October 9, 2023

September inflation – We revise our estimates higher on a more challenging outlook

- **Headline inflation (Sep): 0.44% m/m; Banorte: 0.50%; consensus: 0.47% (range: 0.40% to 0.51%); previous: 0.55%**
- **Core inflation (Sep): 0.36% m/m; Banorte: 0.37%; consensus: 0.36% (range: 0.34% to 0.39%); previous: 0.27%**
- **We highlight education (3.1%), with adjustments having materialized since the 1st half. Remaining services were more mixed, with some favorable seasonal patterns within 'others' (0.0%). In goods, we saw an acceleration in processed foods (0.3%). At the non-core (0.70%) we highlight pressures in agricultural items (0.8%) –albeit with the total increase centered in the 1st half. Energy rose 0.7%, with LP gas (2.8%) eliminating gains seen in the first fortnight**
- **With this, annual inflation moderated to 4.45% from 4.64%. The core adjusted by a larger margin to 5.76% from 6.08%**
- **After the latest figures and an outlook which will likely be more challenging, we revise our forecasts higher. Headline inflation would close this year 5.0% (previous: 4.5%) despite the core being lower, at 5.1% (previous: 5.3%). For year-end 2024, we expect the headline at 4.6% (previous: 4.1%)**
- **Considering higher inflation, a constructive outlook for activity, and complex financial conditions, we reaffirm our call that the first cut from Banxico will materialize until May 2024**

Inflation at 0.44% m/m in September. The period is skewed by several seasonal patterns, with some of them already seen since the 1st fortnight. In this sense, within the core (0.36%), education (3.1%) stands out due to the uptick in tuitions as students returned to school. In the rest of services, 'others' were relatively contained at 0.0%. We observed declines in airfares in the second half, on top of a seasonality in professional services (-14.6%). However, pressures continued in categories such as 'dining away from home' (0.4%). On the other hand, goods (0.3%) were higher at the margin, both in processed foods (0.3%) –highlighting pressures in sugar– and in 'others' (0.3%). At the non-core (0.70%), agricultural items rose for the third consecutive month at 0.8%, although moderating at the margin. On meat and egg, the most relevant increases were in eggs and beef. Fruits and vegetables were more mixed (1.0%). In energy (0.7%), LP gas reversed the drop recorded at the beginning of the month, rising 2.8% due to higher reference prices. Finally, electricity tariffs (0.6%) and low-grade gasoline (0.2%) kept climbing.

September 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	6.8	10.3
Lemons	5.2	33.8
Eggs	4.7	5.4
LP gas	3.3	2.8
Elementary school	4.1	6.1
Goods and services with the largest negative contribution		
Professional services	-3.2	-14.6
Oranges	-2.8	-10.9
Avocadoes	-2.4	-8.6
Squash	-2.3	-27.5
Green tomatoes	-1.9	-12.6

Source: INEGI


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

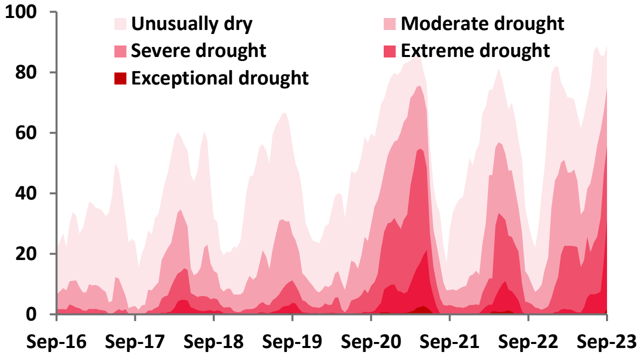
The annual rate moderated once again. The headline came in at 4.45% y/y from 4.64% in August, its lowest level since February 2021. The core fell by a larger magnitude, reaching 5.76% (previous: 6.08%), still helped by a favorable base effect. Nevertheless, the non-core left its low behind, climbing to 0.60% (previous: 0.37%).

We revise our 2023 estimate higher given a more unfavorable base effect and greater risks on the horizon… Despite a moderation in annual headline inflation for an eighth straight month in a row, we believe that today's figure will represent this year's low. First, due to a more challenging base effect. With bi-weekly figures, the peak of inflation last year was in the 2nd half of August at 8.77%. From then on, it dropped to 7.86% by the end of December (minimum: 7.46% in October's second fortnight). Consequently, it will be more difficult to see further declines due to this statistical effect.

However, this situation will be exacerbated by other adverse factors, especially at the non-core. While we had already identified several of these risks several months ago, their impact has been greater than anticipated. We highlight: (1) Rising global energy prices due to the extension of OPEC+ supply restriction measures, in addition to the revival of geopolitical tensions after Hamas's attack on Israel and higher expectations of a 'soft landing' of the global economy, despite China's weakness; (2) risks of a harsher winter due to the *El Niño* phenomenon, which has already started to impact weather (chart below, left), resulting in more significant effects on agricultural items; and (3) greater economic resilience than anticipated –particularly in the US and Mexico–, introducing demand-side pressures. On the first point, the production cut announced so far would be maintained at least until December, which does not let us rule out prices reaching up to 100 US$/bbl, especially given that the largest supply deficit in the last decade is expected in the current quarter (chart below, right). As for the second factor, the *National Oceanic and Atmospheric Agency's* (NOAA) *Climate Prediction Center* estimates that the probability of a strong *El Niño* event in the winter has increased to 71%. Finally, economic dynamism has consistently surprised on the upside in Mexico and our northern neighbor. This has inserted strong risks to our growth estimates for both countries. Also for inflation, as it implies potential demand-side price pressures when taking into account a positive output gap. As a result, we adjust our forecast for headline inflation at the end of 2023 from 4.5% to 5.0% y/y.

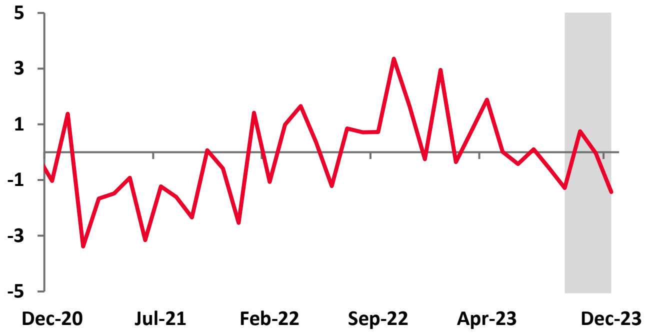
On a more positive note, the Mexican peso appreciated until August, which, in our view, aided in the deceleration of pressures in 'goods' within the core. This has been complemented by less supply chain pressures. On the latter, the index constructed by the New York Fed suggests that these have been lower than their historical average since February, reaching a low in May and still negative through September. Overall, we see a more positive effect on this component. In services, we have also seen a moderation in housing, which we expect to continue due to a high interest rate environment. However, this would be partially offset by other services excluding housing, including airfares (considering higher fuel costs) and non-tourism items on domestic demand strength and high wage gains, among other factors. As a result, we revise our forecast for the core marginally to the downside, expecting it at 5.1% (previous: 5.3%).

Drought monitor
% of the national territory



Source: Banorte with figures from CONAGUA

Deficit (-) or surplus (+) in the global cure oil supply*
Million barrels per day



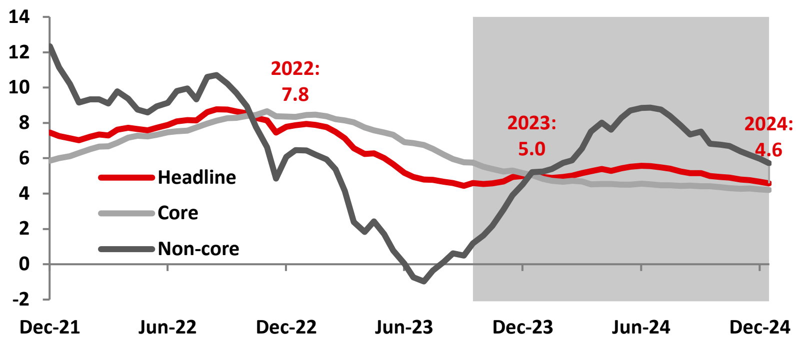
*Shaded area indicates forecasts
Source: Banorte with figures from EIA

...and also for 2024. On top of several factors that would impact price dynamics this year extending, we identify others in 2024 that could drive further increases. Among these, we highlight: (1) Cost pressures from wage increases, anticipating another double-digit increase to the minimum wage, with the possibility of a more marked lighthouse effect amid a tight labor market; (2) fiscal boost to demand, specifically the expansion in social transfers that will raise households' disposable incomes; and (3) the possibility of further supply chain shocks. Conversely, downside risks from tighter financial conditions for longer, as well as their possible impact on commodity prices, could help the price path. Considering these factors, we expect annual inflation to continue to accelerate in the first half of the year, peaking at 5.5% in June. By the end of 2024, we raise our estimate to 4.6% (previous: 4.1%). The core would maintain a downward trajectory throughout the period, reaching 4.2% at the end of the year (previous: 3.7%).

Some factors that could generate upward risks are related to the possible minimum wage increase, fiscal impulse, and structural changes on globalization. On the first point, COPARMEX in the recent days proposed an increase of 12.5% for 2024. However, the president of the National Labor Commission of this body mentioned that the revision will probably be higher on the back of proposals from the government and workers in the Council of Representatives of the *National Minimum Wage Commission* (CONASAMI in Spanish). Although we will know the figure until December and it is the result of a negotiation, we calculate that the goal of a 100% increase in real terms during the current administration would imply an increase close to 15%. However, as we mentioned last year, other targets that have been discussed suggest that it could be as high as 25%. In any case, we believe that the increase will be important. Regarding the second factor, the *2024 Budget Proposal* suggest a higher stimulus on the economic activity recovery, arguing in favor of an output gap that probably would be positive. Finally, escalating geopolitical tensions between the US and China, the continuation of the war in Ukraine, the repercussions of Israel's war against Hamas, and the rearrangement of supply chains, could result in an environment in which higher costs could continue, possibly becoming a structural issue going forward.

Tighter financial conditions could slow the demand impulse on prices, albeit with a more delayed effect. Conversely, some factors could help prices to moderate, although their effects would probably be more evident during the second half of the year. Among them, the greater likelihood of a global and local slowdown due to the lagged effects of tighter monetary policy for longer, which would materialize more strongly. In addition, their potential implications for commodity prices and total aggregate demand.

Banorte: Inflation forecasts
% y/y. bi-weekly frequency



Source: Banorte with figures from INEGI

A more complex outlook for prices and restrictive tone from Banxico are consistent with the possibility that rate cuts will take longer to materialize. With higher inflation forecasts than those from the central bank, accompanied by a more constructive growth outlook, and an environment of increased volatility in financial markets, we believe the best decision from the central bank will be to maintain a cautious stance. This will translate into a delay of the start of rate cuts, now expecting the first reduction to materialize until May rather than in February, bringing the rate down by 25bps. This scenario would also limit the magnitude of such cuts throughout the year, expecting the reference rate to close 2024 at 9.25% (previous: 8.25%).

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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 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, Daniel Sebastián Sosa Aguilar, Jazmin Daniela Cuautencos Mora 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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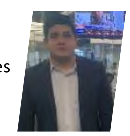

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