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Banxico Watch

Broad-based disinflation gives Banxico ample room to keep cutting rates

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Banxico should cut the policy rate by 50bp before the window to speed up the rate-cut pace probably closes next year

- **The Fed likely remains confident enough to keep cutting rates by 25bp this week as chances are that the recent inflation bump is transitory, echoing the short-lived inflationary episode from 1Q.** Economic activity in the US continues to exhibit signs of strength, with consumer spending remaining a key driver of growth despite the transitory shocks faced by the manufacturing sector (the Boeing strike and hurricanes Helene and Milton). The most recent employment data painted a mixed picture of the labor market: the pace of both new jobs and wage growth remain healthy, but the unemployment rate edged up slightly. Overall, we believe the strong performance of the economy and the almost fully-balanced labor market pose little inflationary risk and are unlikely to spark inflationary fears among Fed members. Recent disappointing inflation data likely signals a temporary pause in significant disinflation progress rather than a resurgence of inflationary pressures (Figure 1). Financial markets have nonetheless priced in these developments, leading to higher long-term Treasury yields, also driven by increased uncertainty around the US inflation and fiscal outlook in the following years amid Trump's potential trade, tax and immigration policies. The Fed will continue to formally stay out of the debate around Trump 2.0, but it is likely that several FOMC participants have begun to incorporate into their thinking some of the obvious effects of potential economic policies. As of now, although the recent inflation stickiness is frustrating, core inflation has (much) more room to slow, so we think FOMC members will likely agree to further normalize the monetary policy stance with a 25bp rate cut this week (see here for additional details on this week's FOMC meeting preview).
- **In Mexico, headline inflation eased to 4.55% in November (from 4.8% in October) supported by a slight but broad-based slowdown in all main sub-indexes.** Non-core inflation eased to 7.6% YoY from 7.7% amid marginal reductions in both agricultural (to 10.74 from 10.92%) and energy (to 4.55 from 4.62%) inflation rates. The roughly 1.0 pp increase in fruits and vegetables inflation in YoY terms (to 16.8%) was offset by a like-sized decline in livestock inflation (to 5.1 from 6.2%), suggesting no further worsening of the supply shocks that drove a rebound in the non-core component last month, which had eased to its lowest this year in September. November's meeting minutes showed board members' remained confident in the assessment that "these shocks constitute changes in relative prices rather than generalized increases." However, "some" of them are likely more sensitive to the high variance of the prices of the non-core component: they "pointed out that further inflation shocks to non-core inflation cannot be ruled out" and "could contaminate the anticipated decline in core inflation." We believe these fears are unfounded in the context of broad-based disinflation elsewhere and well-anchored inflation expectations, as well as considering the ongoing weakness of formal jobs creation. In any case, a majority at Banxico appears to agree on the uselessness of a monetary policy response against the mainly-climate-related supply shocks that have affected the non-core component so far this year.

- **Core inflation eased for the 22nd month in a row to 3.6% YoY, with core services inflation falling for the fourth consecutive month to 4.90% amid broader-based disinflation dynamics.** The main takeaway for November's inflation is that there is a broad-based easing of price pressures. Core inflation rose 0.08% MoM, cooling to 3.6% YoY from 3.8%. Core goods inflation cooled to 2.4% YoY (from 2.8%) while services inflation eased 0.1 pp to 4.9% YoY. Services inflation excluding tuition and housing cooled for the third straight month to 5.7% YoY from 5.9%. Looking ahead, we think that inflation is set to cool much further along amid a weakening demand and a (much) slower pace of job creation (see). 12-month core inflation expectations edged down to 3.74% YoY (from 3.79%), the lowest level in more than three years, and are now close to the average core inflation (3.65%) from 2003, the year the current inflation target was established, to 2019. Expectations are not likely to come down significantly ahead given that inflation has never converged to the 3% inflation target in a consistent way . That is, both actual core inflation and its expectations have returned to the levels at which they fluctuated in the period of low and stable inflation. Not only that, inflation for services other than housing and tuition is beginning to show signs of easing and its trend (using the 3Mo3M of the seasonally-adjusted series) is pointing down again, which along with weakening demand, suggests it is set to cool ahead. **Banxico will likely adjust 0.1 or 0.2 pp down its 4Q24 headline inflation forecast to 4.6 or 4.5%, while leaving the rest of the path unchanged.** As to core inflation forecasts, there is no need to make any major changes as core inflation has eased broadly in line with the projected path, but a -0.1 pp fine-tune to this and next quarters' forecasts is likely.

- **In our view, Banxico should cut rates by 50 bps this week before the window to speed up the rate-cut pace closes, but we think it will deliver another 25bp rate cut.** Core inflation will inch closer to 3.5% by year end and hover around that level in 2025 while headline inflation will catch up to 3.5% by the end of 2025. Cooling services inflation gives Banxico room to a larger cut, but it will likely stick to another 25bp cut. We think there are 40% odds of a larger cut, with two members leaning towards speeding up the easing cycle[1], but two other members are strongly against increasing the pace of cuts[2]. Thus, a larger cut would require a third (non-commital in the last minutes) member to join the other two members that seem to be leaning towards voting for a 50bp cut. Yet, if he/she would rather stick to the current slow pace of easing, a 4-1 vote would be more likely even if the last minutes showed that two members would prefer to speed up the rate-cut pace. In our view, Banxico should cut by 50 bps now that there are signs that disinflation is broad-based, demand is weakening, the labor market is cooling more rapidly than previously thought, and the real ex-ante policy rate (6.4%) remains excessively tight in the current macro backdrop and considering the most likely outlook. The decision to wait on a larger cut would be unwise in our view because by the time of the first meeting next year (in early February) there could be a backdrop of a more cautious Fed with some members suggesting that they are rethinking the number of rate cuts for next year amid the risks to US inflation that could arise if broad-based tariffs are imposed and a context of global risk aversion would probably make Banxico's Board (further) delay a larger cut that would bring down the real ex-ante rate to more appropriate levels. In spite of this, and although **we think there is a 40% chance of a 50bp cut, with two members leaning towards a larger cut, we think that the Board will end sticking to another 25bp cut.** A 50bp rate cut would be a sound policy decision considering that the real ex-ante rate remains excessively restrictive and that the disinflationary process is progressing well.

[1] Member A: "[...] considering the current levels of core inflation [...], a larger rate adjustment could be considered at the next meeting"; member B: "[...] considering the high level of restriction across different metrics and the progress in disinflation, the [rate cut cycle pace] could be calibrated going forward".
[2] Member C: "[...] failing to implement a gradual monetary adjustment entails the risk of attaining equilibrium at higher inflation levels [...]"; Member D: "[...] the environment calls for caution and a gradual approach".

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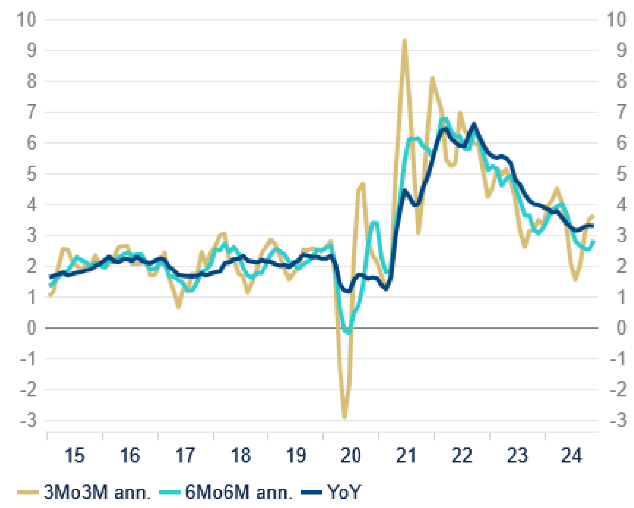
The recent US inflation bump is likely transitory as the short-lived inflationary episode from 1Q

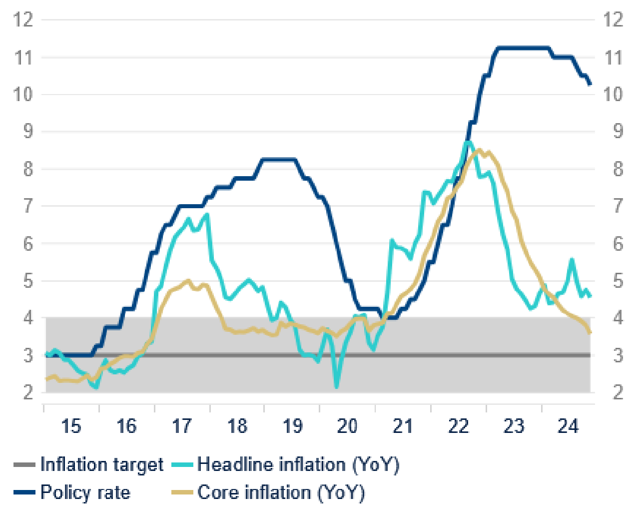
Figure 1. **US CORE CPI INFLATION**
(%)



Source: BBVA Research / BLS

With core inflation easing steadily, the policy rate is excessively high…

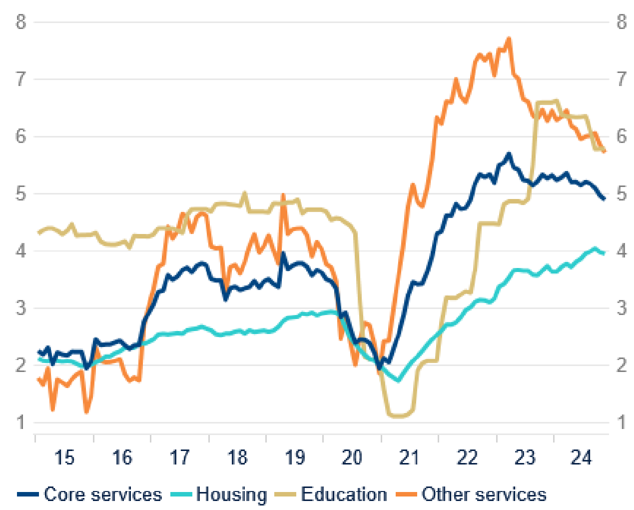
Figure 2. **INFLATION AND BANXICO POLICY RATE**
(%)



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

… and unwarranted considering that core services inflation is showing signs of cooling

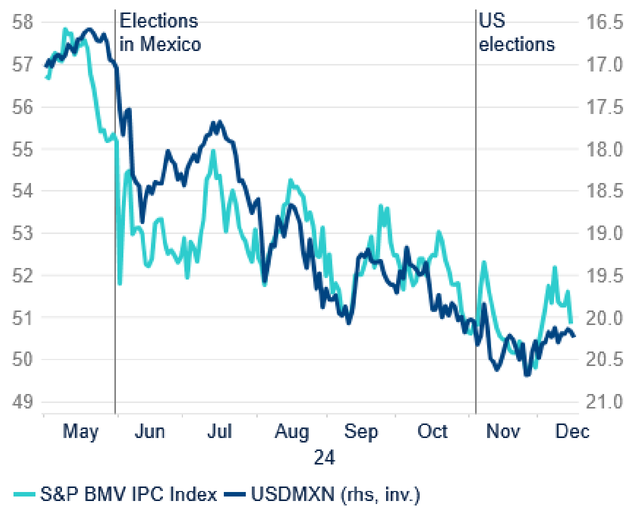
Figure 3. **CORE SERVICES INFLATION**
(%)



Source: BBVA Research / INEGI

Banxico should cut rates by 50 bps before the window to speed up the easing pace closes

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



Source: BBVA Research / BMV / Macrobond

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