# Banxico – An unexpected pause in the easing cycle

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- **In a majority decision, Banxico left the reference rate unchanged at 4.25%, contrary to our expectations and consensus of a 25bps cut**
- **Only one member voted for a 25bps cut, to 4.00%. Considering this and our perception of higher concerns about inflation dynamics, we think the tone of the communique was neutral**
- **Moreover, we highlight:**
  **(1) The addition of two phrases mentioning that this pause provides the necessary room to confirm that the trajectory of inflation converges to the target; and**
  **(2) The elimination of references to productive activity and the financial shock for guiding upcoming decisions, giving more weight to upcoming information, the inflation path and its expectations**
- **In our view, all stars were aligned for a rate cut, particularly global financial conditions, including Mexican peso dynamics against the dollar after the US election and limited fiscal support to tackle the pandemic**
- **After this decision, we believe the door for additional cuts in the short term has been closed. As a result, we expect the reference rate to end this year at 4.25%, with the easing cycle resuming at some moment in 2021**
- **Flattening of local yield curve in the aftermath of Banxico's decision**

**Banxico keeps the reference rate unchanged at 4.25%.** This was contrary to our call and consensus of a 25bps cut. The decision was not unanimous, with one member agreeing with the market. We believe the stars were aligned for a rate cut (see table below), including: (1) A positive reaction in financial assets after the US election, especially the MXN; and (2) limited fiscal support to tackle the pandemic. Nevertheless, the central bank opted to give more relative weight to inflation and its expectations. Considering this, we see the tone of the statement as neutral. It is also our take that the door for additional cuts in the short term has been closed, so the reference rate will end the year at 4.25%, with the easing cycle resuming at some moment in 2021.

**Financial indicators from selected emerging economies**

| Country | Credit rating S&P | Reference rate % | Inflation y/y % | Real rate % | Currency performance (%)* 1H20 | 2H20 | CDS bps |
|---|---|---|---|---|---|---|---|
| Malaysia | A- | 1.75 | -1.40 | 3.19 | -4.5 | 3.7 | 36 |
| South Africa | BB- | 3.50 | 3.00 | 0.49 | -19.3 | 10.8 | 227 |
| South Korea | AA | 0.50 | 0.10 | 0.40 | -3.6 | 7.6 | 21 |
| Russia | BBB- | 4.25 | 4.00 | 0.24 | -12.9 | -7.8 | 81 |
| **Mexico** | **BBB** | **4.25** | **4.09** | **0.15** | **-17.7** | **11.5** | **96** |
| Colombia | BBB- | 1.75 | 1.75 | 0.00 | -12.6 | 2.9 | 95 |
| Peru | BBB+ | 0.25 | 1.72 | -1.45 | -6.5 | -2.8 | 67 |
| Turkey | B+ | 10.25 | 11.89 | -1.47 | -13.2 | -10.9 | 405 |
| Brazil | BB- | 2.00 | 3.92 | -1.85 | -26.4 | 0.1 | 177 |
| Chile | A+ | 0.50 | 2.95 | -2.38 | -8.0 | 7.5 | 53 |
| Czech Republic | AA- | 0.25 | 2.90 | -2.58 | -4.5 | 5.6 | 38 |
| Poland | A- | 0.10 | 3.00 | -2.82 | -4.2 | 4.1 | 60 |

Source: Bloomberg, Banorte *positive means appreciation against the USD

**Greater concerns on inflation.** We believe this was the deciding factor for the pause, with the document highlighting twice that this is necessary to "*…to confirm that the trajectory of inflation converges to the target…*". This responds to at least two factors. First, current dynamics suggest that inflation will exceed the central bank's estimates in 4Q20. Specifically, the 4.1% y/y print in October implies that inflation must average around 3.5% in November and December for the 3.7% forecast to materialize, which we believe is somewhat unlikely. Second, the statement clearly anticipates upward adjustments in the short-term trajectory, on top of warning about revisions of analysts' expectations. The balance of risks remained unchanged, still characterized as uncertain. Finally, we highlight that references to economic activity and the financial shock in the last section were eliminated, suggesting that inflation is firmly the most pressing concern, while reaffirming the commitment to the forecast-based inflation targeting regime.

**Banxico's 2020 policy decisions**

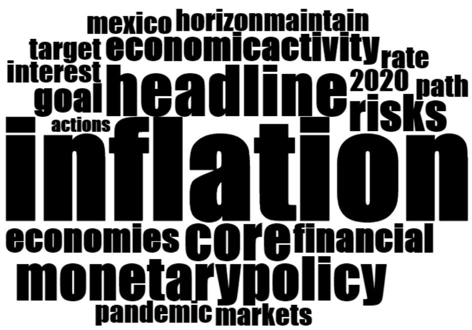
| Date | Decision |
|---|---|
| February 13 | -25bps |
| March 20 (intra-meeting) | -50bps |
| April 21 (intra-meeting) | -50bps |
| May 14 | -50bps |
| June 25 | -50bps |
| August 13 | -50bps |
| September 24 | -25bps |
| November 12 | 0bps |
| December 17 | -- |

Source: Banxico

**The economy remains very deteriorated.** The Board recognized greater risks for global growth relative to the previous statement, among them the sufficiency of fiscal stimulus and the evolution of the pandemic. This also implies higher domestic uncertainty. On Mexico, they acknowledged the recovery of activity in 3Q20, albeit still anticipating ample slack and the balance of risks skewed to the downside.

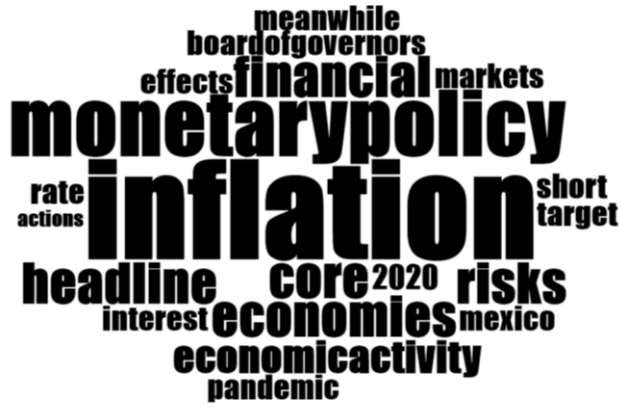
**We expect the rate to remain at 4.25% in the remainder of the year, with at least one cut in 2021.** Despite our expectations of more favorable inflation by year-end (reaching 3.7% from 4.1% currently), we believe the monetary authority will opt to extend the pause further on this easing cycle, waiting for more tangible evidence of a convergence of inflation towards the target. This concern is consistent with our linguistic analysis, in which we noted a greater relative weight of 'inflation' and words related to it such as 'headline' and 'core'. On the contrary, 'economic activity' lost relevance, while 'pandemic' was out of the most relevant (see charts below). In this backdrop, we note that previous pauses have lasted around 6 to 8 months –such as at the end of the last hiking cycle until the first cut between 2018-2019, and even in 2013 after the reduction to 4.00%–. Therefore, we believe the cycle could resume next year, with at least one additional cut of the reference rate given expectations of inflation being under control, prevailing low rates at a global scale, and the need for additional economic stimulus. Nevertheless, doubts over when this will happen and about the magnitude remain, with several factors clouding the scenario, including: (1) The new composition of the Board after Deputy Governor Javier Guzmán leaves his post at the end of the year, with the policy bias of the new member having an important role for upcoming decisions; (2) potential modifications to Banxico's inflation forecasts in the next *Quarterly Report*, to be published on November 25th; and (3) the need for more clarity over each participant's stance, so we will analyze –even more carefully than usual– comments within the minutes for this decision, which will be released on November 26th.

**November 12th, 2020 Statement Word Cloud**




Source: Banorte with data from Banxico

**September 24th, 2020 Statement Word Cloud**




Source: Banorte with data from Banxico

*From our fixed income and FX strategy team*

**Flattening of local yield curve in the aftermath of Banxico's decision.** Following today's decision, the local yield curve flattened with adjustments focused in short-term rates in a magnitude of up to 10bps vs yesterday' close for TIIE-28 swaps, also with Mbonos pairing previous gains during the day. The market was not fully pricing in a rate cut (around -10bps for 2020) reason why we expect a relatively contained adjustment in the next sessions, resuming a steepening bias as a result of a stable short-end and longer maturities sensible to the fragile global backdrop. In the FX market, USD/MXN initially trimmed intraday losses to later bounce back to 20.65 (-0.7%) in a context where we see an attractive carry supporting the cross towards the 20.30 resistance, under stronger risk-on sessions.

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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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