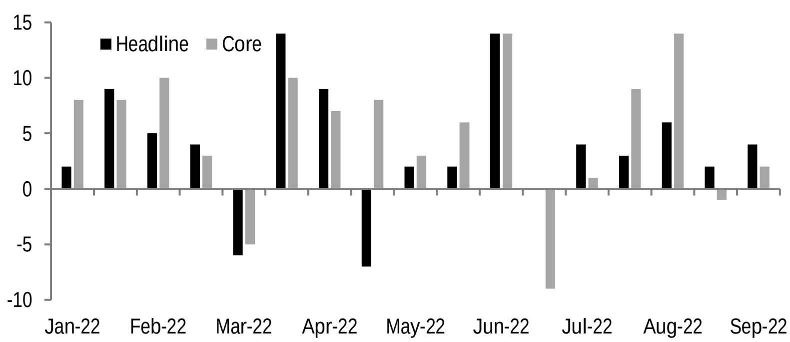
1H-September inflation – Likely pressured for longer, especially the core component

- **Headline inflation (1H-Sep): 0.41% 2w/2w; Banorte: 0.37%; consensus: 0.37% (range: 0.32% to 0.53%); previous: 0.32%**
- **Core inflation (1H-Sep): 0.44% 2w/2w; Banorte: 0.43%; consensus: 0.42% (range: 0.35% to 0.63%); previous: 0.32%**
- **The core remains high relative to long-term averages. This is still driven by goods (0.5%), especially processed foods (0.5%). Services (0.4%) were resented the seasonality in education (2.0%), as well as other pressures. The non-core has benefited from energy (-0.2%) in recent fortnights, but this was reversed by agricultural (0.9%).**
- **In bi-weekly frequency, annual inflation inched lower, to 8.76% from 8.77% previously. Nevertheless, a clear downward trend has not been established yet. The core picked up to 8.27% from 8.13%**
- **Given recent dynamics, among other factors, we revise our forecasts meaningfully higher. We expect year-end inflation at 9.0% y/y from 8.1% previously, with the core at 8.9% from 7.8%**
- **Moreover, we see inflation by December 2023 at 5.4% y/y, about 130bps above our previous estimate (4.1%). We believe that the core will show even more stickiness to the downside, seen at 5.7% from 3.9% (+180bps)**
- **The curve is pricing-in an even higher terminal rate, close to 10.50%**

Headline inflation at 0.41% 2w/2w, surprising to the upside once again. The core reached 0.44%, with the same bias persisting for several fortnights (see chart below). Both were also higher than their 10-year averages of 0.31% and 0.24%, respectively. Goods (0.5%) remain as the greatest concern, mainly processed foods (0.5%), with articles such as corn tortillas among the top ten, extending their recent pressures. 'Others' were also high (0.5%). Seasonal distortions in services due to the start of school remain present. Education advanced 2.0% due to the return to school of basic education students (pre-school, elementary and middle school). Somewhat surprisingly, air fares went up 7.5%, while pressures in dining away from home continued (0.6%). At the non-core, energy (-0.2%) has moderated since 1H-July, this time around on LP gas (-0.9%) and low-grade gasoline (-0.7%). Agricultural goods (0.9%) were more affected by fruits and vegetables (1.2%) than meat and egg (0.6%).

Headline and core inflation surprises
Basis points, bi-weekly frequency (Observed figure minus consensus)



Source: Banorte with data from INEGI and Bloomberg

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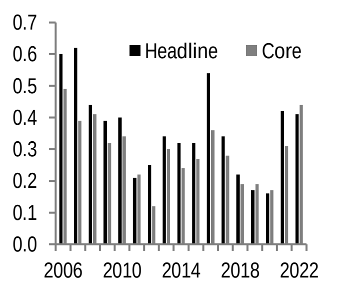
Winners of the award for best economic forecasters for Mexico in 2021, granted by *Refinitiv*

STARMINE AWARDS FOR REUTERS POLLS FROM REFINITIV

Headline and core inflation in 1H-September
% 2w/2w



Source: INEGI

1H-September inflation: Goods and services with the largest contributions
% 2w/2w; bi-weekly incidence in basis points

Goods and services with the largest positive contribution	Incidence	% 2w/2w
Tomatoes	3.0	5.6
Dinning away from home	3.0	0.6
Electricity	2.9	2.0
Elementary school	2.3	4.2
Corn tortillas	2.2	1.0
Goods and services with the largest negative contribution		
Low-grade gasoline	-3.3	-0.7
Professional services	-3.2	-14.6
Avocadoes	-2.8	-9.1
LP gas	-1.8	-0.9
Apples	-0.7	-2.7

Source: INEGI|

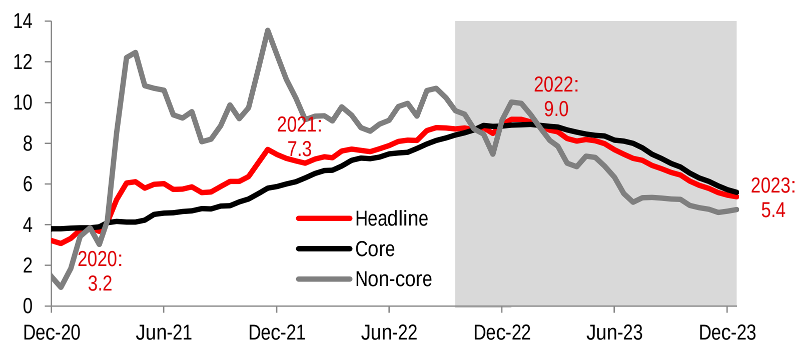
The peak in inflation is likely to be delayed further, so we adjust our year-end forecast to 9.0% from 8.1%... In bi-weekly frequency, annual headline inflation inched lower, to 8.76% from 8.77% previously. Although we recently stated that a high could be reached as soon as this month, a clear downward trend has not been established yet. The core picked up to 8.27% from 8.13%. Given persistent upward surprises –as shown above–, we are less convinced about a moderation in short-term dynamics for the rest of the year and adjust our forecast path, with the end of 2022 to 9.0% from 8.1% for the headline, and 8.9% from 7.8% at the core. It is our take that pressures will likely keep building in the short-term. Main changes include: (1) Higher processed foods at the margin as more companies adjust their prices due to accumulated cost pressures –as recently done by Coca-Cola FEMSA, Bimbo, and Lala, among others; (2) an increase in raw food prices, with risks for global production (due to climate challenges, including our country and others such as Argentina, Brazil, Australia, to name a few), and trade restrictions (*e.g.* India); (3) lingering supply chain issues affecting industries such as autos, with global behemoths Ford and VW, among others, warning about higher cost pressures and microchip shortages that could drag into 2023; (4) potential disruptions in trade, especially in Europe on the lack of natural gas and the upcoming winter, as well as zero-COVID policies in China; and (5) more modest discounts in "*El Buen Fin*" (Mexico's Black Friday) as retailers' profit margins have compressed. On the other hand, we also factor-in the recent decline in commodity prices, especially oil and gasoline. Moreover, there are encouraging signs of less bottlenecks in ports such as LA and Long Beach, helping reduce transportation costs and possibly improving inventory management.

…while the expected moderation for 2023 will probably be slower, changing our forecast to 5.4% from 4.1%. As we have said recently, we believe minimum wage (MW) negotiations for 2023 will be very relevant, with the announcement likely by early December. In this respect, we highlight that: (1) The minimum wage went from $88.33 in 2018 to $172.87 in 2022 (growing 18.3% per year compounded annually); and (2) recently, the *National Wage Commission* said that they want to update their MW target by the end of 2024 due to inflationary pressures, to $260 from a previous goal of $226. This new goal would imply 50.4% growth in two years from its current level (or 22.6% compounded annually). Although negotiations have not started formally, we anticipate an adjustment close to, or slightly higher, than 20%, considering the recent history and news. Therefore, we are cautious as an increase of this magnitude may well have a larger and higher 'lighthouse effect' for all formal sector workers.

In this sense, we highlight that, as of 4Q18, 43.5% of all workers earned up to two MW[1], a figure that has risen to 66.6% by 2Q22. Moreover, the minimum wage has gone from representing 25.1% to 36.3% of the average wage (based on IMSS-affiliated workers) in the same period[2]. This could rise towards 43.5% in case of a 20% rise in 2023[3]. In our view, this will probably be an additional driver of upward cost pressures and a further headwind for a rapid reduction in inflation, especially the core. Hence, we revise our year-end forecast for the latter from 3.9% to 5.7%.

On the other hand, we recognize that very high uncertainty prevails about the impact, magnitude, and duration of various drivers that have been pressuring prices. In this backdrop, we prefer to be conservative because of the rise in mid-term inflation expectations. The latter could result in additional adjustments higher, especially in the first and second quarters. Locally, more government resources for social programs' payments could keep supporting domestic demand in the period, as we think happened during 1H22. In the external front, the potential escalation in the war between Russia and Ukraine could limit further a much-needed relief in supply, and even lead to new disruptions in raw materials, especially in food. On a more favorable note, we see a more rapid deceleration in annual inflation in the second semester due to: (1) The effect of global hiking cycles (including in the US and Mexico) on aggregate demand and commodities' prices; and (2) an improvement in supply chain problems, including for the disruptive effects still present from the zero-COVID policy in China.

Inflation forecasts
% y/y, bi-weekly frequency



Source: INEGI, Banorte

From our fixed income and FX strategy team

The curve is pricing-in an even higher terminal rate, close to 10.50%. Central banks are determined to curb inflation, raising interest rates at a faster pace. In particular, the Federal Reserve announced its third 75bps hike yesterday, above the 50bps seen before the August CPI report. In a similar fashion, prevailing inflationary pressures domestically have supported market expectations of a more restrictive stance from Banxico. In this sense, the curve is pricing-in implicit hikes of +198bps by the end the tightening cycle, close to 10.50%, from about +150bps as soon as on September 12th. This includes +75bps hike in the upcoming decision, on September 29th, in line with our call.

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[1] Using the general minimum wage, not the one that applies for the northern border region.
[2] For 2018 we use the whole-year average for the median wage. For 2022 we use available data from January to August
[3] Assumes that the average wage stays at the same level than so far in 2022.

Since Banxico's last announcement, CPI-linked bonds have lost 42bps on average, while the Mbonos curve has extended its flattening bias and inverted further. The latter because of a 100bps sell-off at the short-end and 70bps at the long-end. Long-term Mbonos –particularly the Nov'38 and Nov'42 nodes – have increased their attractiveness, trading at stressed levels close to +2σ from their 90-day MA and above 9.30%. However, we believe high volatility limits the room for directional positions. In this sense, we reiterate our preference for relative value trades, maintaining our recommendation to pay TIIE-IRS (26x1) and receive 2-year SOFR, initiated on August 18th.

Analyst Certification

We, Alejandro Padilla Santana, Juan Carlos Alderete Macal, Alejandro Cervantes Llamas, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Katia Celina Goya Ostos, Francisco José Flores Serrano, José Luis García Casales, Víctor Hugo Cortes Castro, José Itzamna Espitia Hernández, Carlos Hernández García, Leslie Thalía Orozco Vélez, Hugo Armando Gómez Solís, Yazmín Selene Pérez Enríquez, Cintia Gisela Nava Roa, Miguel Alejandro Calvo Domínguez, Daniela Olea Suárez, José De Jesús Ramírez Martínez, Gerardo Daniel Valle Trujillo, Luis Leopoldo López Salinas, Isaías Rodríguez Sobrino, Paola Soto Leal, Oscar Rodolfo Olivos Ortiz, Daniel Sebastián Sosa Aguilar and Salvador Austria Valencia certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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	Reference
BUY	When the share expected performance is greater than the MEXBOL estimated performance.
HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
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