Headline inflation closes the year at 2.13% yoy

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- ***INEGI* just published its inflation report for December**
- **Headline inflation (Dec): 0.41% m/m (Banorte-Ixe: 0.39% m/m; consensus: 0.36%m/m)**
- **Core inflation (Dec): 0.31%m/m (Banorte-Ixe: 0.34% m/m; consensus: 0.32% m/m)**
- **Inflation in December was explained by pressures on "fruits & vegetables" prices along with increases in "other services" prices**
- **With these figures, year-end inflation stands at 2.13% in 2015 from 4.08% in 2014**

Consumer prices increased 0.41% m/m in December (Banorte-Ixe: 0.39%). Moreover, core inflation edged-up to 0.31%, marginally below our 0.34% m/m forecast. The main deviation from our forecast comes from: (1) A lower than expected contribution of goods prices (7.4bps vs. our 10bps); and (2) a larger than expected contribution of agriculture prices (21.5bps vs. our 17.7bps), as shown in the table below.

December inflation by components
% monthly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.41	0.39	0.01
Core	0.23	0.25	-0.02
Goods	0.07	0.10	-0.03
Processed foods	0.05	0.07	-0.01
Other goods	0.02	0.03	-0.01
Services	0.15	0.15	0.00
Housing	0.03	0.03	0.00
Education	0.00	0.00	0.00
Other services	0.12	0.12	0.00
Non-core	0.18	0.14	0.04
Agriculture	0.22	0.18	0.04
Fruits & vegetables	0.20	0.15	0.06
Meat & eggs	0.02	0.03	-0.02
Energy & government tariffs	-0.04	-0.04	0.00
Energy	-0.05	-0.05	0.00
Government tariffs	0.00	0.01	0.00

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.

Inflation in December was explained by pressures on “other services” prices along with increases in “fruits & vegetables” prices. Within the core index, goods prices increased 0.21% m/m as a result of the 0.34% hike in the processed foods sub-index. Moreover, the services prices increased 0.39% m/m as a result of the 0.72% growth in the “other services” sub-index. Taking a look at the breakdown, airfares (+21.7% m/m) and tourism services prices (+10.3% m/m) posted a significant hike given the beginning of the holiday season. Within the non-core index, agricultural prices increased 2.3% m/m, as a result of higher “fruits and vegetables” prices (+5.99%), given the significant spike in the prices of tomatoes (41.6% m/m) and zucchini (16.5% m/m).

Year-end inflation stood at 2.13% in 2015, and will stand at 2.8% in 2016. Year–end inflation is at 2.13% in 2015 vs. 4.08% in 2014, reaching a new record low. Moreover, core inflation is at 2.41% from 3.2% in 2014. With today’s figures, we maintain our 2.8% yoy estimate for 2016 year-end inflation. The downward trend, not only in the prices of energy but also in other raw materials has resulted in a much lower inflation. Additionally, the pass-through from the FX depreciation to prices has been limited, with only moderate pressures on prices of durable goods. In this context, our forecast also includes a marginally higher pass-through effect of the exchange rate to prices, especially taking into account a significant recovery in domestic demand and the expected trend in gasoline prices.

From our fixed income and FX strategy team

Low inflation supportive for local rates. 2015 annual inflation finished at 2.13% way below the 4.08% portrayed in 2014 and lower than Banxico's target of 3%. Inflation has benefited from a series of one-off effects in addition to structural changes as a result of reforms. The key highlight in the whole inflation story is the mild pass-through effect despite the 17% FX depreciation observed along 2015. Moreover, inflation is expected to remain subdued in 2016 (probably staying below 3% for the entire year) generating favorable conditions for the local fixed-income market. In our view, Banxico could continue hiking rates in tandem with the Federal Reserve at the beginning of 2016. However, tamed inflation and an effect of slack in the economy could halt the restrictive cycle by mid-year. The key factor will be the performance of the Mexican peso which has been affected during the early stages of this year by the strong risk aversion in global markets. Taking into consideration these variables we hold a positive view in term of the belly of the Mbonos curve, especially the tenors from the Dec'18 security to the Dec'24. In accordance with this view, we hold our trade idea opened on November 12th of receiving 1-year TIIE-28 IRS (13x1) with an entry level of 3.92%, target of 3.67%, *stop-loss* of 4.10%, and currently trading at 3.89%. For further details regarding this recommendation please refer to "*Trade Idea: Receive 1-year TIIE-28 IRS (13x1)*, <pdf>. On the other hand, we hold a pessimistic view on Mexican linkers despite a valuation that looks attractive for investments with long-term horizons. Current inflation dynamics are likely to undermine the demand for inflation-linked securities (*e.g.* Udibonos), which could extend the recent sell-off on the back of a positive assessment on inflation for 2016. However, we acknowledge that historical low levels of breakevens could be appropriate for investment strategies with a longer time horizon. In this sense, we could expect a better demand for Mexican linkers between 1Q16 and 2Q16. 3- and 5-year inflation breakevens are hovering 2.2%, while 10-year is at 2.6% and 30-year at 2.8%.

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