Economic Analysis

Inflation set to fall below 3.0% by year-end

We revise down our year-end 3.4% below-consensus forecast to 2.9%

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- **Inflation performance in 2019 has been remarkable**
- **We now expect headline inflation to reach 2.9% by year-end with core at 3.3%**

Inflation performance in 2019 has been remarkable

Despite the temporary upticks driven by supply shocks seen during the summer of 2018 and 2Q19, headline inflation has been on a downward trend since it reached 6.77% in December 2017 following the substantial increase in energy prices after they were liberalized in January 2017 and the significant pass-through seen following the US election (see graph 1). The pace of decrease has recently accelerated. Headline inflation stood at 3.29% in the first half of August and we expect it to fall further to 3.16% in August (see graph 1). The faster drop rate is reflects the lower levels of non-core inflation (see graph 1) driven mainly by a noteworthy performance of energy prices. We expect non-core inflation to stand at 1.4% YoY in August, down from a recent high of 9.2% YoY in September 2018. If our August forecasts prove correct, energy prices inflation would have come down from 19.2% YoY to -1.4% YoY over the same period.

Graph 1. **Falling inflation**

Headline inflation breakdown

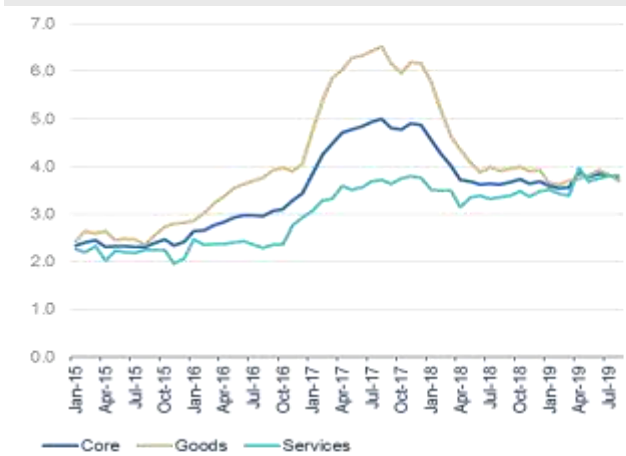
(YoY % change)

* Aug is forecast but 1H Aug data is already known.
Source: BBVA Research / INEGI

Graph 2. **Core stickiness**

Core inflation breakdown

(YoY % change)



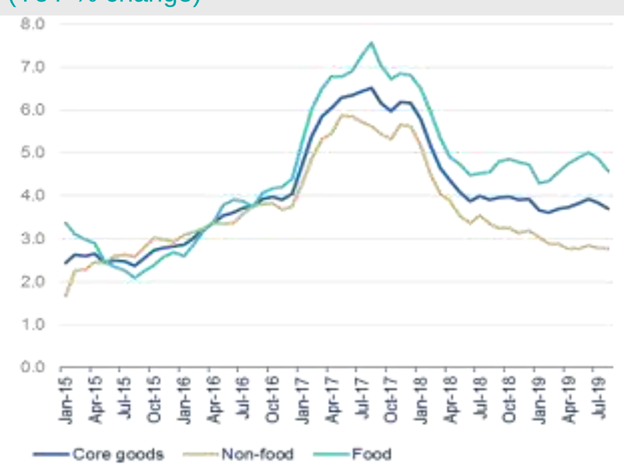
* Aug is forecast but 1H data is already known.
Source: BBVA Research / INEGI

In contrast, core inflation has remained sticky to the downside. After hovering around a narrow 0.2pp range (ie, 3.54% to 3.73%) between April 2018 and March 2019 it jumped to 3.87% in April 2019 and came down only slightly to 3.8% over the last three months (May-July). We expect it to fall to 3.7% in August and to 3.6% in the following months, but the fact is that it has remained sticky to the downside. In our view, this performance should be seen in a positive light, not a negative one since its persistence has occurred in a backdrop of large supply shocks. It is noteworthy that core inflation has remained relatively stable during this period. It is remarkable that there were no significant second order effects to core inflation after the increases in energy prices seen in 2018. Usually in Mexico, the effects would have been larger.

The recent core inflation persistence around 3.8% YoY is explained by elevated core food inflation that has prevented core goods inflation from falling down (see graph 3). While core food inflation has remained significantly above 4.0% YoY over the last 12 months and recently reached 5.0% YoY (in June), non-food core goods inflation remains on a downward trend and has fallen (-)0.8pp to 2.8% YoY over the same period. Our expectation of lower core inflation by year-end is mainly explained by our belief that core food inflation is set to begin to finally slow as fresh food inflation will likely stand below 3.0% YoY in August and the supply shocks that affected these prices in the summer of 2018 and 4Q18 will fade away. Core inflation persistence is also explained by services inflation, which has increased 0.3pp to 3.8% since the end of last year (see graph 4). This increase was mainly driven by higher telecomm prices after the structural fall seen over the last few years and higher tourism-related prices, partially driven by higher airfare prices following the increase in airport-related taxes after the cancelation of the new Mexico City airport. These two factors represent one-off effects and thus, we are not at all concerned with services inflation going forward, particularly in a context of a weak economy and an increasingly negative output gap. With almost zero growth we will not see any demand-side pressures. In addition, although the MXN has recently depreciated due to external factors, the pass-through in the lower part of the cycle is usually negligible or very low, as firms do not have pricing power and need to absorb, at least temporarily, higher costs through lower margins. Although it will likely take some time, these effects should fade away.

Graph 3. **Falling non-food core goods**

Core goods inflation breakdown
(YoY % change)



* Aug is forecast but 1H Aug data is already known.
Source: BBVA Research / INEGI

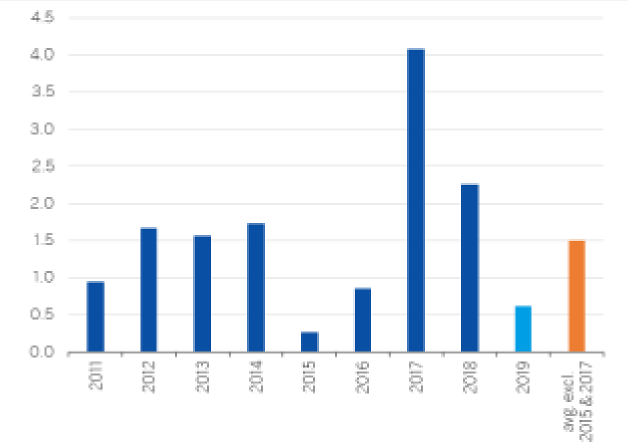
Graph 4. **Higher services inflation**

Core services inflation breakdown
(YoY % change)

* Aug is forecast but 1H data is already known.
Source: BBVA Research / INEGI

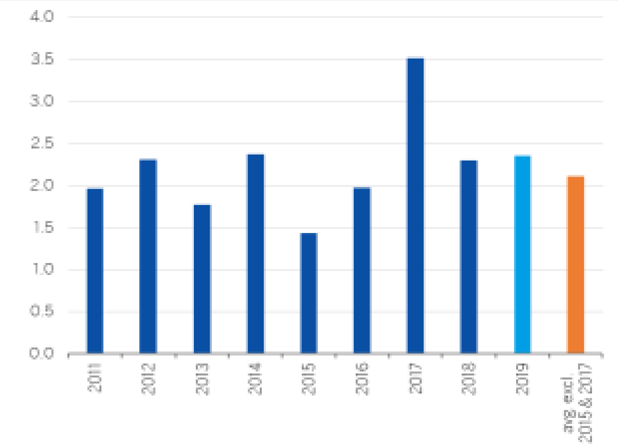
Overall, inflation performance in 2019 has been remarkable. We expect cumulative inflation to August to 0.6pp, the second lowest mark after 2015 when telecomm prices had a one-off significant drop following the telecomm reform, and well below the average performance during the first eight months of the year (see graph 5). In fact, if our August forecasts prove correct, cumulative inflation through August would be only 42% of the average seen during this decade if we exclude 2015 (when inflation reached an all-time low driven by the telecomm reform) and 2017 (when inflation spiked following the liberalization in energy prices and the strong round of pass-through after the US election). Meanwhile, cumulative core inflation through August would most likely be only 11% above that seen during this decade excluding 2015 and 2017 (see graph 6).

Graph 5. **Cumulative headline inflation as of August of each year*** (Pp)



* Aug is forecast but 1H Aug data is already known.
Source: BBVA Research / INEGI

Graph 6. **Cumulative headline inflation as of August of each year*** (Pp)



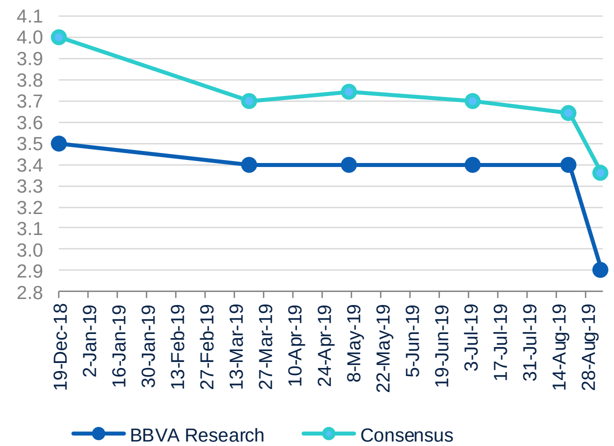
* Aug is forecast but 1H Aug data is already known.
Source: BBVA Research / INEGI

We now expect headline inflation to reach 2.9% by year-end

Since December 2018, we argued that inflation was set to slow sharply in 2019 as we anticipated that the supply shocks seen during 2017-18 were set to fade away. Our 2019 year-end headline inflation forecasts have been consistently below those of the consensus (see graphs 7 & 8). In December 2018, our 2019 year-end inflation forecasts were 3.5% for headline inflation and 3.3% for core inflation, (-)0.5pp and (-)0.2pp, respectively lower than consensus forecasts. In March, we revised down our headline inflation forecast to 3.4% and by that date, consensus forecast had come down to 3.7%. Since then, headline inflation consensus forecast has remained broadly unchanged around 3.7% (see graph 7), but the core inflation forecast has been gradually adjusted to the upside to around 3.5% (see graph 8). Over that period, we did not make any changes to our forecasts but kept a downward bias to our below-consensus headline inflation forecast.

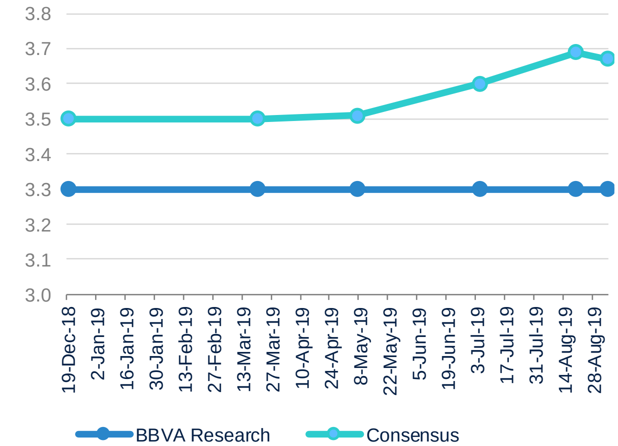
After inflation came in below expectations in the first half of August, it became clearer that inflation would end the year below our forecast. We now expect headline inflation to reach 2.9% by year-end. In the most recent Banxico analysts survey (released on September 2), the consensus adjusted its year-end expectation to 3.4% (our previous forecast) down from 3.7% in the previous survey (see graph 7). That is, the difference between our forecast and that of consensus is slightly smaller but still significant (-0.4pp vs -0.5pp previously). Regarding core inflation, neither the consensus nor we adjusted our year-end expectations, so the difference remains at -0.4pp, 3.3% vs 3.7% (see graph 8). Thus, the 0.5pp difference in the headline inflation forecast is only partially (0.3pp) explained by the difference in the core inflation forecast. We are expecting core prices to ease in 4Q while consensus is not anticipating it, but we are also expecting non-core inflation to perform better over the remainder of the year.

Graph 7. **2019 year-end headline inflation forecasts: BBVA Research vs consensus** (%)



* We plot five CitiBanamex surveys: 19-Dec-18, 20-Mar-19, 7-May-19, 5-Jul-19, 20-Aug-19, and one Banxico survey: 2-Sep-19 because forecasts were revised after inflation data for 1H was released and the latest CitiBanamex survey does not yet incorporate consensus latest forecasts
Source: BBVA Research / CitiBanamex bi-weekly survey / Banxico monthly analysts survey

Graph 8. **2019 year-end core inflation forecasts: BBVA Research vs consensus** (%)



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