US Fed aggressive actions, with Banxico following up with a prudent cut

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- **Last Sunday, the Fed cut the benchmark rate by 100bps and announced further quantitative easing**
- **In addition, the FOMC announced other support actions in order to ensure high levels of liquidity and credit availability**
- **These measures aim to boost markets confidence and reduce the negative economic impact of COVID-19**
- **In this respect, the Fed's announcements in recent days are similar to those undertaken during the 2008/2009 financial crisis**
- **Other central banks have also eased aggressively to halt the negative effects from the COVID-19 outbreak, moving towards uncharted waters**
- **In a similar fashion, Banxico has taken actions to bolster liquidity and an orderly adjustment of the market**
- **We believe the Fed is likely to maintain the reference rate unchanged at least for the rest of the year, while maintaining a strong vigilance in terms of market dynamics to provide necessary liquidity**
- **In these conditions, Banxico's next monetary policy action has become quite challenging. We now expect a 50bps rate cut on March 26th, to 6.50%. Nevertheless, we also see a relatively high probability that the central bank keeps the reference rate unchanged, depending on market conditions, especially the exchange rate**

Last Sunday, the Fed cut the benchmark rate by 100bps and announced further quantitative easing. In line with our expectations, last Sunday the Fed announced a 100bps cut in the benchmark rate range, to 0.00-0.25%. With this action, the central bank has returned the *Fed funds* to the lowest level since the end of 2015, when it began the normalization of its monetary policy. Additionally, the central bank formally restarted quantitative easing (QE). Specifically, the Fed announced that it will buy "at least" US$700 billion in assets, with up to US$500 billion in Treasury bonds and US$200 billion in agency mortgage-backed securities. At the associated press conference, Fed President Jerome Powell said that asset purchases would be carried out "over coming months." In our opinion, this last comment is intended to signal greater flexibility in terms of the pace of purchases as it deems necessary, based on market conditions. In this regard, Powell also stated that there is no cap on weekly and/or monthly purchases. The level of the interest rate on excess reserves (IOER) relative to the *Fed funds* stayed at 0.10%, as well as the differential of the interest rate on overnight reverse repos, which fell to 0.00%.

In terms of forward guidance, the FOMC said it expects to keep the benchmark rate at this level until it is confident that the economy has overcome recent events (related to the coronavirus epidemic) and is on track to meet its price stability and maximum employment goals.

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Although the economy had been strong until now, they warned that the Coronavirus will have a significant economic impact in the short term, including to local industries and external demand. In terms of inflation, they anticipate it to remain below the symmetrical target of 2% this year. It should be noted that the update of macroeconomic estimates, including the dot-plot, was not published either, and that Sunday's decision replaces the meeting scheduled for March 17-18. Jerome Powell explained that providing estimates at this time would not be useful given the uncertainty of the situation, so the next update will be until June 9-10.

Other actions taken to ensure liquidity and credit availability... In recent days, the Fed has been very active. Ahead of Sunday's announcements, the central bank cut the benchmark rate by 50bps at an unscheduled meeting on March 3rd. On the other hand, on March 11th and 12th, they announced changes to the New York Fed's repurchase operations, including: (1) An increase in the amounts in one- and fourteen-day operations, in addition to the already announced one-month offering; and (2) introduction of a weekly auction for US$500,000 million each, in one-and three-month instruments. In this context and on top of what has already been mentioned, other measures were announced with the primary objective of supporting the provision of credit to households and businesses through the financial system. Among them, we highlight:

(1) Reduction of the interest rate in the 'discount window' to 0.25%. This facility allows depositary institutions with the central bank, and the financial system in general, to access funding directly from the Fed. All loans through this mechanism must be collateralized, with three main types –primary, secondary and seasonal–, and different eligibility conditions. Specifically, primary-type loans are commonly overnight loans to depositary institutions with a fixed interest rate of 50bps above the upper limit of the *Fed Funds*. This helps market rates not to deviate much from the *Fed funds,* since these institutions have a backup source of funding market rates increase too much. Although this facility is available to a wide range of institutions (with different conditions), it is typically not used since it has a historical "stigma" attached with obtaining direct funding from the central bank, as it could signal underlying financial problems for these institutions.

In this context, the Fed reduced the interest rate in the discount window to 0.25%, thus eliminating the 50bps differential previously applied. Additionally, they called on financial institutions to use the facility in order to fill-in the demand of resources made by households and companies. They also announced that depositors at the Fed will be able to borrow for up to 90 days, with a daily option for prepayment and renewal. All of these measures seek to encourage the use of the facility and reduce the "stigma" associated with this type of funding. In this sense, yesterday eight of the largest US banks announced they would use it despite having ample funding sources and enough liquidity.

(2) *Intraday credit.* The central bank called on depository institutions to use intraday credit provided through regional banks –which can be with or without collateral– to allow for the proper functioning of the payments system and support the provision of liquidity to households and companies.

(3) *Use of capital and liquidity buffers.* The Fed stated that since the 2008/2009 crisis, banks have accumulated significant levels of capital and liquidity, above those required by regulation.

In this context, regulatory agencies have increased capital and liquidity requirements, have improved the quality of regulatory capital, and have conducted several stress tests. Considering the above, the central bank stated that*: "... it supports institutions that choose to use these capital and liquidity buffers for loans and carry out other support measures in a safe and responsible manner ...".*

(4) Reduction of reserve requirements. In measures similar to those carried out by the BoE and the ECB last week, the bank reserve requirement ratio was reduced to 0%, freeing-up additional resources that can be lent by institutions to households and businesses.

(5) Better conditions and longer tenors in currency swaps. Aiming to ensure adequate dollar funding in other parts of the world, the Fed, in coordination with other central banks (Eurozone, Canada, UK, Japan and Switzerland), announced some changes to currency swaps it offers in order to enhance the provision of US dollar liquidity. The interest rate on these instruments will decrease by 25bps, with a rate equal to the *Overnight Index Swap* plus 25bps. The foreign central banks with which these agreements were reached will begin to offer dollars in each of their jurisdictions with a term of 84 days each week, in addition to the operations currently offered with a one-week term (specifically, the latter by the BoE, BoJ, ECB and SNB).

In this context, it is important to highlight that Mexico has two unrelated swap lines with the United States, for which no measures were announced. The first is with the Fed for US$3,000 million, which has been renewed every year since it was established in 1994 under the *North America Framework Agreement* (NAFA). In parallel, it has a swap line with the US Treasury. for US$9,000 million.

...in addition to a facility to fund commercial paper unveiled today. In a statement, they announced the creation of a special-purpose vehicle (SPV) that will acquire short-term corporate debt (3-month commercial paper), called the *Commercial Paper Funding Facility* (CPFF). It should be noted that, in order for the Fed not to violate its mandate, these purchases will be backed by the Treasury Department, which offered a US$10 billion credit protection to the central bank. The Fed will then provide financing to the SPV, with its loans secured by all of the assets of the SPV. There is a possibility of increasing the amount further. Eligible bonds can be issued by US or foreign companies, as long as these are dollar-denominated with a minimum rating of A-1/P-1/F-1 under the scales of different rating agencies. Additionally, the maximum amount of bonds that the vehicle can hold from a single issuer will be determined by their maximum outstanding debt between March 16th, 2019 and March 16th, 2020. Purchases will be done until March 17th, 2021, with the possibility of an extension of the term in case is needed. Assets acquired will be held until expiration.

Actions taken to boost the market's confidence and reduce the negative impact of the Coronavirus. We believe that recent Fed actions are mainly aimed at bolstering market confidence, but they undoubtedly also seek to cushion the strong impact that the spread of the Coronavirus is having on diverse economic activities. However, we emphasize that even the most pessimistic analysts believe this is a transitory shock with a strong impact in the first half of the year and a rebound in 2H20.

While economic data in the US had been quite positive until a very few days ago, such as with the latest labor market surprising favorably, figures have finally begun to reflect the impact of the Coronavirus. On one hand, recent data related to consumer and business sentiment already show heightened concerns. On the other, the February retail sales report dropped of 0.5% m/m in total sales (but previous month's data was strongly revised upwards, from 0.3% m/m to 0.6% m/m). The control group was flat, below the 0.4% m/m increase estimated by consensus. Meanwhile, manufacturing production grew 0.1% m/m in February, after a downward adjustment to the previous month, from 0.1% m/m to 0.2%.

In this context, analysts have started to make strong adjustments to their estimates in recent days, with some even expecting the virus to take the United States to a recession in the first half of 2020. However, following this steep decline, consensus sees a strong rebound during the second half of the year. Moreover, not every analyst contemplates such a negative scenario, with several of them still seeing positive growth in 1Q20, between 0.5% -1.5% q/q saar, with the greatest effect in the second quarter and a range of estimates that go from null growth up to a 3.0% contraction.

Downward revisions in growth in other regions, specifically China, have been much more pronounced. In this respect, already known data has already turned for the worse. It should be remembered that due to the Lunar New Year holiday, figures for January and February are reported together. Nonetheless, retail sales plunged 20.5% y/y, well below the estimated decline of 4.0%. Industrial production contracted 13.5% y/y, and investment fell 24.5%. In this scenario, some analysts anticipate a 1Q20 GDP contraction of up to 8.0% y/y

For its part, ratings agency S&P expects a global recession in 2020 (two consecutive quarters of decline), with growth between 1.0% and 1.5% and risks to the downside. They highlight that data already published for China shows the economy has been impacted more than projected, although there are already some signs of stability. While, they explained that the US and the European Union are following a similar pattern, with restrictions limiting contact between people which suggests a collapse in aggregate demand.

Fed actions during the 2008/2009 crisis. After reaching a five-year high in June 2006 of 5.25%, the Fed began cutting the *Fed funds* rate in September 2007, reaching in December 2008 an unprecedent range of 0.0%-0.25%. The first hike on interest rates came only in December 2015, when the Fed increased it to a range between 0.25%-0.50%. On December 2016 the central bank hiked again by another quarter point.

In other actions, in February 2009 and after only four weeks of taking office, President Barack Obama signed an US$800 billion economic stimulus package. Additionally, the central bank engaged in quantitative easing. From November 2008 to June 2010, the Fed bought more than US$1.3 trillion dollars in mortgage-backed securities, bank debt and Treasury notes in its first *QE*. Then from November 2010 to June 2011, the Fed launched its second round of quantitative easing, the so called *QE2*, buying US$600 billion dollars in Treasury debt. In September 2012, the Fed began *QE3*, buying 40 billion dollars a month in government-backed bonds, hiked in December to US$85 billion monthly. In October 2014 and after a 10-month tapering process of reduced purchases, the Fed ended *QE3,* after adding US$1.8 trillion to its balance sheet. From September 2008 to November 2014, *QE* added US$3.6 trillion to the Fed's balance sheet, nearly 25% more than the 2.9 trillion expansion of nominal GDP over the same period. Other measures included coordinated actions with G-10 central banks to address pressures in funding markets, an expansion of the securities lending program (Term Securities Lending Facility or TSLF), among several actions and adjustments.

In Mexico, financial authorities also undertook diverse measures in the GFC. During the 2008/2009 global financial crisis, actions were taken both in the currency and fixed-income markets, aimed to quell volatility and ensure proper market functioning. Some of these measures included: (1) US dollar sales, both outright in the spot market, as well as through several rules-based mechanisms; (2) Drawing of US$3.2 billion from the emergency swap line established with the Fed, which operated between October 29th, 2008 and February 1st, 2010, with a total notional amount of US$30 billion; (3) liquidity bolstering measures, including bond exchanges to decrease duration in the market, and lower issuance amounts of longer-dated securities; (4) buybacks of IPAB bonds by the central bank, and (5) an additional liquidity window for commercial banks; among others. It should be remembered also that, during this period, the FCL with the IMF was established (April 17th, 2009) with an amount of around US$47 billion, which has not been tapped so far.

Other central banks have also eased aggressively, moving towards uncharted waters. The COVID-19 outbreak has posed a significant risk for the global economy and the performance of financial markets, forcing central banks and governments to react aggressively, similar to the 2008/2009 crisis. As depicted in the table below, in March (at least until the release of this research note) 30 central banks have reduced their key reference rates to tackle this situation, in addition to other measures to stimulate the economy (*e.g.* ECB) or to improve liquidity conditions for firms and markets via quantitative easing or other options within their toolbox (*e.g.* Federal Reserve). This policy reaction is taking place within a different context *vis-à-vis* 2008, with central banks facing nowadays limited leeway. The Coronavirus shock has come in the middle of a coordinated stimuli process. We observed 60 central banks reducing rates last year, extending this strategy during early 2020. With the recent adjustments, long-term rates are reaching historical lows, curbing the effect of traditional monetary policy in coming quarters. Starting 2008, the Fed funds rate was located at 4.25%, significantly higher than the mid part of the range of 1.625% in early 2020.

Total assets within its balance sheet were considerably lower at US$923 billion against US$4.2 trillion at the start of this year, and the slope of the yield curve (3-month *vs* 10-year) was trading at 70bps in comparison to almost flat in January. Consequently, policymakers are heading towards uncharted territory, suggesting the possibility of new ways to conduct their monetary policy and tackle the adverse economic and financial effects of Coronavirus, with the strong concern that this shock could trigger the next global recession.

Rate cuts by central banks in March
Key interest rates and changes in basis points

Country	Rate	Change in decision	Date of decision	YTD	Country	Rate	Change in decision	Date of decision	YTD
Tunisia	6.75	-100	17-Mar-20	-100	Ukraine	10.00	-100	12-Mar-20	-350
Pakistan	12.50	-75	17-Mar-20	-75	Mongolia	10.00	-100	11-Mar-20	-100
Turkey	9.75	-100	17-Mar-20	-225	Serbia	1.75	-50	11-Mar-20	-50
Armenia	5.25	-25	17-Mar-20	-25	Iceland	2.25	-50	11-Mar-20	-75
Jordan	2.50	-100	16-Mar-20	-150	UK	0.25	-50	11-Mar-20	-50
Chile	1.00	-75	16-Mar-20	-75	Mauritius	2.85	-50	10-Mar-20	-50
Egypt	9.25	-300	16-Mar-20	-300	Argentina	38.00	-200	5-Mar-20	-1700
UAE	1.25	-75	16-Mar-20	-125	Canada	1.25	-50	4-Mar-20	-50
Saudi Arabia	1.00	-75	16-Mar-20	-125	Moldova	4.50	-100	4-Mar-20	-100
Bahrain	1.00	-75	16-Mar-20	-125	Jordan	3.50	-50	4-Mar-20	-50
Qatar	2.50	-100	16-Mar-20	-175	Kuwait	2.50	-25	4-Mar-20	-25
Kuwait	1.50	-100	16-Mar-20	-125	Qatar	3.75	-75	4-Mar-20	-75
Sri Lanka	6.25	-25	16-Mar-20	-75	Macau	1.50	-50	4-Mar-20	-50
South Korea	0.75	-50	16-Mar-20	-50	Hong Kong	1.50	-50	4-Mar-20	-50
Macau	0.86	-64	16-Mar-20	-114	UAE	2.00	-50	3-Mar-20	-50
Hong Kong	0.86	-64	16-Mar-20	-114	Bahrain	1.75	-50	3-Mar-20	-50
New Zealand	0.25	-75	16-Mar-20	-75	Saudi Arabia	1.75	-50	3-Mar-20	-50
US	0.13	-100	15-Mar-20	-150	US	1.13	-50	3-Mar-20	-50
Canada	0.75	-50	13-Mar-20	-100	Malaysia	2.50	-25	3-Mar-20	-50
Norway	1.00	-50	13-Mar-20	-50	Australia	0.50	-25	3-Mar-20	-25

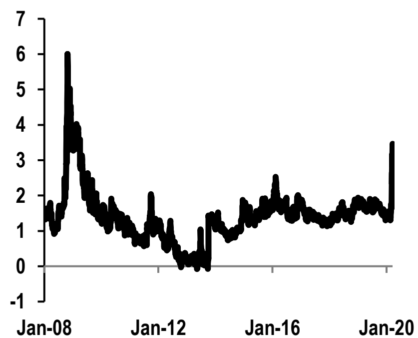
Source: Bloomberg and pages from central banks

We modify our expectation about Banxico's next policy decision, now forecasting a 50bps rate cut to 6.50%, although in a very challenging call. In this context, this would be one of the scenarios presented in our last comment, in which we mentioned that if the Fed cut rates by more than we anticipated, which effectively materialized, we would modify our base case for Banxico. As a result, we now expect a 50bps cut to 6.50% instead of -25bps previously. Despite of this, we also think that the decision has turned more complex, with a high probability that the central bank choses instead to leave the rate unchanged. In this context, the Board is highly aware of the importance of maintaining and promoting stability in financial conditions. On the other hand, a plethora of central banks have undertaken stimulus measures, the outlook for global and domestic growth has deteriorated significantly, while uncertainty about inflation remains elevated.

Regarding financial stability, there has been a considerable move higher in risk-premium metrics. Yield spreads relative to the US have seen a very significant increase, with the 10-year differential between UMS and US Treasuries from 134bps to 332bps in the last month (see chart below on the left). The 5-year CDS climbed to 231bps, highest since the 2008/2009 financial crisis (chart below, center). In the domestic market, liquidity conditions in the FX and local bond market have worsened, while the 2/10 spread in Mbonos up towards 54bps by Friday's close.

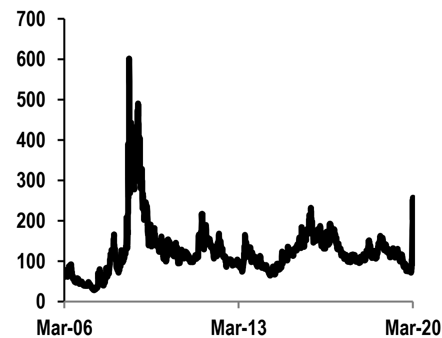
Although the implemented measures have helped, uncertainty about the magnitude and persistence of the effects from COVID-19 does not allow to rule out the need of even stronger measures. Additional to this, the sizable upward adjustment in the exchange rate reinforces the need to be very cautious, as it is hovering nearly all-time highs around 23.10 per dollar (chart below, right). This represents a 24.6% peso depreciation from it February 14th low. Despite recent evidence of a more modest pass-through effect from the exchange rate to prices, this significant shock –as well as its likely persistence– could indeed result in additional upward pressures to prices, particularly at the core level.

Spread between 10-year US Treasuries and UMS
Yield, %



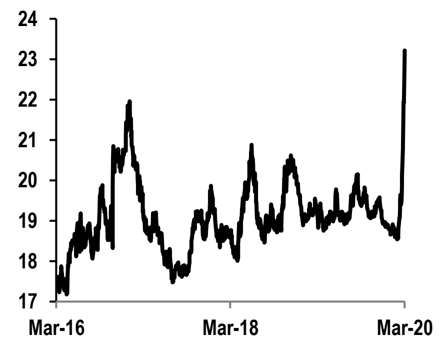
Source: Bloomberg

5-year CDS
Basis points



Source: Bloomberg

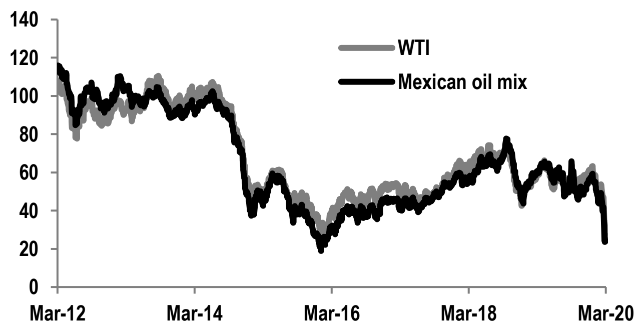
Mexican peso
USD/MXN



Source: Bloomberg

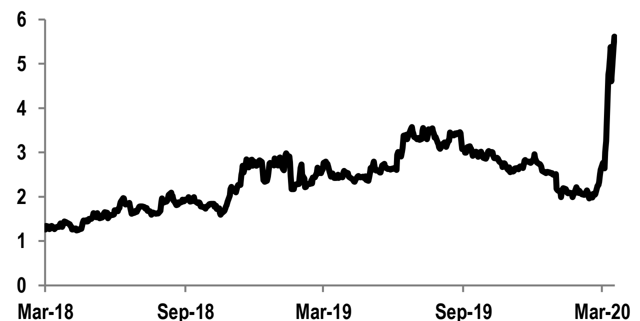
Heightened risk aversion, coupled with the shock to oil markets given the price war between Saudi Arabia and Russia, has increased risks for Pemex. Oil prices have dipped to fresh lows (see chart below on the left), while the SOE bonds have taken a significant hit, with spreads relative to sovereign bonds (chart below on the right) reflecting this situation. We believe this could also add more pressure to rating agencies to comment on Pemex. Even though it is our take that overall macroeconomic fundamentals remain strong, the latter is still an important risk for Banxico's radar, arguing to maintain a cautious and prudent stance.

WTI, Brent and Mexican oil mix
US$/bbl



Source: Bloomberg

Spread between 10-year sovereign bonds and Pemex bonds
%, bonds denominated in USD



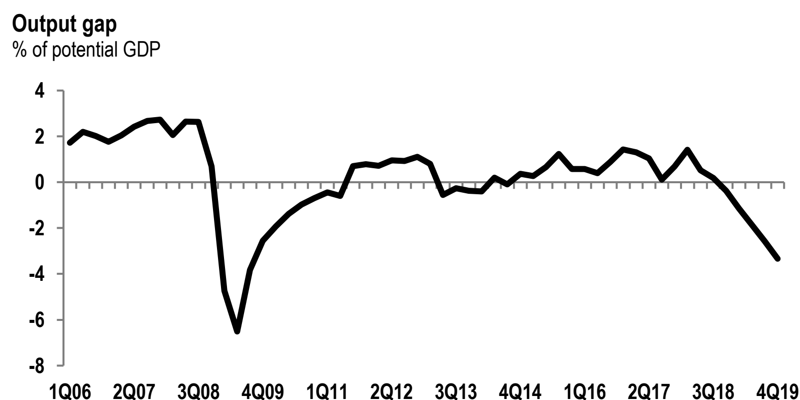
Source: Bloomberg

On the dovish side, the relative monetary stance has widened by 150bps just after the cumulative rate cuts enacted by the Fed in the past two weeks, while other central banks have also eased, as mentioned above. In our view, this is also a key driver within the Board's decision making-process, providing more room to cut, particularly if market conditions improve meaningfully from here to next week's meeting.

Nevertheless, we acknowledge it is not clear if this will be enough. In this context, Governor Díaz de León stated on Friday, in the *Mexican Bankers Association* annual meeting, that they have seen significant outflows in recent days, in line with what is observed in other countries, particularly emerging markets. He also added that while other countries have cut rates, they weren't experiencing currency shocks. In this respect, we believe it would be very relevant to see at least two developments from here for the central bank to decide for a cut in line with our expectations are: (1) A moderation in financial outflows as a result of more stable conditions in global financial markets; and (2) better operating conditions in local markets, including sufficient liquidity and depth in the currency and bond market.

Apart from other central banks, the strongest case for easing is the scenario for economic activity, which has turned more negative and with downside risks materializing quite rapidly. This is explained not only by external supply and demand shocks, but also to the mounting possibility of social distancing measures in the country, which as we saw during the A(H1N1) Influenza outbreak, can have a positive impact on stemming the spread but would take a toll on economic growth, in a context in which the output gap for the Mexican economy is estimated at the lowest since the *Financial Crisis*, even not taking into account the effect from the Coronavirus.

Output gap
% of potential GDP



Source: Banxico

On inflation, the outlook remains very uncertain. On one hand, if the depreciation of the exchange rate is persistent, we could start to see some pass-through to prices, which is still the third most important upside risk for inflation within Banxico's analysis. On top of the latter, the most recent dynamic showed a steep increase in agricultural prices, which so far and according to our monitoring, doesn't seem to have reversed. On the contrary, the decline in oil, which has resulted in lower international gasoline prices, could drive the price of this good significantly down, as observed in recent days. Representatives from the Ministry of Finance stated last week that there could be an increase in the excise tax collected for the hydrocarbon. This makes a lot of sense in the public finance front, resulting in additional income in times in which other revenues, such as income tax and VAT, could come under pressure. In addition, oil price dynamics provide room to stay consistent with the President's promise of maintaining prices constant in real terms. Nevertheless, actions in this front are still unclear.

All in all, we modify our base case, expecting now that Banxico will cut the reference rate 50bps to 6.50% (previous: -25bps). The tone of the central bank is likely to be cautious, stressing the need to watch closely for global and domestic developments regarding the virus. Recent comments from members of the Board, as well as previous statements from some of them, suggest that if more measures are needed, there also are ample tools which the central bank can deploy in order to ensure that markets remain liquid and fully functioning, such as the recent measures undertaken with NDFs, with a special auction carried out last Thursday. Nevertheless, we warn the final call will be based, to a great extent, on how market conditions evolve until the day of the decision, which is highly difficult to forecast given extreme volatility levels. In this respect, we do not rule out that Banxico opts to leave the reference rate unchanged, at least for now. Last but not least, we see a slim chance of a rate hike as in our view the central bank will continue preferring to use targeted measures to address concerns in operating conditions in the local market.

Certification of Analysts.

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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