Central Banks

Banxico to begin a period of an extended monetary policy pause

Fall in inflation along with lower risks takes further hikes in the near-term off the table

Javier Amador / Carlos Serrano

- **The balance of risks to inflation improved in the intermeeting period with the recent rally in the MXN combined with a larger-than-expected fall in inflation in the first half of January**
- **We expect the next move in the monetary policy rate to be a cut, but not until later in the year**

Hikes no longer in play in the near-term

Banxico's continued hawkish tone in the last statement signaled that an additional hike was still in play for tomorrow's meeting. Yet, inflation and risks to inflation have eased notably since the last meeting, and now further tightening seems unlikely. We continue to expect the next move in the monetary policy rate to be down, but not until later in the year. We expect inflation to fall below 4.0% this year but not until the summer with core inflation hovering around 3.5% for most of the year before falling further to 3.3% by year-end. With inflation still above Banxico's upper-limit in the first half of the year, combined with core inflation stickiness to the downside, Banxico is likely to remain hawkish and keep a cautious wait-and-see approach in the near-term. However, our macro scenario of lower inflation combined with a stable MXN will likely imply that the next move in interest rates will be down. We think that discussion around Banxico's monetary policy is likely to steer away from hike talk sooner rather than later. We continue to pencil one rate cut in 4Q19 and four rate cuts in 2020. That is, combined rate cuts of 125bp by year-end 2020 compared to 50 basis points expected by analysts' consensus and additional hikes still expected by markets by year-end 2019.

Why do we think that hikes will no longer be in play in the near-term? Risks to inflation have eased notably on several favorable recent developments. (1) Inflation data has been giving Banxico less reasons to be concerned as inflation fell more than expected in the first half of January; we expect annual headline inflation to fall 0.4pp to 4.4% in January from 4.8% in December. (2) The peso is now stable with easing concerns on Mexico and it has fully recovered from the sharp negative differentiation seen during Oct-Nov 2018 when the new Mexico´s City airport was cancelled (see chart 1) as AMLO-related risk premia in Mexican financial variables has faded significantly. Although MXN negative differentiation recently resurfaced following Fitch downgrade of PEMEX debt and concerns on PEMEX's need to show rating agencies a sustainable model to save its investment grade, the exchange rate has remained relatively stable, limiting risks to inflation going forward. (3) As should have been expected, long-term market based inflation expectations have fallen back following peso's rally (see chart 2) and analysts' consensus expectations have recently decreased (consensus now expects 3.9% headline inflation by year-end). (4) The external backdrop is more favorable with recent Fed's dovishness and more appetite for risk. (5) Banxico should have fewer concerns on the relative monetary policy position with the Fed increasing at most two more times this year. Besides, following the rally in the peso and a more favorable global backdrop, the MXN risk-adjusted carry trade has again a significant positive differentiation (see chart 3). We expect tomorrow's decision to be unanimous and looking ahead, we anticipate that the new board will be more dovish.

Why do we think that the next move in interest rates will be down and is likely to take place later this year? (1) We estimate headline inflation will fall back below 4.0% by the summer and is likely to decline further in 4Q19 as the effect of 4Q18's supply shocks (mainly gasoline prices) fades away. (2) We anticipate the MXN to remain relatively stable throughout the year, keeping in check both inflation expectations and risks to inflation. (3) The real ex-ante interest rate, which is already very restrictive (it is currently at 4.25% while the r* is 2%), is likely to increased further as 12-month inflation expectations gradually fall from its current 4.0% level (see chart 4).

Chart 1. MXN vs EM currencies*
(Index 1 Oct 2018 =100)

*Own calculations based on a reweighting of the JP Morgan Emerging Markets Currency Index after taking out the MXN
Source: BBVA Research / Bloomberg

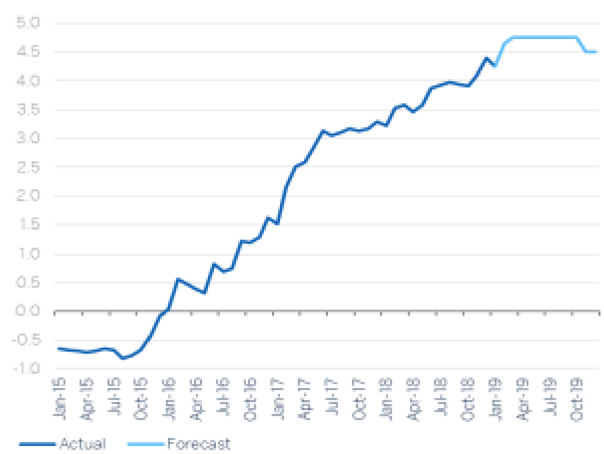
Chart 2. Long-term market based-inflation expectations and exchange rate
(% and ppd)

Source: BBVA Research / Bloomberg

Chart 3. Risk-adjusted carry-trade
(%)

Source: BBVA Research / Bloomberg

Chart 4. Real ex-ante monetary policy rate*
(%)



*Own calculations based on a reweighting of the JP Morgan Emerging Markets Currency Index after taking out the MXN
Source: BBVA Research / Bloomberg

BBVA Research

Disclaimer

This document was prepared by Banco Bilbao Vizcaya Argentaria's (BBVA) BBVA Research and BBVA Bancomer S. A., Institución de Banca Múltiple, Grupo Financiero BBVA Bancomer on behalf of itself and is provided for information purposes only. The information, opinions, estimates and forecasts contained herein refer to the specific date and are subject to changes without notice due to market fluctuations. The information, opinions, estimates and forecasts contained in this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA Bancomer, and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. This document is not an offer to sell or a solicitation to acquire or dispose of an interest in securities.