

Energy prices will fuel inflation in 2017, probably boosting interest rates

January 24, 2017

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- **INEGI just published its inflation report for in the first half of January**
- **Headline inflation (Jan): 1.51%2w/2w (Banorte-Ixe: 1.27%2w/2w; consensus: 1.04%2w/2w; forecast interval: 0.84%-1.46%)**
- **Core inflation (Jan): 0.37%2w/2w (Banorte-Ixe: 0.36%2w/2w; consensus: 0.31%2w/2w; forecast interval: 0.16%-0.60%)**
- **Inflation in the first half of January was explained by pressures on low-grade gasoline prices along with increases in domestic gas prices**
- **With these numbers, we revised up our year-end estimate to 5.7%, from 4.7% previously**
- **We now call Banxico for 200bp interest rate hikes throughout the year, instead of 150bps that as we previously had foreseen**
- **The current inflationary environment continues to be favorable to our trade ideas on CPI-linked Udibonos**

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Consumer prices increased 1.51%2w/2w in in the first half of January, above expectations. Core inflation was 0.37% vs. our 0.36% estimate. The main deviation from our forecast comes from: (1) A larger than expected contribution of energy prices (132.6bps vs. our 91.8bps); (2) an underestimation of government tariffs (9.6bps vs. our 6bps); (3) an underestimation of merchandise prices (20.1bps vs. our 16.5bps); (4) A lower than expected contribution of agricultural prices (-9.6bps vs. our 2bps); and (5) a lower than expected contribution of services prices (7.4bps vs. our 10.5bps), as it is shown in the table below.

1H-January inflation by components

% bi-weekly incidence

	INEGI	Banorte-Ixe	Difference
Total	1.51	1.27	0.245
Core	0.27	0.27	0.005
Goods	0.20	0.17	0.036
Processed foods	0.13	0.12	0.010
Other goods	0.07	0.05	0.026
Services	0.07	0.10	-0.030
Housing	0.03	0.02	0.001
Education	0.02	0.02	-0.003
Other services	0.03	0.06	-0.028
Non-core	1.27	1.00	0.270
Agriculture	-0.10	0.02	-0.116
Fruits & vegetables	-0.12	0.01	-0.123
Meat & eggs	0.02	0.02	0.005
Energy & government tariffs	1.40	0.98	0.424
Energy	1.33	0.92	0.408
Government tariffs	0.10	0.06	0.036

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

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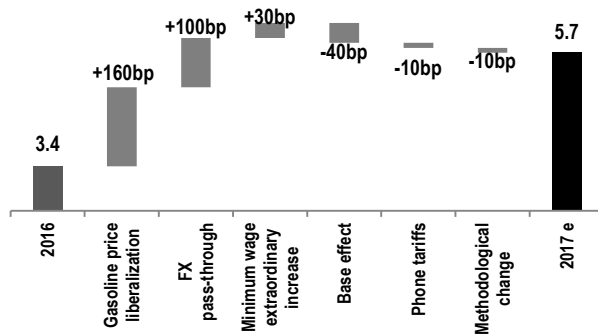
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Inflation in the first half of January was explained by pressures on low-grade gasoline prices along with increases in domestic gas prices. The new gasoline prices announced by the government at the end of last year resulted in an increase of 16.8% in the price of low-grade gasoline along with high-grade prices up 21.7%, adding 93.3bps to total inflation in the first half of January. In addition, gas price were also part of the liberalization of energy prices, bringing domestic LP gas up by 17.8% and adding another 28.5bp to CPI variation during the period in question. In addition, government tariffs were up 1.81%2w/2w on the back of increases in the urban bus fare (3.94%) as well as water service fees (2.34%). Meanwhile, agricultural prices came down 3.31%, with sharp declines in the prices of tomatoes (-26.4%), *Husk* tomatoes (-7.61%), among others. In the core index, merchandise prices increased 0.58%2w/2w explained by a 0.82% increase in processed foods and 0.38% higher prices of other merchandise. Finally, the prices of services were up 0.19% 2w/2w, due to a 0.15% and 0.32% increases in housing and education costs, respectively along with 0.19% higher prices of other services.

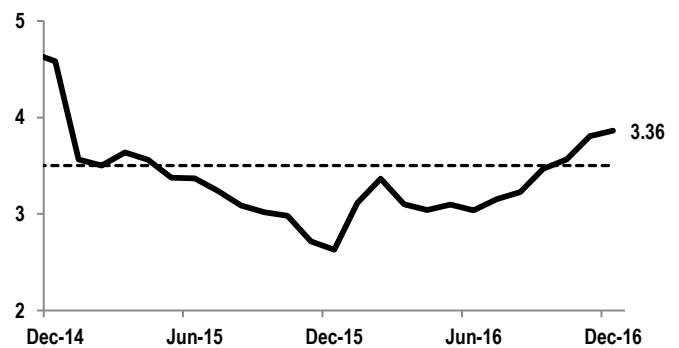
With these data, we revised up our inflation forecast for year-end to 5.7% from 4.7%. Annual inflation is at 4.78% in the first half of January from 3.36% at the end of 2016. Meanwhile, core inflation is at 3.72% from 3.44% in December. Looking ahead, we expect another increase in gasoline prices in February, as well as a larger pass-through effect from exchange rate depreciation, as shown in the chart below on the left. It is worth mentioning that, although inflation had been below the central bank's target for two years (see chart below on the right), current levels are reflecting significant changes in the relative prices derived from several supply-sided shocks such as FX pass-through, the liberalization of gasoline prices and the increase in the minimum wage, which tend to be transitory and will begin to ebb away over time.

2017 inflation forecast
Contribution in bps



Source: Banorte-Ixe with data from INEGI

Total inflation
% y/y



Source: INEGI

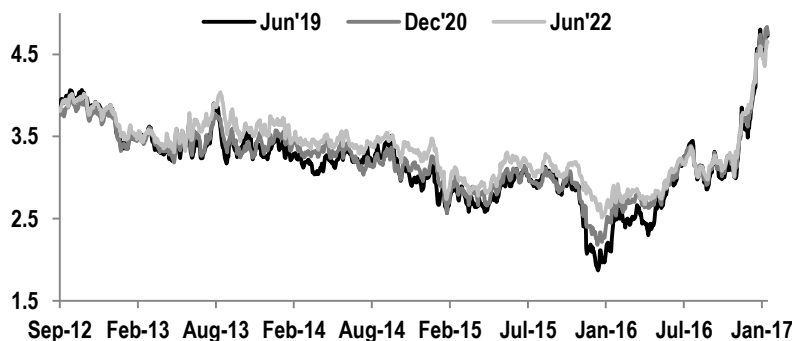
We expect Banxico to hike rates by 200bps in 2017. In particular, we believe that the central bank will hike 50bps at its upcoming meetings of February 9 and March 30, aiming to anchor medium and long term expectations. Moreover, we expect Banxico to follow the Fed and will hike 50bps both, in June and in December.

From our fixed income and FX strategy team:

Inflation conditions the perfect backdrop for our trade ideas on CPI-linked Udibonos. Today’s CPI report confirmed that inflation dynamics will be heavily undermined by higher energy prices (*e.g.* gas and gasolines), in addition with a clear evidence of FX pass-through and other factors. The year started with an above-consensus 1.51% fortnightly print, resulting in an annual metric moving from 3.4% to 4.8%. In the aftermath of this release, Mexican bonds sold off nearly 5bps in almost every tenor, with the market continue pricing in 155bps of implied interest rate hikes from Banxico this year. On the other hand, CPI-indexed Udibonos remain on the positive side, rallying this morning nearly 8bps. In terms of strategy, we recommend holding the long positions on the CPI-linked Udibonos Jun’19, Dec’20 and Jun’22 opened on December 2nd (more details in “*Fixed-Income, FX, and Commodities Update – The Trump Aftershock*” <[pdf](#)>). In our view, the market has not fully priced in the complex inflation dynamics that are likely to be observed during 2017. As a result, we recommend holding positions in these securities ahead of deteriorated inflation dynamics. These securities have been observing a positive performance during the last 7 weeks when we opened this trade idea. However, relative valuation *vis-à-vis* Mbonos has turned expensive. The breakeven of Udibono Jun’19 is at 4.73%, Dec’20 at 4.74%, and Jun’22 at 4.65%, suggesting a modest potential risk reward of 10-15bps. Inflation this year could be severely impacted by three factors, mainly: (1) An additional pass-through effect from peso weakness to prices, (2) gasoline price liberalization, and (3) the minimum wage increase. For our comprehensive view on local rates for 1Q17 please refer to our research note “*Fixed-Income, FX, and Commodities Update – 1Q17 Outlook*” <[pdf](#)>, published on January 20th, 2017.

Inflation breakevens embedded in Udibonos Jun’19, Dec’20 and Jun’22

% (implied market inflation using Fisher Equation)



Source: Banorte-Ixe con información de Valmer

In the FX market, the Mexican peso trades 0.4% stronger relative to yesterday's close at 21.30 per dollar, without a meaningful impact due to the report. In spite of the latter, these figures serve as evidence of the difficult inflation backdrop that in our view is one of the main local challenges for the currency this year. More specifically: (1) Considering markets already discount a quite aggressive path of rate hikes from Banxico in 2017, strong price pressures limit the advantage of local real rates against the US and other EM; and (2) the valuation advantage gained due to the strong nominal depreciation accumulated since mid-2014 (about 40%) is partially diluted by this factor, particularly if we observe strong second-round effects in the near future. Even after the recent dollar correction and peso gains from near 22.00 before Trump's Inauguration, we remain defensive and waiting for better entry levels to reengage in USD/MXN longs, which we see as more attractive below 21.20 pesos per dollar.

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