Inflation in November surprises to the upside on higher agricultural prices

December 7, 2018

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- ***INEGI* just published its inflation report for November**
- **Headline inflation (November): 0.85% m/m; Banorte: 0.71%; consensus: 0.74% (range of estimates: 0.66%-0.92%); previous: 0.52%**
- **Core inflation (November): 0.25% m/m; Banorte: 0.25%; consensus: 0.25% (range of estimates: 0.22%-0.34%); previous: 0.31%**
- **The upward surprise in inflation was due to agricultural prices, with six of ten of the generics with the highest contribution within this category, highlighting tomatoes, husk tomatoes and eggs, among others**
- **Annual inflation stood at 4.72%, lower than the 4.9% of the previous month, but higher than the 4.63% forecast by the consensus. Moreover, core inflation reached 3.63% from 3.73% in October**
- **We maintain our view that Banxico will hike the reference rate 25bps to 8.25% in its next decision on December 20th**
- **We hold our short-term tactical trade in floating-rate securities as November's inflation reading is giving support to the thesis of a 25bps rate hike on December 20th**

Consumer prices increased 0.85% m/m in November. This figure was considerably higher than both the consensus (0.74%) and our forecast (0.71%). Meanwhile, core inflation edged-up 0.25%, in line with our estimate.

The main deviation from our forecast came mainly from a higher contribution from fresh fruits and vegetables, which added 31bps to the headline figure, while we only expected 19bps. There were also some minor discrepancies in meat and egg (+4bps vs. our +2bps), other services (+5bps vs. our +7bps), and core goods (+10bps vs. our +9bps), as shown in the table below.

November inflation by components
% monthly incidence

	INEGI	Banorte	Difference
Total	0.85	0.71	0.14
Core	0.19	0.19	0.00
Goods	0.10	0.09	0.02
Processed foods	0.07	0.07	0.00
Other goods	0.03	0.02	0.01
Services	0.09	0.10	-0.02
Housing	0.03	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.05	0.07	-0.02
Non-core	0.66	0.52	0.14
Agriculture	0.35	0.21	0.14
Fruits & vegetables	0.31	0.19	0.12
Meat & eggs	0.04	0.02	0.02
Energy & government tariffs	0.31	0.31	0.00
Energy	0.30	0.30	0.00
Government tariffs	0.00	0.00	0.00

Source: INEGI, Banorte.
Note: Contributions might not add due to the number of decimals allowed in the table.

Inflation in November was explained by higher agricultural and energy prices. In the first case, they surged 3.5% m/m, explaining 35bps of the headline figure. In particular, six out of ten generics with the highest contributions were in this category, highlighting the 32% increase in tomatoes, followed by husk tomatoes (36.3%), and egg (2.8%), among others. Nevertheless, this was partially compensated by the fall avocadoes (-7.3%), potatoes (-4.6%) and oranges (-10.2%). On the other hand, energy increased 2.9%, as explained by electricity (+23.4%) given the end of summer discounts in the first half of the month. This added 40.4bps to the headline. Nevertheless, LP gas fell 4.5%, contributing the most to the downside at -10.3bps.

Despite the upward surprise, core inflation was in line with our expectations at 0.25% m/m. Within this category, we highlight increases in other services, such as the 0.3% and 0.5% increase in *dining away from home* and restaurants. In our view, this could be driven by a lagged effect from higher energy prices, particularly commercial electricity prices. In other components, processed food picked up 0.36%, contributing 7bps, and likely influenced by recent exchange rate adjustments. On the contrary, other goods increased only 0.2% as a result of discounts related to *El Buen Fin* (Mexico’s Black Friday).

In annual terms, inflation fell to 4.72% from 4.9% in October, although above consensus at 4.63%. We maintain our 4.8% year-end estimate, considering the recent increase in agricultural prices and in spite of some downside pressures in energy, particularly gasoline prices and LP gas given the fall in international benchmarks. In this respect, we see a slight downside risk in our estimate, which is still above consensus at 4.6% according to the latest Banxico survey. In particular, recent news affirm that electricity prices for industry could decrease in December, which could have a positive second-round effect in the price formation process, especially in other services.

In spite of the decrease in annual inflation, we maintain our view that Banxico will hike the reference rate 25bps to 8.25%on December 20th. In our view, Banxico’s latest communications, including the Quarterly Report and minutes, maintained a very hawkish bias. Regarding the former, we believe that an additional rate hike is justified after the upward revision to its inflation forecasts, particularly as they stand significantly above the target during all 2019, coupled with the deteriorated balance of risks for inflation in both the short- and medium-term. We believe that this document suggests that risks are skewed to the upside in terms of the terminal rate for this cycle. On the other hand, we noted in the minutes that at least three members considered a higher increase in the reference rate on November 15th, but only Irene Espinosa voted in favor +50bps. Although the drop in annual inflation is surely welcomed by Banxico, we think the central bank will maintain a prudent stance, taking into account high volatility in local financial markets, particularly MXN weakness, which in our view argues in favor of staying defensive in an environment characterized by high uncertainty, both external and domestic, with relevant risks in the latter such as the 2019 Budget and the likely hike of the minimum wage, among others.

From our fixed income and FX strategy team

We hold our short-term tactical trade in floating-rate securities as November's inflation reading is giving support to the thesis of a 25bps rate hike on December 20th. Today's CPI print could give an additional argument to Banxico for a 25bps rate hike later this month. The yield curve is pricing in +19bps for the December 20th meeting and an implied cumulative increase of 68bps in the repo rate by mid-2019. In our view, current conditions remain supportive for long positions in floating-rate securities. In contrast, Mbonos, TIIE-IRS and CPI-linked Udibonos could remain highly sensitive to foreign and local news, even when we take into account the recent 160bps correction of the October-November period. We remain with a cautious view with respect to this type of instruments. Inflation breakevens trading around 4% in the 3- and 5-year tenors, 4.4% in a 10-year time and 4.7% in the longest end are already incorporating an additional premium of 20 to 40bps, suggesting that Mbonos are currently trading with a more attractive relative valuation *vis-à-vis* Udibonos. Today's market reaction was limited despite the negative surprise, as the yield curve is extending the recent relief rally following the weaker-than-expected BLS labor report in the U.S. earlier today.

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