1H-April inflation – Annual rate plunges below Banxico's 3% target

April 23, 2020

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- **Headline inflation (1H-Apr): -0.72% 2w/2w; Banorte: -0.65%; consensus: -0.65% (range of estimates: -0.90% to 0.13%); previous: -0.78%**
- **Core inflation (1H-Apr): 0.20% 2w/2w; Banorte: 0.08%; consensus: 0.18% (range of estimates: -0.04% to 0.25%); previous: 0.14%**
- **Several factors explain the dip in inflation. Within non-core prices, we highlight: (1) The plunge in gasolines, with these subtracting 53bps to the headline; and (2) the seasonal decline in electricity tariffs (contribution: -25bps). At the core, we note the reduction in airfares (-6.9%) and tourism services (-3.3%), with the industry hit by the COVID-19 pandemic. On the other hand, processed foods were pressured (+0.7%)**
- **Annual inflation declined to 2.08% from 3.25%, below Banxico's target. This was driven by non-core prices at -1.93%, lowest on record. Core inflation also fell, standing at 3.40% from 3.60%, in March**
- **Given these dynamics, in addition to other factors, we expect the central bank to cut the reference rate by an additional 125bps the rest of the year. After this week's out-of-calendar 50bps cut, we expect another -50bps on May 14th, and -75bps on Jun 25th, for a year-end rate of 4.75%**
- **We expect further steepening of the yield curve and pressures in real-rate Udibonos**

Consumer prices fell 0.72% 2w/2w in the first half of April. In line with our view, both direct and indirect effects of the COVID-19 pandemic explain the most relevant falls in prices. Within non-core prices, we highlight plunging gasolines' prices, with these subtracting 53bps to the headline and extending their previous fortnight downfall. At the core, we highlight declines in airfares (-6.9%) and tourism-related services (-3.3%), with the industry hit strongly and not showing its typical Easter holiday seasonality. On the other hand, core goods were slightly pressured on processed foods (+0.7%), while other goods broadly stable.

1H-April inflation by components
%, bi-weekly incidence

	INEGI	Banorte	Difference
Total	-0.72	-0.65	-0.08
Core	0.15	0.06	0.09
Goods	0.16	0.07	0.09
Processed foods	0.15	0.07	0.08
Other goods	0.01	-0.01	0.01
Services	-0.01	-0.01	0.00
Housing	0.02	0.02	0.00
Education	0.00	0.00	0.00
Other services	-0.03	-0.03	0.00
Non-core	-0.87	-0.70	-0.17
Agriculture	-0.09	-0.03	-0.06
Fruits & vegetables	-0.18	-0.08	-0.10
Meat & eggs	0.10	0.05	0.05
Energy & government tariffs	-0.79	-0.67	-0.11
Energy	-0.79	-0.68	-0.11
Government tariffs	0.00	0.01	-0.01

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

1H-April inflation: Goods and services with the largest contributions
% 2w/2w; bi-weekly incidence in basis points

Goods and services with the largest positive contribution	Incidence	% 2w/2w
Eggs	9.2	9.3
Beer	2.4	1.9
Sugar	2.2	5.8
Housing (own)	2.1	0.2
Beans	1.9	3.9
Goods and services with the largest negative contribution		
Low-grade gasoline	-46.6	-10.4
Electricity tariffs	-25.3	-12.2
Tomatoes	-16.2	-21.7
Husk tomatoes	-6.5	-28.0
High-grade gasoline	-6.0	-9.7

Source: INEGI

Annual inflation below Banxico's 3% target, with the core also lower. The headline index came in at 2.08% y/y, significantly below the 3.25% of the previous month. In bi-weekly terms, the annual rate has plunged 179bps in the last three prints (including this), reaching its lowest since early December 2015, when it stood at 2%. This was mainly, but not exclusively, driven by the non-core component, which declined to a new record low of -1.93%. Specifically, we highlight that low- and high-grade gasoline stood at -23.8% and -21.8%, respectively, relative to the same period of 2019. To the latter, we should add that electricity tariffs declined 12.2% 2w/2w as summer discounts kicked-in, in line with the -12.3% of the same period a year ago. Moreover, agricultural goods extended their move lower, albeit with both fresh fruits and vegetables and meat and egg still relatively high, at 8.5% and 9.1% y/y, in the same order. Likewise, the core component fell to 3.40% from 3.60%. One key driver was other services (-0.2% 2w/2w), specially airfares which plunged to -28.5% y/y as prices broke with their typical seasonality ahead of the Easter holiday in both this and the previous fortnight. Tourism services also fell 18.6% y/y. This should lessen somewhat as soon as the 2nd half of the month on base effects, although likely remaining negative on protracted weakness in industry demand and ample unutilized capacity due to COVID-19. On the other hand, goods were higher, to 4.0%. This is mostly on processed foods, running at 5.7%, in our view pressured to some extent by both higher precautionary demand and some impact from FX-passthrough. In this respect, other goods stood at a more modest level of 2.3%.

Banxico to cut more aggressively in coming months. In our view, short-term inflation dynamics could remain relatively benign, with the annual rate below the 3% threshold at least until September, according to our forecast path. We believe this, along the strong global push for monetary easing and our downgrade of GDP growth to -7.8% y/y in 2020, provide additional room for Banxico to keep cutting the reference rate. Specifically, we expect the central bank to cut by an additional 125bps for the rest of the year. After this week's 50bps cut in an out-of-calendar decision, we estimate another -50bps on May 14th, and -75bps on Jun 25th, for a year-end rate of 4.75%. On the other hand, financial stability concerns keep making decisions very challenging, particularly after recent downgrades of the sovereign rating and Pemex by *S&P Global*, *Fitch Ratings* and *Moody's Investors Service*.

From our fixed income and FX strategy team

We expect further steepening of the yield curve and pressures in real-rate Udibonos. Today's fall in CPI supports our view on a steeper slope for the local yield curve, with the market currently pricing-in close to 150bps of implied cuts for Banxico's reference rate for year-end 2020. This print will reflect in Udibonos underperforming and an extension in the downward trend in inflation breakevens, especially in short-term tenors. Yesterday, the 3-year reading closed at 1.79%, a level 123bps below last year's close. In terms of strategy, on March 20th we opened a trade recommendation consisting on receiving 1- and 2-year TIIE-28 swaps, a trade that has resulted in capital gains of 136bps and 134bps, for each security. Meanwhile, we expect Udibonos to remain affected by this inflation backdrop during the quarter.

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