June inflation – Year-end forecast revised to 6.1% from 5.5%, with 2022 at 4.0%

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- **Headline inflation (Jun): 0.53% m/m; Banorte: 0.55%; consensus: 0.52% (range of estimates: 0.45% to 0.61%); previous: 0.20%**
- **Core inflation (Jun): 0.57% m/m; Banorte: 0.56%; consensus: 0.56% (range of estimates: 0.50% to 0.59%); previous: 0.53%**
- **Non-core inflation picked up 0.42%m/m, noting energy at 0.9%, particularly pressures in LP gas (2.9%). Agricultural goods were flat, with some relief at the margin on less severe droughts. At the core, goods grew 0.7%, with processed foods still high (0.8%), while others (0.5%) were likely helped modestly by the start of summer discounts. Services (0.5%) accelerated relative to May, still adjusting to a wider reopening**
- **Annual inflation was almost unchanged, at 5.88% from 5.89% in May, with the core at 4.58% from 4.37% in the same period. Given recent pressures and other factors, we adjust our year-end forecast to 6.1% from 5.5%, while establishing our inflation estimate for the close of 2022 at 4.0%**
- **The local yield curve integrates a modestly excessive pricing for Banxico**

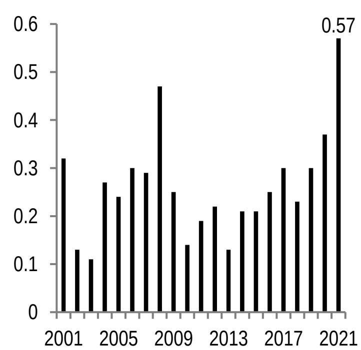
Inflation at 0.53% m/m in June. This was in line with consensus but below our estimate, mostly on the core which picked up 0.57%, surprising upwards since the first half. We saw a modest relief in goods in the 2nd fortnight, albeit up 0.7% m/m. Within processed foods (0.8%), corn tortillas moderated, while other goods (0.5%) were likely benefitted in the second half by the start of summer discounts –and Amazon's *Prime Day*–, mainly in clothing. Services (0.5%) are probably responding to a wider reopening and some cost pressures, with lingering concerns about restaurants. The non-core rose 0.42%, highlighting energy (0.9%), particularly LP gas (2.9%) given higher global reference prices, with low-grade gasoline up 0.1% as excise tax subsidies increased. Agricultural goods (0.0%) seem to be moderating as drought conditions have started to lessen in our country. Fresh fruits increased 0.7% and meat and egg stood at -0.4%

June inflation by components
%, monthly incidence

	INEGI	Banorte	Difference
Total	0.53	0.55	-0.01
Core	0.43	0.42	0.01
Goods	0.26	0.25	0.01
Processed foods	0.16	0.15	0.00
Other goods	0.10	0.09	0.01
Services	0.17	0.17	0.00
Housing	0.03	0.03	0.00
Education	0.00	0.00	0.00
Other services	0.14	0.14	0.00
Non-core	0.10	0.13	-0.02
Agriculture	0.01	0.02	-0.01
Fruits & vegetables	0.03	0.04	-0.01
Meat & egg	-0.03	-0.02	0.00
Energy & government tariffs	0.10	0.11	-0.01
Energy	0.09	0.10	-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.

Core inflation in June
% m/m



Source: INEGI

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

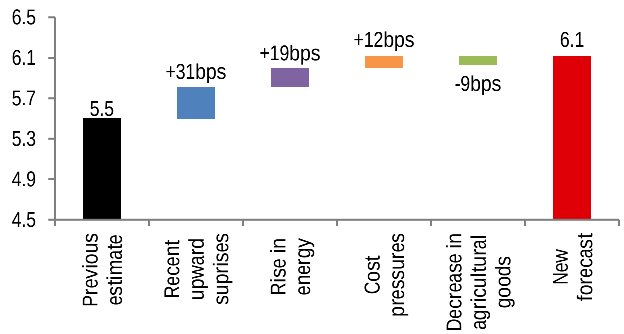
Goods and services with the largest positive contribution	Incidence	% m/m
Tomatoes	10.9	18.9
LP Gas	7.0	2.9
Dining away from home	4.7	1.0
Corn tortillas	3.4	1.7
Airfares	3.4	15.1
Goods and services with the largest negative contribution		
Eggs	-6.4	-7.2
Serrano chilies	-2.7	-22.6
Husk tomatoes	-2.4	-15.2
Lemon	-2.0	-15.2
Grapes	-1.3	-16.7

Source: INEGI

Annual inflation relatively sticky. This metric was almost unchanged, at 5.88% from 5.89% in May despite a less challenging base effect. This suggests other pressures that are more than compensating for the latter. In this respect, we highlight that core inflation stood at 4.58% from 4.37%, despite being broadly stable between the same periods in 2020. In turn, the non-core fell to 10.00% from 10.76% previously. As we have said before, base effects will keep being less challenging until early September. Nevertheless, recent dynamics –especially stickiness at the core– suggest this may not be as favorable as previously thought.

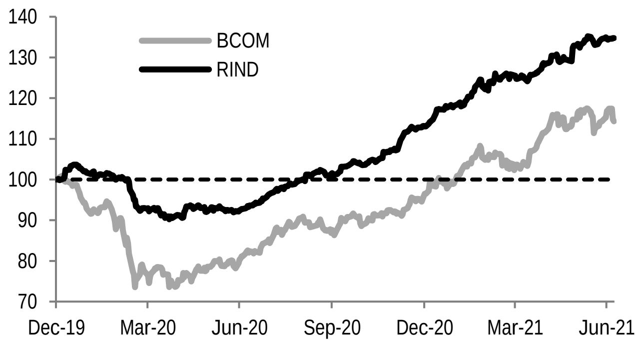
We revise our year-end forecast again, to 6.1% from 5.5%. Moreover, and given the stickiness mentioned above, we now expect core inflation at 4.7% by the end of the year, about 50bps higher than our previous estimate. We believe higher core inflation, particularly on services as the economic reopening extends further, could contribute 14bps more. Apart from this, cost pressures due to supply restrictions, as well as higher energy costs (highlighting persistent increases in LP gas, influenced by global prices, among other factors) are likely to keep affecting key categories such as 'dining away from home' and restaurants. Apart from these, and as shown in the chart below (see chart below, left), our revision also considers: (1) Additional upward surprises in recent inflation prints; (2) Oil prices that keep climbing, reaching new highs this week after the *impasse* on production quotas in the latest OPEC+'s meeting; (3) other commodities stabilizing but still at relatively high levels yet, as shown by some market indices such as BCOM (which is a diversified basket) and RIND (more focused on industrial goods), as shown in the chart below on the right, On the other hand, we also factored in (4) Agricultural goods that may be less pressured at the margin, as they have already accumulated important increases this year, especially in fresh fruits and vegetables, affected by severe drought conditions. The path for the remainder of the year shows that a 5.5% low will be seen in August (in bi-weekly terms), hovering around this point to then accelerate in November –partly due to a less favorable base due to the extended '*Buen Fin*' (Mexico's Black Friday) in 2020– towards 6.1%. Lastly, and very relevant, the core would show a mild uptrend in the rest of 2021. This would be consistent with a wider reopening, with relative prices still adjusting and gradually normalizing after the strong distortions triggered by the pandemic.

2021 inflation estimate
% y/y, contribution in basis points



Source: Banorte

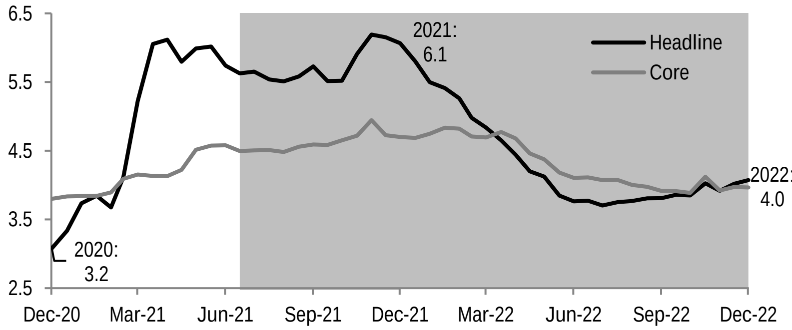
Commodities indices
Base 100 = December 31st, 2019



Source: Banorte with data from Bloomberg

Moreover, we establish a 2022 forecast of 4.0%. The estimate incorporates two broad assumptions: (1) That the global recovery will likely enter a period similar to the late stages of economic cycles, with commodities prices and other inputs more stable given an already strong rebound this year and a more modest impulse from stimulus; and (2) a limited effect of a possible fiscal reform, not expecting any meaningful changes on VAT rates that could trigger price pressures. By categories, we think the core will moderate, albeit in a gradual manner, still impacted by pressures related to continued progress on the pandemic –especially on vaccinations. Specifically, we expect some differences between goods and services, still with adjustments in the first half of the year as dynamics normalize. For the former, we expect lower pass-through both from energy and the exchange rate as they would show more stability, while supply chains disruptions could also decrease as new supply starts to enter the market. On the latter we still expect increases, including in education as students return to in-person classes, albeit still partly offset by lingering slack in housing (maintaining excess supply). Going to the non-core, agricultural prices might continue to show above average pressures given adverse weather conditions on a more frequent basis and with higher intensity, influenced by climate change. Energy could consolidate, with cyclical conditions and actions from OPEC and its allies fostering more stable prices, benefiting dynamics in gasolines. Nevertheless, uncertainty prevails on LP gas, still awaiting results from an investigation by the *Mexican Federal Economic Competition Commission* (COFECE in Spanish) over price manipulation in distribution, which in turn may be pushing prices higher. On the path, we expect headline inflation to return to levels near the upper bound of the range around the target in June (with a low of 3.7% in late July), albeit ending the year at 4.0%. Unfortunately, the core would remain sticky, also near 4.0% by mid 3Q21 and until the end of the year, as seen in the following chart.

Inflation trajectory
% y/y, bi-weekly frequency



Source: INEGI, Banorte

Given the complex price outlook, we believe Banxico has started a hiking cycle. Specifically, and after the last and unexpected decision by the central bank, we think the restrictive cycle has started. In this sense, we expect four consecutive 25bps hikes, with the reference rate closing the year at 5.25%. This would take it slightly below neutrality, which the monetary authority has estimated at 5.6%. In our view, the challenging inflation outlook, including the resistance to the downside of the core, will keep convincing the Board's majority to extend the tightening in coming months to ensure the anchoring of expectations. In addition, we believe the Fed's tapering announcement will be as soon as September, while some EMs have also started hiking. This points to the possibility of a more complex global environment going forward that also supports the need of a more cautious stance ahead.

From our fixed income and FX strategy team

The local yield curve integrates a modestly excessive pricing for Banxico. CPI pressures will keep supporting an elevated valuation for Udibonos, with inflation breakevens picking-up in the last days and the 3-year tenor close to 4.60%, touching 4.95% at the end of June which matched a fresh high since 2010. We acknowledge the carry attractiveness in these securities, although we prefer to wait better entry levels amid potentially more attractive valuations in mid-term tenors. Moreover, broader market uncertainty has increased materially, as reflected in the 10-year Treasury trading at February lows of 1.25%. Meanwhile, the market is currently pricing in implied hikes for Banxico of 119bps by December, a valuation we see as modestly excessive.

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We, Gabriel Casillas Olvera, Alejandro Padilla Santana, Delia María Paredes Mier, Juan Carlos Alderete Macal, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Francisco José Flores Serrano, Katia Celina Goya Ostos, Santiago Leal Singer, José Itzamna Espitia Hernández, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo, Eridani Ruibal Ortega and Juan Barbier Arizmendi, 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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