July inflation – Banxico to keep increasing rates on price pressures at the core

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- **Headline inflation (July): 0.59% m/m; Banorte: 0.57%; consensus: 0.56% (range: 0.50% to 0.61%); previous: 0.53%**
- **Core inflation (July): 0.48% m/m; Banorte: 0.51%; consensus: 0.49% (range: 0.45% to 0.53%); previous: 0.57%**
- **Recent trends remain broadly unchanged. Within the core, processed foods (0.8% m/m) are still pressured, highlighting again corn tortillas (2.4%). Services (0.4%) keep showing more dynamism at the margin, with lingering concerns in non-tourism categories. Non-core inflation advanced 0.93%, mostly from LP gas (5.8%), which has led to new government measures for this good. Agricultural goods have moderated (0.7%), albeit with an uptick in key categories driving prices up**
- **Annual inflation fell to 5.81% from 5.88% in June. More importantly though, the core increased to 4.66% from 4.58%, way above Banxico's target. Given the difficult backdrop for prices, we expect the central bank to hike the rate by 25bps this week, to 4.50%**
- **The market fully prices-in a 25bps rate hike on Thursday**

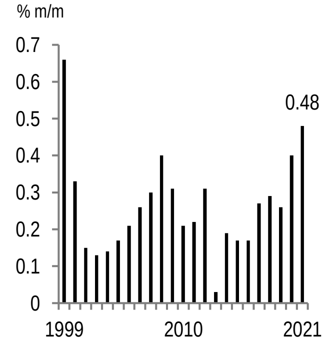
Inflation at 0.59% m/m in July. This surprised slightly to the upside again. The core picked up 0.48%, extending pressures seen since the first half. In this sense, trends within the latter were broadly unchanged. Processed foods led the move (0.8%), with renewed pressures in corn tortillas (2.4%) after moderating last month, as well as sodas (0.7%). Other goods (0.3%) stabilized somewhat, likely benefitted by summer discounts in clothing. In services, some tourism-related categories started to moderate. Nevertheless, we remain concerned about non-tourism categories, in our view still affected by higher costs. At the non-core, energy (1.5%) is still trending higher despite modest changes in gasolines, thus, driven by LP gas (5.8%). This has led to new government measures for this good (see below). Agricultural goods were more modest again (0.7%), albeit with increases in key categories such as onions (+19.4%) and chicken (+0.9%) driving the figure higher.

July inflation by components
%, monthly incidence

	INEGI	Banorte	Difference
Total	0.59	0.57	0.02
Core	0.36	0.38	-0.02
Goods	0.23	0.24	-0.01
Processed foods	0.17	0.18	-0.01
Other goods	0.06	0.06	0.00
Services	0.13	0.14	-0.01
Housing	0.03	0.03	0.00
Education	0.00	0.00	0.00
Other services	0.09	0.11	-0.01
Non-core	0.23	0.19	0.04
Agriculture	0.08	0.04	0.04
Fruits & vegetables	0.04	0.00	0.04
Meat & egg	0.04	0.04	0.00
Energy & government tariffs	0.15	0.15	0.00
Energy	0.15	0.15	0.00
Government tariffs	0.00	0.00	0.00

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

Core inflation in July
% m/m



Source: INEGI

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July 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
LP Gas	14.2	5.8
Corn tortillas	4.7	2.4
Dining away from home	3.7	0.8
Onions	3.0	19.4
Beef	2.9	1.3
Goods and services with the largest negative contribution		
Eggs	-1.8	-2.2
Husk tomatoes	-1.5	-11.0
Grapes	-1.3	-18.9
Tomatoes	-1.3	-1.9
Lemons	-0.8	-6.7

Source: INEGI

Annual core inflation higher for eight consecutive months. Headline inflation fell at the margin, at 5.81% from 5.88% in June, helped further by base effects. Nevertheless, and more importantly, the core reached 4.66% from 4.58%, highest since December 2017. The non-core fell to 9.39% from 10.00%. In the latter, we highlight that LP gas has surged 35.0% y/y, in our view affecting other components. In this sense, uncertainty about short-term dynamics has increased as the federal government established a price ceiling for this good, starting in August. According to our calculations, this could have a contribution of as much as -27bps in the bi-weekly print for the first half of the month. Moreover, we will look closely to its evolution in coming months, particularly as global prices remain high on optimism about the recovery, among other factors. In our view, core dynamics will remain a concern for most Banxico members despite the possibility of more modest energy prices, as it is likely that it will remain above the upper limit around the target at least until 4Q22, according to our forecasts.

Banxico to hike the reference rate by 25bps this week, to 4.50%. We think inflation dynamics reaffirm the need to keep hiking, with Banxico slated to do so on Thursday. For details, see our document, *Ahead of the Curve*. It is our take that details will be key, including: (1) The vote tally, with unanimity –or only one dissenter– strengthening the case that a hiking cycle has begun; and (2) the magnitude of adjustments in inflation forecasts and the expected convergence to the target, which will be released with the statement. If the former happens and/or the latter is delayed further, market participants may increase their bets of more hikes, consistent with our call that the reference rate will end this year and next at 5.25% and 6.00%, respectively.

From our fixed income and FX strategy team

The market fully prices-in a 25bps rate hike on Thursday. This Monday's CPI will strengthen the market expectation of a 25bps rate hike on Thursday, with the yield curve currently pricing in accumulated implied hikes for 54bps for the 3Q21. Moreover, despite the breather in global rates today after the sell-off driven by US Treasuries last week, today's session could hold Mbonos and TIIE-28 swaps under pressures against a more defensive performance in short- and mid-term Udibonos, resulting in wider inflation breakevens whose performance has resumed an upward trend after some stability in previous weeks. Particularly, the 3-year reading stands at 4.48% from 4.29% a week before and 4.53% the previous month. In terms of strategy, we hold a view favoring further flattening of the yield curve, though limited for now, and greater relative value in mid-term Udibonos.

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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, Alik Daniel García Alvarez, Víctor Hugo Cortes Castro, Hugo Armando Gómez Solís, Miguel Alejandro Calvo Domínguez, Luis Leopoldo López Salinas, Leslie Thalía Orozco Vélez, Gerardo Daniel Valle Trujillo 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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