Inflation in March – Pressures on merchandise and services prices

- ***INEGI* just published its inflation report for March**
- **Headline inflation (Mar): 0.15%m/m (Banorte-Ixe: 0.27%m/m; consensus: 0.17%m/m)**
- **Core inflation (Mar): 0.36%m/m (Banorte-Ixe: 0.42%m/m; consensus: 0.4%m/m)**
- **Inflation in March was explained by pressures core items**
- **With these numbers, annual inflation is at 2.6% vs. 2.87% in previous month**
- **Limited market reaction following the CPI report**

Consumer prices increased 0.15%m/m in March, below expectations. Core inflation was 0.36% vs. our 0.42% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of agricultural prices (-9.8bps vs. our -2.2bps); (2) a lower than expected contribution of services prices (14.9bps vs. our 19bps); and (3) an overestimation of merchandise prices (11.8bps vs. our 12.5bps), as shown in the table below.

March's inflation by components
% monthly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.15	0.27	-0.124
Core	0.27	0.32	-0.049
Goods	0.12	0.13	-0.007
Processed foods	0.05	0.06	-0.006
Other goods	0.07	0.07	-0.001
Services	0.15	0.19	-0.041
Housing	0.04	0.04	0.000
Education	0.00	0.00	0.000
Other services	0.11	0.15	-0.042
Non-core	-0.13	-0.05	-0.073
Agriculture	-0.10	-0.02	-0.076
Fruits & vegetables	-0.11	-0.07	-0.044
Meat & eggs	0.01	0.04	-0.031
Energy & government tariffs	-0.03	-0.03	0.002
Energy	-0.03	-0.03	0.001
Government tariffs	0.00	0.00	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.

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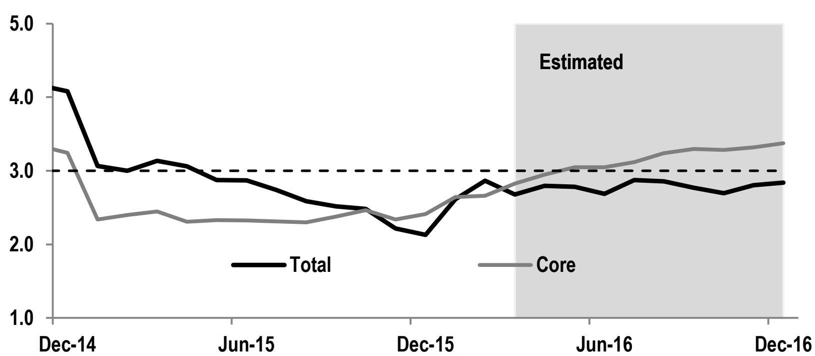
Inflation in March was explained by pressures core items. Merchandise prices increased 0.34%m/m on the back of a 0.33% increase in food prices, and of 0.37% in other merchandise, with car prices up 0.56%m/m. Meanwhile, services inflation was 0.37%m/m as a result of higher housing (0.24%) and education costs (0.01%), as well as seasonal increases in the prices of other services, up 0.63%m/m. *INEGI* highlights tourism services (9.17%), dining away from home items (0.45%), air transportation (5.59%) and cable TV (1.98%), among the products with rising prices. In the non-core index, agricultural prices declined 1%m/m, on the back of a 2.84% fall in the price of fruits and vegetables, which more than offset the marginal increase of 0.18% in "meat and eggs" prices. Meanwhile, energy prices were down 0.28%m/m derived, among others, from the reduction in low-grade gasoline prices (-0.59%), particularly in some border cities in the country. Finally, government tariffs increased 0.06% m / m.

With these numbers, annual inflation is at 2.6% vs. 2.87% in previous month. Meanwhile, core inflation edged up to 2.76% from 2.66% in February, on the back of seasonal increases in services inflation along with some evidence of exchange rate pass-through to merchandise prices. Looking ahead, we expect inflation to reach 2.8% in the coming months, in line with our year-end forecast. Meanwhile, core inflation could continue trending up in the coming months.

Inflation forecast
% yoy



Source: Banorte-Ixe with data from INEGI

From our fixed income and FX strategy team

Limited market reaction following the CPI report. The Mexican fixed-income market traded with moderate gains of 1-2bps along the whole Mbonos curve, except for the shortest tenors (less than a year), immediately after the report. We judge this as a limited reaction, consistent with the slight downward surprise relative to market expectations, also observed in the core measure. As a result, annual inflation dropped from 2.87% in February to a YTD low of 2.60%. It is worth remembering that the market continues discounting nearly 52bps of cumulative implied hikes this year, which we see as reasonable and attainable. 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 -1.9% annualized, but in the second half of 2016 the potential carry is of nearly +4.4%. 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.

The Mexican peso is losing 1% on the day, going from 17.65 to 17.84 per dollar. In our view, today's pressures are mainly a result of the fall in crude-oil prices (WTI: -1% so far) in spite of being roughly at the same time as the inflation report. Nevertheless, it is our take that these figures continue suggesting that risks of a strong rebound in inflation remain broadly contained, allowing Banxico to keep a hawkish bias (as they will remain very vigilant of FX dynamics) but without providing enough support to potential expectations of further preemptive hikes ahead of the Fed, which in turn would a more supportive factor for the currency.

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