May's Inflation – Summer discounts on electricity prices ease pressures from higher agricultural prices

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- ***INEGI* just published its inflation report for May**
- **Headline inflation (May): -0.12% m/m; Banorte-Ixe: -0.14% m/m; consensus: -0.13% m/m (range of estimates: -0.20% to -0.11%); previous: 0.12% m/m**
- **Core inflation (May): 0.28% m/m; Banorte-Ixe: 0.26% m/m; consensus: 0.27% m/m (range of estimates: 0.24% to 0.30%), previous: 0.45% m/m**
- **Inflation in May was explained by the start of the summer discounts in electricity tariffs, which offset for pressures on the price of fruits and vegetables**
- **With these numbers, annual inflation stands at 6.16%, above the 5.82% seen in March**
- **We continue to expect year-end inflation at 5.7%**
- **Current backdrop supports our idea of a flatter yield curve and a stable peso**

Consumer prices decreased 0.12% m/m in May (Banorte-Ixe: -0.14% m/m). In addition, core inflation grew 0.28% m/m, marginally above our estimate (0.26% m/m). The main deviation from our forecast comes from: (1) A higher than expected contribution of meat and egg prices (4bps vs our -1bps); (2) a lower than expected contribution of fruits and vegetables prices (7bps vs our 10bps); and (3) a higher contribution of other goods prices (9bps vs. our -8bps), as shown in the table below.

May inflation by major subcomponent
Monthly incidence, %

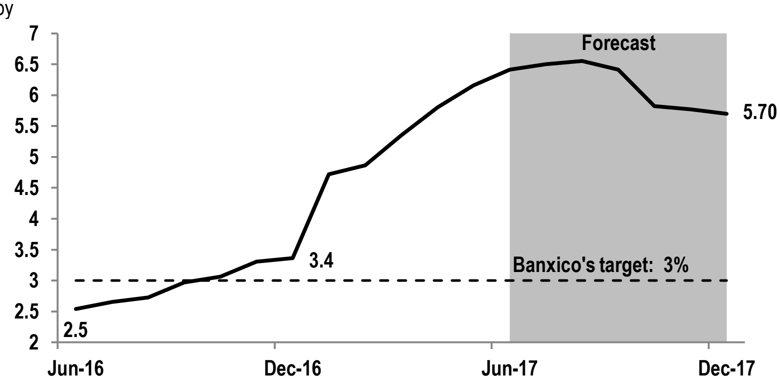
	Observed	Banorte-Ixe forecast	Difference
Headline	-0.12	-0.14	0.02
Core	0.21	0.20	0.01
Goods	0.17	0.15	0.02
Processed foods	0.07	0.07	0.01
Other goods	0.09	0.08	0.01
Services	0.04	0.05	-0.01
Housing	0.04	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.00	0.00	0.00
Non-core	-0.32	-0.34	0.01
Agricultural	0.11	0.09	0.02
Fresh fruits and vegetables	0.07	0.10	-0.03
Meat and egg	0.04	-0.01	0.05
Energy and government regulated	-0.44	-0.44	-0.01
Energy	-0.53	-0.53	0.00
Government regulated	0.10	0.11	-0.01

Source: INEGI, Banorte-Ixe
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 May was explained by the start of the summer discounts in electricity prices, which held off the impact from higher fruits and vegetables prices. In particular, electricity tariffs came down 23.34% m/m, as summer discounts came into effect. Along with this, prices of low grade gasoline prices decreased 0.63% m/m. Moreover, we highlight the reduction in both tourism services and air fares, which declined 8.93% m/m and 4.51% m/m. Such declines were offset by pressures in agricultural prices with prices of fresh fruits and vegetables up 2.16% m/m on the back of higher prices of tomatoes (28.98% m/m), and avocados (17.87% m/m) in particular, despite the sharp declines in the price of lemons (-38.68% m/m), *Husk* tomatoes (-17.13% m/m) and zucchini (-7.79% m/m). In addition, *meat and egg* prices were up 0.63% m/m, driven by higher prices of poultry (1.3% m/m) in particular. Finally, government tariffs were up 1.85% m/m, explained by higher bus transportation costs, which rose 4.78% m/m.

With these numbers, annual inflation stands at 6.16%, 34bp above the previous figure. Moreover, core inflation in the first half of May increased from 4.72% to 4.78%. Looking ahead, expect to peak at 6.55% in august and then converge to our 5.7% year-end forecast, as shown in the chart below.

Inflation forecast 2017
% yoy



Source:INEGI, Banorte-Ixe

From our fixed income and FX strategy team

Current backdrop supports our idea of a flatter yield curve and a stable peso. Today's CPI report came broadly in line with market expectations, depicting several conditions that could undermine the performance of inflation for the remainder of the year. These dynamics support the hawkish assessment from Banxico depicted within the last Quarterly Inflation Report and minutes. As a result, the short-end of the yield curve is trading with an expensive valuation, as the market is currently pricing in 37bps of additional implied hikes in the reference rate by year-end, below our expectation of 75bps. On the other hand, we acknowledge the possibility of an additional flattening bias, identifying a more attractive relative valuation in Mbonos Dec'23, Dec'24 and Mar'26. In terms of CPI-linked Udibonos, short-term securities are not attractive in our view given a drop in UDI-related carry, while the 10-year area looks more attractive taking into account current breakeven trading at 3.83%. However, we are more optimistic in terms of Mbonos *vis-à-vis* Udibonos.

In terms of the FX market, the decline in the country risk premia and a supportive carry for the Mexican peso increases the likelihood of a trading range of 18.06-18.67 for the remainder of the quarter. This currency has benefited recently by the electoral results last Sunday and favorable news coming from the negotiations of trade relations between the U.S. and Mexico. In the aftermath of this backdrop, technical position in the MXN market has improved considerably, giving support for a possible additional rally to the 1-year MAX of 18.06 in the short-term, despite negative news coming from inflation this year.

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