

# Inflation in May falls less than expected due to higher gas prices

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- **INEGI just published its inflation report for May**
- **Headline inflation (May): -0.16% m/m; Banorte: -0.23% m/m; consensus: -0.22% m/m; previous: -0.34% m/m**
- **Core inflation (May): 0.26% m/m; Banorte: 0.23% m/m; consensus: 0.24% m/m; previous: 0.15% m/m**
- **Inflation in May was explained by pressures on domestic gas prices along with increases in other services prices**
- **With these numbers, annual inflation is at 4.51% vs. 4.55% in previous month**
- **Inflation above consensus again, resulting in gains in Udibonos relative to Mbonos in a context of increased pressure to MXN.**

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**Consumer prices decreased 0.16% m/m in May, less than expected.** Core inflation was 0.26% vs. our 0.23% m/m estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of services prices (11.8bps vs. our 12.3bps); (2) an underestimation of goods prices (7.3bps vs. our 4.9bps); along with (3) a larger than expected contribution of energy prices (-25.4bps vs. our -29.8bps), as shown in the table below.

### Inflation by components in May

%monthly incidence	INEGI	Banorte	Difference
Total	-0.16	-0.23	0.07
Core	0.19	0.17	0.02
Goods	0.07	0.05	0.02
Processed foods	0.05	0.05	0.00
Other goods	0.03	0.00	0.02
Services	0.12	0.12	0.00
Housing	0.04	0.04	0.00
Education	0.00	0.00	0.00
Other services	0.08	0.08	0.00
Non-core	-0.35	-0.40	0.05
Agriculture	-0.10	-0.11	0.01
Fruits & vegetables	-0.09	-0.10	0.01
Meat & eggs	-0.01	-0.01	0.00
Energy & government tariffs	-0.25	-0.30	0.04
Energy	-0.25	-0.30	0.04
Government tariffs	0.01	0.01	0.00

Source: INEGI, Banorte

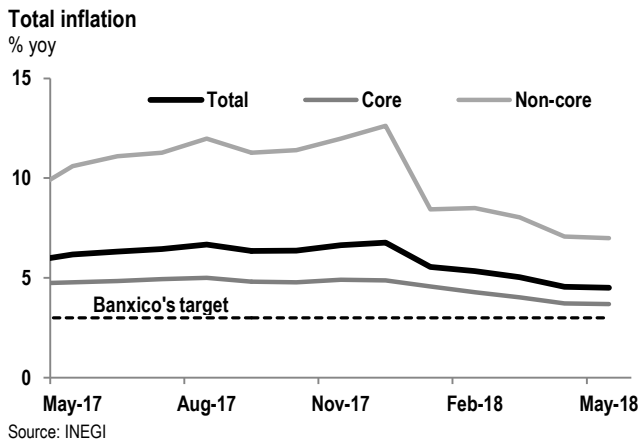
Note: Contributions might not add due to the number of decimals allowed in the table. Previous to year 2011, contributions might not add because of the change in CPI-calculation methodology

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**Inflation fell less than expected on the back of a rebound in domestic gas prices.** In particular, LP gas increased 7.2% m/m, while the prices of low-grade gasoline increased 1.08% m/m. Altogether, these two elements added 20.2 bps to total inflation in May, which was offset by the fall in electricity prices (-22.3% m/m) amid the application of summer discounts. This component subtracted 46.4bps to CPI in the fifth month of the year. Meanwhile, agricultural prices contracted 1.07% as a result of a 2.69% decrease in the prices of fruits and vegetables –we highlight the 40.9% m/m fall in the price of lemons and of 11.9% in the tomato price-, along with the reduction of 0.12% in the prices meat and eggs.

**In the core index, merchandise prices were up 0.21% m/m.** This figure was explained by the 0.3% increase food prices, while other merchandise prices were up 0.14% m/m. Moreover, services CPI increased 0.3% as a result of a 0.21% and 0.04% increase in housing and education costs, respectively, while other services prices were up 0.47% m/m. Within this sub-index, we highlight the increase in airfares (+22% m/m), as well as in dining away from home items (0.27%).

**With these data, annual inflation is at 4.51% vs. 4.55% in the previous month.** Meanwhile, core inflation is at 3.69% from 3.71% in April. Looking ahead, we believe that inflation will continue to be pressured by energy prices, offset by down trending agricultural products. Additionally, we expect temporary pressures on the underlying elements as a result of the volatility observed in the exchange rate. In this context, we maintain our expectation of 4.3% inflation at the end of the year.



*From our fixed income and FX strategy team*

**Inflation above consensus again, resulting in gains in Udibonos relative to Mbonos in a context of increased pressure to MXN.** May's inflation stood at -0.16% m/m, higher than consensus at -0.22% and leading to a mixed reaction in the local fixed-income market, with Mbonos losing 3-4bps while Udibonos are rallying 1-3bps in the mid- and long-end, and even up to 10bps in the case of the Jun'19 maturity. Notwithstanding this surprise, the downtrend in annual inflation during the first five months of the year has been confirmed after a challenging 2017.

Developments in this front have been positive so far in 2018. Nevertheless, investor concerns about FX dynamics have built up since mid-April (given the 11.5% loss of the peso since April 17<sup>th</sup> from USD/MXN 17.94) given its potential pass-through effect to inflation. This has shifted expectations about Banxico's monetary policy, with the market now discounting implicit rate hikes of 26bps this summer (meetings on June 21<sup>st</sup> and August 2<sup>nd</sup>), amid a strong flattening of the yield curve. It is also worth noting the increase in inflation risk premia. Short-term breakevens have been pushed higher in tandem with currency depreciation, with the 3-year maturity from 3.30% to 3.98% and the 5-year from 3.40% to 3.95% since mid-April. Longer tenors have shown similar dynamics (10-year at 3.91% and 30-year at 3.96%). This has resulted in more expensive relative valuations in real-rate securities (*e.g.* Udibonos).

The current backdrop, coupled with our expectation of further increases in country risk premium, keeps us favoring defensive strategies in floating-rate securities, as the case of 5-year Bondes D, while significantly reducing exposure in Mbonos. In our view, this is the most efficient way of maintaining an attractive carry while defensive in the case of additional rate hikes by Banxico.

In the FX market, MXN remains weak relative to other EM even after the brief respite of the dollar according to the BBDXY index (-0.1%), falling 0.8% to 20.46 per dollar. This is its weakest level since February 2017, in our view mostly driven by broad dollar strength and less optimism of a NAFTA agreement, in particular after the imposition of tariffs to aluminum and steel from Mexico by the US. We do not discard additional losses even after the strong fall accumulated so far this quarter, in particular if the risk that the US notifies its intention to withdraw from the agreement materializes. In this backdrop, we stay defensive in the peso even after taking profits in long USD/MXN positions late last week at the 20.00 psychological level, albeit waiting better entry levels to evaluate new dollar purchases.

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