Scotiabank.

GLOBAL ECONOMICS

LATAM INSIGHTS

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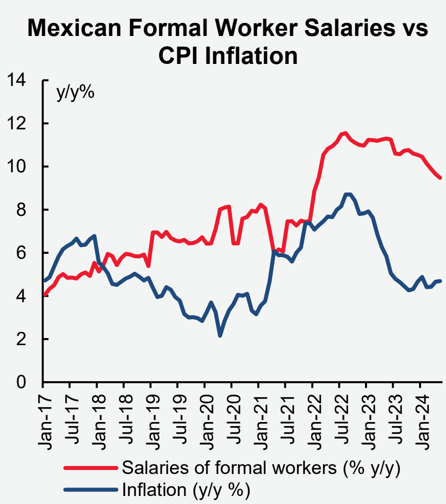
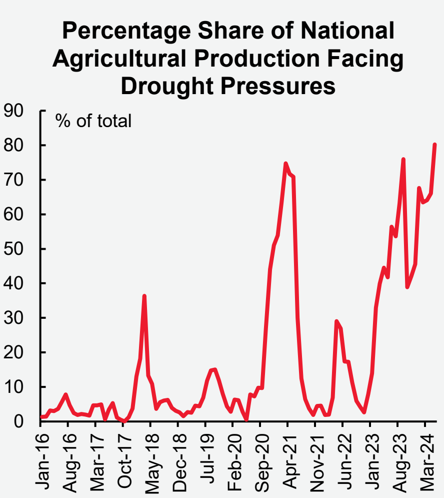
Chart 1



Sources: Scotiabank, Banxico, INEGI.

Chart 2



Sources: Scotiabank, Banxico.

Mexico—Mixed Inflation Signals Combined with Fed Shift and Market Volatility Calls For Caution

Earlier this month, the FOMC revised its dot plot, signaling that its base case for 2024 is now only one 25bps cut as a robust labour market, resilient growth, and stubborn inflation warrant prolonged policy tightness. In addition, following the Mexican elections on June 2nd, markets in Mexico have come under pressure (MXN –7%, 10yr Mexico–US swap spread around 70bps wider). The combination of these two factors is likely to add a layer of caution towards Banxico's policy in the looming policy decision. Looking at domestic data, the picture is more nuanced and complex, with what we see as balanced upside and downside inflation risks.

On the growth side, data for the first few months of the year (and the close of 2023) shows a material slowdown in growth in Q1 (retail sales and the monthly GDP proxy turned negative to close Q1). Outside of tourism, at the national level, all key sectors of GDP posted q/q contractions to start the year (Q1). This presents Banxico with a challenging balancing act as a pure inflation targeter, as domestic markets have suffered material volatility, the Fed has signaled delayed rate cuts, inflation remains high and stubborn, and some inflation risks loom on the horizon (see table 1 below).

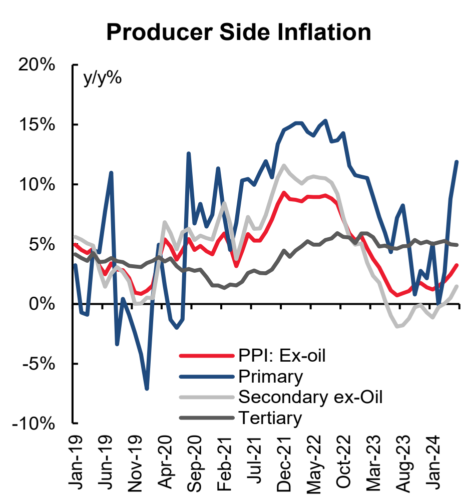
Table 1: Regional Economic Performance

	Q/Q % S.A.									
	National		North		Center-North		Center		South	
	23 IV	24 I	23 IV	24 I	23 IV	24 I	23 IV	24 I	23 IV	24 I
Total	0.0	0.3	0.5	-0.5	-0.3	0.1	0.1	-0.2	-0.2	0.5
Manufact.	-0.6	-0.3	-1.4	-1.5	-0.1	0.1	0.1	-0.4	0.6	1.8
Mining	0.2	-0.8	1.7	-1.4	2.9	5.8	-3.1	2.5	-0.9	-0.8
Construction	0.1	-0.7	5.5	-7.6	-0.1	-12.7	4.4	-7.4	-4.6	4.3
Commerce	-0.3	-1.2	-0.3	-1.4	-0.3	-0.4	-0.1	-1.7	-3.1	-0.7
Tourism	0.2	1.1	-1.6	2.9	1.4	0.1	0.7	0.7	-0.2	1.6
Agro.	1.0	-6.1	1.0	-11.2	-4.2	-3.3	8.9	-7.8	0.1	-2.1

Sources: Scotiabank Economics, Banxico.

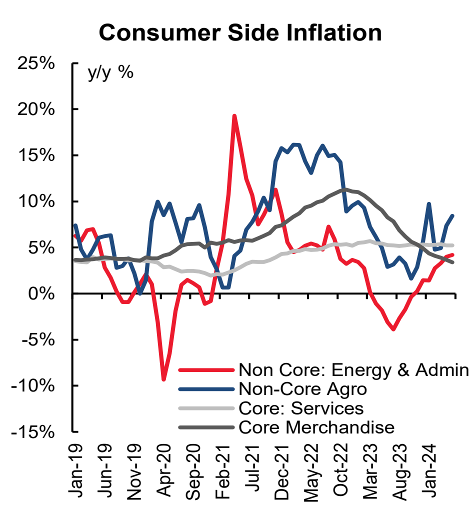
The first challenge looming on the inflation horizon is that despite the drop already seen in inflation, wages significantly trailed in their decline. With Mexican labour markets still very tight, and strong yearly minimum wage hikes (one of the incoming government's proposals would constitutionally mandate minimum wages hikes above inflation every year), wages have continued to post strong gains (chart 1). This is likely to continue to prop-up CPI inflation, particularly in the more labour-intensive services sector. The second looming potential shock is food prices. As global media discussed earlier this year, and chart 2 shows, the past few months have seen Mexico endure a strong drought, that

Chart 3



Sources: Scotiabank, INEGI.

Chart 4



Sources: Scotiabank, INEGI.

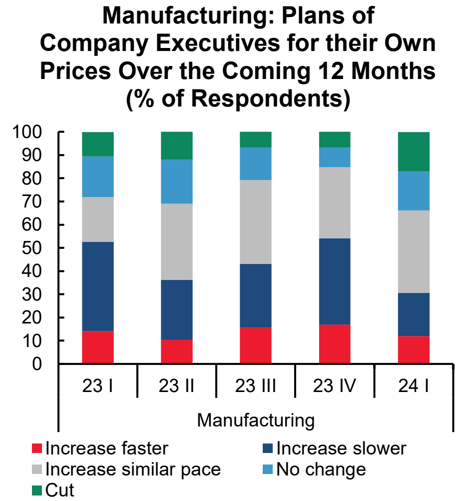
has not only been severe, but long lasting. This risks pressuring food prices, particularly heading into the final 3–4 months of the year.

Additionally, PPI has often given us a 3–6 month preview of turns in CPI cycles (secondary sector inflation sheds light on core goods, and tertiary sector inflation on core services). As charts 3 and 4 show, so far, core services inflation has been very sticky (which we see as partly driven by tight labour markets), but core goods prices trends have been a relief for Banxico. However, if the PPI-CPI relationship holds, the good news on core goods CPI may soon turn into bad news considering the recent run up in secondary PPI.

On the positive, and highly relevant end, expectations of price-setters provided good news for Banxico at the end of Q1, with the share of both manufacturing and non-manufacturing company executives planning on accelerating price increases falling materially in Q1 (charts 5 and 6). This is particularly good news for services sector inflation, as core services CPI has so far been tough to tame. This could be consistent with the dip we're seeing in activity data at the start of the year. The counter argument lies in the spike in PPI that we also saw at the start of the year, which could undermine the willingness of producers to cut prices, eating directly into their margins on all sides (rising input prices, cutting their own prices, while dealing with lower demand if the economy continues to slow).

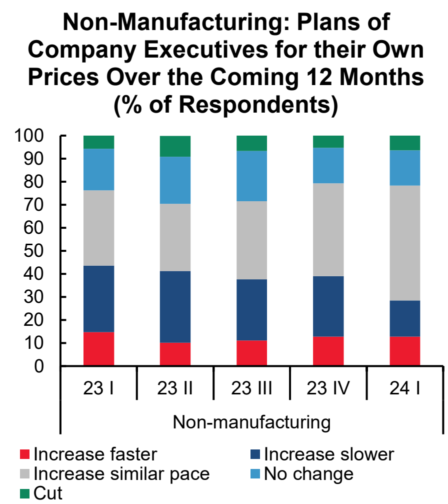
Overall, the Banxico policy outlook is challenging, but given current heightened levels of uncertainty we think risk-reward favours prudence. We anticipate Banxico will stay put in its looming policy-setting meeting (we would not be surprised by a 5–0 "hold" decision), and we maintain a September cut lightly penciled in (with the eraser already at the ready), and a higher conviction 25bps cut in December, alongside the Fed. We think this would be a prudent path for the central bank, particularly given that Mexican market uncertainty could pick up as we head into the final stretch of the year, due to: a) the budget presented by the government for 2025 with its potential changes to tax policy or the reactions of rating agencies, b) the government's "constitutional reform" package which could be submitted to Congress in that window, c) the final stretch of the US electoral process, where Trump's tariff proposals could also impact both rates (due to the impact of tariffs on inflation), and FX markets.

Chart 5



Sources: Scotiabank, Banxico.

Chart 6



Sources: Scotiabank, Banxico.