Banxico Minutes – Rate cuts still ahead, but uncertainty still calls for caution

- **Banxico published the minutes of the intra-meeting decision held on April 21st, in which the central bank cut the reference rate by 50bps to 6.00%, in a unanimous vote**
- **As expected, we identified a dovish bias, albeit with a prudent tone. We highlight that all members coincided in implementing the ten measures announced to promote an orderly functioning of financial markets, strengthen credit channels and provide liquidity**
- **On growth, the central bank alerted that the COVID-19 pandemic is an unprecedented shock that affects both aggregate demand and supply, with the output gap expected to widen significantly to negative territory**
- **We believe discussions on inflation were very informative, with a dovish tilt at least in the short term despite a highly uncertain outlook in the medium- and long-term**
- **We believe most members still favor maintaining a prudent stance, as global and domestic conditions, including those related to financial stability risks, have changed meaningfully**
- **In our view, the tone of the document is consistent with our overall outlook. As such, we maintain our call of two additional rate cuts, of -50bps on May 14th and -75bps on Jun 25th, with the reference rate reaching 4.75% by the end of 2Q20**
- **We hold a view of an anchored short-end of the yield curve, identifying an attractive relative valuation in the Mbono May'29**

Banxico maintains a prudent stance despite its dovish tone. Banco de México published the minutes of the out-of-calendar meeting held on April 21th, in which the Board cut the reference rate by 50bps to 6.00% in a unanimous vote, in line with our expectations but differing from consensus. We also highlight that all members coincided in implementing the ten measures announced to promote an orderly functioning of financial markets, strengthen credit channels and provide liquidity. In our view, the document did not include a lot of surprises, as we observed a dovish tone albeit still prudent in terms of the best way forward for monetary policy. On growth, we saw a universally dovish tilt, with more uncertainty about inflation despite some members arguing that prices will remain contained, at least in the short term, driven by several factors. Despite of these two factors, the majority favors to stay prudent going forward, given the deterioration of risk premiums due to both external and domestic factors and other financial stability risks that limit the room to act for monetary policy. In this respect, the environment remains very challenging and uncertain, given that the pandemic is an unprecedented shock to the global economy.

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Winners of the award for best economic forecasters for Mexico in 2019, given by *Refinitiv*

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Unanimous dovishness on growth. Highlighting a further deterioration of global economic activity due to the COVID-19 outbreak, the outlook is highly negative, possibly reaching new lows since the Great Depression. In this context, they mentioned additional measures from global central banks, including additional easing as well as targeted actions to increase liquidity. In the domestic front, while data for 1Q20 was still unknown at the time of the meeting, the view had been of a steep deceleration of the first half of the year, as portrayed in the statement. In our view, this was validated by GDP figures for the first quarter as well as other timely indicators. In this sense, most members stated the shock going forward will be observed in both aggregate supply and demand, with different factors influencing each one. They remain highly uncertain about the duration of the outbreak, which in turn adds relevant risks as the impact on employment and overall potential of a recovery come into jeopardy. In this regard, the balance of risks is significantly skewed to the downside. On the output gap, the consensus is that slack is widening considerably, driving it further into negative territory.

The outlook on inflation is still uncertain, albeit turning dovish in the short term. Most recent prints show inflation has come down significantly due to lower energy prices, a fact noted within the document and expected to prevail in the short term. In this sense, the debate is still ongoing on opposing forces acting on inflation. To the downside, they highlight lower commodity prices –especially energy–, as well as lower demand-side pressures due to greater economic slack. However, to the upside the majority still stresses the possibility of the passthrough effect from the exchange rate to prices –highly dependent on the duration and magnitude of the shock, and if the depreciation is permanent–, while a few consider there could also be temporary impacts from supply chain disruptions. In this sense, uncertainty around the balance of risks for inflation has increased significantly. Nevertheless, we identified at least three members tilting more dovish, at least about the short-term outlook. In particular, one considered the possibility that downside factors will prevail has increased. Another stated that the "*...balance of risks for inflation in Mexico is clearly biased to the downside…*". Finally, and more aligned to our view, one sees a tilt to the downside in the short-term, with uncertainty in the longer run as there is still a high number of unknown variables. In this sense, we believe that conditions in coming months continue supporting the case for additional easing. Nevertheless, later in the year, we expect that a combination of more challenging base-effects, renewed pressures as activity comes back online, and the impact from exchange rate passthrough will drive inflation higher, reaching 3.2% by the end of the year.

Higher risk premium supports a prudent stance. Despite the factors mentioned above in terms of growth and inflation (mostly dovish), the majority stressed with added emphasis the importance of acting prudently, in our view. In this respect, most members noted that risk premia increased considerably, and " *…some considered that the upward adjustment in country risk indicators shows that the relative monetary policy stance does not have an ample margin, as often believed…".* One also said that the increase in capital outflows also support that said margin is not ample.

Among the issues commented, they underlined: (1) The strong depreciation of the peso exchange rate; (2) the deterioration of domestic financial markets; (3) the importance of fiscal measures but to also not jeopardize the sustainability of public finances; and (4) that "*…the adverse environment the domestic economy is facing resulting from the pandemic and lower oil prices is worsened by idiosyncratic factors…".* Regarding the latter, and as also mentioned in the statement, Banxico highlighted recent credit rating downgrade of both the sovereign and Pemex by the three major rating agencies, with more challenges to the company's financial sustainability. We only identified one member that clearly favors swift actions to cut the reference rate even below the central bank's estimate of neutrality, arguing in favor of a zero or negative real interest rate.

As a result, monetary policy will not be able by itself to solve the difficulties generated by the shocks affecting the economy, but a policy mix to cope with the pandemic is needed, including the comment by one member that "*…a set of policies aimed at fostering both an adequate environment for private investment and productivity growth are needed to boost economic growth…*". In our view, this discussion is consistent with the majority staying cautious given the combination of higher risk premia, financial stability risks and volatility, even if the outlook is tilted towards lower GDP and inflation, at least in the short-term, which supports a lower reference rate.

Consensus about the need of additional measures. On top of the 50bps rate cut, the monetary authority announced ten measures to promote an orderly functioning of financial markets, strengthen credit channels and provide liquidity. There were also comments also about the need to increase credit to MSMEs in a time of mandatory shutdowns, while liquidity measures should help financial institutions fulfil better their role as financial intermediaries. Some other comments alluded to these measures being necessary amid heightened volatility, with one member stating that "*…this extraordinary situation requires acting more boldly and far beyond the traditional schemes…*". In this sense, we believe these actions will play a key role in lowering uncertainty and are laying the groundwork for an economic recovery once the outbreak starts to diminish and social-distancing measures start to be lifted.

We continue expecting Banxico to keep cutting the reference rate in coming months. We reiterate our call of another 50bps cut in next week's scheduled meeting on May 14th, followed by a 75bps decrease on the June 25th decision. Nevertheless, considering highly changing conditions, we do not rule out another intra-meeting action, bringing forward the 75bps cut. In either scenario, this would take the reference rate to 4.75%, level where we expect it to close this year. In addition, we could see an expansion of current liquidity and credit facilities if the situation continues to deteriorate, as we believe that the central bank remains fully committed to ensuring the proper functioning and health of the financial system and the economy. In this respect, we believe differences in opinion in this regard were practically non-existent, in contrast to those regarding inflation and the potential effect of further decreases of the reference rate given risks to financial stability.

From our Fixed income and FX strategy team

We hold a view of an anchored short-end of the yield curve, identifying an attractive relative valuation in Mbono May'29. The bias in Banxico's minutes confirms our view of a short-end of the Mexican yield curve that will remain anchored given the expectation of further monetary stimulus actions from the central bank. However, we acknowledge an expensive valuation as the market is currently pricing-in 152bps of implied accumulated rate cuts during 2020, a more aggressive pricing than our expected total -125bps, estimating a terminal rate at 4.75%. Given this situation, we recommended profit taking in our trade idea of receiving the 1-year (13x1) and 2-year (26x1) TIIE IRS. Due to prevailing volatility and high degree of market uncertainty, we suggest waiting for better conditions for new directional positions.

In this context, we identify an attractive relative valuation in Mbono May'29 considering a duration-adjusted regression against the yield curve, and a risk premium analysis against other maturities. Particularly, spreads to US Treasuries depict greater space of further contraction when crossing mid-term tenors, taking into account levels at the 2- to 5-year area that are already trading below their 12-month mean and are even approaching the lower-end of this 12-month range. Additionally, we still see conditions favoring a relatively low CPI for coming months, a situation that has been reflected in the sharp cheapening of inflation breakevens throughout the year. In this sense, the 3-year mark stands at 1.98%, 104bps below last year's close. We expect Udibonos to maintain the same dynamics for the rest of the quarter, except for short-term maturities which have experienced a relevant appreciation since last week.

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Analyst Certification

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, 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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