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Banxico Watch

A 50bp cut from Banxico would be welcome, but a smaller 25bp move is more likely

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Fading supply shocks, worsening growth prospects and Fed's 50bp cut give Banxico ample room to continue cutting rates

- **Last week, the Fed cut the policy rate by 50 bps to 4.75-5.00% and unequivocally confirmed that its focus has shifted to the labor market. Achieving a soft landing is openly now its main objective.** The decision came in a bit as a surprise as financial markets failed to reach a strong consensus on the magnitude of the rate cut. While mixed data and some Fed speak ahead of the meeting favored a 25bp rate cut, odds in favor of a 50bp cut suddenly increased during the blackout period when a couple of media pieces suggested such a move. At the press conference, Powell tried hard to clear up that opting for a 50bp cut instead of a 25bp cut does not mean the Fed is "in a rush" to cut rates aggressively from now on. He argued that the reason for opting for 50 bps was to signal both the significantly increased confidence among FOMC members that inflation is on a sustainable path towards 2% and the Fed's strong commitment not to get behind in cutting rates. He even downplayed the big start to the easing cycle by stressing that the updated dot-plot pointed to a slower rate cut cycle ahead (most participants project the policy rate will be taken down to 4.25-4.50% by the end of this year and probably to 3.25-3.50% by the end of 2025). With inflation largely out of the spotlight, achieving a soft landing is clearly now the Fed's main objective. In light of these developments, we now anticipate two 25bp fed funds rate cuts at the upcoming November and December meetings and six consecutive 25bp rate cuts next year (for more on the latest FOMC meeting, see here and here).
- **Headline inflation in Mexico dropped to 4.7% YoY in the first half of September, from the 5.6% peak in July, amid fading supply shocks.** Both the 13.7 and 7.3% YoY surge in agricultural and energy and regulated prices from July cooled down to 6.5 and 6.7% in the first fortnight of September, driving non-core inflation to 6.7% from the 10.4% 22-month high. The big supply shock from this year that drove a 8.9% MoM surge in fruits and vegetables prices in July has continued to ease through early September, when prices fell by 1.5% FoF after falling 5.2% MoM in August. In our view, these favorable trends confirm that the 3-2 vote in favor of a 25bp rate cut in August was the right one, since July's surge of non-core inflation proved to be driven by a short-lived change in relative prices, against which a monetary policy response is useless in a backdrop of well-anchored inflation expectations. Indeed, August's meeting minutes showed that "most members" agreed with such an assessment, as they "argued that relative price adjustments rather than generalized increases [were] being observed."
- **After touching the upper band of Banxico's target range in August, core inflation edged down to 3.95% YoY in the first half of September.** Core inflation scored a more modest 0.22% MoM increase in August compared to July's 0.32% figure, which was enough to take the YoY rate (3.996%) just barely below the upper limit of Banxico's 3% +/- 1pp inflation target range for the first time since February 2021. It edged down further in the first half of this month (to 3.95%), and will likely cool down further to 3.9% in full-month September. If our

forecast is confirmed, core inflation would have eased for the 20th month in a row. At 2.9% YoY (from 3.1% in July), core goods inflation may be close to bottoming out and thus further contributions for core disinflation will have to come from lower increases in core services prices, which eased only slightly to 5.18 and 5.15% YoY in August and the first fortnight of September, respectively, from 5.22% in July amid still-rising housing services inflation and both education and other services inflation still-above their pre-pandemic averages (Figure 1). The latter, which has historically shown less persistence, will likely hold the key for breaking core services stickiness in the coming months (Figure 2). As to Banxico's inflation forecasts, in spite of the current favorable trend, we still think that headline inflation projections were only partially revised up in August and thus expect Banxico to further adjust them upwards for 4Q24. As to core inflation, we are not expecting any meaningful changes to Banxico's projected path.

- **A second consecutive rate cut seems a done deal, as recent developments suggest that both Rodríguez and Borja will join Mejía again in supporting a rate cut this week.** Last month's meeting minutes showed that a Board member, most likely Deputy Governor Omar Mejía, continued to convey a firm stance in favor of a consecutive easing cycle going forward. He warned that "reference rate cuts [...] must not be postponed, as there is the risk of [...] incurring unnecessary costs for the economy," a sentiment we fully endorse. But at the same time, he suggested a preference for a "gradual approach." Both Governor Victoria Rodriguez and Deputy Governor Galia Borja, who joined Mejía last month, were more cautious: one stated that "the inflationary environment will allow to continue discussing reference rate adjustments," but acknowledged that "a gradual approach will need to be maintained," while the other signaled that "adjustments may even continue to be spaced out." Despite their greater cautiousness, we think their confidence strengthened following the most recent developments. The Fed's big start to the easing cycle should further boost their conviction that they should continue to gradually ease the very restrictive monetary policy stance. Besides, recent non-core inflation data supported their hypothesis that the effects of "supply shocks tend to dissipate relatively quickly," and countered the argument of one of the hawkish members of the Board, who warned that "the supply shocks that have led to this rebound [in the non-core component] will not necessarily dissipate rapidly." This means that both Rodríguez and Borja will very likely support a second consecutive cut this week. Deputy Governor Jonathan Heath could join them in voting this time for a rate cut.

- **A forceful 50bp move rather than a gradual and more likely 25bp cut would be a very welcome surprise and a sound policy decision.** We don't rule out that growing evidence of a slowdown in economic activity as well as the 50bp cut by the Fed from last week could embolden Banxico to opt for a bigger 50bp cut, but we believe a 25bp cut is more likely amid the continued disagreement among Board members on the inflation outlook, their shared worries around the stickiness of core services inflation, and the uncertainty around the exchange rate, which remains volatile since early June. We think that under a very restrictive monetary policy stance in a context of weakening economic activity and slower job creation, core services inflation is set to break its stickiness in coming months, paving the way for Banxico to lower its excessively high real ex-ante rate, which has not yet eased despite both 25bp cuts from March and August. In our view, the current economic slowdown, in the context of an expansionary fiscal policy, is partly explained by the very restrictive monetary policy that Banxico continues to hold. Furthermore, in view of the lags of monetary policy, we think that Banxico is already late in adjusting the excessively high real ex-ante rate, and thus, the monetary policy stance is set to continue to weigh on the economy in the coming quarters. Thus, although our base case is a 25bp cut, we're assigning a 30% probability to a more aggressive 50bp move, which we think is warranted.

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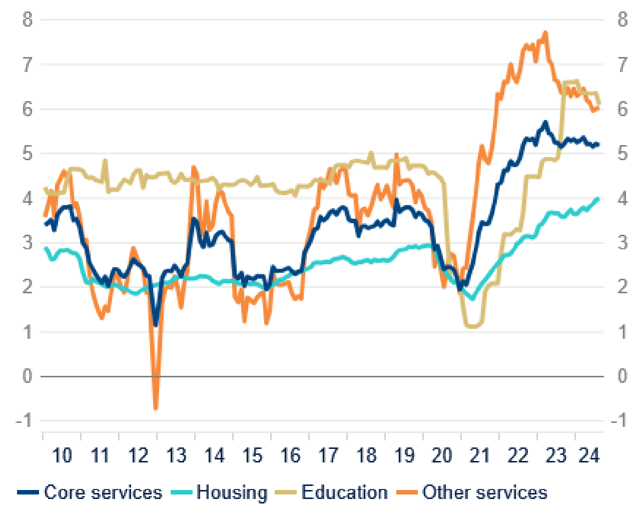
Higher housing and education prices have prevented core services from falling, …

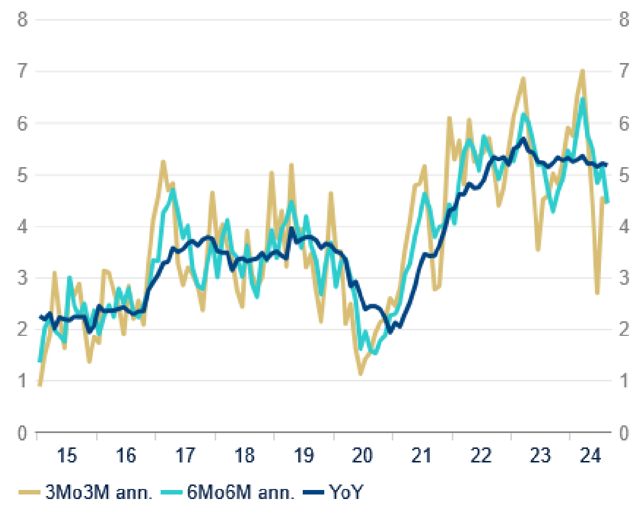
Figure 1. **CORE SERVICES INFLATION**
(%)



Source: BBVA Research / INEGI

… but we think that it will soon break its stickiness to the downside

Figure 2. **CORE SERVICES INFLATION**
(%)



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