Inflation in February still pressured by agricultural and merchandise prices

- *INEGI* **just published its inflation report for February**
- **Headline inflation (Feb): 0.44%m/m (Banorte-Ixe: 0.45%m/m; consensus: 0.49%m/m)**
- **Core inflation (Feb): 0.36%m/m (Banorte-Ixe: 0.34%m/m; consensus: 0.35%m/m)**
- **Inflation February was explained by pressures on merchandise and agricultural prices**
- **With these numbers, annual inflation edges up to 2.87% vs. 2.61% in previous month**
- **Local rates outperforming sovereign bonds worldwide supported by today's inflation report**

March 9, 2016

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Consumer prices increased 0.44%m/m in February, in line with our forecast. Core inflation was 0.36% vs. our 0.34% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of agricultural prices (16.9bps vs. our 19.8bps); (2) An underestimation of merchandise prices (16.8bps vs. our 16.3bps); and (5) a larger than expected contribution of services prices (10.1bps vs. our 9.1bps), as shown in the table below.

February's inflation by components
% monthly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.44	0.45	-0.015
Core	0.27	0.25	0.015
Goods	0.17	0.16	0.005
Processed foods	0.04	0.04	0.000
Other goods	0.12	0.12	0.005
Services	0.10	0.09	0.010
Housing	0.04	0.04	0.001
Education	0.01	0.01	0.001
Other services	0.05	0.04	0.009
Non-core	0.17	0.20	-0.032
Agriculture	0.17	0.20	-0.029
Fruits & vegetables	0.10	0.14	-0.041
Meat & eggs	0.07	0.05	0.013
Energy & government tariffs	0.00	0.00	-0.002
Energy	-0.03	-0.03	0.002
Government tariffs	0.02	0.02	-0.004

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.

Inflation February was explained by pressures on merchandise and agricultural prices. In the first case, prices were up 0.48% during the month in question, on the back of higher food prices (+0.28%) along with pressures on other goods, up 0.66%m/m, with the report citing the price of cars among the products with rising prices. Meanwhile, the cost of services increased 0.25%m/m explained by a 0.24% increase in housing costs; 0.22% higher costs of education and other services prices up 0.28%m/m. *INEGI* contrasts the rising cost of dining away from home items, up 0.44%, with lower prices of tourism services (-1.27%) and mobile phone services (- 0.72%).

In the non-core sub index, agricultural prices increased 1.77% m/m on the back of an increase of 2.79% in the prices of fruits and vegetables, with sharp increases in the price of onions (+12.36%); Serrano chilies (+41.03%) and bananas (14.57%), among others. This was partly offset by the decline observed in the price of tomatoes (-18.13%); *Husk* tomatoes (-19.63%) and cucumbers (-13.97%). In our opinion, the reduction in agricultural prices could continue in March. Meanwhile, *meat and eggs* prices increased 1.12%, with *INEGI*'s report mentioning eggs (+7.96%) among the products with rising prices. Meanwhile, energy prices declined 0.24%m/m, while the government tariffs were up 0.38%m/m.

With these data, 12-month inflation edges up to 2.87% in February vs. 2.61% in the previous month. Meanwhile, core inflation is at 2.66% from 2.64% in January. In our opinion, annual inflation will hover at about 2.5%yoy, in the coming months.

From our fixed income and FX strategy team

Local rates outperforming sovereign bonds worldwide supported by today's inflation report. Today's inflation report came in slightly below market expectations, with evidence of a modest pass-through effect on the goods component, but counterbalanced by lower agricultural prices and non-tradable items (mainly telecommunications services). The data released this morning is consistent with Banxico's assessment on inflation portrayed last week inside its QIR, suggesting a smooth convergence towards 3% objective in coming months. This could imply that Banxico will be able to hold its base-case strategy of hiking rates in tandem with the Federal Reserve going forward (conditioned to FX dynamics), after delivering a 50bps hike on February 17. In this regard, the local yield curve continues pricing in additional cumulative 50bps implied hikes by year-end. In the aftermath of this report, local rates are trading flat, despite a modest profit taking in most sovereign bonds worldwide. Taking into consideration technical and fundamentals, we observe an attractive relative valuation in 10- and 20-year Mbonos. However, we acknowledge that volatility will remain elevated and suggest waiting for better conditions in order to increase exposure in directional trades regarding this segment of the curve, especially following the recent correction in U.S. Treasuries on the back of stronger data.

In addition, we expect Udibonos to recover going forward as inflation dynamics could improve the embedded carry, and valuation remains attractive. In this regards, inflation *breakevens*, especially in the mid-end of the Udibonos curve are appealing for long positions, hovering around 2.8%, below Banxico's target of 3%. However, investors will remain cautious as depicted in recent auctions. Taking into consideration our CPI forecasts we the annualized carry for UDI-linked securities until 2Q16 could be of -2.2% annualized, but in the second half of 2016 the potential carry is of nearly 5.1%. Overall, the tenor of the Udibonos curve with the most attractive valuation is the 10-year security; however we suggest waiting for better entry levels.

In FX market, the Mexican peso is gaining 0.7% today, trading at 17.80 per dollar in a risk positive environment and relatively strong appetite for Latam, with BRL, ARS, CLP and PEN also among the best in EM. We believe that the inflation report is positive for the currency as it suggests that pass-through effects remain limited and give Banxico some leeway to avoid hiking interest rates before the Fed again, which is better for growth prospects. After the announcements made on February 17 and subsequent commentary, we cannot fully discard this scenario if the peso sells off strongly, but it is not our base-case. We see at least two conditions for this to materialize, which we think are relatively unlikely: (1) A rapid and strong peso fall not only in absolute terms but relative to EM, and (2) that the latter is accompanied with signs of lower liquidity, such as an increase in bid-ask spreads. Despite of the recent rally we remain cautious on the peso as we believe that local and external fundamentals have not turned positive enough to change the currency's trend, while concerns over global growth in most regions still high and a potentially less dovish Fed next week than markets imply based on discounted interest rate increases for the rest of the year.

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