# Ahead of the Curve

## Expecting Banxico to hike the reference rate by 50bps to 5.50%, in a tough decision

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www.banorte.com
@analisis_fundam

**Juan Carlos Alderete, CFA**
Director of Economic Research
juan.alderete.macal@banorte.com

**Francisco Flores**
Senior Economist, Mexico
francisco.flores.serrano@banorte.com

Document for distribution among the general public

- **Banxico's monetary policy decision (December 16th).** On Thursday, Banco de México will carry out its last meeting of the year, in which we expect a 50bps hike, taking the reference rate to 5.50%. We still believe that it will be a difficult decision, with diverging opinions within the Board. In this respect, *Bloomberg's* median sees a 25bps increase, with 11 out of 13 economists backing this view. Despite being part of the minority, we believe the backdrop has become more challenging in the last few weeks, which is key to explain our call of an acceleration in the tightening pace. Some of the most relevant developments include: (1) An upward extension of domestic inflationary pressures; (2) the high likelihood of a faster tapering and more accelerated hiking cycle by the Fed; and (3) the recent depreciation of the exchange rate, albeit with the latter moderating in the last few days. We believe this combination of factors will validate the view of the more hawkish members on the Board about the need of a more substantial adjustment

**Mexico weekly calendar**

| DATE | TIME (ET) | EVENT | PERIOD | UNIT | BANORTE | CONSENSUS | PREVIOUS |
|---|---|---|---|---|---|---|---|
| **Mon 13-Dec** | | **ANTAD: Same-store sales** | November | % y/y in real terms | -- | -- | 5.0 |
| **Tue 14-Dec** | **10:00am** | **International reserves** | Dec-10 | US$ bn | -- | -- | 200.0 |
| **Thu 16-Dec** | **2:00pm** | **Monetary policy decision (Banxico)** | Dec-16 | % | 5.50 | 5.25 | 5.00 |
| **Fri 17-Dec** | **10:00am** | **Banxico's survey of economic expectations** | December | | | | |

Source: Banorte; Bloomberg

## Proceeding in chronological order...

**Weekly international reserves report.** Last week, net international reserves increased by US$683 million, closing at US$200.0 billion (please refer to the following table). According to Banxico's report, this was explained by: (1) US dollar sales from Pemex to the central bank amounting US$500 million; and (2) a positive valuation effect in institutional assets of US$183 million. So far this year, the central bank's international reserves have increased by US$4.3 billion.

**Banxico's foreign reserve accumulation details**
US$, million

| | 2020 | Dec 3, 2021 | Dec 3, 2021 | Year-to-date |
|---|---|---|---|---|
| | Balance | | Flows | |
| International reserves (B)-(C) | 195,667 | 199,993 | 683 | 4,326 |
| (B) Gross international reserve | 199,056 | 213,458 | 1,831 | 14,401 |
| Pemex | -- | -- | 400 | 1,158 |
| Federal government | -- | -- | -37 | -1,508 |
| Market operations | -- | -- | 0 | 0 |
| Other | -- | -- | 1,468 | 14,752 |
| (C) Short-term government's liabilities | 3,389 | 13,464 | 1,148 | 10,075 |

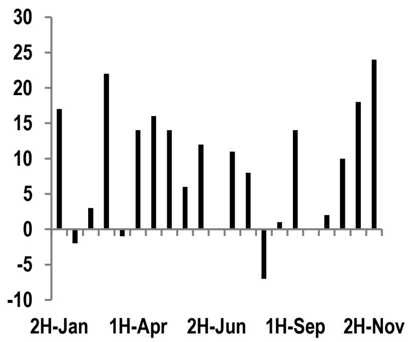
Source: Banco de México

**Banxico to hike 50bps to 5.50% as the outlook worsens.** On Thursday, Banco de México will carry out its last meeting of the year, in which we expect a 50bps hike, taking the reference rate to 5.50%. We still believe that it will be a difficult decision, with diverging opinions within the Board. In this respect, *Bloomberg's* median sees a 25bps increase, with 11 out of 13 economists backing this view. Despite being part of the minority, we believe the backdrop has become more challenging in the last few weeks, which is key to explain our call of an acceleration in the tightening pace. Some of the most relevant developments include: (1) An upward extension of domestic inflationary pressures; (2) the high likelihood of a faster tapering and more accelerated hiking cycle by the Fed; and (3) the recent depreciation of the exchange rate, albeit with the latter moderating in the last few days. We believe this combination of factors will validate the view of the more hawkish members on the Board about the need of a more substantial adjustment

On inflation, November's print surprised higher once again (see chart below, left) climbing 1.14% m/m. As a result, the annual rate deteriorated to 7.37% –highest since January 2001–. Dynamics were characterized by strong pressures in agricultural prices, mainly fruits and vegetables (chart below, middle), on top of the seasonal increase in electricity tariffs. To the downside, LP gas and gasolines moderated, highlighting the former after strong pressures in recent months (chart below, right). In addition, there was some relief in 'other goods' because of discounts during *El Buen Fin* (Mexico's Black Friday). However, the latter was more modest than in previous years, which in turn could be driven by cost pressures and lower businesses' profit margins. Therefore, negative factors keep accumulating, with upside risks materializing with more force each time around, and which we believe will impact short-term expectations in coming surveys. This supports the hypothesis that pressures might not be as 'transitory' as originally thought, a situation already debated by some members in the last decision.

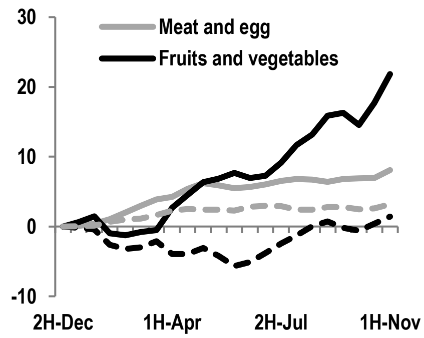
In addition, new factors of potential pressure have arisen for the medium term, including: (1) Possible additional disruptions from the spread of the 'Omicron' variant of COVID-19, although it seems to be more moderate at the margin; and (2) a possible upward skew given a higher-than-anticipated minimum wage increase for 2022. In our opinion, this implies growing risks to the anchoring of medium- and long-term expectations, which in turn requires a firmer monetary stance to support the price formation process.

**Inflation surprises***
Basis points, bi-weekly frequency



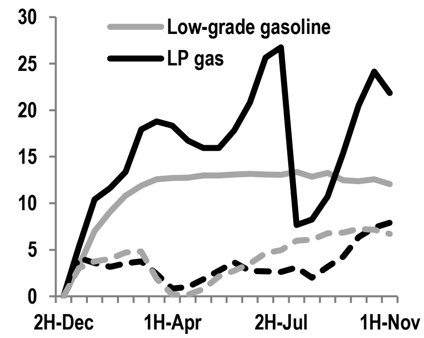

*Calculated as the difference between observed inflation and Bloomberg's median
Source: Banorte with data from INEGI, Bloomberg

**CPI: Fresh fruits and meat & egg***
% accumulated YTD




*Dotted line indicates the 2016-2020 average
Source: Banorte with data from INEGI

**CPI: LP gas and low-grade gasoline***
% accumulated YTD




*Dotted line indicates the 2016-2020 average
Source: Banorte with data from INEGI

On updates to inflation forecasts, we expect once again upward adjustments in those for the short-term horizon. Regarding 4Q21, the average up to November is at 6.8% currently, matching Banxico's estimate for the full quarter (see table below). Therefore, December's inflation would have to be at the same level to come in line with expectations, which we see as highly unlikely. Specifically, our path implies that headline and core inflation would stand at 7.1% (+30bps) and 5.5% (unchanged). We also consider very relevant the increasing chance of not achieving the convergence to the target in the horizon in which monetary policy operates (currently forecasted at 3Q23) due to persistent and sizable upward revisions in the institution's forecasts.

**Banxico: Inflation forecasts**
% y/y, quarterly average

| | 3Q21 | 4Q21 | 1Q22 | 2Q22 | 3Q22 | 4Q22 | 1Q23 | 2Q23 | 3Q23 |
|---|---|---|---|---|---|---|---|---|---|
| **Headline** | 5.8* | 6.8 | 6.3 | 4.8 | 3.9 | 3.3 | 3.2 | 3.2 | 3.1 |
| **Core** | 4.8* | 5.5 | 5.8 | 5.3 | 4.3 | 3.5 | 3.0 | 2.7 | 2.6 |

Source: Banco de México. * Observed data

Another key driver is relative monetary stance, specifically with the Fed. Considering additional inflationary pressures also in that country, as well as favorable dynamics in the employment front, almost all members from that central bank have turned more hawkish. We think this will be reflected in: (1) An acceleration in the tapering pace, which will be announced on December 15th, one day before Banxico's decision; and (2) more rate hikes in 2022. On the former, purchases have been reduced by US$15 billion per month since November, expecting the pace to accelerate to US$30 billion starting on January. This is mainly based on members' comments. Specifically, Chairman Powell mentioned that they will discuss said acceleration and that it is better to remove the characterization of inflation as 'transitory'.

This comes on top of a continuation of the tightening wave in EMs, with additional hikes since the last decision in Brazil (+150bps), Chile (+125bps), Colombia (+50bps), South Korea (+25bps), South Africa (+25bps) and Peru (+50bps), to name a few. All of this has reduced the room to maneuver due to its effect on risks to inflation and financial stability, in our opinion also justifying adjustments of a higher magnitude.

Third, the exchange rate has been more volatile, strongly pressured until reaching USD/MXN 21.92 on November 26th. At the margin, the cross has improved in the last few days –trading at 20.88 per dollar today–, albeit still maintaining a 1.2% depreciation relative to the level at the time of the last decision. Meanwhile, options' implied volatilities have increased substantially in the same period (especially for terms below one month), while other indicators such as speculative positions on the IMM also suggest a challenging backdrop for the currency.

Regarding economic activity, we do not expect substantial changes relative to recent communications. After the deceleration in 3Q21, signals about the recovery in the last quarter seem more favorable. We anticipate the improvement in local epidemiological conditions to help growth, particularly consumption. Nevertheless, price pressures, along new outbreaks, keep representing important risks.

Lastly, we highlight comments from some Board members. In first place, Governor Alejandro Díaz de León spoke at the release of the *Financial Stability Report*. We highlight his comment on the recent increase in market volatility, showing lower risk appetite. In our opinion, he has stressed on several occasions the importance of having orderly market adjustments. This is important ahead of the withdrawal of stimulus from the Fed in a more complex inflationary backdrop, so current conditions could convince him of the need to tighten more quickly. Meanwhile, Deputy Governor Irene Espinosa took part in our podcast *Norte Económico* (available only in Spanish), in our opinion with an even more hawkish stance. Specifically, we highlight her comment that "*…our monetary policy should respond in an overwhelming manner to inflation levels, the persistence of inflation and to signals that we are already seeing in terms of impacts on expectations…*". In our view, she is clearly concerned about price dynamics, affirming that "*…in the last couple of weeks we have seen the probability* [has increased] *of inflationary pressures* (…) *being more persistent than what was anticipated…*". Coupled with opinions which we attribute to her in the last minutes about the convenience of a 50bps hike, we think she will be among the main supporters of accelerating the pace.

Although we firmly believe that conditions support a more severe tightening, it is not possible to rule out that the Board opts for just a 25bps hike, seeking greater consensus among members. In this sense, we believe Deputy Governor Esquivel will keep voting for an unchanged rate, while others could push for a continuation of gradual adjustments.

Following this decision, we expect the tightening cycle to extend to 2022, with accumulated hikes of 125bps in said year and the rate reaching 6.75% by December. Specifically, we anticipate adjustments in February (+50bps), June (+25bps), September (+25bps), and December (+25bps). The first one would be associated mainly to local inflationary pressures and the acceleration of tapering, while the following ones would be influenced more strongly by the relative monetary stance with the Fed, considering that we expect adjustments of the same magnitude in similar dates by the latter.

**Banxico's survey of economic expectations.** As usual, market participants will focus on inflation, growth, reference rate, and exchange rate forecasts. In the first, analysts expect 2021 year-end inflation at 7.2% y/y, lower than our 7.3%. Meanwhile, the forecast for 2022 stands at 4.0%. Considering additional pressures, we do not rule out further increases on short-term estimates, including for 2021 and 2022. Meanwhile, we do not expect significant moves in medium and long-term expectations, still above target. On GDP, this year stands at 5.7%, in line with our forecast, with 2022 at 2.8%. The current view about the reference rate by YE21 is that it will reach 5.25%, lower than our forecast of a 50bps hike to 5.50%, while the median for 2022 is 6.00% (Banorte: 6.75%). Finally, the year-end exchange rate stands at USD/MXN 20.85 (Banorte: 21.10), possibly with upward changes given recent dynamics, with 2022 at 21.30.

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**GRUPO FINANCIERO BANORTE S.A.B. de C.V.**

| | | | |
|---|---|---|---|
| **Research and Strategy** | | | |
| Alejandro Padilla Santana | Chief Economist and Head of Research | alejandro.padilla@banorte.com | (55) 1103 - 4043 |
| Raquel Vázquez Godinez | Assistant | raquel.vazquez@banorte.com | (55) 1670 - 2967 |
| Itzel Martínez Rojas | Analyst | itzel.martinez.rojas@banorte.com | (55) 1670 - 2251 |
| Lourdes Calvo Fernández | Analyst (Edition) | lourdes.calvo@banorte.com | (55) 1103 - 4000 x 2611 |
| **Economic Research** | | | |
| Juan Carlos Alderete Macal, CFA | Director of Economic Research | juan.alderete.macal@banorte.com | (55) 1103 - 4046 |
| Francisco José Flores Serrano | Senior Economist, Mexico | francisco.flores.serrano@banorte.com | (55) 1670 - 2957 |
| Katia Celina Goya Ostos | Senior Economist, Global | katia.goya@banorte.com | (55) 1670 - 1821 |
| Luis Leopoldo López Salinas | Economist, Global | luis.lopez.salinas@banorte.com | (55) 1103 - 4000 x 2707 |
| **Market Strategy** | | | |
| Manuel Jiménez Zaldívar | Director of Market Strategy | manuel.jimenez@banorte.com | (55) 5268 - 1671 |
| **Fixed income and FX Strategy** | | | |
| Santiago Leal Singer | Senior Strategist, Fixed Income and FX | santiago.leal@banorte.com | (55) 1670 - 2144 |
| Leslie Thalía Orozco Vélez | Strategist, Fixed Income and FX | leslie.orozco.velez@banorte.com | (55) 5268 - 1698 |
| **Equity Strategy** | | | |
| Marissa Garza Ostos | Director of Equity Strategy | marissa.garza@banorte.com | (55) 1670 - 1719 |
| José Itzamna Espitia Hernández | Senior Strategist, Equity | jose.espitia@banorte.com | (55) 1670 - 2249 |
| Víctor Hugo Cortes Castro | Senior Strategist, Technical | victorh.cortes@banorte.com | (55) 1670 - 1800 |
| **Corporate Debt** | | | |
| Hugo Armando Gómez Solís | Senior Analyst, Corporate Debt | hugoa.gomez@banorte.com | (55) 1670 - 2247 |
| Gerardo Daniel Valle Trujillo | Analyst, Corporate Debt | gerardo.valle.trujillo@banorte.com | (55) 1670 - 2248 |
| **Economic Studies** | | | |
| Miguel Alejandro Calvo Domínguez | Senior Analyst, Economic Studies | miguel.calvo@banorte.com | (55) 1670 - 2220 |
| **Wholesale Banking** | | | |
| Armando Rodal Espinosa | Head of Wholesale Banking | armando.rodal@banorte.com | (55) 1670 - 1889 |
| Alejandro Aguilar Ceballos | Head of Asset Management | alejandro.aguilar.ceballos@banorte.com | (55) 5004 - 1282 |
| Alejandro Eric Faesi Puente | Head of Global Markets and Institutional Sales | alejandro.faesi@banorte.com | (55) 5268 - 1640 |
| Alejandro Frigolet Vázquez Vela | Head of Sólida Banorte | alejandro.frigolet.vazquezvela@banorte.com | (55) 5268 - 1656 |
| Arturo Monroy Ballesteros | Head of Investment Banking and Structured Finance | arturo.monroy.ballesteros@banorte.com | (55) 5004 - 5140 |
| Carlos Alberto Arciniega Navarro | Head of Treasury Services | carlos.arciniega@banorte.com | (81) 1103 - 4091 |
| Gerardo Zamora Nanez | Head of Transactional Banking, Leasing and Factoring | gerardo.zamora@banorte.com | (81) 8173 - 9127 |
| Jorge de la Vega Grajales | Head of Government Banking | jorge.delavega@banorte.com | (55) 5004 - 5121 |
| Luis Pietrini Sheridan | Head of Private Banking | luis.pietrini@banorte.com | (55) 5249 - 6423 |
| Lizza Velarde Torres | Executive Director of Wholesale Banking | lizza.velarde@banorte.com | (55) 4433 - 4676 |
| Osvaldo Brondo Menchaca | Head of Specialized Banking Services | osvaldo.brondo@banorte.com | (55) 5004 - 1423 |
| Raúl Alejandro Arauzo Romero | Head of Transactional Banking | alejandro.arauzo@banorte.com | (55) 5261 - 4910 |
| René Gerardo Pimentel Ibarrola | Head of Corporate Banking | pimentelr@banorte.com | (55) 5004 - 1051 |
| Ricardo Velázquez Rodríguez | Head of International Banking | rvelazquez@banorte.com | (55) 5004 - 5279 |
| Víctor Antonio Roldan Ferrer | Head of Commercial Banking | victor.roldan.ferrer@banorte.com | (55) 1670 - 1899 |