

## Annual inflation falls to 5.5% from 6.8% in the first half of January

January 24, 2018

- *INEGI* just published its inflation report for the first half of January
- **Headline inflation (1H-Jan): 0.24% 2w/2w; Banorte: 0.29% 2w/2w; consensus: 0.38% 2w/2w; (range of estimates: 0.21% to 0.46%); previous: 0.28% 2w/2w**
- **Core inflation (1H-Jan): 0.17% 2w/2w; Banorte: 0.31% 2w/2w; consensus: 0.25% 2w/2w (range of estimates 0.08% to 0.36%); previous: -0.02% 2w/2w**
- **Inflation in the first half of January was explained by the increase in energy prices, which was mitigated by the fall of other services and fresh fruits and vegetables**
- **Despite the biweekly increase in energy prices, annual inflation fell to 5.51% from 6.77% given the high comparison base derived from the increase in gasoline prices at the beginning of 2017**
- **Strong rally in rates following a better-than-expected inflation print**

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**Consumer prices increased 0.24% 2w/2w in the first half of January, standing below both our forecast (0.29% 2w/2w) and the consensus (0.38% 2w/2w).** Core inflation was 0.17% 2w/2w vs. our 0.31% 2w/2w estimate. The main deviation from our forecast comes from: (1) A higher than expected contribution of energy (18bps vs. our 6bps); (2) a lower impact from other services (-5bps vs. our 4bps); (3) a smaller contribution from fresh fruits and vegetables (-12bps vs. our -5bps); (4) a greater impact from other goods (6bps vs. our 2bps) and (5) a lower impact of processed foods (9bps vs. our 12bps), as shown in the table below.

#### 1H-January inflation by major subcomponent

Bi-weekly incidence, %

	Observed	Banorte-1xe forecast	Difference
Headline	0.24	0.29	-0.06
Core	0.13	0.23	-0.10
Goods	0.14	0.14	0.00
Processed foods	0.09	0.12	-0.03
Other goods	0.06	0.02	0.04
Services	-0.02	0.09	-0.11
Housing	0.02	0.03	-0.01
Education	0.01	0.02	-0.01
Other services	-0.05	0.04	-0.09
Non-core	0.11	0.07	0.04
Agricultural	-0.10	-0.03	-0.07
Fresh fruits and vegetables	-0.12	-0.05	-0.07
Meat and egg	0.03	0.03	0.01
Energy and government regulated	0.21	0.09	0.12
Energy	0.18	0.06	0.12
Government regulated	0.03	0.04	0.00

Source: INEGI, Banorte

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 January was explained by the increase in energy prices, which was mitigated by the fall of other services and fresh fruits and vegetables.** Energy prices increased 1.32% 2w/2w on the back of and higher prices of LP gas (3.86% 2w/2w), low-grade gasoline (1.47% 2w/2w) and electricity tariffs (0.54% 2w/2w). Moreover, prices of fruits and vegetables fell 3.31% 2w/2w, driven by lower prices of tomatoes (17.42% 2w/2w), zucchini (-12.42% 2w/2w) and onions (-5.79% 2w/2w). However, egg prices rose 3.44% 2w/2w, pushing the meat and egg component up 0.57% 2w/2w. In the core index, we highlight the 0.31% 2w/2w decrease in other services given lower airfares (-31.91% 2w/2w) and tourism services (-8.33% 2w/2w). However, dining away from home items rose 0.56% 2w/2w while restaurants climbed 0.64% 2w/2w. Moreover, processed foods prices increased 0.56% 2w/2w while other goods expanded 0.29% 2w/2w.

**With these figures, annual inflation stood at 5.51% vs. 6.77% in December.** Additionally, core inflation edged down to 4.63% from 4.87% seen in the previous month. It is worth mentioning that the sharp fall in the month is due to a base effect, given that inflation in the same period of the previous year showed a strong increase derived from the liberalization of energy prices. We expect inflation to continue showing a downward trend to finish 2018 at 4.3%. In the coming months, 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.

*From our fixed income and FX strategy team*

**Strong rally in rates following a better-than-expected inflation print.** Markets were positively surprised by the figure, inducing a strong rally particularly in TIEE-IRS of 8bps along the curve and up to 14bps in the belly (52x1 at 7.66%). On the other hand, Mbonos extend the gains observed before the release and up to 9bps, also mostly in the belly of the curve. Lastly, Udibonos are pressured by 4bp on average focused in the short-end, lagging other instruments.

Despite of the steep fall in the annual inflation print of 126bps (from 6.77% at year-end 2017 to 5.51%) which was mainly driven by a favorable base effect, we believe price dynamics will remain challenging in coming months. In this respect and according to our forecasts, accumulated inflation for the next 91 days (*i.e.* UDIS's carry) will be 1.14%, equivalent to a 4.53% annualized rate. In our view, this will remain as a driver of relatively high short- and mid-term inflation expectations (e.g. 3-year breakeven at 3.79%), supporting expectations of an additional rate hike by Banxico on February 8<sup>th</sup> from 7.25% to 7.50%. The market already discounts this scenario.

Nevertheless, we expect even more hikes in 1H18 than what is priced-in (50bps more than the 25bps in February), which is around 25bp more than the market. As a result, we maintain our recommendation of long positions in 5-year Bonds D in spite of a more expensive valuation since December, when we initiated this tactical trade idea. This position is also supported by strong investor demand, such as the one observed in the latest primary auction last week with a bid-to-cover ratio of 5.3x, maximum since last September and significantly above the 3.6x average during the last five years.

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