

1H-October inflation – Hovering around the 3% target

- **Headline inflation (1H-Oct): 0.40% 2w/2w; Banorte: 0.38%; consensus: 0.43% (range: 0.07% - 0.64%); previous: 0.13%**
- **Core inflation (1H-Oct): 0.13% 2w/2w; Banorte: 0.14%; consensus: 0.16% (range: 0.12% - 0.20%); previous: 0.12%**
- **Dynamics during the period were mainly explained by the seasonal increase in electricity tariffs (18.5% 2w/2w, contributing 27bps), along pressures in some core goods and other services**
- **With these, annual headline inflation edged-up to 3.01% from 3.00% at the end of September, practically in line with Banxico’s target. Core inflation stood at 3.68%, lowest since March**
- **Today’s report keeps supporting the pricing of the yield curve of additional rate cuts this year and in 2020 by the central bank**

Consumer prices increased 0.40% 2w/2w in 1H-October. This number was lower than consensus (0.43%), but slightly higher than our 0.38% forecast. Core inflation rose 0.13%, again, below market expectations (0.16%), but closer to our estimate (0.14%). The main deviation came from: (1) A higher than expected contribution from energy (+30bps vs our +24bps); (2) a lower impact from agricultural goods (-1bp vs. our +3bps); (3) a more modest contribution from other goods (+1bps vs. our +3bps); (4) higher pressures in processed foods (+4bps vs our +3bps); and (5) a greater impact from government tariffs (+1bp vs. our 0bps), as shown in the table below.

1H-Oct inflation by components

% bi-weekly incidence

| | INEGI | Banorte | Difference |
|-----------------------------|-------|---------|------------|
| Total | 0.40 | 0.38 | 0.02 |
| Core | 0.10 | 0.11 | -0.01 |
| Goods | 0.05 | 0.06 | -0.01 |
| Processed foods | 0.04 | 0.03 | 0.01 |
| Other goods | 0.01 | 0.03 | -0.02 |
| Services | 0.05 | 0.05 | 0.00 |
| Housing | 0.01 | 0.02 | 0.00 |
| Education | 0.00 | 0.00 | 0.00 |
| Other services | 0.04 | 0.03 | 0.00 |
| Non-core | 0.30 | 0.27 | 0.03 |
| Agriculture | -0.01 | 0.03 | -0.03 |
| Fruits & vegetables | 0.01 | 0.02 | -0.01 |
| Meat & egg | -0.01 | 0.01 | -0.02 |
| Energy & government tariffs | 0.31 | 0.25 | 0.06 |
| Energy | 0.30 | 0.24 | 0.05 |
| Government tariffs | 0.01 | 0.00 | 0.01 |

Source: INEGI, Banorte.

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

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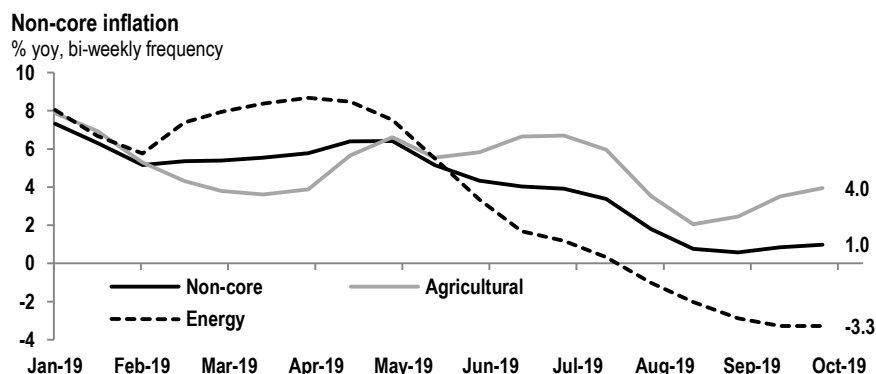
Dynamics were mostly explained by the seasonal increase in electricity tariffs, along with some pressures in some core goods and other services.

Regarding the former, we observed an 18.5% 2w/2w increase, contributing with 27bps as summer subsidies started to be rolled back, in line with typical seasonal patterns and with an additional adjustment expected for the 1st half of November. Within energy, we also highlight that low-grade gasoline fell 0.2%, subtracting 1bp to the headline, helped by an appreciation of the Mexican peso and lower international prices, while excise tax subsidies were broadly stable. LP gas rose 2.2% (+4bps), now adding four consecutive prints higher. On the other hand, agricultural goods fell 0.1%, deducting 1bp. Among the top ten products with the steepest falls, six belong to this category, highlighting avocados (-8.9%), chicken (-1.5%), and oranges (-6.9%). Nevertheless, these were partially offset by increases in tomatoes (+5.9%), extending their upward trend, as well as eggs (+1.5%). We note that pork meat declined 0.4%, even though international markets remain affected by the swine fever in China. In this respect, the USDA showed that during the first week of October, Mexico increased substantially its imports of this product from the US, which may have helped to explain the fall during the period. In addition, we also highlight the 0.2% rise in government tariffs, driven up by higher bus fares (+0.7%).

On the other hand, the core component grew 0.13%, resulting in a contribution of 10bps. We highlight that goods have stayed relatively pressured (0.12%), with the most important contribution stemming from processed foods (+4bps). In addition, other goods added 1bp, with some relevant pressures in the prices of cars (+0.6%), although partially offset by a decline in detergents (-0.8%) and perfumes (-1.9%). Finally, services were up by 0.13%, with most of the impact concentrated in other services (+0.2%; +4bps). In this regard, among the top ten products with the largest contribution, 3 belong to this category, including professional services (+5.0%), restaurants (+0.3%) and tourism services (+2.7%).

Annual inflation remains practically in line with the central bank's target, standing at 3.01% from 3.00% at the end of September. In bi-weekly terms, headline annual inflation has hovered around the 3% target since the 2nd half of August, in our view reaffirming the high likelihood that Banxico will keep cutting the reference rate in the short term. Moreover, we note that core inflation declined 7bps to 3.68%, lowest since March. We believe this is relevant as the resistance to the downside of this component remains somewhat of a concern for some Board members. This has been the case even despite our view that recent communications have signaled a more comfortable stance with the overall outlook for prices, mainly on the anticipated effect of higher economic slack. All in all, we believe the report supports our view that the central bank will cut the reference rate by 25bps in each of the two remaining meetings of the year, with the rate ending 2019 at 7.25%. Nevertheless, some cautiousness is still likely as the non-core component is near historical lows, reaching 0.99% yoy from 0.71% at the end of September.

On a short-term basis, we believe the central bank will be focused on the magnitude of the likely adjustment in the minimum wage, which according to reports is likely to be defined in November. For some time now, Banxico has maintained this as a relevant upward risk, warning that strong increases could lead to cost pressures if they are not coupled with productivity gains. Moreover, we will also keep our attention on dynamics at the non-core component, particularly agricultural goods and energy, with the former exhibiting some signs of an upward trend in recent prints, while the latter remains very low when compared to historical standards, as shown in the chart below.



Source: INEGI

From our fixed income and FX strategy team

Today's report keeps supporting the pricing of the yield curve of additional rate cuts this year and in 2020 by the central bank. Inflation for the first half of October came in below consensus. On an annual basis, headline CPI remained near Banxico's target, while the core declined modestly to 3.68% (depicting a mild reduction in its comparison with the level at the beginning of the year). All things considered, the actual landscape in terms of prices remains supportive for Mexican fixed-income, as investors continue betting on a more aggressive stimulus from Banxico in coming quarters. The yield curve is pricing in 49bps of additional rate cuts this year (with 76% of implied probability of a -25bps policy action in the next meeting on November 14th) and a repo rate that could trend towards 6.00% by the end of 2020. In addition, market participants are reducing the inflationary premia embedded in local rates. Inflation breakevens in a 3-year horizon in currently trading at 3.17%, lower than the average of 3.54% in the previous quarter and from the 2019 high of 4.23% in June. The decline of short-term inflation expectations have also fueled the idea that Banxico has enough leeway to keep on with its easing cycle at the same degree as the yield curve is pricing in. Longer inflation breakevens have also improved significantly in previous months. However, in terms of relative valuation we remain more constructive in terms of nominal-rate Mbonos *vis-à-vis* the CPI-linked Udibonos. In terms of strategy, it is our take that 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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