Banxico Minutes – Safeguarding financial stability justifies prudent easing

May 28, 2020

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

Fixed income and FX Strategy

Manuel Jiménez
Director of Market Strategy
manuel.jimenez@banorte.com

Santiago Leal Singer
Senior Strategist, Fixed-Income and FX
santiago.leal@banorte.com

Leslie Orozco
Strategist, Fixed Income and FX
leslie.orozco.velez@banorte.com

- **Banxico published the minutes of the decision held on May 14th, in which the central bank cut the reference rate by 50bps to 5.50%, in a unanimous vote**
- **The document has lost some relevance after the publication of the 1Q20 *Quarterly Report* yesterday, in which we observed a less dovish tone compared to recent communications and very relevant changes to the outlook for growth and inflation**
- **Despite of this, we identified important comments on at least three topics, with all of them relevant for their monetary policy implications, which are:**
  (1) Debate over the outlook of inflation, which remains characterized as highly uncertain;
  (2) Details about the Board's concerns over the financial shock experienced by the Mexican economy; and
  (3) Policy measures implemented to cope with the impact of COVID-19
- **In our view, most members in Banxico's Board continue favoring easing rates in a prudent manner given the complex global and domestic environment**
- **We maintain our call that the central bank will cut the reference rate by 50bps in each of the next two meetings to be held in June and August, with the reference rate reaching 4.50%, level where we expect it to maintain until year-end. Moreover, we still do not rule out another intra-meeting decision, particularly if high market stress returns**
- **Adjustment in expectations on Banxico favors our long position in real-rate securities**

Banxico minutes lose some relevance after yesterday's *Quarterly Report*. Banco de México published the minutes of the scheduled meeting held earlier this month, in which the Board cut the reference rate by 50bps to 5.50% in a unanimous vote. This surprised some market participants that expected at least one dissenter in favor of a more aggressive cut. In our view, the document has lost some of its importance after yesterday's 1Q20 *Quarterly Report* (QR). In the latter we perceived a less dovish tone and very relevant changes to the outlook for growth (significantly lower for 2020) and inflation (mostly upwards). Therefore, we focus on what we see as the most updated comments not mentioned with that level of detail previously. Among them, we identify: (1) The debate over the outlook of inflation, which remains characterized as very uncertain; (2) details about the Board's concerns over the financial shock experienced by the Mexican economy, which we saw as a very important addition in the statement; and (3) policy measures implemented to cope with the impact of COVID-19. Overall, recent information reaffirms our conviction that most members believe the best course of action is to continue the easing cycle in a prudent manner, fostering the orderly adjustment of the economy and the markets in a very uncertain backdrop.

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

STARMINE AWARDS FOR REUTERS POLLS FROM REFINITIV

The debate on inflation reveals heightened uncertainty. Yesterday, in the QR, inflation forecasts and the balance of risks were updated, including additional ones to those discussed in this meeting. Although the latter is still characterized as uncertain, we perceived a less dovish tone, mainly due to forecast revisions. In our view this tone is also observed in today's document, where we identified a rich discussion on this matter. Relative to the previous minutes, we identified more concern on risks which could push inflation to the upside. In this respect, one member stated "*...that inflation is expected to increase in the following months and that it could attain levels above Banco de México's target in the second half of the year...*". In our opinion, this echoes more closely greater concerns in the updated balance of risks, acknowledging additional shocks from the pandemic. Nevertheless, there are still calls on the contrary, as exemplified by one member stating that he/she expects it to remain below 3% over the remainder of the year, benefitted by lower energy prices. These opposed views are consistent with high uncertainty about the estimates, with a large number of moving and interrelated factors influencing the path going forward. Nevertheless, we think the QR's adjustments, which were mostly upwards, reflect the consensus view that risks to the upside could outweigh for those to the downside. As a result, we believe gradual and cautious actions will continue to be followed, notwithstanding additional data that could induce deviations from the central bank's main scenario.

Considerations about the financial shock and the role of monetary policy. As mentioned at the time of decision, we believe the inclusion of guidance that decisions going forward will be made taking into account the financial shock faced by the economy was very relevant. In this respect, we highlight that "*...most members highlighted that unprecedented capital outflows have been registered and that foreign investors have reduced their government bond holdings by over MXN 250 billion...*". This was referenced today again by Governor Díaz de León in a radio interview and resulted in a deterioration in operating conditions in financial markets, a situation that has persisted even with an improved performance in recent weeks (risk-on). As evidence, some pointed that debt and foreign exchange markets continue to show reduced depth and a shortage of liquidity and one stated it has distorted interest rates in certain nodes of the yield curve. FX has kept trading in a wide range and with high spreads and intraday volatility. Meanwhile, investors maintain a net short position in Mexico's short-term instruments through the derivatives market.

Given this backdrop, later in the document we observed one key comment about its possible implications. Most members *"...pointed out that some emerging economies that have lowered their policy rates rapidly, have suffered a depreciation of their currencies, even despite having intervened in their foreign exchange markets...*". In our view this is quite important as it provides credence to our view that a more aggressive pace of rate cuts could jeopardize an orderly adjustment of the markets, particularly if operating conditions are not ideal. Moreover, additional MXN losses remain among the most important risks to the upside for inflation.

This was reinforced by one member's comment that the adoption of a more aggressive monetary policy stance to support the recovery would imply incurring in high risks in exchange for a modest impact on activity. Another stated that although calls for more aggressive actions to ease have emerged, following a gradual strategy is essential in view of the environment of high uncertainty and the recently gained relevance of idiosyncratic factors. On the contrary, some considered that the context grants a margin to continue lowering the policy rate and that this should contribute to a more effective functioning of recently announced facilities for the provision of liquidity and credit. Overall, this situation maintains a complex and uncertain environment for monetary policy.

In our view, these comments justify the approach followed so far by the central bank, in which prudence is needed and desirable. Mexico is deeply integrated to the global economy and markets, has a high participation by non-residents in domestic assets and wide and easy accessibility by investors, among others. As a result, the central bank must account not only for the effects of its decisions not only on the economy and macro variables but also on incentives to maintain exposure to Mexican assets. In turn, this helps determine adjustments in capital flows and investors' portfolio composition, which in turn affect financial conditions and their stability.

Policy measures in the face of COVID-19. The central bank has been emphasizing this subject for a while, even devoting one of the QR's *grey boxes* to this. The discussion in the minutes is more subjective, albeit with most calling for more actions. In the monetary front, at least two members are pushing for more aggressive rate cuts as it would favor a speedier recovery of activity. In their absence, the adverse impact of the pandemic would be stronger. Nevertheless, there are also concerns from some members about the possible impact that a more aggressive approach could have, as mentioned in the previous section. Moreover, they also acknowledged that increased uncertainty could make monetary policy less effective. In this sense, we believe the tone and actual votes –even while some of them pushed for stronger cuts–, support that easing will remain gradual. Meanwhile, there were also comments on the need to deploy already announced liquidity and credit measures in a timely manner, along the need to analyze their impact to study the possibility of expanding them and/or and introducing new ones.

On the fiscal side, some relevant comments included that "*…measures to support the productive apparatus and to mitigate the effects of the pandemic have been insufficient…*". Nevertheless, the Board recognizes big challenges, including a small margin to maneuver given current public finances and Pemex's situation. However, most believe that fiscal resources need to be reassigned based on their efficiency criteria, with one suggesting "*…there are some margins for maneuver, such as the reallocation of public spending from controversial large-scale projects to priorities arisen as a result of the pandemic…*".

We continue expecting the easing cycle to extend in coming months. We still forecast two 50bps cuts in the upcoming two policy decisions (June and August), taking the reference to 4.50%, where we estimate will finish this year. Considering the Board's data dependency approach on where to end the easing cycle, our macroeconomic framework suggests it could happen relatively soon. While the economic shock will be deep and result in massive disruptions, inflation and financial risks will limit the magnitude of easing. On prices, we expect them to keep climbing in coming months, much in line with Banxico's forecasts, building up gradually on the effects from the depreciation of the exchange rate and supply shocks more than those stemming from higher slack. We believe energy prices have already bottomed-out, which would insert slight upward adjustments in this component. On financial stability, high uncertainty about the pandemic will likely maintain high volatility levels. To add to the later, the US elections continues to loom in the horizon, which has increased risk premiums in domestic assets in previous periods. However, we still think there is some uncertainty about the timing of these cuts, not ruling out another intra-meeting decision in the case of higher financial stress. Nevertheless, and as we stated yesterday, we believe the less dovish tone in both documents has modestly reduced its probability of occurring.

From our Fixed income and FX strategy team

Adjustment in expectations on Banxico favors our long position in real-rate securities. The local fixed-income market started this Thursday's session extending pressures experienced since yesterday, capturing a less dovish assessment for Banxico from market participants. In this sense, the Mbonos and TIIE-28 curves sold-off by 4bps on average, contrasting with a more defensive performance in the real-rate Udibonos curve. However, this performance has moderated as the session unfolds and the Mexican peso strengthens. Consequently, and aligning to our view of a short-end of the yield curve that appeared expensive, the market is currently pricing in accumulated -107bps of implied rate cuts for 2020 from -118bps yesterday. Meanwhile, we highlight within Banxico's most recent communications its upward revision to its inflation forecasts, a factor that favors our trade recommendation on long positions in the Udibono Nov'35 opened last Friday.

Regarding the FX market, the Mexican peso did not experience a relevant reaction to Banxico's minutes, holding a highly sensible price action to global factors with a still present risk-on sentiment. The currency is approaching the next resistance level at 22.10 per dollar (+0.9% d/d). We identify attractive levels for USD purchases below 22.20 acknowledging the possibility of reaching the next relevant figure at 22.00, although holding the expectation of further pressures and volatility in the following months.

.

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.

Relevant statements.

In accordance with current laws and internal procedures manuals, analysts are allowed to hold long or short positions in shares or securities issued by companies that are listed on the Mexican Stock Exchange and may be the subject of this report; nonetheless, equity analysts have to adhere to certain rules that regulate their participation in the market in order to prevent, among other things, the use of private information for their benefit and to avoid conflicts of interest. Analysts shall refrain from investing and holding transactions with securities or derivative instruments directly or through an intermediary person, with Securities subject to research reports, from 30 calendar days prior to the issuance date of the report in question, and up to 10 calendar days after its distribution date.

Compensation of Analysts.

Analysts' compensation is based on activities and services that are aimed at benefiting the investment clients of Casa de Bolsa Banorte and its subsidiaries. Such compensation is determined based on the general profitability of the Brokerage House and the Financial Group and on the individual performance of each analyst. However, investors should note that analysts do not receive direct payment or compensation for any specific transaction in investment banking or in other business areas.

Last-twelve-month activities of the business areas.

Grupo Financiero Banorte S.A.B. de C.V., through its business areas, provides services that include, among others, those corresponding to investment banking and corporate banking, to a large number of companies in Mexico and abroad. It may have provided, is providing or, in the future, will provide a service such as those mentioned to the companies or firms that are the subject of this report. Casa de Bolsa Banorte or its affiliates receive compensation from such corporations in consideration of the aforementioned services.

Over the course of the last twelve months, Grupo Financiero Banorte S.A.B. C.V., has not obtained compensation for services rendered by the investment bank or by any of its other business areas of the following companies or their subsidiaries, some of which could be analyzed within this report.

Activities of the business areas during the next three months.

Casa de Bolsa Banorte, Grupo Financiero Banorte or its subsidiaries expect to receive or intend to obtain revenue from the services provided by investment banking or any other of its business areas, by issuers or their subsidiaries, some of which could be analyzed in this report.

Securities holdings and other disclosures.

As of the end of last quarter, Grupo Financiero Banorte S.A.B. of C.V. has not held investments, directly or indirectly, in securities or derivative financial instruments, whose underlying securities are the subject of recommendations, representing 1% or more of its investment portfolio of outstanding securities or 1 % of the issuance or underlying of the securities issued.

None of the members of the Board of Grupo Financiero Banorte and Casa de Bolsa Banorte, along general managers and executives of an immediately below level, have any charges in the issuers that may be analyzed in this document.

The Analysts of Grupo Financiero Banorte S.A.B. of C.V. do not maintain direct investments or through an intermediary person, in the securities or derivative instruments object of this analysis report.

Guide for investment recommendations.

	Reference
BUY	When the share expected performance is greater than the MEXBOL estimated performance.
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.

Even though this document offers a general criterion of investment, we urge readers to seek advice from their own Consultants or Financial Advisors, in order to consider whether any of the values mentioned in this report are in line with their investment goals, risk and financial position.

Determination of Target Prices

For the calculation of estimated target prices for securities, analysts use a combination of methodologies generally accepted among financial analysts, including, but not limited to, multiples analysis, discounted cash flows, sum-of-the-parts or any other method that could be applicable in each specific case according to the current regulation. No guarantee can be given that the target prices calculated for the securities will be achieved by the analysts of Grupo Financiero Banorte S.A.B. C.V, since this depends on a large number of various endogenous and exogenous factors that affect the performance of the issuing company, the environment in which it performs, along with the influence of trends of the stock market, in which it is listed. Moreover, the investor must consider that the price of the securities or instruments can fluctuate against their interest and cause the partial and even total loss of the invested capital.

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
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 Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Frigolet Vázquez Vela	Head of Sólida Banorte	alejandro.frigolet.vazquezvela@banorte.com	(55) 5268 - 1656
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Carlos Alberto Arciniega Navarro	Head of Treasury Services	carlos.arciniega@banorte.com	(81) 1103 - 4091
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
Lizza Velarde Torres	Executive Director of Wholesale Banking	lizza.velarde@banorte.com	(55) 4433 - 4676
Osvaldo Brondo Menchaca	Head of Specialized Banking Services	osvaldo.brondo@banorte.com	(55) 5004 - 1423
Raúl Alejandro Arauzo Romero	Head of Transactional Banking	alejandro.arauzo@banorte.com	(55) 5261 - 4910
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