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Banxico to extend pause as recovery takes shape

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3Q GDP and core inflation data for the first half of October challenged September's dovish minutes, and weakened the case for further easing

Last week, the Fed voted in a split decision (10-2) to keep the fed funds target range unchanged at 3.75-4.00%, buying time to assess the policy path. The statement upgraded its assessment of economic activity from expanding at a "solid pace" to a "strong pace," while reiterating that "domestic spending has been resilient." While the Fed reiterated that "inflation remains elevated," it also argued that "the accumulation of more information" before the next meeting in December "will help [...] determine the policy stance appropriate to ensure a timely return" of inflation to 2%. Warsh struck a less hawkish tone at his press conference than the upbeat assessment of the economy initially suggested: supply-side inflation risks, and not demand-side pressures, remain his main concern. He appears primarily focused on preventing second-round effects and avoiding any de-anchoring of inflation expectations. Looking ahead, the key question is whether the Fed will move to the sidelines after another rate hike this year (Figure 1). Much will depend on how the Middle East conflict evolves after next week's midterms and whether evidence mounts that the AI investment boom is generating broader demand-driven inflation pressures. We still expect a 25bp hike in December. Incoming data and updated SEP projections should help clarify whether the Fed intends to extend tightening into 2027 or whether our baseline of unchanged rates throughout next year remains appropriate by then.

In Mexico, recent data suggest activity is entering a recovery phase, but persistent output slack and a still-soft labor market point to limited demand-driven inflationary pressures. INEGI's preliminary estimate showed that real GDP expanded 0.9% q/q in 3Q26 (3.2% y/y), following the stronger 1.4% rebound in 2Q (2.1% y/y), with industry and services growing 0.8% and 1.1%, respectively (Figure 2). The recovery is gaining traction in manufacturing and wholesale trade, likely supported by strong US demand linked to AI-related supply chains. Domestic investment is also recovering, led by construction, while machinery and equipment is showing signs of improvement. Taken together, these developments suggest that the recovery is becoming more firmly established, although its strength remains uneven, particularly in the labor market. While cumulative formal job creation through September (excluding digital platform workers) nearly doubled from a year earlier, annual employment growth remained modest at 1.2%, with little evidence of sustained acceleration in monthly hiring that would signal renewed demand-side pressures on core services inflation. Overall, mounting

evidence of an economic recovery, coupled with the Fed's lingering tightening bias, should make the Board less inclined to consider further easing in the near term, despite the dovish tone of the September minutes (see below). Yet, with economic slack expected to persist and the labor market recovering only gradually, activity data provide little justification for a preemptive rate hike either, reinforcing our expectation that Banxico will remain on hold for some time.

Recent inflation data suggest that the gradual moderation in core services inflation remains vulnerable to setbacks, reinforcing the case for Banxico to remain on hold. Core inflation eased to 3.75% y/y in September from 3.88% in August, supported by further moderation in goods and services inflation. The latter declined for a fourth consecutive month, reaching 4.27% from 4.33% in August (Figure 3). However, the first-half October reading interrupted this encouraging trend, with core inflation rising to 3.8% y/y amid a broad-based upside surprise in both goods and services. Headline inflation also edged higher to 3.6%, largely reflecting seasonal electricity price increases and unfavorable base effects, but remains on track to complete six consecutive months within Banxico's variability range. While the threshold for discussing a rate hike in the coming months remains high, the sluggish deceleration in core services makes an extended pause far more plausible than further easing. On the other hand, persistent upside inflation readings would likely be required to convince a majority of the Board that renewed policy tightening is necessary to ensure disinflation. In our view, despite the recovery in economic activity, persistent slack and the continued softness of the labor market should continue to contain demand-side inflationary pressures, with headline and core inflation ending the year at 3.7% and 3.8%, respectively. At the margin, the latest inflation data should temper the most dovish Board members. For now, a majority will still likely prefer to gather more evidence that core services inflation is sustainably losing persistence before reconsidering its policy stance.

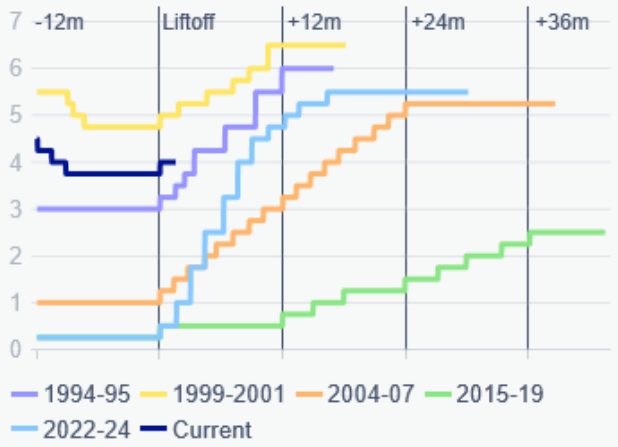
Domestic financial conditions remain orderly despite the peso's depreciation amid expectations of further Fed rate hikes and a narrower policy-rate differential. The peso has weakened by around 6.3% since Banxico's September meeting, underperforming other emerging market currencies amid heightened global uncertainty (Figure 4). Still, FX volatility remains broadly in line with its 10-year average and exchange-rate pass-through to inflation is likely close to zero, while stable sovereign CDS spreads suggest little deterioration in Mexico-specific risk. The 10-year M Bond yield also continues to track US Treasuries closely, pointing to global rather than domestic drivers of elevated yields. Meanwhile, Banxico's September minutes revealed a more dovish Board than anticipated, with three of five members opening the door to potential rate cuts despite the Fed's recent hike and peso depreciation. One suggested that a "one-off reduction" could be considered, while two others also saw scope for easing if conditions allowed. However, these views remained conditional on further disinflation and orderly financial conditions. While the latter condition continues to hold, core services inflation is set to move sideways in October, making the former somewhat less clear. Jonathan Heath, by contrast, favored an extended pause and warned that further Fed tightening could eventually warrant reconsidering the policy stance if inflation failed to converge toward target.

We expect Banxico to keep the policy rate unchanged at 6.50% this week while preserving optionality without signaling the timing or direction of its next move. The

continued recovery in 3Q26 has weakened the case for further easing, while persistent economic slack provides little reason to tighten. The recent small setback in core services disinflation should also temper the willingness of the three members who raised the possibility of rate cuts in September to revisit easing. Besides, we continue to think Banxico will look through a limited, preemptive Fed hiking cycle, given the divergence in domestic economic conditions. Despite the recovery, Mexico's economy remains considerably weaker than the US economy, with inflation much closer to target. The peso's orderly adjustment amid expectations of further rate differential compression supports this view. Beyond the near term, however, a risk is that a substantially more aggressive Fed tightening cycle could materially worsen global financial conditions and force Banxico to reassess its stance. Yet, the recent correction in shares of AI-related companies—the main driver of US economic growth—also suggests that further Fed tightening is not necessarily a one-way bet. For now, we continue to expect the policy rate to remain at 6.50% through end-2027.

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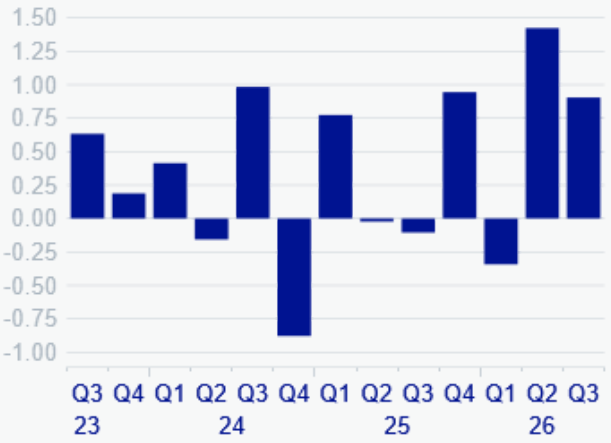
FIGURE 1. FED FUNDS RATE IN TIGHTENING CYCLES (%)



Target rate for the 1994-95, 1999-2001, and 2004-07 cycles; upper limit of the target rate range for the 2015-19 and 2022-24 cycles. Source: BBVA Research, Macrobond.

INEGI's preliminary estimate showed that real GDP expanded 0.9% q/q in 3Q26 (3.2% y/y)

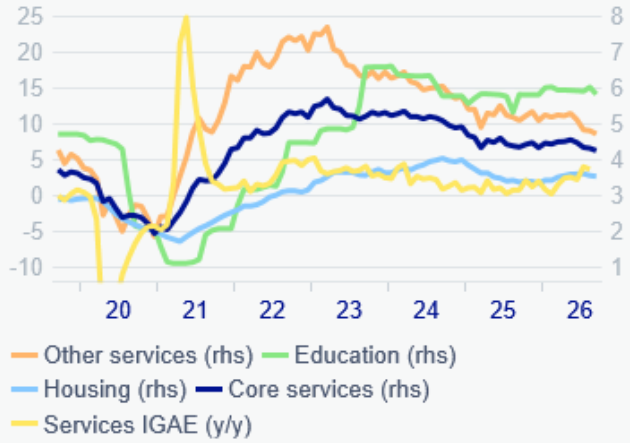
FIGURE 2. MEXICO REAL GDP (Q/Q%)



Source: BBVA Research, Macrobond.

The latest inflation data should temper the most dovish Board members

FIGURE 3. SERVICES IGAE AND CORE SERVICES INFLATION (%)



Source: BBVA Research, INEGI.

The peso has weakened by around 6.3% since Banxico's September meeting

FIGURE 4. USD/MXN RELATIVE PERFORMANCE (28-FEB-26=100)



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

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