Annual inflation keeps declining on lower agro prices

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- ***INEGI* just published its inflation report for February**
- **Headline inflation (February): -0.03% m/m; Banorte: 0.05%; consensus: -0.02% (range of estimates: -0.15% - 0.24%); previous: 0.09%**
- **Core inflation (February): 0.43% m/m; Banorte: 0.40%; consensus: 0.41% (range of estimates: 0.38%-0.42%); previous: 0.20%**
- **Inflation during the period was benefited by lower agrol prices in the month, although partially reversed by higher gasoline in the second half**
- **With this print, annual inflation went from 4.37% in January to 3.94%, within Banxico's target range for the first time since December 2016 on a monthly basis. On the other hand, core inflation also fell from 3.60% to 3.54%**
- **Today's data supports our view that Banxico will cut the reference rate by 25bps in June to 8.00%**
- **Modest market reaction following today's lower-than-expected inflation print**

Consumer prices fell 0.03% m/m in February. This figure was marginally lower than consensus at -0.02% but significantly below our 0.05% forecast. Meanwhile, core inflation stood at 0.43%, slightly above the market at 0.41%. The main deviation from our forecast came from an extension of the decline in agricultural prices, subtracting 48bps to the monthly figure, from which 21bps were from the second half. In contrast, gasoline prices were pressured during the same period as they added 18bps (but only +9pb for the full month). On the other hand, core prices were only slightly above our forecast, adding 19bps instead of our 18bps estimate, as shown in the table below:

February inflation by components
% monthly incidence

	INEGI	Banorte	Difference
Total	-0.03	0.05	-0.07
Core	0.32	0.30	0.02
Goods	0.19	0.18	0.01
Processed foods	0.11	0.10	0.01
Other godos	0.08	0.08	0.00
Services	0.13	0.12	0.01
Housing	0.04	0.04	0.00
Education	0.02	0.02	0.00
Other services	0.07	0.06	0.00
Non-core	-0.35	-0.26	-0.09
Agriculture	-0.46	-0.38	-0.08
Fruits & vegetables	-0.48	-0.41	-0.08
Meat & eggs	0.02	0.03	-0.01
Energy & government tariffs	0.11	0.12	-0.01
Energy	0.09	0.09	-0.01
Government tariffs	0.02	0.01	0.02

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

Inflation in February was benefited by a strong decline in agricultural prices, partially moderated by higher gasoline in the second half. The former fell 4.3% m/m mostly on the back of fresh fruits and vegetables, which plunged 9.1%. In particular, 8 out of 10 goods with the highest negative contribution were in this category, highlighting the decline in tomatoes (-36.4%), *serrano* chilies (-28.7%), and *husk* tomatoes (-34.2%), among others. On the contrary, energy increased 0.8% as a result of low-grade gasoline (+1.8%), which was the one with the highest positive contribution to the headline. This was partially mitigated by the 0.6% fall in electricity.

Inside the core component, processed foods picked up 0.5% while other goods increased 0.4%. In services, tuitions increased 0.6%, higher than in the previous two years. Overall, we believe that price dynamics during the month do not suggest a sizable price impact from recent transitory events, in line with our own views and Banxico's recent study stating that the likely effect on prices would be limited given that these problems were not very persistent.

With this print, annual inflation went from 4.37% in January to 3.94%. Core inflation fell from 3.60% to 3.54%. In our view, today's figure supports our view that inflation is likely to moderate strongly in its annual comparison during the year. We maintain our year-end inflation forecast at 3.5% yoy, below the market at 3.8% which has been grinding gradually lower in recent weeks. Going forward, we will be focused on: (1) The possibility of a reversal in the decline in agricultural prices, which have fallen 5.8% since their peak in 1H-Jan; (2) energy price dynamics, particularly crude-oil, as WTI has stayed above the USD$50-per-barrel psychological level since mid-January but with cross-currents in terms of supply (outlook for production cuts by OPEC) and demand conditions (*e.g* lower global growth).

We maintain our view that Banxico will cut the reference rate in June by 25bps to 8.00%. In our view, today's print reinforces our expectation that inflation will keep declining gradually in coming months, mainly supported by the downward trend in non-core inflation. In the short-term and following the recent increase in gasoline, it will be relevant to watch if the federal government acts through fiscal incentives given its stated policy to avoid higher prices in real terms. In particular, the next announcement will be tomorrow, with the president saying that his team is already looking into this. In the case that subsidies are announced, price pressures would be more contained at the margin and would benefit our call for inflation to end the year at 3.5% yoy. Considering this, along the downgrade of growth forecasts by Banxico, among other factors, we believe economic and inflation conditions will convince the central bank to cut the reference rate by 25bps to 8.00% in the June 27th meeting, with additional room for accumulated cuts between 50-75bps during 2019. For details, please see: "*Banxico QR – We now expect Banxico to begin an easing cycle as soon as June*", February 27th, 2019, <pdf>.

From our fixed income and FX strategy team

Modest market reaction following today's lower-than-expected inflation print. Today's CPI report showed a lower-than-expected fortnightly print for the second half of February, mainly explained by a downward extension in agricultural prices. The inflation landscape continues to be more benign during the kickstart of 2019 *vis-à-vis* the dynamics observed last year or even compared to market expectations. This has resulted in trimmed short-term forecasts and a downward trend in breakevens by 35bps on a year-to-date comparison. On an annual basis, inflation has entered Banxico´s confidence interval this month, contributing to the central bank's more dovish assessment in terms of inflation inside its latest *Quarterly Report* released last week. More details in "*Banxico QR – We now expect Banxico to begin an easing cycle as soon as June*" <pdf>, published February 27th, 2019. Overall, we have observed a modest reaction following today´s release, with an initial 1-3bps rally in Mbonos and slight pressures in CPI-linked Udibonos. However, this performance has reverted on the back of pressures induced to the Mexican peso through a broad USD strengthening. In terms of strategy, we hold a positive view in terms of mid-term Mbonos, however we suggest waiting for better entry points for new directional trades. In terms of the Udibonos curve we acknowledge a significant improvement in the valuation of the short-end despite the expected low carry gains in the remainder of the 1H19.

Regarding the FX market, the Mexican peso depicted a modest reaction to today's release, trading at 19.48 per dollar (-0.6%), though more influenced this morning by foreign factors such as the ECB decision. This performance takes place in a context were March is unfolding with a narrow-range trading extending from February's performance, a month were the currency depreciated 0.9% to 19.28 per dollar. According to our REER model, the peso reflects a "fair value" at around USD/MXN 18.95. It is worth mentioning the relevance from the price dynamics' pressures into the valuation, and given the downward resistance in core inflation. This situation suggests a very relevant floor at the 19.00 area and reinforces our vision of limited space for additional appreciation when close to this figure. In this sense, we wait for better opportunities for new USD longs, with greater conviction when closer to 19.00 per dollar.

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We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Francisco Duarte Alcocer, Jorge Antonio Izquierdo Lobato and Leslie Thalía Orozco Vélez, 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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