

Economic Analysis

First half of February inflation forecast: the base-effect driven temporary rebound is set to continue

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We expect headline inflation to increase 0.19% HoH in the first half of February (3.59% YoY), with core coming in at 0.29% HoH (3.76% YoY). If our forecasts prove accurate, headline inflation would increase 0.3pp while core would edge up 0.03pp in annual terms from 3.29% and 3.73%, respectively in the second half of January. Our initial monthly forecast is for headline inflation to increase 0.29% MoM (3.57%) with core rising 0.44% MoM (3.73%). That is, we do not expect an additional increase in annual terms in the monthly print in either headline or core inflation. Yet, as we argued in the past two months, headline inflation was set to rise an additional 0.4pp to 3.6% YoY in February. This rebound is base-effect driven and should prove temporary (headline inflation only increased 0.03% MoM on average in January-February of last year). We are not expecting March's annual inflation to increase further in annual terms. Looking ahead, we expect annual headline inflation to drop back to 3.3% on average during 2Q. For year-end inflation, we are sticking with our forecasts of 3.5% for headline with core at 3.3%. More importantly, in our view, core inflation is set to ease from Q2 onwards on a widening negative output gap along with MXN's strength. 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).

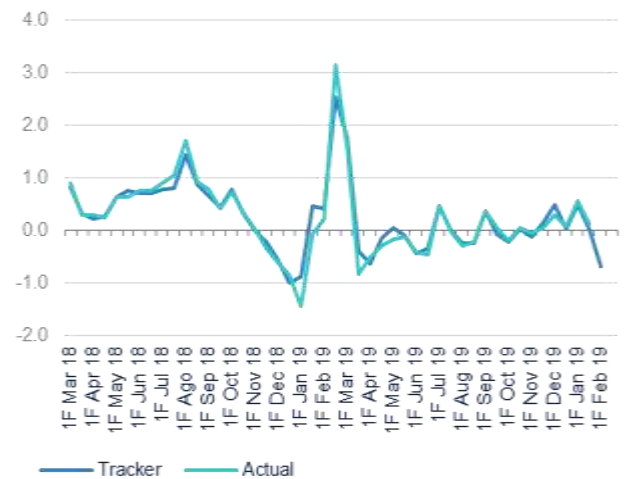
Under such a backdrop, the easing cycle should continue. In our view, rates have plenty of room to decrease. Banxico will most likely continue to ease its restrictive stance at a very gradual pace. We expect 25bp rate cuts in each of the following four meetings, taking the policy rate to 6.0% in August. The risk is that Banxico becomes even more cautious with the Fed on the sidelines, with the temporary rebound in headline inflation and with core sticky to the downside. Banxico has remained overly hawkish and the risk is that they decrease the policy rate less than what is warranted. Yet, Banxico has singled out core inflation's stickiness as its main concern and core inflation will most likely stay on a downward trend from Q2 through the end of the year. Besides, a 6.0% rate would only take the monetary policy to a neutral stance.

Chart 1. **Inflation Breakdown**

	1H Feb		2H Jan
	HoH%	YoY %	YoY %
Headline	0.19	3.59	3.29
Core	0.29	3.76	3.73
Core goods	0.32	3.95	3.97
Core food	0.27	5.11	5.15
Non-food core	0.37	2.72	2.72
Core services	0.26	3.56	3.46
Core Housing	0.11	2.93	2.94
Core Education (tuitions)	0.22	4.52	4.67
Core Other Services	0.40	3.91	3.67
Non-Core	-0.12	3.07	2.01
Non-core Food	0.05	4.97	2.00
Fruits and Vegetables	0.60	6.53	-0.65
Meat and Eggs	-0.40	3.66	4.47
Energy-related and Regulated	-0.24	1.72	2.02
Energy-related	-0.47	0.41	0.87
Regulated	0.28	4.94	4.84

Source: BBVA Research / INEGI

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



Source: BBVA Research / Petroleintelligence

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