Banxico – We anticipate the terminal rate at 11% by the end of 1Q23

- **Today, Banxico's Board raised the reference rate by 75bps to 9.25% with a unanimous vote, in line with our call held since August 11th**
- **The tone of the statement remains hawkish. We highlight that:**
  - ***(1)* Inflation forecasts were adjusted significantly to the upside, with the expected convergence to the target delayed to 3Q24;**
  - **(2) When evaluating the outlook for inflation, they incorporated "*…that their effects will take longer to dissipate…*"; and**
  - **(3) Their forward guidance was unchanged, keeping the door open for another rate hike of the same magnitude**
- **We adjust our call because of an even more difficult environment in terms of the relative stance and inflation. Specifically, we now see the reference rate at 10.50% by year-end (previous: 10.00%), with +75bps in November and +50bps in December**
- **After this, we expect two additional +25bps hikes in early 2023 (February and March), taking the interest rate to 11.00%. We also add some modest easing in the second half, ending said year at 10.25%**
- **The market expects the tightening cycle to end close to 10.80%**

Banxico hikes 75bps, supporting our view of more tightening in 2022… In line with our view held since August 11th, and consensus, the central bank raised the reference rate again by 75bps (see table to the right), taking the rate to 9.25%. The decision was unanimous, as in June and August. In our view, the adjustment responds especially to the hike of the same magnitude by the Fed on September 21st, as well as a more challenging inflation backdrop. In addition, we believe the outlook about the relative stance –with expectations of further tightening by the Fed– and inflation have deteriorated at the margin. This will force Banxico to extend the monetary tightening, both in magnitude and duration. Specifically, we think the reference rate will close this year at 10.50% –with +75bps in November and +50bps in December. The magnitude will be influenced by identical moves from the Fed, despite comments from several members that US monetary policy is just one of the drivers behind their decisions. However, when adding a more challenging inflation backdrop –as reflected, at least partially, in the changes to their forecasts (see section below)–, it is our take that this is the most likely outcome. In addition, we believe that this strategy implies the lowest possible cost in terms of the potential market reaction and for economic activity. For example, if they were to hike less than expected, the exchange rate could depreciate with some force –which could be passed-through to prices and make a moderation in inflation even more difficult–, while increasing communication challenges. If they were to tighten faster, gains in financial stability and the exchange rate could not be enough to offset the likely added impact in terms of economic activity.

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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	+75bps
September 29 *	+75bps
November 10	--
December 15	--

*Minutes of the decision to be released on October 13th. Source: Banxico

…with more hikes at the beginning of 2023. These same factors will influence the decisions at the beginning of next year, the main reason behind our call of two more +25bps hikes each in February and March, taking the rate to 11.00%. We now believe the latter will be the terminal level of this tightening cycle (previous: 10.00%). We expect the rate to remain there for the best part of the year, with inflation still well above the central bank's target (see following section). However, given a higher-than-expected economic slowdown and an eventual consolidation of the downward trend in annual inflation –which would result in a gradual increase in the ex-ante real rate, already in restrictive territory–, we believe that Banxico will begin easing in September with -25bps, followed by adjustments of the same magnitude in November and December. With this, the reference rate would close that year at 10.25%.

Inflation estimates once again higher. Inflation forecasts were revised once again higher –and, in our opinion, significantly– and the balance of risks was unchanged, remaining 'biased significantly to the upside'. In addition, they delayed by one quarter the moment at which they expect the convergence to the target, to 3Q24. We also highlight the inclusion of the phrase that the effects from inflation shocks will take longer to dissipate. Consistent with this, we saw a large adjustment for 2022, but even higher for 2023 (see table below). For the latter year, the average change was +93bps, with a high of +110bps in 3Q23. Also important, revisions for the core were a bit stronger, averaging 100bps. Although the direction of these modifications is adequate, we think the magnitudes are still not enough, suggesting risks of additional revisions to the upside ahead. In this respect, average headline inflation projected by Banxico is between +20bps (4Q22) and up to +190bps (2Q23) below our forecasts.

CPI forecasts
% y/y, quarterly average

	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24
CPI										
Current	7.8*	8.6	8.6	7.9	6.0	4.8	4.0	3.7	3.4	3.1
Previous	7.8*	8.5	8.1	7.1	5.0	3.7	3.2	3.1	3.1	--
Difference (bps)	--	10	50	80	100	110	80	60	30	--
Core										
Current	7.3*	8.0	8.2	7.3	6.2	5.0	4.1	3.6	3.2	3.0
Previous	7.3*	7.9	7.6	6.5	5.1	3.8	3.2	3.1	3.0	--
Difference (bps)	--	10	60	80	110	120	90	50	20	--

Source: Banco de México. *Observed data

From our Fixed Income and FX strategy team

The market expects the tightening cycle to end close to 10.80%. After the decision, local rates exhibited few changes, with Mbonos and TIIE-28 swaps maintaining average losses of 5bps. In addition, the market now sees more clearly that Banxico will extend its restrictive cycle into 1Q23, with a terminal rate around 10.80%. We should mention that local rates have been significantly pressured and have exhibited heightened volatility in recent days due to external drivers. In this backdrop, the Mbonos' curve trades at stressed levels close to +3σ from their 90-day MA, mainly in the long-end. On Tuesday, the 2-year and 10-year benchmarks yields reached their highest since 2008 at 10.47% and 9.85%, respectively. We continue to expect nominal yields to extend their flattening bias and even exacerbate their inversion.

Given recent adjustments, it is our take that long-term Mbonos are more attractive, mainly tenors Nov'38 and Nov'42. Nonetheless, we still think the risk/reward profile in outright, long-duration positions without FX hedge are not attractive enough. Hence, we maintain our trade idea of paying TIIE-IRS (26x1), while receiving 2-year SOFR. In FX, the Mexican peso traded between 20.15 and 20.20 per dollar, stable as it had already priced-in the 75bps hike.We recognize limited room for further peso gains despite Banxico's high reference rate, with a model-estimated fair value of 22.38, and given the dollar's structural strength. In this sense, we see the 20.00 per dollar psychological level as attractive to buy USD.

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, Leslie Thalía Orozco Vélez, Hugo Armando Gómez Solís, Yazmín Selene Pérez Enríquez, Cintia Gisela Nava Roa, 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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