Central Banks

Banxico to continue the cautious pace of easing

The monetary policy rate has plenty of room to decline without affecting inflation or the MXN

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- **Following the split 4 to 1 vote in December, it seems clear that Banxico will not speed up the easing pace at any point of the cycle**
- **If Banxico did not cut more aggressively when the FED was easing, they won't do it now**
- **The temporary and expected rebound in inflation in 1Q20 should not be used as an excuse to pause the easing cycle at least until the monetary policy stance is neutral since inflation expectations remain well-anchored at the lowest levels in years**
- **We continue to expect the policy rate to reach 6.0% by August 2020; a looser monetary policy stance is warranted but we expect Banxico to remain cautious as they assess a higher risk premium**

The rate cut cycle should continue without a pause at least until the monetary policy stance is not restrictive

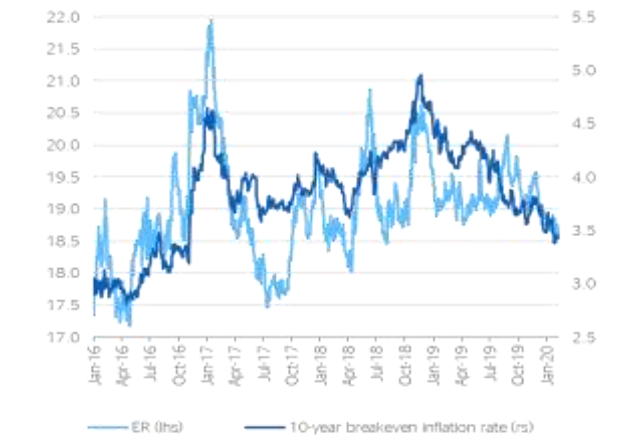
As we have been arguing, the monetary policy rate has stood at the highest level ever vis a vis the prevailing headline and core inflation levels. Banxico has expressed concerns about core inflation's stickiness, but the 3.70% core inflation average since April 2018 (ie, since the start of the current period of stickiness) is almost identical to the 3.64% average from 2008 to 2019 (see graph 1). This stickiness has not affected inflation expectations which have been trending downwards in line with peso's strength (see graph 2) and lower headline inflation. Thus, it could be argued that Banxico's main concern –the possible effect of core inflation stickiness on inflation expectations– is overdone. In fact, market-based long-term inflation expectations stand below 3.5% -below the 3.7% average from 2012 to date, and well below the 4.1% headline inflation average from January 2014 to January 2020- and were unaffected by the temporary base-effect driven increase in headline inflation in January. Short-term analysts' inflation expectations have also come down strongly and now stand at the lowest level since early 2016 when inflation reached an all-time low (see graph 3). Likewise, they have been unaffected by the expected temporary rebound in inflation.

In our opinion, Banxico has maintained an excessively restrictive monetary stance given the context of inflation, growth, MXN and risks for these variables. In fact, the real exante monetary policy rate has barely eased after the four consecutive 25bp rate cuts already seen since August (-100bp), since 12-month inflation expectations have declined around two thirds of that (-0.64pp) since June 2019 (see graph 4). This should have been expected considering the projected downward headline inflation trend and the peso's strength. Thus, in our opinion, monetary policy rate stayed overly restrictive throughout 2019 and was not forward looking. It could been argued that the monetary policy stance should be accommodative in a context of soft inflation, a relatively stable exchange rate, well-anchored inflation expectations, and with a very weak economy and an increasingly negative output gap.

Graph 1. **Monetary policy rate and core inflation**
(% and YoY % change)

Source: BBVA Research / Banxico / INEGI

Graph 2. **Exchange rate and market-based 10-year inflation expectations**
(% and YoY % change)

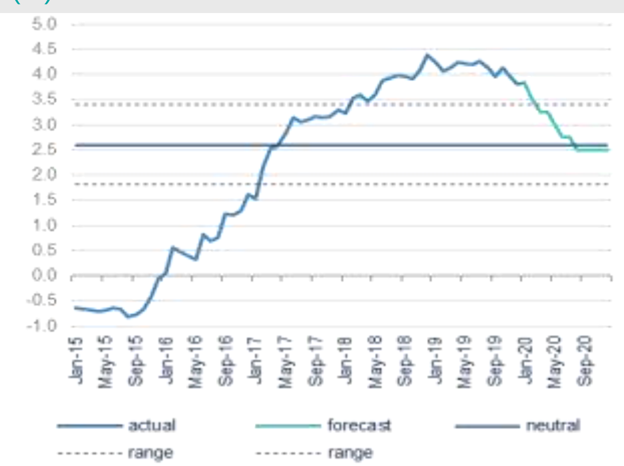


Source: BBVA Research / Bloomberg

Graph 3. **12-month analyst's inflation expectations**
(%)

Source: BBVA Research / Banxico

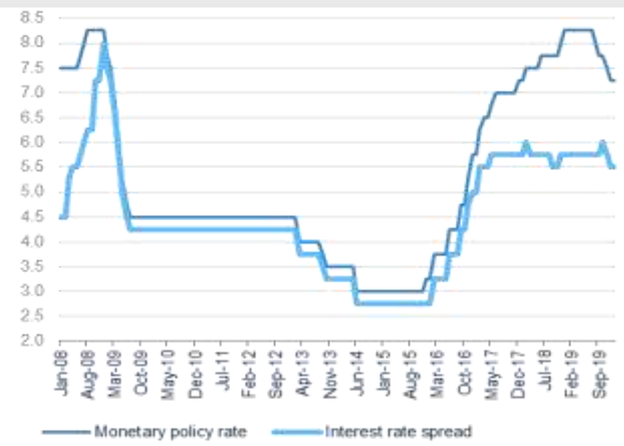
Graph 4. **Real exante monetary policy rate**
(%)



Source: BBVA Research / Banxico / INEGI

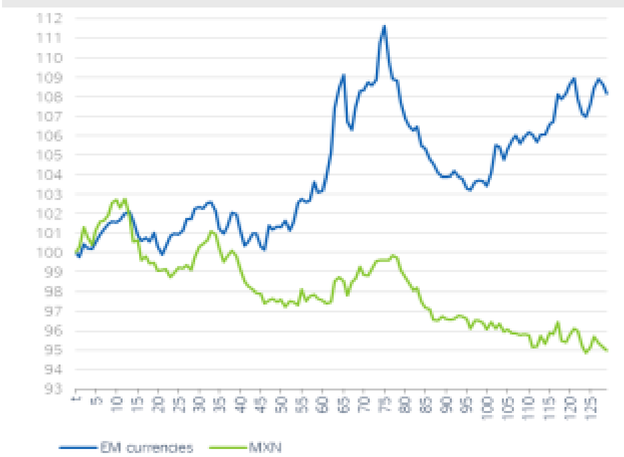
Why has Banxico kept such a cautious approach and such a restrictive stance? We have argued that in our opinion, Banxico believes that the main factor behind the recent strength of the peso is the large interest rate spread between Banxico's monetary policy rate and the fed funds rate. Banxico had decided to keep the spread between the monetary rate and the US federal funds rate basically stable at 5.75% throughout 2018-19. (see graph 5). This implies that Banxico has "gone along with" the monetary policy decisions of the Federal Reserve in the last two years. This spread only began to narrow (to 5.50%) until December 2019 after the fourth consecutive 25bp rate cut. Likely, Banxico fears that reducing this differential could result in pressures on the exchange rate, which in turn translate into greater risks for inflation. Up until now, the peso has continued to outperform since the start of the easing cycle as the main drivers behind the peso's relative performance in any given period since early 2016 do not seem to be associated with the interest rate spreads (see graph 6). In our view, several factors have contributed to the outperformance: i) the expectation and subsequent ratification of the USMCA by the US Congress, ii) a global risk-on mood with the expectation that the Fed will not increase rates in the foreseeable future, iii) low rates everywhere, and to a lesser extent iv) the perception of lower short-term risks for PEMEX due to the financial support of the federal government. Besides, as shown in graph 5, the differential remains very high for historical standards. Moreover, interest rates have decreased in most cases more than in Mexico. This has led to an increasingly better-off risk-adjusted carry trade position in both absolute and relative terms (see graph 7). Moreover, even in the remote event in which rate cuts result in MXN depreciation, evidence (and research conducted by Banxico) suggests that exchange rate pass-through is now very low in Mexico and close to cero in situations of negative output gap, as is the case actually.

Graph 5. **Monetary policy rate and interest rate spread with the fed funds rate**
(%)



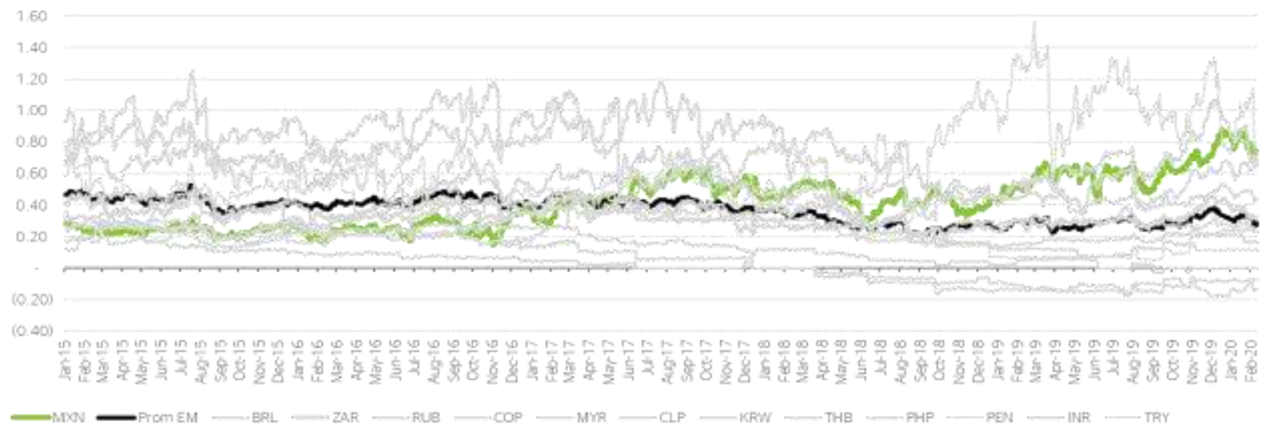
Source: BBVA Research / Banxico / Bloomberg

Graph 6. **MXN vs other EM currencies* since the start of the current rate cut cycle**
(Index 15 Aug 2019 = 100)



* Trade-weighted and liquidity weighted average based on a reweighting of the JP Morgan after taking out the MXN; own calculations
Source: BBVA Research / Bloomberg

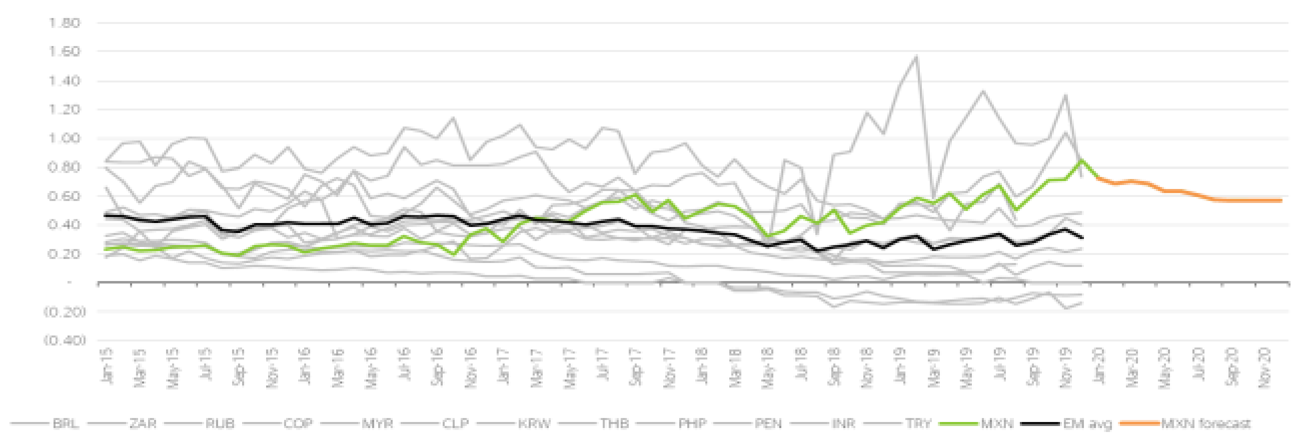
Graph 7. **Risk-adjusted carry-trade***
(Short-term interest rate spread adjusted with 1-month implicit ER volatility, %)



* Own calculations
Source: BBVA Research / Bloomberg

Looking ahead, the peso's relative performance will likely continue influenced by other factors in addition to the interest rate spread and, in principle, there is no reason to believe that the risks to the peso will rise either in absolute or relative terms compared to other emerging market currencies. Our forecasts for the monetary rate in Mexico, the federal funds rate in the US and the implicit volatility of the peso imply that the risk-adjusted carry-trade will decrease as the monetary position gradually becomes less restrictive and reaches a neutral level in August next year. However as other central banks around the emerging world will likely maintain their more accommodative monetary policies, the MXN's risk-adjusted carry-trade will likely remain higher in absolute and relative terms (see graph 8).

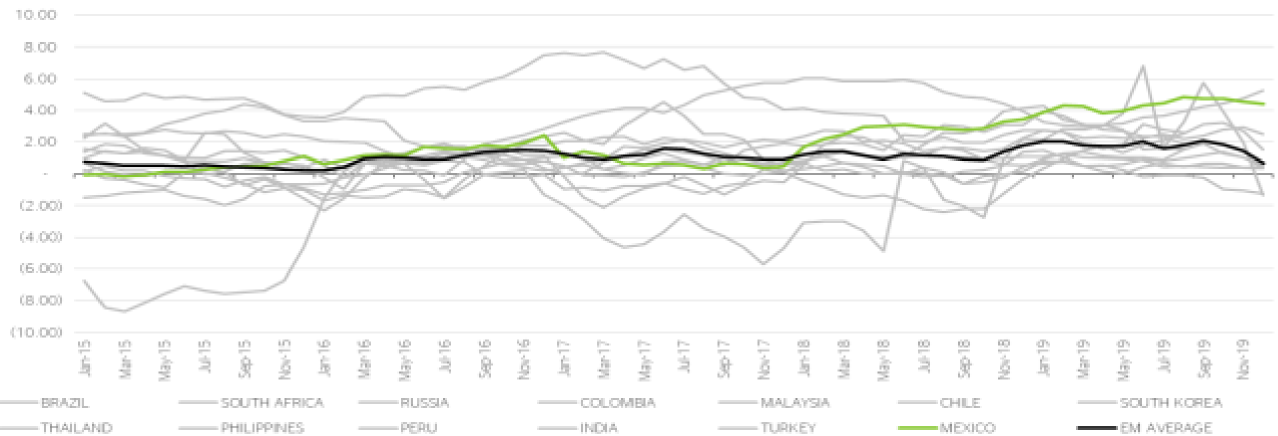
Graph 8. **Risk-adjusted carry-trade: actual and forecast***
(Monthly averages, pp)



* Based on our own fed funds, Banxico's monetary policy rate and MXN implicit volatility forecasts
Source: BBVA Research / Bloomberg

Looking ahead we anticipate that Banxico will remain excessively cautious and will not take its monetary stance to an accommodative level in 2020, as warranted by current conditions. However, we also expect the rate cut cycle to continue with no pause until August 2020, bringing the nominal monetary policy rate and the monetary stance to neutrality in the summer. Thus, we anticipate that the rate cut cycle has plenty of room to go. As can be seen in graph 9, Banxico has been much more conservative than almost all central banks around the emerging market world. In our opinion, the restrictive stance of monetary policy has become less and less justifiable in a context of well-anchored inflation expectations, lower inflation risks, with economic growth coming to a halt, with a widening output gap, and with the peso relative strength and continued outperformance. Therefore, we anticipate that Banxico will cut 25bp the monetary rate in each of the next five meetings, bringing it to 7.00% tomorrow and to 6.0% in August 2020.

Graph 9. **Real expost monetary policy rates**
(%)



* Based on our own fed funds, Banxico's monetary policy rate and MXN implicit volatility forecasts
Source: BBVA Research / Bloomberg

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