Mexican peso corrects: Don't panic!

USD/MXN has spiked higher on news that Banxico wants to start unwinding its short dollar position acquired through FX intervention. While the market may be correct in thinking that Banxico does not want the peso to be a lot stronger, we think that after some temporary weakness in September, the peso will still outperform its steep forward curve

Unwinding the intervention

Late yesterday, Mexico's central bank, Banxico, announced its plans to unwind the outstanding balances of its FX hedging programme, a programme launched in February 2017 to support the beleaguered peso. During two intervention episodes - February 2017 and March 2020 - Banxico effectively acquired short USD/MXN positions in the FX forwards market when spot was trading over 20 and 24, respectively.

In its press release, Banxico clarified that \$5.5bn of its forward position was built during 2017 and another near \$2bn during the March 2020 episode to leave the current outstanding balance near \$7.5bn. Banxico has said that it will let these short USD/MXN positions in the forward market (held in the one to twelve-month tenors) roll off gradually. In practice, this means rolling only 50%, not 100%, of the shorter-dated positions and allowing the longer nine and twelve-month positions to mature on schedule.

There are probably three reasons why USD/MXN spiked so sharply on the news. The first is that the Mexican peso has been investors' EM darling this year and that long MXN positions are crowded. The second is that Banxico's decision to unwind this hedge programme could mean Banxico's tolerance of peso strength has reached some kind of limit. The third is the technical aspect that the biggest impact on the FX market could come this month. If, as Banxico says, only 50% of this month's reported $4.8bn in maturing forwards is rolled, that means the FX market has to absorb the sizeable impact of a $2.4bn Banxico dollar offer disappearing.

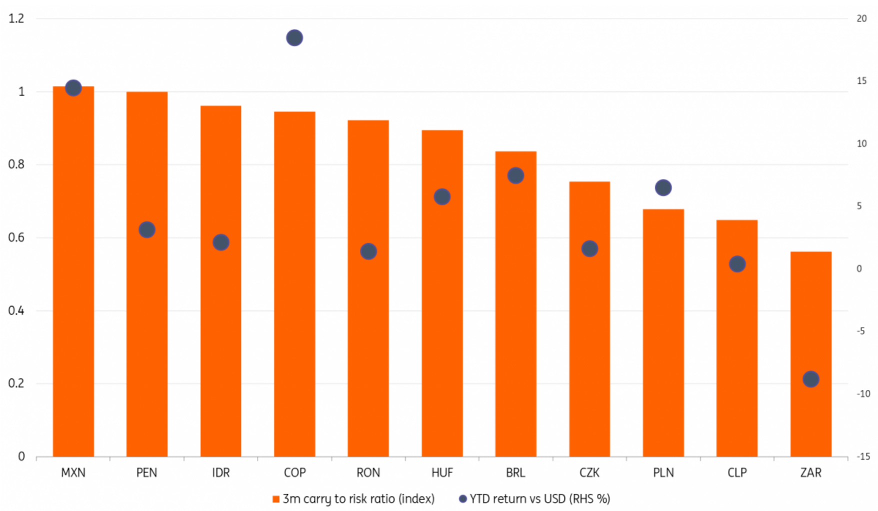
While all of the above concerns have merit, we are less concerned than some and take Banxico's press release at face value. In it, Banxico said it was now unwinding these positions because market conditions are now orderly and liquidity conditions are good (they weren't when the intervention took place). And that, by unwinding these positions now, Banxico allows banks on the other side of these trades to do so in an orderly manner.

Peso positives remain in place

Physically it looks like the majority of this hedge unwind will hit the USD/MXN market in September. However, the hedge unwind does nothing to reduce one of the key driving factors of peso strength this year – which is the risk-adjusted carry. Even Banxico in its meeting minutes highlights how the risk-adjusted yield is the dominant force in driving the peso.

As we highlight below, the peso offers the higher carry-to-risk ratio in the EM space. This is the nominal implied yield available through the deliverable/non-deliverable FX forward market, adjusted by implied volatility from the FX options market. Unless Banxico plans to slash nominal rates or engineer some local factor that would command significantly higher implied volatility for USD/MXN, then this carry-to-risk ratio will remain a major boon to the peso.

EM currencies 'carry-to-risk' ratio and YTD performance versus USD



Source: ING, 'carry-to-risk ratio' is the 3m implied yield through the forward adjusted for FX volatility

On the subject of potential rate cuts, it was noticeable that the Mexican TIIE swap curve barely budged on this announcement. If the FX market thinks Banxico may potentially even want to cut rates to put a floor under USD/MXN, the rates market is not buying the story. And Banxico this week has, in fact, said it will not be rushed into early rate cuts. Recall that Banxico had kept policy rates 600bp+ over the Fed to keep USD/MXN stable. We would be more worried for the peso if Banxico did threaten large, early rate cuts.

New FX policies from central banks?

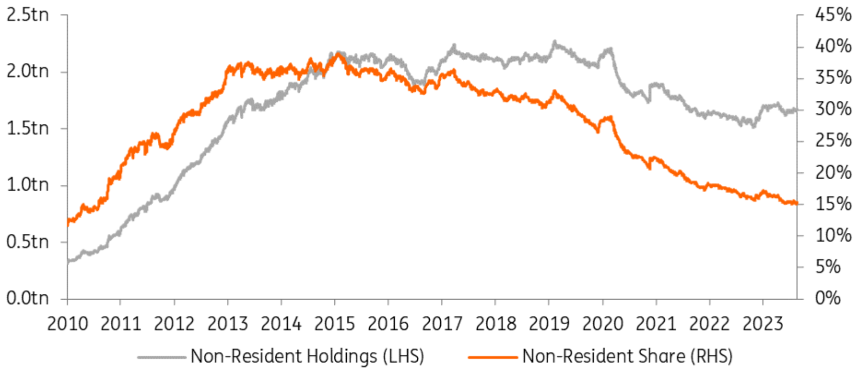
We tend to view this as more a commercial and financial stability-led decision from Banxico rather than a formal red flag to further peso strength. As an aside, Brazil's central bank – the BCB – has a $100bn short USD/BRL position through the FX forwards following intervention and probably would not go near unwinding it for fear of crashing the Brazilian real. Chile's central bank happens to be buying FX at the moment – but that looks a function of financial stability as it tries to rebuild FX reserves after losing half of them last year.

In short, we do not think Banxico's move is part of an effort to cap the strength in Latin currencies. Instead, we think Mexico's high carry, decent growth, strong sovereign position and positioning for geo-political nearshoring should mean strong demand for the peso on any weakness this month.

Additionally, foreign positioning in Mexcio's local currency MBONO bond market is not particularly extreme; Mexico should be well positioned to receive funds when bond markets eventually come back into favour given its large 10% weight in the JPM GBI-EM local currency bond index.

We currently forecast USD/MXN trading down through 16.50 next year when the broad dollar turns lower on a larger-than-expected Fed easing cycle. We do not think this Banxico announcement necessitates a forecast change, and the peso will comfortably outperform its steep forward curve.

Non-resident holdings of Mexican government securities



Source: Bank of Mexico, ING

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

James Wilson
EM Sovereign Strategist
James.wilson@ing.com