March inflation – Plunging gasoline prices drive annual rate to 3.2%

- **Headline inflation (March): -0.05% m/m; Banorte: 0.14%; consensus: 0.06% (range of estimates: -0.07%-0.42%); previous: 0.42%**
- **Core inflation (March): 0.29% m/m; Banorte: 0.28%; consensus: 0.27% (range of estimates: 0.24%-0.32%); previous: 0.36%**
- **The contraction was driven by non-core prices, which subtracted 27bps to the headline. Low- and high- grade gasoline plunged strongly (-7.2% and -6.3% m/m, in the same order), with the former contributing -38bps. On the other hand, agricultural goods advanced modestly (1.3%), despite pressures in meat and egg (1.8%)**
- **With today's print, annual inflation fell to 3.25% from 3.70% in February. Core inflation was broadly stable, at 3.60% from 3.66%. In our view, inflation could fall below 3.0% as soon as April, providing additional room for Banxico to keep cutting the interest rate**
- **CPI's sharp decline should benefit our trade ideas of receiving 1- and 2-year TIIE-IRS**

Consumer prices fell 0.05% m/m, an unusually low print. The core index was more stable at 0.29% m/m, virtually in line with our forecast and with a 22bps contribution. We highlight the 1.06% decline in the non-core index, helped by falling energy prices in the second fortnight. In particular, low- and high- grade gasoline plunged even more than expected, (-7.2% and -6.3% m/m, in the same order), with the former contributing -38bps, both influenced by plunging crude-oil prices. This was only partially compensated by agricultural goods (+1.3%). At the core, processed foods were slightly pressured (0.3%), in our view related to some precautionary purchases due to COVID-19 and FX dynamics. Airfares (0.3%) were only modestly up considering typically high prints ahead of the Easter holiday, while tourism services (-0.9%) inched lower, as the industry has been significantly impacted by the halt in activities.

March inflation by components
%, monthly incidence

	INEGI	Banorte	Difference
Total	-0.05	0.14	-0.18
Core	0.22	0.21	0.01
Goods	0.14	0.14	0.00
Processed foods	0.09	0.08	0.01
Other goods	0.05	0.05	-0.01
Services	0.08	0.07	0.01
Housing	0.04	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.04	0.02	0.01
Non-core	-0.27	-0.07	-0.19
Agriculture	0.14	0.22	-0.08
Fruits & vegetables	0.04	0.15	-0.11
Meat & eggs	0.10	0.07	0.03
Energy & government tariffs	-0.41	-0.29	-0.11
Energy	-0.42	-0.31	-0.12
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.

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March inflation: Goods and services with the largest contributions
% m/m; monthly incidence in basis points

Goods and services with the largest positive contribution	Incidence	m/m
Eggs	5.7	6.3
Chicken	5.2	3.6
Avocadoes	3.3	15.6
Housing (own)	3.3	0.3
Lemons	3.2	32.4
Goods and services with the largest negative contribution		
Low-grade gasoline	-37.9	-7.2
High-grade gasoline	-4-4	-6.3
Tomatoes	-3.4	-3.6
Onions	-2.6	-9.6
Husk tomatoes	-2.3	-8.7

Source: INEGI

Annual inflation falling rapidly towards the 3% target, with Banxico staying cautious. The headline came in at 3.25% y/y from 3.70% in February. This was mainly due to the non-core, standing at a two-month low of 2.19% after reversing a significant part of the previous month's acceleration, which was driven by higher agricultural goods prices –running at a still high rate of 10.0%– and challenging base effects. The core also slowed, to 3.60% from 3.66%. As mentioned above, a key driver were gasolines, which according to our monitoring are still inching lower, albeit at a more modest pace. Coupled with the widening of the output gap, we estimate an additional decline in annual inflation in the short term, with the headline below 3% as soon as April. In our view, this would help Banxico to keep cutting rates. As such, we maintain our view of two consecutive 50bps cuts each, scheduled for May 14th and June 15th, to 5.50%. Moreover, we do not rule out another intra-meeting decision, depending on the virus' and market's dynamics.

Despite of this, we perceived a still prudent stance by the Board's majority in the latest central bank minutes. On inflation, we coincide that the outlook remains very uncertain, given opposing forces for prices. To the upside, there are some concerns about building pressures on the back of the strong depreciation of the peso and potential scarcity of goods due to supply chain disruptions. In this respect, goods inched higher, to 3.8% y/y, particularly processed foods at 5.1%. On the contrary, services excluding housing and education slowed down, which may be related to the fall in gasoline prices and a wider output gap. Furthermore, and although inflation could continue declining in coming months, average headline inflation in 1Q20 stood at 3.4%, slightly above the 3.3% forecasted by Banxico in its *4Q19 Quarterly Report*. Adding to this, some members are concerned about financial stability risks, exacerbated by higher market volatility, lower oil prices, capital outflows, and the increase in country risk premiums, among other factors. In this sense, it is our take that the majority will remain cautious, weighing more the need to protect macro fundamentals as opposed to supporting growth, particularly given the relatively limited role of monetary policy when faced with supply shocks. At least for this year, we believe a decline of the reference rate meaningfully below neutral (estimated at 5.6% by the central bank) is not in their base-case scenario, given that: (1) Core inflation remains somewhat sticky; and (2) it could induce additional peso weakness via a further steepening of the yield curve and lower costs of shorting the peso, among other consequences, which could increase financial stability risks.

Nevertheless, with inflation falling more than expected, analysts' inflation expectations stable and market-implied expectations declining fast, in our view the risk is towards more aggressive cuts than we currently estimate.

From our fixed income and FX strategy team

CPI's sharp decline should benefit our trade ideas of receiving 1- and 2-year TIIE-IRS. In the aftermath of today's inflation report we expect two major effects in the local fixed income market. First, these benign dynamics (supported mainly by non-core components) should support the expectations of further easing from Banxico, with the local yield curve currently pricing-in 130bps of implied rate cuts for 2020 from 117bps a week ago. Second, this report confirms that the effect of slack of the economy combined with lower oil and gasoline prices will be a positive shock for this year, validating the sharp decline in breakevens which are trading remarkably low in short-term maturities. The 3-year reading closed yesterday's session at 2.06% and reached as low as 2.00% last week, its lowest mark since January 2016. We hold our trade idea consisting of receiving 1- and 2-year TIIE-IRS which would be benefited by lower inflation readings going forward. Since we opened this recommendation on March 20th, each security has rallied 62bps and 54bps, respectively.

Certification of Analysts.

We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Tania Abdul Massih Jacobo, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo, Jorge Antonio Izquierdo Lobato and Eridani Ruibal Ortega, 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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	Reference
BUY	When the share expected performance is greater than the MEXBOL estimated performance.
HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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