

## 1H-May inflation – Downward surprise on low pressures in agricultural goods

- **INEGI just published its inflation report for the first half of May**
- **Headline inflation (1H-May): -0.30% 2w/2w; Banorte: -0.19%; consensus: -0.25% (range of estimates: -0.49% - 0.16%); previous: 0.06%**
- **Core inflation (1H-May): 0.09% 2w/2w; Banorte: 0.13%; consensus: 0.10% (range of estimates: 0.03% - 0.15%); previous: -0.02%**
- **Deflation in the period was explained by seasonal reduction in electricity tariffs, along falling prices of fresh fruits**
- **With these figures, annual headline inflation marginally increased to 4.43% from 4.41% at the end of April. On the contrary, core-inflation fell to 3.77% from 3.87% previously**
- **Today's report is supporting Banxico's hawkish view in terms of inflation inside last week's policy announcement**

**Consumer prices declined 0.30% 2w/2w in 1H-May.** This number was lower than both consensus (-0.25%) and our own forecast (-0.19%). Core inflation rose 0.09%, also lower expected. The main deviation from our forecast came from: (1) A lower than expected contribution from prices of fresh fruits and vegetables (-3bps vs. our +7bps); and (2) a smaller impact from prices of other goods at the core level (+1bps vs. our +3bps), as shown in the table below:

### 1H-May inflation by components

% bi-weekly incidence

	INEGI	Banorte	Difference
Total	-0.30	-0.19	-0.11
Core	0.07	0.10	-0.03
Goods	0.05	0.08	-0.03
Processed foods	0.04	0.05	0.00
Other goods	0.01	0.03	-0.02
Services	0.02	0.02	0.00
Housing	0.02	0.02	0.01
Education	0.00	0.00	0.00
Other services	0.00	0.00	-0.01
Non-core	-0.37	-0.29	-0.08
Agriculture	0.02	0.11	-0.09
Fruits & vegetables	-0.03	0.07	-0.10
Meat & eggs	0.05	0.04	0.01
Energy & government tariffs	-0.39	-0.40	0.01
Energy	-0.40	-0.40	0.00
Government tariffs	0.01	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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www.banorte.com

@analisis\_fundam

**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

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**Deflation in the period was explained by seasonal reductions in electricity tariffs due to summer discounts, along declines in the prices of fresh fruits.**

The former declined 20.5% 2w/2w, subtracting 37.5bps to the headline. Low-grade gasoline declined 0.2% in a context in which the government's weekly increase in the fiscal stimulus that started in March was partially reversed in the last days of the period. Meanwhile, LP gas prices were down 0.6%, adding three consecutive prints of declines. Regarding the latter, the prices of agricultural goods picked up 0.2% despite that the ones for fruits and vegetables edged down 0.7%, subtracting 3bps to total index variations. Products with rising prices included poultry (+3.5%), avocados (+16.9%) and bananas (+4.9%), among others. By contrast, the price of onions (-9.6%), lemons (-20.5%) and husk tomatoes (-8.5%) were among those with the most negative contributions.

Core inflation explained 7bps. Similar to the previous print and in line with our expectations, prices of airfares (-2.5%), tourism services (-5.6%), and hotels (-3.3%) kept declining as the seasonal increase due to the Easter holiday unwinds further. Nevertheless, we noted that the former ended higher on an accumulated basis when compared to the level of the index observed at the end of March, before this latter effect took place. Lastly, we highlight that housing increased 0.1%, higher than the previous two years and with this category exhibiting more pressures since the beginning of the year. In our view, this is very relevant considering that its weight in the headline index is around 15.5%.

**Annual inflation increased marginally, ending at 4.43% from 4.41% at the end of April.** In bi-weekly terms, this is the fourth consecutive print in which the annual rate stands above Banxico's upper bound of the variability range around the target. On a more positive note, core inflation edged-down from 3.87% to 3.77%. Despite of this, both the headline and core remain above the levels observed at the end of March of 4.00% and 3.55%, before two relevant effects took place: (1) The negative seasonal effect from the shift in timing of the Easter holiday when compared to the previous year; and (2) the decline in electricity tariffs, which also pressured inflation upwards both due to a more modest decline and a lower weight in the index relative to 2018.

Going forward, we will keep focus on agricultural goods dynamics, given that they have remained low following the plunge observed at the start of the year. Moreover, it will be relevant to see the impact from lower fiscal stimulus on gasoline, considering that it has been decreasing since May 11<sup>th</sup>. Lastly, the possibility of an added influence from structural factors at the core level, which seem to be materializing in housing as well as some other goods and services.

*From our fixed income and FX strategy team*

**Today's report is supporting Banxico's hawkish view in terms of inflation inside last week's policy announcement.** The annual inflation reading remains above Banxico's upper bound of 4%, locating at 4.43% in the first half of May, despite the seasonal deflationary monthly prints of April and May (explained by the implementation of subsidies in electricity tariffs mainly in Northern states). Some of the pressures are coming from the core component (reaching today a 3.77% yoy level). It is important to bear in mind that this is a relevant measure closely monitor by Banxico. Goods and services have been recently affected by higher costs in the economy and larger real earnings. Moreover, the non-core inflation has also suffered by higher energy and agricultural prices. All in all, inflation dynamics have deteriorated in the last two months, fueling Banxico's concerns about several risks (local and external) that could derail the convergence process towards its 3% goal. In addition, this scenario could result in an upward adjustment in inflation expectations (i.e. surveys and breakevens). In the aftermath of today's report the yield curve is trading on a slightly positive tone with the Mbonos curve rallying 1-2bps in line with an extension of the recent rally in U.S. Treasuries and other sovereign bonds. The market has recently adjusted its expectations about Banxico's future policy path, pricing in only -19bps of rate cuts this year vs. -48bps observed only a month ago. Investors have also adjusted their inflation expectations, with breakevens trading 17bps higher vis-à-vis last quarter. Although we acknowledge that the Mexican yield curve could benefit from the dovish inertia from several central banks combined with an attractive carry, we hold a cautious stance for long directional trade ideas. We continue observing a more attractive relative valuation in Mbonos Nov'36 and Nov'38, nevertheless we suggest waiting for better market conditions and entry levels for new long positions.

In the FX market, the Mexican peso reacted with a slightly negative bias to today's CPI report amid a session driven by a broad USD strengthening against global currencies. The pair trades at 19.05 per dollar, equivalent to a 0.3% sell-off vs yesterday's close in which it reached up to intraday 18.93. In our view, the strong carry embedded in the currency will remain as the main anchoring factor, which has proven highly relevant in recent stress and risk aversion market phases. We do not rule out a stronger performance for the peso in the short-term, although we hold a view on a more challenging 2H19. Under this context, we suggest taking advantage of attractive levels below 19.00 for USD longs.

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**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 Godínez	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
Francisco Duarte Alcocer	Analyst, Global Economist	francisco.duarte.alcocer@banorte.com	(55) 1103 - 4000 x 2707
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) 5268 - 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
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
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	hugo.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Manager, 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.cebaldos@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
Victor Antonio Roldan Ferrer	Head of Corporate Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454