

Sum of all (inflation) fears. Banxico will hike rates next week

- **Headline CPI posted a monthly increase of 1.03% in November (Banorte: 1.01%; Mkt: 1.01%; Forecast interval: 0.99%-1.1%; Previous: 0.63%)**
- **Core inflation increased 0.34%/m/m during the same period of time (Banorte: 0.3%; Mkt: 0.32%; Forecast interval: 0.26%-0.36%; Previous: 0.13%)**
- **In fact, 12-month CPI headline inflation came in at 6.67% in Nov-2H, right below Aug-2H inflation of 6.74%**
- **In this context, even though inflation was not well above consensus or from our own forecast, this is the 17th time in the past 22 bi-weekly readings that inflation beats consensus estimates**
- **Consensus is now calling for a 25bp hike while the TIEE futures market had already discounted a 25bp rate hike with a 64% probability**
- **Since it is clear for us that currently high inflation is mainly explained by supply-side factors, that Banxico has already hiked 400bps since December 2015, and that in less than two months 12-month inflation will be between 130 and 160 bps lower, we believe that the monetary authority should not hike. More so with the recent growth, private consumption, and investment weak numbers**
- **Nevertheless, the recent quick depreciation of the peso vis-à-vis the US dollar and today's inflation number, adds to the more hawkish tone we have perceived from new central bank Governor Díaz de León, as well as the fact that the US Fed has also been perceived more hawkish**
- **As a result, we now also expect a 25bp rate hike next week vs. our previous call for Banxico to remain on hold**
- **Looking ahead, however, we continue to believe that Banxico's next move will be a rate cut in the second half of year 2018**

Inflation close to its two year high. INEGI released today its monthly CPI report. Headline CPI posted a monthly increase of 1.03% in November, slightly above consensus and our own estimate of 1.01%. Core inflation increased 0.34%/m/m during the same period of time, slightly above expectations (Banorte: 0.3%; Mkt: 0.32%; Forecasts interval: 0.26%-0.36%; Previous: 0.13%). Inflation during the period in question was explained by pressures on electricity –as a result of the end of summer discounts-, gas and agricultural prices. In fact, 12-month CPI headline inflation came in at 6.67% in Nov-2H, right below Aug-2H inflation of 6.74%, the highest inflation in more than two years (please see chart below on the right). The main deviation from our forecast comes from: (1) A larger than expected contribution of other services prices (5bps vs. our 3bps); (2) a lower than expected contribution of meat and egg prices (0bps vs. our 2bps); and (3) a larger than expected contribution of merchandise prices (12bps vs. our 10bps), as shown in the table below.

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November inflation by major subcomponent

Monthly incidence

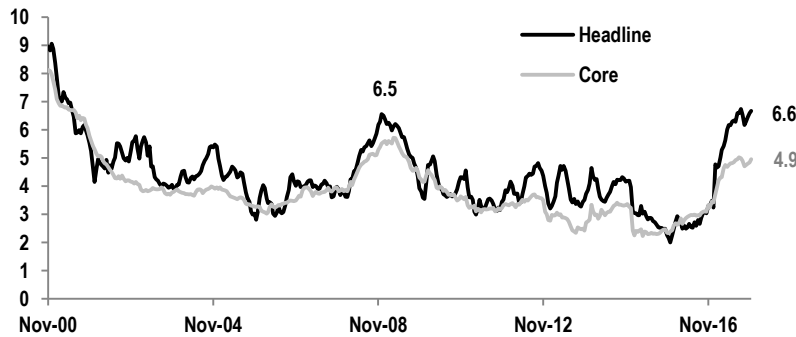
| | Observed | Banorte-ixe forecast | Difference |
|---------------------------------|----------|----------------------|------------|
| Headline | 1.03 | 1.01 | 0.03 |
| Core | 0.26 | 0.23 | 0.03 |
| Goods | 0.12 | 0.10 | 0.01 |
| Processed foods | 0.06 | 0.06 | 0.01 |
| Other goods | 0.05 | 0.05 | 0.01 |
| Services | 0.14 | 0.12 | 0.02 |
| Housing | 0.04 | 0.04 | 0.00 |
| Education | 0.00 | 0.00 | 0.00 |
| Other services | 0.10 | 0.09 | 0.02 |
| Non-core | 0.77 | 0.78 | -0.01 |
| Agricultural | 0.11 | 0.12 | -0.01 |
| Fresh fruits and vegetables | 0.11 | 0.10 | 0.01 |
| Meat and egg | 0.00 | 0.02 | -0.02 |
| Energy and government regulated | 0.66 | 0.66 | 0.00 |
| Energy | 0.64 | 0.64 | 0.00 |
| Government regulated | 0.01 | 0.01 | 0.00 |

Source: INEGI, Banorte-ixe

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

Bi-weekly inflation

% yoy

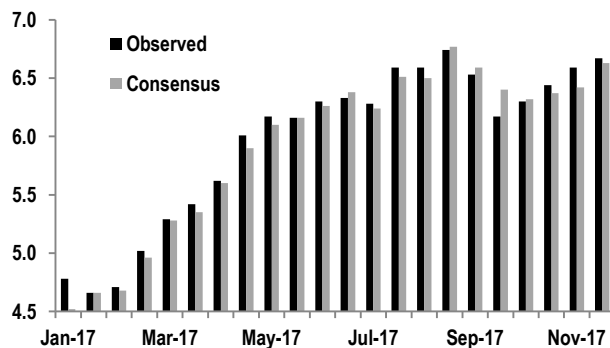


Source: INEGI

Higher-than-expected inflation, again! Even though inflation was not well above consensus or from our projection, this is the 17th time in the past 22 bi-weekly readings that inflation beats consensus estimates (please see the chart/table below on the left). As a result, consensus is now calling for a 25bp rate hike and TIE futures market had already discounted a 25bp rate hike with a 64% probability, as it is shown in the chart below on the right.

Bi-weekly inflation vs. consensus forecast

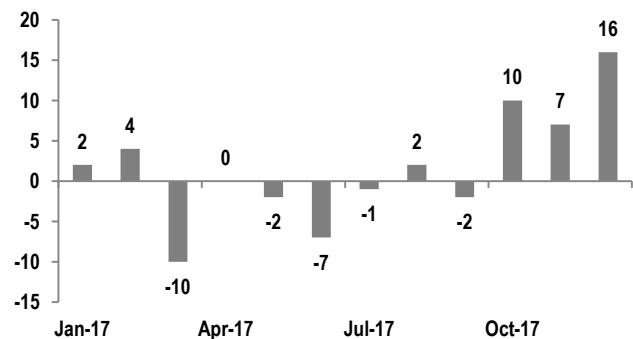
% yoy, bi-weekly frequency



Source: INEGI and Bloomberg

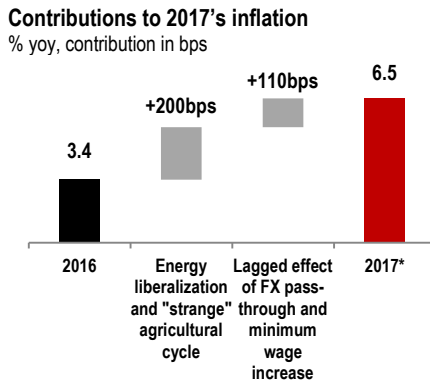
Implied rate movements for Banxico in December

Basis points, using TIE-28 futures

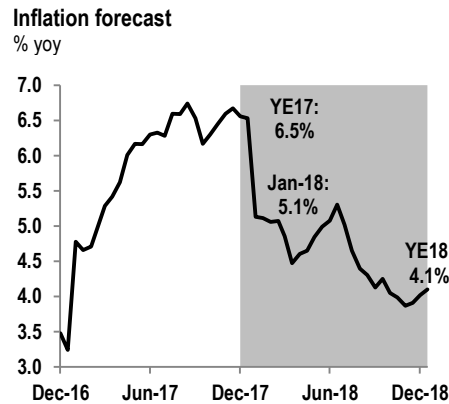


Source: MexDer

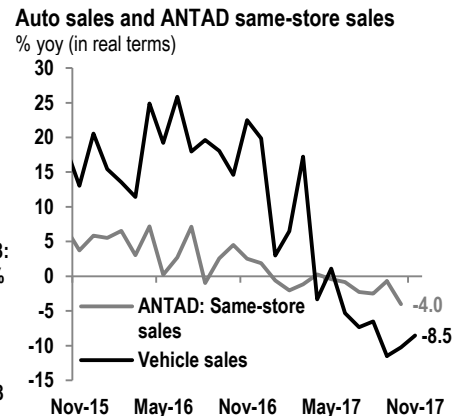
Supply-side shocks, already high reference rate and weaker economic activity: A case for a no hike. It is clear for us that currently high inflation is mainly explained by supply-side factors. Nearly two thirds of this year’s increase in 12-month inflation is due to the gasoline and LP gas price liberalization, as well as an adverse agricultural cycle. The rest reflects lagged effects of the significant depreciation of the peso vis-à-vis the US dollar since year 2014, which seems to have decided to show “*its ugly face*” recently (please see the flying-brick chart below on the extreme left). Moreover, recall that Banxico has already hiked 400bps since December 2015. What is more, we are quite sure that in the absence of extreme shocks, 12-month inflation will be between 130 and 160 bps lower in less than two months, as it is shown in the chart below in the middle. As a result, we believe Banxico should not hike. More so given weak numbers observed recently on growth, private consumption, and investment (please see the chart below on the extreme right). In this contrast, even though the third quarter weakness might have reflected the aftermath of the severe earthquakes the Mexico City and surrounding states faced back in September, the recent “*Buen Fin*” consumer figures (Mexico’s *Black Friday*), could support more structural underlying reasons for the observed deceleration in economic activity.



Source: INEGI



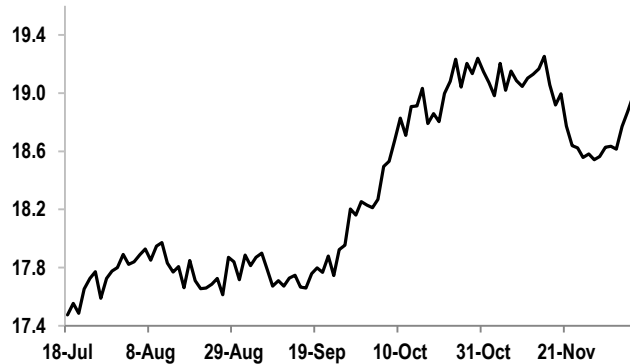
Source: INEGI, Banorte



Source: National Association of Retail, Department and Convenience Stores (ANTAD) and Mexican Association of the Automotive Industry (AMIA)

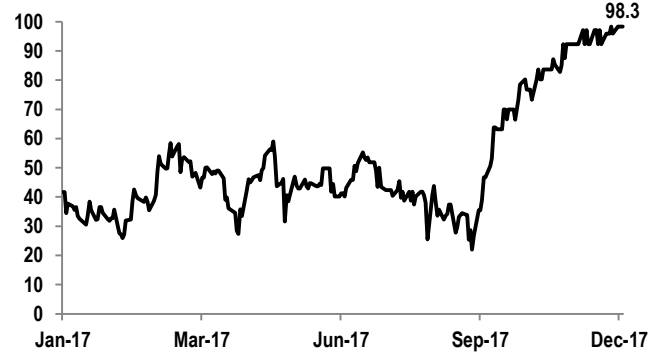
The case for a hike, which we now believe will happen. The recent quick depreciation of the peso vis-à-vis the US dollar (please see chart below on the left), and today’s inflation number, adds to the more hawkish tone we have perceived from new central bank Governor Díaz de León, as well as the fact that the US Fed has also been perceived more hawkish (please see chart below on the right). As a result, we change our call to a 25bp rate hike next week, from having expected Banxico to remain on hold. Looking ahead, we continue to expect Banxico’s next move to be a rate cut in the second half of year 2018.

Mexican peso
USD/MXN



Source: Bloomberg

Probability of Fed funds rate reaching 1.25%-1.5% range in December
%



Source: Bloomberg

From our fixed income and FX strategy team

CPI continues surprising on the upside, putting additional pressures to Banxico, and increasing the appeal for defensive strategies ahead of next week’s policy decision. Once again inflation came in above market expectations, adding pressures to the central bank who is observing deteriorated inflation dynamics that could pose a significant risk for market expectations. Inflation breakevens are hovering around 3.65% in the 3-, 5- and 10-year tenors, while the reading with the longest duration (30 years) is trading at 3.76%. This suggests that second round effects are not contaminating mid-term inflation expectations yet, however with a market that is pricing 16bps of implied hike coming from Banxico next week that could anchor this conjecture. With today’s print, analysts have underestimated the fortnightly inflation in 17 out of 22 readings so far this year, undermining current 12-month ahead and 2018-end forecasts which have significant risks to the upside. Today’s report is especially relevant taking into account that Banxico is holding its last policy meeting of the year next week (December 14th), with a new governor and just a day after the Federal Reserve is likely to deliver another 25bps rate hike (market pricing in an implied probability of 98.3% for this scenario). As the probability of a rate hike from *Banco de México* has increased considerably, we recommend defensive strategies ahead of next week’s events, highlighting a favorable valuation in floating-rate Bonds D and long-term USD-denominated UMS. On the other hand, we suggest closing the short-term trade idea regarding steepeners in the TIEE-IRS curve waiting for Banxico’s decision, which could result in better entry levels. We observed a modest market reaction in the yield curve today, as investors are cautiously preparing for the relevant events mentioned previously.

In the FX market, the Mexican peso has weakened in the past few days in a backdrop of renewed USD strength, from 18.50 by the end of November to almost 19.00 currently. At the margin, this is another reason for Banxico to hike rates next week, instead of staying on hold. The latter would maintain the high attractiveness of the peso's carry (given the high likelihood of a 25bps hike by the Fed), with the 3M annualized rate based on FX forwards at 5.90%. This is augmented by the fact that other Latam countries have cut rates during the year, such as yesterday's 50bps cut in BRL. Despite of the latter, we maintain a cautious stance on the peso, suggesting USD/MXN longs for trading purposes, as it is our take that risk premium could increase further given high idiosyncratic risk factors, particularly NAFTA negotiations and the Presidential election.

Disclaimer

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