

## We revise our year-end inflation forecast to 3.0% yoy from 3.3%

- **Headline inflation (Oct): 0.54% m/m; Banorte: 0.55%; consensus: 0.52% (range: 0.30% - 0.58%); previous: 0.26%**
- **Core inflation (Oct): 0.25% m/m; Banorte: 0.25%; consensus: 0.24% (range: 0.22% - 0.29%); previous: 0.30%**
- **As is typical in this period, the increase was mostly explained by the reversal in subsidies to electricity tariffs in some states (18.5% m/m, contributing 27bps). Moreover, we observed some pressures in some categories within processed foods and other services**
- **With these, annual headline inflation reached 3.02%, only 2bps higher than in September and still virtually at Banxico's target**
- **Core inflation stood at 3.68% (previous: 3.75%), inching lower since June. Meanwhile, non-core inflation remains contained at 1.01%, with a modest uptick after the historical low of 0.71% of the previous month**
- **We lower our year-end inflation forecast to 3.0% yoy from 3.3%, providing additional support to our call that Banxico will extend its easing cycle the rest of this year and in 2020**
- **Market participants are observing a well-anchored inflation ahead of a relevant policy decision next week**

**Consumer prices increased 0.54% m/m in October.** This figure was higher than consensus (0.52%) but closer to our 0.55%. Core inflation rose 0.25%, in line with our view. The main deviation came from: (1) A lower than expected contribution from fresh fruits and vegetables (+2bps vs our +4bps); and (2) more pressures in government-regulated goods and services (2bps vs. our +0bps), as shown below.

### October inflation by components % monthly incidence

	INEGI	Banorte	Difference
Total	0.54	0.55	-0.01
Core	0.19	0.19	0.00
Goods	0.10	0.10	0.00
Processed foods	0.06	0.07	0.00
Other goods	0.04	0.04	0.00
Services	0.09	0.08	0.00
Housing	0.03	0.03	0.00
Education	0.00	0.00	0.00
Other services	0.06	0.05	0.00
Non-core	0.35	0.36	-0.01
Agriculture	0.01	0.03	-0.02
Fruits & vegetables	0.02	0.04	-0.02
Meat & egg	-0.01	0.00	0.00
Energy & government tariffs	0.34	0.33	0.01
Energy	0.32	0.31	0.00
Government tariffs	0.02	0.00	0.02

Source: INEGI, Banorte.

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

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**Dynamics explained mostly by the seasonal increase in electricity tariffs, along some pressures in processed foods and other services.** Regarding the former, we observed a 18.5% m/m increase, contributing 27bps, which is higher than the 17.8% during the same period of 2018. An additional adjustment is scheduled for the 1<sup>st</sup> half of November on the reversal of electricity subsidies in other states. In energy, we also highlight that LP gas kept climbing at 3.1% m/m (+6bps), in our view influenced by higher international reference prices. Agricultural goods ended higher despite the -0.1% 2w/2w of the first fortnight. These added 1.1bps, its first positive contribution since July. In line with our monitoring, we highlight that tomato prices extended their uptrend (14.8%). According to anecdotal evidence, producers have seen prices recover after the deal struck in August with the US on anti-dumping tariffs. Moreover, among the top ten highest increases, we saw eggs (3.3%) and beans (2.7%). On the other hand, this was partially compensated by declines in avocados (-14.9%), chicken (-2.1%), and oranges (-12%), among others.

The core component grew 0.25%, resulting in a 19bps contribution. We highlight that goods kept climbing (0.3% m/m), with processed foods leading the way (+6bps). Other goods were also positive (4bps), with relevant upside in autos (0.7%). Services were higher by 0.2%, which was modest relative to recent years and with most of the advance concentrated in other services (0.3%), such as dining away from home items and restaurants. Overall, core inflation seems to be moderating gradually, which may be a result of the slowdown of economic activity, although still remaining in relatively high levels.

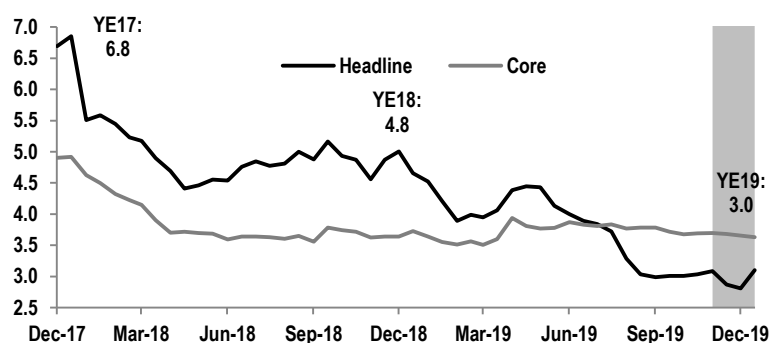
**Annual inflation stands at 3.02%, virtually unchanged from the level at the end of September.** In our view, this shows that inflation remains broadly controlled, helped by the benign dynamics observed throughout the year in the non-core component. We should mention that this modest uptick was driven by a slight move upwards in this latter component, to 1.01% from the historically low print of 0.71% at the end of the previous month. More importantly in our view, core inflation fell slightly, and for a fourth consecutive month, to 3.68%. Although the accumulated decline from the recent high of 3.87% at the end of April is still relatively modest, it is our take that it will be looked favorably by the central bank, which has already shown slightly less concerns over this component in its most recent communications, despite still categorizing its dynamics with resistance to the downside.

**We lower our year-end inflation forecast to 3.0% yoy from 3.3%.** In this respect, we believe greater economic slack will help inflation to stay near current levels at least towards year-end. Moreover, the main reason behind this adjustment is that energy prices, particularly low-grade gasoline, are likely to remain contained in the short-term. In this regard, the Federal Government has kept its commitment to maintain prices at least constant in real terms, in our view helping to explain most of the benign dynamics in the non-core component.

Since the start of this administration and until October, this particular good has actually fallen 0.8%, while headline inflation is up 2.1%. Strictly speaking, this has provided room for an upward adjustment in prices through higher excise taxes since at least April. Nevertheless, this has not been followed through by important price increases so far. In our view, this signals that the government will keep subsidies in place in the short term. Moreover, the global backdrop for international oil prices remains favorable while the exchange rate has been more resilient than anticipated. Therefore, our forecast now incorporates an even more positive outlook in this component than we had already penciled in. On the other hand, we maintain our core inflation forecast unchanged at 3.6%. Although we have observed a recent deceleration due to the widening of the output gap, this has been mitigated to some extent by the pass-through effect from this year's minimum wage increase –including its subsequent impact on other wages in the economy–. In our view, this is reflected more clearly in other services, which stand at 3.9% yoy and has failed to converge downwards since at least early 2017.

#### 2019 inflation forecast

% yoy, bi-weekly frequency



Source: INEGI, Banorte

**Regarding monetary policy, these dynamics provide additional flexibility for Banxico to continue its easing cycle.** The central bank's year-end forecast is at 3.2% (4Q19 average) according to the latest *Quarterly Report*, while analysts' median estimate is 3.0% (end-point). In our view, Banxico will cut the reference rate by 25bps on November 14<sup>th</sup> to 7.50%. Moreover, these price dynamics make it more likely that the central bank shows an even more dovish bias. In particular, this increases the probability of signaling both a more comfortable stance on inflation going forward and even a higher magnitude of future rate cuts and the overall easing cycle. Despite of this, it is our take that details about inflation dynamics so far suggest the central bank is not likely to change completely its relatively cautious approach. First and foremost, the 3% target has been reached mostly on lower non-core inflation, which is very volatile and has started to reverse at least in agricultural goods. Meanwhile, core inflation remains above 3%, while mid- and long-term inflation expectations have stabilized around 3.5%. Last but not least, because Banxico will likely be focused on the magnitude of the adjustment to the minimum wage for 2020, which we believe could be around 10-15%. This is particularly relevant as they have maintained this factor as a relevant upward risk for some time now, warning that strong increases could lead to cost pressures if they are not coupled with productivity gains.

*From our fixed income and FX strategy team*

**Market participants are observing a well-anchored inflation ahead of a relevant policy decision next week.** CPI in Mexico has portrayed a favorable trajectory ahead of a highly important monetary policy decision next week, in which market participants are expecting a more dovish strategy from the central bank. The yield curve is pricing in -67bps of a rate reduction for the remaining of this year (decisions to take place on November 14<sup>th</sup> and December 19<sup>th</sup>), and up to -190bps until 2020-end. Investors are focusing on the following factors in order to assess the future policy actions from Banxico: (1) Positive inflation dynamics, (2) a deeper deceleration of the economy, (3) the coordinated monetary stimuli worldwide, (4) a more resilient Mexican peso despite external shocks and idiosyncratic factors, and (5) lower effects from global geopolitical risks. Under this backdrop, inflation has been printing positive surprises in recent months (especially after the peak observed in April), and today's CPI report for the month of October was no exception. The annual headline inflation stayed close to Banxico's target of 3% (3.02%), holding the positive dynamics observed in recent months, assisted mainly by the non-core component. In a year-to-date basis, consumer prices have declined 181bps, which has eased the concerns among Banxico's board members and have also declined mid- and long-term inflation expectations. It is worth mentioning that inflation breakevens have decreased 89bps on average throughout 2019, with the 3-year tenor trading also close to the 3% objective. The core reading, which has been sticky in recent months and has increased some concerns among few voting members, depicted a mild recovery, printing an annual comparison of 3.68% from 3.75% in September, coming back to the 2018-end level after reaching a 2019-high of 3.87% in April. Overall, the inflationary landscape has significantly improved in Mexico, giving support to the thesis of more policy accommodation from the central bank in coming months. Local rates are trading with 5bps pressures, following the global selloff observed in fixed income markets worldwide amid a risk on mode. Nevertheless, we hold our trade idea of long positions in Mbono Nov'47 opened on October 25<sup>th</sup>, 2019 with an entry level of 7.24% and a target of 7.00%, as we consider that current conditions should support this segment of the yield curve, which has the more attractive relative valuation.

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