1H-June inflation – Good news continue, albeit with a more complicated outlook

- **Headline inflation (1H-Jun): 0.02% 2w/2w; Banorte: 0.02%; consensus: 0.13% (range: 0.02% to 0.30%); previous: -0.01%**
- **Core inflation (1H-Jun): 0.11% 2w/2w; Banorte: 0.19%; consensus: 0.22% (range: 0.16% to 0.31%); previous: 0.17%**
- **There was a sizable improvement in energy again (0.5%) on the back of LP gas (-3.5%), and despite higher low-grade gasoline prices (0.2%). In addition, agricultural goods (-0.2%) declined for a third consecutive fortnight. Going to the core, goods (0.1%) moderated, with 'others' helped by *Hot Sale* discounts. In services, (0.2%) increases continued in 'dinning away from home'**
- **In bi-weekly terms, annual inflation fell to 5.18% from 5.67% –lowest since March 2021. The core came in at 6.91% from 7.32%, below the 7% handle for the first time in a little more than a year**
- **In our view, risks to our year-end inflation forecast of 4.8% are skewed to the downside (consensus: 5.0%). Nevertheless, we maintain it on the need to stay cautious about potential pressures on food and energy in coming months**
- **The market sees an unchanged benchmark rate at 11.25% for at least the next two meetings**

Inflation at 0.02% 2w/2w, again below consensus. Nonetheless, it was in line with our call. Inside the non-core (0.26%), energy (0.5%) was helped by LP gas (-3.5%), despite a modest rebound in low-grade gasoline (0.2%) and electricity tariffs (0.3%). Agricultural goods also fell (0.2%) aided by the -1.3% in meat & egg –highlighting eggs, fish, and chicken. However, fruits and vegetables rose 1.2%, noting the move higher in tomatoes, squash, and potatoes, among others. Inside the core (0.11%), goods (0.1%) maintained better signals, benefitted further by *Hot Sale* discounts, especially in 'others' (0.0%). Services (0.2%) remain relatively high. In 'others' (0.2%) concerns prevail in items such as 'dining away from home' (0.3%) and restaurants (0.3%) in a resilient economic and labor market backdrop which could result in additional cost pressures. In addition, tourism is beginning to show signs of moving upwards, this time around on the arrival of the college vacation period.

1H-June 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
Tomatoes	2.9	5.5
Housing	1.6	0.2
Dining away from home	1.5	0.3
Squash	1.3	22.1
Potatoes	1.2	2.4
Goods and services with the largest negative contribution		
Eggs	-7.5	-7.2
LP gas	-5.2	-3.5
Lemons	-1.2	-8.6
Cellphone service	-0.9	-1.0
Fish	-0.6	-1.6

Source: INEGI

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Winners of the 2023 award for best Mexico economic forecasters, granted by *Focus Economics*

Annual inflation remains to the downside. In bi-weekly frequency, the headline dropped to 5.18% from 5.67%, lowest since March 2021. Meanwhile, the core reached 6.91% (previous: 7.32%), below the 7% handle for the first time in little more than a year (March 2022). As mentioned before, the former's stronger decline has been driven by the non-core, which reached 0.03%. In turn, this component has been helped significantly by items such as domestic gas (-30.1%), key to understand the current backdrop. Notwithstanding, base effects will likely support further the downtrend, at least until September or October.

Downside risks to our year-end inflation estimates, albeit cautious on a potential rebound of the non-core due to the *El Niño* phenomenon. After recent positive surprises, we still see risks of lower headline and core inflation by the end of 2023 relative to our forecasts of 4.8% and 5.6%, in the same order. This, even if consensus anticipates the headline higher, at 5.0%. Despite of the latter, we maintain them given the need to stay cautious due to potential pressures in agricultural goods and energy in coming months. What concerns us the most is the effect that could stem from high temperatures in agricultural production and energy demand (*e.g.* electricity and natural gas for cooling). According to NOAA in the US, we have been experiencing the *El Niño* phenomenon since May this year –unusual warming of surface waters in the eastern tropical Pacific Ocean that induces a variety of climate distortions around the world, such as droughts and hurricanes– which historically has had important effects on the sector and has an average duration of 9 to 12 months. Currently, the probabilities that this event will be moderate or strong stand at 84% and 56%, respectively. According to one study[1], most countries experience higher inflationary pressures due to this as it induces higher commodity prices, both in energy, and non-fuel goods. For Mexico, they estimated an accumulated impact of 1.01%-pts higher in inflation during two quarters. In this context, the last important episode was from May 2014 and June 2016. In said period, agricultural goods prices in Mexico rebounded 12.3% cumulatively (5.7% annualized). Despite of the latter, we suggest being very careful as these goods typically have very high volatility and are affected by a plethora of drivers. Nonetheless, the environment suggests the possibility of a sizable rebound, especially after their recently good performance.

Banxico will maintain the interest rate unchanged today at 11.25%. We expect the central bank to maintain its reference rate unchanged later today, in line with consensus. We also believe it is highly likely that the decision will be unanimous, with a less hawkish tone, and a revision lower in the headline inflation forecast for 2Q23 between 20bps to 30bps. For a more detailed analysis, see our document, *Ahead of the Curve*.

From our fixed income and FX strategy team

The market sees an unchanged benchmark rate at 11.25% for at least the next two meetings. Inflation in Mexico continues to slow down, helping anchor investor expectations that the central bank will keep the reference rate unchanged today and in August. Subsequently, they bet on an accumulated adjustment of -66bps in the remainder of the year.

[1] Cashin, Paul, Kamiar Mohaddes y Mehdi Raissi (2017), "Fair Weather or Foul? The Macroeconomic Effects of El Niño", *Journal of International Economics*, 106: 37-54

In our view, this remains relatively aggressive even if inflation conditions keep surprising to the downside. This, in a backdrop in which price pressures have forced some central banks to accelerate their hiking pace. Today, the UK and Norway surprised with +50bps vs an anticipated +25bps hike, while Fed Chair Powell noted that two more hikes this year remains a good estimate. Returning to Mexico, we maintain our preference for nominal vs. real rates. Furthermore, we see a 'tactical' opportunity in long positions on the 2-year Mbono (Dec'24) for short-term trading due to favorable inflation prints and some a clearer decoupling of monetary policy between developed and emerging markets. However, it is worth noting that gains could be limited by the Fed's hawkish bias, as well as the strong correlation of Mbonos with Treasuries.

Analyst Certification

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 Thalía 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, Juan Carlos Mercado Garduño, 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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