Banxico Minutes – Debating whether to accelerate the hiking pace

- **Banxico published the minutes of the decision held on November 11th, in which, in line with our call, they hiked the rate by 25bps to 5.00%**
- **In our opinion, the document maintains a hawkish tone. Especially, we noted that at least two members pondered about the convenience of accelerating the hiking pace**
- **Focus remains squarely on inflation. Hence, we highlight:**
  (1) Some members expressing more doubts about the transitory nature of inflation and risks to the de-anchoring of expectations;
  (2) That higher inflation in the US has contributed to the increase of inflation in Mexico due to their deep economic integration; and
  (3) Uncertainty about the horizon in which pressures could affect inflation and greater risks to the price formation process
- **We also noted one member's opinion about the convenience of publishing with each monetary policy announcement the foreseen path of the reference rate which is consistent with inflation forecasts**
- **We reiterate our call of a 25bps hike in December and accumulated increases of 125bps in 2022, with the rate reaching 6.50%. Nevertheless, we see a higher probability of an acceleration in the pace of the hiking cycle to 50bps as soon as in the upcoming decision**
- **Muted reaction to the minutes, with the market holding the expectation of a more aggressive stance from Banxico**

Banxico minutes reflect the challenging monetary policy backdrop. Banco de México published the minutes of the meeting held on November 11th, in which they hiked the reference rate by 25bps to 5.00%. Similar to the previous decision and as already known, the only dissenter was Deputy Governor Gerardo Esquivel. In our view, the document has several relevant themes. The most important one was the possibility of accelerating the hiking pace to 50bps steps, mentioned by at least two members. This was based on the risk that price pressures put in the anchoring of mid- and long-term expectations. In this sense, the minutes portray a more difficult decision than what could be interpreted solely by looking to the voting result of 4-1. Also, some members noted that inflationary pressures have been observed in a variety of goods and services and do not seem to reflect only transitory changes. In addition, the "contagion" from external to local inflation, especially because of high inflation in the US. Broadly speaking, we believe the tone remains quite hawkish. In this environment, we reiterate our view of a 25bps hike in December and accumulated increases of 125bps in 2022, with the rate reaching 6.50%. Nevertheless, we see a higher probability of an acceleration in the pace of the hiking cycle to 50bps clips as soon as in the upcoming decision. Specifically, we are waiting for additional information, mainly the *3Q21 Quarterly Report* that will be published next week, to analyze this possibility with greater detail.

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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	+25bps
December 16	--

Source: Banxico

Debate about a possible acceleration in the tightening pace. Within the monetary policy section, comments from Board members were very important. Among them, we highlight mentions about the pace that the hiking cycle should follow. Especially, two members hinted the possibility of accelerating it to 50bps clips. We believe Irene Espinosa and Jonathan Heath were behind these comments. We think Espinosa could have mentioned that "*…the monetary stimulus should be cut by 50 basis points…*". Nevertheless, she softened his stance by arguing that said acceleration could have undesirable effects on the market, at the margin favoring a more gradual stance. Meanwhile, Heath likely stated that "*…the discussion should focus on the persistence of high inflation, particularly of core inflation, in order to determine if convergence to the target will require a greater monetary policy tightening, both in terms of magnitude and timing…*". However, he was less explicit by arguing that "*…an eventual increase in the speed of adjustment must be of a determined duration to rule out an aggressive and prolonged cycle…*". He added this could imply an overly restrictive stance in an environment of economic weakness, so caution is needed. Although conditions in November do not seem to have been in place to proceed at a faster pace, it is our take that the outlook is changing rapidly and could be decisive ahead of December's meeting.

On other members, both Alejandro Díaz de León and Galia Borja maintained a *hawkish* tone, agreeing on the need to reinforce the monetary stance given higher inflation and the possibly of inflation expectations de-anchoring. Along comments made by Espinosa and Heath, their comments reaffirm the concerns about price dynamics, as well as the need for decisive actions to avoid greater distortions. In our view, this reaffirms that the four of them will continue supporting hikes, albeit with doubts about the magnitude ahead.

Lastly, Gerardo Esquivel maintained a *dovish* stance. In his opinion, reference rate hikes will not stop inflationary pressures and could even have adverse effects in several sectors of the economy, including consumption, investment, credit, and public finances, among others. In addition, he argued that the institution should not act in a mechanical fashion, especially considering Mexico's macroeconomic advantages relative to some of its peers. Therefore, we think it will be tough for him to change his stance, at least soon, once again voting to leave the rate unchanged.

More difficult inflation dynamics, with an additional deterioration in the balance of risks. Once again, the Board recognized that part of inflation's behavior is explained by external shocks, including disruptions on productive processes and increases in raw materials and inputs, among others. On this, they noted that a share of inflation is tied to price dynamics in the US due to the deep integration with said country. Nevertheless, they also spoke about changes in consumption patterns, both externally and domestically. Therefore, the discussion centered on the transitory nature of these shocks and their impact. Although the majority still think that the effects are transitory, each time there are more doubts. In this sense, some noted that "*…inflationary pressures have recently been observed in a variety of goods and services and no longer appear to be reflecting only transitory changes in relative prices…*".

Moreover, we saw additional concerns about the core, as it has increased for 11 straight months. Fears seem focused on goods, albeit with services also gathering notoriety. On the non-core, comments were more mixed, with some of higher and lower gravity on energy. Regarding expectations, attention remains squarely on them despite no significant changes in those for the medium- and long-term. In this sense, a member noted that "*...it cannot be assumed that the divergence between short- and long-term expectations will be maintained, given the continuation of the current bubble and the difficulty in fighting it...*". Moreover, some stated that implied expectations in medium- and long-term market instruments have increased.

On updated forecasts, increases were centered in the short-term, with expectations that inflation would reach its highest level in 20 years. This has already been confirmed in 1H-November. Comments on the mid-term outlook are more uncertain, with doubts over when could prices moderate, in turn key for 2022 estimates. On the balance of risks, the most important fact behind the deterioration seems to be the materialization of some upside risks, on top of being much more than those associated to the downside. We think that, with an adverse situation extending in this front, the need to keep increasing the rate is clear, supporting our view that the hiking cycle will continue.

Will we see changes to the regime? We noted the comment made by one member about the "*...convenience of publishing with each monetary policy announcement the foreseen path for the reference rate which is consistent with the board's inflation forecast for the following eight quarters, as many central banks do...*". In our view, this is a positive proposal as it would help improve the communication strategy under the current inflation-forecast targeting regime. In particular, it would define more precisely the assumptions underlying the inflation forecast path. This is because the reference rate tends to influence in an inverse manner the price level. Hence, the central bank's actions (currently, and in the future) would affect the expected inflation trajectory. In this sense, mentioning explicitly the assumed path of the reference rate would help resolve the implicit "circularity" in the forecasts that are currently released.

Despite of this, we warn that including this adds other risks. Therefore, it should be done very carefully if implemented. The reason is that using a rate anticipated by the central bank could be interpreted as an explicit guide about its future path. In turn, this could reduce Banxico's flexibility and could even affect its credibility in case of meaningful deviations. As a result, we believe the best option is to use analysts' expectations (*e.g.* from the central bank's survey) and/or implied in the market as an exogenous factor for the calculation of inflation forecasts.

With this, the central bank could break this embedded "circularity" while also avoids losing flexibility in their decisions. But, strictly speaking, the estimated path could no longer be considered as a forecast by the institution. This is also important to analyze and clearly shows some of the challenges under the current regime. Nevertheless, we think that advances made so far have been favorable for achieving Banxico's mandate.

We reiterate our call of a 25bps in December and of accumulated increases of 125bps in 2022. For next year we maintain our expectation of equal-size hikes of 25bps each, taking place in February, March, May, October and December. In this way, the reference rate would end 2021 and 2022 at 5.25% and 6.50%, respectively. Nevertheless, information in the minutes, on top of other recent developments, have changed our assessment about the probability of a faster hiking cycle relative to this path. In particular, we believe this possibility has increased due to: (1) A more deteriorated inflation outlook, making us revise our forecasts higher this week; (2) recent comments with a more hawkish tone by some members, both in public appearances and in the minutes, along the signal from at least two members about 50bps hikes; (3) the possibility of a faster normalization by the Fed at the margin, as suggested by yesterday's minutes; (4) more complex exchange rate dynamics (see following section) in the last couple of days, which implies further risks for inflation; and (5) slight improvement at the margin in activity data for 4Q21 after the contraction seen in the third quarter. In this context and given high uncertainty about price dynamics, we will look closely to the *3Q21 Quarterly Report,* which will be published on December 1st. In our opinion, it will be noteworthy the magnitude of the likely downward adjustment to GDP growth for this year and the comments that will be made by Governor Alejandro Díaz de León. In addition, it is not possible to rule out new upward revisions to the inflation, at least for the very short-term (4Q21).

From our Fixed income and FX strategy team

Muted reaction to the minutes, with the market holding the expectation of a more aggressive stance from Banxico. Rates in Mexico showed a limited reaction to the release of the minutes, with the market experiencing low trading volume in light of the US holiday. As a result, the short- and mid-end of the Mbonos' curve retained gains of 3-4bps, after a breather at the close of yesterday's session that was characterized by material volatility and wide trading ranges following a new upside surprise in local inflation and other elements adding volatility. In this regard, spreads between Mbonos and Treasuries widened, pushing the reading between 10-year securities to its highest mark since March 2020 at 610bps, with current trading close to these figures. The curve pricing for Banxico's next moves has been skewed towards bets on a more restrictive stance relative to a 25bps hike in December, currently incorporating implied hikes of 39bps by year-end. Moreover, by 2022 year-end the pricing reflects +260bps, a valuation that seems elevated when considering our estimate for the benchmark rate closing in 2022 at 6.50%. In terms of strategy, we wait for better market conditions for directional strategies, opting for a bias favoring a steeper slope in the local curve in the short-term.

In the FX market, the Mexican peso has depicted a more stable price action with respect to the volatility experienced in the last few days. Yet, it trades above USD/MXN 21.50, with its weakest level this year at 21.63 in March. Similar to rates, the reaction to the minutes was muted. Drivers that have recently affected the local risk premium, adding to the foreign contagion of weaker risk appetite, dollar strength, and specific weakness in EM FX have resulted in 3.6% sell-off for the Mexican peso since last Thursday.

Meanwhile, the surge in realized volatility has visibly moved to the implied volatility space, where the whole curve has moved upwards and even turned to an inverted slope on the back of pressures focused in short-term tenors, reflection of the greater uncertainty for the pesos' price action in the near-term. Specifically, the 3-month at-the-money implied volatility has picked-up to its highest since April standing close to 13% from 10% at the beginning of November. In our view, the Fed's stance will result in greater USD strength going forward, although pressures for the Mexican peso could partially revert in the next sessions supported by an improvement in risk appetite and its valuation that already signals some cheapening. However, we suggest holding a cautious stance amid the volatile and uncertain scene prevailing, along with the potential effect of a lower carry appeal.

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Analyst Certification

We, Alejandro Padilla Santana, 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 and Gerardo Daniel Valle Trujillo, 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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