Banxico minutes – The end of the tightening cycle is very close

- **Banxico published the minutes of the decision held on March 30th, in which they hiked the interest rate by 25bps to 11.25% with a unanimous vote**
- **The document reaffirmed the less hawkish tone that we perceived in the statement. We highlight relevant comments across different fronts:**
  (1) The dissenting opinion from Deputy Governor Espinosa, supporting to include an explicit comment that monetary tightening will persist for an extended period;
  (2) An improvement in the outlook for headline inflation, albeit still with some concerns about the core;
  (3) Discussion on the forward guidance and the terminal level in this tightening cycle; and
  (4) The possible need for changes in the central bank's communication policies given its importance for the transmission of monetary actions
- **Despite less hawkish comments, we expect Banxico to hike by 25bps in May to 11.50% due to the inflation backdrop and our call for the Fed. This would be the terminal level in the cycle, with cuts materializing until 1H24. Nevertheless, the risk of no increase in said meeting have risen after this release**
- **The market is convinced that the hiking cycle will end at 11.50% in May**

Banxico's minutes reaffirm a less hawkish tone. They expanded on several of the reasons behind the moderation in the tightening pace in the last decision –with only a 25bps hike. Attention remained on the inflation outlook, with lower concerns for headline inflation, albeit with important risks prevailing for the core. We also highlight important discussions in other fronts, such as: (1) Forward guidance, particularly about the end of the tightening cycle; and (2) the central bank's communication policies, with several members noting their importance, as well as the possible need for changes. Once again, Deputy Governor Espinosa dissented on the contents of the statement, in large part regarding communication, albeit also on the convenience of signaling that the restrictive stance will have to be maintained for an extended period.

The hawkish wing warned about domestic inflation pressures, with risks still tilted to the upside. Overall, all members acknowledged an improvement on inflation, in large part due to non-core dynamics. On top of this, the most noteworthy opinions were on domestic pressures for inflation (instead of external, which have helped recently). Firstly, most warned over the upside trend in services' annual inflation due to higher input costs. Among its drivers, they mentioned: (1) Labor costs, including the minimum wage and higher vacation-related compensation; (2) the tightening of the labor market, (3) mitigation in the change of consumption patterns due to the economic reopening after the sanitary emergency, currently with higher demand of services relative to goods; and (4) one talked about "*...insecurity continues affecting the high distribution costs...*".

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Banxico's 2023 policy decisions

Date	Decision
February 9th	+50bps
March 30th	+25bps
May 18th	--
June 22nd	--
August 10th	--
September 28th	--
November 9th	--
December 14th	--

Source: Banxico

The discussion seems important to us and is consistent with our view that headline inflation will fall at a faster pace than the core, ending this year at 4.8% and 5.6% y/y, respectively. In addition, we think this backdrop will delay the start of the easing cycle, contrasting with the market's discounted view that cuts could materialize in 2H23.

Discussions on the forward guidance, envisioning the end of the cycle. On the former, the statement mentions that "*...for its upcoming decision, the Board will take into account the inflation outlook, considering the monetary policy stance already attained...*". The most important part is that no member considered necessary to explicitly state that an additional hike is warranted. On the hawkish side, we believe Deputy Governor Espinosa said that the phrase about additional increases could be removed, albeit being dependent on inflation. This is quite similar to Deputy Governor Heath, arguing that they will decide if an additional hike is granted in the upcoming decision or not. Governor Rodríguez seems clearer in that it would be convenient to keep the restrictive stance reached in this decision if no additional shocks happen. Lastly, we did not identify clear opinions from Galia Borja and Omar Mejía, although we still think that they have a relatively center/dovish tilt. In this context, we present some of the most relevant comments that we attribute to each member in the following table.

Banorte's assessment on Board member's comments in the March 30th minutes

Bias	Member	Order in the minutes	Relevant comments
Hawkish	Irene Espinosa	2	*"...domestic pressures persist, mainly in the core component and with an upward dynamic in the services sector..."* *"...the reference to future increases may be omitted [...] it should be pointed out that the monetary policy stance is expected to remain restrictive over the entire referred horizon..."* *"...the urgent need to comprehensively assess the central bank communication policy..."*
	Jonathan Heath	3	*"...it is time to focus on tackling domestic-related pressures, especially on services prices..."* *"...during the upcoming monetary policy decision, it will be determined whether the evolution of data allows to confirm the level of 11.25% as the terminal rate or if an additional adjustment is required..."* *"...once said (terminal) level has been attained, during the next phase of the monetary cycle, the interest rate will need to remain fixed for a period of time enough to consolidate the convergence of inflation to the target..."*
	Omar Mejía	4	*"...the policy stance attained [...] will be adequate for inflation to converge to the target within the forecast horizon..."* *"...monetary restriction can be expected to begin showing its effects more clearly during the second half of the year and reach them fully during 2024..."* *"...considered it relevant for communication to contribute to a better understanding of the central bank's reaction function for the rest of the year..."*
	Galia Borja	1	*"...at the margin, a deterioration of inflation dynamics is not perceived, although he/she emphasized that they remain complex..."* *"...looking ahead, the expected trajectory of inflation is similar to that already anticipated during the previous monetary policy decision..."* *"...the central bank currently has an even more solid and robust stance than during the previous monetary policy decision..."*
Dovish	Victoria Rodríguez	5	*"...in the absence of new shocks, looking ahead it would be convenient to maintain the monetary policy stance that would be attained in this decision..."* *"...the ex-ante real interest rate will continue increasing insofar as inflation expectations decrease..."* *"...communication also acts as a policy tool and it can continue strengthening the actions that have already been implemented..."*

Source: Banorte with information from Banxico

Improving communication is becoming increasingly important. We saw some opinions on the convenience and need of a renewed focus in the central bank's communication policy. We believe this is a response after Banxico surprised both analysts and investors after hiking 50bps last February, more than the 25bps that were anticipated. Something similar happened in December 2021, in that occasion in line with our view, and with the start of the tightening cycle in June of the same year.

Firstly, we recognize that: (1) Innovations and changes in the last few years have been quite favorable, with successful efforts from the central bank in this front; and (2) overall, it is harder to identify and communicate inflection points (*e.g.* the start or end of the cycle, changes in the pace of tightening or easing).

Having said that, Deputy Governor Irene Espinosa was the most vocal and led in this respect, dissenting about the statement's content partly as "*...I reiterate the urgent need to evaluate our communication policy...*". In line with her more hawkish tilt, she stated that the current forward guidance is only limited to the upcoming decision and fails to communicate that they expect that monetary policy will need to remain in restrictive territory for two years. In addition: (1) That communications are as important as decisions for an effective transmission of monetary policy; and that (2) they must define the role of the Board members in communicating institutional messages. In this sense "*...in his/her opinion, the fact that, for the second time in 18 months, last February's decision took by surprise all private sector analysts cannot go unnoticed...*".

There were also some comments that we attribute to Governor Rodriguez and Deputy Governor Mejía. The first: "*...pointed that, in addition to the reference rate, communication also acts as a policy tool, and it can continue strengthening the actions that have already been implemented...*". The second "*...considered it relevant for communication to contribute to a better understanding of the central bank's reaction function for the rest of the year, in order to reduce market uncertainty...*". Lastly, Deputy Governor Heath stated that: "*...communication must be as explicit as possible, avoiding an insufficiently clear forward guidance...*". In addition, some months ago he argued about the convenience of being more specific about the underlying assumptions behind the central bank's inflation forecasts, as they are key to the current targeting regime.

Broadly speaking, we celebrate the Governing Board's focus on this issue, which becomes more necessary in an uncertain and volatile global backdrop. This leaves quite clear the importance of a constant evaluation and evolution of the tools used to comply with the mandate in the most efficient way possible.

We reiterate our call for a last 25bps hike in May, with the terminal rate reaching 11.50%. Despite the less hawkish tone, we see the Governing Board announcing an additional 25bps hike in May before ending the restrictive cycle. At least two factors would contribute to this: (1) More uncertainty about energy prices after OPEC+'s production cut, which could halt the downward trend of non-core inflation; and (2) our call of a last 25bps hike by the Fed at the beginning of said month, which if not replicated by Banxico, would reduce the short-term rate spread between these countries, potentially affecting local assets –especially the exchange rate, which has been key for lower prices pressures in tradeable goods.

With this, the reference rate would reach 11.50%, which we see as the terminal level of this cycle. Nevertheless, we recognize increasing risks that this last rate hike does not materializes after this release and our take on members' comments. Lastly, and independently of the latter, we reiterate our view that rate cuts will materialize only until 1H24.

From our Fixed income and FX strategy team

The market is convinced that the hiking cycle will end at 11.50% in May. During the session, the UST curve steepened on the back of a 6bps relief at the short-end triggered by a positive surprise in US producer prices. This move was replicated by Mbonos, albeit it diluted quickly. The market didn't recognize additional information in Banxico's minutes, so local rates' reaction was practically null. In this sense, market bets remain anchored to Banxico ending the tightening cycle with a 25bps hike in May. This would result in a terminal rate of 11.50%, in line with our call, the most aggressive hiking cycle since the reference rate was established as the main monetary policy instrument in 2008 (+750bps vs +500bps in 2015-2018). After greater financial stability in the US and Europe, the market started to moderate its view of cuts in 2H23 to -70bps from -102bps. Hence, Mbonos's 2s/10s spread has widened again, to -189bps. As we rule out cuts in the remainder of the year, we expect short-term rates to dilute further said scenario through a more inverted yield curve. In FX, the Mexican peso did not change after Banxico's minutes, trading around 18.03 per dollar (+0.2%). In EM, it is the third strongest year-to-date, up 8.2%. We expect the Mexican peso to stay resilient, supported by solid macroeconomic fundamentals and an attractive volatility-adjusted carry. As we have been saying, we reiterate our view that USD/MXN will breach the technical floor of 18.00 per dollar in the short-term.

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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, José De Jesús Ramírez Martínez, Gerardo Daniel Valle Trujillo, Luis Leopoldo López Salinas, Isaías Rodríguez Sobrino, Paola Soto Leal, Daniel Sebastián Sosa Aguilar and Andrea Muñoz Sánchez, 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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