CENTRAL BANKS

Banxico will most likely keep rates unchanged and should strike a more dovish tone

We expect significant wording changes to acknowledge lower inflation risks

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- **We expect Banxico to hold rates steady (at 7.50%) next Thursday**
- **As we expected, disinflation pressures are taking hold and inflation is set to fall further; The inflation outlook improvement warrants a more dovish tone**
- **We think Banxico is likely to signal a pause in the near-term. We expect Banxico to begin an easing cycle in October**

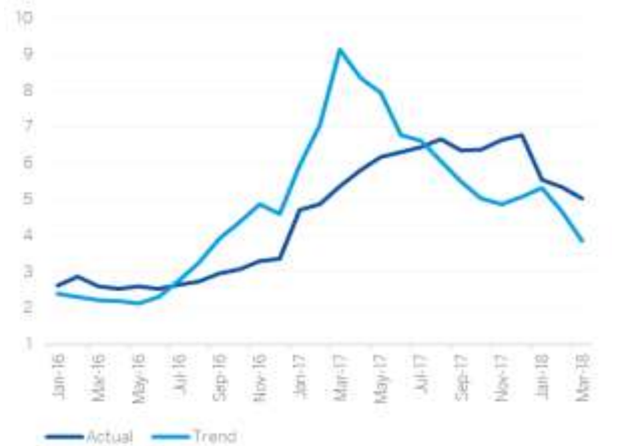
Disinflation pressures are taking hold

Inflation fell sharply in the first three months of the year as we expected. Having peaked at 6.8% YoY, headline inflation fell sharply in the first three months of the year ie, (-)1.7 pp to 5.04%. Core inflation fell (-)0.85 pp to 4.02% over the same period. The falling trend in core inflation is broad-based. Core goods price categories have declined markedly. Pressures on the core component are clearly unwinding and disinflation pressures are taking hold. In annual terms, both core goods components eased substantially from December's levels: food core goods from 6.8% to 5.3% and non-food core goods from 5.6% to 4.0%. Service prices remain stable and well behaved, confirming our view of no second-round effects arising from the temporary uptick in headline inflation during 4Q17. As we argued late last year, the uptick in inflation during 4Q17 was likely to prove temporary as it was driven by supply-shocks that created a speed bump in headline inflation's downward trend following September's turning point. In addition, as we expected, the beginning of a reversion in LP gas prices could speed up the downward trend in inflation, as lower-than-expected inflation in March driven by the decline in LP gas prices shows.

Headline and core inflation trends suggest that both are set to fall further in the near-term (see charts 1 and 2). We expect inflation to continue easing. As we have been anticipating since the turn of the year, headline and core inflation will fall below 5% and 4% respectively in April. The next base effect will take place over these two months. Headline inflation is likely to fall an additional (-)0.5pp over this period. Not only inflation is falling fast and is set to fall further, but also every measure of inflation expectations remains well anchored. As we argued before February's MPC meeting, the expected deceleration of inflation would likely do the job to further anchor inflation expectations. Unsurprisingly, it did. Long-term market-based measures of inflation expectations remain well-anchored, wheareas analysts' expectations have also eased recently (charts 3 and 4). Moreover, the unexpected MXN strengthening in spite of AMLO's improving odds has further lowered inflation risks. Overall, the balance of risks to inflation, which had already improved from December's MPC meeting to the one that took place in early February, has now improved markedly.

Following 4Q17's stickiness, headline inflation fell sharply in the first three months of the year as we expected. It's trend suggests it is set to fall further

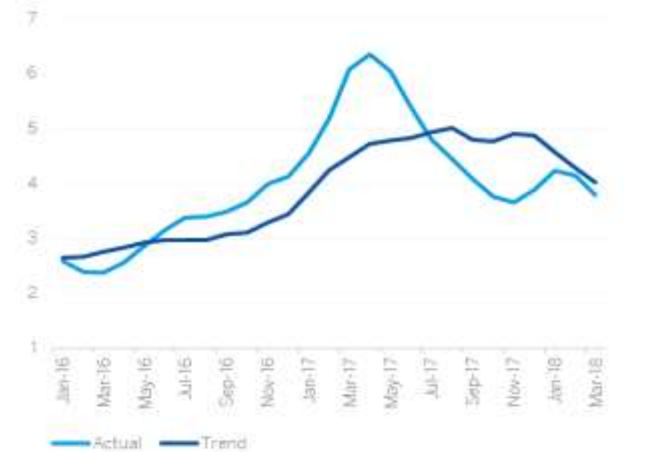
Chart 1. Headline inflation (YoY % change & 3Mo3M saar)



Source: BBVA Research / Bloomberg. Own calculations for sa series.

Core inflation is also falling fast anf its trend points to a slowdown in coming months

Chart 2. Core inflation (YoY % change & 3Mo3M saar)



Source: BBVA Research / INEGI. Own calculations for sa series.

Long-term market-based measures of inflation expectations have remained well anchored…

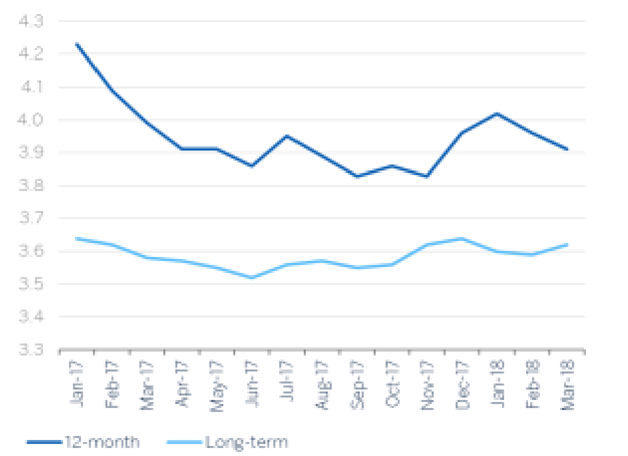
Chart 3. Breakeven inflation rates[1] (%, generic[2])

[1] The actual market-based expected inflation could be 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

… whereas analysts' inflation expectations have recently come round to our view that inflation is likely to fall below 4.0% in the next 12 months

Chart 4. Analysts' inflation expectations (%)



Source: BBVA Research / Banxico's Survey of Economic Analysts

Lower inflation risks tip the balance towards a monetary policy pause

What to watch for. Albeit we are still not out of the woods in terms of inflation risks, Banxico is likely to acknowledge than the balance of risks to inflation improved (markedly) in the inter-meeting period. Banxico has played it safe. In our view, the last two hikes were unnecessary, as monetary policy should not react to supply shocks unless inflation expectations unmistakably increase to become unanchored. In February, we expected Banxico to deliver the signaled 25bp hike. We also anticipated Banxico to retain its hawkish stance to hike again if inflation dynamics deteriorate. However, we anticipated a less hawkish tone to reflect the improvement in the inflation outlook and to have more flexibility to stop hiking rates in coming meetings. Recent communication seems to be trying to distance from previous hawkishness, which in our view is a welcome development.

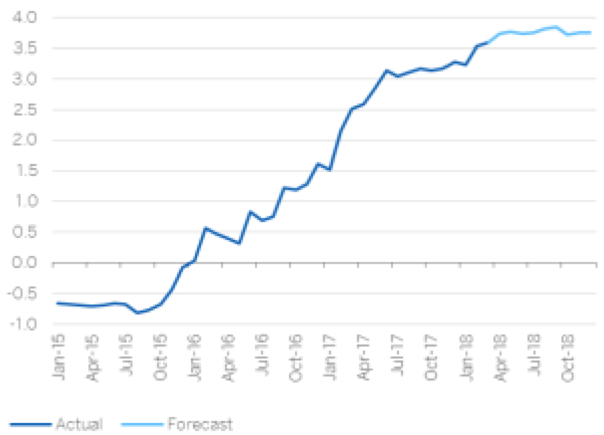
To sum up, we expect Banxico to keep its monetary policy rate on hold. We also think that the improvement in the inflation outlook warrants a more dovish tone. We think that the hawkishness of the previous statement along with the favorable inflation path and lower inflation risks warrants significant wording changes to signal a monetary policy pause in the near-term. A somewhat hawkish hold –leaving the door open to act if inflation dynamics deteriorate–, with inflation on a downward trend towards its target is the best strategy in the near-term.

The door for a rate cut is likely to open in early 4Q18

In our view, it has become clear now that there is no “need” to hike rates further. A monetary policy pause seems likely in the short term. Looking ahead, as the real monetary policy rate becomes increasingly restrictive (see chart 5) with inflation and inflation expectations gradually declining, Banxico is likely to begin to consider in coming months what would be the best timing for a rate cut that would bring down the real monetary policy rate to a less restrictive stance. The relative monetary policy stance will remain at comfortable levels by historical standards even if the Fed ends up hiking rates four times this year (see chart 6). Besides, Banxico has only widened the spread beyond current levels when inflation and 12-month expectations were both above 4.5% and on a diverging path from its target. That would not be the case going forward. Barring any negative surprises, in our view, the door for a rate cut is likely to open in early 4Q18, once headline inflation is below 4.0% and Banxico is increasingly confident that inflation is converging with its target. We now expect the next monetary policy rate move to be a cut. Our call for a rate cut in October would likely mark the beginning of a gradual easing cycle that takes the nominal rate towards 5.5% ie, the real rate to neutral levels around 2.5%.

Even if Banxico holds rates steady in the next two quarters, the real monetary policy rate is likely to become increasingly restrictive in the near-term

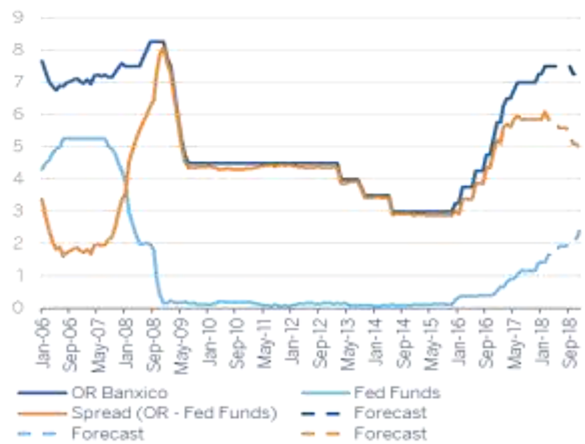
Figure 5. Ex-ante real monetary policy rate[1] (%)



[1] Calculated as the difference between the nominal rate and 12-month inflation expectations from the Banxico survey for actual data and from our own inflation forecasts for the expected path. The real monetary policy rate considers a pause at 7.50% in 2Q-3Q18 and a 25bp rate cut in October
Source: BBVA Research / Bloomberg / Banxico

The relative monetary policy stance will remain at comfortable levels even if the Fed ends up hiking rates four times this year

Figure 6. Overnight Banxico policy rate, fed funds rate and spread[1] (%)



[1] Expected paths discount four Fed rate hikes (instead of the actual three hikes that we expect) for illustrative purposes. The paths also consider our expected 25bp Banxico rate cut in October.
Source: BBVA Research / Banxico / Bloomberg

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