

Lower than expected inflation in the first half of February

February 22, 2018

- **INEGI just published its inflation report for the first half of February**
- **Headline inflation (1H-Feb): 0.20% 2w/2w; Banorte: 0.31% 2w/2w; consensus: 0.26% 2w/2w; (range of estimates: 0.18% to 0.33%); previous: 0.31% 2w/2w**
- **Core inflation (1H-Feb): 0.30% 2w/2w; Banorte: 0.31% 2w/2w; consensus: 0.29% 2w/2w (range of estimates 0.20% to 0.33%); previous: 0.24% 2w/2w**
- **Inflation in the first half of February was explained pressures on goods and energy prices, offset by lower agricultural prices**
- **With these results annual inflation stands at 5.45%, below the 5.55% seen in January**
- **Lower inflation than expected, but with conditions that remain favorable for our trade idea in 5-year Bondes D**

Consumer prices increased 0.20% 2w/2w in the first half of February, standing below both our forecast (0.31% 2w/2w) and the consensus (0.26% 2w/2w). Core inflation was 0.30% 2w/2w, marginally below our 0.31% 2w/2w estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution from fresh fruits and vegetables (-17bps vs. our -8bps); (2) a smaller impact from other services (6bps vs. our 10bps); (3) a lesser contribution from energy (9bps vs. our 12bps); and (4) a greater impact from other goods (9bps vs. our 6bps), as shown in the table below.

1H-February inflation by major subcomponent

Bi-weekly incidence, %

	Observed	Banorte forecast	Difference
Headline	0.20	0.31	-0.11
Core	0.22	0.23	-0.01
Goods	0.13	0.09	0.04
Processed foods	0.04	0.03	0.01
Other goods	0.09	0.06	0.03
Services	0.09	0.14	-0.05
Housing	0.02	0.03	-0.01
Education	0.01	0.01	0.00
Other services	0.06	0.10	-0.04
Non-core	-0.01	0.08	-0.10
Agricultural	-0.12	-0.05	-0.07
Fresh fruits and vegetables	-0.17	-0.08	-0.09
Meat and egg	0.04	0.03	0.01
Energy and government regulated	0.11	0.13	-0.03
Energy	0.09	0.12	-0.03
Government regulated	0.01	0.01	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 February was explained pressures on goods and energy prices, offset by lower agricultural prices. Energy prices increased 0.86% 2w/2w on the back of and higher prices of both low-grade (2.55% 2w/2w) and high grade gasoline (2.06% 2w/2w), while LP gas fell 2.85% 2w/2w. Moreover, prices of fruits and vegetables fell 4.39% 2w/2w, driven by lower prices of tomatoes (-21.72% 2w/2w), onions (-15.35% 2w/2w) and squash (-20.58% 2w/2w), among others. However, the price of bananas posted an increase of 4.88% 2w/2w. In addition, egg and chicken prices rose 2.69% 2w/2w and 1.02% 2w/2w respectively, pushing the meat and egg component up 0.77% 2w/2w.

In the core index, we highlight the 0.48% 2w/2w increase in the costs of other goods on the back of higher automobile prices (0.51% 2w/2w). In addition other services expanded 0.34% 2w/2w given the growth in the prices of airfares (9.23% 2w/2w), dining away from home items (0.31% 2w/2w) and restaurants (0.33% 2w/2w). Finally, housing prices increased 0.13% 2w/2w given the expansion of 0.11% in home ownership costs.

With these figures, annual inflation stood at 5.45% vs. 5.55% in January. Additionally, core inflation edged down to 4.32% from 4.56% seen in the previous month. We continue expecting inflation to show 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

Lower inflation than expected, but with conditions that remain favorable for our trade idea in 5-year Bondes D. Today's inflation report came in below market expectations, temporarily easing the concerns about the CPI backdrop, resulting in local rates extending yesterday's rally. In recent days the Mexican yield curve has depicted a more defensive stance *vis-à-vis* global rates (*e.g.* U.S. Treasuries) given a very attractive carry and an already stressed valuation. Nevertheless, we acknowledge specific events in the 1H18 that could steer the country risk premia higher. This sentiment was highlighted today within Banxico's minutes. In terms of strategy, we expect market participants to hedge against risky events that could steer MXN and the repo rate higher in coming months via floating-rate securities *vs* CPI-linked Udibonos. The rationale behind this assessment comes from three fronts. First, expected inflation dynamics ahead suggests a limited carry in CPI-embedded instruments, with an inflation carry that will diminish significantly throughout the year according to our forecasts (5.33% annualized for a 91-day horizon, 2.74% for a 181-day scope, and 3.57% for a 365-day time frame). Second, an expensive valuation included in inflation breakevens, especially in the long-end (hovering around 3.75% in the 3- and 5-year tenors, and 3.83% in the ones with longer duration). Third, the strong likelihood of at least one additional rate hike from the central bank in the 1H18, that could result in capital losses in Udibonos but a favorable condition for floating-rate instruments (*e.g.* Bondes D).

Taking into account this scenario, we hold our trade idea of long positions in 5-year Bonds D. For more details please refer to our “*Fixed-Income and FX Weekly*” <[pdf](#)>, released last Monday.

In the FX market, the MXN gained 0.6% to 18.71 per dollar, extending today’s appreciation from 18.74 and with additional support after Banxico’s minutes, accumulating +1% to 18.64. Considering the central bank’s persistent hawkish bias, lower inflation helps the currency through increased attractiveness in terms of real interest rate spreads to the US. In spite of the latter, we believe that headwinds for global fixed-income could induce an additional bout of volatility and moderate portfolio inflows from foreigners. We reiterate our defensive stance and directional USD/MXN long recommendation opened on January 19th as it is our take that the peso does not show significant risk premium in a context of high uncertainty because of idiosyncratic factors.

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