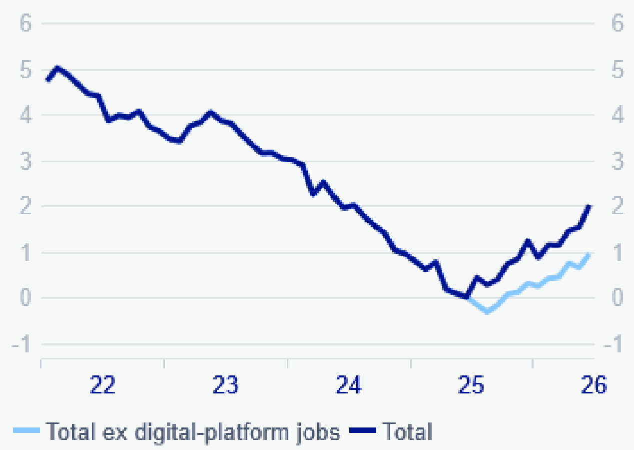
FIGURE 2. MEXICO REAL GDP (Q/Q%)



Source: BBVA Research, IMSS

Much of the recent improvement in formal jobs reflects the incorporation of digital platforms

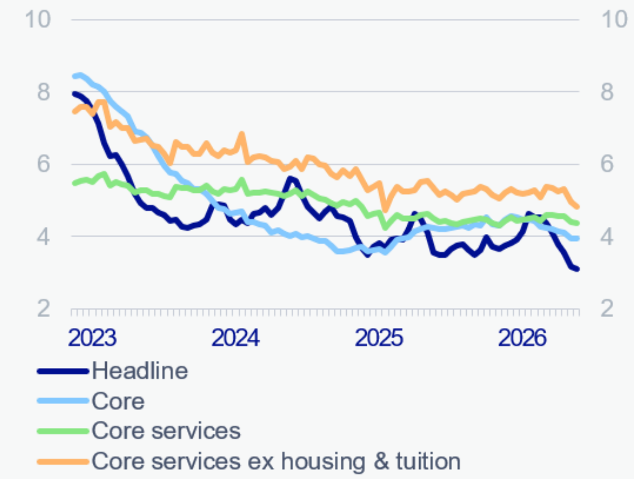
FIGURE 3. JOBS AFFILIATED WITH THE IMSS (Y/Y%)



Source: BBVA Research, IMSS

Core services ex housing and tuition remained below 5% for a second straight fortnight

FIGURE 4. INFLATION (Y/Y%)



Source: BBVA Research, INEGI

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