Inflation in March was explained by the higher prices of tourism services

- ***INEGI*** **just published its inflation report for March**
- **Headline inflation (March): 0.32% m/m; Banorte: 0.41% m/m; consensus: 0.40% m/m; (range of estimates: 0.35% to 0.44%); previous: 0.38% m/m**
- **Core inflation (March): 0.33% m/m; Banorte: 0.37% m/m; consensus: 0.36% m/m (range of estimates 0.32% to 0.40%); previous: 0.38% m/m**
- **Inflation in March was explained by pressures on the prices of tourism services**
- **With these results annual inflation edged down to 5.04%, below the 5.34% in February**
- **The current CPI backdrop remains supportive for our trade idea in terms of long positions in mid-term Mbonos**

Consumer prices increased 0.32% m/m in March, below both our forecast (0.41% m/m) and consensus (0.40% m/m). Core inflation was up 0.33% m/m, below our 0.37% m/m estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution from energy prices (3bps vs. our 9bps); (2) a smaller impact from other services prices (12bps vs. our 14bps); and (3) a lower contribution from meat and egg prices (5bps vs. our 6bps), as shown in the table below.

March inflation by major subcomponent
Monthly incidence, %

	Observed	Banorte forecast	Difference
Headline	0.32	0.41	-0.09
Core	0.24	0.27	-0.03
Goods	0.09	0.09	-0.01
Processed foods	0.03	0.03	0.00
Other goods	0.06	0.07	-0.01
Services	0.16	0.18	-0.02
Housing	0.04	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.12	0.14	-0.02
Non-core	0.08	0.14	-0.06
Agricultural	0.04	0.04	0.00
Fresh fruits and vegetables	-0.01	-0.02	0.01
Meat and egg	0.05	0.06	-0.02
Energy and government regulated	0.04	0.10	-0.06
Energy	0.03	0.09	-0.06
Government regulated	0.01	0.01	0.00

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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Inflation in March was explained by pressures on prices of tourism services. The cost of other services increased 0.68% m/m on the back of higher prices of tourism services (11.29 % m/m), air fares (9.39% m/m), and restaurants (0.39% m/m). Additionally, processed food prices increased 0.18% m/m. Moreover, prices of other goods edged up 0.32% m/m while housing costs increased 0.23% m/m on the back of a similar increase in home ownership costs.

Regarding the non-core index, energy prices increased 0.29% m/m on the back of higher prices of low-grade gasoline (1.39% m/m) and electricity (0.75% m/m), while LP gas costs decreased 3.62% m/m. Moreover, prices of fruits and vegetables edged down 0.68% m/m, driven by lower prices of nopales (-27.32% m/m), and potatoes (-6.14% m/m), among others. However, these were offset by the increase in the price of tomatoes (25.63% m/m) and lemons (47.40% m/m).

With these figures, annual inflation continued edging down to 5.04% vs. 5.34% in February. Additionally, core inflation came down to 4.02% from 4.27% in the previous month. We continue expecting inflation to show a downward trend to finish 2018 at 4.3%. In the coming months, we will focus on the evolution of energy prices, considering the possible increase in the international reference price –given the start of the US driving season–, as well as the behavior of agricultural prices, and the impact they might have in Mexico's CPI.

From our fixed income and FX strategy team

The current CPI backdrop remains supportive for our trade idea in terms of long positions in mid-term Mbonos. Mexican bonds are extending last week's rally on the back of a better than expected CPI inflation report released this morning. Mbonos are registering gains of 4bp as investors are still acknowledging an interesting valuation in terms of carry and risk premia. Annual inflation has depicted a sharp convergence towards lower levels in the 1Q18, moving from 6.77% by 2017-end to 5.04% in March. This situation has been negative for CPI-linked Udibonos in terms of carry, but very positive for nominal-rate Mbonos in terms of embedded inflation premia. Inflation breakevens trading at 3.32% in the 3-year tenor, 3.43% at a 5-year horizon and between 3.50% and 3.60% for longer durations are near the market inflation expectations depicted in recent surveys (*e.g.* Banxico's poll last week), suggesting a limited reward in linkers. These inflation dynamics in tandem with a resilient peso throughout 2018 are reducing the likelihood of additional rate hikes from the central bank in the short-term. In this regard, the market is currently pricing in only 5bps of rate hikes in 2Q18, and an implied repo rate 13bps lower by year-end. This situation is constructive for the belly of the Mbonos curve, with forward rates trading with valuations that depict tighter monetary conditions that are less likely to take place, which could result in additional capital gains in these securities.

Taking into account these conditions, we hold our trade idea of long positions in mid-term Mbonos (7- to 10-year area) that we opened last Monday. There are two events this week that could be supportive for this strategy and could steer an additional rally: Banxico's communiqué and favorable news coming from NAFTA negotiations (*e.g.* Summit of the Americas in Peru on April 13th and 14th, 2018).

Disclaimer

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