Banxico – Another rate cut in the apparently calm aftermath of a highly-volatile US electoral process

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- **Considering recent developments, we modify our expectation about Banxico's upcoming monetary policy meeting, which will take place on Thursday, November 12th**
- **Specifically, we now forecast a 25bps cut, taking the reference rate to 4.00% (previous: 4.25%)**
- **The adjustment responds to the following factors:**
  (1) The market reaction after the electoral process in the US;
  (2) Signals of better price dynamics in the short- and medium-term; and
  (3) Greater risks for the economic recovery in 4Q20
- **We believe this will be a difficult decision. Factoring in the latest comments form Board members, we could see at least one and even maybe two participants voting for an unchanged stance**
- **In this backdrop, we also revise our year-end estimate, now expecting it to close at 4.00%. This would imply no further action on the meeting taking place on December 17th**

We expect an additional rate cut to the reference rate. Next Thursday, Banco de México will carry out its eighth monetary policy meeting of the year. We modify our expectations, now anticipating that the monetary authority will cut the reference rate by 25bps, to 4.00% (previous: 4.25%). This adjustment responds to several recent developments, including: (1) The market reaction after the electoral process in the US; (2) signals of better price dynamics in the short- and medium-term; and (3) greater risks for the economic recovery in 4Q20. Considering comments in the latest minutes, we think the decision might be split, with at least one and even maybe two members voting for an unchanged stance. In this backdrop, we also revise our year-end estimate, now expecting it to close at 4.00%. This would imply no further action on the meeting taking place on December 17th.

Favorable reaction after the US electoral process. Specifically, the most immediate vote tally, as well as counting early Wednesday, pointed to a much closer result, favoring president Donald Trump at some point. In this context, market volatility shot higher, impacting several risky asset classes, including the Mexican peso. During Tuesday night and throughout the early morning hours of the next day, we saw a high of USD/MXN 21.98 (see chart below left). Nevertheless, with vote counting continuing in swing states, trends started to show a win from the Democratic Party candidate, Joe Biden. This led to a renewed positive performance in risky assets, a generalized USD decline and additional strength in our currency, currently close to USD/MXN 20.57. Although we still do not have a definitive result, markets are discounting that the latter candidate will be the winner.

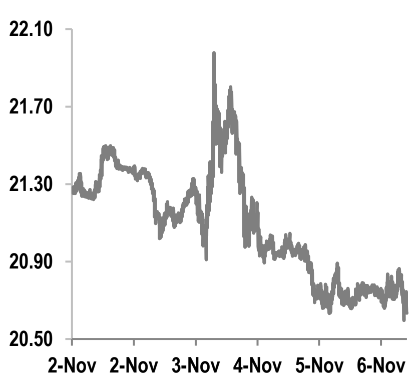
Banxico's 2020 policy decisions

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	-25bps
November 12	--
December 17	--

Source: Banxico

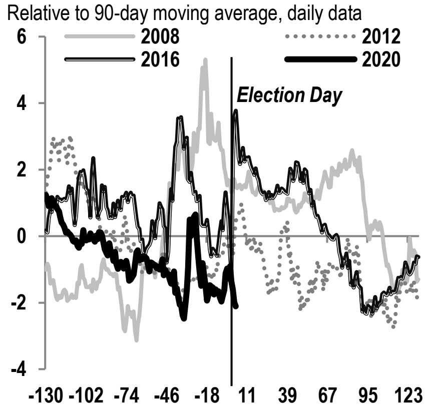
However, there is still uncertainty as President Trump has said that he will go to the courts to challenge some states' results –trying to reverse mail-in and other votes that did not benefit him–. Nonetheless, our view of more persistent volatility did not play out (charts below, middle and right). Given this market reaction, we believe the central bank will take advantage of the available room to extend the easing cycle, while simultaneously keeping a prudent stance.

Mexican peso intraday performance
USD/MXN



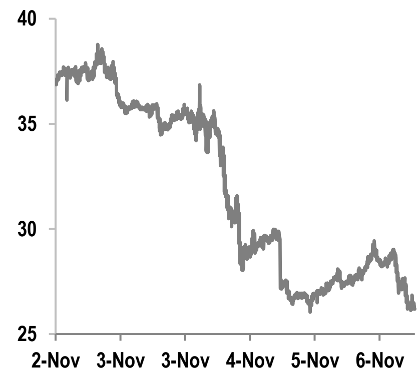
Source: Bloomberg

USD/MXN: Z-score*
Relative to 90-day moving average, daily data



Source: Bloomberg, Banorte *up means MXN depreciation

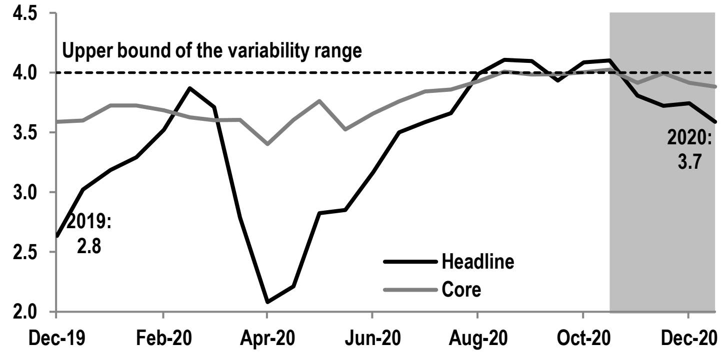
VIX intraday performance
Points



Source: Bloomberg

Outlook for inflation improving in the short- and medium-term. Although most recent dynamics have not been entirely favorable as the price index climbed to 4.09% y/y in the first half of October, a large part of the increase is due to adverse moves in the non-core component, mainly agricultural goods and energy. Meanwhile, core inflation has been more stable, hovering around 4.0% since early August. More importantly, recent signs for the latter suggest a more positive performance after strong upward pressures since the pandemic started. We highlight processed foods, which have moderated their pace of increase, currently nearing their five-year average. On the contrary, services are gaining some momentum, although still quite low (2.4% y/y) and limited by wide economic slack. At the non-core, we think LP gas could remain high. Nevertheless, our price monitoring points toward a relevant decline in gasoline prices at the start of November, with this latter effect overpowering the former. Moreover, and despite not expecting an immediate adjustment down in fruits and vegetables, their historical performance leads us to believe that in the next few months we could see a reversion lower. In the medium term, the outlook has also turned more favorable, with the rejection of some proposals within the Revenue Law which might have had an adverse effect on price dynamics. We highlight that they ruled out the implementation of an additional tariff on excise taxes for fuel, which we estimated could have increased inflation by about 50bps in the annual rate. In addition, upward adjustments on collection from the use of the radio spectrum were more modest, which should be favorable for telecommunication services within the core component.

Inflation trajectory
% y/y, bi-weekly frequency



Source: INEGI, Banorte

Risks around the pace of the economic recovery. A large part of the rebound in the immediate months after the end of the lockdown was driven by base effects, with several sectors resuming operations. Nevertheless, there are some sectors in which challenges remain high, as seen in some in the latest published figures. Specifically, we still see a strong recovery in activities related to external demand, with domestic sectors –such as consumption and investment– lagging somewhat behind. In addition, epidemiological conditions both globally and domestically have deteriorated in the last few weeks, increasing risks for a new impact on activity especially with winter nearing. Considering this backdrop, we do not rule out that the Board will look to incentivize activity, adopting a looser stance.

A complex decision for the Board. As we mentioned, the latest minutes were very clear in showing an ample debate among Board members. In particular, we identified two suggesting the end of the easing cycle, which we think were Deputy Governors Irene Espinosa and Javier Guzmán. On the contrary, two members mentioned it should continue, which we think were Deputy Governors Gerardo Esquivel and Jonathan Heath. Lastly, we Governor Alejandro Díaz de León is likely more neutral, looking at incoming data and the economic environment. Considering the abovementioned factors, it is our take that he will likely back an additional cut. Nevertheless, we do not rule out that Irene Espinosa and/or Javier Guzmán could dissent, mainly because inflation in October is likely to show that inflation has not yet reached an inflection point and that it would stand marginally above the upper bound of Banxico's variability range.

We expect the reference rate at 4.00% by year-end. Following the expected cut on Thursday, we call for Banxico to halt its easing cycle, opting to remain on hold in the decision to be held on December 17th, the last scheduled meeting of the year. With this, we estimate the *ex ante*, real short-term interest rate to fall to around 0.4%, which in our view could represent an important limit for the majority of Board members, which will probably prefer the rate to stay in positive territory. It is also our take that the cost/benefit analysis of further cuts will weigh on the decision-making process, with a more cautious outlook about the risks to financial stability. These include a potentially renewed global fragility because of the pandemic, but also several idiosyncratic risks on the horizon. Therefore, we believe that the reference rate will remain at 4.00% in 2021, even taking into account the possibility of a more dovish bias within the Board following the departure of Deputy Governor Javier Guzman on December 31st.

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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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