Deflation in the 1st half of April – Summer discounts on electricity tariffs start applying

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- ***INEGI* just published its inflation report in the first half of April**
- **Headline inflation (Apr): -0.34%2w/2w (Banorte-Ixe: -0.37%2w/2w; consensus: -0.24%2w/2w)**
- **Core inflation (Apr): 0.15%2w/2w (Banorte-Ixe: 0.13%2w/2w; consensus: 0.12%2w/2w)**
- **Deflation in the first half of April was mainly explained by the start of summer discounts on electricity tariffs**
- **With these numbers, annual inflation remains at 2.6%**
- **Profit taking in Mbonos despite a benign inflation report**

Consumer prices decreased 0.34%2w/2w in in the first half of April, below consensus. Core inflation was 0.15% vs. our 0.13% estimate. The main deviation from our forecast comes from: (1) A larger than expected decline in agricultural prices (-11.5bps vs. our -0.6bps); (2) lower than expected contribution of government tariffs prices (-3.6bps vs. our 0.2bps). By contrast, (3) an underestimation of services prices (2.6bps vs. our 2bps); (4) an underestimation of merchandise prices (8.5bps vs. our 7.5bps); along with (5) a larger than expected contribution of energy prices (-32.4bps vs. our -45.8bps), as shown in the table below.

April's 1H inflation by components
% bi-weekly incidence

	INEGI	Banorte-Ixe	Difference
Total	-0.34	-0.37	0.022
Core	0.11	0.09	0.015
Goods	0.08	0.08	0.010
Processed foods	0.04	0.03	0.011
Other goods	0.05	0.05	-0.002
Services	0.03	0.02	0.006
Housing	0.02	0.02	-0.003
Education	0.00	0.00	0.001
Other services	0.01	0.00	0.009
Non-core	-0.47	-0.46	-0.004
Agriculture	-0.11	-0.01	-0.109
Fruits & vegetables	-0.14	-0.02	-0.121
Meat & eggs	0.02	0.01	0.013
Energy & government tariffs	-0.36	-0.46	0.101
Energy	-0.32	-0.46	0.134
Government tariffs	-0.04	0.00	-0.038

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.

Deflation in the first half of April was explained by the start of summer discounts on electricity tariffs. These came down 13.06% subtracting 32.9bps to inflation during the period in question. Meanwhile, agricultural prices were down 1.2% 2s/2s on the back of a 3.76% decline in the price of fruits and vegetables, due to sharp falls in the prices of tomatoes (17.7%) and onions (-14.96%), among others. These reductions more than offset the sharp increase observed in the price of lemons, up 40.6% 2s/2s. In addition, government tariffs edged down 0.66% 2w/2w, with *INEGI*'s report mentioning declines in the cost of bus transportation (-1.78%) and subway fees (-6.25%), among the products with falling prices. Meanwhile, in the core index, merchandise prices increased 0.24% 2s/2s on the back of higher prices of food (0.23%) and other merchandise (0.26%), respectively. Meanwhile, services prices rose 0.06% on the back of housing costs 0.1% higher, while education costs increased only 0.01%. Finally, other services prices rose 0.04% due to increases in the cost of dining away from home items (0.25%) as well as restaurants (0.29%), which more than made up for the drop in tourist services (-4.16%).

With these numbers, annual inflation remains at 2.6%. Meanwhile, core inflation edged up slightly to 2.79% from 2.76% in March.

From our fixed income and FX strategy team

Profit taking in Mbonos despite a benign inflation report. Mexican rates are heading for a fourth consecutive negative day, trading in tandem with their U.S. counterparts, despite a benign inflation report. Today's fortnightly deflation of -0.34% was bigger than market consensus (although in line with our -0.37% forecast), but unable to counterbalance market dynamics as the local yield curve already prices in a tamed inflation trend for coming months, with breakevens trading at 2.8% in every tenor, below Banxico's target of 3%. As a result, Mbonos Dec'24 and Mar'26 are at 5.83% (+2bps) and 5.93% (+1bp), respectively. It is our take that the yield curve will hold a flattening bias for the remainder of the 2Q16 (for further details please refer to our research note "Fixed-Income, FX and Commodities Quarterly – 2Q16 outlook" <pdf>, published on April 19th). Nevertheless, our short-term view has changed. In recent days we have been recommending taking profit in the 10- and 20-year segment of the Mbonos curve, as market could extend the correction started last Tuesday, following a significant rally in previous weeks. The rationale behind this view lies in the pricing adjustment observed in U.S. Treasuries since last week, with the 10-year note facing an important resistance (sell) level at Fibonacci's 1.76%, in hand with a significant spread contraction between Mexican and U.S. securities in previous sessions.

The spread between Mbono Dec'24 and 10-year Treasury is trading at 395bps from 406bps by the end of March (reaching 391bps on Tuesday), near to the 12-month mean of 389bps, with limited room for further contraction. On the other hand, Mexican linkers (CPI-indexed Udibonos) will continue to be affected for the deflationary period of 2Q16 (as expected in the 10-year auction last Tuesday), despite an attractive valuation for investments with a long-term horizon.

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