

1H-July inflation – Inflation could converge to Banxico’s target faster than expected

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- **INEGI just published its inflation report for the first half of July**
- **Headline inflation (1H-Jul): 0.27% 2w/2w; Banorte: 0.22%; consensus: 0.27% (range of estimates: 0.22% - 0.32%); previous: 0.14%**
- **Core inflation (1H-Jul): 0.17% 2w/2w; Banorte: 0.15%; consensus: 0.16% (range of estimates: 0.12% - 0.22%); previous: 0.11%**
- **Dynamics during the period showed higher price pressures in agricultural goods, along a more modest increase in services, with the latter skewed to the upside influenced by the holiday season**
- **With these figures, annual headline inflation fell to 3.84% from 3.95% at the end of June, once again within Banxico’s variability range. Moreover, core-inflation inched lower to 3.81% from 3.85% previously**
- **We maintain our year-end inflation forecast at 3.5% yoy. Nevertheless, it is our take that recent prints suggest that risks are skewed to the downside**
- **Market participants acknowledge that the CPI landscape is supportive for a rate cut**

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Consumer prices advanced 0.27% 2w/2w in 1H-Jul. This number was in line with consensus but higher than our forecast (0.22%). Core inflation rose 0.17% (Banorte: 0.15%). The main deviation came from: (1) A higher than expected contribution in agricultural goods (+12bps vs. our +8bps); (2) a higher impact from other services (+8bps vs. our +6bps); and (3) more modest pressures in energy (+2bps vs our +3bps), as shown in the table below:

1H-Jul inflation by components
% bi-weekly incidence

	INEGI	Banorte	Difference
Total	0.27	0.22	0.05
Core	0.13	0.11	0.02
Goods	0.03	0.03	0.00
Processed foods	0.03	0.04	-0.01
Other goods	0.00	-0.01	0.01
Services	0.10	0.08	0.02
Housing	0.01	0.02	0.00
Education	0.00	0.00	0.00
Other services	0.08	0.06	0.02
Non-core	0.14	0.11	0.03
Agriculture	0.12	0.08	0.04
Fruits & vegetables	0.08	0.03	0.05
Meat & eggs	0.04	0.05	-0.01
Energy & government tariffs	0.03	0.04	-0.01
Energy	0.02	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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Period dynamics showed higher pressures in agricultural prices, in contrast to recent fortnights. Specifically, agricultural goods increased 1.2% 2w/2w, adding 12bps to the headline. By product, those with the most pressures included chicken (+2.7%), onions (+13.9%), potatoes (+6.5%), and avocados (4.6%). On the contrary, we observed declines in tomatoes (-5.7%), extending its recent fall in a context in which US tariffs remain in place, along squash (-13.4%), and grapes (-19.2%), among others. On the other hand, energy added 2bps. Specifically, low-grade gasoline increased 0.5%, contributing with 3bps, relatively modest considering that the Federal Government kept adjusting the fiscal subsidy during the period. Nevertheless, this was partially compensated by the 0.2% decline in LP gas.

Core inflation contributed 12.7bps, slightly higher than expected by the market. In line with our expectations, some categories were pressured due to seasonal patterns, such as airfares and tourism services. Regarding the latter, it should be mentioned that the increase was observed even with some businesses in *Riviera Maya* announcing discounts to attract tourists as beaches have been affected by seaweed. We also highlight the 0.1% increase in processed foods, while other goods were stable during the period. Housing added less than 2bps for a second print in a row, which had been skewed to the upside recently and in this respect we see this figure as positive in terms of the signal it may be providing for potential pressures going forward.

Annual inflation reached 3.84% from 3.95% at the end of June. In bi-weekly terms, this is the lowest since December 2016, when headline inflation was pushed higher by the gasoline price hike at the beginning of 2017. Moreover, this is the third consecutive print within Banxico's variability range around the 3% target. Core inflation fell 4bps, to 3.81%. We also highlight that despite the abovementioned pressure in some agricultural goods and energy, non-core inflation fell further to 3.92% from 4.19% at the end of June.

Considering recent inflation dynamics, we maintain our year-end inflation forecast at 3.5% yoy, albeit recognizing higher risks to the downside. In particular we think that the balance of risks to inflation have gained some momentum to the downside in recent fortnights. We see as positive that pork prices were not among the top 10 goods with the highest variability in the period, although we will be focused on the possibility that swine flu in China could still impact prices. Additionally, we believe core prices may have started to show some signs of moderating as a result of weaker economic activity. Nevertheless and going forward, we remain focused on: (1) Agricultural goods, which could show an acceleration in coming prints, particularly when considering that 6 out of the top 10 items with the greatest contributions belong to this component; and (2) energy prices, particularly low-grade gasoline, given recent geopolitical tensions and adjustments in fiscal subsidies.

In our view, conditions have turned more favorable for Banxico to cut the reference rate. We maintain our view that the central bank will cut the reference rate by 25bps, to 8.00%, in November. Nevertheless, we believe that both external and local conditions support more forcefully the possibility of a lower reference rate sooner than we expect. At a global scale, the most relevant is the easing bias by central banks in both developed and emerging markets, and particularly by the Fed. We continue expecting a 25bps rate cut by the latter next week, although with an increasing probability of an even more dovish tone as the global economy weakens. Locally, we see two main drivers. First, in our view the economy has weakened more than we previously expected, prompting us to reduce our GDP forecast for 2019 to 0.8% yoy (for details, see: “*Mexico – Economic Activity decelerates more than expected*”), [pdf](#). Second, we think that recent inflation prints may be signaling that recent dynamics have been slightly better than expected by the central bank, converging to target faster than expected. In particular, in its latest Quarterly Report, Banxico estimates to reach the 3% target in 2Q20. In this context, we think that the main obstacle for the start of an easing cycle sooner than we currently anticipate is the lingering risks to financial stability, in particular the concerns expressed by the Board on issues such as the sovereign and Pemex’ rating, along uncertainty about trade tensions with the US –especially regarding the prospects of USMCA ratification.

From our fixed income and FX strategy team

Market participants acknowledge that the CPI landscape is supportive for a rate cut. Mexico has just released the inflation report for the first half of July, with a fortnightly print that came in line with market expectations at 0.27%. Annual headline and core inflations are portraying a mild downward trend in comparison with previous months, recovering from the peaks observed during April and May, and confirming the likely convergence towards levels close to Banxico’s target by year-end. This more benign scenario for CPI could trigger a more dovish stance from Banxico, especially when combined with a like rate cut from the Federal Reserve by the end of this month (July 31st) and the effect of slack in the Mexican economy. As a result, the yield curve is pricing in -52bps of implied rate cuts this year and -157bps until 2020-end. Current valuations in tandem with inflation dynamics convey a more attractive relative valuation in nominal-rate Mbonos against real-rate Udibonos. Specifically, inflation breakevens have depicted relevant declines in recent weeks and still portraying a more attractive valuation in Mbonos, especially in shorter tenors. As an example, the 3-year breakeven is trading at 3.73%, although lower than the 12-month mean of 3.98%, it is still higher than market’s 3-year forecast of 3.50% observed in the latest survey from Banxico. In terms of strategy, we acknowledge that the international landscape (*e.g.* lower rates) could be supportive for the Mexican yield curve, turning our analysis into a slightly more positive assessment, in which we are more comfortable with the carry embedded in short-term securities given the inverted yield curve, waiting for better market conditions and valuation in longer tenors.

Regarding the FX market, the Mexican peso opens this Wednesday's session with a more positive note at 19.14 per dollar (+0.2%) following a 0.7% sell-off yesterday closing at 19.18, amid broad USD strengthening and new downward revisions in IMF global growth forecasts, including Mexico. Banxico's next decision is set for August 15th, in which a bias feeding rate cut expectations is likely to be seen. However, we do not see a significant risk for the strong MXN carry anchoring, for now. As recent price action has been more linked to synchronized stimulus, we believe that the peso's performance will remain under narrow ranges. As a consequence, we suggest taking advantage of attractive spaces for USD longs when trading below 19.00 per dollar, reinforcing our 2019 year-end forecast at 20.30. For further details in our FI and FX views please refer to: "*Fixed-Income, FX, and Commodities - 3Q19 Outlook*", [pdf](#), published yesterday.

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