Banxico – The table is set for an October hike

September 7, 2018

www.banorte.com
@analisis_fundam

Gabriel Casillas
Chief Economist and Head of Research
gabriel.casillas@banorte.com

Delia Paredes
Executive Director of Economic Analysis
delia.paredes@banorte.com

Juan Carlos Alderete, CFA
Senior Economist, Mexico
juan.alderete.macal@banorte.com

Francisco Flores
Economist, Mexico
francisco.flores.serrano@banorte.com

Fixed income and FX Strategy

Alejandro Padilla
Head Strategist – Fixed-Income and FX
alejandro.padilla@banorte.com

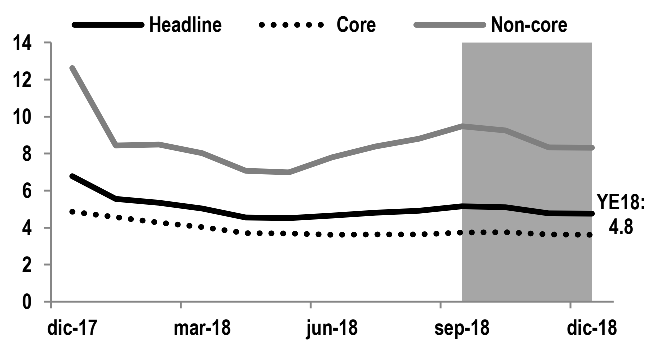
Santiago Leal Singer
Fixed-Income and FX Strategist
santiago.leal@banorte.com

Leslie Orozco
Fixed Income and FX Strategist
leslie.orozco.velez@banorte.com

- **After August's inflation report, we decided to revise up our inflation forecast for year-end from 4.3% to 4.8% yoy**
- **Moreover, we now expect Banxico to hike 25bps to 8.00% on October 4th, remaining on hold at least during the first half of 2019**
- **Headline inflation (August): 0.58% m/m; Banorte: 0.60%; consensus: 0.53% (range: 0.49%-0.60%); previous: 0.54%**
- **Core inflation (August): 0.25% m/m; Banorte: 0.27%; consensus: 0.25% (range: 0.17%-0.35%); previous: 0.29%**
- **Inflation in August was explained once again by pressures in prices of fruits & vegetables and low-grade gasoline**
- **As a result, annual inflation increased from 4.81% to 4.90%**
- **Upside pressures on inflation continue driving investors' sentiment, however still beneficial for our trade idea in the CPI-linked Udibono Jun'22**

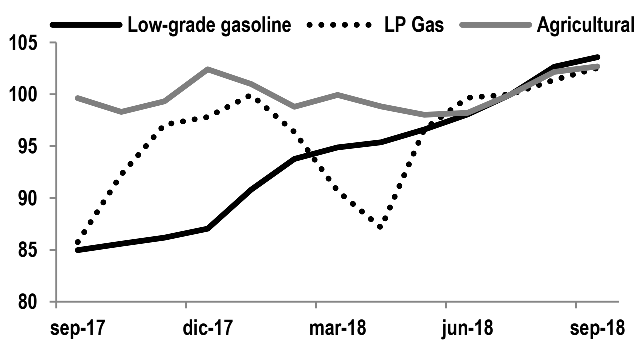
Revising our inflation forecast for year-end 2018. After August's inflation report –released earlier today-, we decided to modify our inflation forecast from 4.3% to 4.8% yoy, while adjusting our core inflation estimate from 3.9% to 3.6% (see chart below on the left). This revision is mostly driven by: (1) A higher-than-expected increase in the non-core component as a result of energy prices, in particular low-grade gasoline (see chart below on the right); (2) some degree of reversion to the mean in agricultural prices after the steep fall registered during the first half of the year; (3) possible pressures in government tariffs (*e.g.* toll roads); and (4) a marginal adjustment higher due to the final composition of new CPI weights.

Inflation forecasts
% yoy; monthly figures



Source: INEGI, Banorte

Energy and agricultural prices
Index 100= 2H-Jul 2018



Source: INEGI, Banorte

Moreover, we now expect Banxico to hike 25bps to 8.00% on October 4th, remaining on hold at least during the 1H19. Even though it is our take that the monetary authority seems to be a bit reluctant to continue hiking rates, we believe some recent factors have increased pressure for Banxico to hike the reference rate in their upcoming October 4th meeting. To a higher-than-expected inflation, we must add: (1) A higher degree of uncertainty in emerging markets, particularly given events in Argentina and in Turkey –among other countries-, which has had a negative impact on the Mexican peso *vis-à-vis* the US dollar; and (2) the FOMC September hike –which markets give now a probability of more than 96% after August's labor market report-, with Banxico not having yet "officially" decoupled from the Fed in its communications. Looking ahead, we estimate Banxico will remain on hold at least during the first of half of 2019.

Meanwhile, consumer prices were up 0.58% m/m in August, higher than expected by the market but marginally below our forecast. As a result, annual inflation climbed to 4.90% yoy from 4.81% in the previous month. Core inflation stood at 0.25% m/m vs. our 0.27% estimate. The main deviation from our forecast comes from: (1) A higher than expected contribution in the prices of fruits and vegetables (23bps vs. our 21bps); along with (2) a lower contribution from other goods (7bps vs. our 8bps), as shown in the table below.

August inflation by components
% monthly incidence

	INEGI	Banorte	Difference
Total	0.58	0.60	-0.02
Core	0.19	0.20	-0.02
Goods	0.15	0.16	-0.01
Processed foods	0.08	0.08	0.00
Other goods	0.07	0.08	-0.01
Services	0.03	0.04	-0.01
Housing	0.02	0.02	0.00
Education	0.05	0.05	0.00
Other services	-0.04	-0.04	-0.01
Non-core	0.39	0.39	0.00
Agriculture	0.19	0.19	0.01
Fruits & vegetables	0.23	0.21	0.02
Meat & eggs	-0.03	-0.01	-0.01
Energy & government tariffs	0.20	0.21	-0.01
Energy	0.19	0.20	-0.01
Government tariffs	0.01	0.00	0.01

Source: Banorte with data from INEGI and Banco de México.
Note: Contributions might not add due to the number of decimals allowed in the table.
Previous to year 2011, contributions might not add because of the change in CPI-calculation methodology

August inflation was once again driven by upward pressures in fruits & vegetables along with low-grade gasoline. Agricultural prices increased 1.9% m/m due to the 5.0% increase in the prices of fruits and vegetables, outweighing for the marginal fall in the prices of *meat and egg* (-0.5%). *INEGI* mentioned the price of tomatoes (+20.8%), onions (+42.5%), and lemons (+24.5%) among the products the increasing prices. Nevertheless, this was partially compensated by the reduction in the prices of husk tomatoes (-15.7%), bananas (-3.7%) and beans (-1.6%), among others. In addition, energy prices picked up by 1.9% as a result of higher low-grade gasoline (+2.7%), LP gas (+0.9%) and high-grade gasoline (+2.3%).

In the core index, merchandise prices increased 0.4% m/m, on the back of similar expansions in both processed foods and other merchandise. In the services index, we highlight the rise in education costs, up 1.4%, given the start of the new school year at the beginning of the month. In particular, college tuition increased 2.1% and high school by 2.4%. This expansion was partially compensated by the 0.3% fall in other services, considering the decrease in airfares (-21.8%) and tourism services (-9.2%) as the summer holiday season came to an end.

From our fixed income and FX strategy team

Upside pressures on inflation continue driving investors' sentiment, however still beneficial for our trade idea in the CPI-linked Udibono Jun'22. Today's CPI reading for August came in above market expectations again, resulting in an annual reading setting at a relevant psychological level of 5% when considering the y/y comparison using the bi-weekly index. These dynamics could result in upward adjustments in market inflation expectations as consensus has underestimated the inflation print in 7 of the last 8 fortnightly reports, also supporting the idea of short-term breakevens above 4% for longer (3-year reading hovering around 4.15%). It is our take that this backdrop could pose some risks for the pricing in the yield curve about Banxico's next policy meeting on October 4th, especially after the recent sell-off in EM that has affected the performance of the Mexican peso (3% loss since last policy decision on August 2nd). The market reaction was consistent with our view of nominal rates with room for additional pressures, yet with real-rates performing defensively due to the inflation context. The curve is currently pricing in +18bps of implied rate hikes in the repo rate for the remainder of the year with more conviction of a policy movement in October. However, it is also relevant to highlight the expectations of easier monetary conditions in the 2H19, which could result in a more defensive stance for mid-term securities. Overall, the factors abovementioned are beneficial for our trade idea of long positions in the CPI-linked Udibono Jun'22. It is important to bear in mind that the expected UDI-related carry of this type of securities based on our CPI forecasts is 2.27% for the remaining 115 days of 2018 (7.10% on an annualized basis).

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BANORTE

GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy			
Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Economic Analysis			
Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Juan Carlos Alderete Macal, CFA	Senior Economist, Mexico	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Miguel Alejandro Calvo Domínguez	Economist, Regional	miguel.calvo@banorte.com	(55) 1670 - 2220
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Fixed income and FX Strategy			
Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Santiago Leal Singer	FX Senior Strategist	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Fixed Income and FX Strategist	leslie.orozco.velez@banorte.com	(55) 1670 - 1698
Equity Strategy			
Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Technical Analysis	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Equity Research – Conglomerates / Financials/ Mining / Petrochemicals	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research – Airlines / Airports / Cement / Infrastructure / REITs	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Francisco Duarte Alcocer	Analyst	francisco.duarte.alcocer@banorte.com	(55) 1670 - 2707
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251
Corporate Debt			
Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248
Wholesale Banking			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Asset Management	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Corporate Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454