Annual inflation reaches its lowest level in two years

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- ***INEGI* just published its inflation report for January**
- **Headline inflation (January): 0.09% m/m; Banorte: 0.19%; consensus: 0.18% (range of estimates: 0.09%-0.50%); previous: 0.70%**
- **Core inflation (January): 0.20% m/m; Banorte: 0.24%; consensus: 0.23% (range of estimates: 0.19%-0.34%); previous: 0.47%**
- **Inflation during the period was benefited by lower energy prices, along a reduction in agricultural prices during the second half of the month**
- **With this print, annual inflation went from 4.83% in December to 4.37%, while core inflation fell from 3.68% to 3.60%. We highlight that both have reached their lowest level since December 2016**
- **We maintain our view that Banxico will keep the reference rate unchanged at 8.25% today, and at least during 1H19, most likely with a less hawkish tone**
- **We hold our trade idea of long positions in Mbonos Jun'22 and Dec'23 taking into account the current inflationary backdrop**

Consumer prices increased 0.09% m/m in January. This figure was significantly below consensus at 0.18% and our 0.19% forecast. Meanwhile, core inflation slowed down to 0.20%. The main deviation from our forecast came mainly from: (1) A lower contribution from energy (-16bps vs. our -12bps); (2) lower impact from agricultural goods (4bps vs. our 8bps); (3) stronger pressures in government regulated, at 6bps vs. our 1bp; and (4) lower pressures in other goods (2bps vs. our 4bps), as shown in the table below:

January inflation by components
% monthly incidence

	INEGI	Banorte	Difference
Total	0.09	0.19	-0.10
Core	0.15	0.18	-0.03
Goods	0.12	0.13	-0.02
Processed foods	0.10	0.09	0.00
Other godos	0.02	0.04	-0.02
Services	0.03	0.05	-0.02
Housing	0.04	0.04	0.00
Education	0.02	0.02	0.00
Other services	-0.02	-0.01	-0.01
Non-core	-0.06	0.01	-0.07
Agriculture	0.04	0.08	-0.04
Fruits & vegetables	0.04	0.05	-0.01
Meat & eggs	0.00	0.03	-0.03
Energy & government tariffs	-0.10	-0.07	-0.03
Energy	-0.16	-0.12	-0.03
Government tariffs	0.06	0.01	0.04

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

Inflation in January was benefited by lower energy prices, along a reduction in agricultural prices during the second half of the month. The former fell 0.7% m/m, subtracting 16bps to the headline figure. In particular, low- and high-grade gasoline decreased 1.9% and 2.4%, respectively. Moreover, LP gas fell 2.5%. On the other hand, agricultural prices increased 0.4% m/m, although in the second half the month they fell 1.2% 2w/2w. Among the products with the most impact, we highlight serrano chilies (67.2% m/m), onions (29.9%) and other chilies (16.8%). On the other hand, tomatoes (-14.9%) and green tomatoes (-35.2%) and chicken (-0.7%) were among those with the highest decreases.

Core inflation also surprised to the downside at 0.20% m/m, below our forecast, adding 15bps to the headline. As expected, airfares plunged 32.3% and tourism services fell 11.6%, given the seasonality due to the end of the holiday season. Moreover, core goods picked up 0.3%, lower than in the same period of the previous two years, and with lower pressures in both subcomponents.

With this print, annual inflation went from 4.83% in December to 4.37%, its lowest since December 2016. On the other hand, core inflation fell from 3.68% to 3.60%. Today's figure support our view that inflation is likely to moderate strongly in its annual comparison along the end of the year, reaching 3.5%, below the 3.9% of consensus. Nevertheless, we recognize that risks to our forecast prevail, among them: (1) Higher volatility in agricultural prices, such as we have observed during the last two months: (2) the possibility of a lagged impact from the above-average increase in the minimum wage for 2019, which could surface throughout the year; and (3) the possibility of an adverse effect from recent bottlenecks due to the disruption in supply chains due to railway blockades and delays in fuel distribution in some states.

We maintain our view that Banxico will keep the reference rate unchanged at 8.25% at least during 1H19. Today at 2:00pm ET, Banxico will hold its first monetary policy decision of 2019. We expect the reference rate unchanged at 8.25%, with a less hawkish tone. Apart from the more benign behavior of recent inflation figures and the relatively steep reduction in the annual comparison, our expectation of a less hawkish tone is also driven by: (1) The deceleration in economic activity, as suggested by the preliminary print of 4Q18 GDP at 0.2% q/q, from 0.8% in the previous quarter; (2) a more dovish Fed, particularly after last week's decision, which prompted us to now think that the FOMC will not hike rates this year; and (3) recent Mexican peso strength, aided by broad dollar weakness but with the central bank maintaining currency performance as one of the main factors to watch going forward.

Despite of a relatively more favorable backdrop for the central bank to remain on hold for longer, we believe that they will reiterate their prudent stance. With inflation still above target, risks to the de-anchoring of mid- and long- term expectations, and high uncertainty in both the external (particularly the trade war between the US and China and global growth) and domestic fronts, it is our take that they could maintain the option open for further rate hikes. Moreover, we see a relatively low probability that the central bank will be able to cut the reference rate this year, even with financial markets already pricing-in the possibility of this scenario materializing during the second half of 2019.

From our fixed income and FX strategy team

We hold our trade idea of long positions in Mbonos Jun'22 and Dec'23 taking into account the current inflationary backdrop. Today's CPI report came in below market consensus, confirming the benign downward trend in annual inflation (4.4% in January *vs* 4.8% for 2018-end). This backdrop is supporting market expectations of a dovish communiqué from Banxico later today, with board members also acknowledging an effect of slack in the Mexican economy, a dovish tilt from the Federal Reserve, and stable FX dynamics. As a result, the yield curve is reacting with a 5bps rally on average, distributed by -6bps in short- and mid-term Mbonos, and -4bps in longer-term maturities with a mild steepening bias in the last two sessions. Meanwhile, CPI-linked Udibonos depict few variations in respect to previous close (+2bps). Current inflation breakevens continue showing a relatively expensive valuation in Udibonos. Overall, the actual landscape argues in favor of our trade idea of long positions in Mbonos Jun'22 and Dec'23 opened on January 9th, 2019. More details in our "*Fixed-Income and FX Weekly*" <pdf>, published on February 5th, 2019.

Analyst Certification.

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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