Sovereign Macro- Banxico Preview, Pick your poison

December 10, 2021

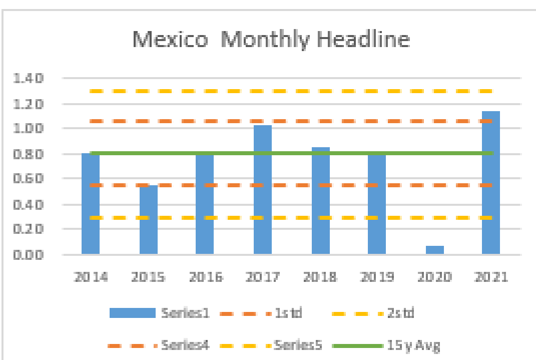
Bottom line: Banxico will likely hike its policy rate by 25bp in its upcoming due to the lack of consensus among its members to tackle a worsening inflationary problem. A 50 bp hike would not be a surprise -I had already called for a 50bp hike in the November meeting and data has only worsened- but it hinges on Governor Diaz de Leon's opinion. He has the key. My call for the terminal rate is now at 7-7.25%.

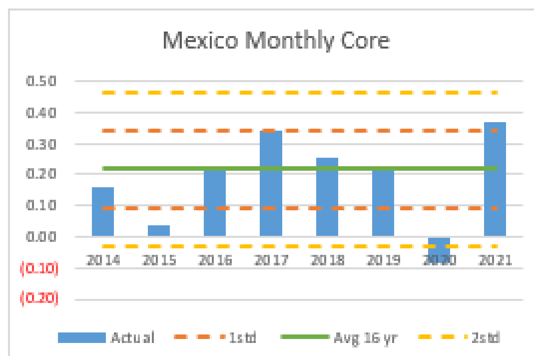
It has become abundantly clear that the pace of adjustment of the policy rate has been insufficient to control inflationary pressures and anchor expectations despite the strength of the currency and the absence of serious demand pressures. Banxico recognizes that the balance of risks continues to deteriorate and is still on the upside especially after today's eye watering inflation print. The staff will have to revise up once again its inflation projections for 2021 since meeting their q4 headline forecast of 6.8% would require deflation of 16bp in December. Not happening. They will probably hit the projection for core which is a good thing. Their projections for 2022 and the timing of convergence to the target will be revised as well. With this in mind, one has to question – I will get to the pace in a minute- what should be the right policy stance to address the problems I just mentioned. Lacking guidance from the board is unfortunate but in my view the policy stance should move to a contractionary posture as soon as possible, neutral doesn't cut it anymore. Or at the very least to the top of the neutral rate band at 3.4% in real terms. Since inflation expectations on average over the next two years are at 3.8%, it means that the terminal policy rate should be in the 7-7.25% area, not in the 6.5% that I had previously called for. If this were the rate that prevailed at the end of 2022, the spread to Fed Funds -assuming that the futures markets are correct in pricing 3 FED hikes- would be about 6-6.25%, a level comparable to the period of mid 2017-end 2019, high but not extraordinarily so. Now, the pace. Banxico will have to pick its poison between continuing to hike at 25 or at 50bp a meeting. Doing it at a slow pace takes the unnecessary risk of allowing expectations to continue to rise and perhaps require a higher terminal rate and a longer period of tightening. It's like trying to cure Covid with cough medicine. Doing it at a somewhat faster pace is no guarantee of success but it does diminish the risk that expectations continue to rise and may actually shorten the cycle. I firmly believe that this is what Banxico should do as I wrote in the preview of the last meeting when I called for a 50bp hike. But we are in the business of what will happen, not what should happen. The reason why I think a 25 bp is more likely is because the board is divided in 3 between those who want 25, those who are open to, but not convinced, accelerating the pace to 50 and the lone deputy governor who opposes hikes. In the minutes it was clear that deputy governor Borja and governor Diaz de Leon -my sincere apologies if this is not the case- voted for 25 bp and they are the ones that could make a difference. The governor has always believed that gradual adjustments are preferable and more efficient because they allow for the smooth adjustment of financial markets and relative prices. To be fair, we have not seen anything out of whack to suggest that markets are under stress. I believe that the governor will have a hard time to move to a 50bp hike and betray his long-standing belief in gradualism but is not impossible for him to change especially after the latest news on inflation and expectations. Deputy governor Borja has been cautious in her decisions, coming a bit late to the consensus of 25 bp hikes, so I don't expect her to vote for a 50 bp adjustment. This is Diaz de Leon's last policy decision and can set the stage for what is coming in 2022. Hiking by 50bp would probably set a minimum pace for the first meeting next year, saving incoming governor Rodriguez from a tough decision.

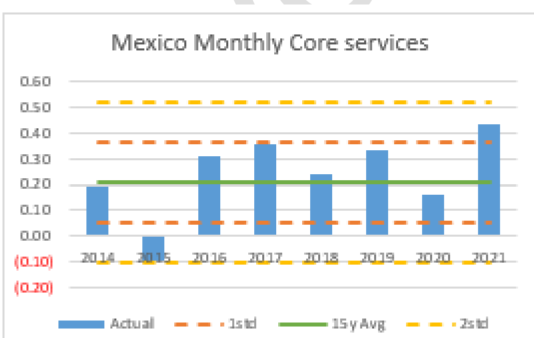
All of this aside, I wish to recognize governor Diaz de Leon for his tremendous performance in very troubled times, protecting the institution against clear attempts to violate its independence. I also wish him well in his future endeavors. All the best Alejandro.

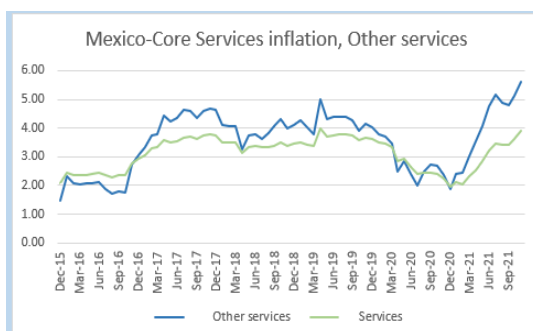
Details

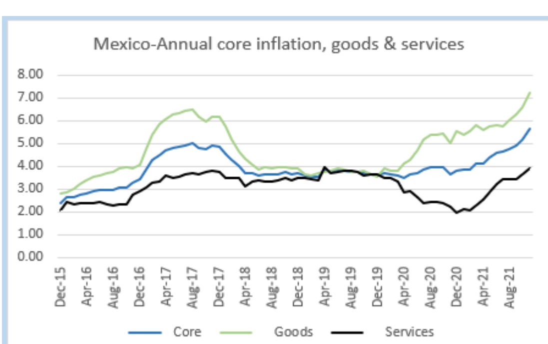
- Inflation dynamics continue to deteriorate demonstrably. The November monthly headline inflation was the highest print on record in at least 20 years and was more than 1stdv from its historical trimmed mean. Not only that, but November inflation was also the highest monthly print in 2021. Core was also 1 stdv above its historical trimmed mean. Surprisingly Core goods was relatively well behaved -maybe because of the discounts of the Buen Fin-, especially in non-food, and the real surprise was core services which came at the highest level in the series for November; it printed more than 2x its historical trimmed mean reflecting the effects of the reopening. On an annual basis headline stood at 7.4% showing a sharp acceleration and core reached 5.7%, picking up speed as well. As I have been mentioning over the last couple of months, services inflation is quite concerning and is now at the top of the tolerance band at 3.92%.

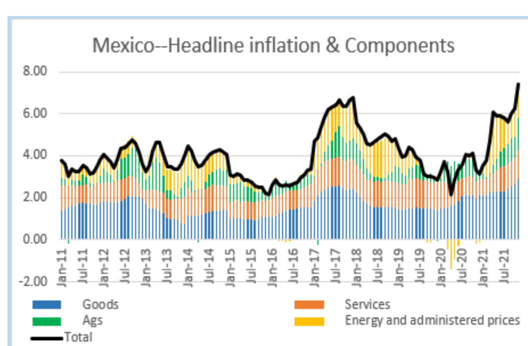




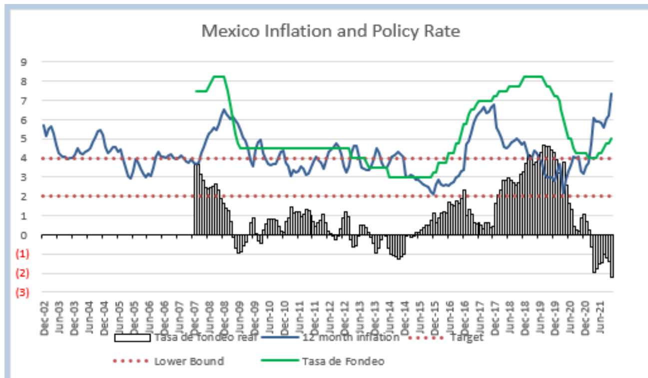






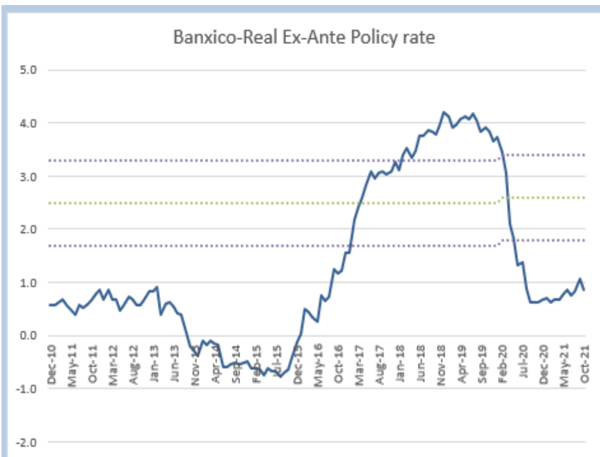


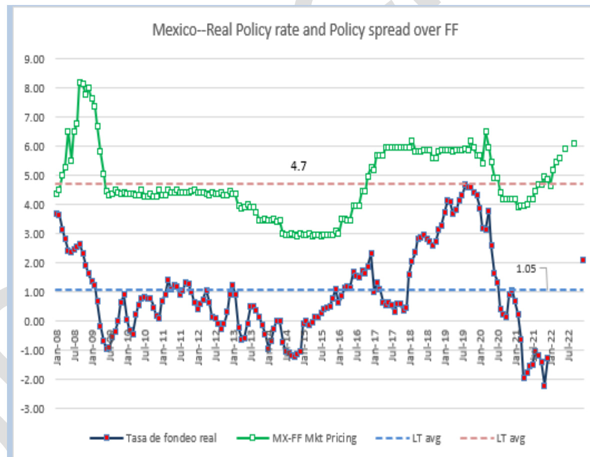
- Mexico is undergoing severe inflationary pressures despite the lack of any fiscal stimulus since 2020 and the currency has been quite strong. That said, monetary policy has been the only source of policy accommodation keeping policy rates well below neutrality. The real contemporaneous policy rate is now at the lowest point since Banxico was granted independence.



- Inflation expectations continue to deteriorate according to the latest surveys that were compiled before the surprise inflation release for November. Expectations for the next 12 months for core (3.8%) and headline (4%) are now above the target of 3% and even higher than the 3.5% that for some reason has been standardized as the "informal" level of stable inflation expectations. In any case, the elevation of expectations compromises the monetary stance of the central bank.

- In my view, the central bank is now behind the curve and its upcoming decision could make a difference. On a contemporaneous basis, the real policy rate is now at the lowest level since the implementation of the inflation targeting regime standing now at -2.2%, and needless to say, a 25 bp hike would make little difference. Also, for instance, on a real ex-ante basis the policy rate is barely at 1% implying a gap vis a vis the center of the neutral band of 160 bp. The gap has narrowed but only a bit from the lows of 200bp a year ago. But this is only illustrative because it has become abundantly clear -at least for me- that adopting a restrictive stance is perhaps the way to go considering the balance of risks. We have also heard arguments that hiking faster would put the rate differential at excessively high levels. Let me debunk that belief. First, the average spread between the FF and Banxico's overnight is 4.7% and has fluctuated in a range between 8% in the GFC and 3% in the massive easing cycle of '14-'15. That spread today is at 4.9% or at the historical average. The US market has priced more than 3 hikes next year for a FF of 95bp. If we take the adjusted 28day TIIE futures as a proxy for Banxico's policy rate, the spread between FF futures and Banxico's policy rate would be around 6.1% (including a terminal rate for Banxico of between 6.75% and 7%) or at the level that prevailed for two and a half years between mid '17 and end 2019. So, in my view a scenario in which Banxico hikes all the way to 7% appears reasonable because it would also imply that the real ex-ante policy rate of about 3.5%, at the top of the neutral rate policy band.





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