

# 1H-May's Inflation – Lower prices of electricity offset pressures on government tariffs

May 24, 2017

- **INEGI just published its inflation report for in the first half of May**
- **Headline inflation (May): -0.34%2w/2w (Banorte-Ixe: -0.38%2w/2w; consensus: -0.4%2w/2w)**
- **Core inflation (May): 0.15%2w/2w (Banorte-Ixe: 0.14%2w/2w; consensus: 0.12%2w/2w)**
- **Inflation in the first half of May was explained by pressures on government tariffs which were offset by lower electricity prices**
- **With these numbers, annual inflation is at 6.17% vs. 5.82% in previous month**
- **Difficult inflation dynamics support our negative bias in Mbonos, particularly in the short-end of the curve**

Consumer prices decreased 0.34%2w/2w in in the first half of May. Core inflation was 0.15% vs. our 0.14% estimate. The main deviation from our forecast comes from: (1) An underestimation of the contraction in energy prices (-54.7bps vs. our -53.1bps); (2) a lower than expected contribution of merchandise prices (8.9bps vs. our 9.5bps); (3) an underestimation of agricultural prices (2.2bps vs. our 1.3bps); (4) an underestimation of services prices (2.4bps vs. our 1.3bps); along with (5) a larger than expected contribution of government tariffs prices (8.3bps vs. our 3bps), as shown in the table below

## 1H-May inflation by major subcomponent

Bi-weekly incidence, %

	INEGI	Banorte-Ixe	Difference
Total	-0.34	-0.38	0.04
Core	0.11	0.11	0.01
Goods	0.09	0.10	-0.01
Processed foods	0.04	0.06	-0.01
Other goods	0.05	0.04	0.01
Services	0.02	0.01	0.01
Housing	0.01	0.02	-0.01
Education	0.00	0.00	0.00
Other services	0.01	-0.01	0.02
Non-core	-0.45	-0.49	0.04
Agriculture	0.02	0.01	0.01
Fruits & vegetables	0.00	-0.02	0.02
Meat & eggs	0.02	0.03	-0.01
Energy & government tariffs	-0.47	-0.50	0.03
Energy	-0.55	-0.53	-0.02
Government tariffs	0.08	0.03	0.05

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

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**Inflation in the first half of May was explained by pressures on government tariffs which were offset by lower electricity prices.** Government tariffs were up 1.54% 2w/2w on the back of the increase in public transportation prices (+3.94%), which added 7.7bp to total inflation during the period in question. This increase was offset by the reduction in energy prices, electricity rates in particular (-23.34%) amid the start of summer discounts. In addition, low-grade gasoline prices (-0.67%) and domestic gas LP (-0.76%) prices were also down. Meanwhile, agricultural prices increased 0.23% 2w/2w as a result of higher prices of tomatoes (+3.36%), avocados (+9.86%), eggs (+2.63%) and poultry (+0.62%). In the core index, merchandise prices increased 0.26% 2w/2w with food prices up 0.25%, while prices of other goods increased 0.26%. *INEGI* highlighted the increases in the price of cars (+0.64%) and detergents (+1.76%). Finally, service prices increased only 0.06% 2w/2w.

**With these numbers, annual inflation is at 6.17% vs. 5.82% in previous month.** Meanwhile, core inflation is at 4.75% from 4.72% in April.

*From our fixed income and FX strategy team*

**Difficult inflation dynamics support our negative bias in Mbonos, particularly in the short-end of the curve.** Today's CPI report came worse than expected with a fortnightly reading of -0.34% 2w/2w, with the deflationary print mainly due to subsidies on electricity tariffs already mentioned but compensated somewhat with higher transportation prices. Despite of the latter, annual inflation remain on an upward trend, moving from 5.8% to 6.2%. These dynamics can put additional pressure to Banxico's strategy, especially after a hawkish assessment on inflation depicted inside last week's policy communiqué. Current conditions support our negative outlook on local bonds, mainly in the short-end of the curve. The market is currently pricing in 47bp of implied rate hikes for the remainder of the year, with a strong likelihood of an additional upward adjustment (Banorte-Ixe +75bps). On the other hand, we expect the yield curve's flattening bias to continue on the bearish side. We acknowledge a more attractive relative valuation in the belly of the Mbonos curve, mainly 5- and 7-year tenors. Nevertheless we expect the sell-off to remain in coming sessions. As a result, we suggest waiting for better entry levels for directional strategies. In terms of CPI-linked Udibonos, the actual inflation backdrop has already increased the inflationary premia in these instruments in recent months, with breakevens trading around 3.7% (close to fair value). Lower UDI-related expected carry for the next three months (about 0.3% during this period or 1.3% annualized) could reduce their attractiveness, at least during the rest of this quarter.

In the FX market, the Mexican peso was broadly unchanged after the report but positive to its previous close, gaining 0.4% to 18.55 per dollar. This print will likely continue supporting market expectations of further rate hikes by Banxico and the attractiveness of carry in long MXN positions in the short term, at least in nominal terms. Nevertheless, it is worth mentioning that the persistent pickup in inflation reduces the peso's real valuation advantage, which coupled with the accumulated gain since the beginning of the year, suggests a more limited room for further appreciation. In this context, we reiterate our USD/MXN buy on dips recommendation for trading purposes, considering that the current level is not attractive for new long MXN positions at least in the short term. We expect the 18.45-18.50 zone to be validated at least until the results of the State of Mexico election on June 4, without discarding some cautiousness among investors ahead of this event.

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