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ECONOMIC ANALYSYS

Inflation: January CPI forecast

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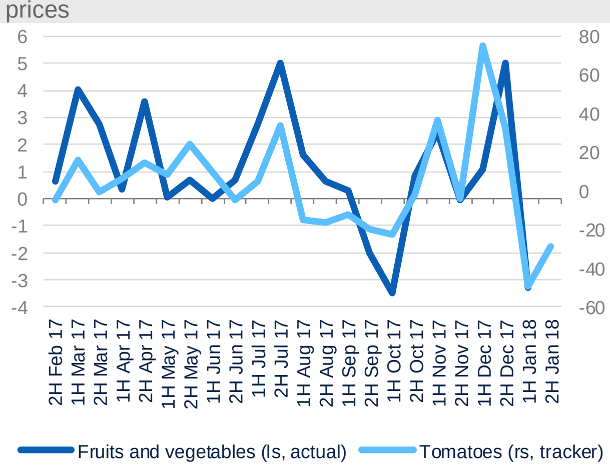
Following the positive surprise in 1H January, **our forecast for the January headline inflation print is 0.40% MoM**, translating into a **5.40% YoY** number (1.4pp lower than in December). We expect **core inflation** to increase **0.22% MoM, 4.49% YoY**, down from 4.87% in December. The positive surprise in 1H January was driven, as expected, by a large drop in tomatoes prices (-17.4% HoH) that subtracted (-)0.11pp to headline inflation. Our fruits and vegetables price tracker suggests that those prices decreased again in H2 January. However, the tracker also points to increases in the prices of other fruits and vegetables. Overall, tomatoes should lead to another decrease (see chart) in the fruit and vegetables component in H2, but smaller than the one observed in 1H. Besides, the base effect (large price increases in December) should lead to a more moderate price decrease in January (compared to the one witnessed in 1H). **Non-core inflation will continue to be pressured by energy prices** (we expect a 2.0% MoM in the energy component), but a favorable base effect is the driver of the large drop in YoY headline inflation. Looking ahead, **we expect January's fall to mark the start of a downward trend after the supply-shock driven temporary increase over 4Q17. We expect headline inflation to fall below 5.0% by April.**

Figure 1. Tomatoes prices vs Fruits and vegetables prices



Source: BBVA Research with Inegi data

Table 1. Inflation breakdown

	MoM % change			YoY % change		
	Jan 18 e	Dec 17	Jan 17	Jan 18 e	Dec 17	Jan 17
Headline	**0.40**	0.59	1.70	**5.40**	6.77	4.72
Core	**0.22**	0.42	0.58	**4.49**	4.87	3.84
Goods	**0.48**	0.32	0.93	**5.70**	6.17	4.75
Food	**0.75**	0.52	1.20	**6.34**	6.82	5.27
Non-food	**0.28**	0.16	0.70	**5.19**	5.62	4.31
Services	**0.01**	0.50	0.28	**3.48**	3.76	3.07
Housing	**0.27**	0.18	0.29	**2.63**	2.65	2.46
Education	**0.28**	0.00	0.49	**4.53**	4.74	4.29
Other	**-0.34**	1.00	0.21	**4.05**	4.63	3.33
Non-core	**1.00**	1.09	5.14	**8.19**	12.62	7.40
Perishable	**0.07**	1.81	-0.88	**10.81**	9.75	0.53
Fruits & Vegetables	**-1.34**	3.56	-3.60	**21.38**	18.60	-6.01
Meat & Eggs	**1.10**	0.67	0.73	**4.89**	4.50	4.67
E&T	**1.56**	0.65	8.96	**6.67**	14.44	11.80
Energy	**2.00**	0.77	12.67	**6.54**	17.69	16.31
Tariffs	**0.84**	0.41	2.02	**7.11**	8.36	3.50

Source: BBVA Research with Inegi data

Core goods prices remain pressured by recent increases in perishable food prices. It will be interesting to see if non-food core goods prices decrease in H2 (we expect a small (-)0.03% HoH drop), when seasonal sales take full effect, or if stickiness to the downside continues. However, core goods prices continue to show a lower pace of increase as should be expected since the peso is already appreciating on YoY terms which is what is relevant for inflation. Besides, **a much better**

than expected perfomance of the MXN in early 2018, as NAFTA break-up risks have diminished, is welcome news for non-food core goods inflation. **We expect core inflation to fall below 4.0% by April.**

The risks to our expected inflation path is subject to upside risks (mainly related to energy prices), but a stronger MXN is easing those risks. Besides, **our below-consensus 2018 inflation forecast (BBVA Research 3.8%, consensus: 4.1%) is also subject to a downside risks, mainly related to fruit and vegetable prices** but also potentially to a postive outcome of NAFTA negotiations (under a NAFTA 2.0 agreement the MXN in our view would markedly appreciate). Regarding the first downside risk, since 2000 and previous to 2017, fruit and vegetables prices increased more than 10% on six years. The YoY change in that component averaged -2.3% on the following years, declining in four out of the six years, and increasing only 0.1% YoY on average on the other two. That is, considering that fruits and vegetables prices increased 18.6% YoY in 2017, **in our view, annual headline inflation is likely to surprise the market to the downside during Q2-Q3 if this positive risk materializes**, following the widely expected decline in annual inflation in Q1. Recall that fruit and vegetable prices increased 3.7% MoM on average during Mar-Aug 2017.

All in all, however, the next move in interest rates will likely be up. While inflation pressures will likely end up easing more than expected in January, and risks also eased more than anticipated driven by a stonger than expected MXN, Banxico will likely deliver the expected additional 25bp rate hike in 8 Feb as: i) risks remain and the MXN is still not out of the woods yet, and ii) the MPC would not be able to distance itself from the hawkishness of the last monetary policy statement and minutes. Delivering the expected hike is now crucial for credibility as they did not leave the door open for a monetary policy pause at the next meeting. Yet, we think this second hike will be last one in this hike cycle.