Banxico Minutes – Debate over inflation to assess the window for additional cuts

- **Banxico published the minutes of the decision held on February 11th, in which the central bank unanimously cut the reference rate by 25bps to 4.00%**
- **In our view, the tone of the document remains *dovish*, similar to what we observed in the last statement, but less than what the market expected**
- **In line with our expectations, we believe the debate on inflation was the most relevant section, considering a highly uncertain scenario**
- **On growth, we still see an accommodative stance, with risks firmly skewed to the downside**
- **Moreover, we believe the document helped confirm the dovish stance of new Deputy Governor Galia Borja**
- **We still expect two 25bps cuts, each in the upcoming March and May decisions, taking the rate to 3.50%. However, and given diverging views on inflation among members, it is unlikely that those decisions will be unanimous**
- **We hold our trade recommendation of receiving the 6-month TIIE IRS and 3-year Udibono, acknowledging sharp market adjustments**

Banxico minutes keep a *dovish* tone. Banco de México published the minutes of the meeting held on February 11th, in which the Board unanimously voted to cut the reference rate by 25bps to 4.00%. In our opinion, the tone of the document remains *dovish*, especially on growth, but less than what the market expected. We believe the most relevant comments were on inflation. Among them, we highlight: (1) The recent increase in non-core inflation given the rebound in energy prices, as well as its possible persistence; (2) the effect of the pandemic on relative prices between goods and services; and (3) the difficult base effect expected in coming months. Meanwhile, we also noted comments on market dynamics, including the performance of local assets, interest rate movements, sovereign risk premia and financial flows. The strong increase in long-term interest rates –and adjustments in other assets, including the Mexican peso– was not widely discussed as it only exacerbated in recent days. Nonetheless, we think it could prove to be more important in upcoming decisions.

After the release, we continue expecting two 25bps cuts each, taking place in the March 25th and May 13th meetings, taking the rate to 3.50%, where the easing cycle would end. However, we consider it is unlikely that these cuts will be unanimous given diverging views about inflation among members. Therefore, we believe contents within the next *Quarterly Report* –to be released on March 3rd– will be key to evaluate what the Board thinks about inflation and markets currently, along how this could impact their upcoming decisions.

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Banxico's 2021 policy decisions

Date	Decision
February 11	-25bps
March 25	--
May 13	--
June 24	--
August 12	--
September 30	--
November 11	--
December 16	--

Source: Banxico

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STARMINE AWARDS FOR REUTERS POLLS FROM REFINITIV

In line with expectations, the debate was mostly on the inflation path. Most members thought that the balance of risks for inflation remains uncertain. Just one mentioned that it remained stable despite the pickup in January (to 3.54% y/y from 3.15% in December). Moreover, this increase continued through the 1st half of February. They acknowledged that this was mostly driven by pressures at the non-core, especially on energy prices (gasolines and LP gas), with some expecting them to wane. In this respect, other members' comments included: (1) The implementation of stimuli by the MoF to contain the increase in gasoline prices; (2) that second-round effects because of these increases are not expected; and (3) the positive effect from the decrease in the annual rate of change of agricultural and livestock products' prices. We think discussions do not signal very strong nervousness about these dynamics. Nevertheless, we warn that we had not yet observed the shock in energy prices due to harsh weather in the US and Mexico's northern region by the time of the decision. Moreover, they mentioned among the risks to the upside the possibility of higher energy prices and of an exchange rate depreciation, with both materializing to some extent since then.

Complex dynamics between goods and services at the core level. About this component, attention focused on the pandemic's effect in the relative price dynamics between goods and services. Most members mentioned that core inflation increased from December to January, with only some adding that they expect it to be around 3% from the second half of the year. One said that its behavior has been favorable and another mentioned that the degree of slack has influenced it to the downside. Although the exchange rate adjustment at the beginning of the pandemic induced higher inflation in categories more exposed to the exchange rate (*e.g.* tradeable goods), some underlined recent reductions in processed foods. One considered that the latter has shown signs of stabilization. Meanwhile, others stressed that declines in services have moderated and that supply and demand shocks stemming from the pandemic have started to fade. We believe these comments do not signal big concerns, despite some recognizing risks of cost-related pressures to firms and one because of the rebalancing of spending towards goods. In this respect, it is premature to think that these rebalancing would necessary result in lower inflationary pressures.

A difficult base effect that will fade away. We should recall that the pandemic's initial shock induced a strong fall in prices that started on the 2nd half of March 2020, which exacerbated in April. This will generate an arithmetic effect that will result in a temporary increase in headline inflation during the second quarter. We anticipate that this could pressure headline inflation above 5% in April. Despite of the latter, they reaffirmed the view that both headline and core inflation will converge towards 3% in the time frame in which monetary policy operates. In this respect, we think that the explicit inclusion of these comments suggests that the majority will not place a lot of weight to this arithmetic effect in their upcoming decisions, concentrating more on current and expected dynamics of the components mentioned above.

An accommodative stance remains on economic activity. The opinion is that the global recovery will continue, supported by stronger stimulus measures. However, some warned about an heterogenous recovery, with different dynamics among countries depending on the degree of fiscal and monetary stimulus. On Mexico, they acknowledged a better result at the end of 2020. Nevertheless, concerns remain over activity at the start of the year, considering the recent evolution of the pandemic. In this sense, most members think that the recovery will continue at a modest pace, with ample slack conditions going forward.

A dovish bias is confirmed for new Deputy Governor Galia Borja. As usual, in the monetary policy section we tried to distinguish the comments and specific bias of each member. In this occasion, this was more difficult as we did not have dissident votes to separate opinions clearly. Nevertheless, considering statements in the press and previous participations, we managed to identify them. Before the release, we argued that the two most relevant opinions this time around would be from Deputy Governors Galia Borja and Irene Espinosa.

In the case of Deputy Governor Borja, we should remember that this was her first meeting, allowing us to learn her opinions with greater detail. Overall, we perceived a *dovish* stance, contrasting with former Deputy Governor Guzmán, who she substituted. In this section we believe she said that current conditions and information about the outlook provided a "*…specific window of opportunity […] that allows for reducing the intrinsic costs in the financial system…*". Moreover, she likely mentioned that "*…the future outlook does not suggest an increasing price dynamic that would lead to a breach of the price stability mandate…*". At least until this decision, she considered that monetary policy was restrictive and that inflation expectations had remained stable. In this sense, it seems that while conditions are adequate (*e.g.* inflation in line with expectations and low growth), she could keep supporting additional rate cuts. Lastly, she signaled little concern about the inflation outlook on ample slack conditions.

Turning to Deputy Governor Espinosa, and despite changing her vote to a cut, we think she maintained a more *hawkish* stance, similar to previous decisions. Once again, she highlighted the importance of maintaining a prudent stance given an uncertain environment. Despite possibly arguing that conditions surrounding inflation, activity and financial markets provided some room for the cut, she added that significant risks remain, including in public finances and volatility episodes. More importantly, she likely included that "*…this decision does not constitute a guide for future actions…*", which leads us to believe that she could stop supporting the easing cycle even as soon as the next meeting.

Meanwhile, we think Governor Alejandro Díaz de León and Deputy Governor Gerardo Esquivel –which we identified as the first and fourth in appearance order within this section, respectively– maintained very similar arguments than in previous occasions and media participations. Lastly, we noted a slight change in the stance of Deputy Governor Jonathan Heath. Although he seems to remain among the dovish members, some comments suggest that he might be skewing more towards a neutral bias. Specifically, we highlight the possible mention that "*…the benefits of a more accommodative stance are increasingly marginal and that this could have undesirable consequences for financial stability…*"

This seems to signal that the floor in terms of the terminal rate might be close, and that the cost/benefit ratio of more cuts is deteriorating. Moreover, there are also doubts about the timing of the next cuts, with him probably arguing that caution is needed going forward, especially considering the inflation 'hump' that will be observed in 2Q21. We think that, in the margin, he could be the deciding vote about whether the easing cycle continues, or a new pause is taken, making his upcoming comments quite relevant.

We still expect two more and consecutive cuts of 25bps each, albeit with some risks on the horizon. We maintain our call that Banxico will cut the reference rate two more times, for 25bps each, on the meetings to be held March 25th and May 13th. With this, the rate would reach 3.50%, where we expect the easing cycle to end. Nevertheless, the recent shock induced by the undersupply of natural gas and the resulting increase in energy prices due to harsh weather conditions has added risks to the inflation outlook. To the latter, we must add: (1) Recent pressures in other commodities, particularly industrials, boosted by expectations of higher global growth; and (2) higher market volatility, with a strong steepening of the curve as long-term rates are pushed higher, along pressures for the Mexican peso on a broad rebound of the USD. In this respect, the next *Quarterly Report* – to be released on March 3rd– will be key to assess the central bank's view regarding these shocks. Specifically, we will carefully watch the magnitude of the adjustments to the forecasted inflation path, which we expect with an upward bias. Moreover, it will be very relevant to assess the central bank's opinion about recent market volatility, especially on the exchange rate given its potential impact on the price formation process, portfolio flows and financial stability.

From our Fixed income and FX strategy team

We hold our trade recommendation on receiving the 6-month TIIE IRS and 3-year Udibono, acknowledging sharp market adjustments. The Mexican rates market has experienced a sharp sell-off in the last weeks which has sharpened in most recent sessions, triggered by the remarkable steepening of the US yield curve, capturing the expectations on economic recovery and greater inflation dynamism amid a backdrop of higher commodity prices. In February, US rates have accumulated a sell-off of up to 50bps in long-term securities, where the 10-year benchmark has reached its highest levels since February 2020 at 1.50% from 1.05% at the beginning of the month. Today's session has been characterized with an extension in the global rates' sell-off, where the Mexican curve depicted few reaction to Banxico's minutes and averages a 20bps sell-off in mid- and long-term Mbonos, while the TIIE-28 swap curve steepens by adjusting up to 35bps in the long-end. To this momentum, a greater risk off mode has also been playing its role, deteriorating the trading space for EM securities. Although we hold a view of steeper curves through the year and rate levels consistent with a positive view on economic recovery, the magnitude of the adjustment and levels already reached suggest a potential breather in the following sessions. In this sense, we hold our trade recommendations on long positions in the 6-month TIIE IRS and the 3-year Udibono Nov'23, considering a market that prices in 16bps of implied rate cuts for Banxico in the 2Q21 and space for further upward correction in short-term inflation breakevens.

In the FX market, the Mexican peso has registered a strong depreciation since last week triggered by the adjustment in US Treasuries, reaching its highest level since November at 20.90 per dollar. Today the MXN trades as the second weakest amid other EM currencies marking a 2.5% depreciation, its greatest sell-off in the year. Volatility in global rates has also impacted in a relevant fashion the FX marketplace, although it has been mostly focused in the EM universe resulting in a modest US strengthening. We suggest caution amid the present global volatility phase, reiterating our expectation of USD/MXN year-end at 19.80 and a stronger performance in the second half of the 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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