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Mexico Strategy and Economics | Latin America

A New Higher Vol Regime: Will Banxico React?

We think that fiscal slippage and unorthodox policy are now more likely, which would increase risk premia in Mexico local assets, and lead Banxico to act next week. We continue to recommend fading rallies and building strategic underweight positions, particularly on the FX front.

Fixed income strategy: We remain concerned about potential fiscal slippage over the medium term. Moreover, we believe that the uncertainty generated around the airport consultation and the actual outcome of it has raised concern among investors about policy implementation risks in the future (see Mexico: Fade The Rallies, October 29, 2018). **We are strategically bearish on MXN local assets and recommend short MXN positions** versus a basket of high-beta EM as we expect USD to trend down (supporting EM overall). We keep defensive positions in rates despite attractive valuations and recommend 5s10s steepeners.

Compared to past episodes of relative stress in EM, we think that the **recent increase in implied volatility relative to realized volatility and Mexico's EM peers was induced by domestic policies, rather than exogenous shocks** – in which usually the latter can be counteracted with a swift and effective policy response. Given the current situation, we think that the financial markets will serve as one of a few counterbalances that the administration will have to face. This means that further episodes of higher volatility and cheaper valuations in the years ahead are more likely, resulting in a 'new regime'.

Economics: Increased currency volatility associated with greater uncertainty about the new administration's policy path comes at an inopportune time for the central bank, when inflation remains elevated, expectations are drifting higher and risks to prices are skewed to the upside. The airport decision and other likely proposals hinting at a shift away from the policy status quo led to an increase in risk premia, which may be signaling that the neutral rate is higher than before – something that Banxico is likely to validate via a rate hike on November 15.

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Fixed income strategy: A new higher vol regime

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As we highlighted in Mexico Economics and Strategy: Mexico: Tightening Cycle Behind, But Not Uncertainty (July 18, 2018), we had been skeptical about the optimism generated around Mexico during the past few months. While we understood the relative attractiveness of Mexico amid the EM sell-off, we were not comfortable with the risks we perceived for a medium-term deterioration in Mexico's investment narrative. These risks have materialized sooner than anticipated, in our view.

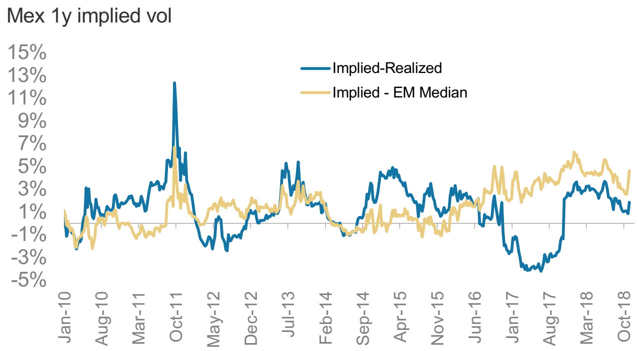
We remain concerned about the potential fiscal slippage over the medium term. In addition, we think that the uncertainty generated around the airport consultation and the actual outcome of it has raised concern among investors about policy implementation risks in the future (see Mexico: Fade The Rallies, October 29, 2018). We are strategically bearish on MXN local assets and recommend short MXN positions versus a basket of high-beta EM as we expect USD to trend down (supporting EM overall). We keep defensive positions in rates despite attractive valuations and recommend 5s10s steepeners.

Keeping a defensive stance in Mexican local assets: Staying bearish on MXN

Risk premia should be structurally higher than during the past administration, in our view: We do believe that EM portfolios with Mexico exposure should adapt to a new higher vol regime. While not necessarily immediate, we contend that greater risks on the policy front **(additional consultations, potential unorthodox policies)** call for an increased volatility risk premium (Exhibit 1) which should weigh on expected risk-adjusted returns and, consequently, the attractiveness of Mexican local assets compared to the rest of EM.

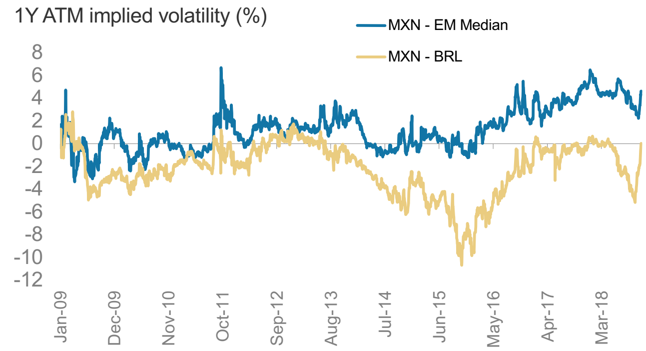
This is also reflected in Exhibit 2 , where 1y MXN ATM-implied vol is trading at very high levels vis-à-vis the median of its EM peers, and close to historical highs compared to BRL.

Exhibit 1: Volatility risk premium poised to increase structurally in MXN



Source: Bloomberg, Morgan Stanley Research

Exhibit 2: MXN vol regime has likely shifted upward relative to its peers

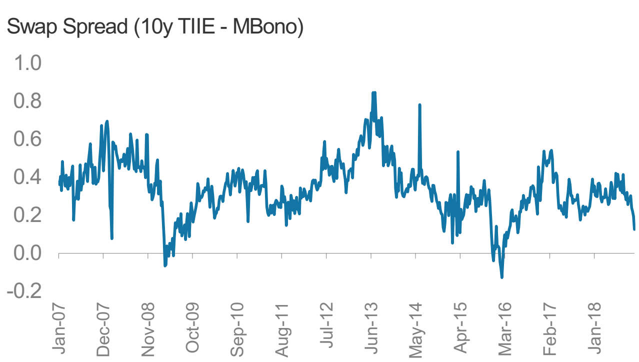


Source: Bloomberg, Morgan Stanley Research

As we see it, there are many reasons for caution: Uncertainty has increased, as we discuss above, and **markets are increasingly pricing in a higher probability of fiscal slippage/central bank independence coming into question.** 5y5y implied inflation in MBonos versus UDIs reflects a substantial increase in the long-term inflation risk premium Exhibit 6) which, although not necessarily explained by a cyclical change in inflation dynamics, will likely keep Banxico on guard.

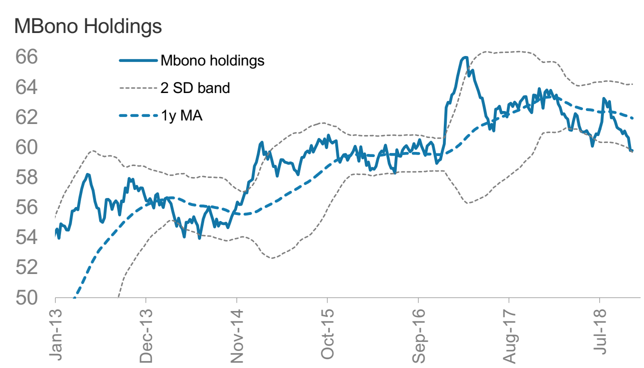
We believe that with inflation risks likely to rise, Banxico will be potentially forced to hike beyond what the policy status quo would have dictated. The increase in long-term rates has been reflected in a **reduced positioning from offshore in MBonos during the past few weeks.** It is important to highlight that, while the percentage of **MBonos in offshore hands** has not decreased to levels that would suggest structural changes, **it seems that it has peaked lately and has been consistently testing the 2 standard deviation band compared to the one-year average. This has happened just a few times in the past – the taper tantrum and the US election come to mind.**

Exhibit 3: While swap spreads have not widened...



Source: Bloomberg, Morgan Stanley Research

Exhibit 4: ...MBono holdings seem to have peaked and potentially signal a downward trend



Source: Bloomberg, Morgan Stanley Research

Taken together, we believe that vol-adjusted returns and fatter left tails (higher probability of downside), suggest that GBI-EM investors will continue to reduce their overweight positions (Exhibit 4), thereby increasing risk premia in Mexican assets in the months and quarters to come (see Mexico: Fade The Rallies, October 29, 2018).

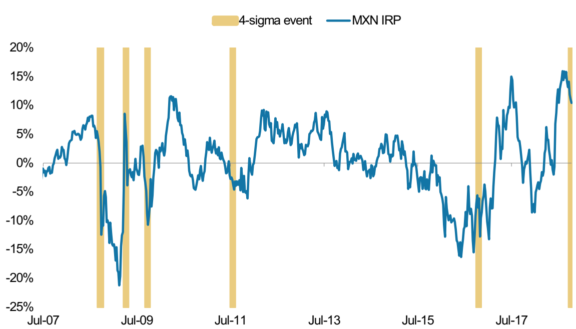
Why we argue that this time is different

Compared to past episodes of relative stress in EM, we think that the **recent increase in implied volatility relative to realized volatility and Mexico's EM peers was induced by domestic policies**, **rather than by exogenous shocks** – in which the latter usually can be counteracted with a swift and effective policy response.

In our opinion, rates and FX have sent a strong message, which continues to point to cautious and underweight positions in Mexican local assets. When looking at the USDMXN move on October 29 relative to comparable moves in the past (scaled by historical vol), two things stand out: i) It marked the first time in the past 10+ years that, in a single day, USDMXN appreciated by four times its 3-month historical vol (4-sigma move) without an external shock (i.e., it was domestically induced); and ii) It was the first time such a move happened while MXN's valuation looked expensive (to us) and positioning was still overweight (Exhibit 5).

Given the current situation, we think that financial markets will serve as one of a few counterbalances that the administration will have to face. This means that further episodes of higher volatility and cheaper valuations in the years ahead are more likely, resulting in a 'new regime'.

Exhibit 5: October 29 was the first 4-sigma move with MXN being expensive and real money positioning not clean



Source: Morgan Stanley Research; Note: We define a 4-sigma move as a % daily change in USDMXN that is four times its 3-month rolling standard deviation.

Exhibit 6: Inflation risk premium clearly on the rise

5y5y BE MXN

Source: Bloomberg, Morgan Stanley Research

New budget is likely the next catalyst: We see the upcoming budget as an important catalyst, owing to the airport consultation results and the administration's rhetoric regarding the outcome. On this, we argue that details are ultimately what matter, as even if a balanced budget is presented for 2019, potential concerns about assumptions on growth and/or savings from spending reengineering will likely tilt risks to the downside. We believe that the budget's details regarding the plans for Pemex will also matter – particularly given recent concerns highlighted by rating agencies – including the uses of future capex. We think that another potential risk to monitor would be the prospects for USMCA trade deal approval in the US after the midterm elections.

USMCA priced for perfection, in our view: While we do believe that the agreement will be ratified by the three countries, risks seem clearly asymmetric, particularly as the US could announce its intention to withdraw from the current NAFTA agreement. If this is the case, we believe that increased volatility and MXN weakness before confirmation of the deal's approval are warranted.

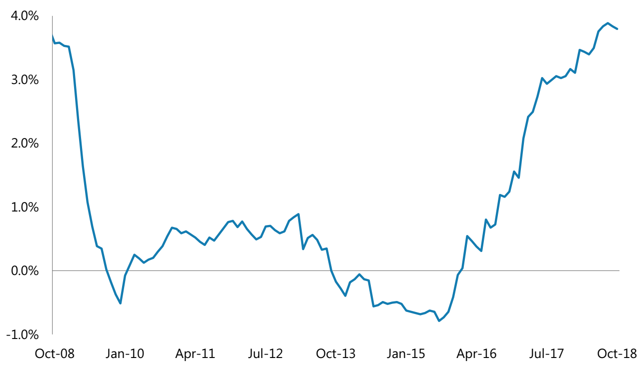
Lastly, in our view, it will be important to monitor interaction between the administration and the central bank, in addition to potential cabinet changes within the current coalition.

Fundamentals and quant are aligned: Our quantitative framework to trade EMFX (see EM Quant Strategy: EMFX Quant's Lab, November 5, 2018) recently shifted to underweight Mexico, confirming the fundamental view of MXN underperformance that we have held since before the airport consultation (see Mexico Economics & Strategy: In a Holding Pattern, October 17, 2018). A confirmation of the signal at the end of this week would only reinforce our conviction on MXN shorts.

Economics: Rising uncertainty, rising rates?

Luis Arcentales

Exhibit 7: Mexico: Real interest rate (ex-ante, annual rate)

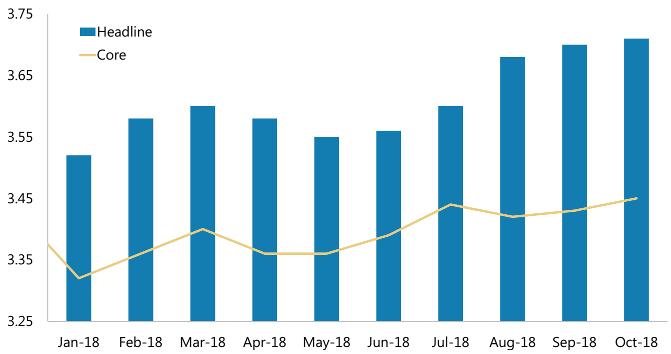


Source: Banxico, Morgan Stanley Latam Economics

For several months, discussions about monetary policy in Mexico focused on the outlook for 2019 and the room, if any, for the central bank to lower interest rates: Since its last rate increase in June, there has been a lull during which Banxico kept rates unchanged at 7.75%, matching expectations at both its August and October meetings. To be fair, the central bank held on to its hawkish rhetoric by reiterating the need for a "prudent" stance and stressed that risks to inflation were skewed to the upside (see Mexico: Tightening Cycle Behind, But Not Uncertainty, July 28, 2018). But policy-makers also hinted that policy was sufficiently tight and, though still running at elevated levels, the outlook for inflation was for a gradual shift lower over the forecast horizon, with most question marks centered on the speed at which prices would moderate rather than the direction (Exhibit 7). Moreover, slack was opening up, policy-makers argued, after the economy hit a soft path around mid-year. In all, it seemed that despite inflation risks being biased to the upside and one board member voting in favor of a 25bp rate increase in October, most policy-makers were comfortable staying on hold for the foreseeable future (see Mexico – Banxico Decision: Hawkish Despite Trade Progress, October 4, 2018). Thereafter, prospects for adopting a more dovish stance in 2019 would depend on a handful of risk events for which there would be greater visibility in the coming months, principally details of the 2019 government budget and minimum wage adjustment, in addition to any potential shift in the outlook for Fed normalization.

Today the monetary policy debate is in full force once again, but one of the different kind: as the November 15 meeting approaches, the question is whether the central bank will resume its tightening cycle: The immediate cause for the shift was the cancellation of the new airport – a move we consider to be a policy mistake – leading to renewed currency volatility and higher yields linked to greater uncertainty about the policy path under the incoming administration (see Exhibit 2 and Mexico: Plan B Airport Receives a Hard Landing, October 30, 2018). The challenge for the central bank goes beyond the initial currency weakness, which by now has been largely reversed: renewed uncertainty comes at a challenging time when there is a wide gap between the (higher) consensus and the more constructive central bank's inflation, expectations have moved up, as have market-based measures of inflation. With two members of the board – one of whom voted in favor of higher rates last month – already warning in October of a "rising probability that under current circumstances" additional rate increases in the near term may be required, the threshold for any additional rate hikes may not be as high as we perceived previously. Accordingly, we see policy-makers increasing rates to 8.00% next week – validating swap pricing – and keeping a hawkish rhetoric.

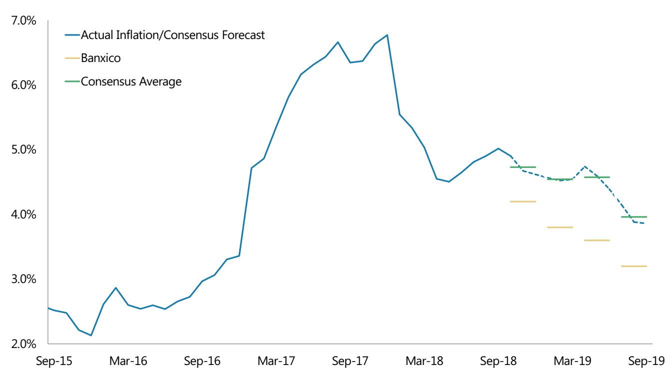
Exhibit 8: Mexico: 2019 inflation expectations (% change y-o-y)



Source: Banxico

The annual rate of headline inflation likely peaked already, yet inflation expectations keep drifting higher – one of the variables the central bank watches closely (Exhibit 8). The rate of inflation reached 5.02%Y in September and moved lower in October (4.90%Y), bringing to an end the energy-led uptrend that began in May. While a favorable comparison base in October-December – because of post-earthquake price hikes (transportation, mobile costs) and a spike in non-core items last year – should lead to a further declines in inflation into year-end, inflation expectations continued creeping up. For 2019, the latest median headline consensus ticked up to 3.71%Y, as did core (3.45%Y), 12-month forward forecasts also moved up to 3.80%Y and, for 2020, they remained stuck at 3.50%Y. A similar upward trend can be seen in breakeven measures (Exhibit 6). In and of themselves, rising expectations shouldn't necessarily force the central bank's hand; however, the persistent move higher in expectations – even though recent price pressures have come mostly from energy and thus are temporary – suggests mounting market concerns about future price dynamics.

Exhibit 9: Mexico: Inflation path (% change y-o-y)



Source: Banxico

Importantly, the deterioration in expectations is likely to prompt the central bank to once again revise its forecasts higher: The central bank took an important step towards greater transparency and accountability at the beginning of the year by re-introducing quarterly inflation forecasts – a practice scrapped in 2010 in favor of fan charts. While a welcome development, the central bank has been repeatedly forced to adjust its forecasts higher, and postpone the timing for convergence to target (currently mid-2020). And a wide gap between the consensus and the central bank's outlook remains – averaging 0.8pp in 2019, for example – suggests that markets do not see policy-makers' projections as credible (Exhibit 9). Repeated upward revisions to the quarterly forecast path, and the wide gap versus consensus, could lead to the gradual erosion over time of the objective the forecasts were supposed to achieve in the first place, namely to help to form expectations and to strengthen the expectations channel in the transmission of monetary policy. We believe that a timely rate hike in November would go a long way towards preventing that erosion by signaling the central bank's resolve, particularly now that expectations seem to signal concerns that may go beyond the recent energy-led, transitory price pressures.

Inflation considerations aside, one relevant debate centers on whether the central bank should react to the greater uncertainty derived from decisions such as the airport cancelation. There are several reasons why policy-makers may choose to do so, in our view. First, Banxico has favored a risk-management approach that prioritizes financial stability, as suggested by the tightening experience of 2016 when the central bank reacted, among other factors, to currency jitters and underperformance. While the peso has reversed part of the airport-linked sell-off, currency volatility is higher, as are yields. The central bank also sees monetary policy in a context of broader macro policy, thus the fiscal stance matters. The airport decision will involve diverting public funds to compensate contractors and investors and to upgrade the other facilities, in turn generating greater uncertainty about the incoming administration's ability and commitment to running a tight fiscal ship. To be clear, we are not arguing that the central bank should adjust rates on expectations of what the budget, fuel pricing policy or minimum wage adjustments may look like – policy-makers will analyze their implications and react accordingly once they are known. However, the airport decision has already translated into higher risk premia, which is likely to persist, as argued by our strategists in the previous section. We interpret the higher risk premia as the market signaling that the neutral rate may be higher than before, something that the central bank is likely to validate via a rate hike next week, in our view (see Global EM Strategist: Will We Rally into Year-End? October 29, 2018).

Exhibit 10: Valuation methodology and risks

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Rates						
5s10s TIIE steepener	15-Aug-18	23	50	10	We believe that there is a higher premium in the short/belly part of the curve created by a historically tight monetary policy stance. Therefore, we prefer to focus on the belly of the curve as a higher USD would likely push Banxico to pull the trigger again, keeping longer tenors anchored. In addition, increased risk sentiment paired with a higher volatility regime should increase risk premium on the curve.	USD strengthening beyond our forecasts, prompting the market to price in additional hikes, or an improvement in risk sentiment that would bring a lower volatility regime.
Dislike Mexico Local Rates	29-Oct-18	NA	NA	NA	We remain concerned about the potential fiscal slippage over the medium term. In addition, we think that the uncertainty generated around the airport consultation and the actual outcome of it has raised concern among investors about policy implementation risks in the future.	Investor sentiment improves as the next administration pursues an orthodox policy agenda.

Source: Morgan Stanley Research

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