

Annual rate of inflation below 3% in the 1st half of May

May 22, 2015

- **INEGI just published its inflation report for in the first half of May**
- **Headline inflation (May): -0.53%2w/2w (Banorte-Ixe: -0.52%2w/2w; consensus: -0.45%2w/2w)**
- **Core inflation (May): 0.03%2w/2w (Banorte-Ixe: 0.15%2w/2w; consensus: 0.12%2w/2w)**
- **Inflation in the first half of May shows once again summer discounts on electricity tariffs, along with lower prices of agricultural goods**
- **With these numbers, annual inflation is at 2.93% vs. 3.06% in previous month**
- **Sell-off in local assets following U.S. CPI and leaving aside momentarily CPI in Mexico**

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Consumer prices decreased 0.53%2w/2w in in the first half of May, in line with our forecast but below market expectations. Core inflation was 0.03% vs. our 0.15% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of merchandise prices (0.8bps vs. our 8bps); (2) a lower than expected contribution of agricultural prices (-8.1bps vs. our -5.5bps); (3) an overestimation of services prices (1.7bps vs. our 3.6bps); and (4) a larger than expected contribution of energy prices (-50.7bps vs. our -58.9bps), as shown in the table below.

1H-May inflation by components

% bi-weekly incidence

	Observed	Banorte-Ixe	Difference
Headline	-0.53	-0.52	-0.008
Core	0.03	0.12	-0.090
Goods	0.01	0.08	-0.072
Processed foods	0.00	0.03	-0.033
Other goods	0.01	0.05	-0.039
Services	0.02	0.04	-0.018
Housing	0.010	0.019	-0.008
Education	0.00	0.00	-0.002
Other services	0.01	0.01	-0.008
Non-core	-0.57	-0.64	0.066
Agricultural	-0.08	-0.06	-0.026
Fresh fruits and vegetables	-0.01	-0.04	0.026
Meat and egg	-0.07	-0.02	-0.051
Energy and government regulated	-0.50	-0.58	0.086
Energy	-0.51	-0.59	0.082
Government regulated	0.00	0.01	-0.006

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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Inflation in the first half of May shows once again the effect of summer discounts on electricity prices as well as lower agricultural prices. Energy prices were down 4.86% 2w/2w on the back of a 23.3% drop in electricity tariffs, which more than offset for the 1.1% increase in low-grade gasoline prices, particularly in some cities in the northern border of the country. Agricultural prices were down 0.87% 2s/2s with sharp declines in products such as eggs (-8.2%); tomatoes (-4.8%); *Husk* tomatoes (-7.4%), onions (-5.4%), among others. However, *INEGI* reports several agricultural products with rising prices, such as *Serrano* chilies (16.7%); *Poblano* chilies (17.1%); and beef (0.3%). In the core index, prices of merchandise were up only 0.02% 2s/2s as a result a decline of 0.02% in food prices coupled with an increase of only 0.06% in the prices of other goods. Finally, services inflation was up 0.04% 2s/2s derived from 0.06% higher housing costs, along with increases of 0.02% and 0.03% in the cost of education and other services.

With these data, the annual inflation comes down to 2.93% vs. 3.06% in the previous month. Meanwhile, core inflation is at 2.36% from 2.31% in April. As we have mentioned in our publications, we expect annual inflation to remain below 3% in the coming months.

From our fixed income and FX strategy team

Sell-off in local assets following U.S. CPI and leaving aside momentarily CPI in Mexico. No surprises inside Mexico's CPI report this morning, as deflation was widely expected on the back of lower electricity tariffs and other seasonal components. Nevertheless, core measure came in below expectations, granting solid arguments of a low pass-through effect and also suggesting that Banxico will have a breather to wait and see Fed's strategy throughout the following months. Market reaction following today's CPI report in Mexico was muted, as investors attentions continue concentrated on the U.S. (CPI and Yellen today) together with other global factors. Overall, we hold a neutral stance on local rates, suggesting waiting for better market conditions to open long directional positions. Investors are aware of the prevailing risks at the global level that are likely to generate an additional sell-off in sovereign bonds worldwide (European bonds' adjustments, uncertainty about the Fed, and Greek's credit impasse). In our view, there is an attractive valuation in the Mexican yield curve, mainly in 20-year Mbonos such as May'31 and Nov'34. However, we acquiesce in the strong likelihood that the sell-off registered in the last days could endure given the uncertainty surrounding the Fed's future actions, waiting for more definition in the economic front. In this sense, we believe patience should keep paying off, waiting for better entry levels for long directional strategies. It is likely that this situation continues despite an attractive Mbonos curve slope and a spread between US rates and local bonds that does not reflect Mexico's fundamentals. In terms of Mexican linkers, valuation is extremely attractive in Udibonos, especially the mid and long ends. Inflation breakevens are hovering 3% in every tenor. The most attractive breakeven is the 10-year (2.96%). Risk rewards in this strategy could be around 60bps.

However, an important issue to take into consideration is the negative carry of Mexican linkers in the 1H15. In this regard, we consider that by the end of this month the market is likely to swap long strategies from Mbonos to Udibonos.

In the FX market, the peso is losing 0.6% on the day to 15.31 per dollar, underperforming since yesterday's revision to Mexico's 2015 GDP forecasts by the Ministry of Finance. The pressure was more acute after April's inflation report in the US (which showed a stronger-than-expected pickup in core prices of 0.3% m/m) and did not react meaningfully to the local print, wiping out the initial gains observed in the MXN and most G10 and EM currencies. In line with our expectations, local prices continued on a downward trend on a year-ago basis, which coupled with more positive employment numbers, provide a favorable backdrop for consumption dynamics in 2H15. Nevertheless, the slow beginning of the year has obliged our economists to lower their GDP expectations for 2015 from 3.6% to 3.2%yoy. In our view, the latter has increased upside risks to our USD/MXN year-end forecast of 14.90 per dollar. Specifically, we believe that: (1) The trend in portfolio inflows could be more muted both on fixed income and equities due to this factor; and (2) low inflation and still weak growth should reaffirm conviction that Banxico will not hike before the Fed and should wait as long as possible for better economic dynamics to consolidate. We now expect the first move by Banxico in October as opposed to July (with the Fed's first move now in September) and a lower year-end reference rate of 3.50% (previous: 4.00%). We maintain our neutral stance on the peso and recommendation to trade the ranges that we believe will remain wide driven by elevated external volatility. Interest in USD/MXN longs is likely to remain high around 15.00 per dollar; on the contrary, higher appetite for short positions could be seen around 15.35-15.40, particularly if the spread between Mexican and US rates in the long-end is high.

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