

Pressures on government tariffs explain inflation in the 1st half of July

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- **INEGI just published its inflation report for in the first half of July**
- **Headline inflation (Jul): 0.28%2w/2w (Banorte-Ixe: 0.21%2w/2w; consensus: 0.22%2w/2w)**
- **Core inflation (Jul): 0.11%2w/2w (Banorte-Ixe: 0.12%2w/2w; consensus: 0.15%2w/2w)**
- **Inflation in the first half of July was explained by pressures on government tariffs prices along with increases in low-grade gasoline prices**
- **With these numbers, annual inflation is at 2.72% vs. 2.54% in previous month**
- **Higher than expected CPI today positive for our trade idea in short-term Mexican linkers**

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Consumer prices increased 0.28%2w/2w in in the first half of July, above expectations. Core inflation was 0.11% vs. our 0.12% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of agricultural prices (-2.1bps vs. our 0bps); (2) a lower than expected contribution of merchandise prices (-0.2bps vs. our 1.5bps); (3) an overestimation of energy prices (11.5bps vs. our 12.1bps). We also observed a (4) an underestimation of services prices (8.8bps vs. our 7.4bps); along with (5) a larger than expected contribution of government tariffs prices (10.4bps vs. our 0.3bps), as shown in the table below.

Inflation by components in the first half of July

% bi-weekly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.28	0.21	0.065
Core	0.09	0.09	-0.002
Goods	0.00	0.02	-0.017
Processed foods	-0.01	0.01	-0.015
Other goods	0.01	0.01	-0.002
Services	0.09	0.07	0.015
Housing	0.02	0.01	0.011
Education	0.01	0.00	0.004
Other services	0.06	0.06	0.001
Non-core	0.20	0.12	0.072
Agriculture	-0.02	0.00	-0.021
Fruits & vegetables	-0.01	-0.02	0.011
Meat & eggs	-0.01	0.02	-0.031
Energy & government tariffs	0.22	0.12	0.098
Energy	0.12	0.12	-0.005
Government tariffs	0.10	0.00	0.101

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 July was explained by pressure on government rates as well as prices of gasoline and electricity. Government tariffs increased 1.96%2w/2w, explaining almost 40% of the CPI variation in the first half of the months. Among others, significant increases were observed in subway fares (25.7%) and urban bus tariffs (3.99%), probably as a result of the end of discounts granted during the environmental contingency program that took place mainly in Mexico City. Meanwhile, gasoline prices increased slightly below what the government announced, with low grade gasoline prices up 1.5%, while prices of high grade gasoline increased 2.17%. Meanwhile, electricity tariffs increased 1.32%2w/2w. In addition, we saw pressures on tourism services prices given the summer vacation season, although these increases were offset by declines in mobile phone services (-2.35%). Merchandise prices came down 0.01%2w/2w with lower prices of both food and other goods. Finally, agricultural prices came down 0.22%2w/2w on the back of lower prices of fruits and vegetables (-0.27%) as well as of “meat and eggs” (-0.19%), with declines mainly in the prices of poultry (-0.97%) and eggs (-1.84%).

With these data, annual inflation is at 2.72% vs. 2.54% in the previous month. Meanwhile, core inflation continues to edge up to 2.99% from 2.97% in June. We believe that pressures observed in the first half of the month are transitory, mainly explained by the return of public transport fares and the increases in tourism services, given the summer vacation season. While we expect further increases in gasoline prices in the coming months, we believe that the effect will be limited, with inflation ending the year around 2.8%yoy.

From our fixed income and FX strategy team

Higher than expected CPI today positive for our trade idea in short-term Mexican linkers. Inflation for the first half of July came in above market expectations, with important pressures coming from energy-related and government-managed prices. In addition, despite a well contained FX passthrough, especially observed in the goods component but not in non-tradable segment, this is a risk for coming months if the MXN continues underperforming other EM currencies and trading in tandem with global risk aversion. In the aftermath of this release, the Mbonos curve observed a 2-3bp sell-off; meanwhile Mexican linkers (Udibonos) rallied 4-5bps. Taking into consideration current inflation dynamics, we hold our trade idea opened last week of long position on Udibono Jun'19 (entry 1.95%, target 1.65%, stop-loss 2.10%, actual 1.88%). More details in our research note “*Mexico Trade Idea: Buy Udibono Jun'19 and Mbono Jun'21*” <[pdf](#)>, published on July 13th, 2016. Breakevens slightly above 3% remain attractive despite the recent adjustment, while de carry embedded in UDIS is expected to be of 2.33% for the remaining 162 days of 2016 (5.25% annualized).

Additional potential risk reward for this strategy could result if government-managed prices continue increasing given the fiscal adjustments in Mexico. On the other hand, we hold our trade idea regarding Mbono Jun'21 (entry 5.60%, target 5.35%, stop-loss 5.80%, actual 5.65%) despite the correction observed in the last two sessions. In our view, implied cumulative rate hikes for year-end at 69bps and for the 12-month ahead at 90bps are feasible and portray an attractive valuation in short-term securities, especially after the strong flattening of the yield curve during 1H16.

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