Central Banks

Banxico to keep rates steady at 8.25% and stay hawkish

After April´s surprising increase in inflation, a more dovish tone is now unlikely in the short term

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- **The board will continue to highlight risks to its inflation target being met as headline inflation is above the upper limit of the target range and the core component remains sticky**
- **Even if the MXN remains relatively stable, the resumption of external risks from a potential US-China trade war should contribute to a cautious approach from Banxico**
- **With inflation falling back in coming months, and a deceleration in economic activity, policy easing should begin in 2H19**

Hawkish statement will continue to signal cautious approach

On the last meeting (March 28), the tone of tone of the statement remained hawkish, signaling that rate cuts are still not in the table. Broadly speaking, the Board did not soften its tone. Banxico is clearly no longer in a ready-to-hike disposition, but, it shifted to a cautious wait-and-see approach and not (yet?) to an easing bias. Following the jump in headline inflation in April (to 4.4% from 4.0% in March), mostly driven by a larger-than-expected rise in core inflation (to 3.9% from 3.6% in March), Banxico will keep rates steady at 8.25% in an unanimous decision and is likely to retain a hawkish tone when it meets next Thursday.

The monetary policy paragraph will most likely remained unchanged. The Board will repeat that it will “maintain a prudent monetary policy stance” and will adjust rates in a “timely and firm manner” if needed. The Board will also repeat that the balance of risks to inflation remains tilted to the upside (we think that is more balanced if not tilted to the downside). Banxico will likely continue to highlight that core inflation remains sticky, noting that core food and core other services prices have increased recently. We think Banxico will continue to stress that inflation expectations “remain at high levels” and above target. I short, Banxico is unlikely to change its tone much, and if anything, they might add a slight hawkish tweak by mentioning that core inflation is now above the 3.6-3.7% narrow range in which it moved for the previous 12 months. Besides, with the resumption of external risks from a potential US-China trade war, Banxico will likely continue to stress that there are factors/risks that could push inflation upwards and “divert it from the expected trajectory”. Banxico is likely to signal that inflation risks will require, in their view, keeping high (and restrictive) interest rates for longer.

We continue to expect an easing cycle to begin in Q3 and anticipate more rate cuts than markets and analysts are expecting this year and next

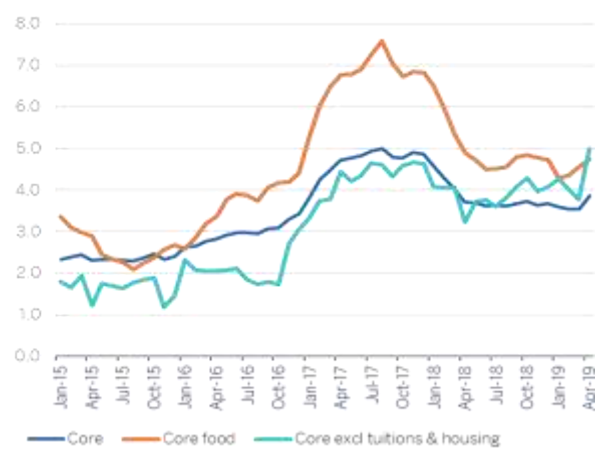
We had been expecting headline inflation to rebound in Q2 and to stay above 4.0% at least until June, core inflation to remain sticky, and that it would not move further down until Q4. Yet, inflation jumped in April by more than expected, supporting recent hawkish rhetoric from Banxico. But we think Banxico's inflation worries are overdone and both headline and core inflation should fall back in the coming quarters. Thus, we remain comfortable with our view for an easing cycle to begin in the second half of the year and we are expecting 50bp of rate cuts this year and 100bp in 2020. In contrast, consensus is pricing in 75bp of cuts by year-end 2020.

Core inflation stickiness is explained by cost-push inflation; demand-side pressures remain absent, in particular, we think that with real wages falling over the past fifteen years labor markets should not be labeled as tight, and with a slower pace of job creation and weakening economic activity, wage pressures will not arise. A closer look at core inflation data reveals that cost-push effects are largely to blame for its stickiness and higher-than-expected jump in April. As seen in chart 1, core inflation stickiness and its most recent jump is explained by two components: services excluding tuitions and housing and core food. As to services, airfares increased 18.9% MoM in April taking the annual pace of increase to 30.3%, the highest on record. The seasonal increase over March-April was 26% compared to an average increase of 17.5% in 2017-18. Besides, the downward adjustment of mobile phone tariffs ended in 2018, contributing to the increase in the services component. As to core food prices, as seen in chart 2, the positive effect of the decline in non-core food prices in late 2018 on core food prices also ended, but recent trends do not point to further pressures on core food prices. In contrast, as seen in chart 3, non-food core prices are likely to remain well behaved. We think that a fraction of the large jump in airfares and tourism-related services will revert in May and although core inflation is likely to remain sticky around 3.7% in the next few months, it will drop in Q4. We continue to expect headline inflation to have peaked in April and to drop back to below 4.0% in the summer.

We thus continue to think that Banxico is likely to shift to an easing bias in the second half of the year. There are several reasons for this: the Fed is on the sidelines, the MXN is relatively stable in spite of the risks, headline inflation should fall below 4.0% from the summer onwards, core will likely remain stable, the economy is weakening, the output gap is widening, Mexico´s risk-adjusted carry trade is among the most attractive in the emerging market arena, and the real exante monetary policy rate is clearly restrictive. In our view, the case for an easing cycle will become strong in a few months' time. Yet, the unexpected large increase in core inflation during April, along with renewed external concerns and continued PEMEX concerns might delay the start of the easing cycle. But for the time being we continue to pencil the timing in Q3.

Core inflation stickiness is explained by cost-push inflation

Chart 1. Core inflation, core food and core other services (YoY % change)



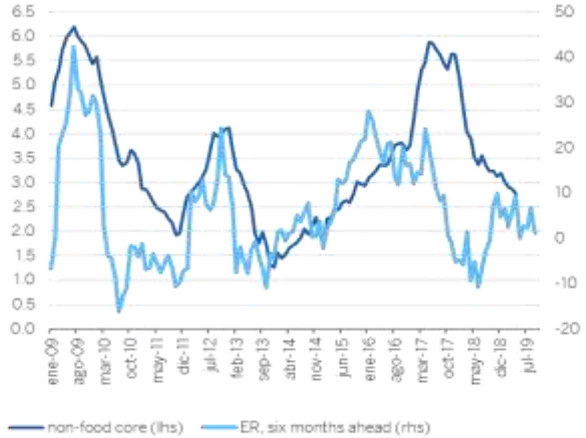
Source: BBVA Research / INEGI

Non-core food prices do not point to further pressures on core food prices

Chart 2. Core food vs non-core food (YoY % change)

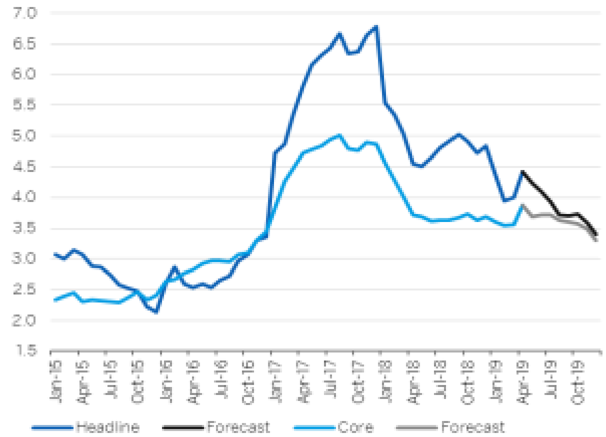
Source: BBVA Research / Bloomberg

Chart 3. Non-food core vs. ER
(YoY % change)



Source: BBVA Research / INEGI / Bloomberg

Chart 4. Inflation outlook
(YoY % change)



Source: BBVA Research / INEGI

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