

July CPI helped by muted pressures in the second half of the month

- **INEGI just published its inflation report for July**
- **Headline inflation (Jul): 0.38% m/m; Banorte: 0.38%; consensus: 0.37% (range of estimates: 0.08% to 0.42%); previous: 0.06%**
- **Core inflation (Jul): 0.26% m/m; Banorte: 0.26%; consensus: 0.25% (range of estimates: 0.24% to 0.28%); previous: 0.30%**
- **Pressures in the second half of the month were relatively low (0.06% 2w/2w), on the back of muted variations of non-core items**
- **With these figures, annual headline inflation fell for third consecutive month, to 3.78% from 3.95% at the end of June. Core-inflation was an inch lower, to 3.82% from 3.85% in the previous month**
- **The downward trend of annual inflation in tandem with economic deceleration and dovish central banks worldwide are contributing to market's view about a monetary stimulus from Banxico soon**

Consumer prices up 0.38% m/m in July. This number was in line with our forecast and an inch higher than consensus (0.37%). Core inflation rose 0.26%, also equal to our estimate. Although our forecast was accurate, the main deviations within the main components came from: (1) A lower than expected contribution from other services (10bps vs. our 12bps); (2) a slightly higher impact from fresh fruits and vegetables (13bps vs. our 12bps); and (3) a lower contribution from energy (-4bps vs. our -3bps), as shown in the table below:

July inflation by components

% monthly incidence

	INEGI	Banorte	Difference
Total	0.38	0.38	0.00
Core	0.20	0.20	0.00
Goods	0.06	0.04	0.02
Processed foods	0.06	0.06	0.00
Other goods	0.00	-0.01	0.01
Services	0.14	0.15	-0.02
Housing	0.03	0.03	0.00
Education	0.01	0.01	0.00
Other services	0.10	0.12	-0.02
Non-core	0.18	0.18	0.00
Agriculture	0.20	0.20	0.01
Fruits & vegetables	0.13	0.12	0.01
Meat & eggs	0.08	0.08	0.00
Energy & government tariffs	-0.03	-0.02	0.00
Energy	-0.04	-0.03	-0.01
Government tariffs	0.02	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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Inflation increased only 0.06% 2w/2w in the second half of the month, driven by a muted increase of the non-core component. This last component expanded a meager 0.03% 2w/2w, significantly below the 0.60% observed in the first fortnight. As a result, monthly non-core inflation stood at 0.74% m/m, with a contribution of 14pbs in the first half and only 1bps in the second part. On a monthly basis, prices of fresh fruit and vegetables increased 2.9%, with the most pressured goods including chicken (+4.5%), onions (+15.9%), potatoes (+8.2%), and oranges (5.9%). By contrast, lower prices in squash (-22.6%), grapes (-29.3%), and tomatoes (-3.1%), among others. Energy subtracted 4bps in July. Specifically, LP gas prices fell by 2.6% m/m, resulting in a -5bps contribution. Moreover, low-grade gasoline increased only 0.2%, contributing 1bps, with a marginal share in the second fortnight in a context in we saw a slight increase in the federal tax subsidy to prices –albeit with an erratic behavior–, gasoline prices in the US declined, and the Mexican peso was broadly stable against the dollar.

Core inflation contributed 20bps to CPI in July. In line with our preview, airfares and tourism services started to decline as the seasonal hike due to the summer holiday starts to reverse. Nevertheless, the total monthly contribution was positive, adding 4bps. We also highlight the 0.3% increase in processed foods, with other goods flat, extending their recent stability. In our view, the relative strength the exchange rate (except for some bouts of volatility with a brief duration) has helped anchor prices somewhat during the last three months, a factor which would be favorable for core inflation to eventually reestablish a downward trend. Housing costs added around 2bps for a fifth fortnight in a row, which is positive given it had been skewed to the upside earlier in the year.

Annual inflation fell to 3.78% from 3.95% in June. Meanwhile, core inflation ebbed to 3.82% from 3.85%. Despite this, the core component remains relatively sticky, averaging 3.83% since last April, when the annual rate popped higher from about 3.5-3.6%. This was already incorporated by the central bank in its latest *Quarterly Report*, with their forecast for average headline inflation in 3Q19 at 4.0% (Banorte: 3.7%), with core inflation at 3.6% (Banorte:3.7%).

In bi-weekly terms, this is the fourth consecutive print with the annual rate within Banxico's variability range. In particular, the annual rate stood at 3.72% in the second fortnight. We should mention that this is the first time with the annual rate fully calculated with the new index weights, as the inflation index was re-based on July-2H, 2018.

Going forward, we will keep focused on: (1) The possibility that the recent stability and relative strength of the MXN helps some components at the core, particularly processed foods and other goods –albeit with the currency pressured against the dollar since the end of last week–; (2) agricultural goods, which continue behaving well but have historically exhibited very high volatility and mean-reversion; (3) energy prices, particularly low-grade gasoline, given recent geopolitical tensions and the more erratic adjustments in fiscal subsidies; and (4) if there are any knock-on effects in coming months from higher tariffs to China by the US, which are targeted more towards final goods.

From our fixed income and FX strategy team

The downward trend of annual inflation in tandem with economic deceleration and dovish central banks worldwide are contributing to market's view about a monetary stimulus from Banxico soon. Inflation for July came in line with Banorte's expectations and confirmed the downward trend of the annual reading after the peak observed in April. The 3.78% reading is the lowest since December 2016, suggesting that the convergence path towards Banxico's target remains in place. Nevertheless, investors remain cautious about dynamics in the core component amid the concerns stressed out by the central bank in its latest reports. Annual core inflation depicted a mild recovery, moving from 3.85% in June to 3.82% in July. Overall, the inflationary landscape in Mexico has improved since last quarter, adding to other factors (*e.g.* weaker growth and dovish central banks worldwide) that could steer a rate cut by the monetary authority sooner than expected. As a result, the market is pricing in -19bps of implied cuts in the 3Q19 with a stronger likelihood for the September 26 meeting (57.4%) vs the August 15 (27.4%). For the remaining of the year, the yield curve is discounting a repo rate 57bps lower from the current 8.25%. Inflation breakevens are trading 20bps lower from the levels observe a month ago, signaling that market participants are adjusting downwards the inflation premia embedded in local assets. In this regard, we continue observing a more attractive relative valuation in Mbonos against CPI-linked Udibonos. In terms of strategy, we acknowledge that the low-rates environment in the world will be supportive for Mexican bonds. Nevertheless, we are waiting for more attractive valuations to start new directional trade ideas in the long-end of the Mbonos curve, following the recent profit taking of our tactical recommendation in the short-end.

In the FX market, the Mexican peso has opened this Thursday's session with a more positive tone, following a weekly performance affected by the fears linked to a weaker trade relation between the U.S. and China, and its effect on global growth. After closing last Friday at 19.30 per dollar, the peso reached on Monday up to 19.74, its weakest level since early June, trading this morning at 19.60 (+0.2%). In these last sessions its price action has held close to this figure and has depicted resistance to breach the USD/MXN 19.50 psychological level, a condition that when integrating implied volatility gauges under greater stress denote a market that will remain cautious about the short-term horizon for the peso. Broadly speaking, today's CPI report still argues for the case of a lower repo rate in Mexico, suggesting an eventual waning in the currency's implied carry. However, these movements have been already priced in by the market, reason why an erosion of the support provided by Banxico's rate to the peso should be limited for now. Moreover, these actions would talk place in tandem to a growing number of central banks cutting rates, holding interest rate spreads favorable for Mexico. On the other hand, throughout the last days the peso has experienced notoriously stronger correlations and betas against the Chinese renminbi, indicating that its performance will remain highly sensitive to global drivers, contrasting with more defensive dynamics in previous risk aversion phases along the year.

Under this context, we identify a strong support area at 19.80, from which we would evaluate short-term tactical MXN longs, targeting the mentioned 19.50 resistance as a first objective. Regarding our trajectory, we forecast MXN to average 19.40 during 3Q19 closing at 19.68, with a 20.14 average during 4Q19 for a 2019 close at 20.30 per dollar.

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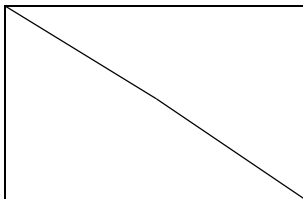
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