

# 1H-September inflation – FX pass-through showing in CPI numbers

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- **INEGI just published its inflation report for in the first half of September**
- **Headline inflation (Sep): 0.54%2w/2w (Banorte-Ixe: 0.41%2w/2w; consensus: 0.37%2w/2w)**
- **Core inflation (Sep): 0.36%2w/2w (Banorte-Ixe: 0.23%2w/2w; consensus: 0.27%2w/2w)**
- **Inflation in the first half of September was explained by pressures on merchandise prices given a higher pass-through effect of the significant depreciation of the Mexican currency to prices**
- **This report reinforces our view that Banxico will likely announce a 50bps rate hike, next September 29th**
- **With these numbers, annual inflation is at 2.88% vs. 2.73% in the previous month**
- **The market is preparing for a rate hike next week from Banxico**

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**Consumer prices increased 0.28%/m/m in August, below expectations. Core inflation was 0.19% in line with our estimates.** Consumer prices increased 0.54%2w/2w in in the first half of September, above our 0.41% forecast. Core inflation was 0.36% vs. our 0.23% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of energy prices (4.2bps vs. our 5.1bps); (2) an underestimation of services prices (12.6bps vs. our 10.9bps); (3) an underestimation of agricultural prices (21.8bps vs. our 19bps); and (4) a larger than expected contribution of merchandise prices (14.7bps vs. our 6.3bps), as shown in the table below.

### Inflation by components in the first half of September

% bi-weekly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.54	0.41	0.12
Core	0.27	0.17	0.10
Goods	0.15	0.06	0.08
Processed foods	0.07	0.04	0.04
Other goods	0.08	0.03	0.05
Services	0.13	0.11	0.02
Housing	0.01	0.01	-0.01
Education	0.12	0.11	0.01
Other services	0.00	-0.02	0.02
Non-core	0.27	0.24	0.03
Agriculture	0.22	0.19	0.03
Fruits & vegetables	0.16	0.15	0.01
Meat & eggs	0.06	0.04	0.02
Energy & government tariffs	0.04	0.05	-0.01
Energy	0.04	0.05	-0.01
Government tariffs	0.00	0.00	0.00

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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**Higher pass-through effect explained the upward trend in merchandise prices.** Merchandise prices edged-up 0.42% 2w/2w on the back of a 0.44% increase in the prices of “processed food”, along with a 0.4% growth in the prices of “other merchandises”. In this context, we believe that the significant depreciation of the Mexican currency has induced a higher pass-through effect to prices. Regarding services inflation, education costs were up 2.18% 2w/2w given the start of the new school year, while housing costs rose 0.05%. By contrast, other services came up by a marginal 0.01% 2w/2w. Within the non-core sub-index, agricultural prices increased 2.37% 2w/2w on the back of significant increases in fruit and vegetables (4.67%) combined with higher of “meat & egg” prices (+1.06%). Within these two sub-indices we highlight the hike in the prices of tomatoes (30.1% 2s/2s), onions (12.7%), egg (6.5%) and chicken meat (1.6%), which account for 35.7% of September’s inflation. Finally, the low-grade gasoline prices rose 0.6%, adding 2.9bps to total CPI variation.

**This report reinforces our expectation that Banxico will announce a 50bps rate hike on 29 September.** With these data, annual inflation is at 2.88% vs. 2.73% in the previous month. Meanwhile, core inflation reached 3.05% y/y. We continue to see pressure on merchandise prices, as a result of FX-pass-through. We believe that even though yesterday’s US Fed decision gave a respite to the exchange rate –trading at levels around USD/MXN19.6 after reaching all-time highs above MXN/USD19.9-, this will not be enough to avoid an action from Banxico. It is worth noting that in the last two days, the number of analysts, who think that Banxico could increase the reference rate next week, has doubled and the market probability is around 88% for a 50bps hike. Having this backdrop in mind, next Monday there are two major events that could affect the performance of the FX: (1) The first presidential debate in the United States; and (2) the OPEC meeting in Algeria.

*From our fixed income and FX strategy team*

**The market is preparing for a rate hike next week from Banxico.** Local rates are rallying 5-7bps this morning in the aftermath of yesterday’s news coming from the Federal Reserve and Bank of Japan, extending the gains observed at the previous session. This situation is taking place despite an inflation reading this morning that came well above market consensus, adding to the beliefs that Banxico will hike its reference rate next week (Banorte-Ixe +50bps). Recent inflation reports have portrayed well contained pass-through effects. However, some board members have highlighted in previous days that additional FX depreciation could have negative effects on the CPI going forward, a situation that the break-evens are not pricing in, but the yield curve is conveying by discounting a strong likelihood of a 50bps hike on September 29th. In terms of strategy, we expect mid- and long-term rates to extend the recent rally, acknowledging a better valuation in the 7-year area. We hold our tactical trade idea of a 2y5y flattener in the TIIIE-IRS curve.

In the FX market, we believe that even if this figure supports expectations of a rate hike by Banxico next week (which we expect at +50bps), relief for MXN in case this materializes is likely to be transitory and modest in magnitude. First, the market already discounts the latter scenario; therefore, we think that only a hawkish surprise is likely to have a relevant impact. Second, appetite for peso longs will remain muted on the back of the uncertainty about the US elections and the possibility of a Trump win, with investors consistently pricing-in a higher risk premium that has pressured the currency. Last but not least, the Fed's hawkish bias yesterday suggests the possibility of renewed jitters in the currency as we approach year-end. We remain neutral and on the sidelines in MXN for now and before Banxico's decision next week, albeit defensive and waiting for better entry levels for new USD longs.

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