Banxico: Continued doses of monetary policy gradualism

Jessica Roldán Peña *
Chief Economist
jroldan@finamex.com.mx
+ 52 (55) 5209 2056

Víctor Gómez Ayala
Senior Economist
vgomez@finamex.com.mx
+ 52 (55) 5209 2151

Montserrat Aldave
Economist
caldave@finamex.com.mx
+ 52 (55) 5209 2029

- This Thursday we expect the Central Bank to reduce its reference rate by 50 bps, from 5.50 to 5.00%, in what could be the last unanimous decision within the present easing cycle.
- We also expect that the accompanying communiqué maintains the somewhat hawkish tone that prevailed in the last Inflation Report since, in our view, the balance of elements that will determine Banxico's action has remained relatively unchanged.
- Given the improvement in domestic financial markets' dynamics and the fact that headline inflation projections continue lying within Banxico's +/-1% variability interval around its 3% inflation target, we believe the path for a 50 bps reduction of the reference rate is paved, as a lower interest rate would contribute to better prospects for an economic recovery.
- Going forward, we continue anticipating additional policy rate cuts by 50 bps. However, we expect that, as the monetary easing cycle continues, the different stances across Board members begin to lie further apart each other, thus making it difficult to observe more unanimous actions. Hence, we do not discard that future adjustments are implemented in a set of two 25 bps cuts, rather than in a single 50 bps move.
- Three things stand in the majority of Board members' way towards introducing a more dovish tone that could suggest a deeper easing cycle than the one that we are currently expecting: i) the possibility of observing new episodes of lower risk aversion and increased volatility in international financial markets; ii) inflation uncertainty; and iii) the continuation and possible escalation of the build-up of idiosyncratic risks.

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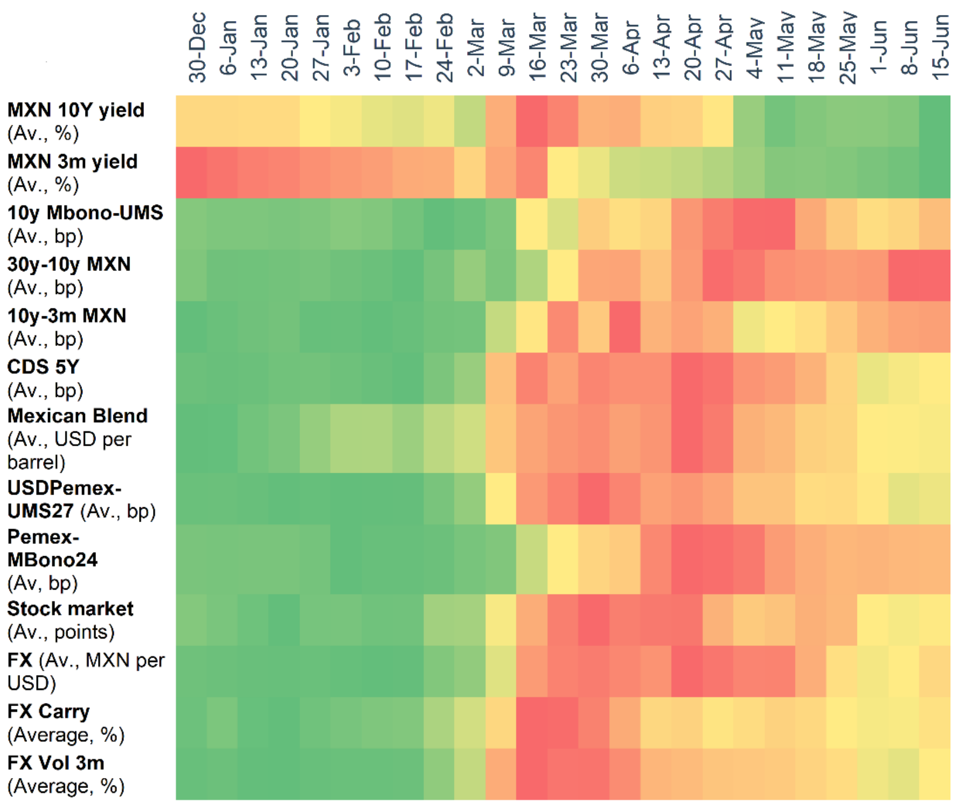
This Thursday afternoon, Banco de México will announce its new monetary policy decision. We expect the Central Bank to reduce its reference rate by 50 basis points (bps), from 5.50 to 5.00%, in what could be the last unanimous decision of the Governing Board within the present easing cycle. We also expect that the accompanying communiqué maintains the somewhat hawkish tone that prevailed in the last Inflation Report since, in our view, the balance of elements that will determine Banxico's action has remained relatively unchanged.

From the last monetary policy decision (in May 14th) till mid-June, domestic financial markets benefited from renewed investors' risk appetite. Accordingly, and despite the short-lived global markets' rout observed a few weeks ago, local interest rates gained additional ground, especially those of short-term maturities, thus steepening the yield curve. Interest rate spreads between Mexico and the U.S. narrowed. The USD/MXN appreciated around 6%, as its implicit volatility within a 12-month horizon either remained the same or decreased. Moreover, 5- and 10-year CDS also went down, by nearly 100 basis points each, outperforming those corresponding to other emerging market economies (EMEs). Remarkably, even Pemex-sovereign spreads fell in both hard and local currency (see Figure 1).

Regarding economic activity, a complete picture of the full impact of COVID-19 pandemic in April's output will not become available until the end of the week with the release of the monthly-based global economic activity indicator (IGAE). However, different data showing sharp reductions in industrial production, employment, exports, imports and retail sales already suggest that the image will be dire. The former, coupled with downward adjustments in Q1-2020 output growth fueled additional revisions to this year's GDP growth expectations. The most relevant figures on this front come from Banxico itself, who in its last Inflation Report (released on May 27th), presented three alternative growth scenarios that anticipate GDP contractions between -4.6 and -8.8% in 2020 and recoveries of up to 4.5% in 2021 (see Figure 2, and our Monetary policy at a glance note "Banxico's Q1-2020 Inflation Report: Higher inflation on sight as economic activity sharply contracts in the Central Bank's new projections," on May 28th).

One of the most important messages conveyed in Banxico's latest Inflation Report is that it expects inflation to be higher relative to the trajectory that it would anticipate prior to the COVID-19 shock, throughout most of the forecasted horizon (we refer to the mid-point of the estimated ranges for inflation corresponding to each one of the three growth scenarios, which is the one that the Bank emphasized). Indeed, even after considering the disinflationary pressures due to the significant widening of slack conditions in the economy, inflationary supply-side elements –namely, FX depreciation and disruptions in some supply and distribution chains– and a high degree of persistence are at the center of the new inflation trajectory, particularly of core inflation, at least in the short-term.

Figure 1. Heat map: Domestic financial markets



Source: Finamex Economic Research with data from Bloomberg.

Figure 2A. 2020 GDP growth expectations (%)

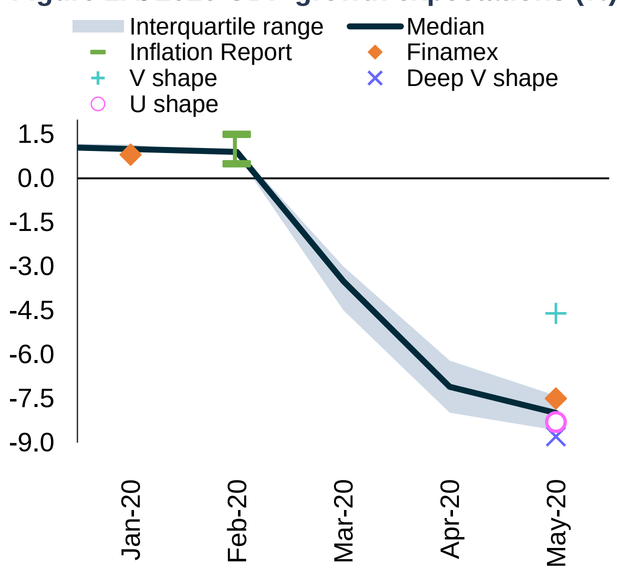
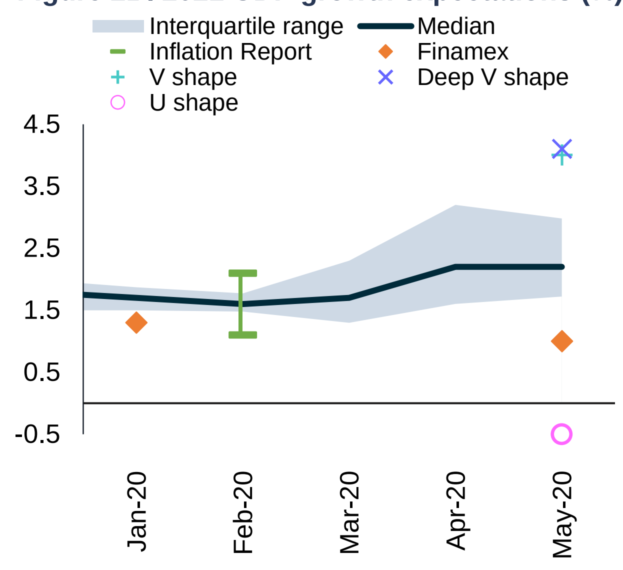


Figure 2B. 2021 GDP growth expectations (%)



Source: Finamex Economic Research with data from Banxico's Expectation Survey and Inflation Reports.

Interestingly, this is the first time that the Central Bank's inflation estimates for the end of any given year meaningfully exceed those of economic analysts' (see Figures 3A and 3B). In the last respect, although latest inflation data proved to be somewhat erratic, a pattern of increasing food merchandise prices has arisen. This behavior has offset the drop in non-food merchandise and other services prices, thus ensuring for the moment relatively stable levels of core inflation (see Figures 3C and 3D).

Given the improvement in domestic financial markets' dynamics and the fact that headline inflation projections continue lying within Banxico's +/-1% variability interval around its 3% inflation target, we believe the path for a 50 bps reduction of the reference rate is paved, as a lower interest rate would contribute to better prospects for an economic recovery. Going forward, we continue anticipating additional policy rate cuts by 50 bps, and do not discard that these are implemented in a set of two 25 bps cuts, rather than in a single 50 bps move. However, we expect that, as the monetary easing cycle continues, the different stances across Board members begin to lie further apart each other, which, in turn, would complicate the Board's ability to undertake additional unanimous actions in the future.

In our view, three things stand in the majority of Board members' way towards introducing a more dovish tone that could suggest a deeper easing cycle than the one that we are currently expecting (with a terminal nominal interest rate at 4.50%):

1. The possibility of observing new episodes of lower risk aversion and increased volatility in international financial markets, as news regarding the evolution of the pandemic and/or other geopolitical risks unfold.
2. Inflation uncertainty.
3. The continuation and possible escalation of the build-up of idiosyncratic risks.

In the last respect, a lack of clarity regarding the direction of fiscal policy is key. Although the government has endlessly declared its commitment to maintain a prudent approach towards public finances, the implementation of fiscal measures of limited-scope to support the economy and the negative spillover effects from the sovereign-Pemex relationship (amid still relatively low oil prices and prospects of a slow recovery), only contribute to cloud the landscape even further. Most of the economic damage of the Great Lockdown in domestic economic conditions has already been done. Although any effort to turn the steering wheel will be welcomed, from our perspective it will come too little too late. The likelihood of observing upward pressure to country risk premium triggered, among other things, by the effects of poor fiscal policy response on growth and, probably, potential output, with the consequent effects for capital outflows and FX dynamics, should be enough for the majority of Board members to believe that the room for further monetary policy easing is coming to an end.

Figure 3A. Evolution of 2019 2020 headline inflation expectations (%)

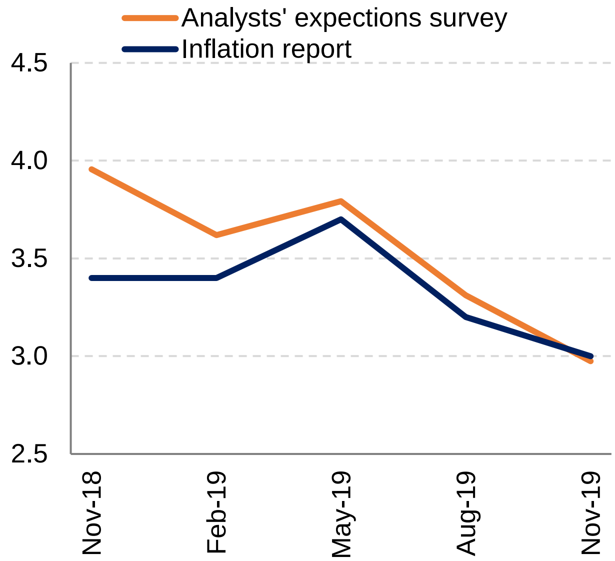


Figure 3B. Evolution of 2020 headline inflation expectations (%)

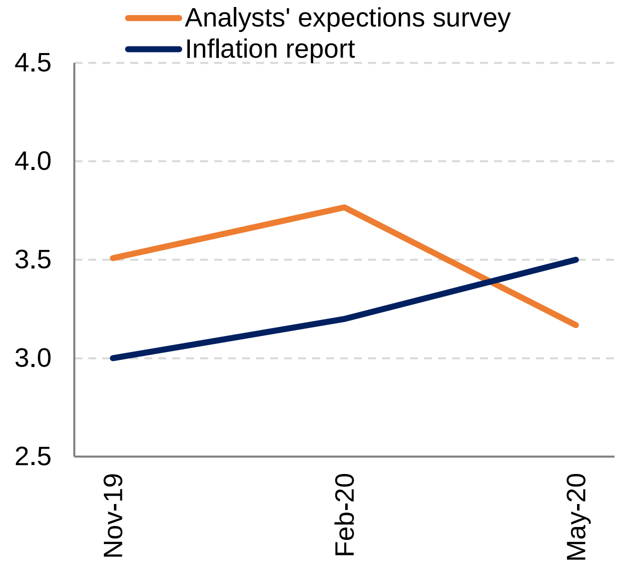


Figure 2A. Annual inflation (%)

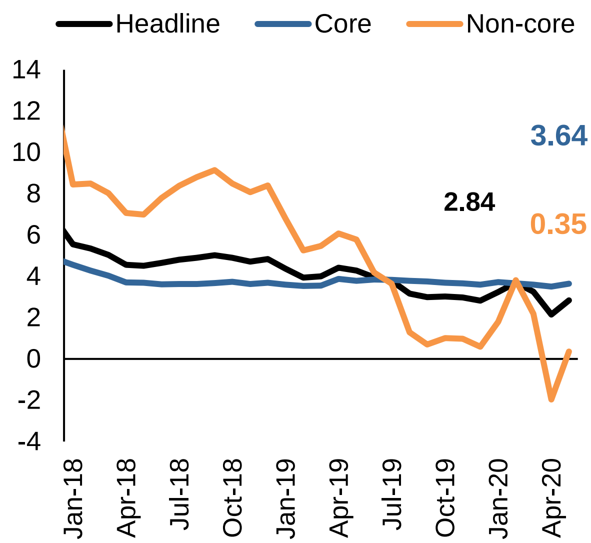
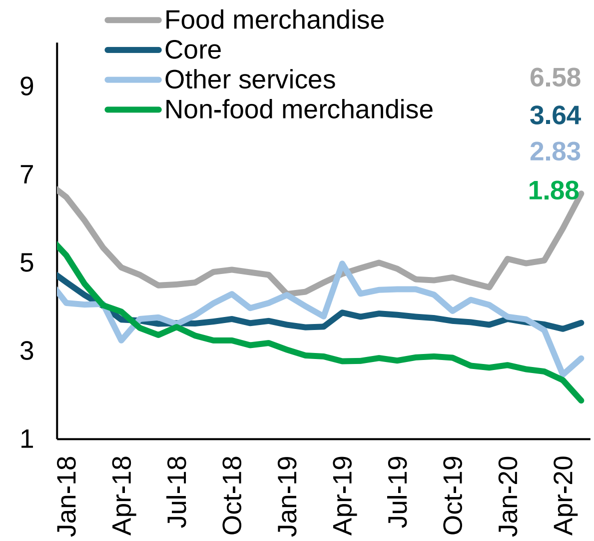


Figure 2B. Core inflation (%)



Note: To calculate Q4 average inflation from analysts' expectations survey, we use the median of monthly inflation expectations to compute monthly paths for annual inflation, we then take the average of the fourth quarter for the corresponding year.
Source: Finamex Economic Research with data from Banxico's Expectation Survey and Inflation Reports and INEGI.

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(*) Research analyst(s) primarily responsible for the preparation and content of this research report.