1H March Inflation Report – Prices increase less than expected

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- ***INEGI* just published its inflation report for in the first half of March**
- **Headline inflation (Mar): 0.18%2w/2w (Banorte-Ixe: 0.29%2w/2w; consensus: 0.25%2w/2w)**
- **Core inflation (Mar): 0.15%2w/2w (Banorte-Ixe: 0.21%2w/2w; consensus: 0.2%2w/2w)**
- **Inflation in the first half of March was explained by higher energy and services prices**
- **With these numbers, annual inflation is at 2.97% vs. 3% in previous month**
- **Investors have acknowledged no evidence of FX pass-through on inflation**

Consumer prices increased 0.18%2w/2w in in the first half of March, below expectations. Core inflation was 0.15% vs. our 0.21% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of agricultural prices (-1.3bps vs. our 4.8bps); (2) a lower than expected contribution of merchandise prices (4.5bps vs. our 7.5bps); and (3) an overestimation of services prices (6.5bps vs. our 8.4bps), as shown in the table below.

1H-March inflation by components
% bi-weekly incidence

	Observed	Banorte-Ixe forecast	Difference
Headline	0.18	0.29	-0.114
Core	0.11	0.16	-0.049
Goods	0.05	0.08	-0.030
Processed foods	0.01	0.04	-0.033
Other goods	0.04	0.04	0.003
Services	0.06	0.08	-0.019
Housing	0.01	0.02	-0.005
Education	0.00	0.00	0.001
Other services	0.05	0.07	-0.015
Non-core	0.07	0.13	-0.064
Agricultural	-0.01	0.05	-0.061
Fresh fruits and vegetables	0.01	0.04	-0.028
Meat and egg	-0.02	0.01	-0.032
Energy and government regulated	0.09	0.09	-0.002
Energy	0.09	0.09	-0.001
Government regulated	0.00	0.00	0.000

Source: Banorte-Ixe with data from INEGI and Banco de México.
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.

Inflation in the first half of March was explained by higher energy and services prices. Energy prices increased 0.81% 2w/2w, on the back of higher low-grade gasoline prices (up 1.68%), particularly in cities near the border. Meanwhile, the cost of services increased 0.16% 2w/2w as a result of higher housing (0.08%) and education (0.03%) costs, while other services inflation was 0.29% during the period in question. The report mentions increases in the cost of tourism services (+2.5%); air transportation (5.8%) along with other dining away from home items (0.21%), among the products with price increases. Meanwhile, merchandise prices were up 0.13% 2w/2w, on the back of a 0.2% increase in the price of merchandise (ex. food). Agricultural prices increased 0.14%, explained by lower prices of "meat and egg" (-0.36%) while the price of fruits and vegetables increased 0.3% in the first half of March. Nevertheless, the report suggests strong increases in key products such as tomatoes (+20%) and lemons (11.7%) –in the fruits and vegetables sub-index; along with eggs (+2.07%). These pressures could continue in the next few weeks, but we believe that they could be temporary.

With these data, annual inflation is at 2.97% vs. 3% in the previous month. Meanwhile, core inflation remains at levels around 2.4% in the first half of March. Looking ahead, we continue to believe that inflation in annual terms will remain at levels of around 3%, with limited pass-through effects from the exchange rate depreciation. Nonetheless, as we said before, there could be some temporary pressures on agricultural prices.

From our fixed income and FX strategy team

Investors have acknowledged no evidence of FX pass-through on inflation. Market inflation expectations remain well anchored on the back of favorable low-inflation inertia worldwide in tandem with lower commodities' prices, despite the fact of a weaker currency in the last 6 months (peso cumulative loss of 14% against USD). Today's CPI report in Mexico depicted additional evidence of low FX pass-through on inflation, which has steered inflation breakevens below Banxico's target of 3% in every tenor (from 3 to 30 years) along the yield curve. In our view this situation will be supportive for local rates, as inflation premia embedded in Mexican bonds is likely to remain relatively stable. We observed a null effect in local markets after the inflation report was released, as investors continue focusing their attention in global drivers: Fed, oil prices and geopolitical risks. However, well-contained inflation dynamics suggests that Banxico will likely start normalizing monetary conditions in tandem with Fed's actions. Putting all these factors together, we hold a positive outlook regarding the Mbonos curve in Mexico, where relative valuation remains favorable in the 10- to 20-year segment. In terms of Mexican linkers, valuation is extremely attractive in Udibonos, especially the mid and long ends. The most attractive breakevens are the 10-year (2.84%) and 30-year (2.92%). Risk rewards in these strategies could be 60-75bps. However, an important issue to take into consideration is the negative carry of Mexican linkers in the 1H15. In this regard, we consider that in April/May the market is likely to swap long strategies from Mbonos to Udibonos.

In terms of the FX market, the Mexican peso's pressure waned somewhat after the report, currently trading 0.1% weaker on the day at 14.94 per dollar. The lower-than-expected CPI print has several implications for the currency. More directly, scant evidence of pass-through effects from currency depreciation to prices is positive as it keeps the ample undervaluation of the currency's real exchange rate according to different models (such as the effective, trade-weighted measure deviation from its 5-year average signaling the peso is 11.4% cheaper) and supports local, ex-post real rates. More indirectly, expectations regarding a sooner rate hike by Banxico when compared to the Fed could be reduced ahead of its decision next Thursday, which in case of a significant adjustment to market expectations and nominal rates could actually result in lower real rates against the US, dampening support for the peso coming from a higher interest rate differential. All in all, we see contained inflation and limited pass-through as a mid-term positive for the currency. Despite of the latter, high volatility in international markets and the possibility of a Fed rate hike sooner than expected by the market should maintain the USD well bid. In this respect, we reiterate our directional long recommendation in USD/MXN suggested on Friday with entry of 14.98, target of 15.50 and stop-loss of 14.60 per dollar as it is our take that local drivers for peso strength will remain limited at least until the 2H15.

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