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May inflation – Downward surprise, although risks continue


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- **Headline inflation (May): -0.19% m/m; Banorte: -0.04%; consensus: -0.07% (range: -0.17% to 0.02%); previous: 0.20%**
- **Core inflation (May): 0.17% m/m; Banorte: 0.24%; consensus: 0.25% (range: 0.23% to 0.27%); previous: 0.21%**
- **Similar to April, the result was driven in large part due to the performance in the 1st fortnight, specifically from summer discounts to electricity (-21.5% m/m). Remaining energy items were mixed again, with LP gas extending lower (-3.1%). In agricultural goods, increases continued (0.7%), with a contrasting performance in the latter part of the month. Within the core, we highlight the positive seasonality from the *Hot Sale* in several fronts. As such, goods (0.1%) were better at the margin, but with services higher (0.3%) as several of prevailing trends continuing**
- **With this, annual inflation kept accelerating in May, now at 4.69% from 4.65% in April. The core kept moderating, reaching 4.21% (previous: 4.37%)**
- **Considering price dynamics so far, we believe Banxico will no longer cut rates in June. Moreover, the gradual approach would extend to the remainder of the year, now expecting the rate at 10.50% by the end of December (previous: 10.00%)**

Inflation of -0.19% m/m in May. Much of the result was dictated by the performance during the 1st fortnight of the month, where we noted the 21.5% m/m decline in electricity as the second tranche of summer discounts came into effect, as is typical in the period. Remaining energy items were mixed again, with LP gas falling 3.1%, but with gasoline up 0.7% –although with a more modest increase in the second half of the month. Agricultural goods extended higher, up 0.7%. The increase was more limited in fruits and vegetables (0.2%) than in meat and egg (1.1%), highlighting pressures in tomatoes and serrano chilies within the former, with eggs leading the latter. Government tariffs remained low at 0.1%. Moving to the core (0.17%), a positive factor in the latter part of the month was the *Hot Sale* discount period, helping to lower prices in several categories. The benefits were most marked within 'other goods' (-0.1%), as well as some tourism items –mainly services (-3.0%)– within 'other services' (0.3%). Nevertheless, some components within the latter maintained some upward pressures. Processed foods were relatively stable (0.2%), while housing (0.4%) accelerated at the margin –mainly driven by a stronger-than-anticipated advance in the first half.

May 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	7.5	11.1
Egg	4.3	4.7
Housing	3.9	0.4
Serrano chilies	3.5	22.5
Low-grade gasoline	3.2	0.7
Goods and services with the largest negative contribution		
Electricity	-37.6	-21.5
Onions	-7.8	-25.1
LP gas	-5.0	-3.1
Husk tomatoes	-2.1	-10.8
Melon	-1.5	-18.0

Source: INEGI

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BANORTE

Annual headline inflation continues to rise, with the core still moderating. With this result, annual headline inflation rose to 4.69% from 4.65% y/y in April, marking three months of upward adjustments. Inside, the non-core rose to 6.19% from 5.54%, driven in large part by a more challenging base effect, albeit with other factors also at play (mainly fruits and vegetables). The core kept moderating, now at 4.21% (previous: 4.37%). As mentioned in our last *View from the Top*, we identified risks to both components, which we will be following closely in coming fortnights. Returning to some of the most recent developments relative to the document, drought levels at the end of May deteriorated further, particularly those catalogued as 'moderate' and 'severe'. Thus, around 86% of the national territory faces some type of affectation. Regarding energy, the most relevant event was the last OPEC+ meeting, where supply restrictions will be reduced gradually starting in October. In view of this, crude oil and other hydrocarbons adjusted downwards –although reversing some part in the last couple of days. Turning to the core, today's report continues to confirm our concerns about services –which remain quite elevated at 5.2%. As we elaborated recently, the factors that are impacting them appear to be more structural. Hence, their persistence to the upside could be more prolonged. In goods, improvements continue, reaching 3.4%, their lowest level since April 2016.

We no longer expect a cut from Banxico in June, with the focus on gradual moves persisting in the remainder of the year. As we have mentioned in recent publications, the central bank's Board has been more emphatic in mentioning that the next adjustments will be subject to new data. Thus, with today's inflation, the quarter-to-date average for the headline stood at 4.7% –above the 4.6% forecast of the institution in its last statement. To achieve this goal, the monthly figure for June would have to be between -0.26% and 0.00%, which seems very difficult considering that the average over the last ten years has been +0.32%. The situation for the core is better at the margin, with an average so far of 4.3%, in line with Banxico's estimate, which makes it easier to achieve. Doing the same exercise, the sequential metric for the last month of the quarter should be between 0.27% and 0.52% for this to materialize, compared to a 10-year average of 0.35%. This is relevant considering that we believe one of the dovish members, Omar Mejia –who would seek to push for the cut-–mentioned in the previous minutes that "*...an adjustment to the policy rate at the next meeting could be considered if the intermediate inflation targets, such as the inflation forecast, are met...*". Considering that one of them could be met –likely the core–, but the other seems more complex –the headline–, doubts arise as to which way he might go. If we add this to a marginally more restrictive stance from Galia Borja and a clearly hawkish position from Irene Espinosa and Jonathan Heath, it is our take that, in the aggregate, members will vote to keep the reference rate unchanged at 11.00% at their next meeting on June 27th. Following this, and with uncertainty around the inflation outlook continuing, we believe the pause would be longer, with the next cut materializing until September (in a -25bps magnitude). Continuing with a gradual approach –and recognizing some noise around the US election– we would expect the rate to stand unchanged in November, with a last 25bps reduction in December. With this, the rate would close the year at 10.50% (previous: 10.00%).

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