Central Banks

Banxico is likely to hike its policy rate on Sep 29; in our view the FX Commission should intervene to lower the incentives of shorting the MXN

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- **In our opinion, risks merit a rate hike by Banxico on Sep 29**
- **The FX Commission should consider lowering the incentives of shorting the MXN**

We expect Banxico to widen the interest rate spread by 50 bp on September 29

Before discussing our monetary policy call, we think that is important to note that the current level of the policy rate is below the estimated neutral level and would remain so even if, as we expect, Banxico leans towards hiking 50 bp on its September 29 meeting. Besides, monetary conditions are close to historical lows and thus, decisively loose. It is important to note this to get a feel of current monetary policy conditions and to question whether the challenging backdrop and risks justify them. That said, we are aware that economic activity does not call for a hike. On inflation, although we believe pass-through remains largely contained, the latest reading (ie, of the first fortnight of September) along with the recent additional weakening of the MXN point to heightened risks; a rate movement will help to anchor expectations and thus, will continue to hinder the risk of second-round effects. In sum, the growth outlook remains relatively unchanged whereas the inflation outlook has deteriorated somewhat from the previous meeting, mainly driven by higher risks associated with the further weakening of the MXN.

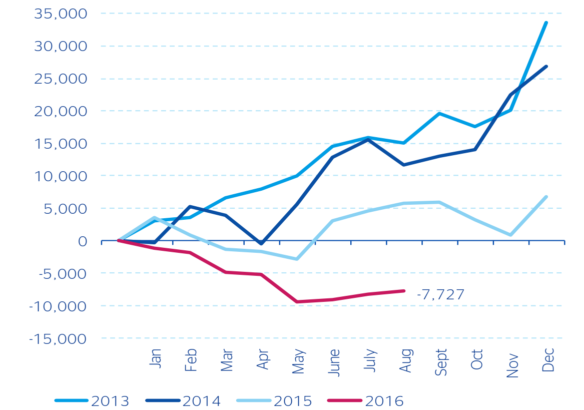
Moreover, even recognizing that the effects of tighter monetary policy on the exchange rate (ER) might be small, we think that Banxico should hike to mitigate the risk of sudden portfolio outflows. As we explained in a previous document (see “Our take on the MXN”, September 19, 2016), Banxico is facing a challenging backdrop which explains our call. In our view, heightened risks arising from peso’s sharp underperfomance should force Banxico to widen the interest rate spread by 50 bp. As in February and June, Banxico will aim to constraint further MXN’s negative differentiation in face of increasing risks as we approach the US election. The main factor behind the recent additional spike in pressures on the MXN seen over the past few weeks seems to be related to the US elections, and Banxico will not meet again before US Election Day[1].

Our view is that although higher policy rates are unlikely to attract flows from foreigners, Banxico should aim at limiting risks of significant outflows from the bond market. In our opinion, the risk of sudden portfolio outflows that can bring disorderly adjustments in the balance of payments outweighs all other considerations (see Chart 1). Besides, the risk-adjusted carry trade remains relatively low in both absolute and relative terms and has recently decreased more relative to other EM currencies (see Chart 2).

[1] Its following meeting will take place on November 17.

Foreign holdings of local currency debt have declined in 2016

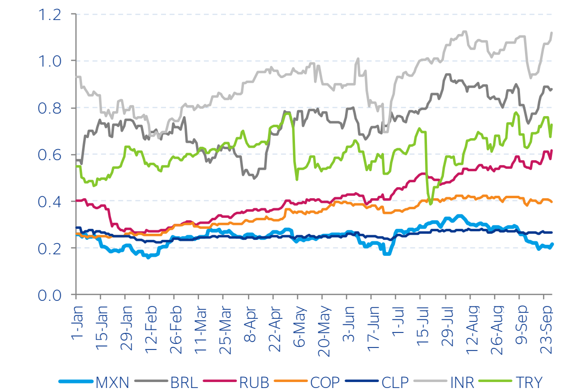
Chart 1
Net change in foreign holdings of local currency debt (CETES (treasury certificates) + M-Bonds, cumulative figures for each year, USD)



Source: BBVA Research / Banxico

The risk-adjusted carry trade remains low in both absolute and relative terms

Chart 2
Risk-adjusted short-term rates carry trade (Adjusted for ER volatility)



Source: BBVA Research / Bloomberg

The FX Commission should consider lowering the incentives of shorting the MXN

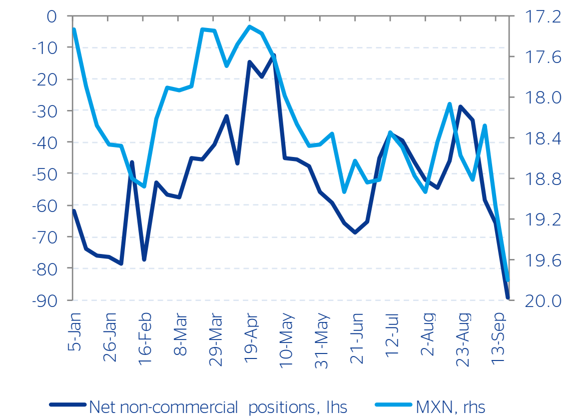
Although Banxico's favourite policy tool to address risks during 2016 has been the policy rate, which we think will help to restrain risks going forward, our view is that another action might also be appropriate and timely during this period of increased risks, especially from now until election day in the US. As Chart 3 shows, the CME Mexican peso net non-commercial (i.e. speculative) positions against the MXN are the largest of the year and indeed the largest of the last 10 years. We think that even if a higher rate would help by making more expensive shorting the MXN, an action by the FX Commission might also be desirable to lower the incentives of shorting the MXN as speculative positions against the MXN seem to have been a drag (see Chart 3).

Although the FX Commission is unlikely to target any USDMXN level, it may well consider acting to reduce incentives to maintain speculative positions against the MXN. Up to now, shorting the MXN has been a one-way bet during this year and by using the discretionary mechanism, the FX Commission could lower the incentives of holding these positions. Such an action could also enhance the desired effects of the increase in the policy rate, particularly taking into account that the mechanism has not been used since February (and thus, might surprise markets). More to the point, even considering the poor showing of Donald Trump in the first presidential debate (as polls show), the race is likely to remain close until Election Day and it might prove difficult for Hillary Clinton to regain a significant lead as we approach November 8. The uncertainty regarding the outcome of the election is likely to continue taking a toll on the MXN (see Chart 4).

Lastly, even though it will not be the aim of the FX Commission, the dollar sales would generate profits for Banxico that eventually (in 2017) could contribute to reduce public debt a critical policy challenge next year.

Markets have continued to increase their short positions on the MXN...

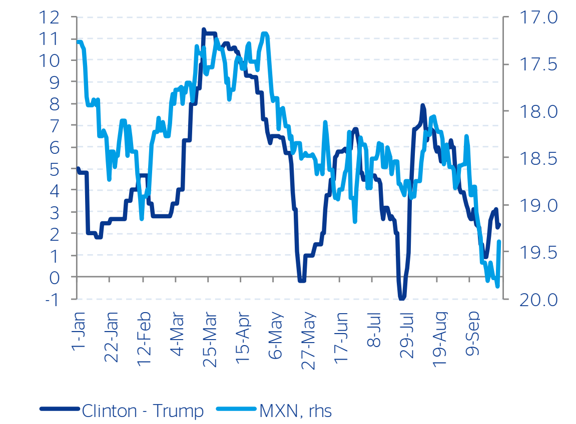
Chart 3
MXN & CME Mexican peso net non-commercial positions (2016, pesos per dollar, inverted scale & no. of contracts, thousands)



Source: BBVA Research / Bloomberg

… investors' sentiment towards the peso is likely to remain negative as the race between Clinton and Trump has tightened

Chart 4
2016: US Election Survey Results & MXN (Clinton minus Trump preferences*)



Source: BBVA Research / Real Clear Politics and Bloomberg
* A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead