

# Annual inflation at a new historical low, yet again

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- **INEGI just published its inflation report for September**
- **Headline inflation (Sep): 0.37%/m/m (Banorte-Ixe: 0.42% m/m; consensus: 0.42%/m/m)**
- **Core inflation (Sep): 0.37%/m/m (Banorte-Ixe: 0.38%/m/m; consensus: 0.36%/m/m)**
- **Inflation in September was explained by pressures on other goods prices along with increases in education prices**
- **With these numbers, annual inflation is at 2.52% vs. 2.59% in previous month**
- **No signs of pass-through but pent-up inflation signals an attractive valuation in Mexican linkers for 4Q15**

**Delia Paredes**  
Executive Director of Economic Analysis  
delia.paredes@banorte.com

**Alejandro Cervantes**  
Senior Economist, Mexico  
alejandro.cervantes@banorte.com

## Fixed income and FX Strategy

**Alejandro Padilla**  
Head Strategist - Fixed-Income and FX  
alejandro.padilla@banorte.com

**Juan Carlos Alderete, CFA**  
FX Strategist  
juan.alderete.macal@banorte.com

**Consumer prices increased 0.37%/m/m in September, below expectations (consensus: 0.42% m/m; Banorte-Ixe: 0.42%).** Moreover, core inflation stood at 0.37% m/m, in line with our 0.38% forecast. The main deviation from our estimate comes from: (1) A lower than expected contribution of agriculture prices (8.2bps vs. our 11.8bps); (2) a lower than expected contribution of services prices (10.8bps vs. our 13.1bps); and (3) a larger than expected contribution of goods prices (17.3bps vs. our 15.3bps), as shown in the table below

### September inflation by components % monthly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.37	0.42	-0.04
Core	0.28	0.28	0.00
Goods	0.17	0.15	0.02
Processed foods	0.06	0.04	0.01
Other goods	0.12	0.11	0.01
Services	0.11	0.13	-0.02
Housing	0.03	0.03	-0.01
Education	0.11	0.11	0.00
Other services	-0.03	-0.01	-0.02
Non-core	0.10	0.14	-0.04
Agriculture	0.08	0.12	-0.04
Fruits & vegetables	0.06	0.09	-0.02
Meat & eggs	0.02	0.03	-0.01
Energy & government tariffs	0.01	0.01	0.00
Energy	-0.01	-0.01	0.00
Government tariffs	0.02	0.02	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.

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**Inflation in September was explained by pressures on other goods prices along with increases in education prices.** Within the core index, merchandise prices increased 0.5% m/m on the back of an increase of 0.36% in food prices. Moreover, “other goods” were up 0.61%, which could suggest some pass-through from the exchange rate depreciation to inflation. Meanwhile, services prices increased 0.26%, as a result of housing costs up 0.15%, while education costs increased 2.06%, explained by seasonal increases given the back to school season. In fact, the report mentioned tuition costs for primary (4.07% m/m), high-school (3.78%), and college (0.8%), among the items with increasing prices.

In the non-core, agricultural prices were up 0.89 m/m due to higher prices of fruits and vegetables (2.01%) along with an increase of 0.29% in “meat and egg”. *INEGI* mentioned onions (20.32% m/m), among the products with rising prices. In addition, government tariffs increased 0.39%, as a result of increases in urban bus fares, among others.

**A new historical low.** With these figures, 12-month inflation stands at 2.52% vs. 2.59% in the previous month, which implies a new historical low. Moreover, the core inflation remains unchanged at 2.38% yoy.

*From our fixed income and FX strategy team*

**No signs of pass-through but pent-up inflation signals an attractive valuation in Mexican linkers for 4Q15.** Today’s CPI came slightly below market expectations, confirming a low degree of FX pass-through effects. This situation will grant Banxico the opportunity to wait for the Fed to start hiking rates, contrary to what has been observed in other Latam countries such as Peru and Colombia. However, concerns regarding pent-up inflation due to recent FX dynamics could support higher demand for inflation-linked Udibonos going forward. Carry embedded in Mexican linkers is likely to improve in 4Q15 as the period of seasonally-high inflation kicks in, with an expected 8.2% annualized gain for UDIS-denominated securities in the next three months. In addition, breakevens are trading below 3.5% in almost every tenor, implying an appealing risk-reward of 40bps. In this regard, we acknowledge a better relative valuation in the 5-year and 10-year segments of the Udibonos curve. On the other hand, we hold our trade recommendation opened last week: A spread position between Mexico and the US in the 10-year maturity, receiving TIE-IRS (Mexico) and simultaneously paying LIBOR-IRS (US) with an entry level of 436bps, target of 410bps, stop-loss of 456bps and currently at 420bps. This strategy implies an expected gain of 2bps per month from carry + roll-down. In our view, the current spread between these two rates does not reflect accurately Mexico’s fundamentals or country-specific risk. Additionally, we believe recent dynamics between these curves have shown some distortions that, in case of a correction, provide greater value to this strategy.

Mexico's curve seems to be already discounting heavily a scenario of rate-normalization going forward, both in Mexico and the US, with a 5y5y forward rate at 7.52%. The latter means that there is attractive value in local rates and could result in a more defensive behavior in Mexico when compared to other emerging and developed markets. For more details please refer to "*Trade Idea: Long 10-year spread between Mexico vs US in swap*" published on September 30<sup>th</sup> [<pdf>](#).

**Mexican peso slightly weaker as Banxico should continue waiting for the Fed.** In the FX market, the Mexican peso weakened slightly after the report, going from 16.60 to 16.62 per dollar. The confirmation of a benign inflation outlook and lack of pass-through effects suggests that Banxico will continue waiting for the Fed's rate hike to begin its own cycle, resulting in low expectations of a higher interest rate differential for the peso against the dollar that could make for relatively more expensive peso shorts. We remain cautious on long peso positions and recommending to buy USD on dips, expecting to see greater dollar buying interest around the 16.45/50 zone. Moreover, if the risk environment keeps stabilizing such as seen in recent days, we believe it is more likely that the Fed decides to hike rates this year (December), which the market continues seeing as a low probability scenario and could pressure our currency once again.

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<b>Research and Strategy</b>			
Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
<b>Economic Analysis</b>			
Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Juan Carlos García Viejo	Economist, International	juan.garcia.viejo@banorte.com	(55) 1670 - 2252
Rey Saúl Torres Olivares	Analyst, Mexico	saul.torres@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
<b>Fixed income and FX Strategy</b>			
Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal; CFA	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1103 - 2368
<b>Equity Strategy</b>			
Manuel Jiménez Zaldivar	Director Equity Research Analyst - Telecommunications / Media	manuel.jimenezza@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/Mining/Chemistry	marissa.garza@banorte.com	(55) 1670 - 1719
Marisol Huerta Mondragón	Senior Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 1670 - 1227
José Itzamna Espitia Hernández	Equity Research Analyst – Airports/Cement/Infrastructure/Fibras	jose.espitia@banorte.com.	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research Analyst – Auto parts	valentin.mendoza@banorte.com	(55) 1670 - 2250
María de la Paz Orozco García	Analyst	maripaz.orozco@banorte.com	(55) 1670 - 2251
<b>Corporate Debt</b>			
Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 1670 - 2248
<b>Wholesale Banking</b>			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Jorge de la Vega Grajales	Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Private Banking	lpietrini@ixe.com.mx	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Asset Management	pimentelr@ixe.com.mx	(55) 5268 - 9004
Ricardo Velazquez Rodríguez	International Banking	rvelazquez@ixe.com.mx	(55) 5268 - 9879
Victor Antonio Roldan Ferrer	Transactional Banking	vrolan@ixe.com.mx	(55) 5004 - 1454