1H-July inflation – We adjust higher our year-end forecast to 3.7% from 3.2%

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- **Headline inflation (1H-Jul): 0.36% 2w/2w; Banorte: 0.32%; consensus: 0.33% (range of estimates: 0.14% to 0.45%); previous: 0.47%**
- **Core inflation (1H-Jul): 0.25% 2w/2w; Banorte: 0.16%; consensus: 0.14% (range of estimates: 0.06% to 0.18%); previous: 0.21%**
- **After today's report, we adjust higher our year-end inflation forecast to 3.7% y/y from 3.2%, with the core at 3.9% from 3.7% previously**
- **The core component was pressured again on higher goods (contribution: 15bps), both in processed foods and other goods. In contrast, services remain muted. At the non-core, energy prices increased 2.1% 2w/2w, adding 19bps, with low-grade gasoline leading gains. On the other hand, agricultural goods were mixed**
- **Annual inflation increased to 3.59% from 3.33% in June, highest level since March. Core inflation stood at 3.84% from 3.71% while non-core prices kept normalizing, at 2.79% from 2.16%**
- **Even though we increased our year-end inflation forecast, we believe conditions still support cuts by Banxico. We reiterate our call for two additional 50bps cuts, in August and September, for the reference rate to end this year at 4.00%**

Consumer prices up 0.36% 2w/2w in the first half of July. This was slightly above consensus at 0.33%, which was virtually in line with our forecast. We highlight that pressures were mostly at the core level (0.25% 2w/2w), pushed by the 0.36% increase in goods as processed foods were still on the upside, while other goods also went up significantly. Services remain more muted, increasing 0.1%. Nevertheless, we noted higher prices in airfares (6.5%) and restaurants (0.4%), possibly influenced to some extent by the holiday period but also a more widespread economic reopening. The non-core contributed 17bps. In these, we still highlight energy prices (2.1% 2w/2w), with both gasolines and LP gas higher. Agricultural goods retraced 0.3%, with a more mixed performance, with fresh fruits and vegetables down but meat and egg up.

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

	INEGI	Banorte	Difference
Total	0.36	0.32	0.03
Core	0.19	0.12	0.07
Goods	0.15	0.08	0.07
Processed foods	0.07	0.06	0.01
Other goods	0.08	0.02	0.06
Services	0.04	0.04	0.00
Housing	0.01	0.01	0.00
Education	0.00	0.00	0.00
Other services	0.03	0.03	0.00
Non-core	0.17	0.20	-0.04
Agriculture	-0.03	0.03	-0.06
Fruits & vegetables	-0.05	0.06	-0.11
Meat & eggs	0.02	-0.03	0.05
Energy & government tariffs	0.20	0.17	0.02
Energy	0.19	0.17	0.02
Government tariffs	0.01	0.00	0.00

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

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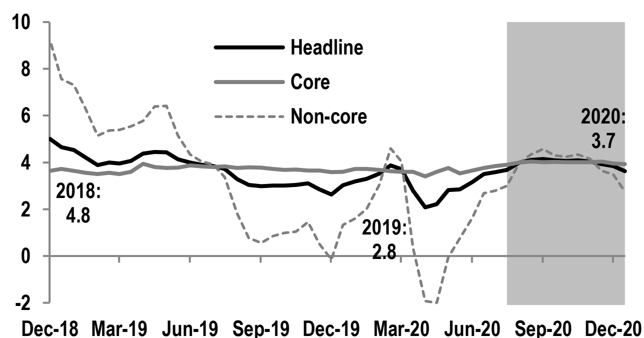
1H-July inflation: Goods and services with the largest contributions
% 2w/2w; bi-weekly incidence in basis points

Goods and services with the largest positive contribution	Incidence	% 2w/2w
Low-grade gasoline	14.6	3.0
Chicken	2.5	1.6
LP Gas	2.4	1.2
Beer	2.1	1.5
Potatoes	2.0	5.9
Goods and services with the largest negative contribution		
Serrano chilies	-2.5	-18.3
Tomatoes	-2.2	-3.7
Grape	-1.1	-17.9
Avocadoes	-1.0	-3.6
Husk Tomatoes	-0.9	-7.0

Source: INEGI

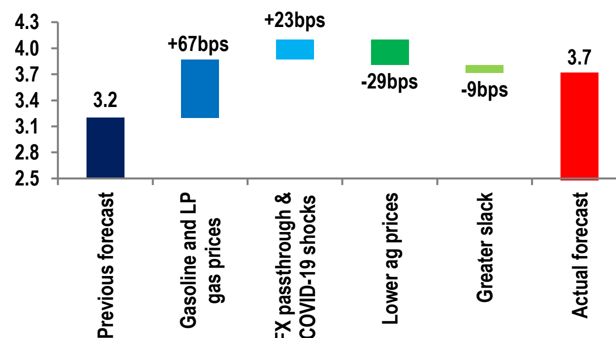
We adjust our year-end inflation forecast to 3.7% from 3.2%. Moreover, we also move higher our core inflation estimate, to 3.9% from 3.7% previously (chart below, left). Both are higher than market expectations, with the latest central bank survey placing them at 3.3% and 3.6%, in the same order. We should mention that, with today's print, annual inflation picked up to 3.59% from 3.33% in June and after being as low as 2.15% at the end of April. Broadly speaking, the non-core would add around 38bps more to our year-end forecast, reaching 3.1% y/y from 1.9% previously, with higher energy prices partially compensated by lower agricultural goods. On the other hand, the core would contribute about 20bps more, mainly on a combination of higher pressures in goods but with even greater slack than anticipated before –mostly on COVID-19 shocks, dampening relatively more prices of some services in a backdrop of very low demand–, as shown in the chart below to the right.

Inflation forecasts
% y/y, bi-weekly frequency



Source: Banorte with data from INEGI

Year-end 2020 headline inflation forecast
% y/y unless otherwise stated



Source: Banorte

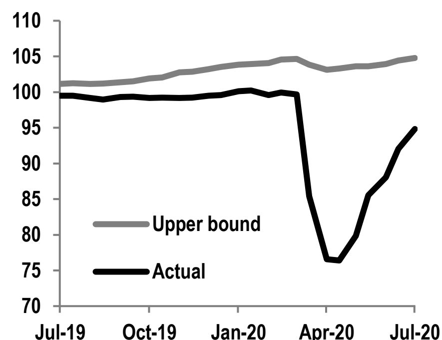
We see higher energy prices... Our most significant upward revision was in gasoline prices. First, we incorporate recent dynamics that have shown a stronger rebound than we had anticipated. Specifically, international crude oil prices have reacted with some optimism about a recovery in demand –despite concerns about a second wave of contagion of COVID-19– on the back of higher stimulus (particularly in developed economies) and the OPEC+ agreement to cut production, among other factors. In our view, even in the case of a second wave of contagion, governments will not be keen to impose nationwide restrictions as strict as those in April and May, given their impact on the economy.

Moreover, the futures curve, coupled with our projected path for the exchange rate, point to greater pressures. Domestically, we believe conditions suggest there is still ample room for an even more sizable move higher. According to our calculations, subsidies to excise taxes –which have stayed at zero since early March 2020– are still some away in the horizon, with a potential move of about +6%-8% from current levels before they could be started to be considered again. Nevertheless, we must add that the government's fiscal space is more limited given the shock to revenues due to lower economic activity, as shown by recent public finance reports and savings efforts via austerity measures –including orders to cut current spending by 75% in some ministries, and the elimination of bonuses and wage cuts to high-ranking officials–, among others. Therefore, and assuming no subsidies are applied as before, we estimate there is around 9.5% of upside in low-grade gasoline prices (see chart below to the left) before the government would start not complying with the commitment of maintaining prices constant in real terms. Another category in which we already accumulate more increases than expected is LP gas, which as of the first half of July is already running at 11.8% y/y.

…along greater passthrough to processed foods… Another important driver behind our revision is persistent upside in core goods, which stand at 5.19% from 3.56% at the end of last year. Within this category, most pressures have been in processed foods, contributing more so far in 2020 than its 5-year historical average (see chart below, middle), and currently at 6.89% y/y. First, we recognize some of this may have been related to: (1) Hoarding behavior –particularly by the end of March through the beginning of April– as demand for essential goods picked up; and (2) supply chain disruptions, both locally and globally, on restrictions to activity. Both are directly related to the pandemic and will likely be less important as the economy gradually reopens. Nevertheless, and in second place, the fact that pressures have not waned more meaningfully have signaled us additional factors behind their performance. In our view, the most relevant is higher passthrough from exchange rate weakness and energy prices, especially as the effect of slack in this category is likely to be much lower than in other components. This would be due to their characteristic of being essential and the relative shift in consumption patterns towards non-durable goods. As a result, we see this category as extending recent price increases.

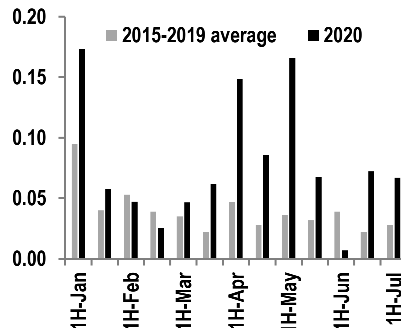
…which would more than compensate for higher slack in other goods and services. In contrast, other goods and services (see chart below, right) would be affected relatively more by the widening of the output gap. In the latter, we highlight housing (which has been undershooting more meaningfully since late April), airfares and tourism services, as those more impacted to the downside. We believe these components will feel most the effect of higher economic slack, with each of them ending the year significantly below Banxico's 3% target.

Low-grade gasoline
Index (100= Nov-2H, 2018),



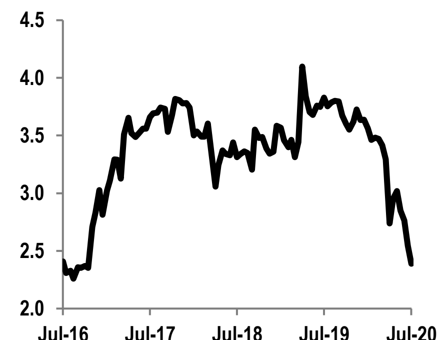
* The upper-bound is the level at which accumulated inflation in low-grade gasoline would match the headline since Nov-2H, 2018
Source: Banorte with data from INEGI

Processed foods contribution to inflation
Bps, quarterly basis



Source: Banorte with data from INEGI

Services inflation
% y/y, bi-weekly frequency



Source: INEGI and Banorte

We reiterate our call of additional rate cuts by Banxico. Specifically, we maintain our view of two additional cuts this year, each of 50bps, in August 13th and September 24th, for the reference rate to end the year at 4.00%. In our view, recent central bank communications –including the minutes of the latest decision, which showed a more dovish tone–, suggest the majority still sees room for additional declines. Despite our upward revision in the inflation outlook, we think that this is currently not the top short-term concern of the central bank. In turn, they will likely continue reducing the rate given that: (1) The outlook for global and domestic growth has worsened at the margin, even before considering the possibility of a second wage of contagion worldwide; and (2) monetary policy easing measures in both developed- and emerging-markets provide more leeway to cut without substantially increasing financial stability risks. On the other hand, our view for prices strengthens the case that they will likely keep a prudent approach and will remain very cautious, particularly as the core could trend higher to finish the year only slightly below the upper bound of Banxico's variability range around the target. In this sense, we believe this also supports the case that it is relatively unlikely that the easing cycle could take the reference rate towards the 3.00% minimum observed between mid-2014 to late-2015, not only because of the need to safeguard the mandate, but also because more fragile conditions in terms of risk premia for Mexican assets and the mid-term outlook for the economy.

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