

Inflation in 2018 at 4.8% yoy, in line with our forecast

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@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

- **INEGI just published its inflation report for December**
- **Headline inflation (December): 0.70% m/m; Banorte: 0.72%; consensus: 0.73% (range of estimates: 0.64%-0.91%); previous: 0.85%**
- **Core inflation (December): 0.47% m/m; Banorte: 0.47%; consensus: 0.45% (range of estimates: 0.43%-0.47%); previous: 0.25%**
- **Inflation during the period was mainly driven by higher agricultural prices, although partially compensated by the reduction in energy, particularly low-grade gasoline**
- **With this result, inflation in 2018 stood at 4.83%, in line with our forecast, and significantly below the 6.77% in 2017. Core inflation reached 3.68% from 4.87% in the previous year**
- **We maintain our view that Banxico will keep the reference rate unchanged at 8.25% at least during 1H19**
- **The inflation landscape is positive for 3-year Mbonos**

Consumer prices increased 0.70% m/m in December. This figure was marginally higher than consensus at 0.73% and slightly closer to our 0.72% forecast. Meanwhile, core inflation edged-up 0.47%, in line with our estimate. The main deviation from our forecast came mainly from a lower contribution from agricultural goods, adding 41bps to the headline figure, while we expected 43bps, as shown in the table below. In this respect, we highlight that after two consecutive prints of significant upside surprises in this category, agricultural prices moderated significantly and contributed with a 7bps decline to the bi-weekly figure.

December inflation by components

% monthly incidence

	INEGI	Banorte	Difference
Total	0.70	0.72	-0.02
Core	0.35	0.35	0.00
Goods	0.13	0.14	-0.01
Processed foods	0.09	0.10	-0.01
Other goods	0.04	0.05	-0.01
Services	0.22	0.21	0.01
Housing	0.03	0.03	0.00
Education	0.00	0.00	0.00
Other services	0.19	0.17	0.01
Non-core	0.35	0.37	-0.01
Agriculture	0.41	0.43	-0.02
Fruits & vegetables	0.36	0.36	-0.01
Meat & eggs	0.05	0.06	-0.01
Energy & government tariffs	-0.07	-0.07	0.00
Energy	-0.07	-0.08	0.01
Government tariffs	0.01	0.01	0.00

Source: INEGI, Banorte.

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

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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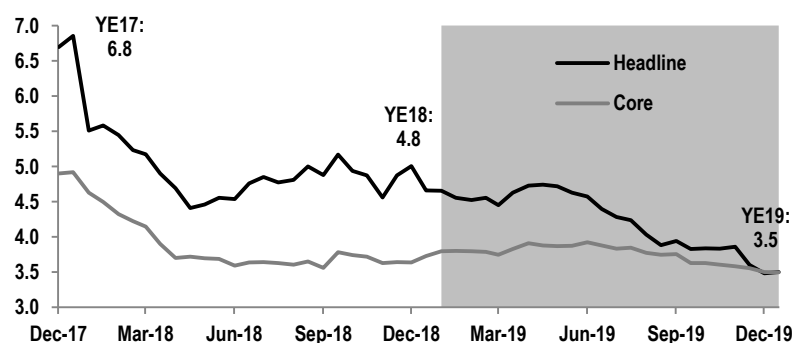
Inflation in December was explained by pressures in agricultural goods, although with some moderation in energy. In the first case, they surged 4.0% m/m, explaining 41bps of the headline figure. In particular, six out of ten generics with the highest contributions were in this category, highlighting the 13.9% increase in tomatoes, followed by husk tomatoes (25.7%), and *serrano* chilies (42.8%), among others. Nevertheless, this was partially compensated by the fall of avocados (-2.8%) and oranges (-4.3%). On the other hand, energy fell 0.7%, as explained by low- (-1.2%) and high-grade gasoline (-1.1%), as well as LP gas (-0.5%). This subtracted 7bps from the headline index.

Core inflation was in line with our expectations at 0.47% m/m. Within this category, we highlight other services at 1.1%, driven by air fares (33.2%) and tourism (13.4%) on the typical holiday seasonality. Moreover, dining away from home items increased 0.6%, a category that has been consistently pressured to the upside in recent months. In goods, processed foods picked up 0.5%, while other goods increased 0.2%, both of these without a significant upside surprise relative to recent years.

Inflation closed 2018 at 4.83% yoy, in line with our forecast, and significantly below the 6.77% in 2017. Core inflation reached 3.68% from 4.87% in the previous year. Moreover, it is worth noting that average annual inflation in 4Q18 stood at 4.8%, 10bps higher than Banxico’s estimate of 4.7% in its latest *Quarterly Report*. Average core inflation reached 3.7%, in line with the central bank’s forecast. For 2019, we maintain our year-end forecast at 3.5% yoy, slightly below the 4.0% according to the latest *Citibanamex* survey. Going forward, we remain focused on the following factors: (1) Dynamics in agricultural prices; (2) the lagged impact on gasoline from lower international oil prices and recent strength in the currency, but combined with higher excise taxes in 2019 on the new pricing policy of the current administration; (3) the behavior of core goods, particularly as Banxico remains focused on higher pass-through risks; (4) the potential effect from an above average increase in the minimum wage (for details, see: “*The National Commission for Minimum Wages agreed on a 16.2% increase for 2019*”, December 17th, 2018, [pdf](#)); and (5) the impact of lower income and VAT taxes in the Northern Border.

Headline and core inflation

% yoy



Source: INEGI, Banorte

We maintain our view that Banxico will keep the reference rate unchanged at 8.25% at least during 1H19. In our view, Banxico's latest communications have remained with a hawkish bias on the back of prevailing medium- and long-term risks for inflation and its expectations. We believe that Banxico has kept the door open for further rate hikes if needed. Nevertheless, and under current conditions, we keep our forecast that the central bank will maintain the reference rate unchanged at 8.25% at least during 1H19. This expectation is based on three factors. First, we estimate that the Mexican economy will decelerate in 2019, with our GDP estimate at +1.8% yoy from +2.1% in 2018, resulting in lower demand-side pressures given a slightly negative output-gap that could widen more at the margin. In this context, published indicators for 4Q18 already suggest a relative slowdown, in line with Banxico's comments. Second, the fall in oil prices seen in the last few months could result in lower inflation in the short-term, particularly in the non-core component. Lastly, it is likely that monetary policy normalization in the US will be slower than expected just a couple of months ago. In fact, we recently revised our expectation for the federal funds rate, seeing now only two 25bps rate hikes during 2019 (previous: 3 hikes of 25bps). In our view, this could provide some additional breathing room for Banxico to maintain the reference rate unchanged in terms of the relative monetary policy stance.

From our fixed income and FX strategy team

The inflation landscape is positive for 3-year Mbonos. CPI dynamics finished 2018 with a better tone but will continue facing short-term challenges in 2019. Nevertheless, the downward trend of annual inflation is likely to continue in coming quarters. This backdrop, in addition to a more stable MXN and a dovish Fed, could grant the central bank some leeway to hold its reference rate unchanged for some months at 8.25%. As a result, the Mexican yield curve is only pricing in 18bps of cumulative implied rate hikes in 1H19 but a stable repo rate by year-end. The 2-year forward rate is hovering around 8.50% after reaching 9.33% in late November, signaling market perception of a lower term and risk premiums embedded in local rates. With no significant surprises at today's report, the market is depicting a null reaction. In general terms, we recommend long positions in the 3-year area of the Mbonos curve as a short-term tactical trade idea, especially after the adjustment observed in the previous two sessions. On the other hand, we hold a less optimistic view in terms of CPI-linked Udibonos, as the low seasonal inflation prints in the 1H19 could affect the embedded carry in this type of securities. Moreover, 3- and 5-year inflation breakevens hovering around 3.80% are nearly 15bps below the 12-month means, suggesting an expensive relative valuation *vis-à-vis* Mbonos, while longer tenors are depicting more attractive implied inflation expectations, but with an inverted curve that is not positive in a carry-adjusted basis.

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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
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
Francisco Duarte Alcocer	Analyst	francisco.duarte.alcocer@banorte.com	(55) 1103 - 4000 x 2707
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	Analyst, 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