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Another 25bp rate hike to end the tightening cycle

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The next monetary policy meeting will be held on Thursday June 22nd. We expect another 25bp rate hike to take the fondeo rate to 7.0%. Unlike recent monetary policy decisions, there is a consensus among analysts and the market that in order to anchor inflation expectations and minimize the possibilities of second round effects, Banxico needs to tighten further its policy stance. The latter as inflation reached 6.2% in May and as central bank communication turned more hawkish recently. Will Thursday's rate hike be the end of the tightening cycle? We do think so based on the following:

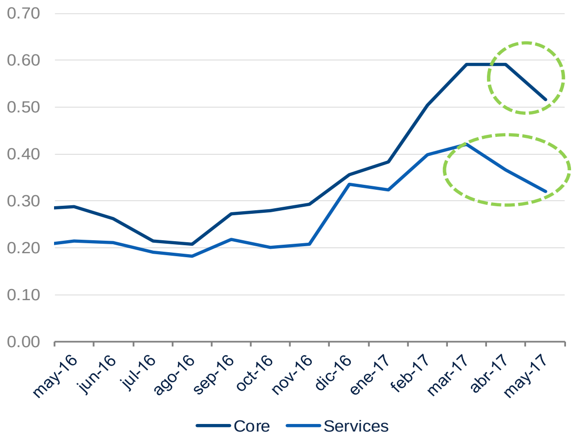
i) Core inflation shows signs of stabilization. After growing above 0.4% MoM during five consecutive months, in May core inflation came at 0.28%MoM, the lowest increase since last November and a figure more in line with the median growth since 2007 (0.29%). In addition, services inflation dropped from 0.32% in April to 0.10% in May, the lowest rate since last October. This is worth noting given that a continuous rise of services´ inflation can be thought of as a symptom of second-round effects. These two facts indicate that inflation is about to reach its peak.

ii) We expect inflation to trend downwards since August and more clearly during the fourth quarter and thereafter giving Banxico more room to hold rates. Once inflation starts decreasing, the risks of higher inflation expectations will diminish. Besides, it is expected that the exchange rate will not reach the levels seen during the last quarter of 2016 and therefore the pass-through would wane, leading to lower risks of second-round effects. If history is any guide, back in 2008 Banxico stopped raising rates once inflation peaked at 6.53%;

iii) Communication. Even when communication turned more hawkish, the most recent minutes showed that a group of Board members think that current stance is not far from that necessary to bring inflation back to its target and that recent monetary policy decisions have given Banxico more degrees of freedom to evaluate and face FED's normalization.

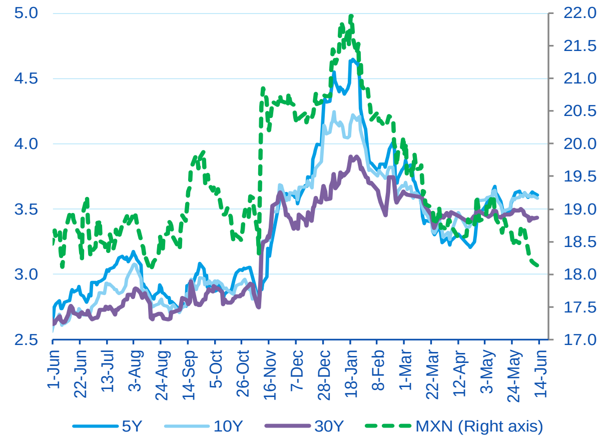
Going forward, we consider that in the most probable scenario the reference rate will be on-hold during most of 2018, particularly considering that inflation will enter the +/-1% interval around the inflation target during 2H18. However, if inflation shows more persistence than currently expected or exchange rate experiments another episode of sudden and sharp depreciation, the tightening cycle could continue during the 2H17 with another 25bp rate hike.

Figure 1. Core and services inflation
% MoM MA(4)



Source: BBVA Research based on Bloomberg data

Figure 2. Inflation breakevens* and exchange rate
(%)



Source: BBVA Research based on Bloomberg data. *Inflation breakevens are adjusted by 40bp of inflationary risk

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