Banxico Minutes – Preemptive approach given risks to inflation expectations

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- **Banxico published the minutes of the decision held on September 30th, in which, in line with expectations, they hiked the rate by 25bps to 4.75%**
- **In our view, the document reinforces the statement's more hawkish tone. We highlight greater concerns about current inflation dynamics and its potential impact on mid- and long-term expectations**
- **Given the focus on inflation, among the comments we highlight:**
  (1) Concerns that inflationary pressures represent a risk to the price formation process and that its persistence could de-anchor medium- and long-term expectations;
  (2) Relevance of external pressures among upside risks, including higher costs and an exchange rate depreciation; and
  (3) The new upward revision to estimates, on top of considerations that these do not incorporate additional shocks or the possibility of current ones extending
- **The Board keeps expecting an extension of the economic recovery in the remainder of the year and into 2022, albeit recognizing some weakness in consumption and investment as well as issues for industry**
- **We believe there is greater consensus over the need of preemptive actions to achieve the convergence of inflation to the target, especially amid a backdrop which is expected to remain complicated**
- **We reiterate our view that the hiking cycle will extend for longer. In particular, we see two 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%**
- **The market is pricing in a more hawkish stance from Banxico**

Banxico minutes reaffirm a more hawkish stance. Banco de México published the minutes of the meeting held on September 30th, in which they hiked the reference rate by 25bps to 4.75%. As already known, the only dissenter was Deputy Governor Gerardo Esquivel, who voted to maintain the rate at 4.50%. We consider that the tone of the document reaffirms the more hawkish bias seen in the statement, with greater consensus over risks to inflation and its expectations, which remain skewed to the upside. Although most members still consider that pressures are transitory, a greater need to adjust the stance is perceived in a more complex backdrop. This led to new upward revisions to inflation forecasts and a delay to the convergence to the target. Overall, we believe information is consistent with our expectation that the hiking cycle will continue for longer than anticipated by the market just a few months ago. In particular, we still expect two additional 25bps hikes this year, taking the rate to 5.25% in December. For 2022 we see two more increases of the same magnitude at the start of the year and one more at the end, closing said period at 6.00%.

Banxico's 2021 policy decisions

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

Source: Banxico

Consensus growing about higher risks to inflation and its expectations. We recall that the only dissenter this time was Deputy Governor Gerardo Esquivel, remaining as the most dovish member. Moreover, Deputy Governor Galia Borja voted for a hike instead of an unchanged rate, joining the remaining members. Just because of this, we think it suggests more consensus within the Board.

Given this, we focus our analysis on their comments. Regarding Esquivel, his arguments were similar than in the previous decision. Nevertheless, we highlight his view that an interest rate increase is ineffective and inefficient. It is ineffective "*...because a higher rate does not solve the factors that originate inflationary pressures...*", which have been driven by higher input prices and supply issues. It is inefficient because it could affect the economy in several areas and reduces the future room for the time when the Fed begins its normalization process. Moreover, he stated that it is counterproductive as it could send the signal that inflation is of a permanent nature, which in turn can affect expectations and the price formation process.

In the case of Galia Borja, we think she stressed more than before the adjustment in expectations, pointing out that inflation increased again and that 12-month ahead expectations increased the most. This could limit the effectiveness of reinforcing monetary policy and has increased challenges to the decision-making process. In contrast, in the previous decision she stated that a hike would validate expectations of a higher rate in the future, adding to the confusion about only reinforcing the policy stance or being in a hiking cycle. This differentiation was repeated, which we see as relevant. Specifically, she said that "*...reinforcing monetary policy allows to act preventively in light of expectations of less accommodative monetary conditions worldwide in the following months...*". This is likely in response to the upcoming Fed tapering and adjustments in other countries. We also note that she talked about the possibility that the range of the neutral interest rate (which Banxico estimates between 4.8% and 6.5% in nominal terms) could be lower. In our view, all this suggests that she could change her stance and vote for an unchanged rate again relatively quickly, mainly given her emphasis that we are not in a hiking cycle.

Going to the rest of the Board (Irene Espinosa, Alejandro Díaz de León and Jonathan Heath), we see a common thread of concern: that the inflation rebound translates into a deterioration in the price formation process and higher inflation expectations. For example, we believe Irene Espinosa said that: (1) If inflation remains elevated for a prolonged period, economic agents would incorporate it; and (2) that a more complex scenario is highly likely, which would require a more aggressive adjustment. It is our take that Governor Díaz de Léon stated that: "*...the inaction of monetary policy given the accumulation of inflationary shocks is a factor that generates a deterioration of expectations...*". Lastly, Heath probably affirmed that "*...there is a risk that price formation and inflation expectations may be contaminated...*". He also mentioned the broad range and magnitude of price increases, which is very similar to his comments in the latest edition of our podcast, *Norte Económico* (available only in Spanish), in which he was our special guest.

The global and domestic recovery will continue, albeit with some risks prevailing. Once again, the Board maintains that the world economy is still recovering, albeit with a high degree of heterogeneity across sectors and countries. They noted that the recent scarcity of raw materials has contributed to a deceleration in industrial production. In this context, one member signaled towards recent downward revisions in growth estimates by international organizations, with a moderation in advanced and Asian economies. They maintain that signs so far is that local activity kept rising in 3Q21, albeit acknowledging several key points, including: (1) Weakness in some consumption indicators; (2) mixed opinions, albeit mostly negative, over investment trends; and (3) strong differences in the external sector, reflecting the lack of inputs –with auto exports very weak, while the rest of manufacturing have been better–. A similar situation is seen on the supply side, with strong gaps across sectors. On the labor market, although there has been a recovery, expanded indicators suggest that weakness prevails, with a long path ahead to compensate for the pandemic shock. Overall, although these factors would entail a looser policy stance, we believe concerns over inflation more than compensate for these facts.

Focus and discussion on inflationary pressures. Most members recognize that a large part of the current dynamic obeys to external supply shocks, which is where risks are centered. Once again, they quoted increases in commodities –including energy– and bottlenecks, adding also transportation costs. In this sense, one member stated that this is not a common supply shock, with strong distortions induced by the pandemic which disrupt demand and therefore, prices. Meanwhile, there doesn't seem to be a strong consensus about the transitory nature of the shocks, with some thinking that these could be more persistent. In this sense, some structural factors showed up on the debate, especially regarding the core component. As such, some think its probable that this latter category might take longer to converge to the target, despite some cost pressures decreasing. This supports most members being concerned over a possible increase in inflation expectations, although so far, they have concentrated in analyst's short-term forecasts. Nevertheless, once highlighted the increase in inflation premiums in longer dated financial instruments. On the upward adjustment to the inflation forecast, they state that this responds to recent shocks that were not foreseen. Despite of this, they mention that the path presented does not incorporate other possible shocks or an extension of current ones. We consider that this helps explain the discrepancy between our forecasts and those of the central bank. We anticipate that several of these will extend not only through the remainder of the year, but also into 2022. In this context, the balance of risks remains tilted to the upside, practically with the same factors than in the previous decision. All in all, we consider that the tone in this front is more hawkish, supporting our view that the monetary restriction will continue on the following months.

We expect most members to keep favoring additional adjustments given a more difficult and uncertain backdrop, validating our call of more hikes. In our view, the minutes reinforced a more hawkish bias among Board members, which in turn seems to support an additional tightening of monetary conditions. Moreover, we see several factors that could complicate the scenario even further. First, it seems that the outlook for prices will remain very difficult at least in the short term, reflected in our forecasts of additional pressures that would take annual inflation to 6.6% by December. Second, regarding the relative monetary stance, the Fed's minutes confirmed yesterday that it is highly likely that the tapering will begin before year-end, which could in turn tighten financial conditions. Moreover, other emerging market central banks have joined the shift towards a more restrictive policy, including Chile yesterday that hiked to 2.75% (+125bps). At the margin, the room to maneuver will diminish even more, pressuring Banxico to raise rates in order to: (1) Maintain a defensive bias on the exchange rate; and (2) mitigate possible capital outflows. Third, risks for the global economy have increased and, therefore, to financial markets. Among them, we include the US fiscal *impasse* and financial stability concerns in China, in this backdrop, we believe Banxico will remain prudent and will strengthen the relative stance to avoid an even higher shock locally. Although we do not rule out that Galia Borja shifts in coming decisions –given the comments that we attribute her in the minutes–, we expect the remaining three members favoring a hike to continue supporting them at least in the two remaining decisions of this year. Hence, we reiterate our call of two additional 25bps hikes in 2021, taking the reference rate to 5.25%. Following this and given our base case of prevailing risks (particularly in the inflation front), the cycle would continue in the first two meetings of 2022, with hikes of the same magnitude even under a new Banxico Governor. Lastly, we see a last increase of 25bps at the end of 2022 for the rate to reach 6.00% in advance of the Fed's start of its own hiking cycle.

From our Fixed income and FX strategy team

The market is pricing in a more hawkish stance from Banxico. As an initial reaction to the minutes, Mexican nominal curves modestly appreciated in a similar performance to US Treasuries, for an afterwards reversal in line with today's hawkish release. Particularly, TIIE-28 swaps sold-off 3bps and Mbonos adjusted +2bps, on average, pairing part of the accumulated breather during the week that marked a rally of ~10bps supported by the Treasuries' flattening bias, despite US inflation breakevens widening. In this sense, the market is currently discounting a more restrictive bias for Banxico vis-á-vis our expectations, pricing in implied hikes for the remainder of this year of +68bps and +149bps for the first half of 2022. In our view, local inflation dynamics (amid a challenging backdrop given commodities' prices surge) and performance in other fixed-income markets in the world will hold the discussions in Banxico's Board highly active. Under this context, we expect the 10-year Mbono to close 2021 at a level of 7.40% and at 7.80% for end of year 2022 considering that Mexican rates will remain highly correlated to their US peers' performance, yet we believe they have for now integrated a great part of the pressures we could see.

Moving to the FX market, the USD/MXN temporally moderated pressures in the session; however, it turned back to levels close to 20.65 per dollar (-0.4%). The Mexican peso has been impacted by global volatility and has reached levels as weak as intraday 20.90 on Tuesday though holding a relatively defensive performance vs other EM currencies. In this sense, MXN is trading near its 3Q21 closing levels compared to strong adjustments in October of -3.2% in TRY, followed by CLP and INR (-1.4%). It is our take that the US dollar will extend a structural strengthening considering the Fed's normalization and the uneven recovery among regions, reason why we suggest USD buying in dips. In the short-term we see USD purchases attractive when USD/MXN close to 20.40.

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We, 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, Alik Daniel García Alvarez, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo 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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