1H-September inflation – At Banxico's target

September 24, 2019

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- **Headline inflation (1H-Sep): 0.17% 2w/2w; Banorte: 0.20%; consensus: 0.21% (range: 0.07% - 0.30%); previous: 0.05%**
- **Core inflation (1H-Sep): 0.19% 2w/2w; Banorte: 0.25%; consensus: 0.21% (range of estimates: 0.16% - 0.25%); previous: 0.10%**
- **Dynamics during the period were impacted by the seasonal increase in education (1.9% 2w/2w, contributing 7bps), with slight pressures in some energy prices**
- **With these, annual headline inflation edged down to 2.99% from 3.16% at the end of August, virtually at Banxico's target for the first time since September 2016. Core inflation stood at 3.78%. We highlight that non-core inflation reached 0.57%, its lowest level in history**
- **We maintain our view that Banxico will cut two more times this year, each of 25bps, this Thursday and in December, with the reference rate at 7.50% by the end of 2019**
- **Today's CPI report is reinforcing investors' strong bet of a dovish cut by Banxico on Thursday. In our view, the current scenario supports our trade idea of long positions in Mbonos Nov'38 and Nov'42, which we initiated on August 16th, 2019**

Consumer prices increased 0.17% 2w/2w in 1H-September. This number was lower than consensus (0.21%), which was only 1bps above our forecast. Core inflation rose 0.19%, also below expectations (Banorte: 0.25%). The main deviation came from: (1) A lower than expected contribution in both airfares (0bps vs our +2bps) and tourism services (-1bp vs or 1bp) within other services; (2) a lower impact from other goods (+4bps vs. our +6bps); (3) a more modest contribution from fresh fruits and vegetables (0bps vs. our 3bps); and (4) higher pressures in energy prices (+3bps vs our 0bps), as shown below:

1H-Sep inflation by components
% bi-weekly incidence

	INEGI	Banorte	Difference
Total	0.17	0.20	-0.03
Core	0.14	0.19	-0.05
Goods	0.08	0.09	0.00
Processed foods	0.05	0.03	0.02
Other goods	0.04	0.06	-0.02
Services	0.06	0.10	-0.05
Housing	0.02	0.02	0.00
Education	0.07	0.08	0.00
Other services	-0.03	0.01	-0.04
Non-core	0.03	0.01	0.02
Agriculture	0.00	0.01	-0.01
Fruits & vegetables	0.00	0.03	-0.03
Meat & egg	0.00	-0.02	0.02
Energy & government tariffs	0.03	0.00	0.02
Energy	0.03	0.00	0.03
Government tariffs	0.00	0.01	0.00

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

Dynamics were impacted by the seasonal increase in education, along with some slight pressures in energy prices. Regarding the former, we observed a 1.9% 2w/2w increase, contributing with 7bps to the headline, remembering that most of the increases in tuition for kindergarten (4.9%), elementary (4.1%) and middle school (3.8%) are accounted in this period. Contrary to our expectations, there were no significant pressures in airfares and tourism services related to the September 16th holiday, which this year allowed for a long weekend. As a result, other services declined 0.2%, resulting in a -3bps contribution. On the other hand, both processed foods and other goods climbed 0.2%, similar to the same period of the previous year. All in all, the core component advanced 0.19%, explaining 14.2bps, which is higher than the 8bps bi-weekly incidence of the previous fortnight.

On the other hand, the non-core component maintained a favorable performance (+0.1%), contributing 3bps and with slight pressures in some categories within energy. In particular, low-grade gasoline was up 0.4% despite a higher subsidy to excise taxes relative to the previous period along better dynamics of both the exchange rate and the international reference price. Moreover, LP gas was higher again (0.7%), albeit with electricity down 0.4% helping overall performance. Agricultural prices remain well-behaved as they were virtually unchanged. It is worth noting that tomatoes (4%) were the only product in this category among the top ten with the largest increases. On the contrary, the most relevant declines were in onions (-9.3%), avocadoes (-3.8%), bananas (-4.6%) and pork meat (-0.6%), among others.

Annual inflation fell again, reaching 2.99% from 3.16% at the end of August. In bi-weekly terms, this represents a new low since September 2016 and the first time since then that it reaches the central bank’s target. As has been the case for several months now, this is mainly explained by the strong decline in pressures at the non-core component, which reached 0.57% yoy, the lowest in history taking into account that the bi-weekly series is available since January 1989. In particular, agricultural goods stood at 2.4% and energy at -2.9%. In our view, the risk that the former sees more pressures is higher than in the case of energy, given that the Federal Government remains committed to the policy of at least maintaining gasoline, gas and electricity prices constant in real terms during this six-year term. The core component has stayed relatively sticky as it remained unchanged when compared to the previous print. In our view, some members of the Board, such as Deputy Governor Javier Guzman, are likely to remain somewhat cautious of its dynamics. In particular, expectations are that the minimum wage will keep climbing at an above-average pace early next year, a situation that has been pinpointed by the central bank as one of the most relevant behind the resistance to the downside of this component and despite weakness in economic activity.

We expect Banxico to cut the reference rate 25bps on Thursday, to 7.75%. In our view, today’s report –which showed an additional decline in the annual rate of inflation to reach the central bank’s target– coupled with the slowdown in economic activity, provide additional room for lower rates. Moreover, we believe conditions are set for Banxico to maintain a dovish tone.

Another issue that will likely be factored-in is that the window of opportunity for easing remains open, especially because of the Fed, which last week cut the *fed funds* range by 25bps. Moreover, it is our take that domestic developments have reduced some of the uncertainty about the most acute risks to financial stability, highlighting the *2020 Budget* proposal and recent announcements on Pemex. In our view, recent comments by Board members suggest an easing bias to achieve the inflation target in the most cost-efficient way for activity. In this respect, we believe the central bank will maintain a dovish tone, likely signaling additional cuts. We maintain our view that the reference rate will be lowered again in December to end the year at 7.50%. However, we recognize that risks are skewed for two 25bps cuts, one in November in addition to the one we expect in December, which would result in a year-end level of 7.25%. For further details about this week's decision and our monetary policy expectations, see: "*Ahead of the Curve*", <pdf>, September 20th, 2019.

From our fixed income and FX strategy team

Today's CPI report is reinforcing investors' strong bet of a dovish cut by Banxico on Thursday. The market is observing another positive surprise coming from the 1H-Sep CPI report this morning, boosting the expectations of a dovish cut from Banxico on Thursday. The fortnightly reading came below consensus and the annual headline print moved to 2.99% (below the central bank's 3%) for the first time since 2016. Short-term breakevens are hovering around 3.1%, signaling that market inflation expectations are well-anchored. Moreover, longer breakevens are trading 40bps lower with respect to the previous quarter. In the aftermath of this benign inflationary landscape, local investors are debating about the magnitude of the likely rate cut on Thursday, also taking into account weaker economic data and the global easing cycle that could boost additional rate cuts from the Mexican authority. As a result, the yield curve is pricing in -79bps of implied rate cuts for the rest of the year, assessing a 100% probability of a 25bps reduction in every remaining meeting (*i.e.* September 26th, November 14th, and December 19th). In our view, the current scenario supports our trade idea of long positions in Mbonos Nov'38 and Nov'42, which we started on August 16th, 2019. Nevertheless, we have to disclose that these securities are currently breaching our expected profit-taking objectives, suggesting limited room for an additional rally.

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, Luis Leopoldo López Salinas, 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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