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Banxico set to extend the pause despite Fed hike

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Despite a 2Q demand rebound and the Fed hike, economic slack and gradually easing services inflation continue to favor a prolonged pause

Last week, the Fed unanimously raised the fed funds rate by 25 bps to 3.75-4.00%, underscoring its commitment to preserving policy credibility. The policy statement characterized the rate hike as a move to support a “timelier return” to the 2% goal. While the Committee provided no forward guidance on whether additional tightening will follow, the dot plot depicted a hawkish policy-rate path: 16 out of 18 FOMC participants project at least one more hike this year. Looking out to 2027, views split with eight participants favoring a third hike. However, the median projection keeps rates unchanged through 2027, followed by single 25bp rate cuts in both 2028 and 2029 (Table 1). Warsh’s Q&A focused on the rationale for hiking without establishing a clear path for rates ahead. As the labor market remains a limited concern, the Committee’s “predominant focus” is on price stability: “the plain fact is that inflation is too high and has been for too long.” While he avoided explicit forward guidance, Warsh’s remarks that a hike “starts to show we’re serious about this,” and his reiterated message that the Fed “will deliver on the price stability objective,” suggest the Committee remains willing to tighten further if inflation remains sticky. We expect only one additional 25bp increase, most likely in December. We then expect the Fed to remain on hold through 2027.

In Mexico, the 2Q26 rebound was partially supported by a recovery in gross fixed investment, but whether this signals a lasting recovery remains unclear. The second GDP estimate confirmed a solid 1.4% q/q expansion after the 0.3% contraction in 1Q, while the recently released demand breakdown showed private consumption rising 0.9% q/q and gross fixed investment jumping 4.3%. Consumption and investment both contributed positively to annual GDP growth in 2Q26, with investment adding 0.9 pp—its first positive contribution since 3Q24 after several quarters in which it partly offset the support from consumption (Figure 1). The investment recovery has been supported by the continued but still gradual improvement in construction while the machinery and equipment component is still in contraction. However, activity appeared to lose momentum toward the end of the quarter, with the IGAE declining 0.1% m/m in June. Labor market conditions also continue to point to a still-weak recovery: formal employment growth remained around 1.5% y/y in August and just 1.2% excluding digital platform workers, with labor income increasingly supported by real wage gains rather than stronger job creation. So far, there is still insufficient evidence that stronger domestic demand will persist long enough to significantly reduce economic slack, making the 2Q rebound unlikely

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to materially alter Banxico's policy assessment. At the margin, stronger activity data and the expected Fed hikes should make the Board less inclined to consider further policy easing.

There are initial signs that suggest sticky core services inflation is starting to break, albeit slowly. Core inflation declined from 4.03% y/y in June to 3.95% in July and 3.88% in August, supported by continued moderation in goods inflation and encouraging services inflation readings. Core services inflation eased from an average 4.5% in 1H26 to 4.36% in July and 4.33% in August (Figure 2), suggesting that weak domestic demand is gradually feeding into the stickiest component of inflation. While core goods inflation is now rising at a pace broadly consistent with steady-state levels, services inflation remains elevated, making further progress on core disinflation increasingly dependent on a sustained moderation in services. Headline inflation, meanwhile, rose to 3.3% y/y in August from 3.1% in July, but largely reflecting base effects that should push it even somewhat higher over the coming months. In any case, we continue to expect persistent economic slack to help keep inflation within Banxico's variability range over the coming quarters, and forecast headline and core inflation to end the year at 3.7% and 3.8%, respectively. Banxico will likely require several more favorable core services inflation readings before concluding that its persistence has decisively broken. That process will likely continue to unfold only gradually, reinforcing the case for keeping the policy rate unchanged rather than preemptively mirroring the Fed's renewed tightening cycle.

Orderly domestic financial market conditions continue to support Banxico's preference for remaining on hold, even after the Fed resumed tightening. The peso has depreciated around 3% since the August US CPI prompted markets to fully price in a Fed hike, but is still about 3% stronger year-to-date, outperforming the broader EM complex (Figure 3). At the same time, the 10-year M Bond yield has continued to move largely with U.S. Treasuries rather than reflecting higher domestic risk premia as reflected by the behavior of the CDS. Importantly, these orderly conditions have persisted even as the policy-rate differential with the Fed narrowed to 250 bps for the first time since Banxico adopted the interest rate as its policy instrument. This reinforces our view that Mexico's improved macroeconomic fundamentals over the past two decades allow the economy to sustain a narrower differential without generating significant pressure on the peso. Meanwhile, Banxico's August minutes reinforced broad support for an extended pause despite somewhat different views on inflation. Members differed in their emphasis on economic slack, core inflation persistence and upside risks, but broadly agreed that the current stance should remain in place until further progress on inflation is consolidated. Overall, the debate will likely remain centered on how long to hold at 6.50%, rather than on moving rates in either direction.

We expect Banxico to keep the policy rate unchanged at 6.50% this week and to reiterate that the current stance remains appropriate. We think Banxico will look through a preemptive Fed hiking cycle, as diverging domestic demand conditions should give the Board room to allow the policy-rate differential to narrow below historical lows. The orderly behavior of the peso even as the spread has fallen to 250 bps supports this view. Domestic conditions will therefore remain the main driver of Banxico's policy decisions: stronger 2Q activity has further weakened the case for additional easing, while persistent economic slack and gradually moderating core services inflation provide little reason to tighten. Beyond the near term, however, this outlook is conditional on the Fed delivering a limited preemptive tightening cycle. A substantially more aggressive Fed response to persistent inflation would likely tighten global financial conditions materially and could eventually require Banxico to reassess its stance. For now, the Board appears comfortable with the policy rate at its current, broadly neutral level, and we continue to expect it to remain at 6.50% through year-end.

As the labor market remains a limited concern, the Fed's "predominant focus" is on inflation

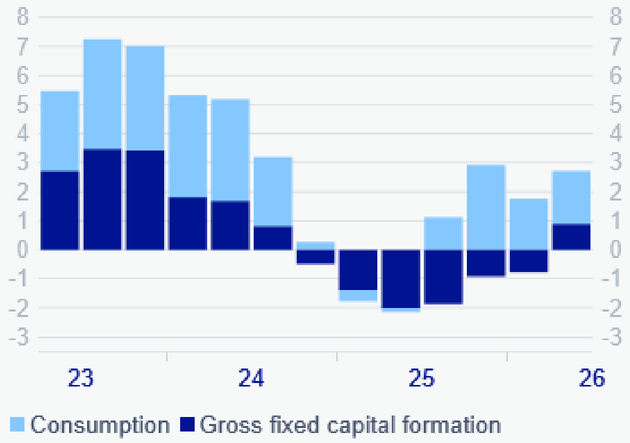
TABLE 1. FOMC ECONOMIC PROJECTIONS (SEPTEMBER 2026, %)

Variable	Median				
	2026	2027	2028	2029	LR
Change in real GDP	2.3	2.4	2.2	2.1	2.0
Jun-26	2.2	2.3	2.2		2.0
Unemployment rate	4.1	4.1	4.1	4.1	4.2
Jun-26	4.3	4.3	4.2		4.2
PCE inflation	3.7	2.3	2.1	2.0	2.0
Jun-26	3.6	2.3	2.0		2.0
Core PCE inflation	3.4	2.5	2.2	2.0	
Jun-26	3.3	2.5	2.1		
Federal funds rate	4.1	4.1	3.9	3.6	3.2
Jun-26	3.8	3.6	3.4		3.1

Source: BBVA Research, Fed

Consumption and investment both contributed positively to annual GDP growth in 2Q26

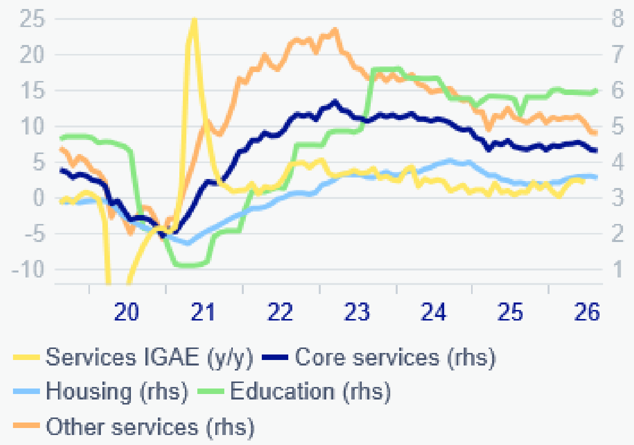
FIGURE 1. CONTRIBUTION TO Y/Y GDP GROWTH (PP)



Source: BBVA Research, Macrobond

Core services inflation eased from a 4.5% avg. in 1H26 to 4.36% in July and 4.33% in August

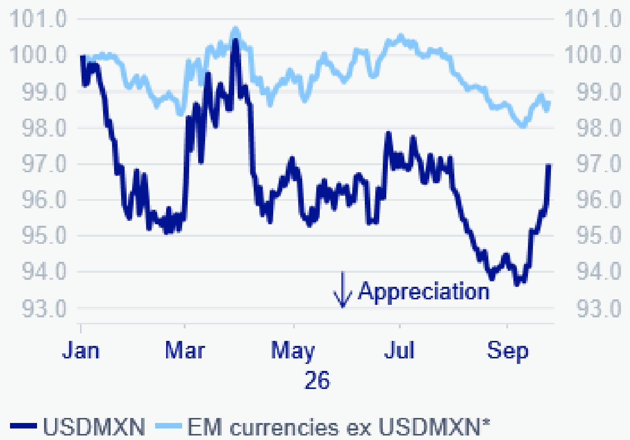
FIGURE 2. SERVICES IGAE AND CORE SERVICES INFLATION (%)



Source: BBVA Research, INEGI

The peso has depreciated 2% since the Aug US CPI release, but is still about 4% stronger YTD

FIGURE 3. USDMXN RELATIVE PERFORMANCE (01-JAN-25=100)



* Reweighted version of the Fed's Emerging Market Economies (EME) Dollar Index

Source: BBVA Research, Fed, Macrobond

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