

# 1H-December inflation explained by the start of the holidays

- **INEGI just published its inflation report for the first half of December**
- **Headline inflation (1H-Dec): 0.44% 2w/2w; Banorte: 0.39% 2w/2w; consensus: 0.39% 2w/2w; (range of estimates: 0.24% to 0.45%); previous: 0.04% 2w/2w**
- **Core inflation (1H-Dec): 0.43% 2w/2w; Banorte: 0.32% 2w/2w; consensus: 0.36% 2w/2w (range of estimates 0.28% to 0.49%); previous: 0% 2w/2w**
- **Inflation in the first half of December was explained by the increases in air fares and tourism services given the start of the holiday period**
- **With these numbers, annual inflation is at 6.69% vs. 6.63% in the previous month**
- **CPI continues surprising on the upside, steering stronger concerns about future hikes from Banxico**

**Consumer prices increased 0.44% 2w/2w in the first half of December, surpassing both our forecast and the consensus (0.39% 2w/2w). Core inflation was 0.43% 2w/2w vs. our 0.32% 2w/2w estimate. The main deviation from our forecast comes from: (1) A higher than expected contribution of other services (21bps vs. our 13bps); and (2) a lower impact of fresh fruits and vegetables (4bps vs. our 9bps), as shown in the table below.**

## 1H-December inflation by major subcomponent

Bi-weekly incidence, %

	Observed	Banorte-ixe forecast	Difference
Headline	0.44	0.39	0.05
Core	0.32	0.24	0.08
Goods	0.09	0.09	0.00
Processed foods	0.04	0.04	0.00
Other goods	0.05	0.06	0.00
Services	0.22	0.15	0.07
Housing	0.01	0.02	-0.01
Education	0.00	0.00	0.00
Other services	0.21	0.13	0.08
Non-core	0.12	0.15	-0.03
Agricultural	0.06	0.10	-0.04
Fresh fruits and vegetables	0.04	0.09	-0.05
Meat and egg	0.02	0.01	0.01
Energy and government regulated	0.06	0.05	0.02
Energy	0.05	0.04	0.00
Government regulated	0.02	0.00	0.01

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 in the first half of December was explained by the increases in airfares and tourism services given the start of the holiday period.** Other services posted a 1.25% 2w/2w expansion on the back of the 41.12% 2w/2w rise in airfares, 12.4% 2w/2w in tourism services, 2.65% 2w/2w, 2.65% interstate buses and 0.33% 2w/2w in restaurants. Additionally, goods prices grew 0.27% given the 0.25% 2w/2w advance in processed foods and 0.29% 2w/2w in other goods. It is worth noting that within the latter component, automobile prices rose 0.39% 2w/2w.

Regarding the non-core index, we highlight the 1.06% increase in the prices of fresh fruits and vegetables. This growth was mainly explained by the 19.56% advance in tomato prices and 13.2% in squash. However, these were mitigated by the fall in the prices of onions (-14.24% 2w/2w) and potatoes (-2.99% 2w/2w) among others. On the other hand, energy prices rose 0.39% 2w/2w driven by the increases in the price of low-grade gasoline (0.44% 2w/2w) and LP gas (0.83% 2w/2w).

**With these numbers, annual inflation edges up to 6.69% vs. 6.63% in November.** Additionally, core inflation stood at to 4.9%, unchanged from November's print. Looking ahead we will focus on the evolution of energy prices and the behavior of agricultural prices, and the impact they might have in Mexico's CPI. Moreover, this report validates our 2017 year-end forecast at 6.7%.

*From our fixed income and FX strategy team*

**CPI continues surprising on the upside, steering stronger concerns about future hikes from Banxico.** Today's inflation print came in above market expectations, depicting reluctance to return to a downward trend and conveying consistency with the strong concerns portrayed by Banxico's governing council within its monetary policy communiqué released last week. With the reading published this morning (Dec-1H), market consensus has underestimated the observed inflation in 18 out of 23 fortnightly reports for 2017, suggesting the possibility of a significant upward adjustment in 2018-end and mid-term expectations. Investors are ahead of the curve with this situation. Short-term breakevens are trading with an upward adjustment recently, in the aftermath of a more negative inflation assessment for coming months, hovering around 4.00%. Long-term inflation expectations have been also affected by these dynamics, trading nearly 3.95%. All these breakevens were trading 40bps lower a month ago. In the aftermath of this report, TIE-IRS and Mbonos curves are observing a 4bps sell-off, contrary to the 2bps rally in CPI-linked Udibonos and the defensive performance of floating-rate Bondes D. The Mexican yield curve is pricing in nearly 63bps of implied rate hikes by the end of 1H18, while discounting a modest easing by the end of next year (less than 25bps). In addition, the 2-year forward rate has increased towards 7.73% from nearly 7.08% a month ago.

These expectations have been fueled by the hawkish hike from Banxico last week. Following the central bank's hawkish rhetoric last week and negative news on the inflation front today we remain bearish in terms of local bonds and continue recommending defensive strategies in floating-rate bonds and in long-term UMS (10-year tenor). More details in our "*Fixed-Income and FX Weekly*" [<pdf>](#) released on December 18<sup>th</sup>, 2017.

In the FX market, the Mexican peso extended losses after the report, from 19.29 to 19.32 per dollar. Higher inflation strips support from the currency through its impact in real exchange rate and interest rate spreads, apart from its potentially negative effect on consumption and growth. We maintain our preference for USD/MXN longs despite negative carry (0.5-0.6% per month), with weak activity as additional challenge in the face of a series of local and external risks that could impact our currency strongly, stilly as the economy's main shock absorber.

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