Banxico Minutes – A divided Board about the best response to current price pressures

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- **Banxico published the minutes of the decision held on June 24th, in which they surprised market participants by hiking the rate 25bps to 4.25%**
- **In line with expectations, we saw a hawkish tone, with an ample debate on inflation. In addition, the dissenters were Deputy Governors Galia Borja and Gerardo Esquivel**
- **Among the comments regarding prices we highlight:**
  (1) Renewed focus on the increase in core inflation given higher services prices and persistently elevated levels for goods;
  (2) The opinion of some members that the path for inflation in the upcoming eight quarters has been revised significantly up; and
  (3) The expectation that pressures are transitory remain, albeit with most emphasizing the risk that supply chain disruptions might stay longer than previously foreseen
- **We also noted comments about the possibility that the Fed starts to normalize its policy before than currently expected, a situation that might exacerbate volatility**
- **In our view, there are some divisions over the need of adjustments on the policy stance, with the hawkish wing focused on inflation and its expectations, while those more dovish concerned about the consistency and predictability of the decisions**
- **We still expect four additional 25bps hikes this year, with the rate ending at 5.25%. For 2022 we see two more hikes of the same magnitude at the start of the year and one more at the end, closing at 6.00%**
- **We expect a further flattening of the local yield curve**

The minutes suggest a difficult decision by Banxico. Banco de México published the minutes of the meeting held on June 24th, in which they surprised analysts and the market by hiking the reference rate 25bps to 4.25%. In our opinion the tone is hawkish, highlighting greater concerns about the outlook for prices given recent inflation surprises, with special focus in the core. Meanwhile, and as expected, the two dissenters were Deputy Governors Galia Borja and Gerardo Esquivel. In other topics, we noted doubts about the convenience of increasing the reference rate, flagging it as a risk to the consistency and predictability of monetary policy. However, among the rest we saw the need to respond to recent price shocks to maintain the institution's credibility given the high likelihood of upward revisions to their forecasts. Despite of this, most still believed pressures are transitory, so they did not signal the start of a tightening cycle. Based on our inflation call and global monetary policy, among other factors, we still expect four additional 25bps hikes in the reference rate this year, taking it to 5.25%. In addition, for 2022 we see two additional increases of the same magnitude at the start of the year and one more at the end, closing at 6.00%.

Banxico's 2021 policy decisions

Date	Decision
February 11	-25bps
March 25	0bps
May 13	0bps
June 24	+25bps
August 12	--
September 30	--
November 11	--
December 16	--

Source: Banxico

Ample debate on the factors impacting inflation. In line with expectations, we consider that comments on this front were the most relevant. On one hand, they talked about the increase in global inflation, with most countries above their central bank's targets. In this sense, the main risk for financial markets is the possibility of higher-than-expected inflation, especially given potential changes that this could trigger in terms of monetary policy. Especially, if the Fed starts to normalize before expectations, which in turn could exacerbate pressures in emerging economies (*e.g.* from the potential effect on exchange rates). In the local front, we noted a renewed focus on core inflation (and its resistance to the downside despite ample slack) given certain pressures in services –reversing the downtrend seen throughout most of 2020, given the greater degree of the reopening– and persistently high levels in goods. In this sense, a member said that 75% of the latter are growing at a pace faster than 4% and all together present annual increases close to 6%. In addition, *some* members stated that the path of inflation for the upcoming eight quarters has been revised significantly to the upside. This is relevant as it could imply changes in their expectations for the convergence of inflation to its target in 3Q22 –with a member explicitly saying that there is some skepticism in this front. Lastly, most still consider inflationary pressures to be transitory, with some highlighting the moderation in energy prices, the stabilization in commodities and that the effects of the rebalancing in spending will only happen once. Another added the fading out of increases in agricultural prices, impacted by the drought. Nevertheless, most emphasized the risk of disruptions in supply chains as more prevalent, resulting in the adverse effect on prices of some of these shocks –which have been the ones with the most impact– as being more persistent.

Expectations of robust but heterogeneous growth remain. Most members expect the global recovery to continue, albeit with differences depending on the degree of economic stimulus and availability of vaccines. Locally something similar is foreseen, with strength mostly in the external sector and some lag in both consumption and investment despite showing a marginal improvement. In this context, the balance of risks is more equilibrated, with ample slack conditions prevailing, including the labor market.

A divided Board. Considering the tally of the votes on this decision, identifying the comments made by each member is easier. In this sense, we see a clear divide between more hawkish and dovish members. Among the first, which include Governor Alejandro Díaz de León and Deputy Governors Irene Espinosa and Jonathan Heath, the prevailing message shows concerns about the effects current shocks on inflation may have and its implications to the central bank's credibility.

Specifically, we think Governor Díaz de León highlighted that: "*…the baseline scenario for inflation foreseen in the Quarterly Report did not incorporate additional pressures…*". This, coupled with his view about important challenges ahead in this front, likely led him to support a reinforcement of the monetary policy stance. Nevertheless, his view about the likely direction of next decisions is not clear, consistent with the data dependency mode that has characterized him since the beginning of his tenure. On the other hand, we saw Jonathan Heath with a more definitive stance, portraying a more hawkish bias than what we expected. He possibly argued that "*…the monetary policy stance that was needed in 2020*

[…] *is different from what is needed now…*”. He also added that the institution’s credibility should be preserved, as well as to avoid the impression of a *de facto* dual mandate. In this backdrop, and in our view even more important, he stated that “*…in the following decisions it will be necessary to show resolve in order to avoid a de-anchoring of expectations…*”, which would point to the possibility that he could vote for further hikes in the near future. Slightly less hawkish at the margin, we think Deputy Governor Espinosa was behind the comment that, despite pressures mostly being driven by supply-side issues, *“…it must be ensured that second-round effects are not generated…”.* Nevertheless, and more relevant going forward, she commented that “*…this decision does not necessarily imply the beginning of a monetary tightening cycle…”,* also adding a data dependency component. Factoring in our inflation outlook, we think these three members will keep voting for rate hikes in upcoming meetings.

In the dovish wing, Deputy Governors Galia Borja and Gerardo Esquivel were very critical as a hike would not be consistent with the stance that the institution had been showing. Moreover, it would also be counterproductive both for the narrative that inflation is transitory, as well as for economic activity. Deputy Governor Borja highlighted that, when considering price pressures, these “*…will hardly be solved through monetary policy*…” given that they stem form supply shocks and changes in consumption patterns. She added that medium- and long-term inflation expectations so far remain anchored, suggesting there is no need to act. Finally, Deputy Governor Esquivel mentioned that the decision to hike was hasty, and that it suggests “*…an abrupt change in narrative, which sends the signal of an erratic and unpredictable behavior by the Bank…*”. In addition, he argued that the adjustment might have an adverse effect on expectations, suggesting that current shocks are more of a permanent nature. In this context, we think that upcoming decisions will remain divided, needing a material change in the outlook for these two members to support more interest rate increases.

We maintain our call of more rate hikes this year, extending through early 2022. Considering that most members in the hawkish wing mentioned that they will remain data dependent and focused on the broad environment, we believe overall conditions will force them to continue hiking the reference rate. Specifically, we anticipate a more complex inflation environment, estimating it at 6.1% by year-end, still affected by the pandemic and a modest uptrend in core inflation, reaching 4.7% y/y by December. To this we add a more difficult global backdrop, with the Fed preparing for tapering its asset purchases. Moreover, several emerging markets are also starting a restrictive cycle, highlighting Brazil among them, which is one of the most important in terms of the relative stance because of its position as a key flow competitor for Mexico in the region. Hence, we maintain our call of 25bps hikes in each of the remaining four meetings of this year, taking the reference rate to 5.25% by the end of 2021. For 2022 the outlook would remain challenging, especially at the start of the year, so we anticipate that the hiking cycle will extend to the first two meetings with accumulated rate hikes of 50bps. This would be determined by inflation –which would remain relatively elevated– and higher volatility due to the start of the tapering process, with the need to reinforce the stance to counter them.

After this, and with the rate slightly above neutrality (at 5.6%) by that time, we could see a relatively prolonged pause, with inflation nearing the range around the target and a downtrend until August (to 3.7%), closing the year at 4.0%. By the end of 2022 we could see another 25bps hike, possibly reacting to a similar action by the Fed, with the latter institution beginning its own tightening process. Therefore, Mexico's reference rate would end at 6.00% in said year.

From our Fixed income and FX strategy team

We expect a further flattening of the local yield curve. Divided positions inside Banxico's Board will result in some uncertainly about the central bank's next movements; however, we consider that current valuation in the short-end of the yield curve integrates an appropriate view on future monetary policy actions, particularly given CPI dynamics. Having said that, the 114bps of current implied hikes reflect a slightly more aggressive expectation than our view of a reference rate closing this year at 5.25%. Reaction to today's minutes was mixed, contaminated by higher volatility in global rates and most markets. The release matched a USD dollar reversal amid a sharp rally in EUR and JPY, while US Treasuries held a strong performance that has led the 10-year note to trade below the 1.30% handle. This combination resulted in a 2bps appreciation in Mbonos from the 3-year area onwards, while the short-end kept pressured by 2bps. TIIE-28 IRS experienced a similar performance but at a stronger magnitude in which the curve gained 7bps from mid-term tenors onwards. This movement suggests a market that is reevaluating its views on the global economic recovery in the midst of this new risk aversion wave, although acknowledges the need of a more restrictive monetary policy at a local level. In terms of strategy, we hold a view favoring a further flattening of the yield curve.

In the FX market, although also influenced by the USD weakening this Thursday, the MXN observed a modestly positive reaction trading close to 20.00 per dollar and partially moderating the accumulated sell-off in the session. In our view, carry attractiveness derived from Banxico's hikes and current pricing could push the currency to trade even below the 19.50 resistance, should risk appetite conditions allow it. Nevertheless, we hold a cautious view for the MXN amid the global uncertainty and potential structural USD strength in the months ahead.

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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, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, 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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