

Inflation at 2.5% yoy in June

July 7, 2016

- **INEGI just published its inflation report for June**
- **Headline inflation (Jun): 0.11%/m/m (Banorte-Ixe: 0.18%/m/m; consensus: 0.16%/m/m)**
- **Core inflation (Jun): 0.25%/m/m (Banorte-Ixe: 0.27%/m/m; consensus: 0.27%/m/m)**
- **Inflation June was explained by pressures on the price of core items**
- **With these numbers, annual inflation is at 2.54% vs. 2.6% in previous month**
- **INEGI delayed the change of the CPI methodology to 2017**
- **Markets assimilate a still low FX-pass-through effect on the CPI, albeit holding a cautious stance given recent concerns by the central bank**

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Consumer prices increased 0.11%/m/m in June, slightly below expectations. Core inflation was 0.25% vs. our 0.27% estimate. The main deviation from our forecast comes from: (1) An underestimation of the decline of agricultural prices (-13.4bps vs. our -9.2bps); (2) a lower than expected contribution of energy prices (5.1bps vs. our 7bps); (3) an overestimation of merchandise prices (9.5bps vs. our 11.4bps); along with (4) a larger than expected contribution from services prices (9.7bps vs. our 8.7bps), as shown in the table below.

Inflation by components in June
%monthly incidence

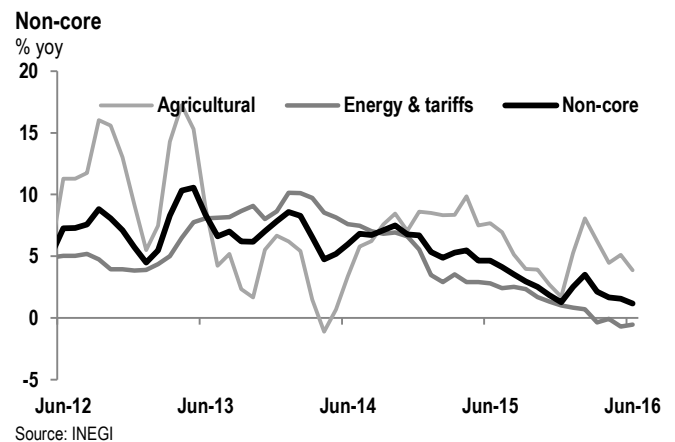
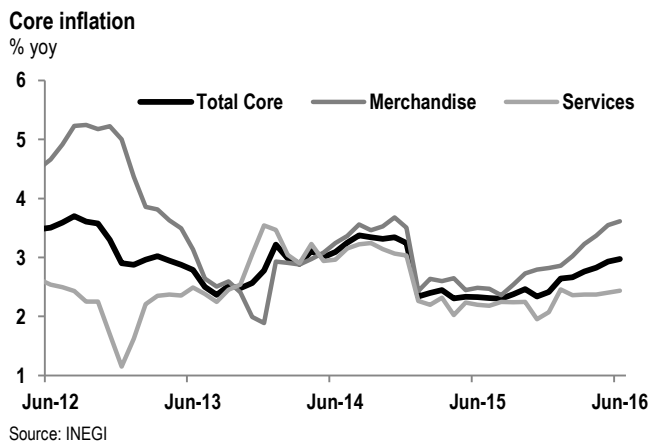
	INEGI	Banorte-Ixe	Difference
Total	0.11	0.18	-0.069
Core	0.19	0.20	-0.009
Goods	0.10	0.11	-0.019
Processed foods	0.06	0.06	-0.003
Other goods	0.04	0.06	-0.016
Services	0.10	0.09	0.010
Housing	0.04	0.04	-0.001
Education	0.01	0.00	0.001
Other services	0.06	0.05	0.010
Non-core	-0.09	-0.02	-0.061
Agriculture	-0.13	-0.09	-0.043
Fruits & vegetables	-0.08	-0.05	-0.029
Meat & eggs	-0.06	-0.04	-0.013
Energy & government tariffs	0.05	0.07	-0.018
Energy	0.05	0.07	-0.019
Government tariffs	0.00	0.00	0.001

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 June was explained by pressures on core items. Services inflation was up 0.24% m/m on the back of higher housing (+0.2%) and education (0.1%) costs, coupled with higher prices of other services (0.33%). In fact, *INEGI*'s report mentioned, among the products with rising prices, air transportation (+13.8%), tourism services (4.01%), restaurants et. al (0.33%). Meanwhile, merchandise prices increased 0.27% m/m as a result of an increase of 0.35% in food and of 0.2% other merchandise prices. In the non-core index, we observe an increase of 0.53% in energy prices due to an increase in low-grade gasoline prices (+0.84%). Meanwhile, agricultural prices came down 1.42% m/m on the back of sharp declines in the price of avocados (47.6%), oranges (27.3%) and tomatoes (+4.2%). This more than offset the significant reductions observed in the price of lemons (-49%), *Husk* tomatoes (-17.8%), grapes (19.4%) and bananas (-4.5%), among others.

With these data, annual inflation is down to 2.54% vs. 2.6% in the previous month. Meanwhile, core inflation edged up marginally to 2.97% from 2.93% in May. Low levels of inflation continue to be explained mainly by the reduction in energy prices as well as the downward cycle in agricultural prices, as you can see in the chart below right. In contrast, core inflation has shown an upward trend, with inflation at 3.61% yoy from 2.8% in year-end 2015, which shows some pass-through from exchange rate to prices (see chart below left). However, we still believe that inflation will end the year at around 2.8%, taking into account, among others: (1) Increases in gasoline prices; (2) increases in high consumption electricity tariffs; and (3) the fact that *INEGI* has delayed the coming year change in CPI methodology.



Delay in the change of CPI methodology. *INEGI* also reported today that the new CPI, estimated under a new base year, will be published in 2017. Recall that adjustments to the new index include: (1) A new basket of goods and services; (2) the update of weights; (3) a wider geographical sample, (4) changes of the reference point of the series and (5) the implementation of a new statistical design for the selection of the sample.

From our fixed income and FX strategy team

Markets assimilate a still low FX-pass-through effect on the CPI, albeit holding a cautious stance given recent concerns by the central bank.

Limited reaction of local assets towards today's CPI report, which came in below expectations, but showing evidence of pass-through effects on core goods component, however still well anchored. Taking into consideration current conditions, we hold our view of a further flattening of the Mexican yield curve. In our view, short-term securities will remain highly sensitive to market expectations of additional restrictive monetary conditions locally, on the back of an extremely volatile FX market. On the other hand, long-term bonds continue depicting an attractive valuation in spite of the significant rally of recent weeks, taking into consideration a risk premium (spreads against U.S. Treasuries) which trades higher *vis-à-vis* Mexico's macro fundamentals, in tandem with appealing monthly carry gains. It is under this context that we continue acknowledging a more interesting relative valuation in 10- and 20-year Mbonos. Mexican linkers (Udibonos) have also appreciated in recent weeks in a significant fashion, portraying breakevens hovering around 3% in every tenor from 2.8% a year ago. In the FX market, the Mexican peso weakened from 18.69 to 18.73 per dollar after the release. Notwithstanding the lower figure in the general index, some evidence of pass-through from FX weakness and its downward effect on real rates are likely stripping some support to the currency. We believe that the market will be more focused on inflation dynamics going forward due to its potential impact on expectations of additional rate hikes from Banxico during the rest of the year, which could also increase the peso's sensitivity to these figures. So far, we are still recommending a defensive stance and USD/MXN longs given a challenging external backdrop, expecting renewed pressures towards the 19.00 psychological level.

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