Disinflationary trend interrupted

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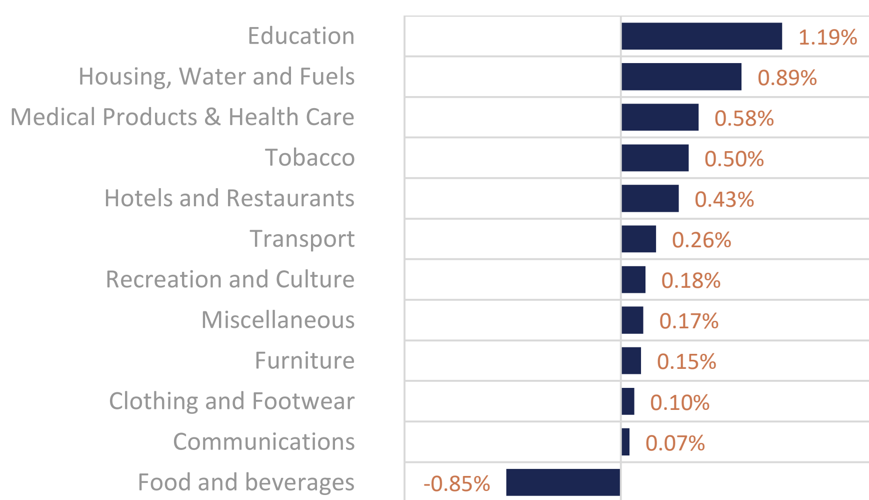
Despite the slight pick-up, lower food prices kept inflation significantly low: The disinflationary trend that continued to gather pace over the last couple of months was interrupted in September due to the unfavorable base effect and a more sluggish fall in food prices. Annual urban headline inflation picked up slightly to 3.7% in September, up from 3.4% in August, albeit still significantly below the CBE's target range of 9% ± 3%. On a monthly basis, inflation accelerated to +0.3% in September, up from -0.2% in August, on the back of **(1)** the ongoing process of reopening the economy and **(2)** the improvement in consumption sentiment, driven by the back-to-school season.

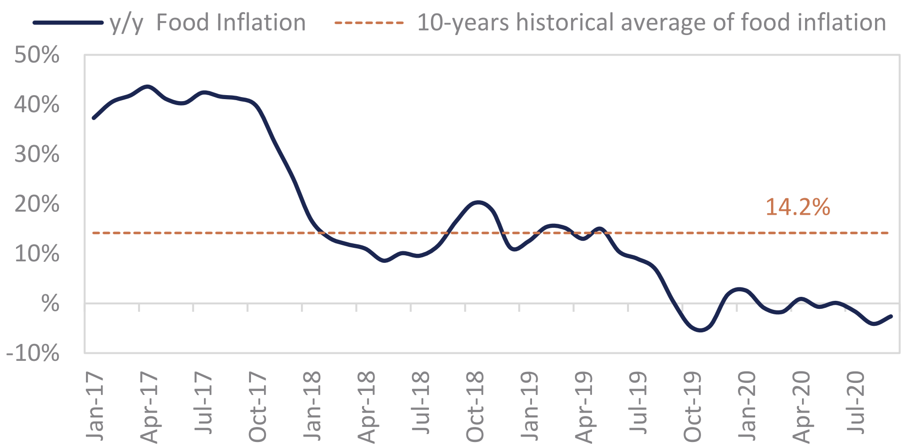
Structural weakness in food prices eased the unfavorable base year effect, pressuring our expectations downward: Food prices remained on a deflationary trend y/y for the third consecutive month in September, falling at a slower pace of 2.6% vs. 4.1% in August. We note that throughout the course of 2020 food prices remained well below their 10-year historical average of 14%, thanks to **(1)** absence of climate shocks, **(2)** muted demand during the pandemic turmoil, and **(3)** government policies ensuring the stability of domestic food supply chain. In September, most of the food and beverages (F&B) basket components witnessed a decline in their prices except for fruits. This slashed the contribution of the F&B basket in the headline figure to -0.85% in September (vs. -1.3% in August). Non-food inflation remained almost flat at 7% with its contribution to annual inflation led by the education, housing utilities, and medical products baskets. *The magnitude of the structural weakness in food prices, in addition to the pandemic-induced slowdown in demand, drove us to tweak our inflation forecast for Q4 2020 to range between 4.3-5%. This should keep the inflation readings well below the CBE target and lower than the 6% expected by the CBE governor.*

Chart 1: Deflated food prices kept annual inflation significantly low in September



Source: CAPMAS, Prime Research.

Chart 2: The significant downward shift in food inflation has so far been quite persistent through 2020



Source: CBE, Prime Research.

The F&B basket partially offset the effect of accelerating non-food inflation: On a monthly basis, food inflation remained negative for the fifth month in a row, registering -0.2% in September vs. -1.7% in August. This was driven by the increase in vegetable prices and a slower decline in the prices of most other F&B basket components. Meanwhile, monthly headline inflation was mainly driven by the housing and communication baskets.

The significant acceleration in core figures was driven by the unfavorable base effect and the process of reopening the economy: Annual core inflation elevated to 3.3% in September, up from 0.8% in August, while monthly inflation was also up at +0.1% vs. -0.2% in August. This came on the back of **(1)** the normalization of economic activity and the catch-up effect from the pandemic shock, which continue to gain momentum with the PMI registering its first expansion in 14 months in September, **(2)** the unfavorable base-year effect, and **(3)** the lower fall in non-volatile food prices.

Continued downward inflation readings raises the risk of falling short of the CBE target, opening the door for further easing: With the next MPC meeting scheduled for 12 November, we believe the committee will be assessing **(1)** the October inflation reading, **(2)** the trajectory of economic recovery, and **(3)** vulnerability of the external accounts in light of increasing global concerns over a second wave of COVID-19. *In our opinion, we believe a significantly low October inflation reading and slower-than-expected domestic growth prospects would spur another easing decision. Yet, external concerns could hamper such a move; the stability of oil prices and a strengthening EGP vis-à-vis the USD should pull inflation expectations downward further. Indeed, we expect October inflation reading to remain below 5%. Moreover, the underlying inflationary pressures will likely weaken by subdued demand and labor market slack. Thus, the CBE's next meeting decision will depend on the flow of information concerning the trajectory of economic recovery, labor market dynamics, and stability of the external position.*

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