

## EM Alpha

## Mexico: Receive 2y TIIE vs. SOFR

**The trade: Receive 2y TIIE vs. SOFR**

We receive 2y TIIE vs. SOFR (entry: 521, target: 400, stop: 580) into Mexico's easing cycle. The trade has a volatility of about 34bp per month. While carry and roll are -7bp per month, we believe that the spread should narrow as Banxico begins to cut rates in March while the Fed remains on hold until at least June. Hitting a Sharpe ratio close to 1 requires an 80bp tightening within 3 months, achievable under our baseline. Hitting target would require a delay in the Fed and an earlier Banxico acceleration vs. baseline.

Even if the market is already to some extent pricing a decoupling, we believe that risk-reward of front-end spreads remains attractive. In our view, spreads allow to position for Banxico's easing cycle and take advantage of a potential hawkish repricing in US rates, while also limiting the carry and roll cost versus an outright receiver.

**Banxico to begin easing policy in March**

Even if services inflation remains highly persistent and the labor market continues to be tight, recent forward guidance leads us to believe that Banxico is set to cut rates in March (see [Banxico will anticipate the Fed](#)). For instance, the most recent monetary policy minutes showed that the majority of board members are in favor of easing policy in the short-term, as they deem policy restrictive enough to allow for cuts without jeopardizing the convergence of inflation to the 2% target.

With the recent downward surprise on GDP growth, as well as core inflation resuming a falling trend (see Unexpected deceleration and [Headline keeps increasing, while core inflation fell below 5%](#)), we think Banxico will not have trouble justifying cuts in March.

**... while the Fed remains hold until at least June**

In contrast, the Fed has taken a relatively hawkish stance, pushing back on the narrative for earlier cuts. This is consistent with our view that there are significant upside inflation risks in the US (see [Let's talk about inflation risks](#)). While our baseline is that the Fed will begin easing policy in line with market pricing in June, we remain concerned that the Fed may delay cuts even further (see What if the Fed doesn't cut?).

**The Great Schism should narrow spreads**

We have strong conviction that Banxico will decouple from the Fed. This has only happened twice since Mexico adopted an inflation-targeting regime: in 2005 and 2013. In both cases, the spread between 2y rates in Mexico and the US narrowed significantly.

We do not see why this time would be different. In fact, we could argue that this year's decoupling may even be more meaningful than in 2013. Back in 2013, Banxico cut rates while the Fed was on hold. However, the Fed was at the zero lower bound and conducting unconventional policy to ease financial conditions. After accounting for QE, Banxico's cuts in 2013 were consistent with US monetary policy.

- **The trade:** Receive 2y TIIE vs. SOFR (entry: 521, target: 400, stop: 580)

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GEM FI & FX Strategy  
Emerging Markets Global

**Christian Gonzalez Rojas**  
LatAm Local Markets Strategist  
BofAS  
[christian.gonzalezrojas@bofa.com](mailto:christian.gonzalezrojas@bofa.com)

**Ezequiel Aguirre**  
LatAm FI/FX Strategist  
BofAS  
[ezequiel.aguirre2@bofa.com](mailto:ezequiel.aguirre2@bofa.com)

**Carlos Capistran**  
Canada and Mexico Economist  
BofAS  
[carlos.capistran@bofa.com](mailto:carlos.capistran@bofa.com)

**LatAm FI Strategy & Economics**  
BofAS

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## Receive 2y TIIE vs. SOFR

We like to receive 2y TIIE vs. SOFR (entry: 521, target: 400, stop: 580) into Mexico's easing cycle. The trade has a volatility of about 22bp per month. While carry and roll are about -7bp per month, we believe the spread should narrow as Banxico begins to cut in March while the Fed remains on hold until at least June. To hit a Sharpe ratio of 1, the spread should narrow by 80bp within 3 months, achievable under our baseline. Hitting target would require a delay in the Fed and an earlier Banxico acceleration vs. baseline.

While the market is already pricing some decoupling, under our baseline we expect the policy rate differential to be about 100bp lower than market pricing by February 2025 (Exhibit 1). Thus, risk-reward of front-end spreads remains attractive, as it allows to position for Banxico's easing cycle and take advantage of a potential hawkish repricing in US rates, while limiting the carry and roll cost versus outright receivers.

### Banxico to begin easing policy in March

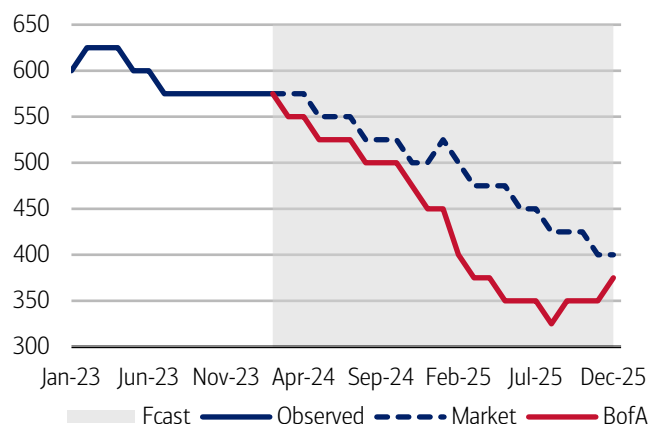
Even if services inflation remains highly persistent and the labor market tight, forward guidance leads us to believe Banxico is set to cut rates in March. Banxico's monetary policy minutes and the quarterly report presentation showed that most board members favor easing policy in the short-term, as they deem it restrictive enough to allow for cuts without jeopardizing the convergence of inflation to the 2% target.

Despite our concerns about a still-positive output gap that is keeping services inflation above 5.0% and risks to non-core inflation (see [Drought is likely to keep \(non-core\) inflation high](#)), we believe Banxico will not have trouble justifying the start of the easing cycle in March. The recent downward surprises on GDP growth, as well as core inflation resuming a falling trend, provide a dovish narrative (see [Unexpected deceleration and Headline keeps increasing, while core inflation fell below 5% in January](#)).

Hence, we recently updated our Banxico call, expecting the central bank to now embark on a full cycle (see [Banxico will anticipate the Fed](#)). We think Banxico will be cautious early-on in the easing cycle, cutting at a pace of 25bp per meeting. Our view is that growth will remain strong in 1H24, largely driven by a sharp fiscal impulse ahead of the presidential election. Yet, a fiscal cliff in 2H24, along with a mild US deceleration will weigh on the Mexican economy. As a result, we have strong confidence that Banxico will have room to step up the pace of easing to 50bp at the end of 2H24, with risks that it takes place earlier. Such an acceleration is not currently priced by the market (Exhibit 2). As a result, we are calling for a 7.5% terminal rate, lower than the 8.0% currently priced.

#### Exhibit 1: Mexico vs. US monetary policy rate spread (bp)

We expect a narrower MX-US interest rate differential than the market

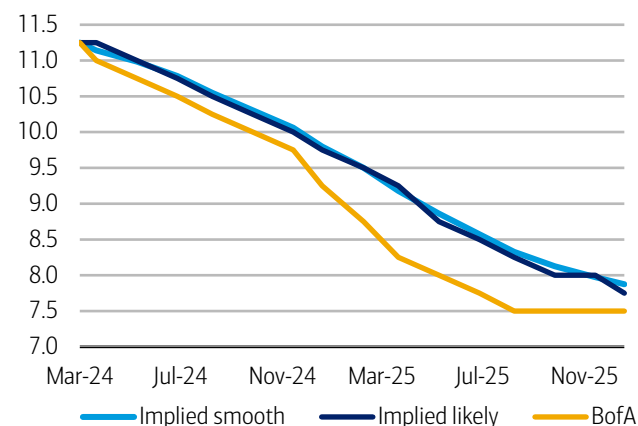


Source: BofA Global Research, Bloomberg.

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#### Exhibit 2: Market-implied policy rate vs. BofA (%)

We expect an acceleration in the easing cycle that is not currently priced



Source: BofA Global Research, Bloomberg.

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## We expect the Fed on hold until at least June

In contrast to the dovish tone from Banxico, the Fed has taken a relatively hawkish stance, pushing back on the narrative for earlier cuts. This is consistent with our view that there are significant upside inflation risks in the US (see [Let's talk about inflation risks](#)). Our economics team has argued that most of the observed disinflation has been driven by supply factors. Therefore, a pause or reversion in goods inflation amid a still-strong wage growth and tight labor market, may push services inflation to rates that could be inconsistent with the Fed's 2% inflation target.

These risks should warrant caution from the Fed. Our baseline is that the Fed will cut rates by 75bp this year, starting in June, and 100bp in 2025. While this is roughly in line with market pricing, we remain concerned that the Fed may delay cuts even further (see What if the Fed doesn't cut?). The last time 2y US breakevens were as high as 2.7%, the Fed was still hiking. Yet, the market is now confidently pricing cuts in the short-term. In fact, our US rates team believes that upside to rates remains a risk and that February data confirming the January strength may force the market to push out the timing and extent of cuts (see [Connecting \(to\) the dots](#)).

## The Great Schism should narrow spreads

While we are generally worried about crowded EM receivers and have closed most of them (see Climbing the three Walls of Worry), we think that Mexico is a laggard given that Banxico has not started cutting rates. Moreover, we have strong conviction that Banxico will decouple from the Fed. This Great Schism has only happened twice since Mexico adopted an inflation-targeting regime: in 2005 and 2013. In both cases, the spread between 2y rates in Mexico and the US narrowed significantly (Exhibit 3).

We do not see why this time would be different. In fact, we could argue that this year's decoupling may even be more meaningful than in 2013. Back in 2013, Banxico cut rates while the Fed was on hold. However, the Fed was at the zero lower bound and conducting unconventional policy to ease financial conditions. After accounting for QE, Banxico's cuts in 2013 seemed consistent with US monetary policy (Exhibit 4).

An important question is if the TIIE vs. SOFR spread has compressed enough already. After all, current levels seem low relative to recent history. In our view, the market will most likely reprice the more aggressive easing cycle we are expecting once Banxico decides to cut for the first time. Historically, the market tends to underprice both easing and hiking cycles in Mexico (Exhibit 5). Hence, we believe that Banxico cutting rates may act as a potential trigger for a further compression in TIIE vs. SOFR spreads.

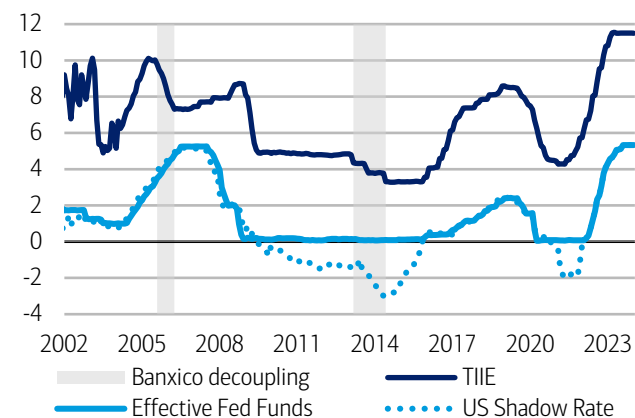
**Exhibit 3: 2y TIIE vs. US spread during Banxico decouplings (bp)**

2y TIIE vs US spread has narrowed when Banxico has anticipated the Fed



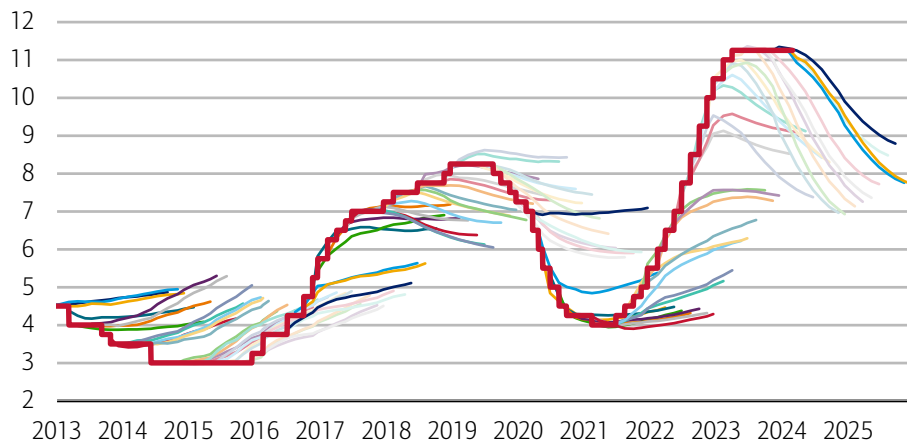
**Exhibit 4: TIIE, effective Fed Funds rate and US shadow rate (bp)**

Accounting for QE, Banxico's cuts in 2013 were consistent with Fed easing



**Exhibit 5: Policy rate and market-implied policy rates into Banxico meetings (%)**

Historically, the market tends to underprice both easing and hiking cycles in Mexico



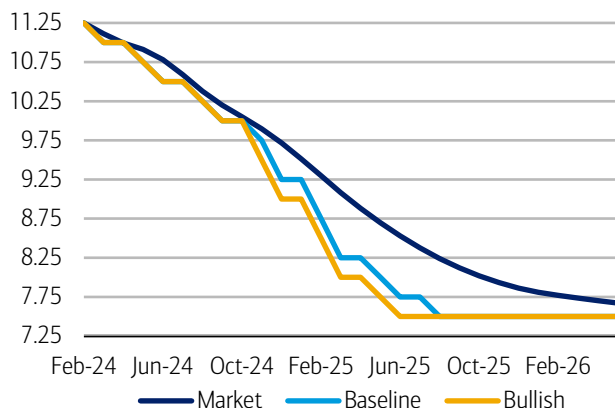
**Source:** BofA Global Research, Bloomberg. Thin lines show market-implied policy rates the week prior to each Banxico meeting since 2013.  
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While it seems like a reasonable strategy to pay rates into hiking cycles and receive rates into easing cycles, we believe that a hawkish Fed makes current risk-reward of front-end TIIE vs. SOFR spreads more attractive than outright receivers. In our view, spreads benefit from the combination of a dovish Banxico and a hawkish Fed. At the same time, receiving the spread reduces negative carry significantly.

Another important question is whether our target is feasible. First, a back-of-the-envelope analysis suggests that the convergence of market pricing to our baseline monetary policy rate paths for Mexico (Exhibit 6) and the US (Exhibit 7) would result in a tightening of the 2y TIIE vs. SOFR spread of between 60bp and 70bp. This would imply a Sharpe ratio between 0.7 and 0.9 if the repricing occurs within 3 months. Yet, we see risks that the market could price a delay in the Fed or an earlier Banxico acceleration. Under a bullish scenario in which the Fed delays cuts to September, we believe the 2y TIIE vs. SOFR spread could tighten between 80bp and 100bp. Similarly, a bullish scenario with an earlier Banxico acceleration to 50bp in November could result in a 2y TIIE vs. SOFR spread that is between 70bp and 85bp tighter. We think that if the market prices a combination of a Fed remaining on hold for longer and a Banxico that accelerates the pace earlier than our baseline would make our target feasible.

**Exhibit 6: Mexico's policy rate under different scenarios**

Under an earlier acceleration of Banxico's easing cycle, the 2y TIIE vs. SOFR spread could tighten by up to 85bp

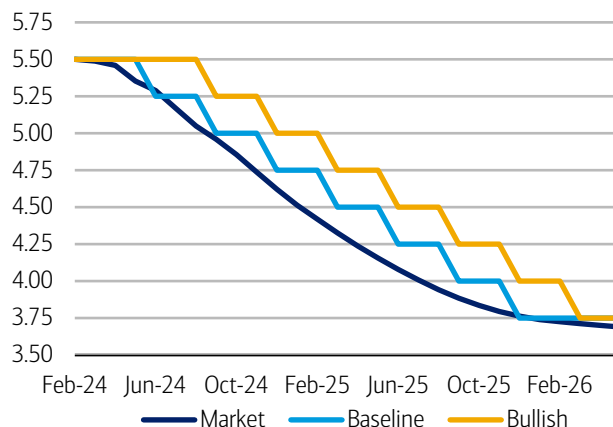


**Source:** BofA Global Research, Bloomberg.

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**Exhibit 7: US policy rate under different scenarios**

Under a delay in the Fed's easing cycle, the 2y TIIE vs. SOFR spread could tighten by almost 100bp



**Source:** BofA Global Research, Bloomberg.

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## Risks: A hawkish Banxico and a dovish Fed

Though unlikely, a risk to our trade, in our view, is a potential shift to a hawkish Banxico. While this may contrast with current guidance, we believe there is still a case to keep rates high for longer. The fact that the output gap is still significantly positive, the labor market remarkably resilient, inflation expectations relatively unanchored and services inflation still highly persistent, suggests that Mexican inflation dynamics suffer similar upside risks than US inflation. This is, a shock to goods inflation may need to be accommodated with still-high services inflation, which could jeopardize the path to the 3% inflation target. Moreover, the option value of keeping rates high is still attractive, as the tradeoff between growth and inflation is still not evident in Mexico. In other words, just as we think that Banxico can easily justify the start of the easing cycle, there is also a path to justify a delay.

A hawkish shift in Banxico may also be triggered by a further hawkish shift in the Fed. For instance, Banxico may decide to delay the easing cycle if the Fed pushes cuts too much into the future. This would trigger an extension of the high-beta-to-US-rates regime that has characterized Mexican rates during the hiking cycle, which could imply that the 2y TIEE vs. SOFR spread may fail to substantially narrow. However, we argue that this scenario is unlikely. We believe that the 2y TIEE vs. SOFR spread may actually be narrower if a delay in the Fed easing cycle materializes. With a fiscal cliff due in Mexico in 2H24, Banxico would be between a rock and a hard place, as the Mexican economy decelerates, and the Fed remains on hold. In our view, Banxico will most likely opt to keep cutting rates. Overall, our conviction is that the strong correlation we had recently observed between MX and US rates may break soon, which supports the 2y spread receiver.

One other risk to our trade is a dovish Fed. This could be triggered by a better-than-expected inflation outlook, downward surprises to economic activity and a weakening of the labor market. While this may allow Banxico to be dovish as well, domestic dynamics in Mexico may prevent Banxico from cutting aggressively in the short-term.

### **List of acronyms**

Banxico: Central Bank of Mexico

Fed: US Federal Reserve

GDP: Gross Domestic Product

SOFR: Secured Overnight Funding Rate

TIIE: Tasa de Interes Interbancaria de Equilibrio (Mexico's interbank rate)

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# Research Analysts

## Global Economics

**Claudio Irigoyen**  
Global Economist  
BofAS  
+1 646 855 1734  
claudio.irigoyen@bofa.com

**Antonio Gabriel**  
Global Economist  
BofAS  
antonio.gabriel@bofa.com

## Global EM FI/FX Strategy

**David Hauner, CFA** >>  
Global EM FI/FX Strategist  
MLI (UK)  
+44 20 7996 1241  
david.hauner@bofa.com

## Asia FI/FX Strategy & Economics

**Helen Qiao**  
China & Asia Economist  
Merrill Lynch (Hong Kong)  
+852 3508 3961  
helen.qiao@bofa.com

**Claudio Piron**  
Emerging Asia FI/FX Strategist  
Merrill Lynch (Singapore)  
+65 6678 0401  
claudio.piron@bofa.com

**Jojo Gonzales** ^^  
Research Analyst  
Philippine Equity Partners  
jojo.gonzales@pep.com.ph

**Abhay Gupta**  
Emerging Asia FI/FX Strategist  
Merrill Lynch (Singapore)  
abhay.gupta2@bofa.com

**Pipat Luengnaruemitchai**  
Emerging Asia Economist  
Kiatnakin Phatra Securities  
pipat.luen@kkpfg.com

**Miao Ouyang**  
China & Asia Economist  
Merrill Lynch (Hong Kong)  
miao.ouyang@bofa.com

**Xiaoqing Pi**  
China Economist  
Merrill Lynch (Hong Kong)  
xiaoqing.pi@bofa.com

**Benson Wu**  
China & Korea Economist  
Merrill Lynch (Hong Kong)  
benenson.wu@bofa.com

**Ting Him Ho, CFA**  
Asia Economist  
Merrill Lynch (Hong Kong)  
tinghim.ho@bofa.com

**Janice Xue**  
Emerging Asia FI/FX Strategist  
Merrill Lynch (Hong Kong)  
janice.xue@bofa.com

**Chun Him Cheung, CFA**  
Emerging Asia FI/FX Strategist  
Merrill Lynch (Hong Kong)  
chunhim.cheung@bofa.com

**Kai Wei Ang**  
Asia & ASEAN Economist  
Merrill Lynch (Singapore)  
kaiwei.ang@bofa.com

## EEMEA Cross Asset Strategy, Econ

**Mai Doan**  
CEE Economist  
MLI (UK)  
+44 20 7995 9597  
mai.doan@bofa.com

**Zumrut Imamoglu**  
Turkey & Israel Economist  
MLI (UK)  
zumrut.imamoglu@bofa.com

**Vladimir Osakovskiy** >>  
EM Sovereign FI/EQ strategist  
Merrill Lynch (DIFC)  
vladimir.osakovskiy@bofa.com

**Jean-Michel Saliba**  
MENA Economist/Strategist  
MLI (UK)  
jean-michel.saliba@bofa.com

**Merveille Paja**  
EEMEA Sovereign FI Strategist  
MLI (UK)  
merveille.paja@bofa.com

**Mikhail Liluashvili**  
EEMEA Local Markets Strategist  
MLI (UK)  
mikhail.liluashvili@bofa.com

**Tatonga Rusike**  
Sub-Saharan Africa Economist  
MLI (UK)  
tatonga.rusike@bofa.com

## LatAm FI/FX Strategy & Economics

**David Beker** >>  
Bz Econ/FI & LatAm EQ Strategy  
Merrill Lynch (Brazil)  
+55 11 2188 4371  
david.beker@bofa.com

**Jane Brauer**  
Sovereign Debt FI Strategist  
BofAS  
+1 646 855 9388  
jane.brauer@bofa.com

**Carlos Capistran**  
Canada and Mexico Economist  
BofAS  
+1 646 743 2921  
carlos.capistran@bofa.com

**Ezequiel Aguirre**  
LatAm FI/FX Strategist  
BofAS  
ezequiel.aguirre2@bofa.com

**Pedro Diaz**  
Caribbean Economist  
BofAS  
pdiaz2@bofa.com

**Christian Gonzalez Rojas**  
LatAm Local Markets Strategist  
BofAS  
christian.gonzalezrojas@bofa.com

**Lucas Martin, CFA**  
Sovereign Debt FI Strategist  
BofAS  
lucas.martin@bofa.com

**Alexander Müller**  
Andean(ex-Ven) Carib Economist  
BofAS  
alexander.muller@bofa.com

**Natacha Perez**  
Brazil Economist  
Merrill Lynch (Brazil)  
natacha.perez@bofa.com

**Sebastian Rondeau**  
Southern Cone & Venez Economist  
BofAS  
sebastian.rondeau@bofa.com

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