Inflation during January fueled by energy prices

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- ***INEGI* just published its inflation report for January**
- **Headline inflation (January): 1.7%m/m; Banorte-Ixe: 1.63%m/m; consensus: 1.69%m/m; previous: 0.46% m/m**
- **Core inflation (January): 0.58% m/m; Banorte-Ixe: 0.48% m/m; consensus: 0.52% m/m; previous: 0.45%**
- **Inflation was explained by pressures on low-grade gasoline prices along with increases in domestic gas prices**
- **With these numbers, annual inflation stands at 4.72% vs. 3.36% in December**
- **We expect year-end inflation at 5.7%**
- **Market is pricing in a rate hike this afternoon from Banxico following a strong deterioration on CPI conditions**

Consumer prices increased 1.7% m/m in January (Banorte-Ixe: 1.63% m/m). In addition, core inflation was 0.58% vs. our 0.48% estimate. The main deviation from our forecast comes from: (1) A higher than expected contribution of processed foods (19.1bp vs our 15.2bp); (2) an underestimation of other goods prices (13.2bp vs our 8.5bp); and (3) a lower than expected contribution of other services (3.6bp vs our 5.4bp), as shown in the table below.

January CPI inflation by major subcomponent
Monthly incidence, %

	Observed	Banorte-Ixe forecast	Difference
Headline	1.70	1.63	0.07
Core	0.43	0.36	0.07
Goods	0.32	0.24	0.09
Processed foods	0.19	0.15	0.04
Other goods	0.13	0.09	0.05
Services	0.11	0.13	-0.02
Housing	0.05	0.05	0.00
Education	0.03	0.03	0.00
Other services	0.04	0.05	-0.02
Non-core	1.30	1.30	0.00
Agricultural	-0.08	-0.08	0.00
Fresh fruits and vegetables	-0.13	-0.12	-0.01
Meat and egg	0.04	0.04	0.01
Energy and government regulated	1.41	1.41	0.00
Energy	1.33	1.33	0.00
Government regulated	0.11	0.10	0.00

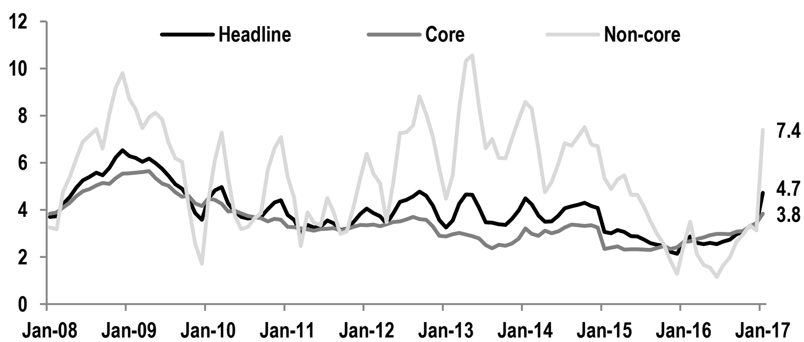
Source: INEGI, Banorte-Ixe
Note: Contributions might not add due to the number of decimals allowed in the table. Previous to year 2011, contributions might not add because of the change in CPI-calculation methodology

Inflation in January was explained by pressures on low-grade gasoline prices along with increases in domestic gas prices. According to *INEGI*, among the items with the most change in prices were energy products (12.67% m/m), mainly due to the 16.81% m/m increase of low grade gasoline, the 17.85% m/m domestic LP gas rise, and the 21.73% m/m increase of high grade gasoline. Moreover, another sub-index with substantial changes was other services, mainly driven by increases in prices in diners (1.24% m/m), bus transportation (4.03% m/m), and restaurants (1.06% m/m).

On the other hand, the biggest decreases were seen in the fresh fruits and vegetables prices, which declined 3.6% m/m, driven by lower prices of tomatoes (-35.39% m/m) and husk tomatoes (-12.33% m/m) among others. In addition, airfares and tourism services prices declined 30% m/m and 9.09% m/m respectively.

With these numbers, annual inflation stands at 4.72% vs. 3.36% in December. Moreover, core inflation in January increased from 3.44% last month to 3.84%. Looking ahead, we consider that inflation will be impacted by: (1) The increase and liberalization of gasoline prices; (2) the higher pass-through effect of the depreciation of the Mexican peso to prices; and (3) the impact of the minimum wage increase. We expect it to close 2017 at 5.7% yoy.

CPI Inflation: Headline, Core and Non-core indices
% yoy



Source: INEGI

From our fixed income and FX strategy team

Market is pricing in a rate hike this afternoon from Banxico following a strong deterioration on CPI conditions. Local bonds with a mild reaction to the monthly inflation print, which confirmed that current conditions could force Banxico to hike its reference rate ahead. The yield curve is pricing in 34bps of implied rate hikes for today's policy meeting (Banorte-Ixe +50bps) and 112bps for the entire year. Investors have already taken into consideration a rough path of inflation dynamics through 2017, with breakevens depicting figures slightly above 4.05% in 3- and 5-year tenors, and hovering around 3.90% in implied inflation metrics for the 10- and 30-year securities. This suggests a limited risk reward for CPI-adjusted strategies. On the other hand, the 5y10y slope in TIIE-IRS curve is reaching interesting levels for a steepener position. We believe there is a more attractive valuation in a 5y10y steepener, currently at 34bps. We wait for a more attractive entry level of 30bps for trading this position as we believe it could end 1Q17 around 45bps, especially when taking into account the current level of the 5y5y forward rate at 8.07%, which in our view is already taking into account a reasonable scenario in terms of monetary conditions in coming years.

The Mexican peso is 0.3% stronger on the day at 20.42 per dollar, with no significant reaction to the report. Apart from a broadly positive backdrop for other EM currencies, we believe that the currency is likely driven by expectations of a rate hike by Banxico later today, which we forecast at 50bps. In this respect, we believe that the inflation figure released today supports our expectations. In spite of the latter, the possibility of further price pressures going forward could be a potential source of weakness for MXN given its negative effect on real interest rate spreads against the US and on valuation levels. We remain on the sidelines for now, waiting for more stable trading conditions for new directional positions, albeit considering the current backdrop as positive for long MXN positions on an intraday basis and with a limited risk exposure, without discarding an extension towards the support zone around 20.22 (100-day MA) and 20.13 (Fibonacci level).

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