

ECONOMIC ANALYSIS

Fall in inflation the start of a downwards trend

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As widely expected, annual inflation declines sharply in January

Headline inflation in January was 0.53% MoM, slightly above consensus (0.50%) but well above our below-consensus forecast (0.40%). In annual terms, it dropped from 6.8% YoY in December to a 9-month low of **5.55% YoY**. **Core inflation was 0.28% MoM**, broadly in line with consensus but above our own forecast (0.22%). In annual terms, core inflation fell to **4.56% YoY** (a 10-month low) from 4.87% in December.

Sizable gasoline and LP gas price increases

Unsurprisingly, the sharp drop in the annual rate reflects the large base effect from last year's sharp energy price increase in January. Yet, pressures on these prices remain and we see significant increases in gasoline and LP gas prices (3.2% and 3.0% MoM, respectively), which together explain 45% of the overall headline increase. Relative to our non-core forecasts, energy and regulated prices explain most of our error (see table). Outside of energy, fruit and vegetable prices declined more than we expected, led by tomatoes, but meat & eggs increased more, led by eggs.

Turning point in non-food core goods prices; service prices remain well behaved

Within core inflation, relative to our forecast, the surprise was mainly driven by food prices (see table). Although the increase in this component was larger than we expected, in annual terms it fell to 6.5% from 6.8% in December. Non-food core goods increased broadly in line with our forecast (see table), in annual terms down to 5.2% from 5.6%. Overall, core goods data continues to reflect the absence of relevant pass-through from 4Q17 peso's weakness. Service prices remain well behaved (in annual terms down to 3.5% from 3.8%), which supports our view of no second-round effects from the uptick in headline inflation during 4Q17. Yet, relative to our forecast tuition prices increase much more than we anticipated in 2H Jan, after increasing less than expected in 1H Jan.

Annual inflation fall is quite likely to be the start of a downwards trend

Headline and core inflation will likely to fall below 5% and 4% in April, respectively. Looking ahead, the upside surprise relative to our forecasts, does not change our view of gradually lower inflation going forward. The next significant base effect will likely come in April-May. Yet, we do not expect headline inflation to fall back into Banxico's target range until 4Q18.

Today's print does not change our view for monetary policy

We expect Banxico to deliver the signaled 25bp hike later today but to change the wording to reflect a less hawkish leaning stance going forward. Inflation is likely to continue receding and to fall within Banxico's target in 4Q, there are no demand-side pressures, relevant pass-through or second-round effects, and the monetary stance is already tight. We think that today's hike will be the last of the cycle, but also that any discussion on rate cuts will be off the table until 4Q18.

Our **preliminary forecasts for February** are: **headline 0.45% MoM** with a **0.50% MoM** increase in **core** prices.

Table 1. Inflation breakdown

	MoM % change				YoY % change			
	Jan 18	Jan 18 ^e	Dec 17	Jan 17	Jan 18	Jan 18 ^e	Dec 17	Jan 17
Headline	0.53	0.40	0.59	1.70	5.55	5.40	6.77	4.72
Core	0.28	0.22	0.42	0.58	4.56	4.49	4.87	3.84
Goods	0.56	0.48	0.32	0.93	5.78	5.70	6.17	4.75
Food	0.90	0.75	0.52	1.20	6.50	6.34	6.82	5.27
Non-food	0.27	0.28	0.16	0.70	5.17	5.19	5.62	4.31
Services	0.04	0.01	0.50	0.28	3.52	3.48	3.76	3.07
Housing	0.26	0.27	0.18	0.29	2.62	2.63	2.65	2.46
Education	0.44	0.28	0.00	0.49	4.69	4.53	4.74	4.29
Other	-0.31	-0.34	1.00	0.21	4.09	4.05	4.63	3.33
Non-core	1.24	1.00	1.09	5.14	8.44	8.19	12.62	7.40
Perishable	0.03	0.07	1.81	-0.88	10.76	10.81	9.75	0.53
Fruits & Vegetables	-1.93	-1.34	3.56	-3.60	20.65	21.38	18.60	-6.01
Meat & Eggs	1.35	1.10	0.67	0.73	5.14	4.89	4.50	4.67
Energy & Regulated	1.97	1.56	0.65	8.96	7.10	6.67	14.44	11.80
Energy	2.44	2.00	0.77	12.67	7.00	6.54	17.69	16.31
Regulated	1.03	0.84	0.41	2.02	7.31	7.11	8.36	3.50

Source: BBVA Research with Inegi data

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