Inflation in the first half of January, below expectations

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- ***INEGI* just published its inflation report for in the first half of January**
- **Headline inflation (Jan): 0.03%2w/2w (Banorte-Ixe: 0.09%2w/2w; consensus: 0.09%2w/2w)**
- **Core inflation (Jan): 0.08%2w/2w (Banorte-Ixe: 0.17%2w/2w; consensus: 0.2%2w/2w)**
- **Inflation was explained by pressures on domestic gas prices along with increases in the prices of processed food, which were offset by lower gasoline and other services prices**
- **With these numbers, annual inflation is at 2.48% vs. 2.13% in previous month**
- **Anchored inflation suggests a still complicated scenario for Udibonos**
- **The MXN remains vulnerable given the relatively low interest rate differential when compared to other EM**

Consumer prices increased 0.03%2w/2w in in the first half of January. Core inflation was 0.08% vs. our 0.17% estimate. The main deviation from our forecast comes from: (1) A larger than expected contraction of energy prices (-10.8bps vs. our -4.6bps); (2) a lower than expected contribution of merchandise prices (6.7bps vs. our 10bps); (3) an overestimation of services prices (-0.7bps vs. our 2.5bps); along with (4) a larger than expected contribution of agricultural prices (2.1bps vs. our -3.5bps), as shown in the table below.

1H-January inflation by components
% bi-weekly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.03	0.09	-0.063
Core	0.06	0.13	-0.067
Goods	0.07	0.10	-0.033
Processed foods	0.05	0.07	-0.023
Other goods	0.02	0.03	-0.011
Services	-0.01	0.03	-0.033
Housing	0.02	0.02	0.003
Education	0.02	0.01	0.003
Other services	-0.05	-0.01	-0.040
Non-core	-0.03	-0.04	0.003
Agriculture	0.02	-0.04	0.056
Fruits & vegetables	0.03	-0.05	0.076
Meat & eggs	-0.01	0.02	-0.020
Energy & government tariffs	-0.06	0.00	-0.057
Energy	-0.11	-0.05	-0.062
Government tariffs	0.05	0.05	0.002

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.

Inflation in the first half of January is explained by pressures on domestic gas prices, as well as in processed foods. Energy prices declined 1.02% as a result of the reduction in the price of low-grade (-2.2%) and the high-grade gasoline (-2.23%), which together subtracted 11.7bps to total inflation during the first half of January. Nevertheless, this decline was offset by the increase in the price of domestic gas, up 2.74%, adding 4.9pbs to total index variation. Government tariffs increased 0.89% 2w/2w on the back of higher costs in water supply fees (2.23%) and city bus prices (1.05%), among others. Meanwhile, agricultural prices increased 0.23%2w/2w explained by higher prices of fruits and vegetables (0.75%) coupled with a fall in meat and egg prices (-0.09%). In the core index, merchandise prices increased 0.19%2w/2w as a result of a 0.3% inflation in food, while other merchandise increased 0.1%2w/2w. Finally, services prices were down 0.02%2w/2w due to lower prices for “other services” (-0.28%), which were offset by a 0.13% inflation in housing and a 0.32% increase in education costs. *INEGI* mentioned the fall in the cost of tourism services (-8.45%), air transportation (-15.33%) and mobile phones services (-0.9%), among the products with lower prices. These decreases were offset, in part, by the observed increases in the cost of restaurants (+ 0.44%) and other dining away from home items (0.34%).

With these data, the annual inflation was 2.48% vs. 2.13% in the previous month. Meanwhile, core inflation is at 2.61% from 2.41% in December. We believe that 12-month inflation will remain around 2.5%yoy in the next couple of months.

From our fixed income and FX strategy team

Anchored inflation suggests a still complicated scenario for Udibonos. In our view, today’s inflation report keeps showing a more favorable environment for nominal rates and complicated dynamics for real-rate instruments. Price levels continue portraying a scenario characterized by low pass-through effects from FX depreciation. Moreover, the general index benefited from transitory effects such as the reduction in electricity, gasoline and telecom services -among others- outweighing for the contribution of some goods (mostly agricultural products) and services that could remain with a positive incidence. Inflation in the 1st half of January situated annual inflation at 2.48%, which we believe gives Banxico enough reasons to think that exchange rate dynamics so far will not exert significant pressures on inflation in coming months. This argument favors the strategies that we have recently recommended. Moreover, it suggests that the inflation outlook is not quite right for long directional positions in Udibonos, as carry during the next five months is likely to be negative (according to our estimates), even after incorporating valuations near historical lows when compared to Mbonos. In particular, inflation breakevens stand at 2.06%, 2.44%, 2.59%, and 2.98% for 3-, 5-, 10-, and 30-year tenors, respectively. In our view, the most attractive securities are those maturing on Jun’19, Dec’20 and Jun’22. Nevertheless, it is our take that the right moment to buy will most likely be until 2Q16.

The MXN remains vulnerable given the relatively low interest rate differential when compared to other EM. In the FX market, the peso accumulates a 1.7% gain on the day, trading at 18.42 per dollar, trending along other EM in a more positive environment for risky assets on the back of greater expectations of additional monetary stimulus, particularly from the ECB. Regarding the report, we highlight that evidence of strong pass-through effects remains low. The latter signals the possibility that Banxico is unlikely to rate hikes before the Fed. In this respect, we still believe that the currency is vulnerable to the external environment given relatively low interest rate differentials to the US when compared to other EM, with some countries actually raising rates because of this. Therefore, we reiterate our recommendation to buy USD/MXN on dips as seen today, even if some technical indicators (short-term vols, skew, and relative strength) suggest a possible relief rally after strong losses observed in recent weeks, which in our view could be taken advantage of by entering new positions at better levels.

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