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A "hawkish hold" with risks ahead in an unusual context is the best strategy for now

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Monetary Policy should not react to temporary supply shocks

- **In a close call (70-30 odds) we expect Banxico to hold rates steady at next week's policy meeting. A hawkish pause is enough for the time being**
- **By keeping the policy rate unchanged at 7.0%, the MPC might lean to save some bullets as risks ahead are likely to continue to build up in a context of a limited room for a more restrictive stance**
- **We expect significant wording changes that could open the door for a pre-emptive hike at the next meeting (8 Feb 2018)**
- **If Fed and/or NAFTA-related risks are increasingly priced in, the window for a less restrictive stance in 2018 could decrease and may possibly even tip the balance towards one or two 25bp pre-emptive hikes in 2018**
- **Yet, it is still too soon to tell if such (probable) risk tightening would prompt Banxico to hike amid slowing inflation and growth at the beginning of the year**

Still contained inflation risks tip the balance towards a "hawkish hold"

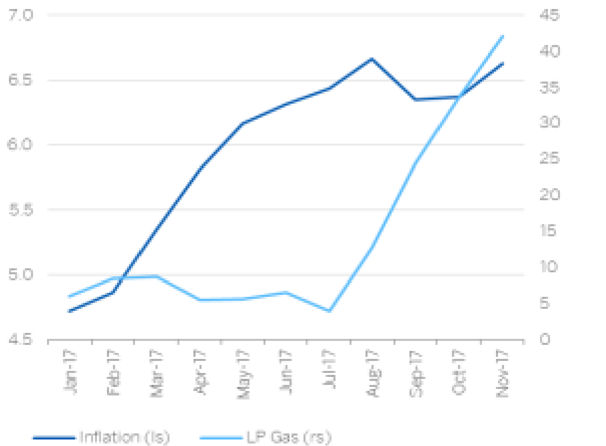
We expect Banxico to keep its monetary policy rate on hold at next week's MPC meeting, which will be Alejandro Díaz de León's first as governor. We think his was an excellent appointment since he is a very good economist with financial sector expertise that knows the Central Bank very well. While he has definitely seemed hawkish in interviews since he was appointed as governor and headline inflation has increased over the last two months, strengthening the case for a pre-emptive 25bp hike in the policy rate, we think that a hawkish hold would be the best strategy for now.

Although the balance of risks to inflation has deteriorated over the last two months, the uptick in inflation, which created a speed bump in its downward trend following September's turning point, has been mainly driven by a new supply shock, now in energy prices, particularly LP gas prices (figure 1). In fact, increases in gas prices explain 0.41 percentage points of the increase in headline inflation since September. If gas prices had not increased in the last four months, annual headline inflation would stand at 6.2% instead of 6.6%. That is, headline inflation stickiness (figure 2) is explained by this supply shock, which has been mainly driven by the hurricane season –Harvey in particular– which caused a spike in international reference prices in a recently liberalized sector. However, additional pressures from this source should not

be expected as LP gas prices have recently stabilized (figure 3). It is true that inflation has remained sticky, but its trend continues to point to a slowdown in the coming months (figure 2). Moreover, a possible reversion in LP gas prices could speed up the expected downward trend in inflation.

LP gas prices have pushed headline inflation up, creating a speed bump in its downward movement

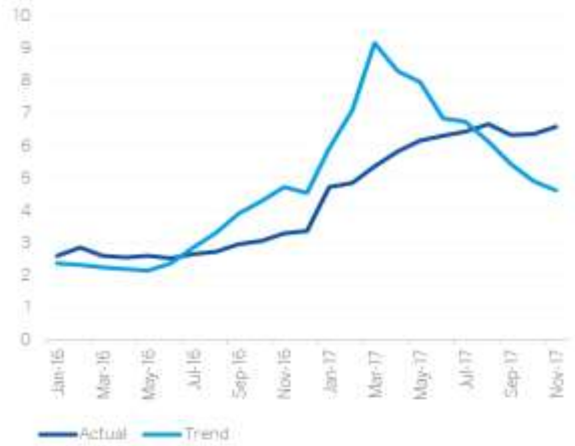
Figure 1. Headline inflation and LP gas prices (YoY % change)



Source: BBVA Research / INEGI

… it has thus remained sticky, but its trend continues to point to a slowdown in the coming months

Figure 2. Headline inflation (YoY % change & 3Mo3M saar)



Source: BBVA Research / INEGI

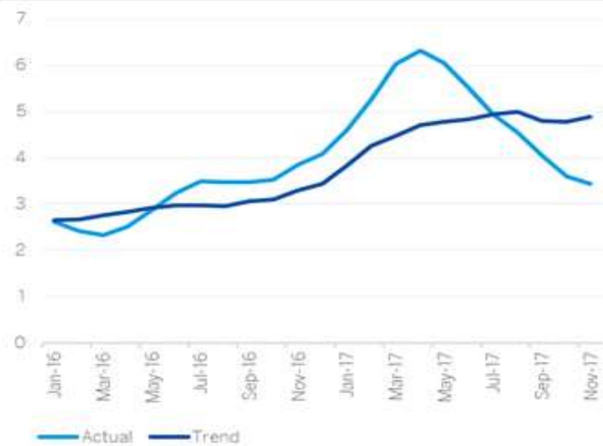
With LPG gas prices stabilizing, headline inflation should drop soon

Figure 3. US gas prices, 2017 (North American LPG Propane Mt Belvieu, MXN/Gallon)

Source: BBVA Research / Bloomberg

The core inflation trend continues to slow down

Figure 4. Core inflation (YoY % change & 3Mo3M saar)



Source: BBVA Research / INEGI

The core inflation trend also continues to slow down (figure 4) and remains under control. The uptick in November to 4.9% YoY from 4.8% should revert in December. Indeed, we expect core inflation to decelerate to 4.7% in December. Summing up, inflation stickiness does not represent a change in the downward expected path in the coming months. Headline inflation should end 2017 at 6.5% YoY. We expect it to drop to 5.2% in January, to stand below 5.0% in March, to further

decrease to 4.0% on average in 3Q18 and to finish 2018 at 3.7%. Lastly, inflation pressures did not increase further in the second fortnight of November (the latest available data before the MPC meeting).

Not only does the uptick in inflation is not worrisome (because is the response to an unexpected supply shock), every measure of inflation expectations remains well anchored. Analysts' inflation expectations (12 months) have moved along a narrow 3.8-3.9% range since April, when both headline and core inflation trends began to show a clear turning point (figures 2 and 4). Long-term market-based measures of inflation expectations remain well anchored (figure 5).

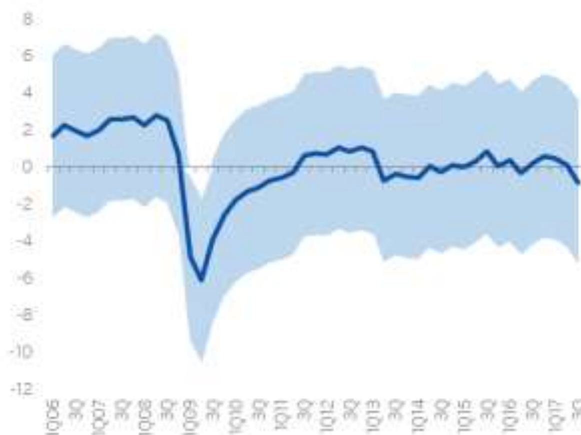
Long-term market-based measures of inflation expectations remain well anchored

Figure 5. Breakeven inflation rates[1] (%, generic[2])

1: The actual market-based expected inflation is lower since breakeven rates have two components: compensation for inflation (ie, expected inflation) and inflationary risk. 2 Calculated using the closest nominal government bond to the inflation-linked bonds.
Source: BBVA Research / Bloomberg

The output gap which had remained slightly positive over the past few quarters turned slightly negative in 3Q

Figure 6. Output gap[1] (% of potential GDP, sa)



1: Elaborated using seasonally adjusted GDP figures Estimated with the Hodrick-Prescott filter. Confidence interval calculated with +/-2 standard deviations.
Source: BBVA Research / INEGI

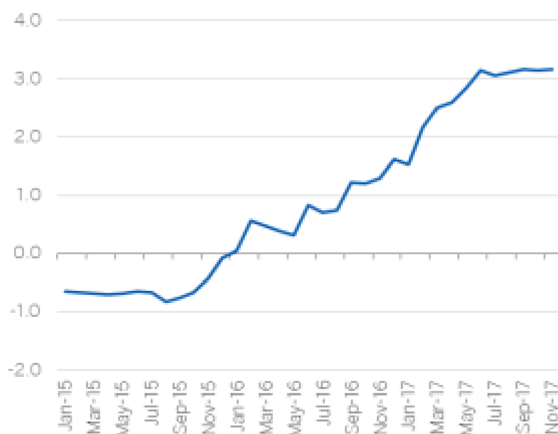
Furthermore, with short-term inflation risks still contained in our view, the room for a more restrictive stance of monetary policy is currently limited. On the one hand, the output gap which had remained slightly positive over the past few quarters turned slightly negative in 3Q (figure 6). A pre-emptive hike at next week's meeting would not be consistent with Banxico's strategy of an **"efficient convergence"** of inflation with its 3.0% target. On the other hand, the real ex-ante monetary policy rate remains above 3.0%, close to the upper limit of Banxico's long-term estimated neutral range, already slightly restrictive in our view (figure 7). Possibly due to these two facts and considering that the balance of risks to growth has also recently deteriorated, MPC board members have expressed that the room for a more restrictive stance is limited.

Although Alejandro Díaz de León might feel some pressure to show its inflation-fighting credentials at his first meeting and a 25 bp pre-emptive hike will be for sure discussed, we think that a prudent strategy in which Banxico saves some bullets for the likely build-up of exchange-rate related risks (that might come if the NAFTA outlook further deteriorates or with uncertainty around next year´s elections) is the best for next week's meeting. Having said that, the odds between a hold and a hike seem to be more balanced than a few weeks ago (60-40) with the a re-pricing of next year's expected Fed

hikes (figure 8) and renewed NAFTA concerns that have the MXN underperforming again over the last few days (figures 9 and 10) after outperforming following the end of NAFTA 2.0 round 4 of negotiations.

The real monetary policy rate remains above 3.0%, close to the upper limit of Banxico's LT estimated neutral range, already slightly restrictive in our view

Figure 7. Ex-ante real monetary policy rate[1] (%)



1: Calculated as the difference between the nominal rate and 12-month inflation expectations from the Banxico survey.
Source: BBVA Research / Bloomberg / Banxico

Risk 1: The market is re-pricing next year's expected Fed hikes

Figure 8. Probability of Fed rate hikes by year-end 2018[1] (%)

1: Fed funds futures implied probability
Source: BBVA Research / Bloomberg

Bottom-line

All in all, in our opinion, the new governor and the currently four-member MPC (in case of a tie Díaz de León has the quality vote) should not react to a cost-push shock and/or market pressures. Inflation is not currently facing any demand-side pressures that would warrant a hike. Its trend continues to point to a sharp slowdown soon. Inflation expectations remain relatively stable. A hawkish pause is enough for the time being. A hike is not necessary and can be costly for an economy that contracted in the last quarter and where fiscal policy will remain contractionary during 2018.

Significant wording changes to signal a possible pre-emptive hike should be expected

What to watch for. Looking ahead, there are three risks that could prompt Banxico to make significant wording changes to open the door to possible pre-emptive hikes in 1H18 if risks heighten. First, with Banxico's renewed focus on the relative monetary policy stance to the US, a continued re-pricing of Fed expected hikes between now and the end of 2018 increases the odds of a possible tightening by Banxico in 1H18. Although markets continue to expect only three Fed hikes by year-end 2018 (Dec 17's hike is fully priced in, thus only two hikes are currently expected for 2018), there's a re-pricing that has the market now beginning to consider the possibility of four hikes in 2018 (5 or more hikes line in figure 8). In a context of full employment, the increasingly likely fiscal stimulus in the US (badly-timed in our opinion) could translate into a faster inflation pace, and could thus push the Fed board members to increase their rate projections. A possible faster Fed tightening in 2018 is one risk to watch. Second, over the last few days, the MXN is again underperforming amid renewed NAFTA concerns. Even though a weaker peso should not trigger an additional pass-through round, international

energy prices could further increase, potentially limiting headline inflation's downward trend pace. Third, the upcoming elections could pressure the MXN as soon as in 1Q18.

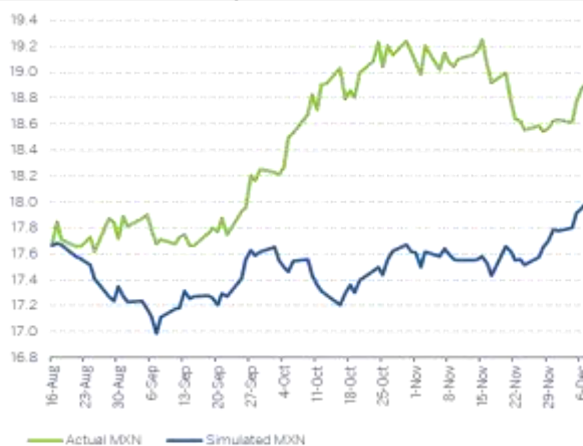
Risk 2: With renewed NAFTA concerns, the MXN could face increasing pressures in coming months

Figure 9. MXN & other EM currencies[1], Aug-Dec (Aug 1, 2017=100; +/- for depreciation/appreciation vs USD)

1: Own calculations based on a re-weighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.
Source: BBVA Research / Bloomberg

Although inflation will drop sharply in 1Q18, if markets increasingly price in these two risks, the balance of risks to inflation would not improve as markedly

Figure 10. Actual MXN vs. simulated MXN path[1] (Exchange rate, ppd, since 16 Aug 17)



1: Replicating the average performance of EM currencies since 16 Aug 17. Own calculations based on a re-weighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.
Source: BBVA Research / Bloomberg

Bottom-line

Considering that current inflation risks are still contained but a build-up is probable, Banxico is likely to open the door for a hike. That is, we think that the pause at next week's meeting would be as hawkish as they come and the wording will leave the door open to a pre-emptive hike if conditions warrant. Yet, it is still too soon to tell if such (probable) risk tightening would prompt Banxico to hike amid slowing inflation and growth at the beginning of the year.

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