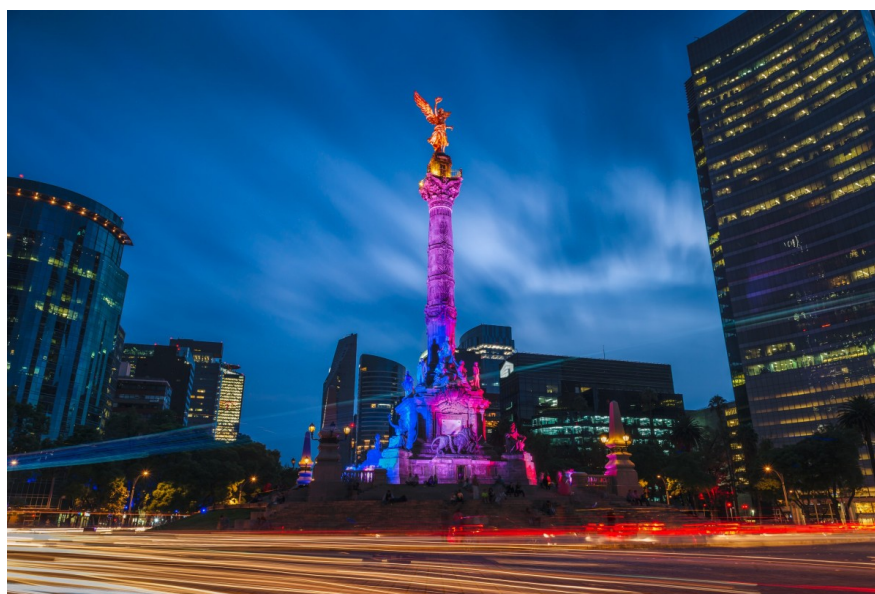


## Mexico: Policy stimulus has further to go

Policy rates are already at or near their “operational lower bound” in several countries in LATAM but, in Mexico, officials continue to sound cautious, in their willingness to stimulate the economy through rate cuts. We suspect that resistance should gradually wane, amid evidence of deep recession and disinflation



Source: Shutterstock

### Dovish surprises everywhere

The Covid-19 crisis has led most central banks in LATAM to surprise with dovish actions in recent months. Frontloaded easing cycles in Chile and Peru already brought the overnight rate to their lower bound, near zero.

Brazil also recently surprised with a bigger-than-expected rate cut and signaled that its SELIC rate may be brought to 2.25% next month. That's the level that BACEN officials consider to be Brazil's “operational lower bound”. In Colombia, the 3.25% reference rate should also move nearer Brazil's in the coming months.

This leaves Mexico as a persistent outlier, with the reference rate still at 6%, and only gradually moving toward the 4-5% range.

According to Banxico's consensus survey, the current monetary easing cycle will end after a cumulative 100bp rate drop in the coming months, to 5.0%. This contrasts with our call for a more frontloaded and deeper easing cycle.

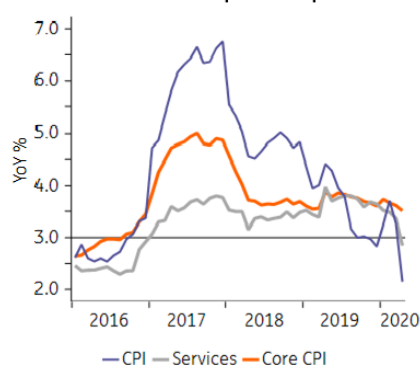
We expect another 50bp rate cut at tomorrow's regularly scheduled monetary policy meeting, to 5.5%, followed by three additional 50bp cuts in June-August, during "emergency" and regularly-scheduled meetings. This would imply a reference rate of 4.0% by August.

## FX concerns turn secondary amid sharp disinflation

Broad-based FX weakness could, arguably, be a persuasive argument for central bankers to proceed cautiously in their rate-cutting cycle. But that argument appears to be losing weight given the severity of the recession and the sharp disinflation local economies are already experiencing.

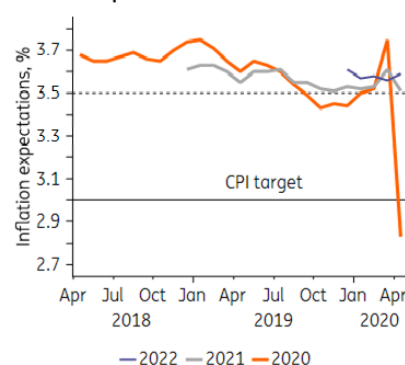
Inflation fell to 2.1% year on year in April in Mexico, matching the previous record low for the indicator. Inflation expectations are also falling, and we expect 2020 forecasts to fall deeper below the 3% target.

Headline inflation collapsed in April



Source: Macrobond, ING

Inflation expectations also moved lower



Source: Macrobond, ING

Brazilian central bankers have, for instance, acknowledged that rate cuts have contributed to heightened volatility in local assets, notably the BRL. In their policy minutes released this week, the bank appeared unusually candid about the internal debate they are having over the impact of their actions on FX markets.

But concerns over FX stability appear to have become secondary of late, as it has not stopped BACEN, for instance, from frequently surprising with dovish policy announcements.

Historically, concerns over financial market or FX instability have held much sway in Mexico. And even though the bank has been more aggressive in recent weeks, meeting more frequently during emergency meetings, the more cautious guidance remains an indelible part of the bank's DNA.

## Words and actions

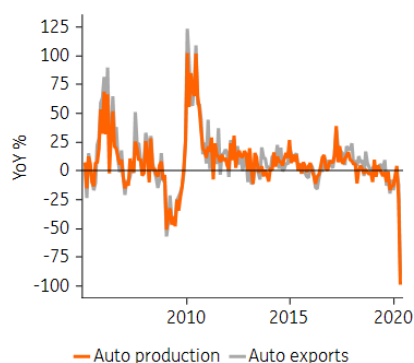
Banxico often appears to waver between the desire to signal moderation and the need to counter the widening slack in the local economy, which has been intensifying for more than a year now.

This has resulted in more frequent splits within the board, with dissents on both sides of the hawkish-to-dovish spectrum, depending on the meeting.

As the full economic impact of the Covid-19 crisis is realized, we expect the majority within Banxico's board to side with their more dovish members. Low inflation, along with the "peer-pressure" illustrated by dovish central bank actions across EM, should help weaken arguments against rate cuts.

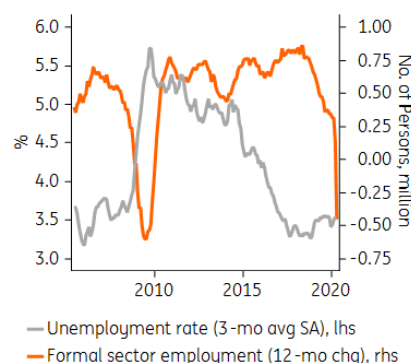
Few economic indicators have been published for April, when social-distancing measures were fully adopted. But initial evidence, including the highest monthly decline on record for auto production and for dismissals in the formal sector, suggests that the deterioration seen in March is bound to get much worse once the full roster of economic indicators is released for April.

**Auto sector was nearly shut-down in April, signalling a sharp drop in manufacturing**



Source: Macrobond, ING

**Formal sector layoffs reached the highest monthly decline on record in April**



Source: Macrobond, ING

And given that severe social distancing rules should remain in place throughout May as well, any recovery in economic activity data is unlikely any time soon.

## Resistance to fiscal stimulus continues

Mexico is likely to face one of the deepest recessions in LATAM this year, with market consensus moving towards a 7-9% drop in GDP, and the country's timid policy-relief efforts has increased the downside risk to economic activity.

President Lopez Obrador (AMLO) continues to resist the implementation of fiscal (or monetary) assistance to local private-sector corporations, claiming that the process would be fraught with corruption.

That argument, presumably, should not be extended to state-owned companies, however. Despite the ample evidence of widespread corruption within SOEs in Brazil and elsewhere in the region, the Mexican leader claims that his guardianship is an effective antidote to corruption practices within the public sector.

Mexico's state-owned oil giant PEMEX would likely be the primary beneficiary of any fiscal relief effort. In fact, the sharp drop in oil prices suggests that PEMEX should continue to struggle to deliver on its financial goals, increasing the need for continued financial assistance from the federal government. And any effort to "rescue" PEMEX through tax cuts or cash injections would reduce the scope for other types of fiscal transfers, deepening concerns over misallocation of resources.

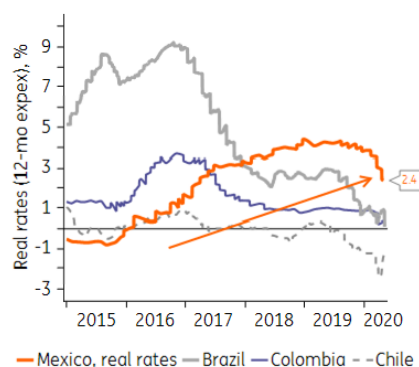
Overall, we think that AMLO's fiscal policy choices should also strengthen the case for a deeper rates-based stimulus program by Mexico's central bank.

## Local assets to remain relatively attractive

Even though we remain far from constructive about the Mexican economy's macro outlook, we believe that some local assets may continue to appeal to a broad range of investors.

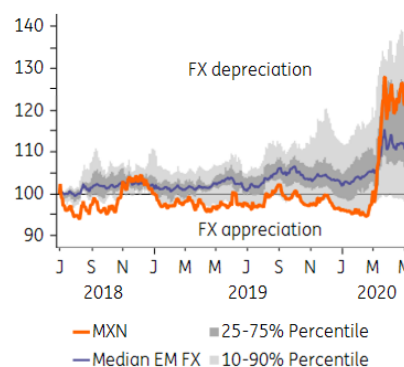
In the nearer term, the MXN's yield advantage may continue to benefit the currency in relation to its LATAM peers. Moreover, even though Mexico has suffered credit-rating downgrades by all major rating agencies recently, Mexico still retains, for now, a credit-rating advantage relative to regional peers like Brazil and Colombia.

Mexico's yield-advantage should persist ...



Source: Macrobond, ING

lending some support to local FI assets



Source: Macrobond, ING

We also continue to worry about Mexico's vulnerability to oil prices, and the MXN remains particularly vulnerable to a new wave of portfolio outflows, should global risk aversion spikes again. But high rates should be an effective short-term anchor for the currency and the greater scope for rate cuts suggests that local bonds may also be considered attractive.

That could change, in the medium term, if, for instance, the severe recession causes a major deterioration in the outlook for Mexico's fiscal accounts, eventually threatening the sovereign's investment-grade rating. A major reshuffling in Banxico's board composition could, likewise, help erode policy credibility and eliminate the current yield-advantage enjoyed by the MXN.

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