Emerging Insight

Mexico – Could Banxico hike again?

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GEM Fixed Income Strategy & Economics
Global

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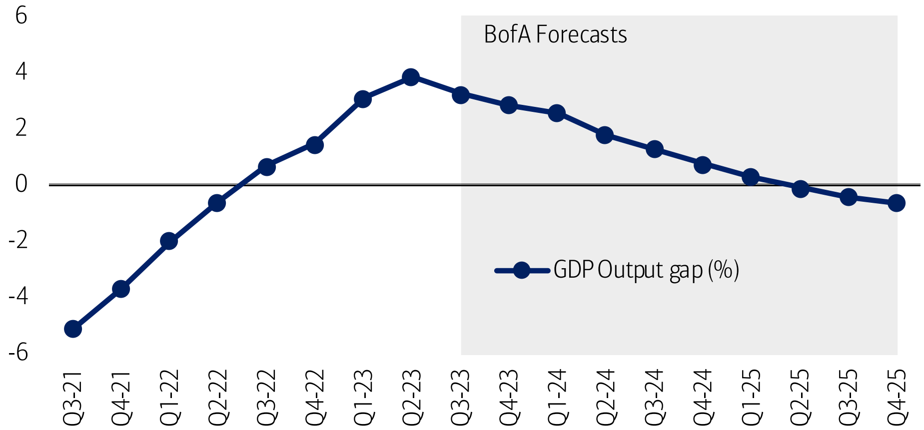
Key takeaways

- We think the market is underestimating the probability that Banxico could hike again.
- Core inflation is still high (>6.5%) while the output gap is positive (>3.5%) and many quarters away from closing.
- Therefore, we like to pay rates in Mexico, as we think the market remains too optimistic about the easing cycle.

By Carlos Capistran and Christian Gonzalez-Rojas

Chart of the day: The output gap is positive and will likely take a long time to close
We estimate the output gap won't close until 2025E



Source: BofA Global Research estimates

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Mexico: Could Banxico hike again?

Mexico's GDP grew 3.6% yoy in the first half of the year, well above trend growth. We estimate the output gap is currently 3.8%. We also estimate that it will take more than six quarters to close, based on our most recent GDP growth forecasts (3.2% for 2023 and 1.4% for 2024) (Chart of the day). This means pressure on inflation will continue, with two implications: 1) the balance of risks for Banxico is still to the upside in the short term; and 2) Banxico probably won't cut rates in 2023 or early next year. We like to pay rates in Mexico, as we think the market remains too optimistic about the easing cycle. MXN resilience should be supported by Banxico on hold for longer. *See our full analysis: [Mexico is having a good run = Banxico will likely take longer to cut]*

Timestamp: 06 August 2023 10:11PM EDT

Activity keeps surprising to the upside

Mexico grew 3.6% yoy in the first half of the year. We attribute this to: 1) the US also having a good first half (2.2% yoy), helping Mexico through trade and remittances; 2) nearshoring, which is now visible in investment and the labor market (see our report on the new global order and implications for EM); and 3) the President's big infrastructure projects (Refinery, Maya train, Isthmus train and Tulum airport) now visible in government expenditure and in construction.

Soft landing more likely than a recession

Strong growth in Mexico and in the US along with falling inflation increase the probability of a soft-landing scenario vs. a recession. Indeed, growth continues to be resilient in both countries despite tight monetary policies. Our US economists think that in the US a soft-landing is more likely than a recession. If the US is not going into a recession, then there is no reason for the Mexican economy to go into one either. So, we recently switched to a soft-landing scenario for Mexico, although we still think that the main alternative is a recession (in both the US and Mexico). We expect Mexico's GDP to grow 3.2% in 2023 and 1.4% in 2024. The deceleration will likely be noticeable as soon as 3Q 2023, with growth likely below 2% at the margin. But the deceleration will likely be relatively smooth.

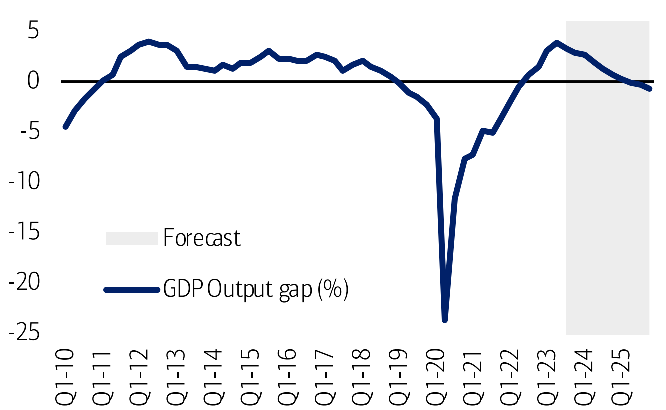
The output gap is wide open and will take time to close

Our measure of output gap shows that up to 2Q 2023 the output gap in Mexico was positive, large, and increasing. Using the flash 2Q GDP we estimate the output gap at 3.8% (Exhibit 1). With our new path for GDP the output gap takes longer to close than before. Now it won't close until 2025E, unless a recession materializes (Exhibit 2). So, the pressure for Banxico is to hike more in the short run and to keep the interest rate higher for longer. The pressure is corroborated by a very tight labor market (Exhibit 3 and Exhibit 4), as the most recent unemployment rate print surprised to the downside at 2.7% in June, from 3.0% in May.

Inflation is still under pressure

Inflation has been falling rapidly in recent months, which has many on the market calling for Banxico cuts this year (Exhibit 5). But the level of core inflation remains quite high (above 6.5%, Exhibit 6). And the pressure on the goods and labor markets imply that Banxico must keep the rate high for longer. In addition, pressure on non-core inflation is building up again as global food prices are increasing. Furthermore, our US economists now expect the US Fed to start its cutting cycle in June 2024.

Exhibit 1: We expect the output gap to remain positive for a while
The output gap is at historically high levels



Source: BofA Global Research estimates

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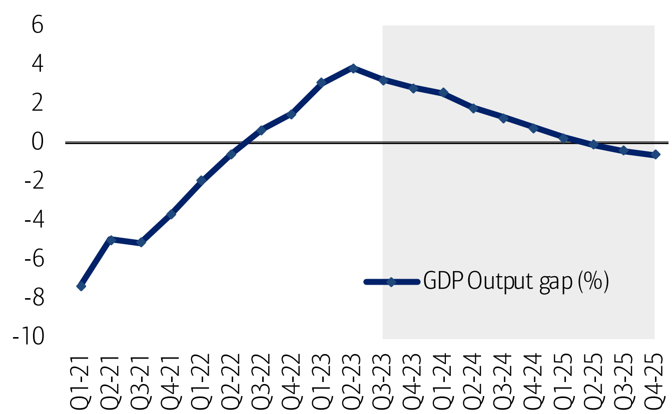
Exhibit 2: Zoom to our expectations for the output gap
The output gap will likely take longer to close



Source: BofA Global Research estimates

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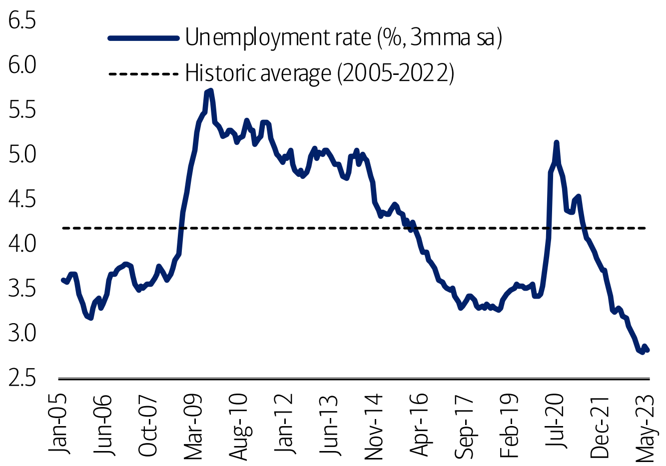
Banxico will likely take longer to cut

We expect Banxico to remain on hold in 2023, with upside risks, and only start a cutting cycle in June 2024. We have the policy rate at 11.25% by end 2023, 8.75% by end 2024 and 7.5% by end 2025. But we see two important risks to our Banxico call: 1) that Banxico needs to hike again this year given the positive output gap, tight labor market, high level of core inflation, inflation expectations above the target and the Fed still hiking (we expect one more hike); and 2) if core inflation goes below 5% and 12-month inflation expectations go below 4%, Banxico could do a 25bp or 50bp adjustment before starting a proper cutting cycle. We believe that risk (1) has a higher probability than risk (2) in the August and September meetings although probably (2) has a higher risk than (1) in the November and December meetings (as some board members have mentioned this possibility).

Exhibit 3: Unemployment rate
Unemployment surprised at 2.7% in June, a new all-time low



Source: BofA Global Research, INEGI

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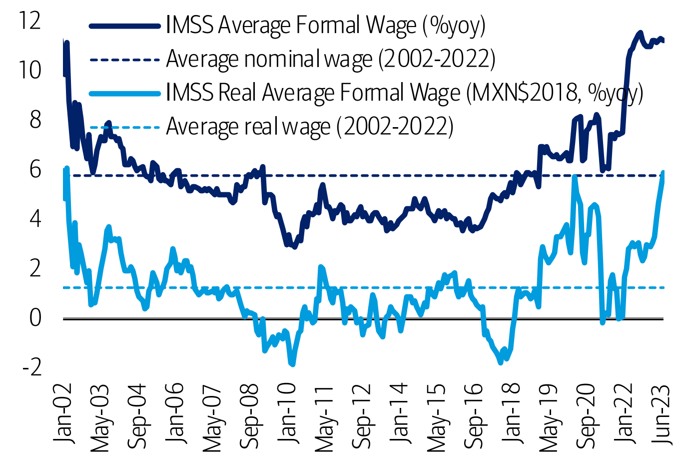
Exhibit 4: Formal wage growth rate in Mexico
Wages are increasing at a double-digit pace, weighting in services inflation



Source: BofA Global Research, IMSS

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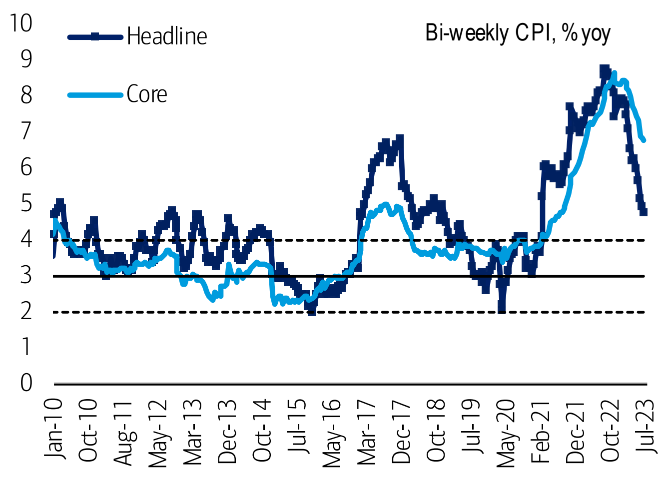
Exhibit 5: Headline, core, and non-core inflation (%yoy)
Both headline and core inflation are falling quickly



Source: BofA Global Research, INEGI

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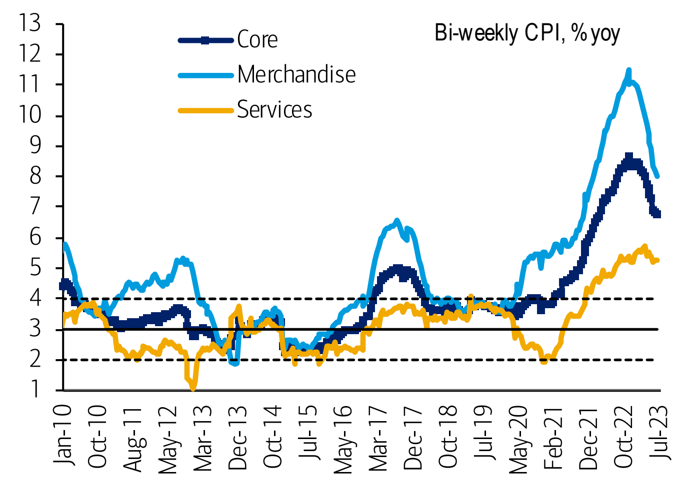
Exhibit 6: Biweekly core inflation (%yoy) is falling
However, services inflation remains stuck around 5.5% yoy



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Higher-for-longer provides room to keep paying rates

Our updated outlook for Banxico opens opportunities to continue paying rates in Mexico, as we think that the market is pricing a cutting cycle that starts too early (Exhibit 7). As a result, we continue to favor front-end payers. Specifically, we like to keep paying 1y TIIE (current: 10.98) as it allows to take advantage of the point in the curve where our view differs the most from the market, while earning positive carry. Risks to the trade include an earlier start of monetary policy easing, sharp downward surprises to inflation or a significant deceleration in economic activity.

Similarly, we believe there is still some space to pay 5y TIIE (current: 8.61). According to Banxico, the neutral real rate is between 1.8% and 3.4%. If we consider that average inflation in Mexico over the past 20 years has been roughly 4.4%, the neutral nominal rate is somewhere between 6.2% and 7.8%. With 3y2y forward rates currently at 7.7%, we believe that the market is being too optimistic about the terminal rate in Mexico. In our view, a highly persistent inflation will not only push Banxico to keep rates on hold this year, but it will also prevent the central bank from cutting rates beyond 7.5%. Risks to the trade include a dovish shift from Banxico, an earlier end of the Fed's hiking cycle, a quick drop in Mexico's core inflation, or a significant deceleration in US growth.

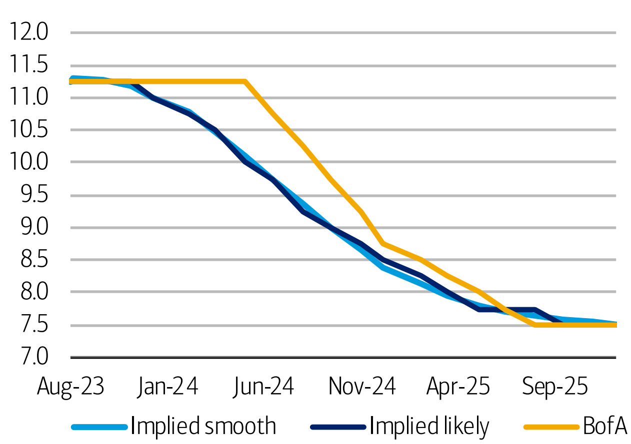
... and supports MXN resilience

In our view, the best scenario for the peso – and for any carry currency – is one in which spreads against the US remain high and the US avoids a recession. This is a combination that keeps carry high and volatility low (Exhibit 8).

Our revisions to the US and Mexican outlook are more aligned with a soft-landing, so we believe the global and domestic backdrop will continue to support MXN resilience. Our stronger US growth forecast lowers the probability of a deep recession, which reduces the likelihood a sharp MXN correction in the short-term. A strong US economy is also positive for remittances and nearshoring, both largely seen as factors providing support to the peso. Moreover, a more delayed hiking cycle extends the period of wide spreads relative to the Fed, which means MXN may continue to be supported by high carry.

As a result, we expect the MXN overvaluation to persist for longer than we initially thought, given that its carry appeal will likely persist for longer. Yet, since the possibility of a US recession cannot be completely ruled out, we continue to believe risks remain tilted towards MXN depreciation. Therefore, despite our revisions, we prefer to remain neutral MXN as we believe risk-reward is not attractive given the current valuation. Our view continues to be that the potential downside in spot returns outweighs the carry.

Exhibit 7: Market-implied policy rates vs. BofA forecast (%)
The market is pricing an early cutting cycle



Source: BofA Global Research, Bloomberg

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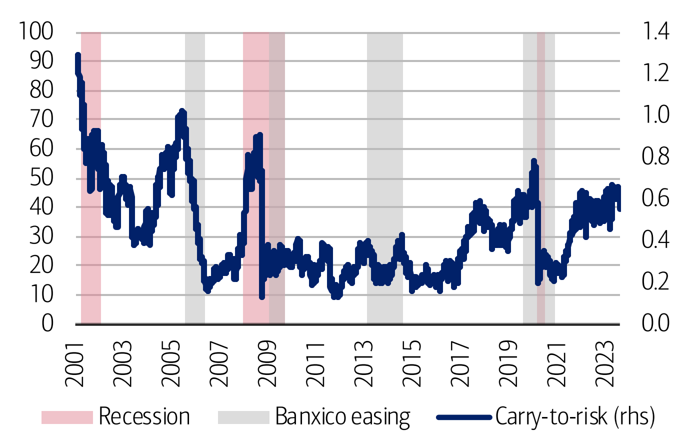
Exhibit 8: Carry-to-vol during US recessions and Banxico easing cycles
Carry-to-vol should remain resilient absent a US recession or an easing cycle



Source: BofA Global Research, Bloomberg

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News and Views

Mexico: Private consumption increased 3.9% yoy nsa in May

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Private consumption in May decreased 0.3% mom sa (vs +0.4% in April). Imported goods consumption increased 2.7% mom sa (vs 3.3% in April), domestic services consumption decreased 1.1% mom sa (vs +1.0% in April), while domestic goods consumption decreased 0.9% mom sa (vs 0.6% in April). On annual terms, private consumption increased 3.9% yoy nsa (E. 3.8%, BofA 3.8%). Year to date, consumption increased 3.8% sa (vs 7.9% last year).

- **To follow**: Consumption continues to be strong in Mexico, in line with our view that the economy continues to do well and that a soft landing, rather than a recession, seems more likely now. But this also implies that Banxico is not anywhere close to cutting rates.

Mexico: Investment above than expected at 17.4% yoy nsa in May

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Investment in May above than expected at 17.4% yoy nsa (E. 9.7%, BofA 15.2%). At the margin, investment grew 4.5% mom sa, up from a 0.3% mom sa increase in April. Construction grew 7.6% mom sa (vs -2.3% in April), driven by non-residential construction at 9.7% mom sa (vs 3.9% in April), while machinery and equipment grew 1.2% mom sa (vs 2.3% in April). Year to date, investment increased 10% (vs 5.6% last year).

- **To follow**: Investment continues to be strong, this time driven by construction (in turn driven by AMLO's infrastructure projects in the south). In line with our view that soft landing is possible and with the view that Banxico will remain on hold for longer.

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