CENTRAL BANKS

Banxico is set to hike rates…

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Banxico needs to anchor inflation expectations and avoid renewed pressures on the MXN.

… in tandem with the Fed or more than the Fed?

Banxico's board will meet tomorrow to discuss interest rates for the second time since the US election outcome and following Fed's meeting on Wednesday which brought the first interest rate hike in a year. While a quarter-point rate hike on Thursday to 5.5% is practically a foregone conclusion –with the Fed expected to hike 25bps and Banxico likely to at least match Fed's anticipated move–, a 50bps rate hike is also a probable outcome.

Although Fed's hike was fully priced-in, as well as the slow and gradual end of low rates, it still implies a challenging backdrop for portfolio inflows into emerging markets. Banxico has raised its monetary policy rate by 150 pb this year to a level close to neutral (in a recent report Banxico considers the level of the neutral rate to be 5.5%). We think that the moves were mainly aimed at containing MXN and outflows related risks. The objective was twofold. On the one hand, Banxico wanted to limit a possible substantial outflow of portfolio flows, mainly from the bond market, in an adverse context for risky assets. On the other hand, MXN's liquidity is high and it has been used to hedge any kind of risks in global markets. Thus, increasing MXN's carry-trade was needed to preemptively contain risks.

Thursday's meeting is different on two accounts: i) The Fed will most likely increase rates by 25 bp and Banxico will not allow a reduction of the rate differential with the US; and ii) the balance of risks to inflation has worsened significantly ever since the US election outcome further weakened the peso. Inflation is an upward trend. We expect headline inflation to reach levels close to 4.5% by mid-year and to average levels slightly above 4.0% (the upper-limit of the target-range) during 2017. The most recent inflation reading (November) which surprised to the downside on account of lower-than-expect core goods prices is unlikely to bring any comfort to inflation worries. The good reading was likely influenced by steeper-than-anticipated discounts on the second fortnight of November that will only delay a faster pace of pass-through at the turn of the year as we think that there is no more room to absorb the increase in costs even if demand is prone to slow down. In short, there are more pass-though related pressures in the pipeline. Besides, services inflation has risen recently (also on the back of the direct effects of pass-through with tourism and airfares increasing more than expected) which will limit its offsetting effect on overall inflation going forward. More importantly, both market-based and analysts mid and long-term inflation expectations have risen markedly since Banxico last held a monetary policy meeting. Definitely, the balance of risks to inflation has worsened.

Does such a context justify only a neutral rate? Or a hike that takes the policy rate beyond its neutral level is more appropriate? Although we have seen a total hiking of 225 bp so far this cycle, in the last statement Banxico dropped previous wording which was aimed at signaling that previous moves were not part of a cycle (ie, that the rate hike was “not meant to start a cycle”). By doing so it signaled that they were ready to start a hiking cycle to limit risks going forward. We think that Banxico should hike 50 bp to contain inflation risks and take a preemptive approach. However, we think they might lean to rising only 25bp to “save some bullets” if as we think the hiking cycle still has legs and taking into account the current context of a relatively more stable exchange rate.

Under any of the two likely outcomes, the wording will be key. We think that the statement will continue to leave the door open for further tightening and that although they will signal that the balance of risks for both growth and inflation has showed additional deterioration, the wording will give more importance to the latter.

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