Economic Analysis

First half of January inflation forecast: base-effect driven temporary rebound

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January 22, 2020

We expect headline inflation to increase 0.25% HoH in in the first half of January (3.17% YoY), with core coming in at 0.18% HoH (3.70% YoY). If our forecasts prove accurate, headline inflation would increase 0.15pp and core 0.1pp in annual terms from 3.02% and 3.60%, respectively in the second half of December. Our initial monthly forecast is for headline inflation to increase 0.46% MoM (3.22%) with core rising 0.30% MoM (3.69%). That is, we do not expect an additional increase in annual terms in the monthly print. Yet, we expect headline inflation to rise an additional 0.4pp to 3.6% YoY. Both January and February increases in annual terms are base-effect driven, as headline inflation barely increased in the same months of last year (0.03% MoM on average). We are not expecting March's annual inflation to increase further. The 1Q increase will most likely prove temporary as inflation during April-May of last year (-0.12% MoM) was much higher than usual. Thus, we expect annual headline inflation to drop back to 3.3-3.4% on average during 2Q. For year-end inflation, we are sticking with our forecasts of 3.5% for headline with core at 3.3%. For the whole year, we expect headline inflation to average 3.5% (slightly below last year's 3.6% average) and core 3.5% (vs. 3.7% in 2019). Looking ahead, low international energy prices (eg, US natural gas prices had not been this seasonally cheap in 20 years) should partially offset the current supply shock in fresh food prices that will likely increase significantly for the third month in a row. More importantly, after rebounding due to base-effects in Jan-Feb, core inflation is likely to resume its downward trend in a context of a weak economy and a widening output gap.

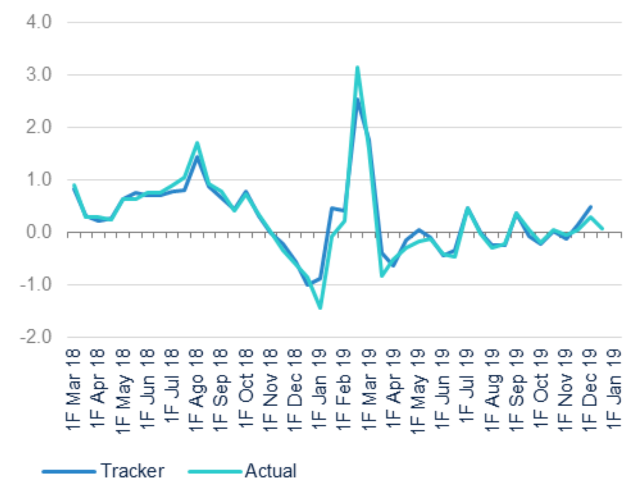
Under such a backdrop, the easing cycle, which actually just started in November since the first two cuts of 2019 were offset by the decline in inflation expectations, has plenty of room to go. Banxico has shown that it prefers to ease policy at a very gradual pace. We expect 25bp rate cuts in each of the first five meetings, taking the policy rate to 6.0% in August. The risk is that Banxico becomes even more cautious with the Fed on the sidelines and with the temporary increase in inflation. A 6.0% rate would only take the monetary policy to a neutral stance. Yet, Banxico has remained overly hawkish and the risk is that they decrease the policy rate less than what is warranted.

Chart 1. **Inflation Breakdown**

	1H Jan		2H Dec
	HoH%	YoY %	YoY %
Headline	0.25	3.17	3.02
Core	0.18	3.70	3.60
Core goods	0.28	3.63	3.56
Core food	0.42	4.58	4.48
Non-food core	0.14	2.63	2.60
Core services	0.06	3.77	3.64
Core Housing	0.14	2.92	2.90
Core Education (tuitions)	0.00	4.51	4.73
Core Other Services	0.00	4.37	4.07
Non-Core	0.49	1.63	1.33
Non-core Food	0.54	0.77	1.51
Fruits and Vegetables	1.05	-3.94	-2.41
Meat and Eggs	0.12	5.26	5.14
Energy-related and Regulated	0.45	2.28	1.20
Energy-related	0.27	1.16	-0.30
Regulated	0.89	5.02	5.00

Source: BBVA Research / INEGI

Graph 1. **Low octane gasoline prices: actual vs tracker** (HoH % change)



Source: BBVA Research / Petrointelligence

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