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Banxico Watch

Banxico is set to keep cutting rates amid cooling core services inflation

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Trump's potential measures and MXN depreciation shouldn't prevent Banxico from cutting rates in the short term amid a still very restrictive real ex-ante rate

- **Last week, the Fed cut the policy rate by 25 bps to a 4.50-4.75% target range and continued to signal that their plan points towards a further gradual reduction of policy restraint.** With recent data suggesting that the path to a soft landing is not as narrow as initially thought, it made sense that the Fed would slow the pace of rate cuts from September's big 50bp initial cut. A couple of tweaks to the statement seemed hawkish at first glance amid the stronger-than-expected activity data for 3Q and recent signals of stickiness in core services prices, but Chair Powell was careful to explain that they neither hint that the Fed has fresh concerns about inflation, nor intent to signal an upcoming pause in the rate-cut cycle. He avoided commenting on any issues related to the result of the presidential election and the likely effects of Trump's potential policies ("We don't guess, we don't speculate, and we don't assume"). The sense among market participants and analysts (us included) points to greater inflationary challenges under Trump's potential trade, fiscal and immigration policies, which at first glance may result in fewer rate cuts next year. In our view, this is part of the reasons behind the upward shift of the middle and long ends of the Treasury yield curve in recent weeks (Figure 1). However, the Fed will likely avoid changing its reaction function in response to the election result and will only adjust policy plans until Trump's measures are formally outlined and become law. We continue to think that the rate cut cycle still has legs, but following the election outcome the Fed will likely end the cycle sooner than previously thought (for more on the latest FOMC meeting, see here and here). In any case, the unaltered short-term Fed's plans would drive Banxico to cut rates this week.
- **Headline inflation broke a two-month downward streak and inched up to 4.8% YoY in October (from 4.6% in September), driven by unfavorable base effects (Figure 2).** Non-core prices jumped to 7.7% YoY from 6.5% in the previous month and from 0.6% in September 2023. Even though energy and regulated prices cooled down to 4.6% (from 6.0%), the end of warm-season subsidies in many cities drove electricity prices to 18.1% MoM, representing the highest contribution (0.2 pp) to the 0.55% MoM change in the headline index, which more than offset contributions to the downside from domestic gas (-0.036 pp) and gasoline prices (-0.008 pp). After reversing at a fast pace in August and September, agricultural prices rose to 10.9% YoY in October from 6.8% in the previous month, driven by a 15.9% increase in fruits and vegetable prices, with six products explaining almost half the MoM change in the headline index, an outcome explained by supply shocks. September's meeting minutes showed that Banxico's board members welcomed the reversal of non-core inflation that started to take place since the first half of August, and while "most members stated that headline inflation [was] expected to resume its downward trend," the nature from last month's rise is unlikely to change their view on the underlying headline disinflation trend, even more so considering the opinion among a couple of members who expressed that "there are no signs of a pass-through of the aforementioned [supply] shocks,

which are temporary, to the core component."

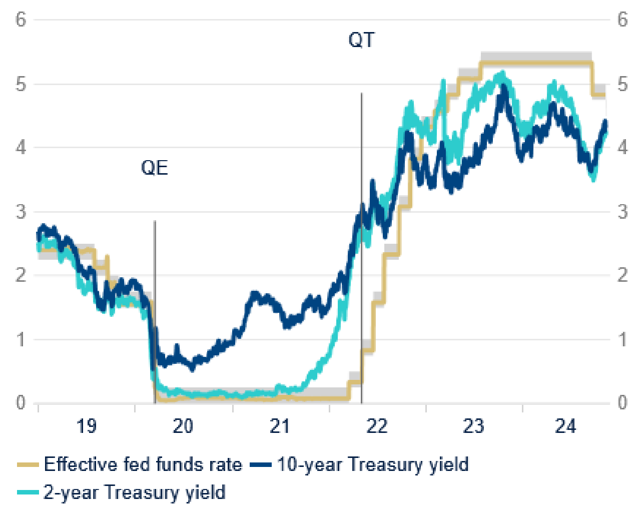
- **Core inflation eased for the 21st month in a row to 3.8% YoY, with core services inflation falling below 5.0% (to 4.98%) for the first time since August 2022.** Core inflation fell (or remained unchanged) across all major sub-indices on YoY terms for the second time since December 2020 (Figure 3). Goods inflation eased further to 2.8% (from 2.9%), though at a slower pace compared to the first half of the year. The continued disinflation of processed foods to 3.8% (from 3.9%) will give confidence to Banxico's board members regarding the absence of a significant pass-through of fresh foods inflation to the core component. Prices of non-food goods edged down to 1.6%, a 10-year low. On the other hand, core services disinflation was supported by unchanged tuition price increases (at 5.8%) and an encouraging slight slowdown of housing services prices (to 4.0%), which had shown a worrying uninterrupted upward trend since May of this year. Other services inflation ticked down to 5.9% from 6.1%. While core services inflation had started to show signs of slowing down in both September fortnights, board members avoided drawing conclusions from those data points in the last meeting: the minutes continued to show that "all members stated that services inflation continues showing persistence." Such incipient improvement has been supported by data from the two most recent intermeeting fortnights, and could drive board members to acknowledge it and will likely prevent them from any hesitation around cutting rates this week. While one of Jonathan Heath's long-held tests for beginning to support a rate cut cycle is breaking the persistence of services inflation, we think it is still unlikely that he joins the majority considering his arguments around the need to force expectations to anchor at the 3% inflation target, something that has never happened consistently since Banxico adopted the inflation target regime.
- **Banxico will likely adjust the 4Q24 headline inflation forecast to the upside as November and December are months with seasonally high inflation.** In the previous meeting, Banxico revised down its 4Q24 headline inflation forecast to 4.3% (-0.1 pp), while leaving the rest of the path unchanged. Given that headline inflation in October came in at 4.8% YoY, it would need to average 0.3% MoM over the last two months of the year to meet Banxico's forecast, an unlikely scenario. This required change for 4Q24 will likely drive up its forecast for 1Q25 too. We're not expecting notable changes to any other quarter of the projected headline inflation path. As to core inflation forecasts, in our view, there is no need to make any changes. Core inflation has eased broadly in line with the projected path. They might fine-tune 0.1 pp down this and next quarters' forecasts, but Banxico will likely leave the core inflation path mostly unchanged.
- **Greater exchange-rate volatility following the result of last week's US elections should not derail Banxico's plan to continue removing the excessively high degree of monetary restriction.** The peso depreciation trend that began after the election in Mexico has deepened after last week's US presidential election, which drove an initial 1.3% depreciation on election day and a cumulative 20% change from late-May. At 20.5 ppd, the exchange rate is only 2.2% above the day before the election since Trump's victory was not as unexpected this time as in 2016 (when the USDMXN depreciated 7.6% on election day). September meeting minutes suggest that Banxico was already expecting higher "volatility [...] given the electoral process" in the US, and while volatility did spike temporarily, a still elevated MXN-USD policy rate spread has prevented the risk-adjusted carry from collapsing, which is also in line with the opinion of one of the members who stated that "Mexico has robust fundamentals and that the risk-adjusted interest rate spread remains among the most attractive." This means the USDMXN developments shouldn't prevent Banxico from cutting rates in the short term. Indeed, monetary policy shouldn't be used to try to offset this kind of shocks. Instead, it is desirable that the free-floating exchange rate plays its role as a shock absorber. By allowing the exchange rate to float freely, an otherwise larger negative external shock is offset. The economy is better off under such a scenario. If Trump ends up applying tariffs to Mexico, a further exchange rate depreciation would help to absorb the shock so that Mexican exports remain competitive. Besides, higher interest rates along the yield curve are already adding a

boost to policy tightness (Figure 4).

- **Banxico is likely set to cut the policy rate by 25 bps this week in a backdrop of easing core services inflation, which is starting to turn a corner amid a challenging context for economic activity.** With the Fed lowering rates again, the peso recovering after the initial depreciation following the outcome of the US elections, slower pace of job creation and wage growth (which will further ease services inflation along the road), and particularly a still excessively high real ex-ante rate, a majority of board members are likely determined to continue the easing cycle. September's meeting minutes showed that one member (probably Deputy Governor Mejía) "considered that continuing to adjust the level of monetary restriction is not only timely but also necessary." Another member (either Governor Rodriguez or Deputy Governor Borja) also highlighted that "the inflationary outlook is consistent with ongoing adjustments to the reference rate." All three likely agree on the need to "adopt a path of continuous data-dependent adjustments," and two of them suggested growing chances for bigger rate cuts by noting that "the magnitude of adjustments could be evaluated" and that "discussions could begin regarding the level of reference rate cuts." Besides, the surprising vote of Deputy Governor Espinosa in the last meeting makes a sudden breakup of this majority very unlikely. A 50bp rate cut is off the table given Banxico's usual cautiousness around periods of exchange rate volatility, but despite these risks, it would be a sound policy decision considering that the real ex-ante rate remains close to 7%.

The Fed cut the fed funds rate by 25 bps to a 4.50-4.75% target range

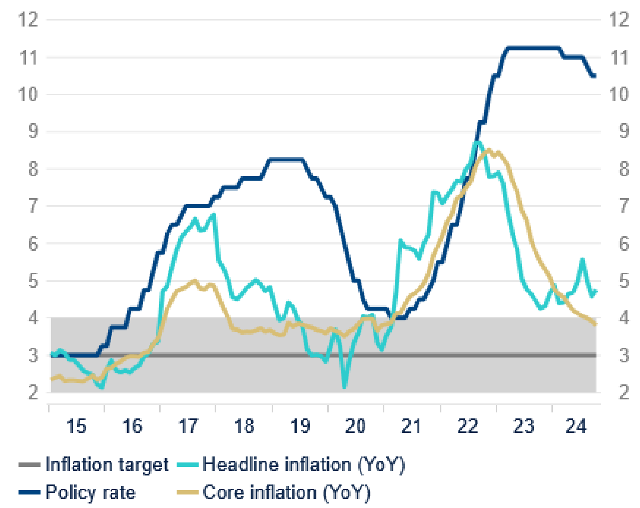
Figure 1. **FED FUNDS RATE AND TREASURY YIELDS (%)**



The gray area indicates the fed funds rate target range; QE and QT indicate quantitative easing and tightening announcements
Source: BBVA Research / Fed / Treasury

Headline inflation broke a two-month downward streak and inched up to 4.8% YoY in October

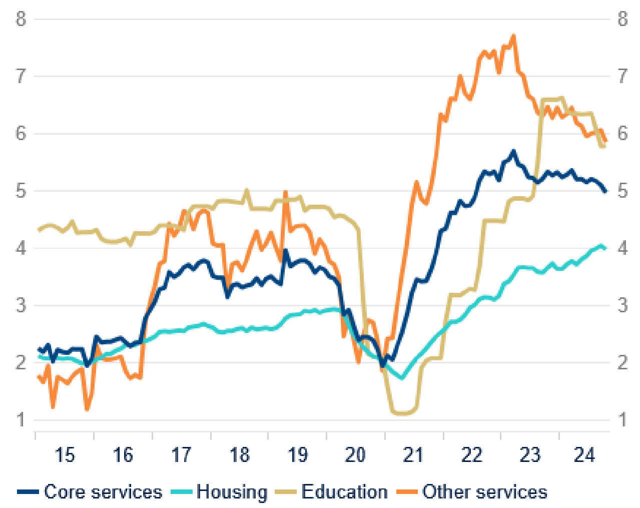
Figure 2. **INFLATION AND BANXICO POLICY RATE (%)**



The shaded area indicates the inflation target range
Source: BBVA Research / INEGI / Banxico

Core inflation eased for the 21st month in a row to 3.8% YoY; core services inflation fell below 5%

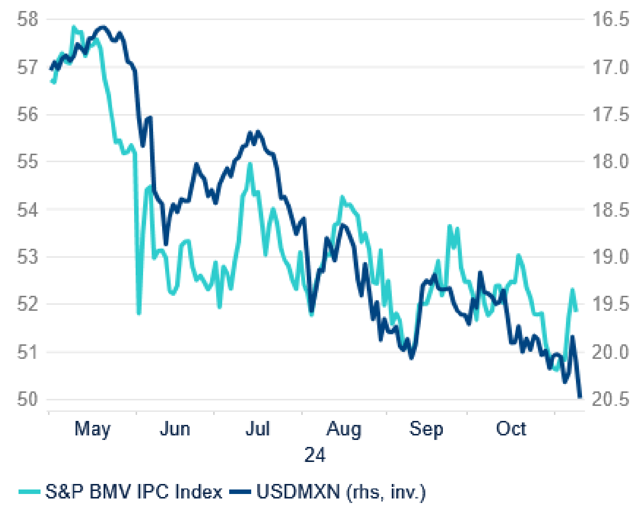
Figure 3. **CORE SERVICES INFLATION (%)**



Source: BBVA Research / INEGI

The peso depreciation trend has deepened after last week's US presidential election

Figure 4. **MARKET TRENDS (THOUSANDS AND PPD)**



Source: BBVA Research / BMV / Macrobond

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