

# 1H-May – Energy prices came down less than expected

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- **INEGI just published its inflation report for the first half of May**
- **Headline inflation (1H-May): -0.29% 2w/2w; Banorte: -0.39% 2w/2w; consensus: -0.34% 2w/2w; (range of estimates: -0.54% to 0.36%); previous: 0.00% 2w/2w**
- **Core inflation (1H-May): 0.13% 2w/2w; Banorte: 0.15% 2w/2w; consensus: 0.12% 2w/2w (range of estimates 0.08% to 0.16%); previous: 0.10% 2w/2w**
- **Deflation in the first half of May was explained by lower electricity tariffs as summer discounts continue to apply, which were partially offset by higher than expected gas and gasoline prices**
- **With these results annual inflation continued to edge down to 4.46%, below 4.55% in April**
- **Positive reaction in short-term Udibonos amid a more modest deflation print and prevailing risks**

## Fixed income and FX Strategy

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Consumer prices decreased 0.29% 2w/2w in the first half of May, above both our forecast (-0.39% 2w/2w) and consensus (-0.34% 2w/2w). Core inflation was up 0.13% 2w/2w, marginally below our 0.15% 2w/2w estimate. The main deviation from our forecast comes from: (1) Energy prices came down less than expected (-32bps vs. our -46bps); (2) a lower impact from other goods prices (-1bps vs. our 3bps); (3) agricultural prices decreased more than we estimated (-7bps vs. our -4bps); and (4) a slightly higher than expected contribution from other services (6bps vs. our 4bps), as shown in the table below.

### 1H-May inflation by major subcomponent

Bi-weekly incidence, %

	Observed	Banorte forecast	Difference
Headline	-0.29	-0.39	0.09
Core	0.09	0.11	-0.02
Goods	0.02	0.06	-0.03
Processed foods	0.03	0.03	0.00
Other goods	-0.01	0.03	-0.03
Services	0.07	0.06	0.02
Housing	0.02	0.02	0.00
Education	0.00	0.00	0.00
Other services	0.06	0.04	0.02
Non-core	-0.39	-0.50	0.11
Agricultural	-0.07	-0.04	-0.03
Fresh fruits and vegetables	-0.06	-0.05	-0.01
Meat and egg	-0.01	0.01	-0.02
Energy and government regulated	-0.32	-0.46	0.13
Energy	-0.32	-0.46	0.14
Government regulated	0.00	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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**Deflation in the first half of May was explained by lower electricity tariffs as summer discounts continue to apply.** Nevertheless, this decline was offset by higher than expected gas and gasoline prices. Energy prices came down 3% 2w/2w on the back of lower prices of electricity (-22.32% 2w/2w), as summer discounts continued to start applying and offset by higher LP gas (5.3% 2w/2w) and low-grade gasoline (0.64% 2w/2w) prices.

Moreover, prices of fruits and vegetables edged-down 1.6% 2w/2w, driven by lower prices of lemons (-25.9% 2w/2w) and tomatoes (-7.8% 2w/2w), among others. These were partially offset by the increase in the price of oranges (14.7% 2w/2w). In addition, poultry prices increased 1.4% 2w/2w, while prices of eggs and fish decreased 3.9% and 1.2% 2w/2w, respectively, driving down the meat and egg component 0.16% 2w/2w.

In the core index, the cost of other services increased 0.33% 2w/2w on the back of higher prices of air fares (16.9% 2w/2w), tourism services (2.1% 2w/2w) and dining away from home items (0.16% 2w/2w). Moreover, prices of processed foods edged up 0.19% 2w/2w while housing costs increased 0.09% 2w/2w on the back of a similar increase in home ownership costs. By contrast, other goods prices fell by 0.04% 2w/2w driven by lower automobile costs (-0.27% 2w/2w).

**With these figures, annual inflation continued edging down to 4.46% vs. 4.55% in April.** Additionally, core inflation came down to 3.69% from 3.71% 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*

**Positive reaction in short-term Udibonos amid a more modest deflation print and prevailing risks.** May's 1st biweekly CPI report was above market expectations, printing at -0.29% 2w/2w (Banorte -0.39%, consensus -0.34%, previous 0.00%) with an annual rate at 4.46% (Banorte 4.36%, consensus 4.41%, previous 4.55%). This situation has taken place in a context where in 6 out of the last 9 biweekly reports have been a positive surprise (with a market overestimating the figure). Following this report, the local fixed-income market limited a good performance in nominal rates which in part was supported by other global rates rallying and a defensive performance in the Mexican peso. Meanwhile, Udibonos reacted positively, especially in the shortest-end of the curve.

Recent CPI developments have provided space for Banxico to maintain their policy stance, albeit with a less hawkish bias than the one expected by the market, just as in its latest monetary policy decision. However, in our view there are still prevailing factors that could argue for a rate hike during this quarter, in line with our expectations (Banorte: +25bps on June 21<sup>st</sup>). Among these we highlight the FX depreciation accumulated since April 17<sup>th</sup> (~9%) and the gasoline price increase in a context of energy costs rising worldwide. Given this backdrop and despite the rally in the last two days, we stay on the sidelines in the Mbonos market, waiting for better conditions and entry levels for new trade ideas. We reiterate our recommendation of sticking with defensive strategies in floating-rate securities (*e.g.* Bondes D).

Regarding real rates, the breakevens' recent upward adjustment reflects a less attractive valuation, locating at 3.79% and 3.71% for the 3- and 5-year tenors respectively, from 3.40% and 3.58% the previous month, in the same order. Moreover, UDIS' carry is still low and could remain in this state at least during the second half of the year. According to our forecasts, implicit carry for the next 91 days prints at 0.45% (1.82% annualized) and for the next 182 days at 1.54% (3.10% annualized).

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