Banxico Minutes – Consensus on the need of stronger tightening

- **Banxico published the minutes of the decision held on December 16th, in which they hiked the rate by 50bps to 5.50%, in line with our call**
- **In our opinion, the document reinforces the more hawkish tone seen in the statement, with most members emphasizing the need to accelerate the tightening of monetary conditions**
- **Discussions on inflation remain very important, highlighting:**
  (1) Greater consensus about a generalized upward trend in prices, mainly at the core, and a weaker perception over their transitory nature;
  (2) The balance of risks deteriorated and remains skewed to the upside, with uncertainty about the possible extension of some shocks; and
  (3) The evaluation that short-term market expectations keep adjusting higher, representing risks of a possible de-anchoring
- **We also highlight comments on recent Fed actions, being a relevant factor for more restriction locally**
- **Considering this, as well as a still challenging inflation outlook and other factors, we reiterate our view of a 50bps hike in February, followed by 25bps increases in June, September, and December. As such, the rate would close this year at 6.75%**
- **The market is pricing-in a restrictive stance for Banxico in 2022**

Banxico minutes corroborate factors behind the need of a larger hike. Banco de México published the minutes of the meeting held on December 16th, in which they hiked the reference rate by 50bps to 5.50%, in line with our call. Similar to the previous decision and as already known, the only dissenter was Deputy Governor Gerardo Esquivel, albeit this time supporting a 25bps increase. In our opinion, the document reinforces the more hawkish view seen in the statement, even suggesting that the decision was less difficult than what we thought at the time. Specifically, most members continue quoting the difficult inflation backdrop among the factors behind their vote –with special attention on the core component–, as well as its possible effect on expectations. Another driving factor –even skewing Esquivel– was the Fed's decision to increase the pace of reduction of its QE program and the signal of a less accommodative stance ahead. Considering this and our estimate that inflation will keep exhibiting complicated dynamics, we reiterate our view of a 50bps hike on February 10th, followed by 25bps increases in June, September, and December, in line with adjustments in the same magnitude by the Fed. With this, the rate would close this year at 6.75%.

Actions were necessary on risks to expectations and Banxico's credibility. We believe that, for most members, arguments to accelerate the tightening pace were sustained by: (1) High inflation, which could impact the anchoring of expectations; (2) the need of more decisive actions to protect the bank's credibility; and (3) expectations that have risen more than expected, limiting their effect on the real ex-ante rate.

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www.banorte.com
@analisis_fundam

Alejandro Padilla
Chief Economist and Head of Research
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA
Executive Director of Economic Research and Financial Markets Strategy
juan.alderete.macal@banorte.com

Francisco Flores
Director of Economic Research, Mexico
francisco.flores.serrano@banorte.com

Fixed income and FX Strategy

Manuel Jiménez
Director of Market Strategy
manuel.jimenez@banorte.com

Leslie Orozco
Senior Strategist, Fixed Income and FX
leslie.orozco.velez@banorte.com

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	+50bps

Source: Banxico

Banxico's 2022 policy decisions

Date	Decision
February 10	--
March 24	--
May 12	--
June 23	--
August 11	--
September 29	--
November 10	--
December 15	--

Source: Banxico

Document for distribution among the general public

These seem to have a relevant weight among the 50bps voters, albeit heterogeneous in magnitude. In our view, the most relevant comments that we attribute to each one of them are, by order of appearance:

- Gerardo Esquivel: "*...a moderate tightening of the monetary policy stance is necessary. However, he/she warned that this should be done with caution, given that an overly restrictive policy stance could affect economic growth and, eventually, capital flows and the exchange rate...*". The Deputy Governor maintains the most dovish bias, concerned about the effect of hikes on GDP growth and consistent with his vote of only a 25bps increase.
- Galia Borja: "*...He/she pointed out that his/her vote seeks to propitiate an adequate formation of inflation expectations and their firm anchoring* (…) *the monetary strengthening should not require increases similar to those observed in other economies...*". This Deputy Governor seems more concerned over price dynamics –and its effect on expectations–, as well as due to the faster Fed tapering, albeit emphasizing once again the "reinforcement" instead of an outright, more restrictive, stance.
- Jonathan Heath: "*a balance must be found between a weak economic recovery, persistent inflationary pressures, and the beginning of the new monetary tightening cycle by the Federal Reserve* (…) *he/she emphasized that the monetary policy response should be proportional to the inflationary outlook in order to preserve credibility and the long-term anchoring of expectations…*". Once again, we highlight the call to bolster the forecast-based inflation targeting regime. Comments seem to be more in the center of the spectrum, balancing the effects of hikes on growth, inflation, and its expectations.
- Irene Espinosa: "*…in the absence of a more decisive and forceful action that ratifies the commitment to the primary objective, there is a risk of losing credibility and of a de-anchoring of inflation expectations…*". In our opinion, this shows a more hawkish tilt as it also noted the need of congruence between statements and actions taken and that risks must be tackled in a timely and decisive manner.
- Alejandro Díaz de León: "*...monetary policy should keep inflation expectations anchored, bring about orderly conditions in the exchange market, contain risk premia along the yield curve, and enable the convergence of headline inflation to its 3% target…*". We think the Governor has stressed on repeated occasions the need to carefully manage economic and financial risks stemming from high inflation in order to ensure the convergence to the target.

Additional deterioration in inflation dynamics drove forecasts higher. The Governing Board recognized that a part of inflation's behavior is explained by external drivers. Hence, they explained that the strong economic integration with the US has "*…contributed to the rebound of inflation in Mexico…*". Nevertheless, they admitted that domestic drivers complicate the scenario. In this backdrop, most suggested that the problem seems quite generalized, with clear upward trends in several components. Concerns are centered at the core, citing its strong uptick in November and unfavorable trends mainly on goods, although with services also accelerating.

Related to these increases, some commented that "*...the phenomenon of readjustment in relative prices and the arguments about the transitory nature of inflationary pressures no longer seem appropriate to explain the current situation...*". In fact, one was even more forceful by saying that the debate about the transitory nature has been left behind, while another stated that it remains valid.

Balance of risks still deteriorated and to the upside. Revisions to the inflation path were highly for both the headline and the core. Members expressed doubts about the possibility of estimating the duration of current shocks. Short-term inflation kept rising, which even one member saying that: "*...analysts do not expect inflation to decrease as fast as estimated by the central bank and that there is a significant discrepancy regarding the rate of decrease of the core component...*". The latter is consistent with our view and supports a higher monetary restriction. On expectations, those for the mid- and long-term remain stable, although with those extracted from financial instruments higher when compared to survey-based measures.

Unchanged call. We reiterate our view of 125bps in rate hikes this year, in the decisions to be held in February (+50bps), June (+25bps), September (+25bps), and December (+25bps). We believe the key factors behind the need of a faster pace remain valid. On inflation, concerns are still elevated, mainly at the core level. The latter surprised to the upside again in the 1H-December, albeit with the headline benefitted strongly by lower prices in agricultural goods and energy (especially LP gas). Figures for the first months of 2022 will be very important ahead of the February meeting, although we estimate that difficulties will stay due to new restrictions because of Omicron, among other drivers. Externally, yesterday's Fed minutes showed the possibility of an even faster normalization process, especially in terms of rate hikes and balance sheet reduction. We believe this supports Banxico's more restrictive stance as it could impact capital flows and the FX market, which in turn constitute upside risks for prices.

From our Fixed income and FX strategy team

The market is pricing-in a restrictive stance for Banxico in 2022. Local rates depreciated after Banxico's minutes amid a session characterized by widespread pressures on global sovereign bonds, led by US Treasuries that keep digesting the hawkish tone of yesterday's Fed minutes. Specifically, short- and mid-term Mbonos lost 5bps on average, extending the +50bps adjustment since Banxico's last policy decision. Long-term securities were pressured by 3bps and have added about +34bps during the same period. In addition, the TIIE-28 IRS curve steepened, with the long-end depreciating up to 9bps and few changes in the short-end. However, the latter segment has accumulated ~+45bps since December 16th. In this sense, the market is pricing-in a restrictive stance from Banxico, with implied hikes of +47bps for the February decision and +218bps accumulated by year-end. The former is in line with our call, but the latter is more aggressive relative view of a rate at 6.75% (equivalent to +15bps). In terms of strategy, we keep waiting better levels in Mbonos as the start of the year has been difficult. We still see a greater flattening bias, in a backdrop of high volatility and inflationary pressures.

In FX, the MXN appreciated after the release. The currency traded below the psychological level of 20.50 per dollar (0.7% d/d), positioning itself as the second strongest relative to EM, just behind ZAR (+1.3%). Since this beginning of the year, the Mexican peso has traded in a range of 41 cents between 20.34 and 20.75 per dollar, slightly below the 2021 weekly average at 50 cents. Looking forward, we still see the USD with structural gains on Fed normalization and an uneven economic recovery across regions. Therefore, we recommend buying USD in dips for trading purposes. In the short-term, we believe USD purchases are attractive if USD/MXN moves close to 20.40 per dollar.

Analyst Certification

We, Alejandro Padilla Santana, Juan Carlos Alderete Macal, Alejandro Cervantes Llamas, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Francisco José Flores Serrano, Katia Celina Goya Ostos, 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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BANORTE

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	Executive Director of Economic Research and Financial Markets Strategy	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Francisco José Flores Serrano	Director of Economic Research, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Katia Celina Goya Ostos	Director of Economic Research, 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			
Leslie Thalía Orozco Vélez	Senior 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
Quantitative Analysis			
Alejandro Cervantes Llamas	Executive Director of Quantitative Analysis	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Miguel Alejandro Calvo Domínguez	Senior Analyst, Quantitative Analysis	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