Banxico to cut another 175bps during the rest of the year, with the next 50bps very soon

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www.banorte.com
@analisis_fundam

Gabriel Casillas
IRO and Chief Economist
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

- **Given the current backdrop, we now expect Banxico to cut the reference rate by 175bps for the rest of 2020, to a level of 4.75% by the end of the year, instead of our previous forecast of 5.50%**
- **We continue believing the next move will be a 50bps reduction before the next scheduled meeting in May, which could happen as soon as this week**
- **A favorable combination of factors that could drive annual inflation to converge faster towards the target, an economy resenting the impact from the COVID-19 pandemic, and global central banks easing monetary conditions in an accelerated fashion, offer a window of opportunity for Banxico to act faster and more aggressively**
- **Additionally, we lower our 2020 year-end inflation forecast to 3.2% from 3.6%**

A more aggressive Banxico to the downside. Given the current backdrop, we now expect Banco de México to cut the reference rate by 175bps during the rest of the year (terminal rate: 4.75%; previous: 5.50%). Specifically, we continue expecting a 50bps reduction before the next scheduled meeting in May, although we now believe it could be as soon as this week. Despite Banxico's relatively prudent stance in the minutes of the March 20th intra-meeting decision, in which the central bank cut the reference rate by 50bps, we believe Board members fully recognize a very relevant change in the current environment. A favorable combination of factors that could drive annual inflation to converge faster towards the target (with risks of further declines), an economy resenting the impact from the COVID-19 pandemic, and global central banks easing monetary conditions in a more accelerated fashion, offer a window of opportunity for Banxico to cut more aggressively. Moreover, we believe the monetary authority will cut again, also by 50bps, in the meeting to be held in May (to 5.50%), with an additional move of -75bps in June 25th (4.75%).

Banxico's 2020 monetary policy decisions

Date	Decision
February 13	-25bps
March 20 (out-of-calendar)	-50bps
May 14	--
June 25	--
August 13	--
September 24	--
November 12	--
December 17	--

Source: Banxico

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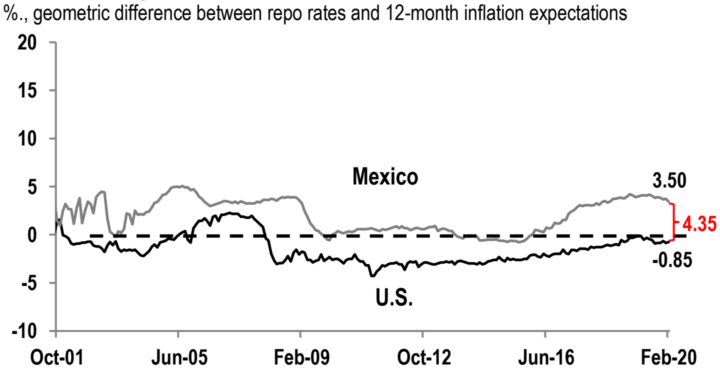
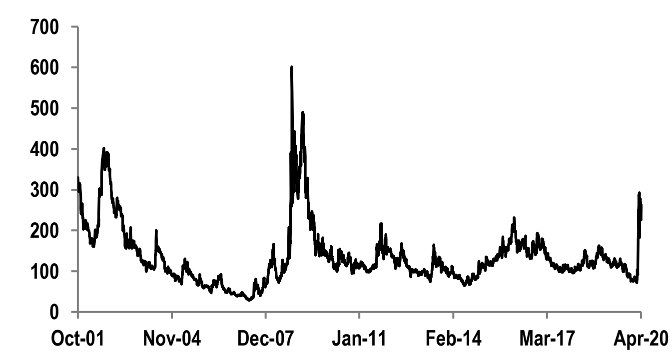
Ex ante overnight real interest rates in the US and Mexico
%., geometric difference between repo rates and 12-month inflation expectations



Source: Banorte with information from Banxico and Bloomberg

Volatility and sovereign risk premium proxied by the 5-year CDS
Basis points

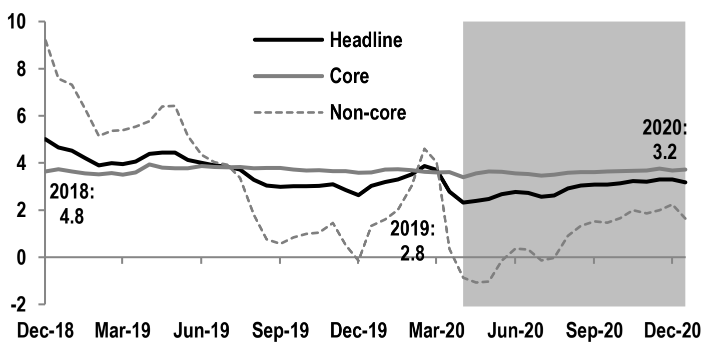


Source: Bloomberg

Forecast adjustment on the back of a changing landscape. We recognize that the accelerated speed in which local and global conditions have been changing provides additional flexibility to the central bank to act when needed, independently of the meetings scheduled in their calendar for 2020. It is also important to mention that the short-term, real rate spread between Mexico and the US, when adjusted for different levels of risk premia, provides an additional room of 175bps of cuts to prevent an additional depreciation of the currency (*i.e*. via the erosion of carry). Nonetheless, in these moments of risk aversion and unusual volatility, the latter has not been a factor as relevant as it previously was for investors.

We lower our year-end inflation forecast to 3.2% from 3.6%. In our view, there are several factors that will help inflation decline towards Banxico's target in the short term. Among them, we highlight the strong fall in gasoline prices, a likely decrease in prices for services –especially those related to tourism and airfares–, and a relatively low exchange-rate pass-through from peso depreciation to prices of goods, on the back of additional economic weakness –forcing companies to lower their profit margins when experiencing higher costs, in order to maintain their market share–. Some of these were already observed in the report for the 2H-March, with headline inflation declining to 3.25% y/y from 3.70% in February. As a result, we adjust lower our year-end inflation forecast, to 3.2% y/y from 3.6% (see chart below). Core inflation would be an inch higher, at 3.7% from 3.5%. Regarding the latter, we add pressures in goods (to 4.8%), acknowledging the pass-through effect, albeit relatively modest given the high degree of economic slack. This would only be partially compensated by services (falling to 2.5%), where we highlight significant adjustments lower in airfares (-7.0%), and tourism services (-3.1%). Specifically, we anticipate both a direct (travel restrictions) and indirect (weaker demand) impact to these industries. On the other hand, non-core inflation would dip to 1.9% from 3.6% before. Most of this would be driven by low-grade gasoline, plunging to -13.4% from a previous year-end forecast of around +3.0%, while agricultural goods –particularly meat and eggs– could see some temporary pressures due to supply chain disruptions.

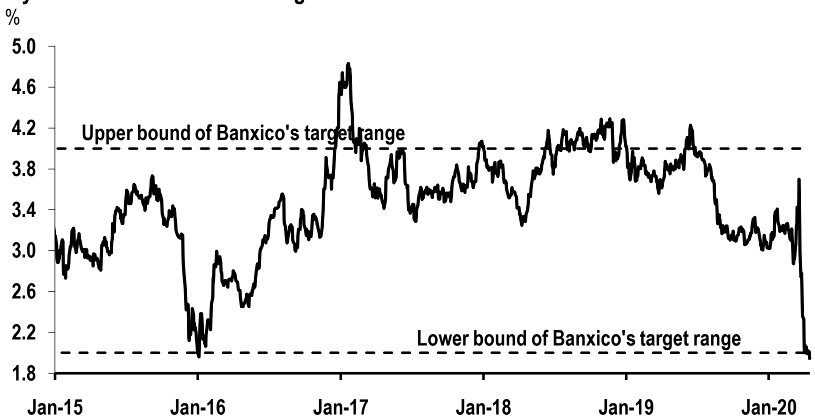
Inflation trajectory
% y/y, bi-weekly frequency



Source: INEGI, Banorte

Well-anchored inflation expectations. Current CPI dynamics have led to a decline in inflation expectations, both in analysts' surveys and in market-implied measures. In this context, the 3-year inflation breakeven (measured as the geometric difference between the Mbono and Udibono) is currently at 1.95% from 3.02% at the beginning of the year (chart below). We have also observed a strong fall of 92bps in mid-term expectations (5-year at 2.36%) and -10bps in the 10-year tenor (3.25%). The anchoring of mid- and long-term inflation expectations is another relevant factor in Banxico's reaction function, while it is considered as a signal of the success of the monetary policy transmission channel.

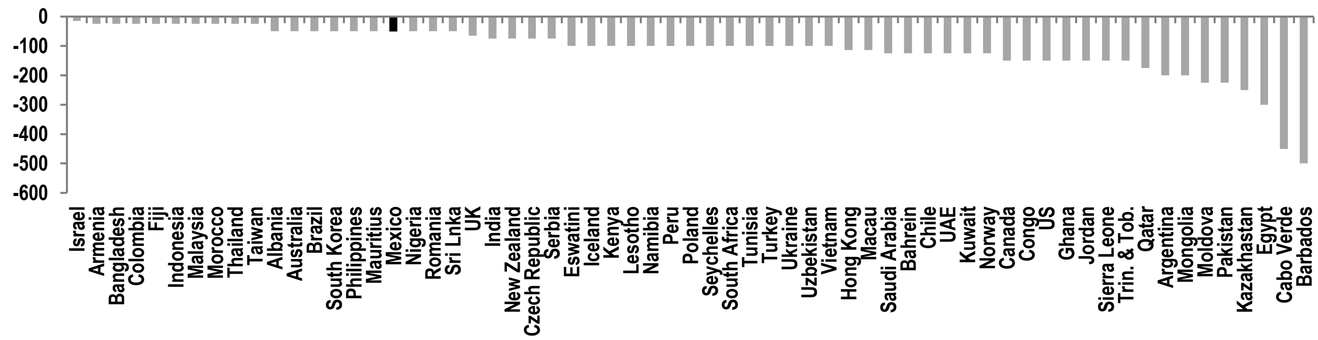
3-year breakeven inflation using MBonos & Udibonos



Source: Banorte with data from Valmer

Banxico facing the global inertia towards more easing. Another important factor for the central bank is its relative stance against the rest of the world. The COVID-19 pandemic has wreaked havoc to the global economy, to such extent that central banks and governments have unveiled unprecedented stimulus programs. In this context, since the beginning of March –when the phase of the virus' spread from China to the rest of the world started to accelerate–, 63 central banks have cut their reference rate (see chart below). They have also announced several quantitative easing programs to provide liquidity to consumers and businesses. In this respect, when comparing some emerging markets that naturally compete with Mexico in terms of capital flows, we see that Banxico's rate (both in nominal and real terms) remains as one of the most attractive, providing some leeway that other central banks do not have (table below). As a result, and even with the central bank recognizing that the room for further easing is limited and that the most efficient response is fiscal policy, it is likely that this global inertia gives the central bank a window of opportunity to continue cutting.

Accumulated reference rate cuts by central banks since March
Basis points



Source: Central Banks web pages, Bloomberg

Performance of EM currencies and reference rates

Country	Currency performance last 30 days (%)	S&P Sovereign Rating	Reference rate		Real rate
			%	Δ in 2020 (pb)	%
South Africa	-15.3	BB	4.25	-225	-0.33
Mexico	-9.9	BBB	6.50	-75	3.15
Turkey	-8.8	B	9.75	-225	-1.89
Brazil	-8.6	BB-	3.75	-75	0.44
Poland	-5.8	A-	0.50	-100	-3.92
Czech Republic	-5.3	AA-	1.00	-100	-2.32
Russia	-2.8	BBB-	6.00	-25	3.41
Chile	-2.6	A+	0.50	-125	-3.12
Malaysia	-1.4	A-	2.50	-50	1.18
South Korea	0.2	AA	0.75	-50	-0.25
Colombia	3.2	BBB-	3.75	-50	-0.11
Peru	3.6	BBB+	0.25	-200	-1.54

Source: Bloomberg

Banxico to cut as much as possible, given the current backdrop. In our view, the central bank is keenly aware of the complex conditions of the current crisis, resulting in a more challenging trade-off in terms of the adequate level of the reference rate. In this respect, we had already perceived some cautiousness among Board members in the latest minutes about the possible magnitude of the easing cycle. Given current conditions –including the relatively limited effectiveness of monetary policy to counteract the impact to growth from the COVID-19 pandemic, the outlook for inflation, and risks to financial stability and capital flows–, we estimate that Banxico has about 175bps of additional room to cut the reference rate. In this respect, we believe the monetary authority will act fast to decrease the rate by this magnitude, with the reference rate ending reaching 4.75% by mid-year. Specifically, the backdrop for both growth and inflation, along other central bank actions, provides the central bank room to move more aggressively As a result, and as mentioned above, we believe the next move will be a 50bps reduction in an intra-meeting decision which could happen as soon as this week, followed by another 50bps in the meeting to be held in May (to 5.50%), and with an additional adjustment of -75bps in June 25th (to 4.75%). Nevertheless, the outlook is highly uncertain, which will make the central bank's decisions going forward more challenging.

Policy rate actions by central banks since 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
Uzbekistan	15.00	-100	15-Apr-20	-100	Poland	1.00	-50	17-Mar-20	-50
South Africa	4.25	-100	14-Apr-20	-225	Vietnam	5.00	-100	17-Mar-20	-100
Mongolia	9.00	-100	13-Apr-20	-200	Morocco	2.00	-25	17-Mar-20	-25
Serbia	1.50	-25	09-Apr-20	-75	Tunisia	6.75	-100	17-Mar-20	-100
Poland	0.50	-50	08-Apr-20	-100	Pakistan	12.50	-75	17-Mar-20	-75
Israel	0.10	-15	06-Apr-20	-15	Turkey	9.75	-100	17-Mar-20	-225
Uganda	8.00	-100	06-Apr-20	-100	Armenia	5.25	-25	17-Mar-20	-25
Kazakhstan	9.50	-250	03-Apr-20	25	Jordan	2.50	-100	16-Mar-20	-150
Sri Lanka	6.00	-25	03-Apr-20	-100	Chile	1.00	-75	16-Mar-20	-75
Chile	0.50	-50	31-Mar-20	-125	Egypt	9.25	-300	16-Mar-20	-300
Barbados	2.00	-500	30-Mar-20	-500	UAE	1.25	-75	16-Mar-20	-125
Canada	0.25	-50	27-Mar-20	-150	Saudi Arabia	1.00	-75	16-Mar-20	-125
Colombia	3.75	-25	27-Mar-20	-75	Bahrain	1.00	-75	16-Mar-20	-125
India	4.40	-75	27-Mar-20	-75	Taste	2.50	-100	16-Mar-20	-175
Cape Verde	1.00	-450	26-Mar-20	-450	Kuwait	1.50	-100	16-Mar-20	-125
Czech Republic	1.00	-75	26-Mar-20	-100	Sri Lanka	6.25	-25	16-Mar-20	-75
Albania	0.50	-50	25-Mar-20	-50	South Korea	0.75	-50	16-Mar-20	-50
Congo	7.50	-150	24-Mar-20	-150	Macao	0.86	-64	16-Mar-20	-114
Pakistan	11.00	-150	24-Mar-20	-225	Hong Kong	0.86	-64	16-Mar-20	-114
Bangladesh	5.75	-25	24-Mar-20	-25	New Zealand	0.25	-75	16-Mar-20	-75
Lesotho	5.25	-100	23-Mar-20	-125	U.S.	0.13	-100	15-Mar-20	-150
Seychelles	4.00	-100	23-Mar-20	-100	Canada	0.75	-50	13-Mar-20	-100
Kenya	7.25	-100	23-Mar-20	-125	Norway	1.00	-50	13-Mar-20	-50
Esuatini	5.50	-100	20-Mar-20	-100	Ukraine	10.00	-100	12-Mar-20	-350
Mexico	6.50	-50	20-Mar-20	-75	Mongolia	10.00	-100	11-Mar-20	-100
Moldova	3.25	-125	20-Mar-20	-225	Serbi	1.75	-50	11-Mar-20	-50
Romania	2.00	-50	20-Mar-20	-50	Iceland	2.25	-50	11-Mar-20	-75
Namibia	5.25	-100	20-Mar-20	-125	United Kingdom	0.25	-50	11-Mar-20	-50
Thailand	0.75	-25	20-Mar-20	-50	Mauricio	2.85	-50	10-Mar-20	-50
Peru	1.25	-100	19-Mar-20	-100	Argentina	38.00	-200	05-Mar-20	-1700
Norway	0.25	-75	19-Mar-20	-125	Canada	1.25	-50	04-Mar-20	-50
Denmark	-0.60	15	19-Mar-20	15	Moldova	4.50	-100	04-Mar-20	-100
United Kingdom	0.10	-15	19-Mar-20	-65	Jordan	3.50	-50	04-Mar-20	-50
South Africa	5.25	-100	19-Mar-20	-125	Kuwait	2.50	-25	04-Mar-20	-25
Australia	0.25	-25	19-Mar-20	-50	Taste	3.75	-75	04-Mar-20	-75
Philippines	3.25	-50	19-Mar-20	-75	Macao	1.50	-50	04-Mar-20	-50
Indonesia	4.50	-25	19-Mar-20	-50	Hong Kong	1.50	-50	04-Mar-20	-50
Taiwan	1.13	-25	19-Mar-20	-25	UAE	2.00	-50	03-Mar-20	-50
Brazil	3.75	-50	18-Mar-20	-75	Bahrain	1.75	-50	03-Mar-20	-50
Ghana	14.50	-150	18-Mar-20	-150	Saudi Arabia	1.75	-50	03-Mar-20	-50
Iceland	1.75	-50	18-Mar-20	-125	U.S.	1.13	-50	03-Mar-20	-50
Fiji	0.25	-25	18-Mar-20	-25	Malaysia	2.50	-25	03-Mar-20	-50
Trinidad and Tobago	3.50	-150	17-Mar-20	-150	Australia	0.50	-25	03-Mar-20	-25

Source: Bloomberg and pages from central banks

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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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