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Mexico Economics & Strategy

Just checking: our tightening call is still fine

- **Fears over growth and a benign inflation path have prompted us to check on our monetary policy call**
- **We stick with our base case of tightening starting in March 2012, but caution a slowdown could see it delayed**
- **We see good risk/reward in receiving 1Y1Y TIIE forward for a delayed hike scenario**

Monetary policy call: fine and dandy

The concerns over US growth, the better-than-expected inflation path in the 1H11, and the more moderate growth than estimated have prompted us to revisit our monetary policy view to see if our call for tightening in March 2012 is still adequate.

We show that our monetary policy call is still satisfactory resorting to a simple Taylor rule analysis, which implies the estimation of an output gap and inflation gap. In particular, our projections suggest that the *services gap*, which is more related to domestic demand than the total *output gap,* will become positive until mid-next year, giving the central bank space to hold off its decision to start hiking rates.

This view, however, is subject to our current base-case scenario with inflation rate at 3.6% and 3.5% in 2011 and 2012 respectively, and GDP growth rate at 4.1% for both years. Therefore, if the recent fears on economic growth slowdown materialize and consequently the existing inflation path improves even more, then the central bank could extend its current monetary policy stance towards 2H12.

Given that the risk for Banxico to stay on hold throughout 2012 is not negligible, we believe that the front-end of the TIIE curve offers significant value. Comparing the 1y, 2y and the 1y1y forward, we find that the latter provides the best risk/reward in a delayed hike scenario. Forwards optimize the expected roll-down in a prolonged on-hold scenario. We also consider receiving the front-end a suitable defensive strategy in case global risk aversion rises. We opened a receiver position in the 1y1y TIIE forward as Trade #64 on 22 June at 5.82%, with target at 5.25% and stop at 6.10%.

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HSBC

Just checking: tightening call is fine

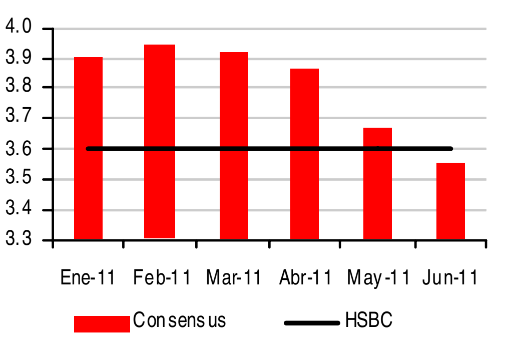
- Fears over growth and a benign inflation path have prompted us to check on our monetary policy call
- We stick with our base case of tightening starting in March 2012, with 3.6%/3.5% inflation for 2011/12 and GDP growth of 4.1% for both years, but caution a slowdown could see tightening delayed
- We see good risk/reward in receiving 1Y1Y TIIE forward for a delayed hike scenario

Just checking…

Recent global concerns have lurched from inflation to economic growth. In particular, inflation fears in Mexico have been dissipating over the course of the year, as inflation has shown a consistent downward trend, reaching an annual rate of 3.2% in May. This has triggered private analysts to revise down its inflation projections through the year. The latest Banxico survey shows that consensus expects inflation to close this year at 3.56%, below the expectation of 3.91% envisaged in January.

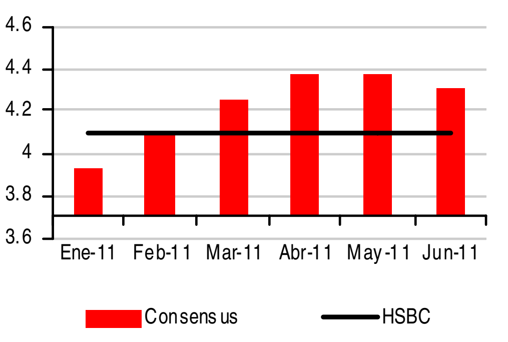
Given this favourable inflation scenario, the recent fears on the US economic slowdown and its impact on the Mexican economy have worsened the balance of risks for economic growth. As a result, GDP expectations for this have stabilized recently, showing a marginal downward revision to 4.31% in June from 4.37% in May. This environment has prompted the central bank to express a more dovish tone in the accompanying communiqué of its latest monetary policy announcement in May.

Inflation expectations (end 2011)



Source: Banxico, HSBC

GDP expectations for 2011



Source: Banxico, HSBC

This change in the global scenario and, in particular, the fears on the evolution of the US economy has made us to resort to our simple "Taylor rule" as a tool of analysis to evaluate our current monetary policy call, which contemplates the first hike in March of next year.

Taylor rule re-visited[1]

A common approach to analyse monetary policy is to resort to the "Taylor Rule". This allows us to evaluate how much the central bank has to change the monetary policy in response to the divergence between the expected inflation and inflation target (inflation gap), as well as the deviation between observed and potential GDP (output gap).

An adequate manoeuvring of these interest rate mechanics may promote price stability, lead to higher central bank credibility and business certainty and provoke lower levels of unemployment in the long term

We will analyze the components of the Taylor rule separately to provide a broader picture of the balance of risks between inflation and growth.

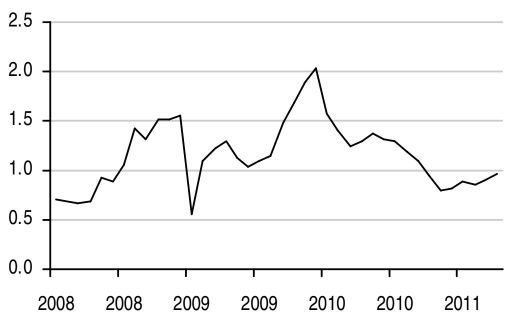
Inflation gap with comfortable space

Inflation dynamics have been favourable this year, prompting the annual headline inflation rate to run near the central bank's inflation target of 3%. Despite that we expect some rebound in headline inflation for the second half of the year on the back of a less favourable arithmetical effect; we recognize that inflation could come even below our current projection of 3.6% for end of this year.

Additionally, core inflation, which strips out volatile and agreed prices, has declined consistently throughout the year, reaching an annual rate of 3.1% in May.

This favourable inflation trajectory has prompted 2011 year-end inflation expectations to decrease throughout the year. Meanwhile, the 12-month inflation expectations have rebounded to some extent, which has deteriorated somewhat the inflation gap.

Inflation gap using 12-month inflation expectations



Source: HSBC estimates

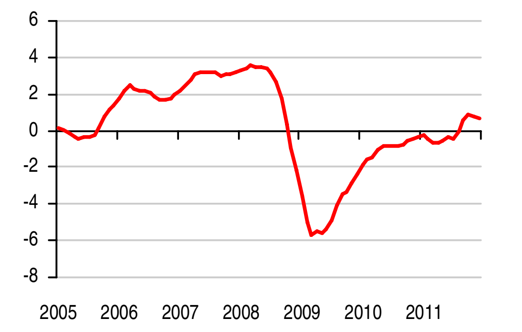
This modest inflation gap deterioration suggests that although central bank has room to maintain the fondeo rate unchanged, it might be vigilant to the evolution of inflation expectations.

The output gap closes more slowly

The output gap has continued to close, although at a more moderate pace, given that the economy started to reduce its pace of growth at the beginning of the second quarter of the year. In addition, our economic growth outlook contemplates an additional moderation in the second half of the year. Our estimates using the monthly economic activity indicator (IGAE) indicate that the output gap is still negative and that it will move into positive territory by 2H11, instead of by 1H11, as we estimated previously. This suggests that the economy is still operating below its potential, which keeps demand-side inflation pressures under control.

1 For those interested in more particulars about the model estimation by Generalized Method of Moments (GMM), we offer a brief and non-technical description of the model solution in the Appendix.

Output gap (Six-month centred moving average)



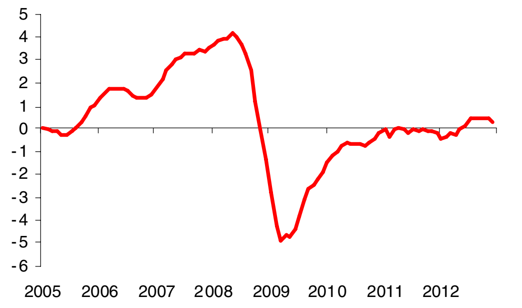
Source: HSBC estimates

In addition, as we have stated previously (see Mexico Economics & Strategy: A closing output gap is not a threat, 9 February 2011), the output gap responds to the economy's general dynamics including the positive impact of a vivid external demand. To avoid such bias we used a more relevant concept such as the "service" gap. In fact, the central bank did a similar exercise with a "tradable good" gap a couple of months later (Banxico, Minutes, April 29 2011) with the same purpose.

We decomposed the IGAE and calculated the gap for the services sector, as it is more related to domestic demand. Given that the services sector has been catching up the industrial sector, we found that its gap has been closing faster, but it is still negative. According to our projections, the services gap will close until mid-next year, which will maintain demand-side pressures contained for the rest of this year and the first half of the next.

As a result, we consider that despite that the output gap is expected to close in 3Q11, domestic demand will continue to be tepid even beyond that date, containing pressures on prices. This will give the central bank space to hold off its decision to start hiking rates until next year, probably in March, to act pre-emptively to possible near future inflation pressures.

Services gap (Six-month centred moving average)

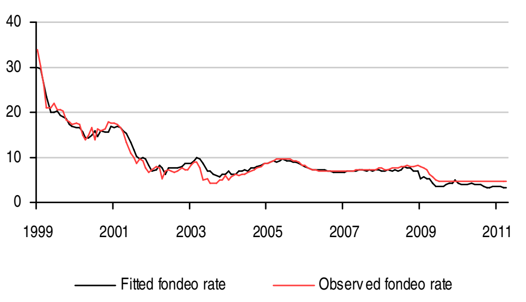


Source: HSBC estimates

Our call is still adequate

Running our simple model, we see a close correlation between the observed and fitted Fondeo rate, indicating that the reaction function of monetary policy implemented by Banxico is well represented by the Taylor Rule.

Observed and fitted Fondeo rate



Source: Banxico, HSBC estimates

The observed and fitted Fondeo rate run very close to each other and it looks that the central bank has smoothed out changes in monetary policy confronting different scenarios. The current balance between the output and inflation gaps suggests that the central bank would have some space to apply a more accommodative stance in the near future.

It is worth noticing, however, that our analysis has some limitations and it can not be considered as completely conclusive. The central banks all over the world take into account for their monetary policy decisions a great number of variables and economic factors. For example, it is important to monitor the evolution of the exchange rate, as a sudden depreciation derived from volatility in the international markets could detour the positive trajectory of inflation and contaminate inflation expectations. Therefore, although our Taylor Rule suggests that the central bank would have space to apply a more accommodative stance, we do not contemplate such scenario.

An alternative scenario: What if…

As we mentioned above, our current monetary policy call looks adequate, although it is subject to our current base scenario. This contemplates year-end inflation rates of 3.6% and 3.5% in 2011 and 2012 and GDP growth rates at 4.1% for both years. However, the rising concerns on the global economic growth; in particular the slowing momentum in the US manufacturing activity represents a source of concern for the trajectory of the Mexican economy. Hence, if the recent fears of a further growth moderation in the US materialize, the Mexican economy could be harmed and registered slower growth rates than expected. This, at the same time, could improve even more the current favourable inflation path, which would offer room to the central bank to maintain its current monetary policy stance until 2H12.

Receive 1y1y TIIE forward

We see good risk/reward in receiving front-end forwards

Given that the risk for Banxico to stay on hold for longer or the possibility to stay put throughout 2012 is not negligible, we believe that the front-end of the TIIE curve offers significant value (see Table below). Moreover, the risk/reward looks favorable compared to (1) the "*market scenario*" (as expressed in the latest Banamex survey, which anticipates a first Fondeo hike of 25bp in March 2012 to 5.5% by the end 2012) and (2) the *HSBC Economics forecast* of 50bp hikes each in March and April 2012. Comparing the 1y, 2y and the 1y1y forward, we find that the latter provides the best risk/reward, with the lowest downside (7bp) in the HSBC scenario and the highest upside (57bp) in "*delayed-hike*" scenario. Finally, we consider receiving the front-end a suitable defensive strategy in case global risk aversion rises.

High roll-down supports the trade, especially if there are no hikes

Forwards optimize the expected roll-down in a prolonged on-hold scenario. The front-end should be evaluated in terms of carry and roll-down, which currently peaks in the 2y sector. The 1y1y forward is trading at 5.82% mid, about 57bp above fair value under an on hold scenario. If the curve remains unchanged over the next year, it would roll-down 77bp to the current 1y. Thus, on 22 June we opened a receiver position in the 1y1y TIIE forward at 5.82% as Trade #64: Receive 1y1y TIIE forward with target at 5.25% and stop at 6.10% (Please insert link).

TIIE Fair Values under different monetary policy scenarios

TIIE Tenor	Current Value	Market Scenario FV	bp +/-	HSBC Eco FV	bp +/-	No hikes in 2012 FV	bp +/-
1Y	5.02%	5.17%	-15	5.27%	-25	4.90%	12
2Y	5.43%	5.54%	-11	5.59%	-16	5.10%	33
1Y1Y	5.84%	5.91%	-7	5.91%	-7	5.29%	55

Source: HSBC, Bloomberg

Appendix

We use econometric techniques to estimate a Taylor Rule model, which is a useful guidance of how a central bank should set short-term nominal interest rates in response to deviations of inflation expectations from an inflation target and deviations of real output from its long-run potential level.

We used the Generalized Method of Moments (GMM) to estimate the Taylor Rule through the following equation.

$$i_t = \rho i_{t-1} + (1-\rho)\left[\beta_1 + \beta_2 + \beta_3\left(\pi^e_{t,t+12} - \bar{\pi}\right) + \beta_4\left(y_t - \bar{y}\right)\right]$$

We included the policy interest rate with a one-period lag as an explanatory variable, given that interest rates have a degree of inertia. This means that the central bank smoothes the path of interest rates.

The results are consistent with theoretical predictions. The next table illustrates that the sings of the coefficients are correct at a 1% level of significance.

Taylor rule model

	Generalized Method of Moments (GMM)
Constant	11.630
	(9.886)
Lagged Fondeo (-1)	0.653
	(4.425)
Inflation gap	3.52
	(2.743)
Output gap	68.84
	(2.742)
Trend	-0.090
	(7.710)

Source: HSBC estimates. Note: Figures in parenthesis are t values

The coefficient associated to the interest rate with a one-period lag is positive, but less than 1, which implies that the estimated interest rate oscillates around a constant average value. The coefficient associated to deviations of expected inflation from an inflation target is positive. This means that if expected inflation increases, the central bank should increase the interest rate in a greater proportion. Finally, the coefficient to deviations of real output from its long-run potential level is also positive; implying that as the observed real output increases over the potential output the interest rate should increase over time.

Disclosure appendix

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