Banxico Minutes – We expect the easing cycle to resume in 2021

- **Banxico published the minutes of the decision held on November 12th, in which the central bank surprisingly kept the reference rate unchanged at 4.25%, in a majority decision**
- **The dissident vote was made by Deputy Governor Jonathan Heath, who argued that an additional 25bps cut would help the economic recovery, in a context in which inflation is under control**
- **In our view, the tone of the document is broadly neutral, similar to the last statement and yesterday's Quarterly Report**
- **We believe that comments about growth and inflation lost some relevance, taking into account more updated information in this regard in the report released yesterday**
- **Therefore, attention was focused again in the debate about monetary policy, with a special emphasis in the difficult backdrop for the economy and its effect on inflation dynamics**
- **We maintain our call that the reference rate will close this year at 4.25%. Moreover, we expect the easing cycle to resume sometime in 2Q21, with accumulated cuts of 50-75bps next year**
- **The local yield curve depicts an interesting valuation to receive rates from a 6-month maturity onwards, while we also see attractive relative value in long-term Mbonos**

Banxico minutes show a neutral tone. Banco de México published the minutes of the meeting held on November 12th, in which the Board surprisingly held the reference rate unchanged at 4.25%, in a majority decision. The dissenter was Deputy Governor Jonathan Heath, who called for a 25bps cut. We should also mention that comments about growth and inflation lose some relevance given the release of the 3Q20 Quarterly Report yesterday. Specially, because these include two more weeks of information, highlighting inflation for the 1st half of November (significantly below expectations) and considering the bank's data dependency. Uncertainty is still elevated, not much in terms of direction –with a clear easing bias– but on the timing for resuming the cycle. Therefore, we centered our attention on the discussion about monetary policy, in which we noted an ample debate, particularly given the difficult backdrop for the economy and its effect on inflation dynamics. Weighing all information available so far, it is our take the reference rate will end this year at 4.25%. Moreover, we expect the easing cycle to resume somewhere in 2Q21, with accumulated cuts of 50-75bps next year.

Banxico Hawk-o-meter

Source: Banorte; Images: Banxico Educa

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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	-50bps
September 24	-25bps
November 12	0bps
December 17	--

Source: Banxico

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Dissident vote by Deputy Governor Jonathan Heath. In the document, he argued that lowering the reference rate by 25bps at the meeting was necessary, along extending the easing cycle as much as possible. This would support the economic recovery, as he believes this is the main problem faced by the economy, mainly its impact on the labor market. Moreover, he mentioned that inflationary conditions currently are mostly under control, even with a slight rebound in the annual rate now (at 4.09% in October), which would allow to implement a more accommodative stance. Going forward, he also mentioned that "*…given the difficulty of implementing a greater fiscal stimulus, a more expansionary monetary policy is needed and that it should be signaled that it will remain so for a long time…".* In this environment, we believe that he will keep pushing for a easier stance in upcoming decisions.

Ample discussion about monetary policy ahead, still with diverse opinions among Board members. After identifying Deputy Governor Heath, identifying the rest is a little bit easier. Nevertheless, and contrary to what the vote count suggested at first sight, we think the Board is still somewhat split about actions going forward. In our view, the two most *hawkish* (Deputy Governors Irene Espinosa and Javier Guzman) confirmed their stance. Governor Diaz de León likely did the same, talking about the need to be data dependent. Nevertheless, we were somewhat surprised by the vote of Deputy Governor Esquivel, as we thought he was the most dovish. In this backdrop, we will detail some comments, from how we perceived them and ordered from most to less hawkish.

First, we believe the most hawkish is Irene Espinosa. In our view, she mentioned that the pause represents a prudent stance and reinforces the institution's credibility, very much in line with previous comments. She also added that "*…the decision seeks to guarantee the downward path of inflation to the target…",* which is consistent with a less accommodative stance. Moreover, she stressed that the impact of a lower interest rate could not even be that positive considering that the benefits in terms of investment, credit and consumption are limited. On the contrary, she mentioned that the costs in terms of the possibility of a volatility shock are higher.

Second, we think Deputy Governor Guzmán focused on inflation dynamics, detailing about the risks to both the headline and core. Specifically, he mentioned that "*…the possibility of inflation converging to the target within the previously forecasted period seems to fade…*". In addition, he likely said that a prudent stance is still necessary, reinforcing the institution's credibility. Nevertheless, it i sour take that he showed a slightly less hawkish bias at the margin, mentioning that this pause will depend on various factors, including the behavior of inflation, its expectations and forecasts. We believe the latter suggests that he would be willing to continue the easing cycle at some point. Nevertheless, it is likely that the time needed for this is not enough, remembering that his last scheduled decision will be on December 17th.

Governor Alejandro Díaz de León probably maintained a relatively similar view when compared to the previous decision. He elaborated again about aggregate supply and demand dynamics and its implications for the economy. Moreover, he stressed further on yield curve adjustments, arguing that a solid macroeconomic framework is needed for these to be in an orderly manner. We think this shows some concern about the market reaction and repricing in risk and inflation premiums. In this context, he mentioned that: *"…a pause would grant space to confirm the downward trajectory of headline and core inflation to the 3% target…*"

Lastly, we believe Deputy Governor Esquivel said that "*…from different perspectives, monetary easing is still insufficient and that a pause should in no way be interpreted as the end of the easing cycle…*". He stated that the ex-ante real interest rate is still high, an argument also mentioned in other public forums. Nevertheless, this time around he emphasized that "*…monetary easing should continue when inflationary pressures begin to ease…*". In our view, this suggests that he gave more weight to inflation when compared to previous decisions, consistent with voting for a pause. The rest of his comments still show concerns about economic activity, which could be enough to restart the easing cycle sooner than other more hawkish members.

We expect the easing cycle to resume in 2Q21. Considering short-term concerns about the inflation outlook and the comments made by Board members, we believe the reference rate will close this year at 4.25%. For the upcoming decision in December and given the bank's data dependency, we believe that they will wait to have more information, especially on prices. Given doubts about the dynamics because of *El Buen Fin* (Mexico's Black Friday), most members will likely be cautious to see if (and in which magnitude) the reversal of discounts materializes. This typically happens in the 1st half of December, with this data point to be published on December 23rd. As the next scheduled decision is on December 17th, we believe the door is closed to cut in said meeting.

Nevertheless, the Board's skew to continue easing is very clear. One factor that further supports that it could be relatively soon is the exit of Deputy Governor Javier Guzmán at the end of the year. Although we do not know who will replace him, it is likely that his/her stance will be relatively more dovish. Specifically, we expect the pause to end somewhere in 2Q21. Although uncertainty about this is still high, we think that available information allows to anticipate with further detail a likely path for the reference rate. Our view is supported by: (1) Information contained in today's document and the Quarterly Report; (2) the central bank's forecasted path for inflation; (3) the ample degree of economic slack; and (4) the potential shift of the Board's bias next year. Regarding the second factor, inflation would reestablish a downward trend after April 2021, after leaving behind a challenging base effect (due to the impact of the pandemic in 2020). In this context, it is likely that inflation will return to target before the quarter ends (see table below). About the magnitude, we estimate accumulated rate cuts in 2021 between 50-75bps. In this regard, comments about the ex ante real rate were very insightful to approximate the terminal rate.

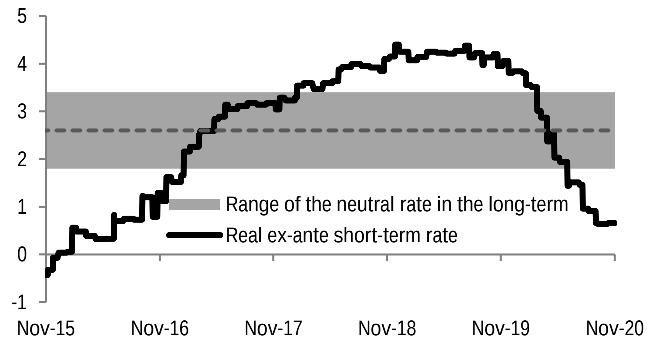
Currently, this rate stands at 0.66% –with the reference rate at 4.25% and 12-month inflation expectations of 3.59%, see chart below–. Assuming most members would prefer this rate to stay close to zero, the available room would be in the abovementioned range (as it will ultimately depend on inflation expectations at that time). Lastly, regarding the pace of cuts, we believe it will be maintained at steps of 25bps, consistent with the central bank's prudent stance and the data dependency that they are looking for, with this strategy providing them with flexibility to implement and adjust monetary policy as required.

Banxico: Inflation forecasts
% y/y, quarterly average

	2020	2021			
	IV	I	II	III	IV
CPI					
Current	3.6	3.6	4.3	3.1	3.3
Previous	3.7	3.6	4.2	3.1	2.9
Difference (bps)	-10	0	10	0	40
Core					
Current	3.8	3.9	3.6	3.0	3.1
Previous	3.8	3.8	3.5	3.0	2.8
Difference (bps)	0	10	10	0	30

Source: Banxico 3Q20 Quarterly Report

Real ex-ante short-term rate
%



Note: Calculated using the reference rate and 12-month ahead inflation expectations
Source: Banxico.

From our Fixed income and FX strategy team

The local yield curve depicts an interesting valuation to receive rates from a 6-month maturity onwards, while we also see attractive relative value in long-term Mbonos. Following the last monetary policy decision on November 12th, the local fixed-income market has eased the initial correction after the rate was left unchanged at 4.25%, contrary to market expectations. The favorable context in financial markets due to the optimism on the developments of COVID-19 vaccines and greater light regarding the political transition in the US has resulted in a renewed appetite for risk assets, reflected in a strengthening of capital flows towards EM. Thus, over the past two weeks, Mbonos have experienced a positive performance with a flattening bias, focusing gains in the mid-/long-end of the curve. At the same time, the market has notoriously repriced a 25bps from Banxico for 2021, currently incorporating implied cuts for the 1Q21 of -14bps and of -20bps for the 2Q21. This performance has also been supported by the recent tone in the central bank's communications and the downward surprise in inflation in the first half of November. Given this pricing and considering our new terminal rate estimate for 2021 between 3.75% and 3.50%, we identify an attractive valuation to receive short-term securities maturing in 6 months onwards. In parallel, we suggest short-term long tactical trades favoring long-term Mbonos, where we still find a better relative valuation for the Nov'36 and Nov'38 maturities, taking into account their duration adjusted yield and a greater space for proportional contraction in their spreads against US Treasuries.

In the FX market, the Mexican peso has stabilized in the region of 20.00, accumulating in November an appreciation of 6%. This situation has taken place under a broad weakening of the US dollar that has resulted in gains of up to 8% in other currencies such as the Brazilian real and a positive balance in virtually all other major crosses. While this performance has been largely driven by the weakening of the USD and the global risk on mood, the MXN has also benefited from its embedded carry as a result of the relative monetary position. Considering this and other factors, we adjusted our Mexican peso forecast for year-end 2020 and 2021, now estimating levels of 20.50 and 19.80 per dollar, respectively, recognizing in the projected trajectory levels as strong as 19.00 the following year.

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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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