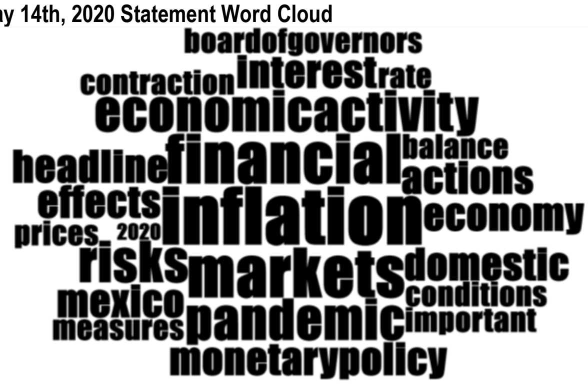
Banxico – Steady as it goes with 50bps cuts, with two more expected this year

- **Banxico decided today, in a unanimous decision, to cut the reference rate by 50bps to 5.50%, in line with our expectations and consensus**
- **We believe one of the key takeaways was the inclusion of guidance that decisions going forward will be made "…*considering the large impact on productive activity as well as the evolution of the financial shock that we are currently facing*…"**
- **Moreover, and in our view, the tone was more dovish when compared to the previous statement, given that:**
  (1) The outlook for both global and domestic growth is weaker;
  (2) The central bank acknowledged the decline in short-term inflation, despite still characterizing the balance of risks as uncertain; and
  (3) Several central banks have cut rates significantly and taken measures to improve the functioning of financial markets
- **Our linguistic analysis showed a higher importance of "*pandemic*" and the appearance of the word "*contraction*", related to economic activity. Moreover, "*inflation*" retook the place as the most mentioned word, while "*financial*" and "*markets*" maintained a high relevance**
- **We adjust our call for the rest of the year, now expecting two additional rate cuts of 50bps in the June and August meetings, taking the rate to 4.50% (previous: 4.75%). Nevertheless, we do not rule out an intra-meeting decision if global and/or domestic conditions call for it**

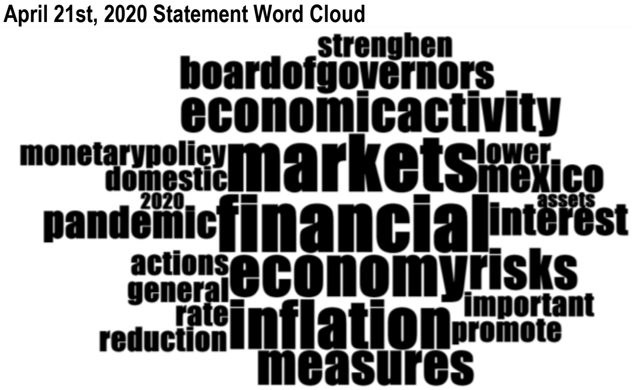
Banxico cuts the reference rate by 50bps to 5.50%. In line with our expectations and most analysts, the central bank cut the reference rate by 50bps to 5.50% in a unanimous decision. In our view, the tone was more dovish than in the previous statement but not as much as expected by the market, with some seeing at least one dissenter in favor of a more aggressive cut. Moreover, we believe one of the highlights was the inclusion of guidance that decisions will be made "*…considering the large impact on productive activity as well as the evolution of the financial shock that we are currently facing…*". We see the latter as very relevant, as it was coupled with references about the greatest contraction recorded ever of holdings of emerging economies' assets and extraordinary measures taken by advanced economies to restore financing, provide liquidity and foster the proper functioning of markets.

May 14th, 2020 Statement Word Cloud



Source: Banorte with data from Banxico

April 21st, 2020 Statement Word Cloud



Source: Banorte with data from Banxico

May 14, 2020

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Banxico's 2020 policy decisions	
Date	Decision
February 13	-25bps
March 20 (intra-meeting)	-50bps
April 21 (intra-meeting)	-50bps
May 14	-50bps
June 25	--
August 13	--
September 24	--
November 12	--
December 17	--

Source: Banxico

The relevance of the financial shock due to the COVID-19 pandemic. In our view, the inclusion of several comments about the evolution of financial markets was very relevant. These have been shocked by the COVID-19 pandemic, having also a very sizable effect on the outlook for growth and inflation, leading to "*…unprecedented revisions of economic expectations…*". Among other factors, this has also resulted in a sharp fall of commodity prices, including crude oil. Consequently, several central banks have cut interest rates significantly and taken extraordinary measures to restore financing, improve liquidity and foster the proper functioning of financial markets. Banxico has also acted in this front, with the latest being the announcement of ten additional measures on April 21st (follow link in the table to the right). Although these have contributed to a better performance of domestic financial markets, the statement makes very clear that conditions "*…will continue to be subject to the outlook for the effects of the pandemic…*". In this sense, it is our take that: (1) Board members remain very focused on global and domestic dynamics, including those in the banking sector, while standing ready to act again if these deteriorate again (including the credit channel, financial intermediation, liquidity, price discovery, etc.); and (2) easing measures by other central banks provide additional room for Banxico to keep cutting rates.

Even more dovish on global and domestic growth. On the former and consistent with our view, the Board acknowledged the unprecedented nature of the impact to economic activity, extending their concerns over the outlook throughout 2020 from only during the first half of the year previously. In the domestic front, and after recognizing the strong impact to the economy in 1Q20, attention turned to the second quarter, where they see an even worse performance. This is in line with our expectation of a 17.1% y/y contraction (-11.7% q/q), considering most of the effect from distancing measures enacted as part of the sanitary emergency did not took hold fully until April. We highlight that the Board voiced concerns over employment levels, likely related to strong losses of formal jobs in April. All in all, the balance of risks remains significantly biased to the downside, with economic slack widening further into negative territory.

Lower short-term inflation, with the balance of risks still uncertain. In our view, the tone about inflation also tilted more dovish, especially considering its recent performance and the mention of lower short-term expectations. This is relevant as they had not referenced it in the last two statements. On factors influencing the balance of risks, they stressed the widening of the output gap as a downside factor, while on the contrary, formally added supply-chain constraints on the upside. The latter was discussed in the previous minutes. Nevertheless, given recent dynamics in some components such as upward pressures in prices of processed foods, it is not surprising that they generated increased attention. We note that, despite the decline in short-term inflation, the balance of risks remains characterized as uncertain. We believe the central bank's view is largely aligned with our own, expecting short-term inflation to remain below the 3% target. Nevertheless, it has likely or is close to bottoming out, becoming increasingly uncertain later in the year. In this sense, it will be very important to analyze Banxico's updated forecasts in the *1Q20 Quarterly Report* on May 27th.

We now expect two additional 50bps cuts in their upcoming two decisions, in June and August. This would take the reference rate to 4.50%, 25bps below our previous estimate. We think the main signal from today's unanimous vote is that the Board is comfortable easing in steps of this magnitude (-50bps). On the other hand, we still believe there are limits on the total degree of easing that the central bank can deploy. As mentioned before, this is mainly due to the adjustment higher of the country's risk premium as well as other risks to financial stability. Moreover, we reiterate our view that higher volatility as we get closer to the US election will limit actions in the second half of the year, particularly in the fourth quarter. On the specific timing of these cuts, another intra-meeting decision can certainly happen, particularly when taking into account the current backdrop and added concerns on "*...the unprecedented impact on economic activity as well as* […] *the financial shock…*". In our view, additional surprises in terms of economic and market events could trigger an earlier action. On the former, we highlight very relevant publications before the decision on June 25th, including final data for 1Q20 GDP and April's industrial production and retail sales (see table below for additional details). Significantly worse data could convince the majority to bring forward what we believe are planned cuts going forward. On the latter, it should be reminded that developments about the pandemic remain mired in uncertainty. Therefore, we cannot rule out that new episodes of meaningful market stress compromise financial conditions once again, impacting risk premiums and liquidity levels, convincing the central bank to also act sooner.

Relevant economic data before the June 25th meeting

Indicator	Period	Release date	Indicator	Period	Release date
Retail sales	March	May-22	Vehicle sales	May	Jun-3
CPI	1H-May	May-22	Gross fixed investment	March	Jun-5
Trade balance	April	May-25	Vehicle production and exports	May	Jun-5
Current account	1Q20	May-25	CPI	May	Jun-9
GDP	1Q20 (F)	May-26	ANTAD's retail sales	May	Jun-10
Banxico's Quarterly Report	*1Q20*	*May-27*	Industrial production	April	Jun-11
Monetary policy minutes	*May-14*	*May-28*	Formal employment	May	Jun-12
Banking credit	April	May-29	Aggregate supply and demand	1Q20	Jun-19
Public finances	April	May-29	CPI	1H-Jun	Jun-24
Remittances	April	Jun-1	Retail sales	April	Jun-25
IMEF's PMIs	May	Jun-1	*Monetary policy decision*	*Jun-25*	*Jun-25*

Source: INEGI, Banxico, IMEF, Bloomberg

From our fixed income and FX strategy team

We see an anchored short-end of the yield curve and attractive relative value in mid-/long-term Mbonos. The local fixed income market paired the gains registered before today's decision with the Mbonos curve adjusting +3bps, after trading with a 3bps gain before Banxico, experiencing a similar performance in TIIE-28 swaps. This situation is consistent with a communiqué reflecting a prudent approach towards further stimulus, resulting in a less dovish bias with respect to market expectations. The local yield curve has recently benefited from the combination of some risk appetite stability, low CPI conditions, and recession expectations for the Mexican economy. As a consequence, Mbonos have outperformed US Treasuries, reflecting in a sharp compression in their rate differentials.

In this sense, the spread between 10-year Mbonos and Treasuries stands at 550bps from 717bps in its highest print during March. In our view, the expectation on further cuts from Banxico will hold the short-end of the local yield curve anchored, although we still see an expensive valuation for this region despite our updated terminal rate estimate now at 4.50% (from 4.75%). In terms of strategy, we see attractive relative value in the mid-/long-end of the curve, highlighting Mbono May'29. Hence, we expect the sharp steepening experienced in previous months to continue moderating.

In the FX market, the Mexican peso registered an initial positive reaction to the decision, which extended for a 1.6% d/d rally to 23.80 per dollar. These dynamics are consistent with our view of a market expectation widely pricing-in the currency's carry erosion as Banxico continues easing, but partially moderated in line with the rates' market adjustment. In the aftermath of the violent sell-off started in March, the peso has recently outlined a more stable channel under a range between USD/MXN 23.25 and 25.30 with realized volatility levels compressing remarkably, although still above readings before March. In this sense, weekly ranges have also compressed in a relevant fashion averaging 136 cents in May from 170 in April, and 238 cents in March, though still fairly distant to the 35 cents averaged in 2019. Meanwhile, the peso holds a 21.5% year-to-date deprecation, the 3rd strongest in the EM spectrum just after ZAR and BRL. In our view, MXN will hold at elevated levels, capturing the greater premiums associated with the structural factors derived from the pandemic. We still expect a volatile trajectory in the following months with a short-term performance defined by the risk appetite mood, level of global economic reopening, and the contagion curves' dynamics. Looking ahead to the 2H20 we expect new pressures linked to geopolitical risks focused in the US presidential election. We hold a cautious view for the currency, waiting for better market conditions for directional strategies.

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 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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