

## Temporary increase in annual inflation above the target range on seasonal effects

- **Headline inflation (April): 0.05% m/m; Banorte: 0.10%; consensus: 0.06% (range of estimates: 0.02% - 0.10%); previous: 0.39%**
- **Core inflation (April): 0.46% m/m; Banorte: 0.52%; consensus: 0.50% (range of estimates: 0.46% - 0.54%); previous: 0.34%**
- **Inflation during the period was driven by the start of electricity tariff discounts, compensated by higher airfares and tourism services due to the Easter holiday, along pressures in some goods**
- **With this print, annual inflation went from 4.00% in March to 4.41%, back above the top of Banxico's variability range around the target. Core inflation went from 3.55% to 3.87%**
- **We believe this was mainly driven by two factors: (1) A seasonal effect due to the timing of the Easter holiday; and (2) the lower relative weight in electricity tariffs within CPI**
- **Market participants have lowered the amount of implied rate cuts expected this year given recent inflationary pressures in Mexico**

**Consumer prices up 0.05% m/m in April.** This figure was virtually in line with consensus at 0.06%, and lower than our forecast of 0.10%. Core inflation stood at 0.46%. The main differences between actual figures and our forecast came from: (1) A lower than expected contribution from other services (15bps vs. our 18bps); (2) a lower impact from other goods (6bps vs. our 8bps); (3) a higher contribution from meat and egg (8bps vs. our 6bps); and (4) a lower effect from fruits and vegetables (-2bps vs our -1bp), as shown in the table below.

### April inflation by components % monthly incidence

	INEGI	Banorte	Difference
Total	0.05	0.10	-0.04
Core	0.34	0.39	-0.05
Goods	0.14	0.16	-0.02
Processed foods	0.08	0.08	0.00
Other goods	0.06	0.08	-0.02
Services	0.20	0.23	-0.03
Housing	0.05	0.05	0.00
Education	0.00	0.00	0.00
Other services	0.15	0.18	-0.03
Non-core	-0.29	-0.29	0.01
Agriculture	0.05	0.05	0.00
Fruits & vegetables	-0.02	-0.01	-0.02
Meat & eggs	0.08	0.06	0.02
Energy & government tariffs	-0.34	-0.35	0.01
Energy	-0.35	-0.36	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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**Inflation during the period was driven by the start of electricity tariff discounts, compensated by higher airfares and tourism services due to the Easter holiday.** Regarding non-core prices, electricity tariffs fell 12.3% as a result of summer discounts that began in the first half of the month, a factor that will also be present in May. Low-grade gasoline fell 1.1%. This decline was observed in a context in which the Federal Government has kept increasing the subsidy on excise taxes, which was reintroduced in March and is currently at a new-high since last October. It should be noted that accumulated inflation since the end of November has been 1.06%, while low-grade gasoline has picked up 0.22%. Given the government's commitment with a constant price in real terms, the difference suggests that the increase in subsidies could moderate or even stop from now on. LP gas also diminished 1.7%. Agricultural goods contributed 5.4bps to the headline. Products with the most upside included chicken (4.6%), avocado (25.8%) and onions (8.9%). On the contrary, those with the most relevant declines were tomatoes (-7.3%), serrano chilies (-19.9%), and bananas (-7.1%), among others.

At the core level, we observed some pressures in other services, particularly airfares, tourism services and lodging, increasing 19.9%, 11.9%, and 5.2% m/m, respectively, driven by the typical seasonal related to the Easter holiday. Moreover, processed foods picked up 0.4%, explaining 8bps of the headline. Lastly, other goods were up 0.3%, explaining 6bps.

**Annual inflation went from 4.00% in March to 4.41%.** This metric has once again surpassed the top end of Banxico's variability range around the target of 3.00% after two months inside this limit. We believe this was mainly driven by two factors: (1) A seasonal effect due to the timing of the Easter holiday, as it took place in April this year vs. March 2018, resulting in an unfavorable base effect; and (2) the lower relative weight in electricity tariffs within the index when compared to the previous year given methodology changes in CPI, with the current weight at 1.49% vs 2.81%. In this respect, in 2019 these prices fell 12.3%, broadly in line with the 3-year average for the same month at -13.4%.

Considering the latter, we continue expecting headline inflation to decrease in coming months, with our year-end forecast unchanged at 3.5%. On the other hand, core inflation stood at 3.87%, highest since March 2018. Going forward, we will be vigilant of: (1) Announcements of the amount of gasoline subsidies, given the decrease in retail prices since the second half of March; (2) dynamics in agro prices, which remain relatively low but could start climbing given their cyclical nature of the index. In particular, the potential impact that the reintroduction of tariffs by the US on Mexican tomato exports; and (3) the performance of processed foods and other services at the core level.

*From our fixed income and FX strategy team*

**Market participants have lowered the amount of implied rate cuts expected this year given recent inflationary pressures in Mexico.** Inflation came in line market expectations in the second half of April, after the negative surprise in the 1H-Apr. Overall, pressures in some agricultural products and tourism prices during the month offset the seasonal decline in electricity tariffs (explained by subsidies). As a result, the annual inflation reading moved from 4.00% in March to 4.41% in April, locating above Banxico's upper bound of its confidence range of 4.00%. Moving forward, we expect an additional increase in the annual headline CPI reading during Summer, conveying the seasonal effect coming from international gasoline prices (e.g. the driving season in the U.S.), but with more benign dynamics in the 2H19, which could help inflation reach our 3.50% year-end forecasts. In the aftermath of this inflationary landscape the Mexican yield curve has been observing a correction since last month, as market participants have decreased their conviction about the start of an easing cycle from Banxico in coming months. Inflation breakevens have soared by 35bps in the last month, while the yield curve is only pricing a lower repo rate by -24bps in 2019 and -77bps in 2020 in comparison to -37bps and -100bps at the beginning of April. Investors will closely monitor Banxico's monetary policy decision next week in order to assess the likely policy path to be observed during the remainder of 2019 given the actual combination of a weaker economy, recent inflationary pressures, and a defensive MXN supported by one of the most attractive carry gains among EM. In our view Banxico will stay put, holding a mild dovish bias. As a result, we remain cautious about the current valuation of the yield curve, waiting for better entry points or market conditions for new directions long positions in the long-end of the Mbonos curve, observing a better relative valuation in the Nov'36 and Nov'38 securities.

In the FX market, the Mexican peso trades with a 1.05% daily sell-off at 19.28 per dollar, extending recent sessions in which the currency's performance has deteriorated amid a less favorable backdrop for risk assets due to the mounting trade tensions between the U.S. and China, a context which has resulted in a broad USD strengthening. However, USD/MXN has hold in a relatively narrow trading range respecting the 18.94 handle as its strongest level on Monday's session and with pressures that have push it up to 19.30 today. In a short-term horizon we still expect a defensive peso and we do not rule out drivers that could lead it towards the 18.75 floor, though heading towards a more challenging 2H19. Under this view, we see USD purchases as appropriate below 19.00 per dollar, waiting for more attractive levels to open directional recommendations in this sense.

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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 Thalia 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.cebillos@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