

1H-October Inflation explained by the end of summer discounts in electricity tariffs as well as the rebound in public transportation tariffs

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- **INEGI just published its inflation report for the first half of October**
- **Headline inflation (1H-Oct): 0.62% 2w/2w; Banorte-Ixe: 0.62% 2w/2w; consensus: 0.64% 2w/2w; (range of estimates: 0.45% to 0.72%); previous: -0.17% 2w/2w**
- **Core inflation (1H-Oct): 0.21% 2w/2w; Banorte-Ixe: 0.17% 2w/2w; consensus: 0.19% 2w/2w (range of estimates 0.13% to 0.26%); previous: -0.04% 2w/2w**
- **Inflation in the first half of October was explained by the end of the summer discounts on electricity tariffs as well as the rebound in the prices of public transportation and mobile phone services**
- **With these numbers, annual inflation is at 6.3% vs. 6.35% in previous month**
- **Current CPI conditions support the idea of a slightly hawkish Banxico for longer**

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Consumer prices increased 0.62% 2w/2w in the first half of October, in line with our forecast. Core inflation was 0.21% 2w/2w vs. our 0.17% 2w/2w estimate. However, we observed a greater impact in government tariffs (19bps vs. our 15bps), as well as other services (9bps vs. our 7bps). However, there were offset by a lower impact of fresh fruits and vegetables (-14bps vs. our -5bps), as shown in the table below.

1H-October inflation by major subcomponent

Bi-weekly incidence, %

	Observed	Banorte-Ixe forecast	Difference
Headline	0.62	0.62	0.00
Core	0.16	0.13	0.03
Goods	0.05	0.04	0.01
Processed foods	0.03	0.02	0.01
Other goods	0.02	0.03	0.00
Services	0.11	0.09	0.02
Housing	0.02	0.02	0.00
Education	0.00	0.00	0.00
Other services	0.09	0.07	0.02
Non-core	0.46	0.49	-0.03
Agricultural	-0.15	-0.07	-0.08
Fresh fruits and vegetables	-0.14	-0.05	-0.09
Meat and egg	-0.01	-0.02	0.01
Energy and government regulated	0.62	0.56	0.06
Energy	0.43	0.41	0.02
Government regulated	0.19	0.15	0.04

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 October was explained by the end of the summer discounts on electricity tariffs as well as the rebound in the prices of public transportation and mobile phone services. Particularly, energy rose 4.43% 2w/2w, mainly driven by the increase in electricity (19.99% 2w/2w), LP gas (4.11% 2w/2w) and low-grade gasoline (0.51% 2w/2w). Moreover, we highlight the 3.38% 2w/2w increase in government tariffs, as a result of the rebound after suspension of highway tolls and public transportation after the September 19th earthquake. It is worth noting that subway tariffs increased 88.61% 2w/2w due to this same effect. In addition, prices of fresh fruits and vegetables declined 3.46% 2w/2w on the back of lower prices of tomatoes (-22.76% 2w/2w), avocados (-5.54% 2w/2w) and *husk tomatoes* (-7.65% 2w/2w) among others.

Regarding the core index, other services rose 0.54% 2w/2w, given the 6.72% 2w/2w rebound in the mobile phone prices as well as the increases in landlines (1.33% 2w/2w) and tourism services (2.24% 2w/2w). On the other hand, we saw a 0.13% 2w/2w in goods, given the 0.16% 2w/2w in processed foods coupled with a 0.11% expansion in other goods.

With these numbers, annual inflation edges down to 6.30% vs. 6.35% in September. Moreover, core inflation decreased to 4.75% (vs. 4.94% in September). Looking ahead we will focus on the evolution of energy prices and the behavior of agricultural prices, and the impact they might have in Mexico's CPI. Considering this we still expect inflation at 6.4% by year-end 2017.

From our fixed income and FX strategy team

Current CPI conditions support the idea of a slightly hawkish Banxico for longer. Today's CPI print came slightly lower than market expectations, yet in line with our forecasts, with headline index reverting the favorable effect of the earthquakes observed in the previous fortnightly figure. Moreover it is worth mentioning that core inflation did print above market expectations. Annual inflation observed an inflection during August, however, seasonal factors will remain during 4Q17, making more difficult the convergence path towards Banxico's interval in coming months, especially next year. This explains the recent adjustment in short-term breakevens (*e.g.* 3-year tenor trading at 3.80% as of yesterday's closing level above the 12-month mean at 3.75%). Market reaction after the 1H-Oct report was negative for the Mbonos curve as pressures registered before the reading increased by around 1bp, but positive for short- and mid-term Udibonos which started the session losing around 1bp and at the moment of this publication are rallying 3bps on average. This scenario, in tandem with the uncertainty about Fed future actions, Trump's tax-cut plan and the process of NAFTA negotiations is likely to shed light on Banxico staying put for longer, similar to what is priced in the yield curve.

IRS are discounting 12bps of implied hikes for year-end (not feasible *vis-à-vis* our expectations), 8bps in a 12-month horizon, but 8bps of rate cut by the end of 2018. In our view this will result in a flatter curve between the front-end and the 2- and 3-year area, especially with an attractive 2y2y forward rate at 7.10%, granting significant carry gains. However, we expect several factors to increase the risk and term premiums in longer tenors, resulting in a possible steepening of the yield curve between the mid- and long-ends. Overall, we believe that relative value tactical strategies are more convenient, especially targeting steepeners in the TIE-IRS curve such as 2s5s (currently at -16bps) and 2s10s (+6bps).

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