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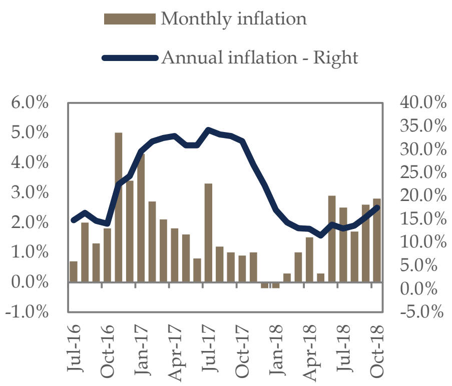
Too much "potatoes" made inflation "fat": October reading breaches CBE's upper boundary

Inflation data released by CAPMAS for October showed that annual inflation accelerated more than expected to hit 17.5% for total republic and 17.7% for urban areas. Monthly urban inflation accelerated as well to 2.6% in October, up from 2.5% in September. This is much higher than market expectations and raises questions about monetary stance. We see a grey area for the MPC action in its upcoming meeting (on 15 November), giving a 50-50 probability for keeping rates unchanged or a 1-2% hike as we find both actions equally justifiable.

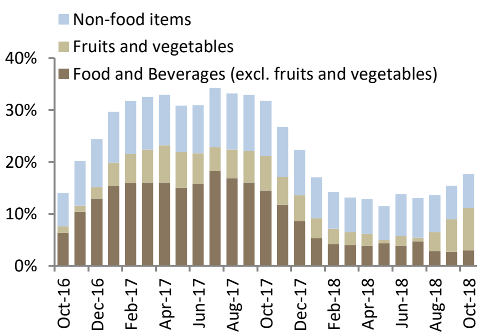
- **Fruits and vegetables gave too much calories to inflation:** While non-food items contributed 6.5% out of the 17.5% total inflation (total republic), vegetables item alone rose 54% y/y, contributing a whole 7.6% due in part to 147% higher potato prices.
- **Headline inflation has crossed the CBE's upper boundary, raising the likelihood of a possible rate hike:** The 17.7% urban inflation reading well exceeds the upper boundary of the target inflation previously declared by the CBE (13% ±3%). Besides, such a high inflation rate kicks the current policy rates (17.75% and 16.75% for O/N lending and O/N deposit, respectively) down into the negative real area. These are two main factors that may push the CBE to hike by 1-2%, which we expect would be temporary and should be reversed in H1 2019.
- **Core inflation slightly up y/y, but monthly reading is worrisome:** Annual core inflation inched up from 8.55% in September to 8.86% in October, while the monthly rate reversed its –0.06% to +0.98%. We are more concerned with the monthly core rate that we consider high as it is represents the underlying inflationary pressures during the month.
- **However, October inflation is mainly driven by food items that are seasonal and volatile in nature:** The composition of inflation rate in October suggests highly volatile items are the main driver for the CPI rally. This may lead the CBE to prefer a "wait and see" approach, as inflation is expected to cool down in the near term, something that makes it in no hurry for any action.
- **A 50-50 probability to hiking/maintaining rates:** We assign equal probabilities to (1) hiking rates on higher-than-targeted urban inflation (17.5% > 16%) and (2) maintaining rates on the ground that higher inflation was driven by items of volatile nature.

Annual and monthly urban inflation rates (total republic)



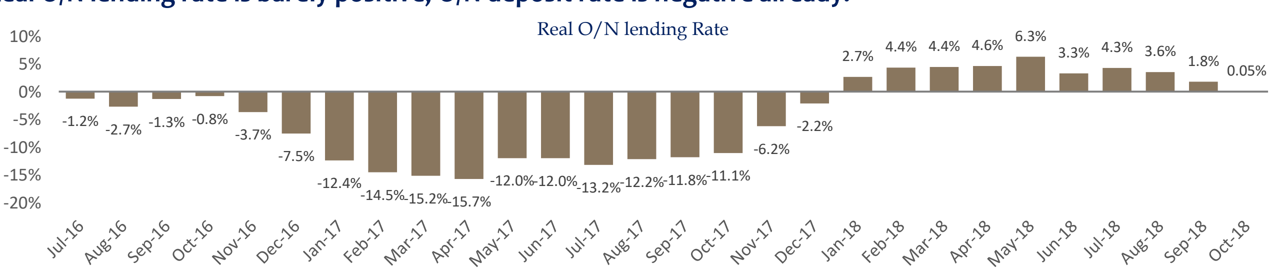
Source: CAPMAS

Contribution to annual headline inflation (total republic)



Source: CAPMAS

Real O/N lending rate is barely positive; O/N deposit rate is negative already.



Source: CBE, CAPMAS

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