Banxico – The band gets back together with a unanimous 25bps cut

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www.banorte.com
@analisis_fundam

Gabriel Casillas
Chief Economist and Head of Research
gabriel.casillas@banorte.com

Alejandro Padilla
Executive Director of Economic Research and Financial Markets Strategy
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA
Director of Economic Research
juan.alderete.macal@banorte.com

Francisco Flores
Senior Economist, Mexico
francisco.flores.serrano@banorte.com

Fixed income and FX Strategy

Manuel Jiménez
Director of Market Strategy
manuel.jimenez@banorte.com

Santiago Leal Singer
Senior Strategist, Fixed-Income and FX
santiago.leal@banorte.com

Leslie Orozco
Strategist, Fixed Income and FX
leslie.orozco.velez@banorte.com

- **Banxico decided today to cut the reference rate by 25bps to 7.00%, in line with our call and market expectations**
- **We highlight that the decision was unanimous, a situation that had not happened since the monetary policy meeting held on May 2019**
- **In our view, the most relevant takeaway is that the tone of the communiqué was slightly less dovish than the previous statement, given that:**
  (1) All members voted for a 25bps cut, with Deputy Governor Esquivel shifting away from supporting a 50bps reduction
  (2) There was more cautiousness about the outlook for inflation, affirming more strongly that their forecasts will be revised higher in the next *Quarterly Report,* to be published on February 26th
  (3) They dropped the reference about the possibility of lower variations in the non-core component as a downward risk for prices, while stating that core inflation expectations have increased
- **Nevertheless, other factors partially offset for this, including: (1) Energy prices were changed from an upward to a downward risk for inflation, given the demand shock stemming from the coronavirus; and (2) weak economic conditions, with the statement anticipating a revision lower in GDP forecasts and stating that the output gap has widened further**
- **The statement was shortened considerably after changes in the central bank's communication strategy, which was announced earlier this week. In this context, we do not present our traditional linguistic analysis**
- **The minutes of this meeting will be released on February 27th, 2020**
- **All in all, we reiterate our view that Banxico will cut the reference rate by 25bps in each of the decisions to be held in March and May, followed by a pause for the rest of the year, with the reference rate closing 2020 at 6.50%**
- **Banxico's communiqué supports our expectations about an additional flattening of the Mbonos curve and an interesting valuation in CPI-linked Udibonos**

Banxico cuts the reference rate by 25bps, to 7.00%. As broadly expected by us and the market, the central bank cut the reference rate by 25bps for a fifth consecutive time, to 7.00%. More interestingly though, today's decision was unanimous instead of a 4-1 vote, a scenario we warned about in our preview and that had not happened since May 2019 (see table below). Particularly, Deputy Governor Gerardo Esquivel shifted his stance away from a 50bps cut, which he had favored in each of the previous four meetings. In our view, this change alone is consistent with a less dovish stance, reinforcing further the need of maintaining a prudent stance. Nevertheless, we only see a modest shift as other factors, especially in terms of the growth outlook, suggest that the easing bias remains.

Latest monetary policy decisions

Date	Decision	In favor	Against	Dissenters
May 16, 2019	Unchanged	5	0	--
Jun 27, 2019	Unchanged	4	1	G. Esquivel
Aug 15, 2019	-25bps	4	1	G. Esquivel
Sep 26, 2019	-25bps	3	2	G. Esquivel & J. Heath
Nov 14, 2019	-25bps	3	2	G. Esquivel & J. Heath
Dec 19, 2019	-25bps	4	1	G. Esquivel
Feb 17, 2020	-25bps	5	0	--

Source: Banxico

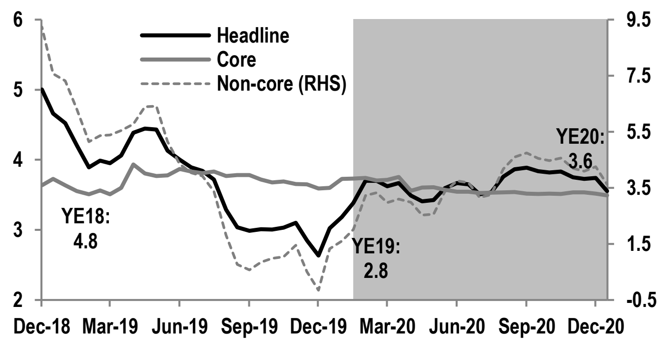
Uncertainty about inflation remains high. First, we highlight that among the reasons behind their decision they included "*…the current levels of headline inflation…*", which between November 2019 and January 2020 rose from 2.97% to 3.24% y/y. We think they signaled more forcefully that the foreseen path of inflation will be higher than their current forecasts (see table below, left). This update will be made in the next *Quarterly Report*, to be released on February 26th. Moreover, they said that, while headline inflation expectations were relatively stable, those for the core component across all tenors have increased. On the contrary, we noted that one of the risks for inflation, namely possible adjustments to energy prices, is now to the downside while in the previous decision was catalogued to the upside. This comes because of the demand shock to the oil market stemming from the coronavirus. Other risks, such as the imposition of tariffs (to the upside) and lower variations of the non-core component (to the downside) had already been eliminated in the 2020 Monetary Program, released earlier this year. We believe the former was erased because of the ratification of USMCA, while the latter, in our view, signal more confidence that agricultural goods prices at least will not fall significantly in the foreseeable future, given the shift already mentioned in terms of energy prices. This is more consistent with our view that non-core inflation will rebound in 2020, pushing headline inflation higher throughout the year (chart below, right).

Inflation forecasts
% y/y, quarterly average

	1Q20	2Q20	3Q20	4Q20
Banorte				
Headline	3.5	3.5	3.7	3.7
Core	3.7	3.6	3.5	3.6
Banxico				
Headline	3.5	3.1	3.1	3.0
Core	3.6	3.2	3.1	2.9

Source: Banxico, Banorte

2020 Inflation forecasts
% y/y, bi-weekly frequency



Source: INEGI, Banorte

Lower growth for Mexico in 2020. In line with our expectations, the Board mentioned that the outlook for global growth has worsened due to several factors of uncertainty, with an additional risk due to the coronavirus outbreak. In this context, members acknowledged that "*…economic activity in Mexico has remained stagnant for several quarters…*", impacting all sectors of aggregate demand and resulting once again in a widening of the slack in the economy (see chart below, left).

Considering this, Banxico anticipated that 2020 GDP will likely expand less relative to their current estimate, which stands between 0.8%-1.8% (mid-point: 1.3%). In this regard, our forecast remains at 0.8% (see table below), which is also below consensus at 1.0%. Overall, comments about the outlook for growth, with the balance of risks still tilted to the downside, are consistent with Banxico's dovish bias.

Output gap
% of potential GDP

* For 4Q19 we use figures from the preliminary estimate released by INEGI
Source: Banorte with data from INEGI

2020 growth estimates
% y/y

	1Q20	2Q20	3Q20	4Q20	2020
GDP	**0.9**	**0.8**	**1.0**	**0.6**	**0.8**
Private consumption	1.5	1.2	1.4	0.7	1.2
Investment	-1.0	1.1	0.9	0.1	0.3
Government spending	0.5	0.6	0.4	0.0	0.4
Exports	2.3	1.5	2.2	1.2	1.8
Imports	0.6	1.3	1.2	0.7	1.0

Source: Banorte

Changes to the communication strategy. Today's communique was drastically shorter than the one in December, coming in at 3,200 characters (previous: 6,985). In this respect, the reduction in the length of the statement is part of recent changes announced by the central bank to the way it communicates to economic agents, with the goal of being more effective. In this respect, our traditional linguistic analysis is not presented, as we believe that word-count changes could be highly misleading in the visual representation. Nevertheless, we should be able to resume it at the next meeting, as we will have more comparable statements. In addition, the quorum of the meeting was included for the first time, mentioning that all five members were present.

We reiterate our view that Banxico will continue with the easing cycle, with the reference rate at 6.50% by year-end. It is our take that the communiqué showed a slightly less dovish bias, albeit confirming our expectation that there is still some room left for continuing cutting the reference rate. Particularly, we maintain our view of two additional 25bps reductions, in March and May. We believe forthcoming adjustments to the inflation path will be skewed towards our current expectations, which incorporates a more significant impact from cost-driven pressures to consumer prices, at least in part but not exclusively, because of the recent minimum wage increases.

Nevertheless, we acknowledge a risk to our view that the effect of slack in the economy could widen further, resulting in dampened demand-side pressures and consequently inflation trending downwards. Despite of this, we believe that the central bank keeps signaling clearly that the best way to conduct monetary policy for the remainder of the easing cycle is to maintain a prudent approach, favoring stability, predictability and caution to ensure an orderly and sustained convergence of headline inflation to its target.

BANORTE

From our fixed income and FX strategy team

Banxico's communiqué supports our expectations about an additional flattening of the Mbonos curve and an interesting valuation in CPI-linked Udibonos. Market participants acknowledged a less dovish tilt inside Banxico's communiqué, stressing out a unanimous decision (in contrast with the dissenters observed in previous policy announcements) in tandem with dovish arguments about growth but a more hawkish assessment on inflation. As a result, the yield curve finished with a flattening bias, in line with our view, with long-term Mbonos rallying 2bps, while shorter tenors were modestly pressured (1bp). The market continues pricing in 3 more rate cuts in 2020, which in our view are not supported by current conditions. In this regard, the expensive valuation in short-term securities and a more appealing premium in the longest end (*e.g.* Mbono Nov'47) should result in an additional flattening. Moreover, we share Banxico's concerns about inflation dynamics. In this regard, we hold an optimistic view on the CPI-linked Udibonos curve, even though we closed recently two trade ideas considering securities Jun'22 and Nov'28 after they reached the profit taking targets. In the FX market, the Mexican peso depicted a marginal reaction to Banxico's decision, holding levels close to 18.62 per dollar (unchanged vs yesterday's close). Its performance so far in 2020 has revealed remarkably defensive *vis-á-vis* other EM crosses, outperforming its peers with a 1.6% rally. Moreover, these dynamics have emerged in spite of conditions favoring the USD, with the DXY index trading at its strongest mark since October. The peso has been benefited by its high implied carry, a factor that will remain supportive when considering today's tone and the already priced-in cuts for Banxico. This situation has been reflected in a widely long MXN positioning, according to IMM figures, and a contained implied volatility structure. We expect these dynamics to prevail for the first half of this year, experiencing higher sensibility to foreign factors in the second half. We look for new lows for USD short-term tactical longs, identifying a relevant resistance at USD/MXN 18.55.

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We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Tania Abdul Massih Jacobo, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo, Jorge Antonio Izquierdo Lobato and Eridani Ruibal Ortega, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy			
Gabriel Casillas Olvera	IRO and Chief Economist	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Economic Research and Financial Market Strategy			
Alejandro Padilla Santana	Executive Director of Economic Research and Financial Markets Strategy	alejandro.padilla@banorte.com	(55) 1103 - 4043
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251
Economic Research			
Juan Carlos Alderete Macal, CFA	Director of Economic Research	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Francisco José Flores Serrano	Senior Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Katia Celina Goya Ostos	Senior Economist, Global	katia.goya@banorte.com	(55) 1670 - 1821
Luis Leopoldo López Salinas	Economist, Global	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
Market Strategy			
Manuel Jiménez Zaldívar	Director of Market Strategy	manuel.jimenez@banorte.com	(55) 5268 - 1671
Fixed income and FX Strategy			
Santiago Leal Singer	Senior Strategist, Fixed Income and FX	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Strategist, Fixed Income and FX	leslie.orozco.velez@banorte.com	(55) 5268 - 1698
Equity Strategy			
Marissa Garza Ostos	Director of Equity Strategy	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Senior Strategist, Equity	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Senior Strategist, Equity	valentin.mendoza@banorte.com	(55) 1670 - 2250
Víctor Hugo Cortes Castro	Senior Strategist, Technical	victorh.cortes@banorte.com	(55) 1670 - 1800
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
Eridani Ruibal Ortega	Analyst	eridani.ruibal.ortega@banorte.com	(55) 1103 - 4000 x 2755
Corporate Debt			
Tania Abdul Massih Jacobo	Director of Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248
Economic Studies			
Delia María Paredes Mier	Executive Director of Economic Studies	delia.paredes@banorte.com	(55) 5268 - 1694
Miguel Alejandro Calvo Domínguez	Senior Analyst, Economic Studies	miguel.calvo@banorte.com	(55) 1670 - 2220
Wholesale Banking			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(81) 8319 - 6895
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Commercial Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454