CENTRAL BANKS

Banxico will deliver the signaled 25bp hike; the inflation outlook improvement warrants a more dovish tone

We expect wording changes to signal a possible pause in coming meetings

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- **We expect Banxico to increase the policy rate by 25bp to 7.5%**
- **Banxico will retain a hawkish stance to hike again if inflationary dynamics deteriorate, but the improvement in the inflation outlook warrants a more dovish tone**
- **We expect wording changes to prevent Banxico from cornering into hiking again at April's meeting**
- **We believe that this hike will be the last of the cycle**

Banxico will deliver the signaled 25bp hike…

We believe Banxico will deliver a widely expected 25bp rate hike, as it strongly signaled in in the multiple statements to the media by the Governor. In our view, this hike is not necessary and the previous one was not warranted (see). While inflation will likely end up easing more than expected in January, and risks also eased more than anticipated driven by a stonger than expected MXN, we expect Banxico to hike the policy rate for the second consecutive meeting as the MPC would not be able to distance itself from the hawkishness of the last monetary policy statement and meeting minutes. Delivering the expected hike is now crucial for credibility as they did not leave the door open for a monetary policy pause at this meeting. Although Banxico's previous hike was priced into markets, it was a "hawkish hike" with a surprising hawkish tone of the statement: i) one member voted for a larger hike; ii) it left the door wide open to further hikes by signaling that the MPC would "act as soon as necessary" should inflation risks intensify; iii) the decision to hike was justified by the need to keep mid and long-term inflation expectations anchored and to "reinforce the downward inflation trend towards its target"; and iv) it dropped the "efficient convergence" reference.

The meeting minutes had additional hawkish elements that strongly signal an additional hike. One member stressed that "under a risk-management approach, […], it would be more costly error not to raise the rate if necessary, than to raise it even when it was not". Another stressed the importance of achieving the convergence of inflation to the target, "at a pace that preserves the Bank's credibility". Even if this member watered-down what this remark implies by adding that the MPC should take into consideration that this process should be carried out at the lowest possible cost for economic activity, it is still a hawkish remark. Recall that at the time of December's meeting, inflation, in our view, remained under control despite the supply-shock driven deteriorarion over 4Q17. More importantly, monetary policy should not react to temporary supply shocks i.e., the policy rate cannot by itself speed-up the convergence pace under the absence of demand-side pressures and with inflation expectations anchored.

… but should strike a more dovish tone

Although in our view Banxico's recent communication cornered itself to hike at tomorrow's meeting, a more dovish tone in the press release should be expected on the grounds on an improvement in the inflation outlook. As we, consensus, and Banxico expected, the uptick in inflation during 4Q17, which created a speed bump in its downward trend following September's turning point, was mainly driven by a new supply shock, now in energy prices, and additional supply-related prices (i.e., in perishable food prices). Headline inflation stickiness was explained by supply shocks. The most recent inflation data supports this view. Inflation surprised on the downside in the first half of January (0.24% HoH, while the market was expecting 0.36%), and more importantly, the headline surprise was mainly driven by weaker-than-expected core inflation, which increased 0.17% HoH compared to market expectations of 0.25%. Data continues to reflect the absecence of relevant FX pass-through from 4Q peso's weakness and second-round effects from the recent uptick in headline inflation. Also, as widely expected, the annual inflation rate dropped to 5.5% in 1H January (from 6.9% in 2H December), as the base effect from the gasoline price increase that took place in January 2017 fade out.

Looking ahead, we expect January's fall to mark the start of a downward trend after the supply-shock driven temporary increase over 4Q17. We expect headline inflation to fall to 5.4% in January and to fall below 5.0% by April. We also expect core inflation to fall below 4.0% by April. Besides, a much better than expected perfomance of the MXN in early 2018, as NAFTA break-up risks have diminished, is welcome news for core inflation. All in all, in our view, the balance of risks to inflation has improved since the last meeting and the tone of the statement should reflect it. Wording changes to signal a possible pause in coming meetings should be expected. We believe that this hike will be the last of the cycle.

However, even if Banxico tweaks its tone to a less hawkish one, risks will likely remain tilted towards an additional hike if developments on NAFTA talks are not positive. Lastly, while Banxico has recently focused again on the relative stance of monetary policy between Mexico and the US, and warned about the risks of weakening this relative stance in a context of upward risks to inflation, we think that Banxico has already done the job and should not follow Fed's footsteps. MXN's risk-adjusted carry trade looks better than that of other emerging market currencies. Besides, after these two hikes, the real ex-ante monetary policy rate will be already restrictive and might further increase over Q2 and Q3 if as we expect, annual headline inflation surprises the market to the downside during this period, and 12-month inflation expectations somewhat fall from current levels. Under that scenario, the real ex-ante monetary policy rate will stay above 3.5% during 2H18, further limiting the room for additional hikes. In fact, the high real rate is already creating headwinds in the demand for credit. All in all, in our view, Banxico should not follow this year's three expected Fed hikes.

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