Annual inflation manages to stay within Banxico's target range

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- ***INEGI* just published its inflation report for March**
- **Headline inflation (March): 0.39% m/m; Banorte: 0.38%; consensus: 0.40% (range of estimates: 0.36% - 0.46%); previous: -0.03%**
- **Core inflation (March): 0.34% m/m; Banorte: 0.33%; consensus: 0.33% (range of estimates: 0.31% - 0.38%); previous: 0.43%**
- **Inflation during the period was driven by higher energy prices, such as low-grade gasoline and LP gas, and some pressure in core goods, particularly in the first half of the month**
- **With this print, annual inflation went from 3.94% in February to 4.00%, right at the top of Banxico's target range. On the other hand, core inflation went from 3.54% to 3.55%**
- **We maintain our view that Banxico will cut the reference rate by 25bps to 8.00% in the meeting to be held on June 27th, with the market's attention on the minutes of the latest decision to be released on Thursday**
- **Limited reaction in local bonds' performance following today's CPI report**

Consumer prices increased 0.39% m/m in March. This figure was marginally lower than consensus at 0.40% and just above our 0.38% forecast. Core inflation stood at 0.34%, slightly above the market estimate at 0.33%, which matched our own. While we missed the estimate by just one basis point in both the headline and core components, there were several differences when looking at the breakdown, with the highest being: (1) Lower than expected fresh fruits prices (-6bps vs. our -3bps); (2) higher than forecasted meat and egg prices (-1bps vs. our -3bps); and (3) a greater contribution from other services (8bps vs. our 6bps), as shown in the table below.

March inflation by components
% monthly incidence

	INEGI	Banorte	Difference
Total	0.39	0.38	0.01
Core	0.26	0.25	0.01
Goods	0.13	0.14	-0.01
Processed foods	0.08	0.08	0.00
Other godos	0.06	0.06	0.00
Services	0.12	0.11	0.02
Housing	0.05	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.08	0.06	0.01
Non-core	0.13	0.13	-0.01
Agriculture	-0.07	-0.06	0.00
Fruits & vegetables	-0.06	-0.03	-0.03
Meat & eggs	-0.01	-0.03	0.02
Energy & government tariffs	0.20	0.20	0.00
Energy	0.19	0.19	-0.01
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.

Inflation in March was mainly driven by higher energy prices, along some goods at the core index, particularly in the first half of the month. The former posted a 1.8% m/m, driven to the upside by both low- and high-grade gasoline (+2.7% and +3.0%, respectively) as well as LP gas (+1.4%). With this, those three components added close to 20bps to the headline. However, it should be noted that low-grade gasoline did came down in the second half of the month as a result in part of higher tax stimulus, while the other two components stayed relatively flat during the period. Regarding agricultural goods, they posted a 0.7% contraction, despite a considerable 69.9% increase in lemons and 5.1% in tomatoes. Nine out of the ten components with the highest negative contributions belong to this sub-index, highlighting the fall in *serrano* chilies (-30.2%), potatoes (-7.3%), and other chilies (-12.7%), among others.

Inside the core component, processed foods picked up 0.3% while other goods increased 0.4%, which are higher than those seen in the previous year. Other services posted a 0.5% rise, explained in part by the March 18th holiday, which pushed air fares up 6.5%. Nevertheless, other components such as dining away from home (+0.4%) and restaurants (+0.3%) posted notable increases.

With this print, annual inflation went from 3.94% in February to 4.00% in March. Core inflation rose marginally from 3.54% to 3.55%. In spite of the increase in the headline at the margin, annual inflation remained within Banxico's variability range. We keep expecting the headline to continue moving downwards in coming months. It should be noted that we now have the complete information for inflation in the first quarter of the year, highlight that average inflation during 1Q19 was 4.1%, just at the latest forecast from Banxico. Moreover, average core inflation stood at 3.6%, an inch above the central bank's forecast of 3.5%. In this context, we reiterate our year-end forecast of 3.5%. Regarding energy, we highlight that according to our price monitoring, gasoline prices during the first days of April have reacted to higher fiscal stimulus, which was reinstated at the beginning of March and has been gathering pace. It is our take that this will help contain tailwinds observed at the non-core index today (going from 5.25% in the previous month to 5.47%). On the other hand, we will also be focused on: (1) Dynamics of agro prices, as they have started to increase after strong downward surprises since the beginning of the year; and (2) potential pressures in core goods and other services at the core level, which have been flagged by Banxico as potential upside risks for headline and core inflation.

We reiterate our view that Banxico will cut the reference rate in June by 25bps to 8.00%. In our view, today's figure was mainly driven by pressures in from energy prices. In this respect and as already mentioned, we have observed lower gasoline prices during the first days of the current month, while electricity subsidies that start in April will be kept by the new administration. We consider this could help limit strong increases in the non-core component. We believe discussions in the minutes of the latest meeting (to be released on Thursday) will be focused on risks for inflation and its mid- to long-term expectations, particularly at the core.

In particular, we will look for further details about: (1) Elements in core inflation that remain elevated, such as processed foods and some services; (2) mid- and long-term core expectations, as they have stayed above Banxico's target; and (3) possible details about the intensification of downside risks for non-core inflation. Moreover, the assessment about the slowdown in global and local growth, the relative monetary policy stance with the Fed, and risks such as credit rating downgrades, will be watched. We expect the tone to be similar to the communique, which in our opinion was more dovish than the previous decision despite still remaining cautious on inflation. For details, see: "*Ahead of the curve – Banxico minutes to focus on risks for inflation despite its recent fall*", April 5th, 2019, <pdf>.

From our fixed income and FX strategy team

Limited reaction in local bonds' performance following today's CPI report. The March CPI print came in below market expectations for the seventh consecutive report; however, reaction in local rates was fairly limited holding losses that registered 1-2bps before the CPI print. The good news at the inflationary landscape is a key factor behind the expectations about a lower repo rate in Mexico in the second half of the year. The yield curve in Mexico continues pricing in -39bps of cumulative rate cuts in 2019 and -103bps in 2020 ahead of the publication of Banxico's minutes on Thursday. Overall, current global and local conditions remain supportive for Mbonos, especially the long-end, taking into consideration the inverted slope between the front-end and the 10-year area. We acknowledge that current conditions are favorable for interest rates worldwide and this backdrop will be beneficial for the Mexican yield curve. This will result in market participants that will hold a significant exposure in local bonds. Nevertheless, we see a valuation for local assets that has become more expensive. As a result, we suggest waiting for better entry levels for new directional long positions in Mbonos, with greater preference in the 20-year area, which depicts a more attractive relative valuation. In terms of CPI-linked Udibonos, these securities are trading +1bp in the aftermath of today's report. *Breakevens* suggest an attractive relative valuation in the 30-year area. Nevertheless, investors are acknowledging the negative carry embedded in UDIS-related securities when taking into account the seasonally low inflation prints of the second quarter.

In the FX market, the Mexican peso modestly extended gains registered before the report, currently trading at USD/MXN 18.92, equivalent to a 0.3% appreciation in respect to yesterday's close. The pair's performance has been recently more defensive supported by a more favorable backdrop for risk assets and EM currencies. In our view, the space for further appreciation is limited when breaching the 19.00 area, stressing out a "fair value" according to our REER model hovering around 18.90. In this sense, we wait for attractive levels for new USD longs.

Analyst Certification.

We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Francisco Duarte Alcocer, Jorge Antonio Izquierdo Lobato and Leslie Thalía Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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