

1H-August inflation – We lower our year-end inflation forecast to 3.3% from 3.5%

- **Headline inflation (1H-Aug): -0.08% 2w/2w; Banorte: 0.05%; consensus: 0.14% (range: 0.05% - 0.27%); previous: 0.06%**
- **Core inflation (1H-Aug): 0.11% 2w/2w; Banorte: 0.13%; consensus: 0.16% (range of estimates: 0.13% - 0.21%); previous: 0.08%**
- **We now expect year-end inflation at 3.3% yoy from 3.5% previously**
- **Moreover, we reiterate our view that Banxico will cut by 25bps in both the September and December meetings, with the reference rate ending the year at 7.50%**
- **Dynamics during the period were very favorable for the non-core component, with a 0.7% 2w/2w reduction, led by agricultural goods prices (-1.4%)**
- **With these figures, annual headline inflation edged down to 3.29% from 3.78% at the end of July. Core inflation stood at 3.77% from 3.82% in the previous month**
- **A more benign inflation landscape is supportive for likely additional rate cuts in Mexico, and positive for our current trade idea in Mbonos Nov'38 and Nov'42**

Consumer prices declined 0.08% 2w/2w in 1H-August. This number was lower than consensus (0.14%) and our forecast (0.05%). Core inflation rose 0.11% (Banorte: 0.13%). The main deviation came from: (1) A lower than expected contribution from agricultural goods (-15bps vs. our -4bps), on the back of lower prices of both 'fresh fruits and vegetables' and 'meat and egg'; (2) a lower impact from processed foods (+1bps vs. our +3bps); and (3) higher pressures in other goods (+5bps vs our +2bps), as shown in the table below:

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

	INEGI	Banorte	Difference
Total	-0.08	0.05	-0.12
Core	0.09	0.09	-0.01
Goods	0.06	0.05	0.01
Processed foods	0.01	0.03	-0.02
Other goods	0.05	0.02	0.03
Services	0.03	0.04	-0.02
Housing	0.02	0.01	0.00
Education	0.04	0.05	-0.01
Other services	-0.02	-0.02	-0.01
Non-core	-0.16	-0.05	-0.11
Agriculture	-0.15	-0.04	-0.11
Fruits & vegetables	-0.07	-0.02	-0.05
Meat & egg	-0.08	-0.02	-0.06
Energy & government tariffs	-0.01	-0.01	0.00
Energy	-0.02	-0.02	-0.01
Government tariffs	0.01	0.01	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 were very favorable for the non-core component, on top of continuing declines in some components within services. Agricultural prices declined 1.4% 2w/2w, subtracting 15bps to the headline. The report mentions among the products with largest price declines: poultry (-6.3%), onions (-14.4%), avocados (-8.8%), and tomatoes (-2.6%). By contrast, we observed price increases in eggs (3.4%), lemons (18.5%) and oranges (8.2%). In addition, energy prices subtracted 2bps. In this context, we note that electricity increased 0.7% 2w/2w despite the recent announcement from the *Energy Regulatory Commission* (CRE) of a 0.8% m/m reduction in the base price. This was offset by declines in the prices of low-grade gasoline (-0.3%) –in a context of lower fiscal stimulus and some pressures in the exchange rate, but with a decrease in international prices—and LP gas (-0.9%), both components subtracting 3bps.

Meanwhile, core inflation added 9bps to the headline. Airfares and tourism services kept declining given that the summer holiday season is nearing its end. Also within services, we highlight the 1% increase in education costs, with a 1.8% hike in high school fees and +1.4% in college tuitions, as the school year is starting. We also noted the 0.2% increase in merchandise prices, with a 1bp contribution from processed foods and 5bps from other goods. It should be noted that the Mexican peso saw more sizable pressures since the start of August, a situation that may have impacted prices in this category. Nevertheless, we continue thinking that the economic deceleration could have a clearer effect in terms of containing demand-side pressures on prices going forward.

Annual inflation fell strongly, standing at 3.29% from 3.78% at the end of July. In bi-weekly terms, this represents a new low since December 2016. In addition, it marks the fifth consecutive fortnight with the annual comparison within Banxico's variability range around the 3% target. In our opinion, this result supports the signal from the last monetary policy communiqué, which showed that the central bank's Board is relatively more comfortable with the current inflation outlook. Moreover, core inflation edged-down 5bps to 3.77%, which despite showing some persistence to the upside, it is relatively favorable given that it has consistently climbed down from the year-to-date high of 3.94% observed in early April.

We now expect inflation at 3.3% at the end of the year from 3.5% previously. This figure is still below consensus, which according to the latest poll from *Citibanamex* stands at 3.6%. The adjustment lower is largely driven by the fall in the non-core component, which stands at 1.8% from 3.6% in the previous month. Our view is backed by several factors, which we believe are likely to continue supporting the recent trend in headline inflation in coming months. In particular, the federal government is likely to maintain its policy of capping energy prices, including electricity and gasoline. In this respect, we believe pressures in low-grade gasoline are likely to stay limited, even if fiscal subsidies continue to scale back gradually and even if we observe some pressures in USD/MXN. In our view, crude-oil prices could be contained to the upside as global demand falters given more modest prospects for economic growth.

Moreover, a favorable base-effect in agricultural prices is likely to keep benefiting this component, particularly as they were pressured at the end of last year. Last but not least, we believe that demand-side pressures at the core level will be lower due to the weakness in economic activity and a wider output gap.

Nevertheless, we see some risks to our forecast coming from: (1) The possibility of higher than expected energy prices, particularly low-grade gasoline, as subsidies are gradually retired in a context of relatively low flexibility in fiscal accounts; (2) pressures in agricultural prices, particularly tomatoes after the agreement reached between the US and Mexico to end antidumping duties, which could help normalize the market and decrease domestic supply; and (3) additional stickiness and upside pressures at the core level, given the strong advance in wage negotiations so far in 2019 and the possibility of additional and sizable increases in the minimum wage by the end of the year.

From our fixed income and FX strategy team

A more benign inflation landscape is supportive for likely additional rate cuts in Mexico, and positive for our current trade idea in Mbonos Nov'38 and Nov'42. Today's inflation report for the first half of August surprised market consensus, depicting a deflationary biweekly print, and an annual headline reading moving from 3.72% to 3.29%, closer to Banxico's target of 3%, and the lowest since December 2016. It is worth taking into account that back in April and May the annual inflation was hovering around 4.44%. In our view, this benign scenario could steer a more dovish tilt from the central bank at next week's *Quarterly Report*, especially after Governor Díaz de León comments yesterday at *Banorte's Annual Forum*, stressing out several dovish arguments regarding real exchange rate (an orderly adjustment won't be a concern for the central bank), decline in global commodity prices (already observed in the strong downward trend in the non-core component), the effect of slack in the Mexican economy (positive demand-side shock for prices), and the low-rate environment worldwide (allowing Banxico to normalize monetary conditions without affecting the relative carry gains of the MXN vs. other currencies). In addition, market inflation expectations have adjusted towards more comfortable levels for the central bank, hovering around 3.3% in shorter tenors and 3.7% in long-term breakevens, nearly 40bps lower from a month ago. In the aftermath of today's CPI report, Mbonos are extending yesterday's 7bps rally, gaining this morning around 9bps. A similar situation is observed in TIE-IRS. The yield curve is currently pricing in -48bps of additional implied rate cuts for the rest of this year and -171bps until 2020-end. In terms of strategy, we acknowledge that the current dynamics in the global fixed-income markets will remain as a positive driver for Mexican sovereign bonds. Taking into account this situation and the more dovish approach from Banco de México we hold our trade recommendation of long positions in Mbonos of larger duration which we started last Friday, with a more attractive relative valuation in the Nov'38 and Nov'42 tenors.

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