

May inflation – Further signals of fewer pressures in both components

- **Headline inflation (May): -0.22% m/m; Banorte: -0.20%; consensus: -0.18% (range: -0.22% to 0.01%); previous: -0.02%**
- **Core inflation (May): 0.32% m/m; Banorte: 0.33%; consensus: 0.32% (range: 0.19% to 0.35%); previous: 0.39%**
- **As already known, most of the fall was driven by electricity tariffs (-21.2%), subtracting 37bps to the headline. Domestic gas (-3.2%) and low-grade gasoline (-0.1%) within energy (-4.8%) also helped. Agricultural goods had few changes (-0.3%). At the core, we highlight goods (0.3%), which kept moderating at the margin. Nevertheless, in services (0.2%) lingering pressures remain in ‘others’ (0.3%)**
- **Annual inflation dropped to 5.84% from 6.25%, below 6% for the first time since August 2021. The core also diminished but remains elevated, at 7.39% from 7.67% previously**
- **Broadly speaking, results are consistent with Banxico’s forecasts for the next two quarters. Based on this and recent information from the Board, we still believe that the reference rate will stay at 11.25% for the rest of the year**
- **May’s inflation supports the end of Banxico’s hiking cycle**

Inflation at -0.22% m/m, below recent averages. As already known, this is to a great extent because of a favorable seasonality due to the second tranche of electricity tariff subsidies. Apart from this, energy (-4.8%) was helped also by other items, among them LP gas (-2.9%) and low-grade gasoline (-0.1%). We think that better supply conditions, fears of a global recession, and MXN strength have helped these goods. Agricultural goods (-0.3%) were more stable, albeit also lower. In fruits and vegetables (0.3%), we noted increases in potatoes, but with lemons lower; in livestock (-0.8), the decline in chicken and eggs. The core (0.32%) also improved at the margin, even though the non-core still explains most of inflation’s decline. We highlight goods (0.3%) as they maintained more favorable signals, with ‘others’ (0.1%) likely more benefited from Hot Sale discounts. Hence, Banxico’s focus will stay on services (0.3%), which remain high despite a favorable seasonality.

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
Potatoes	5.7	13.8
Housing	3.2	0.3
Dining away from home	2.8	0.6
Restaurants	1.9	0.7
Oranges	1.9	9.3
Goods and services with the largest negative contribution		
Electricity	-37.4	-21.2
Lemon	-4.7	-24.0
LP Gas	-4.6	-2.9
Chicken	-2.4	-1.4
Eggs	-2.4	-2.2

Source: INEGI

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Annual inflation will keep falling despite potential setbacks from the non-core. Headline inflation declined to 5.84% y/y from 6.25% in the previous month, while the core stood at 7.39% from 7.67%. The latter has been moving down for the last four months and is more than 100bps below its high of 8.51% in November 2022. Moreover, it is quite likely that both keep decreasing, recalling that base effects will remain very favorable at least until September or October. More importantly though, and based on our forecasts, average annual headline inflation in 2Q23 and 3Q23 will likely be meaningfully below Banxico's current estimates for said periods. As we have mentioned before, it is more complicated for the core, currently in line with the central bank's forecasts for the second quarter. This is relevant as it provides some room for negative surprises in prices without implying the need for further upward adjustments in estimates, especially in the case of the non-core. On the latter, [Saudi Arabia announced a voluntary daily cut of 1 million barrels of crude oil](#) in July in a bid to 'stabilize the market' and push prices. Higher temperatures are also seen in the US, which could pressure natural gas. So far, these have not had a sizable impact on international benchmarks. On the other hand, the global food price index from the UN fell to two-year lows in May. Nevertheless, wheat has increased about 6% in the last five days as the war between Russia and Ukraine escalates. This led to the destruction of a dam that flooded a zone that could complicate logistics and transportation of grains to the three ports that form part of the deal between both countries to ensure these goods keep flowing to the markets. Apart of the potential impact from these events, other risks to the upside include: (1) More vigorous global growth and less recession fears, especially in China, which could lift commodity prices more broadly; and (2) strong volatility, risk aversion, or other factor that weakens the MXN, in our view key as it has helped to mitigate pressures in tradeable goods. In our view, these two factors could be increasingly important in the second half, which in turn could affect current price dynamics.

Banxico should remain vigilant, maintaining the rate at its current level for the rest of 2023. Considering current inflation prints and the central bank's forecasts, comments from Board members, the [1Q23 Quarterly Report](#) and the [minutes of the last meeting](#), we reiterate our call that Banxico has already reached the terminal rate of this restrictive cycle. Therefore, the debate has shifted to when could rate cuts begin. The market is pricing-in about 50bps in cuts this year. In contrast, we believe that they will be more cautious and could start easing until the start of next year, as a rebound at the non-core –as already mentioned– could induce more pressures to headline inflation and even to the core. Although the latter will keep falling, it will do so at a more modest pace, an additional reason for the central bank to stay prudent.

From our fixed income and FX strategy team

May's inflation supports the end of Banxico's hiking cycle. The report will support the market's perception that Mexico's tightening cycle is over, even though US swaps reflect a high probability of a 25bps hike by July. In addition, investors expect Banxico to cut earlier and by a greater magnitude relative to the Fed towards the end of the year, with the curve pricing-in -55bps for the former and -25bps for the latter. This is contrary to our call of an unchanged reference rate at 11.25% for the remainder of the year. In this backdrop, breakevens for all maturities are close to 12-month lows.

For example, the 3-year breakeven stands at 4.59%, only 4bps above said low. However, carry embedded in CPI-linked bonds (Udibonos) is not attractive considering inflation's downward trend, so we continue to prefer nominal vs. real rates.

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We, Alejandro Padilla Santana, Juan Carlos Alderete Macal, Alejandro Cervantes Llamas, Manuel Jiménez Zaldívar, Marissa Garza Ostos, Katia Celina Goya Ostos, Francisco José Flores Serrano, José Luis García Casales, Víctor Hugo Cortes Castro, José Itzamna Espitia Hernández, Carlos Hernández García, Leslie Thalia Orozco Vélez, Hugo Armando Gómez Solís, Yazmín Selene Pérez Enríquez, Cintia Gisela Nava Roa, Miguel Alejandro Calvo Domínguez, José De Jesús Ramírez Martínez, Gerardo Daniel Valle Trujillo, Luis Leopoldo López Salinas, Isaías Rodríguez Sobrino, Paola Soto Leal, Daniel Sebastián Sosa Aguilar and Andrea Muñoz Sánchez, 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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