Banxico Minutes – Dovish, but with nuances about the magnitude of the easing cycle

- **Banxico published the minutes of the decision held on June 25th, in which the central bank cut the reference rate by 50bps to 5.00%, in a unanimous vote**
- **In our view, the document reaffirms the more dovish tone we observed in the statement, especially on the bias of most members regarding the outlook for inflation, despite a still uncertain balance of risks**
- **We consider that concerns about growth –coupled with the possible downward effect that high economic slack is likely to have in price dynamics– will convince most members of cutting the reference rate further**
- **While acknowledging favorable developments in financial markets, concerns remain over risks for financial conditions, both stemming from global and domestic factors**
- **Moreover, we think the most important debate was about the room left for additional cuts, with a close call between members seeing plenty of space due to economic conditions, and those considering it is more limited due to high uncertainty and the risks that it poses to financial stability**
- **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 August and September, with the reference rate reaching 4.00%, level where we expect the current easing cycle to end**
- **Local yield curve depicting a fair pricing for 2020**

Banxico minutes maintain a dovish bias, debating the room for further easing. Banco de México published the minutes of the meeting held on June 25th, in which the Board cut the reference rate by 50bps to 5.00% in a unanimous vote. In our view, the document reaffirms the more dovish tone perceived in the statement, especially about inflation despite the still uncertain balance of risks. The outlook for growth was characterized as weaker –both globally and domestically–, especially because of the evolution of the pandemic. Apart from this, we highlight the discussion on possible decisions going forward. On one hand, we perceived broad agreement that there is still room to cut the reference rate. Nevertheless, the most important part was the debate about the magnitude, which seems to be a close call. Comments from some members suggest there is still ample room, especially because of the shock to growth and its effect on prices. In contrast, others see it as more limited given the need to remain very prudent in a context of high uncertainty, with a rate that is too low potentially inducing higher financial instability. Considering these, we maintain our view of two additional 50bps cuts in this easing cycle, in August and September, with the reference rate reaching 4.00%, where we expect it to close this year.

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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	-50bps
August 13	--
September 24	--
November 12	--
December 17	--

Source: Banxico

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

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Even more deteriorated prospects for growth. In this respect, most members noted that the multilateral organizations and analysts have cut further their estimates for global GDP in 2020. Among the most important risks, they pointed out to the possibility of a "second wave" of contagion. Nevertheless, there are others, with one of the members listing among them: (1) The risk that fiscal stimulus is not enough or retired prematurely, particularly in countries with high debt levels; (2) new episodes of financial market volatility; (3) social and political unrest due to the effects of COVID-19; and (4) a resurgence of trade conflicts and the US electoral process. Given this backdrop, all members "*…made reference to the severe deterioration of economic activity in Mexico…",* pointing out to the hit on both aggregate demand and supply, along employment levels. Therefore, and even with the reopening of the economy that could help activity, the impact has already been sizable. On the other hand, it is not clear which of the scenarios presented in the Quarterly Report (QR) is favored by the majority. Nevertheless, we highlight that one of them said that a very deep recession is being observed with a slow and complex "U-shaped" recovery, and that the possibility of a second wave along insufficient support measures –with some commenting about the lack of a balanced policy response, particularly on the fiscal side– has increased the risk of a "W-shaped" recovery. As a result, the balance of risks is firmly and significantly tilted to the downside.

A more dovish tilt on inflation. As we stated at the time of the decision, it is our take that the minutes confirmed that the majority sees the outlook for inflation as more benign at the margin, despite a still uncertain balance or risks. In this respect, they also said that one relevant factor to the downside was the inclusion of the trend lower in global inflation. Among the most important conditions that support this skew include higher economic slack, more exchange rate stability, and the assumption of the financial shock staying contained. Some members remain relatively concerned about core inflation dynamics, with attention on the rise of processed foods which could be related to supply chain disruptions and higher demand due to shifting consumption patterns. Despite of the latter, we highlight dovish comments by at least four members. One stated that if more stable conditions hold true, the path for inflation would be slightly lower than in the QR. Another expected annual inflation to be close or even below Banxico's target. A third said that headline inflation has diminished since last year and that short-term expectations are around 3%, motivated by higher slack. One last member affirmed that, if additional shocks do not materialize, core inflation should reflect the effect of a more negative output gap. Overall, these details portray less concerns about the path for inflation, especially if financial volatility remains contained, based primarily on the effect of slack in prices and less global inflation.

While financial markets improved, idiosyncratic concerns remain. There were mostly favorable comments regarding the recent performance of global markets in general, including both the exchange rate and government bond yields, mostly driven by lower risk aversion. In this context, which has prevailed so far despite risks of a second wave of contagion, we saw as important the statement that "*… the spread between domestic and external interest rates may gain greater importance in offsetting idiosyncratic risks and avoiding net capital outflows…*".

Specifically, we highlight some focus on public finances, showing some caution about revenues, with some members saying that "*...public finances are expected to show a significant deterioration during the year...*", even after accounting for non-recurrent income (such as the recovery of assets held in trusts) and the use of resources from the Stabilization Fund. Moreover, Pemex was once again a key factor, as most are still concerned about its financial situation, with the attention on the possibility of further capitalization efforts by the Federal Government. In this sense, and considering the possibility of new bouts of volatility, among other factors, we believe the Board will continue prioritizing a prudent and cautions approach. Moreover, it is our take that this is particularly relevant in an environment in which some participants stated that "*...trading conditions remain deteriorated in the FX and fixed income markets...*", with a rate too low potentially exacerbating this situation, which in turn would increase risks to financial stability.

Consensus about room for more easing, albeit with uncertainty on the terminal rate. In our opinion, there is a dilemma between aggressive cuts in order to foster higher economic activity, on one hand, and maintaining a more prudent approach on the other, given uncertainty about inflation –and the need of being careful on delivering on the mandate– and possible consequences stemming from the financial shock –which has been stressed in the last two policy statements–. In this context, it seems clear that the Board's majority supports further easing, identifying at least four members supporting these. Nevertheless, nuances on individual statements still signal an ample debate on the adequate level for the terminal rate. Specifically, we identified two members showing more caution, including statements from one alluding to "*...some room to continue easing monetary policy...*", but maintaining "*...extreme caution...*". Another mentioned that "*...although there appears to be additional room to reduce the policy rate* [...] *risks are also increasing...*". In this sense, we consider these members would probably push to end the easing cycle relatively soon. On the contrary, two others seem to be skewing towards even more easing. One stated that the crisis supports a much looser policy stance, although introducing some moderation stating that "*...said room could face limitations in the future...*". The other participant –showing a much more dovish bias– said that conditions call for "*...the real interest rate to possibly be taken to levels close to zero or even negative before the end of the year...*", conditioned on complying with the inflation target. In this section, were not able to identify specific comments about the fifth member. Notwithstanding, it is our take that these comments point to a close call and debate about the magnitude of cuts to reach the most adequate of the terminal rate in this easing cycle.

We maintain our expectation of additional easing. Regarding growth, April's IGAE showed an historical decline, while indicators for May remain mixed. As mentioned, this drove the central bank to adopt a more dovish stance on growth and the balance of risks to the downside. This is broadly in line with our recent GDP revision to -9.8% y/y in 2020 and 1.8% in 2021, as the reopening of the economy has been very gradual. On the other hand, and despite signals of a more favorable view about inflation in the document, we believe conditions have turned slightly more adverse, as evidenced by today's report.

The latter, in tandem with concerns about financial stability risks –as stressed once again– will limit the total room the central bank has for easing. In this respect, we reiterate our view that the terminal rate will probably be above the historical low of 3.00% seen in 2014/2015. We think cautiousness will prevail, remembering that both external and domestic risks remain very elevated, including the possibility of a "new normal". Apart from this, we see a high likelihood of renewed volatility ahead of the US election, on November 3rd. Therefore, we maintain our estimate of two additional and consecutive 50bps cuts, in August 13th and September 24th, taking the reference rate to 4.00%, level where we expect the easing cycle to end.

From our Fixed income and FX strategy team

Local yield curve depicting a fair pricing for 2020. The Mexican fixed income market acknowledged the dovish tone in Banxico's minutes partially moderating the losses triggered by a new upward surprise in this morning's CPI report. This situation is consistent with a tone that has affirmed the space for further cuts in the benchmark rate, with the market currently pricing in -100bps of implied rate cuts for 2020. Considering our view of terminal rate for Banxico at 4.00% this year, there is little value in the short-end of the yield curve, reason why we wait for better entry levels in long positions in long-term Mbonos, securities that have experienced a stronger relative performance recently. Meanwhile, taking to account the minutes' tone regarding inflation and given the upward risks to our 2020 year-end estimate currently at 3.2%, we hold a favorable view in real-rate Udibonos for the second half of 2020.

In the FX market, the Mexican peso was mostly unchanged in the aftermath of Banxico's minutes, holding a price action dominated by global risk appetite, trading close to 22.75 per dollar (-0.20% d/d). In terms of strategy we see USD/MXN 21.50 attractive to initiate long positions in USD, while we reiterate our 2020 closing estimate at 22.00 under a cautious framework considering the wide ranges and high possibility of asymmetric price movements.

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Analyst Certification

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, Eridani Ruibal Ortega and Juan Barbier Arizmendi, 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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