

Inflation hits Banxico's target in September

- **Headline inflation (Sep): 0.26% m/m; Banorte: 0.25%; consensus: 0.26% (range: 0.21% - 0.30%); previous: -0.02%**
- **Core inflation (Sep): 0.30% m/m; Banorte: 0.29%; consensus: 0.30% (range of estimates: 0.27% - 0.32%); previous: 0.2%**
- **Similar to previous periods, core items show greater price pressures, adding 23bps to the monthly variation**
- **In the ninth month of the year, we highlight the seasonal increase in education costs, which were up 2.1% m/m (+8bps). In addition, there were also notable adjustments in core goods, up 0.4% (+15bps)**
- **With these results, annual headline inflation stood at 3%, down from 3.16% at the end of August, in line with the central bank's target. Core inflation stood at 3.75% (previous: 3.78%), while non-core inflation reached 0.71% (previous: 1.28%), its lowest level ever**
- **We consider that today's print further supports our view of two additional 25bps rate cuts by Banxico, with the reference rate at 7.25% by year-end**
- **The market is holding its bet for a more aggressive easing cycle as inflation reached Banxico's target**

Consumer prices increased 0.26% m/m in September. This number came in line with consensus, and only 1bps above our forecast. Core inflation rose 0.30%, also in line with expectations (Banorte: 0.29%). Our forecast showed marginal deviations from actual numbers, as shown in the table below.

September inflation by components

% monthly incidence

	INEGI	Banorte	Difference
Total	0.26	0.25	0.02
Core	0.23	0.22	0.01
Goods	0.15	0.15	0.00
Processed foods	0.08	0.08	0.00
Other goods	0.07	0.07	0.01
Services	0.07	0.07	0.01
Housing	0.03	0.03	0.00
Education	0.08	0.08	0.00
Other services	-0.04	-0.04	0.01
Non-core	0.04	0.03	0.01
Agriculture	0.00	0.00	0.00
Fruits & vegetables	0.01	0.01	0.01
Meat & egg	-0.02	-0.01	-0.01
Energy & government tariffs	0.04	0.03	0.01
Energy	0.03	0.03	0.01
Government tariffs	0.01	0.00	0.00

Source: INEGI, Banorte.

Note: Contributions might not add due to the number of decimals allowed in the table.

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Dynamics were impacted by the seasonal increase in education costs, along with some pressures in core items. Education costs were up 2.1% m/m increase, contributing with 8bps to the headline, considering that most of the increases in tuition for kindergarten (4.9%) and elementary (4.2%) are accounted for in this period. Other services edged-down 0.2%, driven by professional services (-16.7%), internet, phone and TV packages (-1.4%), airfares (-5.2%), and tourism services (-3.2%). In addition, in line with our expectations, there were some pressures in core goods (0.4%), with matching increases in both processed foods and other goods. In this context, among the top ten items with the greatest contribution, from these two categories we highlight autos (1.2%) and sodas (0.8%).

Meanwhile, non-core maintained a favorable performance (+0.15%), contributing 4bps and with slight pressures in some categories within energy. In particular, LP gas was higher again (+1.2%), while low-grade gasoline only increased 0.3%. In this last case, we noted a volatile behavior in international reference prices given supply disruptions due to attacks on Saudi Arabia's oil infrastructure, but also an increase in excise tax subsidies, which helped to mitigate the former. Agricultural prices remain well-behaved as they were virtually unchanged. It is worth noting that tomatoes (7.8%), papayas (13.2%), and eggs (2.4%) were the only products in this category among the top ten with the largest increases. On the contrary, the most relevant declines were in onions (-15.7%), chicken (-2.2%), avocados (-9.6%), bananas (-8.2%), apples (-4.4%) and potatoes (-3.0%).

Annual inflation stood at 3%, down from 3.16% at the end of August. In monthly terms, this represents a new low since September 2016 and the first time since then that it reaches the central bank's target. In this regard, the decline is explained by the recent trend of the non-core component, which came in at 0.71% yoy, standing at a new historical low –remembering that the monthly non-core series is available since January 1983–. Inside, agricultural goods broke with the trend of decline, climbing relative to the previous month at 2.98%. Nevertheless, energy continues to fall (-3.09%). We believe that upside risks are relatively contained, at least on energy given the commitment of the Federal Government to, in the worst-case scenario, maintain prices constant in real terms. However, the agricultural component is still the one who faces greater exposure to shocks, with lingering risks on pork prices given the swine flu outbreak in Asia. Regarding the core index, it stood at 3.75%, marginally improving but still higher than the year-to-date lows of 3.53% in February. In this context, discussions on the behavior of this component from the central bank's Board will be particularly relevant, with the minutes of the last decision –in which the monetary authority lowered the reference rate 25bps to 7.75%– to be published tomorrow.

We consider that today's print further supports our view of two additional 25bps rate cuts by Banxico in 2019. Despite the persistence to the upside from core inflation, we believe that overall upside risks are relatively contained. In addition, possible pressures stemming from another above-average wage increase –which could lead to greater demand-side pressures–, could be offset by greater slack in the labor market, which should help the core component to converge towards the target.

In this sense, current economic conditions still point to a more muted growth, albeit with the possibility of a slight recovery towards the end of the year starting to look more feasible. Finally, some financial stability risks, such as the possibility of a credit rating downgrade to either Pemex or the sovereign, have in our view decreased on the back of the *2020 Fiscal Budget* and the recent support measures to the state-owned company from the Federal Government. All in all, we believe that Banxico will continue with its easing cycle in the remainder of the year, with 25bps cuts in each of the last two meetings of 2019, taking the reference rate by year-end to 7.25%. We also think that the latter could extend into next year, with our expectation of the reference rate by year-end 2020 at 6.00%.

From our fixed income and FX strategy team

The market is holding its bet for a more aggressive easing cycle as inflation reached Banxico's target. September's inflation report brought no surprises for market participants, as monthly changes (headline and core) came in line with expectations. The annual print moved from 3.16% to 3.00%, confirming a more rapid convergence path to Banxico's target than originally estimated, mainly explained by the non-core component than the core measure. Nevertheless, the benign inflationary landscape has anchored short- and mid-term expectations in several surveys and has also reduced breakevens (*i.e.* geometric spread between nominal and real rates) nearly 45bps in 3- and 5-year tenors from the 3Q19 average. Moreover, these tenors are depicting minimum levels not observed since September 2016. Longer inflation breakevens are portraying a similar performance. The lack of cost pressures, in tandem with an effect of slack in the Mexican economy and the global monetary stimuli is fueling the expectations of a more aggressive easing cycle from *Banco de México* in coming quarters. As a result, the yield curve is pricing in two more 25bps rate cuts this year (decisions to take place on November 14th and December 19th), and up to -178bps until 2020-end. Considering this backdrop, we hold our thesis that Mbonos will continue outperforming CPI-linked Udibonos. In our view, current conditions will remain favorable for interest rates worldwide, and this will also influence the Mexican market. However, we are waiting for better entry levels for new long strategies in Mbonos, especially in the 30-year tenor Nov'47.

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