Central Banks

We expect Banxico to remain on hold

With no additional deterioration of inflation risks, and the recent appreciation of the MXN, we expect Banxico to hold rates steady

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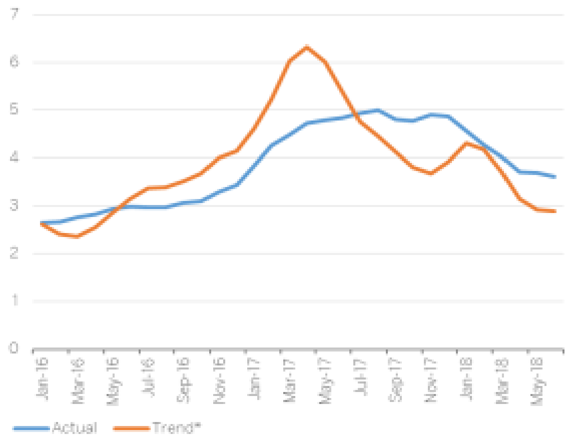
- **A “hawkish hold” is the most likely outcome in our view, as core inflation remains well behaved and the MXN strengthened significantly since the last policy meeting on better NAFTA 2.0 prospects**
- **The temporary reversal in headline inflation’s downward trend along with somewhat higher inflation expectations warrant a hawkish wording. Banxico will likely leave the door open for another pre-emptive hike if the balance of risks to inflation deteriorates again**

Disappointing inflation data since the last meeting; stickiness in the near-term and slower convergence pace to the 3.0% target…

Annual headline inflation had already decelerated less than expected in May before the last policy meeting. Since then, actual inflation has been higher than expected. In June, headline inflation was 0.39% MoM, significantly higher than our and consensus forecasts at the beginning of the month. In annual terms, inflation rose to 4.65% from 4.51% in May. In the first half of July, headline inflation was 0.32% HoH (4.85% YoY). For July, we project a 0.50% MoM headline inflation print (4.8% YoY) Since May, the headline inflation trend (see Chart 2) pointed to an uptick in actual annual headline inflation that has materialized. Yet, this uptick has been mainly driven by the sharp increase in energy prices (see Chart 3), and core inflation remains on a downward trend (see Chart 1).

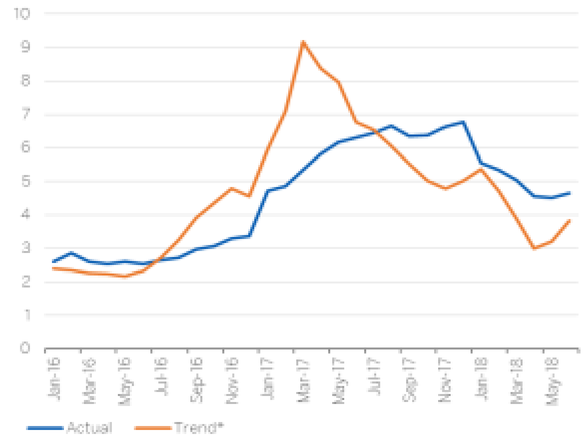
Headline inflation is set to remain sticky to the downside in the near-term, following June-July’s uptick. Our projections are that annual headline inflation will average 4.7% in 3Q18, will decrease slightly to 4.6% in Oct, and decreased more significantly only until November, when it benefits from a base effect. This is considerably higher than Banxico’s projections which most likely will be upwardly revised in its next quarterly inflation report on 29 August. That is, inflation will definitely converge to the 3.0% target at a slower pace than previously thought.

Albeit more slowly, core inflation is set to slow down further in the near-term…
Chart 1. Core inflation: actual & trend*
(YoY % change & 3Mo3M saar)



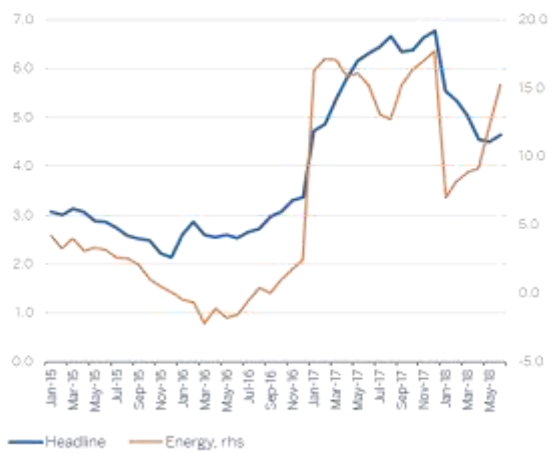
* Based on own calculations of the seasonally-adjusted CPI index.
Source: BBVA Research / INEGI

… But headline inflation is likely to remain sticky to the downside in the coming months following June-July's uptick
Chart 2. Headline inflation: actual & trend*
(YoY % change & 3Mo3M saar)



* Based on own calculations of the seasonally-adjusted CPI index
Source: BBVA Research / INEGI

Non-core pressures from energy prices push up headline inflation
Chart 3. Headline and energy inflation
(YoY % change)



Source: BBVA Research / INEGI

Stickiness ahead in the near-term for headline inflation
Chart 4. Inflation outlook
(YoY % change)

Source: BBVA Research / INEGI

… but no further deterioration of inflation risks

Our projections also suggest that core inflation is likely to stabilize at around 3.6% in the near-term, before decreasing further in the last two months of the year (see Chart 4) to 3.4% by year-end. The falling trend in core goods inflation remains broad-based. The significant weakening of the MXN seen between mid-April and late June was increasing risks of a fresh round of pass-through, but the sharp strengthening during July on better NAFTA 2.0 prospects is lowering these risks. The stronger MXN should also bring down market-based inflation expectations which have increased recently (see Chart 6). Meanwhile, the increase in analysts' long-term inflation expectations might proved short-lived if we are correct and inflation does not increase further after July. The expected headline inflation stickiness is explained by supply shocks on energy and fruit and vegetable prices.

In our view, Banxico has not enough elements to increase the policy rate for the second consecutive meeting. Inflation and inflation expectations have increased recently, but on the back on non-core pressures and a weak MXN, respectively, with no evidence of second round effects. Although the convergence to the target is going to take longer, core inflation suggests that short-term inflation risks are still contained in our view, and if anything, decreased somewhat since the last meeting following the strengthening of the MXN during July. Besides, with a slowing economy (-0.1% QoQ sa GDP growth in 2Q18) and no demand-side pressures, the room for a more restrictive stance of monetary policy seems limited –the real ex-ante monetary policy rate will likely hover slightly above 4.0% the rest of the year (we think the neutral real rate is around 2.0%). Banxico will likely remain cautious and the wording is likely to remain hawkish but the MPC might acknowledge that the real monetary policy rate is already high, signaling that further pre-emptive hikes are unlikely unless the inflation outlook deteriorates appreciably. Besides, the recent increase in inflation was due entirely to supply shocks, and monetary policy should not be used against them.

No evidence of a fresh round of pass-through; looking ahead, the recent strengthening of the MXN lowers risks going forward
Chart 5. Non-food core goods & ER*
(YoY % change)

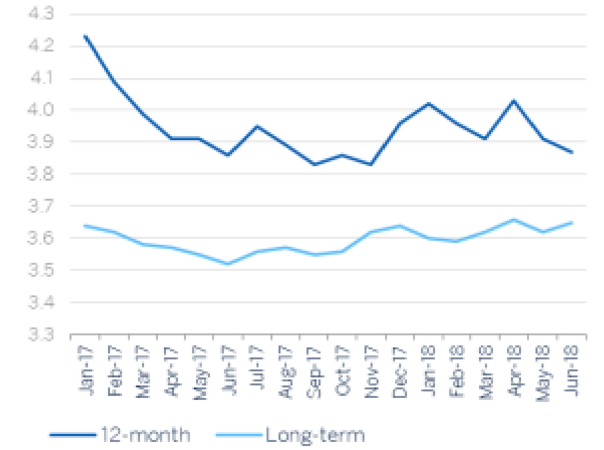
* Based on own calculations of the seasonally-adjusted CPI index.
Source: BBVA Research / INEGI

While market-based inflation expectations have increased, a stronger MXN should bring them down in the near-term
Chart 6. Breakeven inflation expectations vs. ER
(10-year & ppd)

* Based on own calculations of the seasonally-adjusted CPI index.
Source: BBVA Research / INEGI

While long-term inflation expectations have increased somewhat, no additional inflation increase after July should translate into lower expectations

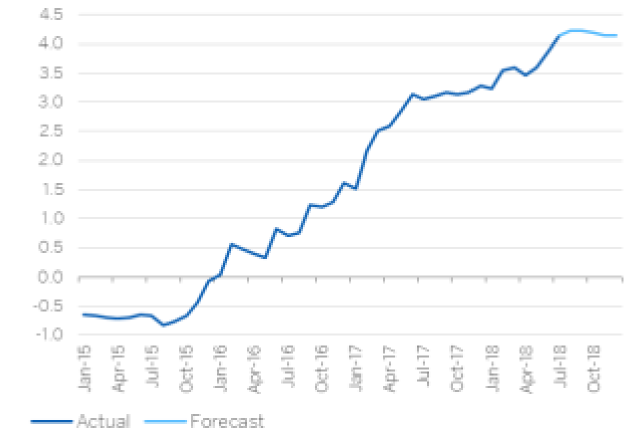
Chart 7. Analysts' inflation expectations
(Banxico Survey, %)



Source: BBVA Research / Banxico

Even if Banxico holds rates at 7.75%, the real ex-ante monetary policy rate will likely stay above 4.0% in 2H18 which is high by historical standards

Chart 8. 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 our 12-month inflation forecasts for projected data.
Source: BBVA Research / Bloomberg / Banxico

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