

# Banxico has signaled the end of the tightening cycle

- Banxico's members most recent comments –noting Governor Rodríguez and Deputy Governor Heath– suggest that the end of the restrictive cycle was reached in March
- Despite a still complex outlook for inflation –especially for the core– and the possibility of another 25bps hike from the Fed next week, we believe the central bank considers that the current level and the lagged effects of monetary policy are already enough to support the disinflationary process and to reach the target in their forecast horizon
- Hence, we adjust our forecast for the next decision on May 18<sup>th</sup>. Now, we expect them to maintain the reference rate unchanged (previous: +25bps), leaving it at 11.25%. Moreover, this level would be maintained for the rest of 2023
- We believe that our monetary policy call for Mexico and the US still supports our year-end exchange rate forecast of 18.70 per dollar

**Banxico members send a dovish message.** In recent days, we have had more information from some members of Banco de México's Board. In our view, these have contributed to strengthening the institution's forward guidance. At the beginning of the week, there was still a lot of debate and uncertainty about the central bank's upcoming decision on May 18<sup>th</sup>, both among analysts, and in the market. On the former, the latest banking sector survey showed a wide dispersion among surveyed participants, with a median of a final 25bps hike, but also a very wide forecast distribution. On the latter, the yield curve was discounting 13bps of implied hikes last Monday, practically giving a probability close to 50% to each of two scenarios: (1) Leaving the rate unchanged at 11.25%; or (2) increasing it by 25bps to 11.50%. Given this scenario, it is our take that some members opted to send a clearer message, foresting the consistency and credibility of the central bank's communication channel.

Specifically, two comments stood out in recent days. The first was Governor Victoria Rodríguez's appearance before the Senate's Finance and Public Credit Committee on April 25<sup>th</sup>, highlighting that *"...it would not be a surprise if we evaluate the possibility of a pause in the rate..."*. The other comment was from Deputy Governor Jonathan Heath on an interview to the *El Economista* newspaper. He highlighted that [inflation in the 1<sup>st</sup> half of April](#) was in line with Banxico's expectations, so *"...it significantly increases the probability that the rate we reached in March is already the terminal level we were looking for..."*.

**The probability of an unchanged rate at the May 18<sup>th</sup> meeting has picked up significantly.** Given our perception of the bias that both members could have –with the Governor on the dovish wing, and the Deputy Governor with a hawkish tilt (see table below)– we infer that at least four of the five Board members could vote in favor of keeping the rate unchanged at the May meeting.

April 28, 2023

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## Banxico's 2023 policy decisions

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

Source: Banxico

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If we add to this a more complex scenario in the US that could make the Fed end its tightening cycle with a final 25bps hike on May 3<sup>rd</sup>, we see enough arguments to change our view. Thus, we no longer expect a hike on May 18<sup>th</sup> (previous: +25bps), but that it will be kept unchanged at its current level of 11.25%. In addition, they could reaffirm that the hiking cycle has ended if their view on the inflation process and outlook materializes. Even with this modest adjustment, we keep expecting that Banxico will maintain the reference at this level for the rest of 2023, with cuts starting until 1Q24.

**Banorte's assessment on Board member's policy skew based on the comments made after the latest minutes**

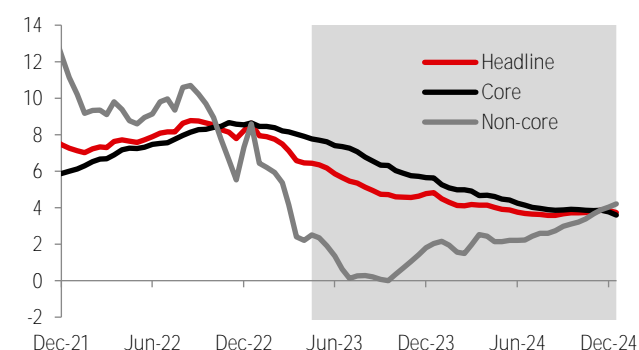
Bias	Member	Relevant comments
Hawkish	Irene Espinosa	No public interventions during the period
	Jonathan Heath	"...it significantly increases the probability that the rate we reached in March is already the terminal rate we were looking for..." "...we are now presenting a more inertial inflation due to persistence in domestic inflation and we have a sufficiently restrictive rate to face this challenge..." "...we must remember that at the end of the day, the decision by consensus. I may be of the opinion that 11.25% could be the terminal rate, subject to the information that we will know in the coming weeks, but my colleagues on the Board would have to have the same opinion..."
	Omar Mejia	"...the Bank of Mexico acted in a timely manner by starting this hiking interest rate cycle since June 2021..." "...each Board member is committed to the constitutional mandate. And this is precisely what gives credibility to an institution such as Banxico..." "...I believe that the Bank of Mexico, from the beginning, has made it clear that its commitment is to the country's price stability..."
	Galia Borja	"...it seems premature to me to talk about how long we will be on pause (on the hiking cycle) when in the most recent decision (March 30 <sup>th</sup> ) the rate was increased by 25 basis points..." "...several policy-makers agree that the monetary policy will have to remain restrictive for some time to come, given the still high levels of inflation..." "...I would like to identify myself more as a, committed Board member, responsible with the mandate we have which is to procure a low and stable inflation for the welfare of all..."
	Victoria Rodríguez	"...it would not be a surprise if we evaluate the possibility of pause in the rate cycle..." "...in the March 30 <sup>th</sup> decision, Banxico found itself in a stronger position to face the challenges of the inflationary environment..." "...there is no exchange rate target, or interest rate differential target with respect to that of any other economy..."
Dovish		

Source: Banorte with information from Banxico

**However, inflation challenges remain in place, especially for the core.** One aspect that most Board members probably considered is the downtrend in headline inflation from 7.82% y/y at the end of 2022 –using monthly data– to 6.24% in the 1<sup>st</sup> half of April. This is even more significant if we consider the peak of 8.70% in August and September of last year. It is important to highlight that a significant share of this was driven by the non-core, which contains the most volatile components within CPI –representing 24.4% of the index–, as it declined close to 900bps from the abovementioned highs. However, the outlook for core inflation, which includes goods and services that are ‘more stable’ and comprises 75.6% of the rest, shows a more challenging story. Core inflation peaked at 8.51% in November 2022 and, since that point, has declined to just 7.75%. Inside, the moderation has concentrated in goods –in our view helped recently by the exchange rate, along with lower raw material costs. However, other items within services still maintain an upward trend, which we believe is more closely related with rising labor costs. Apart from this, we should consider the strength of the Mexican economy in recent months, which is one of the drivers behind [our recent forecast change to 2.0%](#) from 1.5% for this year's GDP. In our view, the risk of demand-side pressures for inflation is not negligible, especially considering [the state of the labor market](#).

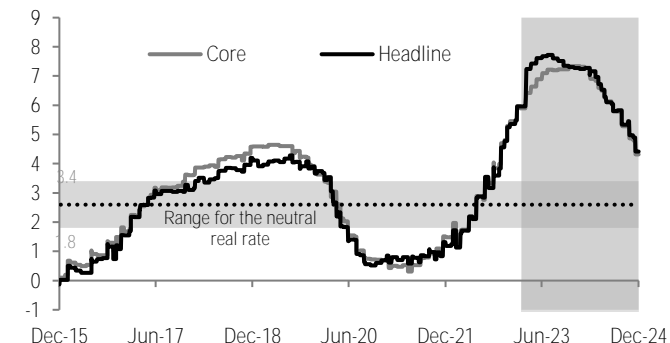
Probably, it is key for Banxico: (1) The lagged effect (and uncertain in magnitude) of a very restrictive monetary policy (with an ex-ante real rate currently at 6.2%, well above the neutral zone of 1.8% to 3.4%); and (2) the possibility of a moderation in US economic activity and the rest of the world, which could affect the Mexican economy towards the end of the year (consistent with our view of a modest GDP contraction at the end of 4Q23).

Inflation forecasts  
% y/y, bi-weekly frequency



Source: INEGI, Banorte

Ex-ante real rate\*  
%

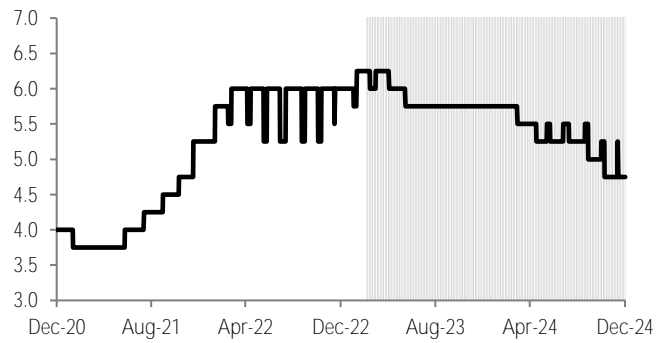


Note: Starting from May 2023, we use our 12-month forecasts. Before this, data is from Banxico's survey. Source: Banorte with data from Banxico

**The market will be watching the MXN's reaction to modest changes in the rate spread with the US.** So far this year, we have already seen a decoupling between Banxico and the Fed, which we believe has contributed to a strong peso. Specifically, it took place when Banxico hiked 50bps in February, higher than the Fed's +25bps at the same time. With this, the rate spread went from 600bps –which had stayed at that level most of the previous year– to 625bps (see chart below, left). Nevertheless, if our call materializes, the spread returns to 600bps in May. Based on our sensitivity analysis about the effect that the carry trade has on our currency (about 15 cents lower for every 25bps reduction in the spread between Cetes and implied forward rates), the initial effect should be limited. However, market participants' analysis of Banxico's signaling ahead will be important, especially: (1) About when they could start cutting rates; and (2) given the current expectation that Banxico may cut an accumulated 65bps from the current level for the rest of the year. In our view, this highlights once again the importance of the institutional communication channel.

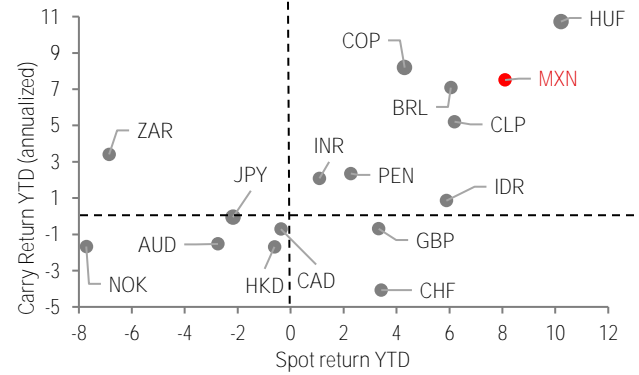
On the other hand, we also believe that stronger economic growth in the US (and its positive impact in Mexico) could be, at the margin, positive for the MXN relative to other EM currencies. Given high carry (even if the spread narrows), it is our take that the peso is not an attractive alternative for hedging, in contrast with has happened in the past. Now, it trades more closely and correlated with global USD dynamics due to our interdependence with said country, exacerbated by new investment dynamics in the context of nearshoring. In this sense, a lower spread at the margin, but higher expected growth in both economics, would tend to cancel each other out. All in all, we believe that our monetary policy call for Mexico and the US during the rest of the year (for which, in the case of the Fed, we see a lower probability of another hike in June) still support our exchange rate forecast by year-end of 18.70 pesos per dollar.

Interest rate spread between Mexico and the US\*  
Percentage points



\*Note: The spread is calculated using the upper bound of the Fed funds range  
Source: Federal Reserve, Banxico, Banorte

Performance of selected currencies  
%, annualized rate based in 3M forwards



Source: Banorte, Bloomberg

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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 Thalia 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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