# Banxico Minutes – A relatively prudent policy stance in a highly complex scenario

- **Banxico published the minutes of the intra-meeting decision held on March 20th, in which the central bank cut the reference rate by 50bps to 6.50%, in a majority vote**
- **Specifically, Deputy Governor Javier Guzman voted for a 25bps rate cut, as the COVID-19 pandemic has increased challenges for monetary policy, demanding its implementation in a prudent manner**
- **In our view, the tone was not particularly dovish with respect to the communiqué, as the central bank recognized a challenging and complex backdrop in which monetary policy has a limited capacity to mitigate the fall of economic activity due to the impact of the virus**
- **On growth, the balance of risks is skewed to the downside, highlighting the risk of a higher number than expected of COVID-19 infections. Domestically, they argued that despite the high degree of uncertainty, the economy was already in a weak spot and most believe a contraction of GDP in 2020 is likely**
- **Regarding inflation, the outlook is very uncertain due to several opposing forces. To the upside, the potential pass-through from the exchange rate depreciation to prices along possible scarcity of products on supply chain disruptions. To the downside, the effect of economic slack and the decline in commodity prices, particularly crude oil**
- **On monetary policy, the majority agreed that given the increase in risk premium, the relative monetary policy stance could not have a room to cut as wide as perceived**
- **We maintain our view of two additional and consecutive 50bps rate cuts, in May and June, to 5.50%, where we expect the reference rate to end the year. Nevertheless, we do not rule out another intra-meeting decision, depending on virus' and market's dynamics**
- **We hold tactical longs in 1- and 2-year TIIE-28 swaps**

**Banxico signals a prudent stance going forward.** Banco de México published the minutes of the out-of-calendar meeting held on March 20th, in which the Board cut the reference rate by 50bps to 6.50% in a majority vote (4-1). In this respect, Deputy Governor Javier Guzman favored a 25bps cut, explaining that the COVID-19 pandemic has increased challenges for monetary policy, demanding its implementation in a prudent manner given other challenges, both domestic and external. Moreover, and coupled with the decline in oil prices, inflation pressures face opposing forces, with the need that monetary policy adjusts when needed so the central bank contributes to foster orderly conditions in the domestic financial market and the exchange rate. In our view, the tone was not particularly dovish with respect to the communiqué, as the central bank recognizes a challenging and complex backdrop, in which monetary policy has a limited capacity to mitigate the fall of economic activity due to the impact of the virus.

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**Very dovish on growth.** As expected, most members said the probability of a global recession in 2020 has increased meaningfully, highlighting the risk of a higher number than expected of COVID-19 infections. Some members stated that other risks included an increase in trade tensions, geopolitical conflicts, and the US electoral process, arguing that the balance of risks for the global economy is skewed to the downside, resulting in several central banks in both advanced and emerging economies reducing interest rates. Domestically, some members said that timely information showed that the economy remained in a weak spot even before the COVID-19 pandemic hit. Moreover, several manufacturing companies suspended operations in March on supply constraints, while other travel restrictions suppose a heavy impact in services, including tourism. In this respect, the majority argued that although it is not possible to estimate precisely the impact on the economy, they can anticipate a contraction of GDP in 2020. As such, the balance of risks is considerably skewed to the downside, with economic slack conditions widening even more than previously anticipated.

**Uncertainty about inflation, with opposing factors in play.** The Board agrees with our assessment that the scenario has turned considerably more uncertain regarding prices, as there are several forces acting in tandem. To the downside, members highlighted: (1) Lower demand-side pressures given a higher degree of slack in the economy; and (2) a reduction in energy and other commodity prices, particularly gasoline. However, to the upside they noted: (1) The potential pass-through effect of the depreciation of the exchange rate to prices; and (2) the potential scarcity of some goods on the back of supply chain disruptions. In this regard, there was a heated debate among members in terms of the balance of risks, including its expectations. We consider that a broader sense of caution and prudence prevails, as estimating the potential effect and magnitude of said factors is very complicated. In this context, it is our take that factors to the downside could mostly compensate those to the upside. In the short-term, inflation is likely to fall rather quickly on the back of lower gasoline prices, while evidence of the pass-through effect is still more modest and unclear. Therefore, short-term price dynamics could favor additional easing, with the possibility of backing off as more evidence of pressure emerges later in the year, leading us to maintain our year-end forecast at 3.6%, still inside Banxico's variability range around the target.

**Fiscal policy is needed, with monetary policy limited.** We believe one of the most interesting debates was about monetary policy's potential in helping mitigate the effects of the health crisis. In this respect, "*…Most members highlighted that the policy that is the most effective in responding to the current conditions is fiscal policy…*". They argued that the capacity of monetary policy to mitigate the decline of economic activity is limited. One said that the transmission of policy through the credit channel is modest in Mexico due to low financial inclusion and in the face of supply shocks. In this sense, "*…the scope of action of monetary policy is centered on the policy rate and on fostering an orderly functioning of financial markets; however, it cannot by itself offset the real effects of the observed shocks…".*

Therefore, most members mentioned the possibility of fiscal measures to address the needs of the health sector and support the population, firms, and sectors that are most affected by the COVID-19 pandemic. Nevertheless, there are challenges in this regard, as the majority warned that: "*...the both the fall in oil prices and the lower economic growth increase fiscal accounts' vulnerability. In this context, they highlighted the importance of maintaining the sustainability of public finances...".* In this respect, several members gave their opinions on potential actions in this front, with one of them saying that "*...actions to strengthen confidence in the authorities' capacity to overcome the current situation would increase monetary policy's margin of maneuver...*".

**Financial stability will be key in future decisions.** In the minutes, the Board acknowledged a plethora of challenges our country faces in the midst of the COVID-19 outbreak and lower oil prices. We believe that the key discussions centered on market developments, the inflation outlook, the role of monetary policy, and public finances. Within the former, they noted relevant price adjustments, the increase in risk premiums, and the deterioration in operating conditions in domestic financial markets, with more focus on the exchange rate. We think that in order to tackle these issues, the central bank will maintain –or even establish new– mechanisms to quell volatility and ensure the orderly functioning of markets. In this context, we highlight the following statement, saying "*...although interest rate spreads between Mexico and the United States widened, after adjusting for FX volatility, they have in fact been narrowing...*". This is one of the key factors that make us believe the Board will keep favoring a very prudent approach. Going into public finances, there are two main topics discussed: (1) The need for fiscal action in order to support the economy in the midst of the pandemic, as explained previously, which is also important for financial stability; and (2) risks to fiscal accounts, including Pemex. On the latter, they seemed particularly cautious on the complex issue that represents the plunge in oil prices and lower economic growth to the fiscal position of both entities. In this respect, one of the risks that has materialized includes the downgrade by S&P to both the sovereign rating and Pemex. All in all, we believe the Board will give more weight to protecting macro fundamentals, given the relatively limited role of monetary policy to support growth and as they will be key given the uncertain backdrop, in which prudence and caution should help foster the latter.

**We maintain our call of two additional cuts of 50bps to 5.50%.** In our view, the magnitude of future rate decisions will be highly dependent on the behavior of three main factors: (1) Inflation; (2) growth; and (3) financial stability concerns. Given current conditions, as well as our outlook, we maintain our call of two additional 50bps rate cuts in the following two meetings (scheduled for May 14th and June 25th), taking the rate to 5.50%, followed by a pause at the same level towards year-end. Nevertheless, we do not rule out another intra-meeting decision, depending on virus' and market's dynamics. Lastly, we believe the Board could skew to provide additional accommodation given the very weak outlook for global and domestic growth going forward. The latter, coupled with the possibility of maintaining inflation within the target range, as the pass-through effect of currency depreciation to prices is also influenced by slack in the economy, which is set to increase meaningfully in coming months.

*From our Fixed income and FX strategy team*

**We hold tactical longs in 1- and 2-year TIIE-28 swaps.** The local market has depicted a mild reaction to Banxico's minutes, with investors acknowledging the factors analyzed in the previous section of this document. Consistent with this balance, the Mexican yield curve has steepened since mid-March, a condition we expect to prevail with a more defensive performance in short-term tenors. In this sense, the 2s10s spread in TIIE-28 swaps trades at 145bps, its highest level since 2016 elevating from 22bps at the end of February. Meanwhile, the yield curve is currently pricing-in 130bps of implied rate cuts for Banxico during 2020. In terms of strategy, we hold our tactical recommendation consisting of receiving 1- and 2-year TIIE-28 derivatives, a trade that has resulted in a 69bps and 64bps appreciation for each security as of this Friday.

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**We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Luis Leopoldo López Salinas, Jorge Antonio Izquierdo Lobato, Eridani Ruibal Ortega and Leslie Thalía Orozco Vélez, 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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