

# Annual inflation at a new historical low, yet again

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- **INEGI just published its inflation report for the first half of August**
- **Headline inflation (August): 0.12% 2w/2w; Banorte-Ixe: 0.16% 2w/2w; consensus: 0.16% 2w/2w (range of estimates: 0.10% to 0.22%); previous: 0.08%**
- **Core inflation (August): 0.12% 2w/2w; Banorte-Ixe: 0.15% 2w/2w; consensus: 0.15% 2w/2w (range of estimates: 0.12% to 0.27%); previous: 0.06%**
- **Inflation in the first half of August was explained by pressures in “other goods” and “education services” prices**
- **With these numbers, annual inflation is at 2.64% vs. 2.72% in July, which implies that headline inflation has reached a new historical low**
- **Short-term inflation-protected securities unattractive as there is no evidence of significant FX pass-through to prices.**

**Fixed income and FX Strategy**

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According to *INEGI’s* report published today, consumer prices increased **0.12% 2w/2w in the first half of August**. Moreover, core inflation stood at 0.12% vs. our 0.15% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of services prices (-0.2bps vs. our 5.9bps); (2) a lower than expected contribution of agriculture prices (-1.3bps vs. our 3.3bps); (3) an underestimation of government tariffs prices (2.1bps vs. our 0.4bps); and (4) a larger than expected contribution of goods prices (9.5bps vs. our 5.5bps), as shown in the table below

**1H-August inflation by components**

% bi-weekly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.12	0.16	-0.048
Core	0.09	0.11	-0.023
Goods	0.10	0.06	0.040
Processed foods	0.02	0.02	0.004
Other goods	0.07	0.04	0.037
Services	0.00	0.06	-0.062
Housing	0.01	0.02	-0.004
Education	0.05	0.05	0.005
Other services	-0.07	0.00	-0.063
Non-core	0.02	0.05	-0.026
Agriculture	-0.01	0.03	-0.046
Fruits & vegetables	-0.02	0.00	-0.024
Meat & eggs	0.01	0.03	-0.022
Energy & government tariffs	0.04	0.02	0.021
Energy	0.02	0.01	0.004
Government tariffs	0.02	0.00	0.017

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 the first half of August was explained by pressures in “other goods” and “education” prices.** Taking a look at the breakdown, “goods” prices increased 0.27% 2w/2w, as a result of the 0.15% 2w/2w expansion in the “processed foods” sub-index. Moreover, “other goods” prices edged-up 0.38%, which implies that the *pass-through* effect of the exchange rate to inflation has been quite low. Within the services sub-index, “other services” prices fell 0.37% 2w/2w derived from the 8% fall in tourism services. Similarly, airfares declined 10.8% as a result of the beginning of the school year, which was also reflected in the seasonal 0.94% spike in the “education” prices.

Within the non-core index, agricultural goods prices fell 0.14% 2w/2w as a result of the 0.65% fall in the “fruits and vegetables” sub-index. Within this group, *INEGI* highlighted the decline in the prices of tomato (-6.4% 2w/2w), onion (-4%), and potatoes (-2.6% 2w/2w). Moreover, “meat and egg” prices increased 0.13% given the hike in beef prices (1% 2w/2w).

**With these numbers, annual inflation is at 2.64% vs. 2.72% in previous month, which implies that headline inflation has reached a new historical low.** Moreover, core inflation is at 2.29% from 2.31% in July. As we have mentioned in our publications, we expect annual inflation to remain below 3% in the coming months.

*From our fixed income and FX strategy team*

**Short-term inflation-protected securities unattractive as there is no evidence of significant FX pass-through to prices.** Inflation in the first half of August undershoot both our and consensus expectations, with Udibonos selling off after the report by about 5-7bps and in a context of high risk aversion. The report shows that pass-through effects from the significant depreciation of the Mexican peso (6.3% in the past two weeks and 23.8% in the last twelve months) have been scarce and concentrated in few items (mostly durable goods), with the fall in commodity prices keeping a lid in overall price pressures. Regarding these instruments, it is our take that value in short-term Udibonos is scarce as appetite remains very low given current inflation dynamics. We prefer 5- to 10-year instruments, although with relatively low conviction, with inflation breakevens in these tenors below equilibrium levels. In particular, the 5-year measure ended Friday at 3.21% and the 10-year maturity at 3.09%, with the latter more attractively valued, in our view.

Regarding nominal rates, we believe that the yield curve will observe a bear flattening bias, with different dynamics than the ones portrayed in the previous 6 weeks. We acknowledge that the short-end of the Mbonos curve could remain pressured in the aftermath of market speculation that Banxico could be more aggressive once starting the hiking cycle (in a way to stand up to the complex scenario for the MXN). On the other hand, longer tenors could continue observing a modest profit-taking as valuation has turned more expensive following August rally. In this sense, the 10-year Mbono Dec'24 finished last week with a modest sell-off of nearly 5pbs to 6.04% and is extending losses today, trading at 6.12% (+8bps). Current conditions suggest that losses could continue, with important resistance levels at 5.97% and 6.00%. We remain cautious despite a wide spread vs the 10-year Treasury at 413bps currently, although we believe that market participants could start building up some long positions at levels around 6.15%.

In FX, the Mexican peso continues selling off as market concerns over China and volatility remain on the upside, ticking up from 17.11 to 17.15 per dollar immediately after the report and 0.8% weaker on the day to 17.12, with pressures waning somewhat after Banxico sold US\$ 200 million in its minimum-price auction. In our view, the peso's depreciation today is mostly driven by global growth concerns along the deep fall in oil prices and stock markets. Nevertheless, the additional loss after the data could be driven at least in part by speculation that low inflation dynamics (and growth prospects) will prevent Banxico from hiking rates before the Fed even if the peso has depreciated strongly, with some market participants betting on the possibility of a preemptive move by the central bank. We remain very defensive on the peso despite the breach of the 17.00 per dollar psychological resistance and a very attractive valuation. We cannot discard further losses as investors have turned very bearish on EM prospects, volatility has surged, and oil prices keep falling at an accelerated pace. Last but not least, market bets about a rate hike in September by the Fed have been reduced strongly in the past two weeks. In this respect, we still see risks of dollar demand if US data surprises to the upside, with all eyes on this week's 2Q15 GDP that is expected to be revised upward and could pressure the peso once again.

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