Inflation in the 1st half of March resents seasonal increases in services prices

- ***INEGI* just published its inflation report for in the first half of March**
- **Headline inflation (Mar): 0.1%2w/2w (Banorte-Ixe: 0.04%2w/2w; consensus: 0.19%2w/2w)**
- **Core inflation (Mar): 0.3%2w/2w (Banorte-Ixe: 0.1%2w/2w; consensus: 0.18%2w/2w)**
- **Inflation in the first half of March was explained by seasonal pressures on "other services" prices, tourism services in particular**
- **With these numbers, annual inflation is at 2.71% vs. 2.87% in previous month**
- **Limited market reaction following the fortnightly CPI report**

Consumer prices increased 0.1%2w/2w in in the first half of March, below expectations. Core inflation was 0.3% vs. our 0.1% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of agricultural prices (-10bps vs. our 0bps); (2) an underestimation of services prices (14.6bps vs. our 10.5bps); y (3) a larger than expected contribution of merchandise prices (7.8bps vs. our -3bps), as shown in the table below.

March's 1H inflation by components
% bi-weekly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.10	0.04	0.057
Core	0.22	0.07	0.149
Goods	0.08	-0.03	0.108
Processed foods	0.03	-0.03	0.055
Other goods	0.05	-0.01	0.053
Services	0.15	0.10	0.041
Housing	0.02	0.01	0.007
Education	0.00	0.00	0.000
Other services	0.13	0.09	0.035
Non-core	-0.13	-0.03	-0.099
Agriculture	-0.10	0.00	-0.100
Fruits & vegetables	-0.10	0.02	-0.125
Meat & eggs	0.00	-0.02	0.021
Energy & government tariffs	-0.03	-0.03	0.003
Energy	-0.03	-0.03	0.002
Government tariffs	0.00	0.00	0.000

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 the first half of March is explained by seasonal pressures on the prices of "*other services*". Prices in this sub-index were up 0.73%2w/2w at the start of the Easter holiday season. The report highlighted increases in the prices of tourism services, up 12.9%, while the cost of air transportation increased 12.7%. These two items added 9.8pbs to total inflation of the 1st half of March. The report also mentions increases in cable TV services (+1.89%) and in the costs of dining away from home items (0.24%). Meanwhile, merchandise prices increased 0.23%2w/2w on the back of 0.19% higher food prices, while prices of other goods increased 0.25%, with the prices of cars up 0.5%. In the non-core index, there was a negative change in agricultural prices (-1.02%) due to sharp falls in the prices of fruits and vegetables (-2.67%) while the prices of “meat and eggs” increased 0.03%. Additionally, the report shows declines in energy prices, down 0.32% on the back of lower prices low grade gasoline (-0.64%).

With these data, annual inflation is at 2.71% vs. 2.87% in the previous month. Meanwhile, the core inflation edges up to 2.86% from 2.66% in February.

From our fixed income and FX strategy team

Limited market reaction following the fortnightly CPI report. The Mexican fixed-income market is depicting a 2-3bps sell-off this morning in tandem with the movement of +2pb in U.S. Treasuries since last Friday. Today’s CPI report resulted in a modest market reaction, as the yield curve continues discounting nearly 48bps of cumulative implied hikes this year, which we still see as attainable. Nevertheless, we do not rule out a possible shift lower in between 25-50bps in case global central banks perpetuate an environment of higher lassitude and the peso extends its recent rally. On the other hand, the 5y5y forward rate stands at 6.77% from 7.02% a month ago, suggesting more limited gains in this section of the curve as opposed to the 10- and 20-year zone, especially given a higher slope. Taking into consideration technical and fundamentals, we observe an attractive relative valuation in 10- and 20-year Mbonos, especially Jun’22, Dec’24, Mar’26 and May’31 tenors. In addition, we expect Udibonos to recover going forward as inflation dynamics could improve the embedded carry in the 2H16, and valuation remains attractive. In this regards, inflation breakevens, especially in the mid and long-ends 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, the annualized carry for UDI-linked securities until 2Q16 could be of -2.6% 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 the FX market, the Mexican peso did not observe a relevant reaction to the CPI report, as today's trading has been more influenced by the performance of oil prices. WTI and Brent are trading slightly positive in comparison to yesterday's close. In particular, USD/MXN portrays a 0.5% rally, trading at 17.33 per dollar whereas WTI stands at 41.57 $/bbl equal to a 0.1% gain. Oil prices have witnessed a sharp recovery, greater than 55%, from 12-year low reached on past February, triggering an important appreciation in most EM currencies.

From our fixed income and FX strategy team

Mexican linkers rallying in the aftermath of the CPI report. Mexican bonds are observing a modest sell-off in the extremes of the Mbonos and derivatives curves, while the belly is depicting a defensive stance this morning. On the other hand, linkers (Udibonos) are rallying nearly 10bps following the inflation report released today as we anticipated at the beginning of this week (see "*Fixed-Income and FX Weekly*" dated February 22, 2016 <pdf>). Prices for the first half of February depicted a 0.29% increase (Banorte-Ixe 0.34%, Market consensus 0.20%, Previous 0.35%) which suggests the evidence of some FX pass-through effects on inflation, especially in certain core components. Today's pressures were also explained by a spike several agricultural prices. As a result, short-term securities sold off nearly 2bps as investors remain cautious of Banxico's policy path ahead, especially after the surprising 50bps rate hike from last week. On the other hand, the long-end is catching up from the losses in previous weeks as a response to higher global risk aversion. In our view, 10-

and 20-year Mbonos depict an attractive relative valuation after important changes that took place since last week. 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. In addition, we expect Udibonos to experience better demands 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. Market inflation expectations stand at 2.89% for the 3-year tenor, 2.87% for 5-year, 2.80% for 10-year and 2.89% for 30-year.

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