February inflation – Downward surprise at the core

- **Headline inflation (February): 0.56% m/m; Banorte: 0.61%; consensus: 0.62% (range: 0.57% to 0.68%); previous: 0.68%**
- **Core inflation (February): 0.61% m/m; Banorte: 0.66%; consensus: 0.66% (range: 0.62% to 0.69%); previous: 0.71%**
- **Results were partially explained by relevant seasonal factors in the period. On the positive side, processed foods (0.7%) had their most modest uptick since November last year. Services (0.6%) increased more at the margin, influenced by seasonal distortions in education. At the non-core, energy (0.8%) was affected by LP gas. Lastly, agricultural goods (-0.1%) were mixed**
- **Annual inflation dropped to 7.62% from 7.91%, likely resuming its downward trend due to favorable base effects. The core fell to 8.29% from 8.45% previously**
- **After today's print, we reiterate our call of a 25bps hike by Banxico this month. Nevertheless, risks are still skewed towards a +50bps adjustment. Despite this, we still expect the terminal rate for the hiking cycle at 11.75%**
- **In fixed income, we reiterate our preference for nominal vs real rates**

Inflation at 0.56% m/m, lower than consensus. The core came in at 0.61%, also surprising lower. Overall, we saw more limited adjustments relative to those in the 1st half. In goods (0.7%), the moderation in processed foods (0.7%) was positive as it was its lowest increase since November. 'Others' were also modest, albeit already affected since the first half. At the margin, we believe that MXN strength could be helping to limit increases in both categories. Services (0.6%) accelerated due to the seasonality in education (0.8%), as well as a slight upward adjustment in tourism categories. Apart from this, dining away from home stayed pressured. At the non-core (0.40%), energy was stable in the second fortnight, although with previous rises impacting the monthly result (0.7%). As such, LP gas picked up 4.1% after a strong adjustment in the previous period, with remaining items without major changes. In agricultural goods (-0.1%), fruits and vegetables declined 3.0%, particularly because of lower prices in tomatoes and serrano chilies. This helped offset meat and egg (2.4%), which have been affected since the start of the year by the avian flu.

February inflation: Goods and services with the largest contributions
% m/m; monthly incidence in basis points

Goods and services with the largest positive contribution	Incidence	% m/m
Eggs	8.9	9.0
LP gas	7.0	4.1
Chicken	6.4	3.8
Dinning away from home	4.3	0.9
Bananas	3.2	11.3
Goods and services with the largest negative contribution		
Tomatoes	-13.9	-18.5
Serrano Chilies	-3.7	-20.2
Electricity	-1.2	-11.8
Lettuces	-0.9	-0.5
Onions	-0.8	-4.3

Source: INEGI

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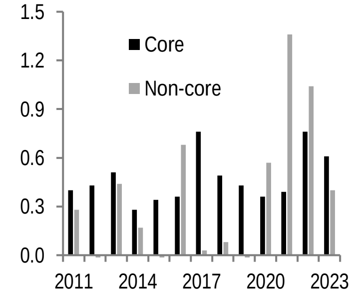
Core and non-core inflation in February
% m/m



Source: INEGI

Annual inflation has likely resumed its downward trend, but risks remain. Headline inflation fell to 7.62% y/y from 7.91%, lower after two months of moving higher. The core also declined, at 8.29% from 8.45%. As stated in the previous fortnight, both will likely show a clearer decline for the rest of the year due to favorable base effects stemming from the distortions after Russia's invasion of Ukraine in late February 2022. Another positive factor is the accumulated appreciation of the MXN in annual terms, with the latter reaching its strongest level since 2017. Nevertheless, caution is still granted because of uncertainty about the potential pace of decline. In our view, at least two factors could limit it in the short-term: (1) Companies' hesitancy to cut and/or reduce the pace of recent price increases as the economy remains resilient and cost pressures abound in other fronts; on the latter, we note that nominal wages associated to IMSS affiliated workers rose 11.2% y/y in February; and (2) latest news that warn about the possibility of a harsh drought season in coming months, which could impact the price of agricultural goods as they already are in a fragile situation, particularly for meat & egg. In our view, the first factor could also be increasingly relevant for services, which have shown some difficulties in moderating their pace to the upside. This could heighten the central bank's concerns about price dynamics at the core, which is still in focus.

We reiterate our call of a 25bps hike by Banxico this month. Today's print was still above its 5-year average, albeit closing its gap relative to previous periods. This is important as inflation remains Banxico's key driver due to its high data-dependency. Given this, and that the forward guidance in its last decision signaled a possible moderation in the hiking pace, we maintain our view of a 25bps rate hike on March 30th. Nevertheless, it is our take that risks are skewed towards a +50bps adjustment. Along with still challenging price dynamics, bets about a 50bps hike by the Fed on March 22nd have been increasing after Powell's hearings in Congress this week. Banxico members have insisted that the Fed's stance is only one among many factors in their reaction function. Nevertheless, we believe it would be quite difficult for them to cut the pace if the latter increases it again to 50bps. This would be the case even if we discount for the fact that Banxico started the cycle earlier and that the spread with the *Fed funds* is currently at a new historical high of 625bps. Despite this, we still expect the terminal rate for the hiking cycle at 11.75%.

From our fixed income and FX strategy team

In fixed income, we reiterate our preference for nominal vs real rates. Investors are pricing in the likelihood of higher interest rates, including an increase in the hiking pace by the Fed if inflation does not abate. With this, fears of a global recession jumped. In this context, yields of short-term sovereign bonds in different latitudes have reached multi-year highs. In Mexico, 1- and 2-year Cetes trade above 12.00%, while the 2-year Mbono is at unprecedented levels of 11.24%. Once again, the Mbonos' curve extended its inversion, with the 2/30 spread at -192bps from -112bps at the beginning of February. The CPI-linked bonds (Udibonos) curve also was more pressured at the short- vs long-end, although with more modest changes.

As a result, *breakevens* increased more strongly at short tenors. The 3-year reading stands at 5.57% from 5.10% at the beginning of February, well above its 12-month average (5.08%) and Banxico's inflation target (3.00%). With February's inflation surprising to the downside and due to relative valuations, we reiterate our preference for nominal vs real rates.

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, Daniel Sebastián Sosa Aguilar and Andrea Muñoz Sánchez, 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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HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
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