

June CPI confirms inflation is back to Banxico's target variability interval

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- **INEGI just published its inflation report for June**
- **Headline inflation (Jun): 0.06% m/m; Banorte: 0.07%; consensus: 0.06% (range of estimates: 0.04% to 0.09%); previous: -0.29%**
- **Core inflation (Jun): 0.30% m/m; Banorte: 0.30%; consensus: 0.31% (range of estimates: 0.29% to 0.33%); previous: 0.16%**
- **Inflation during the period was helped by the 0.7% m/m decline in the non-core component, particularly energy, followed by fresh fruits and vegetables**
- **With these figures, annual headline inflation fell to 3.95% from 4.28% at the end of May. Nevertheless, core-inflation increased to 3.85% from 3.77% in the previous month**
- **We reaffirm our call that Banxico will cut the reference rate by 25bps in its November meeting as annual inflation keeps slowing down, although slightly later than consensus due to lingering uncertainty about financial stability risks**
- **Inflation conditions validating the market's pricing direction on Banxico's path going forward**

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Consumer prices up 0.06% m/m in June. This number was in line with consensus and only 1bps below our forecast. Core inflation rose 0.30%, equal to our estimate. The main deviation from our forecast came from: (1) A higher than expected contribution from agricultural prices (-2bps vs. our -7bps); (2) a lower impact from energy prices (-15bps vs. our -9bps); and (3) a lower contribution from prices of other goods at the core component x(+2bps vs. our +3bps), as shown in the table below:

June inflation by components

% monthly incidence

	INEGI	Banorte	Difference
Total	0.06	0.07	0.00
Core	0.23	0.23	0.00
Goods	0.09	0.10	-0.01
Processed foods	0.07	0.07	0.00
Other goods	0.02	0.03	-0.01
Services	0.14	0.13	0.01
Housing	0.04	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.10	0.09	0.01
Non-core	-0.17	-0.16	0.00
Agriculture	-0.02	-0.07	0.06
Fruits & vegetables	-0.07	-0.11	0.03
Meat & eggs	0.05	0.03	0.02
Energy & government tariffs	-0.15	-0.09	-0.06
Energy	-0.15	-0.09	-0.06
Government tariffs	0.01	0.00	0.00

Source: INEGI, Banorte.

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

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Inflation in the period was helped by the non-core component, particularly energy prices but also from fresh fruits and vegetables. In particular, non-core inflation during the month stood at -0.7% m/m. Energy prices declined 1.6%, with the most relevant surprise in LP gas which fell 5.7% in the month, subtracting 12bps to the headline. Additionally, low-grade gasoline prices were also lower (-0.7%), contributing with an additional -4bps in spite of the gradual decrease in fiscal subsidies by the Federal Government since mid-May until the end of June. Nevertheless, subsidies are increasing again, a situation that could limit a significant upside in coming weeks.

Meanwhile, prices of fresh fruits and vegetables during the second fortnight increased significantly, although not enough to reverse the decline registered during the first half, with this category subtracting -7bps as they declined 1.6%. Nevertheless, meat and egg prices were higher once again (0.9%), equivalent to +5bps. Specifically, we highlight the reductions in prices of onions (-17.9%), tomatoes (-5.1%), lemon (-21.9%), and eggs (-3.0%). Nevertheless, the most pressured included chicken (+4.4%), avocados (+13.0%), and squash (+52.1%), among others. We also note that pork increased 1.9% (contribution: 1.1bp), which we believe is related to a supply shock due to swine flu in China.

Nevertheless, core inflation was up 0.3%, adding 23bps to the headline. The most important increases came in seasonally-sensible categories, particularly related to tourism, including airfares (+23.8%) and tourism services (5.2%). Moreover, processed foods added 7.3bps, a category that remains watched by the central bank, while other goods were responsible for 2pbs.

Annual inflation fell to 3.95% from 4.28% at the end of May. In bi-weekly terms, this is the second consecutive time with the annual rate within Banxico's variability range. Nevertheless, core inflation increased to 3.85% from 3.77%. With this figure, the latter averaged 3.8% yoy in 2Q19, in line with Banxico's forecast but above the 3.6% of the first quarter. On the other hand, the average for headline inflation is 4.2%, actually 10bps below the central bank's latest estimate. Going forward, we will keep focused in: (1) Dynamics in agricultural goods, which seem to be showing tentative signs of a rebound after having a very good performance so far this year, likely starting its tendency towards mean reversion; (2) the additional effect that could be in store in pork due to swine flu, as observed since the previous fortnight; (3) energy, particularly low-grade gasoline, given recent geopolitical tensions; and (4) potential pressures at a more structural level at the core, in a context in which the central bank has kept warning about the magnitude of wage revisions, growing 5.8% yoy in the first five months of 2019.

We maintain our view that Banxico will cut the reference rate later this year. Despite core inflation's resistance to the downside, we reaffirm our view that headline inflation will reach 3.5% by year-end, lower than consensus at 3.7%. We will pay attention to Banxico's minutes of the June 27th monetary policy meeting on Thursday, when the Board left the rate unchanged at 8.25%, albeit with one member favoring a 25bps cut. We believe the document will be interesting, with discussions on financial stability risks and the outlook for growth and inflation, among others. We will look for comments about Pemex and the sovereign rating, uncertainty about USMCA, the implications of more dovish central banks (particularly the Fed), inflation expectations and its balance of risks. We expect the tone to be slightly dovish. In our view, economic conditions will allow Banxico to cut the reference rate by 25bps at the November 14th meeting as financial stability risks diminish gradually, without discarding these to materialize earlier if uncertainty falls sooner than expected. For further details, see "*Mexico: Ahead of the Curve*", [pdf](#).

From our fixed income and FX strategy team

Inflation conditions validating the market's pricing direction on Banxico's path going forward. June's CPI report continue reflecting more stable local price dynamics, with the annual reading printing at 0.06%, in line with market consensus, and with the annual figure marking 3.95%, marginally above market expectations, but in Banxico's confidence range. Despite local rates modestly pressured in recent sessions in the aftermath of the strong NFP report released last Friday (and waiting for Powell's Testimony to Congress), the local yield curve incorporates -54bps of implied cuts for Banxico for year-end. Although this magnitude could be subject to adjustments going forward with some local risks lingering (*e.g.* Mexico-U.S. trade relation and other factors such as Pemex), this morning's CPI print at least validates the pricing's direction. With local rates favored by the global dovish synchrony which has been joined by Banxico and more favorable CPI dynamics, inflation breakevens have also experienced an improvement. Particularly, implied inflation in local fixed-income securities has dropped ~30bps from its highest levels in mid-June. However, some maturities, especially those of longer duration, are still reflecting a more attractive valuation in nominal rates vs real-rate ones. Under this context, we suggest to overweight positions in Mbono Nov'42 as a short-term strategy, still acknowledging idiosyncratic factors that could weaken the Mexican risk premia. For further details in our fixed-income views please consult: "*Fixed Income and FX Strategy*", [pdf](#), published yesterday.

In the FX market, the Mexican peso opens the session with modest pressures of 0.2% to USD/MXN 18.94, with a broad USD extending its strengthening since last week and with investors receiving news about new U.S. tariffs to Mexican steel. In our view, price action below 18.90 looks attractive for USD long positions, especially when trading closer to 18.80, a level from which we see few margin for additional MXN appreciation.

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