Banxico Minutes – We now expect -25bps in September

- **Banxico published the minutes of the decision held on August 13th, in which the central bank cut the reference rate by 50bps to 4.50%, in a majority decision**
- **Contrary to our expectations, the document revealed that the dissenter was Deputy Governor Irene Espinosa, arguing that inflation might not have been influenced as much by economic slack, while the performance of financial flows relative to peers has been concerning**
- **In our view, the minutes showed a less dovish tone relative to the last statement and the Quarterly Report. Considering this, as well as recent comments from Board members, we now expect only a 25bps rate cut in the September 24th meeting (previous: -50bps), thus taking the reference rate to 4.25% by year-end 2020 and throughout 2021 (previous: 4.00%)**
- **In this context, we highlight discussions about the path for monetary policy going forward. We believe that consensus is for further easing; however, its magnitude and depth is still the main point of contention. In this sense, it is our view that the Board is skewing towards more moderate easing, which is one of the driving factors behind our estimate change**
- **On growth, the broad view is rather similar to yesterday's QR. Nevertheless, there was a more heated argument on inflation, albeit with a consensus view consistent with the latest central bank forecasts**
- **Meanwhile, the tone regarding macro-financial factors was rather similar to the previous minutes, recognizing recent positive developments while maintaining concerns regarding both global and domestic factors**
- **The market valuation is already pricing the end of Banxico's easing cycle**

Banxico minutes show a less dovish bias, narrowing the room for easing. Banco de México published the minutes of the meeting held on August 13th, in which the Board cut the reference rate by 50bps to 4.50%. The vote was not unanimous, with one dissenter in favor of a 25bps cut. Contrary to our expectations, this was casted by Deputy Governor Irene Espinosa. In our view, the minutes were less dovish relative to the last monetary policy statement and the 2Q20 Quarterly Report (QR), presented yesterday. Discussions on economic activity and inflation were very consistent with the QR. Meanwhile, and more important in our opinion, were the comments on the path forward for the reference rate, in which there was once again an ample discussion about the costs and benefits of additional easing. Considering the identity of the dissenter, as well as comments regarding the future path, we now expect a 25bps cut in the September 24th meeting (previous: -50bps), thus taking the reference rate to 4.25% by year-end 2020 (previous: 4.00%) and throughout 2021.

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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

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'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	-50bps
September 24	--
November 12	--
December 17	--

Source: Banxico

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The dissenter: Irene Espinosa. This was contrary to our view that the vote would come from Deputy Governor Javier Guzmán. It should be noted that the fact that the vote came from her instead of Mr. Guzmán is also one of the driving factors behind the change in our monetary policy call. Among the reasons driving Mrs. Espinosa's vote, we highlight: (1) Inflation persistently higher relative to target, with slack not having enough of an impact on price dynamics to the downside; and (2) financial outflows that have been higher relative to EM peers. In another section, we believe she also stressed that risks for the convergence of inflation towards the target are also one of the main drivers that make it more adequate to adjust the pace of easing.

Recognizing adverse growth conditions… It should be noted that, considering the release of newer forecasts in the QR on both GDP and inflation, comments on these topics matter slightly less, as more timely data is already available. However, these are still helpful to gauge overall thoughts of Board members. On activity, they acknowledged the considerable plunge of the economy in 2Q20, noting marked effects on both investment and consumption, which most members expect to remain weak going forward. They also stressed concerns about the labor market, highlighting key findings within the latest employment survey by INEGI, which despite a slight recovery, still suggests heavy job losses. Moreover, and consistent with the fact that scenarios were maintained for GDP, they stressed that uncertainty about the path of the recovery remains elevated, with some mentioning that they anticipate a slow recovery on the back of lockdown measures being lifted on a gradual manner.

…and high uncertainty for inflation. They stressed recent that upward pressures in the non-core component have been a result of the rebound in energy prices. However, there was a more detailed analysis of core prices, as goods have shown an upward trend, but services moderated strongly. These dynamics were explored further in one of the *grey boxes* in the QR. The discussion on the medium term was more important, as one member stated that "*…the risk of inflation failing to converge to the target within the forecast horizon has increased and that deviations appear to be increasingly less attributable to transitory factors…*". As mentioned, we believe this might have been made by Deputy Governor Espinosa. However, at least three other members considered the recent increase would be temporary, with the effects of the pandemic dissipating over time and showing confidence over the convergence to 3%. This is relevant given yesterday's inflation forecast maintained their timeframe for it to happen in 4Q21. Despite of the latter, and as the balance of risks remains uncertain, we still see an increased sense of data dependency, which echoed recent additions to the statement.

Despite some favorable developments, concerns remain on macro-financial factors. There were relatively small changes in this section. They acknowledged the positive performance of global markets, with exchange rate stability and lower government bond yields domestically. Some members stated that there has been a slowdown in capital outflows. Nevertheless, others continue pointing risk factors, with one member saying that "*…trading conditions remain deteriorated; that the negative balance of the net currency position continued to widen; and that outflows in fixed income instruments have accumulated over USD 15 billion so far this year…*".

We think this comment was also probably made by Deputy Governor Espinosa, as it is consistent with her overall view. Nonetheless, there were also other concerns, such as the upcoming US election and other idiosyncratic factors. There was once again a focus on public finances and Pemex. On the former, some members stated that "*...they are expected to deteriorate and that the public debt-to-GDP ratio is anticipated to increase...*". There were also additional comments on specific situations, such as the use of the Stabilization Funds and the final figures some fiscal indicators might show. On the latter, most members are still concerned about the company's financial situation, with one stressing that "*...in addition to its operational deterioration, the State- owned company will face large maturities that will probably call for an increased fiscal support...*". Considering these, it is clear to us that the Board will continue prioritizing a prudent and cautious approach.

Skew towards more modest easing, albeit still with varying opinions. On monetary policy, the debate about the best path of the reference rate was again ample. However, and unlike in the previous decision, having a dissenter clears the path for analysis. The most hawkish was Deputy Governor Espinosa, as her comments in this section in the general document were very similar to the one included in the reasons behind her dissent. However, there was also another comment showing doubts over the level of the rate and its relative position vs. neutral, given that "*...he/she considered that with a reference rate of 4.5%, the margins for additional reductions, if existent at all, would be significantly narrower...*". We believe this was from Deputy Governor Guzmán, as it is very similar to comments made in an interview he gave to the *El Economista* newspaper afterwards.

On the other side of the argument, one member stated that it is "*...important for monetary policy to continue its easing cycle, without ruling out the possibility of reaching a real interest rate close to zero or even negative...*". He went on to elaborate other benefits of a low interest rate, in our view arguing for additional –and still probably some aggressive– easing. Also taking into account a recent interview, we believe these statements correspond to Deputy Governor Gerardo Esquivel.

Finally, the remaining two comments were relatively more neutral. One participant debated the dilemma monetary policy is facing, stressing there is need to "*...identify the challenges* […] *by incorporating all available information and considering a wide range of scenarios...*". This could be suggesting a relatively more cautious stance. The last participant, while showing signals that further easing might continue, also stated that "*...the velocity at which we approach the cycle's endpoint is key to prevent premature and undesirable monetary policy reversions...*". Overall, in our view, this suggests the preference is tilting towards more modest easing.

We now expect a more modest cut of 25bps in the September 24th meeting. In particular, our estimate is now for a 25bps reduction instead of -50bps. While we had already acknowledged risks towards this scenario, relevant changes to the overall tone in the minutes and the identity of the dissenting vote –Deputy Governor Espinosa– instead of usual hawk, Deputy Governor Guzmán, convinced us for the new call. We believe a divided decision will likely take place again. In our opinion, the position of at least three members is rather clear. However, and based on our assessment of the identity behind comments from different members, it is likely that Deputy Governor Jonathan Heath might push for a 50bps cut along Deputy Governor Esquivel, with Governor Alejandro Díaz de León siding with Mrs. Espinosa and Mr. Guzmán for -25bps. With this, the reference rate would stand at 4.25%, where we expect it to remain by year-end 2020 and throughout 2021. We still believe the scenario for additional easing in the remainder of the year is complex, with the US election looming over the November decision. There are also many unknowns for 2021, leading us to expect a prudent approach from the central bank by leaving the rate unchanged. However, and considering risks for economic activity and their scenarios for inflation, among other factors, we believe risks are tilted towards more easing instead of a tighter policy stance.

From our Fixed income and FX strategy team

The market valuation is already pricing the end of Banxico's easing cycle. Dynamics in the Mexican fixed-income market this Thursday have been mainly defined by global price action assimilating the presentation of the Fed's longer-run goals in the virtual meetings of the Jackson Hole Symposium. In this sense, local reaction to Banxico's minutes has been combined with strong pressures in US Treasuries, where the curve reverted an original strengthening following a widely dovish tone from Jerome Powell, currently trading with pressures as strong as 7bps in the 30-year region. Consequently, Mbonos average a 1bp appreciation while TIIE-28 swaps appreciate 2bps in short-term securities, but adjust +1bp in longer-term tenors, with a performance parallel to the sharp reversion in the US Treasuries after a local opening that averaged a 3bps rally. Under this scene, the market prices in implied rate cuts for Banxico by -28bps for 2020, suggesting there is consensus about a rate cut cycle that will conclude shortly and is biased to our updated expectation of a terminal rate at 4.25%. This situation currently presents a fair valuation for the local yield curve and when considering a yield analysis against duration, the curve also presents unappealing deviations to structure directional strategies, for the time being. Hence, we wait for better entry levels. Moreover, we hold a view of geopolitical premiums which will be integrating greater volatility at the end of this quarter, especially considering the US presidential election, a context which we will assess for relative value positions that could offer interesting opportunities for tactical steepeners.

Regarding foreign exchange dynamics, the Mexican peso has also experienced a volatile session this Thursday, trading at 22.17 per dollar (-1.1%) having briefly breached the 21.85 technical resistance in an intraday basis. Reaction in the aftermath of the minutes was marginal, with its performance mainly steered by a USD rebound following the rates' activity.

In our view, MXN laterality (trading between 21.82 and 23.23 in the last 11 weeks) will acquire more dynamism as the US electoral process unfolds, reason why we consider appropriate USD longs when MXN approaches 21.50. In technical terms the 21.80 region is still a strong resistance, but we do not rule out short-term drivers that could feed further risk appetite or imply additional pressures for the USD, opening windows that will allow to capitalize a greater volatility space in the next weeks. Consistent with this view, the MXN at-the-money volatility curve has already depicted the first sings of factoring premiums specifically associated with the US electoral process.

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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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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
Juan Barbier Arizmendi	Analyst	juan.barbier@banorte.com	(55) 1670 - 1746
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