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Banxico Watch

Mexico

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Banxico seems to be targeting a cut but the uncertainty remains: how to play it?

Bottom line: Banxico's monetary policy minutes were much in line with its latest communiqué. Although we keep our call of a monetary pause, we acknowledge a higher probability of a cut. The scenarios would be a long, persistent downtrend in inflation, a strong and stable MXN and/or further economic slowdown. As a result, and given current monetary conditions, we expect markets to start pricing in a cut of 50bp, and thus we are keeping open our strategies: receiving the short and long ends of the curve. In the short term, Banxico would limit the appreciation scope for MXN, but the forces for a stronger currency in 2H13 remain.

Members seem to be prone to cut rates, but.....

The minutes from the January 18 monetary decision released today confirm that, as in previous occasions, most members of the Board seem prone to cut rates if the downward trend in inflation is confirmed. Using similar arguments reflected in the March 2012 minutes, most members pointed that convergence can be achieved at a lower economic cost. However, one member considered that it is too soon to send a rate cut signal given the lack of information regarding the capacity of the economy to keep inflation from trending downwards. This opinion was based on the fact that the slump in the last months depended crucially on a reduction of telecommunication tariffs that could prove transitory.

For the moment, we maintain our call of a monetary pause in the coming months based on the following elements: i) the diverse views inside the Board regarding the level and the time inflation should stay around the target to confirm the convergence, ii) our view that inflation will not be on the target in the short term, and iii) the persistence of mid-term inflation expectations around 3.5%. If inflation stays around the target for several months, however, a 50bp cut could materialize in our view. We believe this is so given the position of some Board members, who consider that the rate cut should be a one-time reduction to reflect the gains in inflation achievements and the fact that real rates have not been negative for a prolonged period in the last decade. Additionally, if MXN remains strong and/or the economic pace keeps decelerating, there would be room for a cut within the current inflation context.

So, how to play it?

On January 8 we recommended receiving the front-end of the TIIE curve in view of the positive inflation dynamics in force, a strong and stable MXN, and the slowdown in Mexico's growth pace. Additionally, we are following Banxico's stance with our Monetary Conditions Index, which suggested that monetary conditions were less lax and, therefore, a change in the Board to a more dovish stance was to be expected.

The abovementioned is the past, so what now?
We are standing pat on our current recommendation (see our January 18 note) that involves receiving 1yr TIIE (although the 2yr sector also offers value), but we have moved our stop loss to the 4.90 entry level and lowered our target to 4.50 from the original 4.70. We are also maintaining our butterfly recommendation in MBonos: long the 3yr and 30yr vs. the 10yr, in place since July 2012.We are now sure that Banxico will not hike the fondeo rate in the long run, but the possibility of a cut should continue favoring the short end of the curve while the long-end will probably remain bid ahead.

The rationale for our strategies:

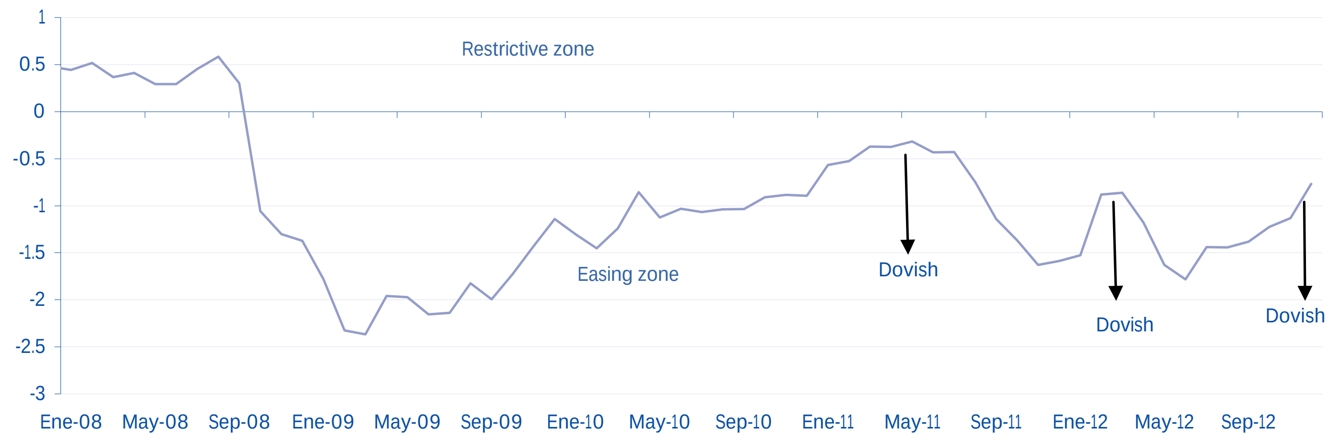
Banxico is now dovish as inflation risks have eased and MXN remains stable. We expect inflation to near 3.3%. Risks from core inflation are negligible. According to our analysis, prospects of Banxico cutting the fondeo rate would increase significantly if MXN keeps fluctuating around USDMXN12.5 and the inflation drops below 3.5%. An additional element to consider is economic risks, which are pointing to the downside. Recent US and Mexican leading indicators suggest modest growth, with trending variables moving to an uncomfortable zone. In other words, if economic risks heighten and inflation remains at low levels, Banxico will cut rates regardless of the MXN level. Thus, we believe that all odds are signalling to play Banxico cut scenario of around 50bp. Since we are already half way at the short end, we insist that the long end should continue outperforming.

Is the MXN a key driver or an upshot?

As we mentioned above, an appreciation trend in MXN together with declining inflation would certainly increase the likelihood of a rate cut. This same possibility, however, could limit the short-term downward potential of USDMXN. MXN reacted negatively to the radical change in Banxico's stance during its last monetary policy meeting. In our view, however, this reaction responded also to some adjustment following its previous rally, and the statement was merely an excuse to take profits as markets were not pricing in even a 25bp cut. Again we note that, since the decision, both markets and the analyst consensus have moved towards a more dovish bias as inflation and economic activity readings have continued surprising on the downside. Thus, the probability has increased now, and carry will not be so appealing if markets move to a 50bp cut.

The factors that grounded expectations of a short-lived depreciation after the latest statement still prevail: the fiscal cliff is still being discussed, the debt ceiling will probably be raised in 3 months and the long MXN positioning remains around historical highs. Lower carry, together with these global and technical factors, would limit MXN gains to around the recent technical support of 12.50. Still, inflation is scheduled to bottom in the summer and the fiscal cliff discussion should be over by then (or most likely being postponed to year-end). The noise resulting from the fiscal reform should increase by 2H13 and underpin currently strong foreign inflows to Mexico, which in turn would take MXN below its current support level in our view. With a structural fiscal reform approved this autumn, the margin for an appreciation would be higher (our current year-end estimate stands at 12.25).

Figure 1
Monetary Condition Index and Banxico dovish statements



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