

Mexico Flash

Banxico: Back to Basics

In line with our call, Banco de México kept the fondeo rate unchanged at 4.5% and the local curve bear flattened significantly. In a highly anticipated monetary policy decision, given that the latest minutes strongly raised expectations for a rate cut, Banxico's announcement keeps the door open for easing monetary conditions should the outlook for financial markets improve. We believe that a fondeo rate cut is not justified yet. The economic balance of risks has to lean more strongly and decisively for the central bank to shift its balance towards monetary accommodation. Since we do not foresee financial and economic conditions that could trigger a strong appreciation of the MXN in the coming two months, we are keeping our call for a fondeo rate at 4.5% in the next meeting. However, the risks on the global economy, suggest a downward bias due to spillover effects coming from a potential deepening of the Eurozone funding crisis. In addition, domestic inflation could consolidate around the 3.0% target and, therefore, a rate cut in 2H12 should not be dismissed in this case. We stick to flatteners.

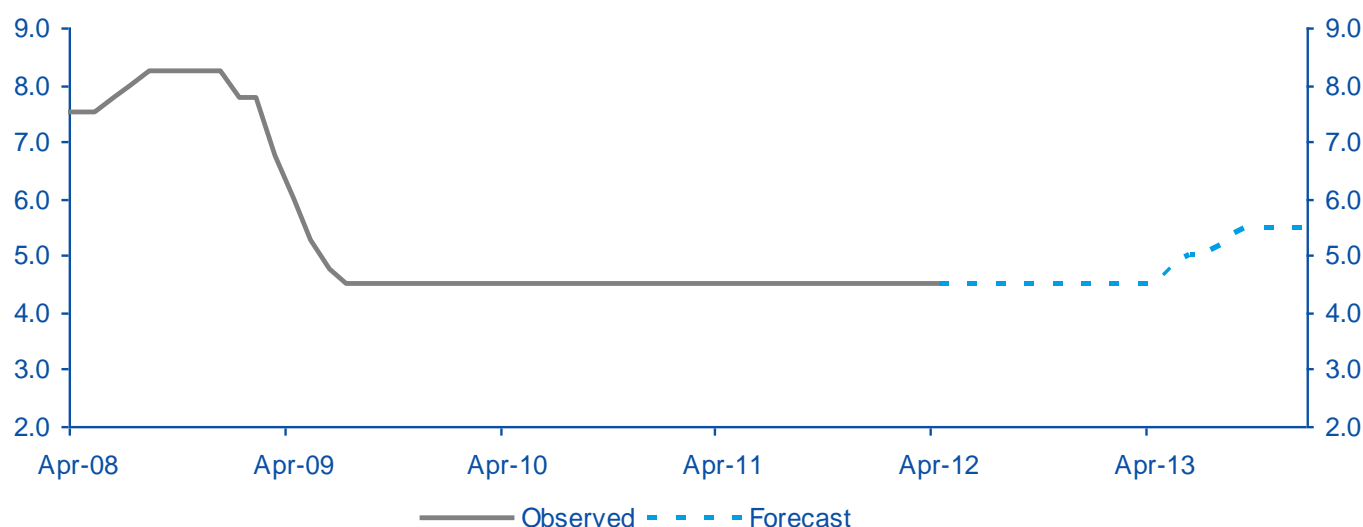
Banxico Maintains its Last Meeting Stance...

...however, it stressed the behavior of international financial markets is a relevant factor to consider a rate cut. In our opinion, Banxico is giving itself some margin to maneuver in the face of a potential deterioration of global economic activity.

The Monetary Policy Rate Will Remain Unchanged

In line with our economic scenario, we believe that the monetary policy rate will remain on hold, with a hike in mid-2013, based on the following factors. First, according to Banxico, the outlook on the US economy has improved slightly, while in Mexico, activity remains resilient. Second, the inflation balance of risks has not changed and BBVA Research expects local inflation to reach 3.6% in 2012 on average. However, there are two reasons to think that a rate cut should not be dismissed. On one hand, the risks on the global economy are tilted downwards by spillover effects coming from a potential deepening of the Euro zone funding crisis. On the other hand, a scenario where domestic inflation consolidates around the 3% target should not be discarded.

Figure 1
Mexico Fondeo Rate (%)



Some Members Want to Cut, but No Consensus Has Been Achieved

Although the balance of risks continues justifying a prolonged monetary policy pause, it is clear from the latest minutes that some members are prone to lower interest rates. Therefore, we do not rule out that the minutes that will be released on May 11, will reflect again a fierce debate among members. The room for a cut had already been open but the dovish side apparently gave the benefit of the doubt to those against a cut. In the coming meeting, hawkish members could have a case for keeping the current rate level if international markets remain volatile or the economic outlook continues improving.

Could the MXN rally be sustainable?

Since Banxico showed a more dovish bias in its March 30 minutes, MXN's sensitivity to monetary policy expectations has increased. Indeed, market expectations of Fondeo cut were one of many risk factors behind MXN's depreciation since early April, which was partially reversed following Banxico's rate freeze confirmation. We had already anticipated a MXN rally if the Central Bank did not send any clear signals of more imminent cuts. Still, we have been mentioning that MXN's main driver is rather external, as carry typically depends on risk appetite levels in global markets. Accordingly, we do not expect Friday's price action to set a stronger trend, or at least not based on monetary policy expectations. A sustained strengthening of MXN would likely need further global support. Considering this week's downward surprises in economic indicators, fresh political tensions in the EMU, Spain's downgrade by S&P and the risk for coming downgrades to other countries, it seems that risk aversion is far from diminishing in the short-term. Last but not least, general elections are approaching in the domestic front. Therefore, we see little chances of a strong breach of USDMXN 12.85 but rather ongoing trading within the 12.85-13.30 range in the short-term.

Do not chase Banxico and stick to the flatteners

As we have been arguing, beyond immediate decisions, Banxico is clearly sitting on the dovish side and the current balance of risks supports this monetary policy stance for a longer period. It is a different story whether the current balance of risks warrants a more accommodative policy stance. The debate is not over, but for now, the more dovish stance should continue supporting the long end of the local curves. One thing we know for sure: no hikes will materialize in the medium-term and the current inflation scenario is adding room to increase duration. We believe that this context should continue translating into much more attractive valuations for the longer end of the curve, particularly against the belly, where current valuations imply a rate cut of 25bp. Based on the above, we are keeping our flattener M2038/M2018 (Dec), with target at 165bp and stop loss at 210bp. The upside correction in the short-end immediately after the monetary policy decision will open opportunities to take long positions again, as we expect Banxico to remain on the dovish side. But we will continue to wait for more attractive levels. This correction is justifying the risk/reward strategy that we followed by taking profits from this segment.

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