

Annual inflation ends 2016 at 3.36%, with significant pressures ahead

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- **INEGI just published its inflation report for December**
- **Headline inflation (December): 0.46% m/m; Banorte-Ixe: 0.55% m/m; consensus: 0.5% m/m (range of estimates: 0.46% to 0.62%); previous: 0.78% m/m**
- **Core inflation (December): 0.45% m/m; Banorte-Ixe: 0.50% m/m; consensus: 0.50% m/m; (range of estimates: 0.42% to 0.58%); previous: 0.22%**
- **Inflation was explained by pressures on the prices of airfares and tourism services**
- **With these numbers, annual inflation closed 2016 is at 3.36% vs. 3.31% in November**
- **We expect inflation in 2017 to close the year at 4.7%**
- **Inflation conditions for 2017 are likely to benefit our trade ideas of long positions in Udibonos Jun'19, Dec'20 and Jun'22.**

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Consumer prices increased 0.46% m/m in November. In addition, core inflation was 0.45% vs. our 0.50% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of services prices (21.2bps vs. our 26.6bps); (2) an overestimation of agricultural prices (9.1bps vs. our 14.4bps); and (3) a larger than expected contribution of goods prices (12.1bps vs. our 10.8bps); as shown in the table below.

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December CPI inflation by major subcomponent

Monthly incidence, %

	Observed	Banorte-Ixe forecast	Difference
Headline	0.46	0.55	-0.09
Core	0.33	0.37	-0.04
Goods	0.12	0.11	0.01
Processed foods	0.09	0.08	0.01
Other goods	0.04	0.03	0.01
Services	0.21	0.27	-0.05
Housing	0.04	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.18	0.23	-0.05
Non-core	0.13	0.18	-0.05
Agricultural	0.09	0.14	-0.05
Fresh fruits and vegetables	0.01	0.05	-0.04
Meat and egg	0.08	0.09	-0.01
Energy and government regulated	0.03	0.03	0.00
Energy	0.02	0.02	0.00
Electricity tariffs	0.01	0.01	0.00
Government regulated	0.01	0.01	0.00

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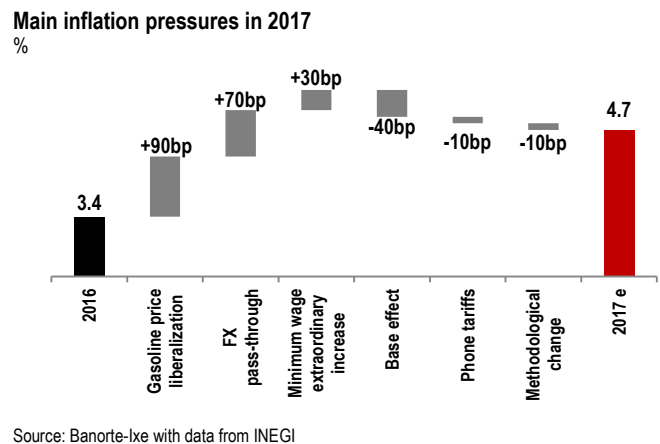
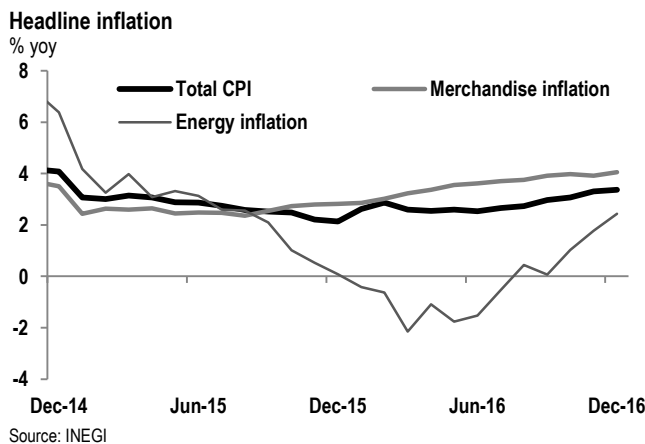
Source: Banorte-Ixe with data from INEGI and Banco de México

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 December was explained by pressures on airfares and tourism services. According to *INEGI*, the price of other merchandise increased 1.04% m/m, on the back of significant increases in airfares (+19.71%) and tourism services (+9.82%) prices. Additionally, processed foods increased 0.54% m/m. In the non-core index, meat and egg prices were up 1.35%, explained by pressures on the price of eggs (+5.29%) and pork meat (+2.56%). Meanwhile, the prices of fruits and vegetables increased 0.33% on the back of significant increases in the prices of onions (+13.97%), lemons (+23.12%) and grapes (+16.33%), among others, which were offset by declines in the prices of tomatoes (-1.74%), *Husk* tomatoes (-11.2%) and papaya (-13.4%), among others.

With these numbers, annual inflation closed 2016 is at 3.36% vs. 2.1% in 2015. The increase comes as a result of a significant increase in the core index, which increased 3.4%y/y vs. 2.4% in 2015. Moreover, energy inflation increased from 0.06% in 2016 to 2.4%yoy, as shown in the chart below. Looking ahead, we consider that inflation will be impacted in the first half of January by the increase in gasoline prices and expect it close 2017 at 4.7%. Next year's upward trend will be explained by: (1) The increase and liberalization of gasoline prices; (2) the higher pass-through effect of the depreciation of the Mexican peso to prices; and (3) the impact of the 9.58% increase in Mexico's minimum wage.



From our fixed income and FX strategy team

Inflation conditions for 2017 are likely to benefit our trade ideas of long positions in Udibonos Jun'19, Dec'20 and Jun'22. Today's CPI report came in below market expectations, resulting in an extended relief rally in local rates. However, market participants will remain cautious regarding difficult dynamics for inflation this year. We expect investors to continue adjusting their inflation assessment for coming years and increasing their demand for CPI-linked Udibonos. In this regard, breakevens are currently trading at 4.79% for the 3-year tenor, 4.76% for the 5-year, 4.42% for the 10-year and 3.91% for the 30-year horizon. Inflation this year could be severely impacted by three factors, mainly: (1) An additional pass-through effect from peso weakness to prices, (2) gasoline price liberalization, and (3) the increase in minimum wages. We forecast 2017 year-end inflation at 4.3%. Taking into account this scenario, we hold our trade recommendations of long positions in Udibonos Jun'19, Dec'20, and Jun'22.

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