In an emergency move, Fed cuts rates by 50bps, Banxico will follow

- **In an inter-meeting decision, the Fed has just announced a 50bps cut to the *Fed Funds* rate range, placing it at 1.00%-1.25%**
- **The central bank highlighted that despite the US economy remaining solid, coronavirus means risks to economic activity**
- **This is not the first time the Fed cuts the rate between meetings. The previous occasion was in October 2008, before the bankruptcy of Lehman Brothers**
- **Prior to the Fed's decision, the G7 published a statement in the morning explaining that they are ready to act further on timely and effective measures to address the economic impact of the coronavirus**
- **We believe the 50bps rate cut today is not the beginning of an easing cycle, but a one-off movement. However, we cannot rule out an additional 25bps cut in the FOMC's March 17-18 meeting**
- **We maintain our estimate of a 25bps reduction from Banxico in its March 26th meeting. Nevertheless, we recognize that, if conditions for the exchange rate and local markets improve, and/or if the Fed undertakes additional easing, the cut could be more aggressive, by 50bps**
- **In the aftermath of Fed´s rate cut we see greater value in the long-end of the Mbonos curve**

In an inter-meeting decision, the Fed slashed interest rates by 50bps, placing the reference rate range at 1.00%-1.25%. In the statement that accompanied the decision, the central bank explained that, although the fundamentals of the US economy remain solid, the coronavirus means risks to economic activity. They explained that in light of these risks, and in support of achieving their goals of maximum employment and price stability, they decided to cut the reference rate. They also stressed that the Committee is closely monitoring developments and its implications for the economic outlook and will use its tools and act as appropriate to support the economy.

It is not the first time that the Fed acts between scheduled meetings. The Fed has cut interest rates in previous years to face situations that considers require timely action. In fact, the release of a statement on Friday by Powell made it clear that they were ready to act. On October 8, 2008, the central bank cut the reference rate by 50bps in an inter-meeting decision, when in September of that year, the collapse of Lehman Brothers pushed markets down and increased fears of an economic recession. After that cut that placed the rate at 1.50%, on October 29th, at the scheduled meeting the central bank reduced the rate again by 50bps, placing it at 1.00%. Previously, on January 22nd of that same year, they had cut the reference rate between meetings by 75bps amid fears of an economic recession, placing it at 3.50% and then at the meeting scheduled on January 30 they lowered the rate by another 50bps.

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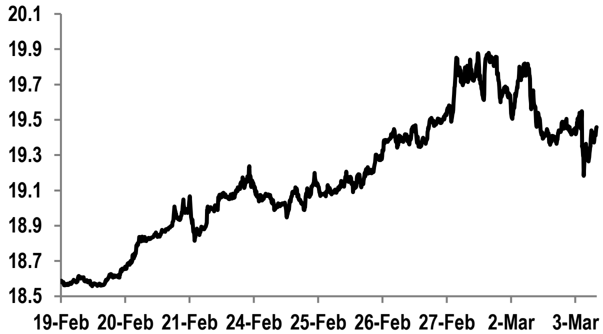
In the morning, G7 published a statement explaining that it is ready to act if necessary. The Fed's action comes after G7 published a statement in the morning after a conference call between finance ministers and governors of the group's central banks. In that statement, it was explained that they are closely monitoring the spread of the coronavirus and its impact on markets and economic conditions. They reaffirmed their commitment to use all economic policy tools to achieve sustained growth and deal with downside risks. They stressed that they are willing to use both, monetary and fiscal policy, and that they are ready to cooperate and take appropriate actions. While the markets seemed to anticipate an announcement of concrete measures, there was no statement with specific measures to be implemented, but the Fed's action hours later made it clear that the monetary authorities are ready to support growth.

We consider that it is a one-off cut. Although the previous episodes where the Fed has acted between meetings have been accompanied by new rate cuts at following decisions, this time we consider things might be different, since the situation seems to be less critical than what was experienced in 2008. Given the latter, our base scenario is that this 50bps cut will be a one-off adjustment and does not imply the beginning of an easing cycle. However, we cannot rule out a new reduction in the rate at March 18th meeting, which we consider would be of -25bps, only if the economic outlook continues to deteriorate substantially due to the impact of the virus.

We continue to expect a 25bps cut from Banxico in its March meeting. Despite the surprise cut from the Fed today, we consider that Banxico’s Board will wait until its March 26th meeting to adjust the reference rate. Even though the 50bps cut represents a relevant chance to follow with an adjustment in a similar magnitude –when taking into account the relative monetary stance–, we consider that the exchange rate will be the variable that will determine if an adjustment of the same size can be made, or a more moderate one will have to be conducted. In particular, we believe that it is possible that the Mexican peso remains pressured as appetite for safer assets remains, reflected by both the depreciation of the currency in recent days, reaching intraday highs close to 20.00 per dollar (see chart below on the left), as well as adjustments to the upside in the country’s risk premium (observed both in the differential vs. Treasuries and the CDS).

In addition, we believe that local conditions still favor a prudent stance, with recent revisions from the monetary authority to its inflation forecasts, mostly up (see table below on the right). To the latter we must add possible pressures on financial stability, including operating conditions in local financial markets (such as volatility, liquidity and depth, among others). Although we must also consider that this represents additional risks to the downside in terms of economic activity –both by external factors in terms of disruptions to global supply chains, as well as domestic shocks due to the possibility of an internal impact given greater contagion in Mexico–, we believe the factors previously laid out will weigh more heavily.

Intraday performance of the Mexican peso
USD/MXN



Source: Bloomberg

Inflation estimates
% y/y, quarterly average

	1Q20	2Q20	3Q20	4Q20
Banorte				
Headline	3.4	3.4	3.6	3.6
Core	3.7	3.5	3.5	3.5
Banxico				
Headline	3.3	3.3	3.4	3.2
Core	3.6	3.3	3.2	3.0

Source: Banxico, Banorte

Similar to the virus' evolution, there are several scenarios for Banxico's upcoming decision. As mentioned above, in our base-case we expect a 25bps cut by Banxico on March 26th, followed by a similar adjustment in the May decision, with the reference rate reaching 6.50% by year-end. This scenario assumes that the Fed stands apt on March 18th. Nevertheless, there is a high probability of a 50bps cut by the central bank if conditions improve for the exchange rate and the Mexico's risk premium. In this respect, if the Fed pulls the trigger and cuts again in its March 18th decision, a 50bps reduction by Banxico would be practically certain, thus resulting in a terminal rate for 2020 at 6.25%.

Scenarios over the next policy decision from the Fed and Banxico

	Fed (March 18th)	Banxico (March 26th)
Scenario 1 (Base case)	—	-25pb
Scenario 2	-25pb	-50pb
Scenario 3	-50pb	-50pb

Source: Banorte

From our Fixed income and FX strategy team

In the aftermath of Fed´s rate cut we see greater value in the long-end of the Mbonos curve. After the surprising Fed´s cut to counterbalance the possible impacts of Coronavirus on economic activity, the fixed-income markets were benefited. In this context, the Mbonos curve printed a 20bps rally extending gains from the previous session (-25bps). Specifically, the 10-year note reached its lowest level since October 2016 at 6.38% (-19bps). This adjustment was in line with the positive performance observed in the Treasuries curve, where securities are reaching fresh historic lows levels. Under this context, the local risk premium approximated by the spread between Mbonos and Treasuries came back to its 12-month average at 535bps after reaching its highest level since August 2019 (569bps). In strategy terms, we see greater value in the long-end of the Mbonos curve, highlighting the Nov'38 and Nov'42 securities.

Regarding the FX market, the Mexican peso reacted positively to the Fed´s announcement reaching levels of up to 19.17 per dollar, equivalent to an 1.2% appreciation, crossing down the 150- and 200-day MA, after trading at levels of 19.55 per dollar. In this year, MXN scores a 2% depreciation, still relatively defensive when considering pressures as high a 10% in BRL and ZAR. In the following days the peso´s dynamics will be determined by the expectations of the investors about the next monetary policy decision of Banco de México considering that the main driver is the attractive reference rate. In this framework, we suggest to hold cautious strategies and wait for greater clarity on the global outlook to build new positions.

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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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