Banxico – We expect a 10% reference rate by year-end

- **Today, Banxico's Board unanimously decided to hike the reference rate by 75bps to 7.75%, in line with our call**
- **Despite an acceleration in the pace, the tone of the statement remains very hawkish. We highlight that:**
  - ***(1)*** **In our opinion, the key change was in the quote about upcoming steps, in which they "*…will evaluate taking the same forceful measures if conditions so require…*";**
  - **(2) Inflation forecasts were adjusted again strongly to the upside, but with the convergence to the target still estimated by 1Q24; and**
  - **(3) They mentioned that headline inflation expectations in the medium- and long-term rose slightly, although the balance of risks was no longer characterized as having "an additional deterioration"**
- **Given challenging inflationary dynamics, the new upward adjustments in forecasts, and more aggressive restrictive cycles around the world, we revise our monetary policy trajectory. We now project +75bps in August and three hikes of 50bps each for the rest of the year**
- **With this, the reference rate would reach 10.00% at the end of 2022 (previous: 9.50%), a level at which the current cycle would end**
- **After this, we consider that skew for 2023 is towards one or more cuts, especially on the back of fears about a global recession**
- **The market consolidates its view for Banxico**

Banxico hikes 75bps and maintains a hawkish tone. In line with our view and consensus, the central bank accelerated the tightening pace (see table to the right), taking the rate to 7.75%. The decision was unanimous, despite some speculation about at least one dissenter in favor of a stronger increase. In our opinion, the vote is explained by: (1) A hike of the same magnitude from the Fed last week; and (2) inflation that keeps surprising to the upside. In this context, the tone and details remain quite hawkish. We highlight the new upward revision in the forecasts (see table below), but with the convergence to the target still in 1Q24. The key change was in the quote regarding upcoming decisions, saying that: "*…the Board intends to continue raising the reference rate and will evaluate taking the same forceful measures if conditions so require…*". In our opinion, this is a clear sign of a 75bps ceiling for the next meeting. Although the global slowdown in 2Q22 was mentioned, members remain focused on the price outlook. Specifically, they also noted that medium- and long-term headline inflation expectations rose slightly. Although the balance of risks was not characterized as deteriorated, it is important to mention that it occurred only after the strong adjustment in estimates. Considering this, today's change to our inflation forecasts, and more aggressive restrictive cycles in the world, we revise our monetary policy call. We forecast +75bps in August and three 50bps hikes each in the remainder of the year. With this, the reference rate would reach 10.00% by the end of 2022 (previous: 9.50%), which constitutes our new estimate for the terminal rate in this cycle.

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Winners of the award for best economic forecasters for Mexico in 2021, granted by *Refinitiv*

STARMINE AWARDS FOR REUTERS POLLS FROM REFINITIV

Banxico's 2022 policy decisions

Date	Decision
February 10	+50bps
March 24	+50bps
May 12	+50bps
June 23	+75bps
August 11	--
September 29	--
November 10	--
December 15	--

Source: Banxico

A challenging backdrop for inflation prevails, with new estimate revisions. Overall, the perception about the drivers and shocks to inflation was the same than in the last meeting, although recognizing that the annual print for the headline and core reached 20-year highs. On the balance of risks, it remains skewed to the upside in a "significant" way, although it was not perceived with a further deterioration. Risks both to the upside and downside were the same than in the last statement. In our view, the most relevant point was the strong changes to inflation forecasts, both for the headline and the core. Specifically, adjustments for 2Q22 were tighter (considering information already known). Nevertheless, the average move for the next four quarters was +108bps for the former and +83bps in the latter. Although substantial, we believe these forecasts are still somewhat optimistic, particularly on the timing of the convergence to the target which was kept in 1Q24, contrasting with our view that inflation will reach 8.1% by year-end and 4.1% by December 2023.

CPI forecasts
% y/y, quarterly average

	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24
CPI										
Current	7.3*	7.8	8.1	7.5	6.5	4.4	3.5	3.2	3.1	3.1
Previous	7.3*	7.6	7.0	6.4	5.3	3.5	3.2	3.2	3.1	--
Difference (bps)	--	20	110	110	120	90	30	0	0	--
Core										
Current	6.5*	7.3	7.4	6.8	5.7	4.3	3.5	3.2	3.1	3.1
Previous	6.5*	7.2	6.6	5.9	4.8	3.6	3.3	3.1	3.0	--
Difference (bps)	--	10	80	90	90	70	20	10	10	--

Source: Banco de México. *Observed data

The reference rate will climb faster than previously expected and will reach 10% this year… Firstly, this is based on our expectation of a higher inflation path this year. In particular, Banxico's headline and core estimates for 4Q22 stand at 7.5% and 6.8%, respectively. Although the increase is substantial, they are still 50bps and 110bps lower than our view, in the same order. In second place, we expect the Fed to take its reference rate to 4.00% by the end of this year, with the magnitude of each hike setting a 'floor' on Banxico's adjustment. On this, we still believe that a key consideration is the management of the interest rate differential with the US due to its potential effects on the exchange rate, capital flows, and financial stability. Given the challenging inflation backdrop, the new upward adjustment on estimates, and more aggressive tightening cycles across the world, we revise our monetary policy path. We now expect 75bps in August and three 50bps hikes each for the rest of the year. With this, the reference rate would reach 10.00% by the end of 2022 (previous: 9.50%), at which the current hiking cycle would end.

…while the probability of cuts in 2023 has increased. A 10% reference rate would imply a very restrictive stance, albeit necessary to fight high inflation. According to our forecasts, the ex-ante real interest rate at the beginning of 2023 would stand between 5.5% to 5.8%. For comparison, the same rate reached close to 4.2% at its highest point in the previous hiking cycle (2015-2018), while Banxico estimates restrictive territory at 3.4% and above. Considering this, a higher probability of a US recession next year –with some institutions estimating it close to 50%– and that inflation will likely be on a downward trend, we think it is much more likely that Banxico will cut rates in 2023.

Specifically, the pace and exact timing will depend on two factors: (1) The absolute levels and path of inflation by then, with the need to confirm if the convergence to the target will happen at the estimated time horizon; and (2) the magnitude of a possible deceleration in Mexico. For now, the visibility about these drivers is very limited because of very high uncertainty. Nonetheless, it is our take that the skew in that direction is quite clear and could materialize in the second half of the year.

From our Fixed Income and FX strategy team

The market consolidates its view for Banxico. After the decision, nominal rates extended their flattening bias with greater gains in the long-end. It is worth noting that today's session was characterized by widespread gains in sovereign bonds led by US Treasuries as recession fears increased. Hence, the Mbonos' curve gained 4bps at the short-end and rallied 14bps in the long-end. In a similar fashion, longer-term TIIE-28 IRS declined up to 20bps, while short-term tenors were virtually unchanged. As a result, the market keeps pricing-in additional hikes of 75bps in the next two meetings followed by two +50bps moves in November and December. With this, the tightening cycle would finish this year with a reference rate at 10.25%. This scenario is slightly more aggressive than our call of a terminal rate of 10.00%.

We expect nominal curves to maintain a flattening bias. Moreover, we believe short-term rates look increasingly attractive for short-term trading as they already discount a very restrictive cycle. However, high volatility and the possibility of other negative inflation surprises could add further pressure in this segment. Furthermore, we still think long-term Mbonos remain attractive as the tightening cycle starts to be reflected in a decline of long-term inflation expectations. We favor Mbonos Nov'42 and Nov'47 with levels above 9.00% for buy-and-hold investors. Finally, we do not see attractive valuations in real rates despite inflationary pressures. CPI-linked Udibonos remain expensive, particularly short-term securities. For example, the 3-year breakeven stands at 5.14%, way above Banxico's target and its 12-month average of 4.66%.

In FX, the USD closed in positive territory, advancing against most developed and emerging market currencies. The Mexican peso appreciated up to 0.3% after Banxico's decision, temporarily breaching the psychological level of 20.00 per dollar. By the end of the trading day, it closed at 20.03 (+0.1%), gaining for five days in a row. We maintain our view of structural USD strength given heightened recession fears and a more hawkish tone by the Fed. However, Banxico's stance will continue to support the peso in the short term. We estimate the room for a short-term appreciation towards the 19.75/19.80 resistance, which we believe is likely to be tested in coming days.

Analyst Certification

We, Alejandro Padilla Santana, Juan Carlos Alderete Macal, Alejandro Cervantes Llamas, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Katia Celina Goya Ostos, Francisco José Flores Serrano, José Luis García Casales, Víctor Hugo Cortes Castro, José Itzamna Espitia Hernández, Carlos Hernández García, David Alejandro Arenas Sánchez, Leslie Thalía Orozco Vélez, Hugo Armando Gómez Solís, Yazmín Selene Pérez Enríquez, Miguel Alejandro Calvo Domínguez, Daniela Olea Suárez, José De Jesús Ramírez Martínez, Gerardo Daniel Valle Trujillo, Luis Leopoldo López Salinas, Isaías Rodríguez Sobrino, Paola Soto Leal, Oscar Rodolfo Olivos Ortiz, Daniel Sebastián Sosa Aguilar and Salvador Austria Valencia 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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HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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