International Commentary — November 10, 2022

Banxico Still Stuck to the Fed's Hip

Summary

Banxico, as expected, delivered a 75 bps rate hike at its November monetary policy meeting. While the decision was not a surprise, there was a fair amount of interest in the forward guidance Mexico's policymakers would provide as market participants now anticipate a slowdown in the future pace of Federal Reserve tightening. However, Banxico provided little new forward guidance, leading us to believe the central bank will continue to follow the Fed's lead when determining monetary policy settings. With Banxico likely to match the Fed's pace of tightening, and as local political risk is non-apparent for the time being, we believe recent Mexican peso stability is likely to persist. In the short-term, we expect a range bound Mexican peso, while we believe the peso can gradually strengthen over the second half of 2023 into early 2024.

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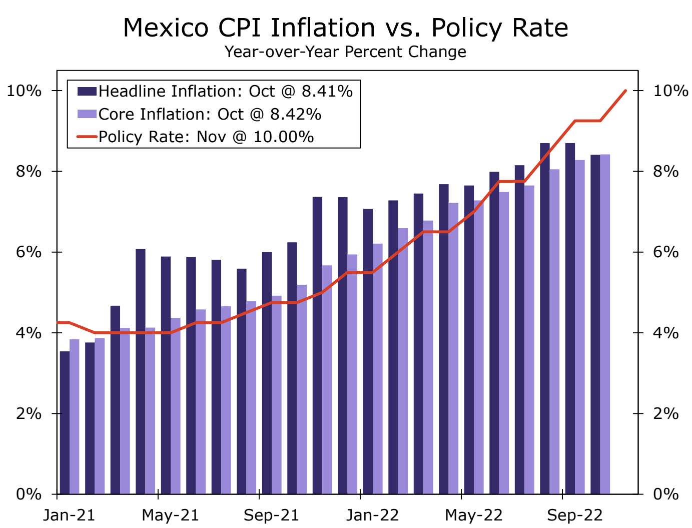
Banxico Doesn't Break From the Fed

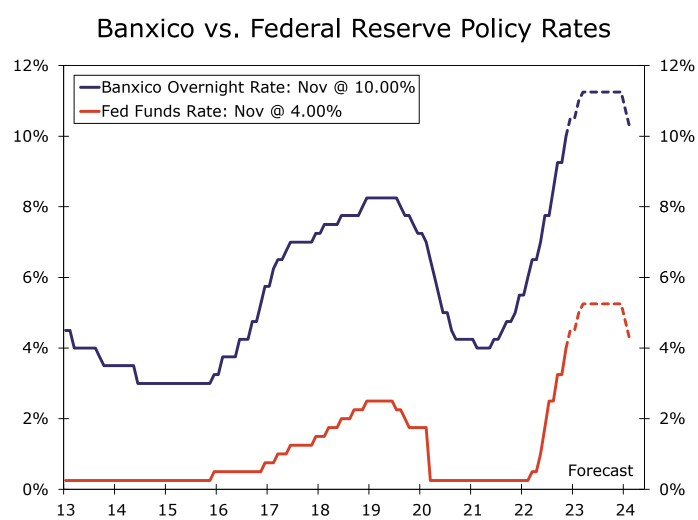
As expected, Central Bank of Mexico policymakers raised the Overnight Rate 75 bps to 10.00% at their November meeting (Figure 1). Leading into the meeting, there was little contention or debate among economists that Banxico would deliver a 75 bps rate hike; however, we should note the decision to lift the Overnight Rate 75 bps was not unanimous. As expected, Gerardo Esquivel, arguably the most dovish Banxico voting member, dissented in favor of a 50 bps hike. While the 75 bps rate hike was fully priced by financial markets and Esquivel's dissension was anticipated, there was still interest in the November meeting. Indeed, we were particularly curious in regard to the forward guidance policymakers would provide as U.S. CPI inflation moved surprisingly lower than expected in October, and markets priced a slower pace of tightening from the Federal Reserve. However, the official Banxico statement did not provide a ton of excitement nor any new forward guidance of significance. Language in the November statement, especially on the outlook for policy rates, was very similar to forward guidance provided in September, leaving financial markets with little new information to react to and absorb. The only change to note is that Banxico policymakers now forecast a slower pace of headline inflation than they forecast in September, although the central bank now believes core inflation will be stickier than previously expected. Some comfort can be taken in the fact policymakers believe headline inflation has peaked, but with core inflation now expected to rise at a faster pace than previously, policymakers are likely to continue their tightening cycle going forward. With that said, there is little evidence which suggests Banxico will look to deviate from the Federal Reserve's monetary policy path. From here, even though Banxico suggests it will be data dependent, we believe the central bank will continue to take its cue on future interest rate decisions from the Federal Reserve.

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Mexican Peso Stability to Persist

Over the course of this year, the Mexican peso has been one of the few foreign currencies to strengthen against the U.S. dollar. As of early November, Mexico's currency has strengthened close to 6% year-to-date against the greenback, which is notable as most emerging market currencies have weakened over the last ten months. In our view, there are two dynamics that have supported the peso's rally. The first being Central Bank of Mexico policymakers have maintained an aggressive posture towards monetary tightening. Policymakers started their tightening cycle in mid-2021 when inflationary pressures were building, and over the course of the last 18 months, have remained steadfast in their commitment to bring inflation back to the target range, and resisting pivoting toward less restrictive monetary policy. As far as the Banxico tightening cycle, the Central Bank of Mexico has also been one of the few central banks to keep pace with Fed interest rate hikes. Historically, whenever Banxico has deviated from the Fed's monetary policy decisions, capital flows have shifted quite dramatically. In an effort to avoid capital exiting Mexico and to prevent a sharp peso depreciation that likely would fuel inflation higher, policymakers have instead lifted interest rates in lockstep with the Fed during the current cycle. This attractive carry and stable interest rate differential has been a key pillar of support for the peso this year. In addition to a hawkish central bank, an easing of local political risk, in our view, has also provided a fair amount of support to the peso. This is in contrast to other developments across Latin America, where regional elections have resulted in a wave of presidents with unorthodox policy agendas, which has raised risk premium associated with currencies impacted (i.e.: COP, CLP, PEN & BRL). Mexico has been absent from this rising political risk trend across Latin America as mid-term elections in 2021 resulted in the AMLO government losing its congressional majority. With President AMLO now unlikely to implement any of his unconventional policy agenda items and in a “lame duck” period, political risk premium has been lifted off the peso and has arguably turned Mexico into the safe haven of Latin America.

Going forward, we expect the dynamic of attractive carry and stable local politics to continue, and for the peso's recent stability to persist for the time being. To that point, Mexico's November monetary policy meeting gives us a fair amount of confidence that Banxico, in contemplating future rate hikes, is unlikely to deviate from the pattern of the Federal Reserve's monetary policy path (Figure 2). In December, we believe the Fed will raise policy rates 50 bps and believe Central Bank of Mexico policymakers will match that degree of tightening. We also believe the Fed will deliver additional interest rate hikes in early 2023, which we believe Banxico members will also match. As Banxico-Fed monetary policy paths do not diverge, policy interest rate differentials should remain steady and not be a source of depreciation on the peso. On the political front, presidential elections will not take place until July 2024, which should keep political risk off the peso for an extended period of time. AMLO's more unconventional policies such as energy reform and restricting foreign investment into Pemex should not be a source of depreciation pressure on the peso given a lack of congressional support, even if headlines suggest these policies are still being pursued by the AMLO administration. Also, no candidate for the 2024 presidency has a significant amount of momentum behind them. Unless a candidate with an unorthodox policy agenda has strong support very early in the election cycle, we believe Mexico is currently in a state of political nirvana and that political risk will not have a material impact on the direction of the currency. Through the end of this year and into mid-2023, we believe the USD/MXN exchange rate can hover between the MXN19.50-19.75 range.

Over the longer-term, we believe the U.S. dollar could exhibit a trend of broad-based cyclical depreciation as the Federal Reserve begins to signal, and ultimately deliver, interest rate cuts to offset a looming recession. While we believe Mexico's economy can slip into recession in early 2023 and Banxico will also cut interest rates next year, a backdrop of Fed interest rate cuts should support global financial markets and especially risk-sensitive currencies. These interest rate cuts should result in emerging market currencies outperforming relative to the foreign currency complex, and we believe the Mexican peso can perform quite well in this type of environment. In that sense, over the second half of 2023 and into early 2024, we believe the USD/MXN exchange rate can gradually move toward MXN19.00. We will certainly keep an eye on how election-related developments in Mexico evolve in 2024, and should a candidate with an unorthodox policy agenda have strong support, the peso could suffer the consequences and risks of a weaker Mexican peso than our base case scenario could take shape. But, until we have more visibility into Mexico's 2024 election, we will refrain from incorporating any potential rise in political risk into our long-term Mexican peso outlook.

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