

## Slightly higher than expected inflation in the first half of June as pressures on core items continued

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- **INEGI just published its inflation report for in the first half of June**
- **Headline inflation (1H-Jun): 0.15% 2w/2w (Banorte-Ixe: 0.1% 2w/2w; consensus: 0.13% 2w/2w)**
- **Core inflation (1H-Jun): 0.17%2w/2w (Banorte-Ixe: 0.18% 2w/2w; consensus: 0.16% 2w/2w)**
- **Inflation in the first half of June was explained by pressures on the prices of services and processed foods**
- **With these numbers, annual inflation is at 6.3% vs. 6.16% in previous month**
- **Local rates and MXN with a defensive performance despite a negative CPI report and cautiousness ahead of Banxico**

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**Consumer prices increased 0.15%2w/2w in in the first half of June.** Core inflation was 0.17% vs. our 0.18% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of goods prices (6.2bps vs. our 7.5bps); (2) a lower than expected contribution of government tariffs prices (0.2bps vs. our 1bps); (3) an underestimation of services prices (6.6bps vs. our 6.1bps); (4) an underestimation of agriculture prices (0.3bps vs. our -2.5bps); and (5) a larger than expected contribution of energy prices (1.8bps vs. our -2.2bps), as shown in the table below

#### 1H-Jun inflation by major subcomponent

Bi-weekly incidence, %

	INEGI	Banorte-Ixe	Difference
Total	0.15	0.10	0.05
Core	0.13	0.14	-0.01
Goods	0.06	0.08	-0.01
Processed foods	0.04	0.04	0.01
Other goods	0.02	0.04	-0.02
Services	0.07	0.06	0.01
Housing	0.02	0.02	-0.01
Education	0.00	0.00	0.00
Other services	0.05	0.04	0.01
Non-core	0.02	-0.04	0.06
Agriculture	0.00	-0.03	0.03
Fruits & vegetables	0.00	-0.04	0.04
Meat & eggs	0.00	0.02	-0.01
Energy & government tariffs	0.02	-0.01	0.03
Energy	0.02	-0.02	0.04
Government tariffs	0.00	0.01	-0.01

Source: INEGI, Banorte-Ixe

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 June was explained by pressures on the prices of services, along with increases in the prices of processed foods.**

Particularly, other services prices increased 0.29% 2w/2w, mainly due to the rise in airfares (8.71% 2w/2w), dining away from home items (0.24% 2w/2w) and tourism services (1.91% 2w/2w). Moreover, goods increased 0.18% 2w/2w given the 0.26% rise in processed foods.

Regarding non-core items, fresh fruits and vegetables prices only increased 0.03% 2w/2w, given that the increase in tomatoes (6.75% 2w/2w) and potatoes (3.5% 2w/2w) was offset by the decrease in husk tomatoes (-14.66% 2w/2w), grapes (-13.16% 2w/2w) and lemons (-8.95% 2w/2w) among others. Additionally, the prices of energy rose 0.19%, given the 2.04% 2w/2w in liquefied gas, despite de 0.28% 2w/2w decrease in low-grade gasoline.

**With these numbers, annual inflation is at 6.3% vs. 6.16% in previous month.** Meanwhile, core inflation is at 4.82% from 4.78% in May.

*From our fixed income and FX strategy team*

**Local rates and MXN with a defensive performance despite a negative CPI report and cautiousness ahead of Banxico.** Local rates are trading with a positive performance in tandem with their U.S. counterparts, despite a negative print coming from the fortnightly CPI report this morning and the cautiousness surrounding Banxico's policy decision later this Thursday, but supported by a relief rally in the Mexican peso. The market is pricing in a high probability of a 25bp rate hike today, but a stable rate going forward in the 2H17 and rate cuts in 1H18. This situation poses significant risks for the short-end of the yield curve, as the possibility of a rate hike today accompanied by a still hawkish rhetoric by the central bank could suggest additional increases despite the strong likelihood of almost reaching a neutral policy rate. As we have commented before (please refer to our Fixed-Income and FX Weekly [pdf](#)), published on June 12<sup>th</sup>, 2017), according to an adjusted Monetary Conditions Index and to the 12-month real ex ante interest rate, additional 50bps to the current repo rate could turn conditions into a restrictive environment. However, we expect Banxico to hold the hawkish tone from the previous communiqués as inflation continues heading upwards with 11 consecutive biweekly inflation figures above market expectations that could undermine the convergent trajectory of inflation expected in the next 12 and 18 months. In addition, Banxico will be cautious of any changes in the monetary stance coming from the Federal Reserve and other global factors that could increase the risk premia ahead. We are more optimistic about the mid-end of the Mbonos curve, especially 3- and 5-year tenors, with a 5y5y forward rate trading at 7.07% with a significant risk reward taking into account the possibility of rate cuts in 2018. In terms of Udibonos, we expect UDI-related carry to decline ahead, but breakevens that are trading with a modest premia in the 5- and 7-year area.

In the FX market, MXN gains 0.4% to 18.17 per dollar, with no strong reaction despite the higher-than expected print. Nevertheless, the surprise could be relevant for Banxico's decision later today and positive for the peso as the Board could maintain a relatively hawkish and cautious tone even if the market already discounts a 25bps rate hike. We remain on the sidelines of MXN longs for now, waiting for better entry levels for new positions and after suggesting profit taking early last week before the Fed meeting. Notwithstanding, we reiterate our positive bias for tactical trading purposes before this decision and after validating an immediate resistance around 18.18-18.20, expecting the currency to maintain a relatively strong performance when compared to EM in a context in which high carry and low volatilities keep it supported.

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