

Inflation in 1H-December remains highly pressured on pickup in agricultural prices

- **INEGI** just published its inflation report for the first half of December
- **Headline inflation (1H-Dec): 0.56% 2w/2w; Banorte: 0.27%; consensus: 0.34% (range of estimates: 0.20%-0.59%); previous: 0.33%**
- **Core inflation (1H-Dec): 0.42% 2w/2w; Banorte: 0.26%; consensus: 0.32% (range of estimates: 0.26%-0.44%); previous: 0.02%**
- **Inflation in the period was explained by the strong increase in the agricultural goods (and for second print in a row), coupled with growth in core goods and other services due to the holiday season**
- **With these figures, annual inflation increased to 5.00% from 4.72%. On the other hand, core-inflation edged-up to 3.64% from 3.63% in November**
- **Difficult landscape for inflation supports the central bank's hawkish tilt and our trade idea in floating-rate securities**

Consumer prices increased 0.56% 2w/2w in the first half of December. This number was considerably above both consensus (0.34%) and our forecast (0.27%). Meanwhile, core inflation stood at 0.42% vs. our 0.26% estimate.

The main deviation from our forecast came from: (1) A higher than expected contribution from fresh fruits and vegetables (22bps vs. our 5bps); (2) a higher impact from core goods (11bps vs. our 4bps); and (3) a stronger contribution from other services (19bps vs. our 14bps), as shown in the table below.

1H-December inflation by components

% bi-weekly incidence

	INEGI	Banorte	Difference
Total	0.56	0.27	0.29
Core	0.32	0.19	0.12
Goods	0.11	0.04	0.07
Processed foods	0.06	0.03	0.04
Other goods	0.05	0.02	0.03
Services	0.21	0.15	0.05
Housing	0.01	0.01	0.00
Education	0.00	0.00	0.00
Other services	0.19	0.14	0.05
Non-core	0.24	0.08	0.16
Agriculture	0.26	0.09	0.17
Fruits & vegetables	0.22	0.05	0.18
Meat & eggs	0.03	0.05	-0.01
Energy & government tariffs	-0.02	-0.01	-0.01
Energy	-0.03	-0.01	-0.01
Government tariffs	0.00	0.01	0.00

Source: INEGI, Banorte.

Note: Contributions might not add due to the number of decimals allowed in the table.

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Inflation in the period was explained by the strong increase in agricultural goods, coupled with higher core goods and other services due to the holiday season. The first category posted a 2.6% 2w/2w increase, thus adding 26bp to the headline index. For comparison purposes, this percent increase was at 0.6% last year, and 0.5% in 2016. Moreover, this was the second consecutive print with a significant upside surprise, as in the previous fortnight agro prices increased 3.5% 2w/2w. In this context, 6 out of the 10 products with the highest increase belong to this sector, highlighting tomatoes (8.1%), *husk tomatoes* (26.5%), and serrano chilies (24.4%), among others. On the flipside, out of the 10 with the sharpest contractions there were only 3 in this category, including avocados (-1.4%), oranges (-2.2%) and squash (-3.8%).

Energy prices fell 0.2% 2w/2w as a result of lower gasoline prices, with low-grade falling 0.6% and high-grade at -0.5%. This is likely influenced by the steep drop in benchmark oil prices that began since October, more than compensating for the elimination of subsidies to gasoline prices that has been in place since November-end for low-grade.

Core inflation increased 0.42% 2w/2w, considerably above the 0.02% of the previous print. Despite the latter, it is worth mentioning that seasonality plays a relevant role, in particular as tourism services (19.7%) and airfares (43.1%) pickup up ahead of the holiday season. In this respect, these categories contributed 14bps. On the other hand, processed foods increased 0.3%, while other goods grew 0.2%, with both of them without a very relevant deviation when compared to recent years.

In annual terms, inflation surprisingly increased to 5.00% from 4.72% in the previous month and from 4.87% in the previous fortnight. In this respect, today's figure marked the second consecutive print in which the annual rate of inflation picked up. As a result, inflation reached its highest since September, which was skewed to the upside due to an unfavorable base effect. We maintain our 4.8% year-end estimate, although this recent surprises have flipped the risk to our forecast from the downside to the upside. It is worth noting that agro prices are unusually volatile, which given their recent surge, we cannot discard a strong reversion to the mean in the very short-term. Moreover, core prices remain well behaved, which could suggest that the pass-through from higher non-core inflation has so far stayed limited. Going forward, we will be very attentive to Banxico's comments about the risk that high non-core inflation translates into challenges for the convergence of headline inflation to the 3% target. In this respect, it is worth remembering that the Board has been stressing this factor in their most recent communications about the resistance of core inflation to keep declining, and particularly since they updated their inflations forecasts in the Quarterly Report for 3Q18.

From our fixed income and FX strategy team

Difficult landscape for inflation supports the central bank's hawkish tilt and our trade idea in floating-rate securities. Negative news coming from inflation today are steering a bear flattening bias in the yield curve, with short-term rates losing 13bps while longer tenors are selling off nearly 10bps. Market participants have underestimated the CPI fortnightly reading in two consecutive reports, suggesting the possibility of further adjustment in the inflation premia embedded in local rates, especially when taking into account difficult market conditions going forward. As of today, breakevens are trading at 4.2% in 3- and 5-year tenors, while longer securities discount an implied annual inflation around 4.5%. Moreover, expectations about Banxico's future actions depict implied cumulative hikes of nearly 45bps by mid-2019, taking into account the hawkish tilt inside yesterday's communiqué. In the same tone, the 2-year forward rate at 8.68% is likely to head towards de 9.00% observed by the end of November. More info in our research note "*Banxico's monetary policy decision: Reference rate ends the year at 8.25%*" [<pdf>](#). Overall, current conditions remain appropriate for our trade recommendation of long positions in floating-rate securities. For a more comprehensive analysis please refer to our "*Fixed-Income and FX Weekly*" [<pdf>](#), released on December 17th, 2018.

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