

Inflation in 1H-October – The end of summer discounts on electricity tariffs

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- **INEGI just published its inflation report for in the first half of October**
- **Headline inflation (Oct): 0.46%2w/2w (Banorte-Ixe: 0.46%2w/2w; consensus: 0.42%2w/2w)**
- **Core inflation (Oct): 0.16%2w/2w (Banorte-Ixe: 0.14%2w/2w; consensus: 0.36%2w/2w)**
- **Inflation in the first half of October was explained by pressures on electricity tariffs, given the end of summer discounts, along with increases in other services prices**
- **With these numbers, annual inflation is at 2.47% vs. 2.52% in previous month**
- **Investors are aware of the kick-off regarding seasonal high inflation figures**

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Consumer prices increased 0.46%2w/2w in in the first half of October, in line with our estimates. Core inflation was 0.16% vs. our 0.14% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of agricultural prices (0bps vs. our 4.8bps); (2) an underestimation of government tariffs (1.2bps vs. our 0.1bps); (3) an underestimation of services prices (4.8bps vs. our 3.2bps); along with (5) a larger than expected contribution from energy prices (35.5bps vs. our 30.6bps), as shown in the table below.

1H-October inflation by components

% bi-weekly incidence

	INEGI	Banorte-ixe	Difference
Total	0.46	0.46	0.000
Core	0.12	0.11	0.010
Goods	0.07	0.08	-0.005
Processed foods	0.03	0.04	-0.007
Other goods	0.04	0.04	0.002
Services	0.05	0.03	0.016
Housing	0.01	0.01	-0.005
Education	0.00	0.00	0.000
Other services	0.04	0.02	0.021
Non-core	0.35	0.35	0.000
Agriculture	0.00	0.05	-0.047
Fruits & vegetables	0.01	0.04	-0.031
Meat & eggs	-0.01	0.01	-0.016
Energy & government tariffs	0.36	0.31	0.053
Energy	0.36	0.31	0.049
Government tariffs	0.01	0.00	0.011

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 October was explained by pressures on electricity tariffs. According to *INEGI*, electricity tariffs increased 20.3%, given the end of summer discounts in some regions of the country. In addition, there were some pressures in the prices of other services. In particular, the report mentions professional services (+5.89%), tourism services (+1.79%) and air transportation (+3.01%), among the items with increasing prices. Meanwhile, merchandise inflation was up 0.16%2w/2w, with higher prices of both processed food (+0.18%2w/2w) and other merchandise prices (+0.22%). In the non-core index, there were mixed results in agricultural prices, with the price of fruits and vegetables increasing 0.28%, while meat and egg prices declined 0.15%, on the back of lower prices of poultry (-1.16%) and fish (-1.04%). Finally, we highlight the 0.22%2w/2w in government tariffs, particularly as a result of increases in the cost of public transport (0.41%).

12-month inflation continues to edge down. With these data, 12-month inflation is at 2.47% vs. 2.52%, in the previous month. Meanwhile, core inflation is at 2.46% from 2.38% in September. Looking ahead, we expect inflation will start converging towards our 3% forecast for year-end.

From our fixed income and FX strategy team

Investors are aware of the kick-off regarding seasonal high inflation figures. The 4Q15 will be characterized by seasonal high inflation figures. This situation portrays no risk to the valuation of the yield curve, but suggests that Mexican linkers (e.g. Udibonos) could start gaining momentum (as observed at last Tuesday's auction with a strong demand for the 3-year security). Breakevens are trading today at 3.38% for the 3-year tenor, 3.31% for 5-year, and 3.03% on both, the 10- and 30-year segments. This pricing implies a possible risk-reward of 40bps for longer tenors. The securities in the Udibonos market with the most attractive valuation in our view are Jun'19, Dec'20 and Jun'22.

On the other hand, current inflation dynamics are not a concern for Banxico's board members, despite the strong FX depreciation observed along 2015, as annual inflation reading remains at record lows well below the central bank's target of 3%. Bearing this in mind, we expect market participants to holding the implied cumulative hikes priced in the curve (9bps for 4Q15, 24bps for 1Q16, 56bps for 2Q16, 82bps for 3Q16 and 108bps for 4Q16). In general terms, we hold a positive view on the Mexican yield curve, as the slope of the curve, forward rates and spread against U.S. Treasuries are extremely attractive when compared with other EM with less sound macro fundamentals. In this regard, we hold our relative-value trade recommendation: a spread position between Mexico and the US in the 10-year maturity, receiving TIEE-IRS (Mexico) and simultaneously paying LIBOR-IRS (US) with an entry level of 436bps, target of 410bps, stop-loss of 456bps and currently trading at 415bps. For more details please refer to "*Trade Idea: Long 10-year spread between Mexico vs US in swap*" published on September 30th [pdf](#).

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