

Favorable dynamics in inflation during May

- **INEGI just published its inflation report for May**
- **Headline inflation (May): -0.29% m/m; Banorte: -0.25%; consensus: -0.22% (range of estimates: -0.26% to -0.15%); previous: 0.05%**
- **Core inflation (May): 0.16% m/m; Banorte: 0.15%; consensus: 0.15% (range of estimates: 0.12% to 0.17%); previous: 0.46%**
- **Deflation in the period was explained by the seasonal reduction in electricity tariffs, along falling prices of LP gas, low-grade gasoline and fresh fruits**
- **With these figures, annual headline inflation decreased to 4.28% from 4.41% at the end of April. Moreover, core-inflation fell to 3.77% from 3.87% previously**
- **Limited reaction in local securities to May's CPI report**

Consumer prices declined 0.29% m/m in May. This number was lower than both consensus but closer to our -0.25% forecast. Core inflation rose 0.16%, practically in line with our expectation. The main deviation from our forecast came from: (1) A lower than expected contribution from prices of fresh fruits and vegetables (-8bps vs. our -3bps); (2) a further reduction in energy prices (-44bps vs. our -0.42bps); (3) a higher contribution of meat and egg (+10bps vs. our +8bps); and (4) an overall greater impact from core goods (+11bps vs. our +9bps), as shown in the table below.

May inflation by components % monthly incidence

	INEGI	Banorte	Difference
Total	-0.29	-0.25	-0.04
Core	0.12	0.11	0.01
Goods	0.11	0.09	0.03
Processed foods	0.08	0.07	0.01
Other goods	0.03	0.01	0.01
Services	0.01	0.03	-0.02
Housing	0.04	0.04	0.00
Education	0.00	0.00	0.00
Other services	-0.03	-0.02	-0.01
Non-core	-0.41	-0.37	-0.05
Agriculture	0.02	0.04	-0.03
Fruits & vegetables	-0.08	-0.03	-0.05
Meat & eggs	0.10	0.08	0.02
Energy & government tariffs	-0.43	-0.41	-0.02
Energy	-0.44	-0.42	-0.02
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 mostly explained by seasonal reductions in electricity tariffs due to summer discounts. In particular, energy prices edged down 4.25% m/m, deducting 44bps from the headline index. Electricity explains most of that contraction (-38bps). However, there were some additional relief from falling prices of LP gas (-4bps) and low-grade gasoline (-2bps). In addition, fresh fruits prices decreased 1.74%, subtracting 8bps to May's CPI variation. We highlight the reductions in the price of onions (-8bps), lemons (-5bps) and *husk* tomatoes (-1bps), among others. These were partially offset by rising prices of avocados (+8bps), potatoes, bananas and, oranges (+1bp each). The dynamics within meat and egg was less favorable, with prices up 1.75% (+10bps) driven by higher prices of poultry (+10bps) and pork (+1bps). The increase in the latter could be explained by the global trend seen in this commodity due to a fall in production in Asia given a new outbreak of swine flu.

Core inflation explained 12bps of CPI variation in the period, contained by the downward adjustment in categories related to tourism as the price hike associated with the Easter holiday fades away. In this context, there were notable falls in tourism services (-5bps) and airfares (-2bps). However, and on a more negative note, we saw some pressures in the prices of core goods. In addition, housing costs continue to trend upwards, contributing with 4bps. Regarding this component, we note that it has been pressured since the start of the year, showing above average increases particularly in the last three months.

Annual inflation falls to 4.28% from 4.41% in the previous month. In bi-weekly terms, this is the fifth consecutive print in which the annual rate stands above Banxico's upper bound of the variability range around the target. However, it reached its slowest pace of expansion since the first half of April, and now adds two fortnights slowing down. Moreover, core inflation fell to 3.77%, 10bps below the yearly high seen in April. We believe that if this behavior were to continue, this would be positive in the eyes of the central bank, giving them room to start to start an easing cycle later this year.

Looking ahead, we will keep focus on agricultural goods price dynamics, given that they have remained low following the plunge observed at the start of the year and given possible additional pressures stemming from disruptions in the supply of pork. Moreover, it will be relevant to see the impact from lower fiscal stimulus on gasoline, considering that it has been decreasing since May 11th and reaching a new low for the week of June 8th - 14th not seen since mid-March for low-grade gasoline. 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

Limited reaction in local securities to May's CPI report. May's inflation report came with more favorable prints with respect to recent readings, with the annual mark moving to 4.28% yoy from 4.41% in April, below market expectations (4.35%), but holding above Banxico's upper bound of 4%. Particularly, regarding core inflation the report was fairly in line with the market consensus, registering a 0.16% monthly increase (3.77% yoy). Some of the factors that contributed positively included a decrease in the price of fruits and vegetables, as well as some energy components such as LP gas and low-grade gasoline. On the contrary, processed fruits and meat and eggs resulted higher than expected. The deterioration in local prices reflected in a more hawkish bias from Banxico in its latest communications when referring to this front, as expressed in its latest Quarterly Report and minutes. Moreover, these dynamics triggered an increase in the inflation expectations embedded in sovereign fixed-income securities. Specifically, inflation breakevens trade at levels higher than 4.00% in the 3-, 5-, 10-, and 30-year maturities, surging by 11bps on average since the latest CPI report on May 23rd. In addition, these readings trade above their 12-month mean and median, with a more visible space in the 3- and 30-year terms. It is worth mentioning that the latest performance has been also fueled by market participants reflecting concerns about pass-through effects given the FX depreciation associated with the U.S. trade threat and adjustments in rating agencies' views on Mexico and Pemex. In terms of the market expectation about future actions from the central bank, the yield curve is currently pricing only -1bp of implied rate cuts this year, against -21bps a month ago, and -39bps at the beginning of April. In the aftermath of today's report, local rates reaction had a limited effect with Mbonos trading within a ± 1 bp range with respect to yesterday's close and TIEE-28 swaps rallying 3bps. Meanwhile, real-rate Udibonos depict a 3bps sell-off, mainly focused in short-term maturities. We hold a cautious stance in terms of Mbonos, waiting for better entry levels and market conditions for new long positions, as we expect an additional correction.

In the FX market, the Mexican peso reflected a marginal reaction to this morning's report, with price action stirred by investors waiting for further information related to the trade negotiations between Mexico and the U.S., in a context where the USD is broadly weaker following a disappointing NFP report. The peso trades close to 19.63 per dollar, 0.3% stronger vs yesterday's close ranging during the week between 19.47 and 19.88. In terms of strategy we hold a cautious vision for trading purposes, opting to favor USD long positions.

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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.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