

2017 year-end inflation at 6.8%

- **INEGI just published its inflation report for December**
- **Headline inflation (Dec): 0.59% m/m; Banorte: 0.6% m/m; consensus: 0.58% m/m; (range of estimates: 0.51% to 0.66%); previous: 1.03% m/m**
- **Core inflation (Dec): 0.42% m/m; Banorte: 0.46% m/m; consensus: 0.47% m/m (range of estimates 0.45% to 0.49%); previous: 0.34% m/m**
- **Inflation in December was explained by the increases in air fares and tourism services given the start of the holiday period**
- **With these numbers, annual inflation closed 2017 at 6.77%, reaching its highest level since May 2001**
- **Inflation setting suggests a flatter curve and more demand for floating rates**

Consumer prices increased 0.59% m/m in December, surpassing the consensus (0.58% m/m) but marginally below our forecast (0.6% m/m). Core inflation was 0.42% m/m vs. our 0.46% m/m estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of other services (17bps vs. our 20bps); and (2) a larger impact of fresh fruits and vegetables (13bps vs. our 11bps), as shown in the table below.

December inflation by major subcomponent

Monthly incidence, %

	Observed	Banorte-ixe forecast	Difference
Headline	0.59	0.60	0.00
Core	0.31	0.34	-0.03
Goods	0.11	0.12	0.00
Processed foods	0.08	0.08	0.01
Other goods	0.03	0.04	-0.01
Services	0.20	0.23	-0.03
Housing	0.03	0.03	0.00
Education	0.00	0.00	0.00
Other services	0.17	0.20	-0.03
Non-core	0.28	0.25	0.03
Agricultural	0.17	0.15	0.02
Fresh fruits and vegetables	0.13	0.11	0.02
Meat and egg	0.04	0.04	0.00
Energy and government regulated	0.11	0.11	0.00
Energy	0.08	0.09	-0.01
Government regulated	0.02	0.02	0.01

Source: INEGI, Banorte

Note: Contributions might not add due to the number of decimals allowed in the table. Previous to year 2011, contributions might not add because of the change in CPI-calculation methodology

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www.banorte.com
www.ixe.com.mx
@analisis_fundam

Delia Paredes

Executive Director of Economic Analysis
delia.paredes@banorte.com

Francisco Flores

Economist, Mexico
francisco.flores.serrano@banorte.com

Fixed income and FX Strategy

Alejandro Padilla

Head Strategist – Fixed-Income and FX
alejandropadilla@banorte.com

Juan Carlos Alderete, CFA

FX Senior Strategist
juan.alderete.macal@banorte.com

Santiago Leal Singer

Fixed-Income and FX Strategist
santiago.leal@banorte.com

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Inflation in December was explained by the increases in the price of tomatoes as well as air fares and tourism services given the holiday period.

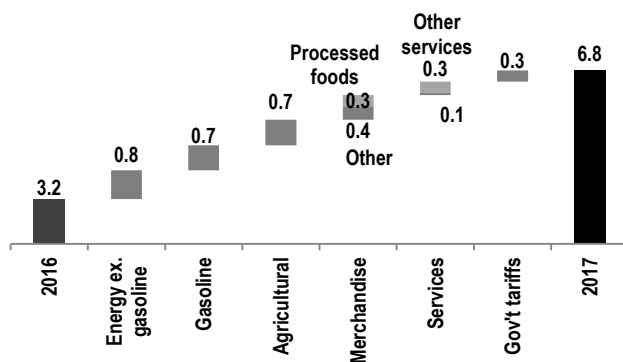
We highlight the 3.56% m/m expansion in the prices of fresh fruits and vegetables. This growth was mainly explained by the 42.91% advance in tomato prices and 26.81% in squash. However, these were mitigated by the fall in the prices of onions (-19.23% m/m) and avocados (-9% m/m) among others. Moreover, meat and egg prices rose 0.67% m/m given the growth in the price of eggs (5.76% m/m). In addition, energy prices advanced 0.77% m/m driven by the increases in the price of low-grade gasoline (0.82% m/m) and propane gas (1.4% m/m).

Regarding the core index, other services posted a 1% m/m expansion on the back of the 22.69% m/m rise in airfares, 7.43% m/m in tourism services, 0.59% m/m in restaurants, and 0.84% in local bus fares. Additionally, goods prices grew 0.32% given the 0.52% m/m advance in processed foods and 0.16% m/m in other goods.

With these numbers, annual inflation closed 2017 at 6.77%, reaching its highest level since May 2001.

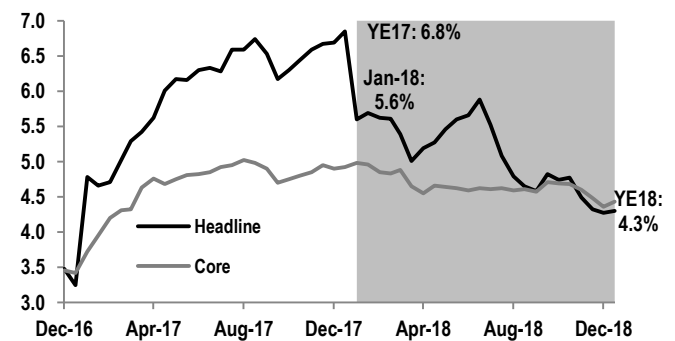
Additionally, core inflation stood at 4.87%. Inflation in 2017 was explained by the surge in energy prices, gasoline prices in the first half of the year and gas prices in 2H18. In addition, the agricultural cycle was not favorable for prices, with agricultural prices adding 0.7%-pts to total inflation. Moreover, there were pressures on merchandise prices as a result of FX pass-through along with the increase in minimum wage (see chart below on the left). For 2018 we expect inflation to start coming down as soon as in the first half of January (given the base-effect due to the increase in energy prices in 2017), ending the year at 4.3%. Looking ahead we will focus on the evolution of energy prices and the behavior of agricultural prices, and the impact they might have in Mexico's CPI.

Inflation in 2017
%



Source: Banorte with data from INEGI

Inflation forecast 2018
% yoy



Source: Banorte with data from INEGI

From our fixed income and FX strategy team

Inflation setting suggests a flatter curve and more demand for floating rates. 2017 annual inflation closed at 6.77% from 3.36% a year ago, with analyst once again underestimating inflation this Tuesday (19 out of the 24 fortnightly readings in the entire year). This backdrop confirms our view that Banxico will have a hawkish tilt in further communications suggesting another rate hike on February 8th, and two more in the 1H18, especially if we take into account that consumer prices are likely to remain pressured in coming months and this could result in unanchored mid-term inflation expectations. According to our forecasts, cumulative inflation in the following 91 days will be 1.61% (6.36% annualized), despite a “year-on-year” reading dropping towards 5.64%. In addition, Banco de México will be closing monitoring the relative stance vis-à-vis a more hawkish Federal Reserve. In the aftermath of today’s report the market observed a mild negative reaction, but with a cautious sentiment that could be conveyed at today’s weekly auctions of government securities. Local rates kicked off 2018 with a breather, however with investors acknowledging several factors ahead that could pose additional risk to country-specific premia (e.g. NAFTA, elections, hawkish central banks and implementation of the U.S. fiscal reform). Despite inflation dynamics, demand for CPI-linked Udibonos has weakened on the back of recent Banxico hikes and the expectations of tighter monetary conditions ahead (yield curve pricing in 2 rate hikes in 1H18). However, investors have been hedging against inflation via floating rates and not Udibonos, with breakevens hovering 3.9% granting limited potential. In terms of strategy, we hold our recommendations in floating-rate securities Bondes D and 10-year foreign-denominated currency UMS.

In terms of the FX market, the Mexican peso is selling off for the 2nd consecutive session after last week’s 2.5% rally, trading 0.5% weaker at USD/MXN 19.32. Despite today’s performance, the local currency has been resilient in the face of the risk factors mentioned above, trading as one of the most defensive EM year-to-date. Expectations of a hawkish Banxico have been supportive for the peso in a carry-adjusted basis. However, current valuation is reaching significant short-term supports around 19.20 and 19.00 that could result in a change in market technical position. In this regard, we are waiting for better entry points for long USD recommendations.

Disclaimer

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GRUPO FINANCIERO BANORTE S.A.B. de C.V.
Research and Strategy

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

Economic Analysis

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Juan Carlos García Viejo	Economist, International	juan.garcia.viejo@banorte.com	(55) 1670 - 2252
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

Fixed income and FX Strategy

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal, CFA	FX Senior Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Strategist Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

Equity Strategy

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Technical Analysis	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Equity Research – Conglomerates / Financials/ Mining / Petrochemicals	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research – Airlines / Airports / Cement / Infrastructure / REITs	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251

Corporate Debt

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248

Wholesale Banking

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.cebillos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Asset Management	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Victor Antonio Roldan Ferrer	Head of Corporate Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454