

February's inflation – Moderate pressures on merchandise prices

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- **INEGI just published its inflation report for February**
- **Headline inflation (Feb): 0.19% m/m; Banorte-Ixe: 0.29% m/m; consensus: 0.22%/m/m (range of estimates: 0.07% to 0.30%); previous: -0.09%**
- **Core inflation (Feb): 0.34% m/m; Banorte-Ixe: 0.39% m/m; consensus: 0.37% m/m (range of estimates: 0.27% to 0.40%); previous: -0.03%**
- **Inflation during February was explained by pressures on “other goods” prices along with increases in “other services” prices**
- **With these numbers, annual inflation is at 3% vs. 3.07% in January**

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Consumer prices increased 0.19% m/m in February, below expectations. Similarly, core inflation stood at 0.34% m/m vs. our 0.39% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of agriculture prices (-8.2bps vs. our -2.2bps); (2) a lower than expected contribution of goods prices (11.3bps vs. our 14.4bps); and (3) an overestimation of energy prices (-0.4bps vs. our 0.4bps), as shown in the table below.

February inflation by components

% monthly incidence

	Observed	Banorte-Ixe forecast	Difference
Headline	0.19	0.29	-0.10
Core	0.25	0.29	-0.04
Goods	0.11	0.14	-0.03
Processed foods	0.00	0.01	-0.01
Other goods	0.11	0.14	-0.03
Services	0.14	0.15	-0.01
Housing	0.04	0.04	0.00
Education	0.02	0.02	0.00
Other services	0.09	0.09	0.00
Non-core	-0.07	0.00	-0.06
Agricultural	-0.08	-0.02	-0.06
Fresh fruits and vegetables	-0.12	-0.07	-0.05
Meat and egg	0.03	0.05	-0.01
Energy and government regulated	0.02	0.02	0.00
Energy	0.00	0.00	-0.01
Government regulated	0.02	0.02	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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Inflation during February was explained by pressures on “other goods” prices along with increases in “other services” prices. We highlight the 0.51% m/m hike in “other services” prices, which was mainly explained by the 3.28% increase in mobile services and the 0.31% expansion in the prices of restaurants. However, agricultural goods prices decreased 0.88% m/m derived from the sharp fall in the prices of tomato (-30.1% m/m), onions (-9.21% m/m), and zucchini (-14.75% m/m). Similarly, energy prices fell -0.03% m/m as a result of the 0.37% reduction in electricity rates. Finally, “goods” prices rose 0.33% m/m derived from the 0.59% m/m hike in the component of “other goods”. In particular, we believe that this increase suggests a certain *pass-through* effect of the depreciation of the Mexican currency to inflation. However, it was only visible during the first half of February.

With these numbers, annual inflation is at 3% vs. 3.07% in January. Meanwhile, core inflation is at 2.4% from 2.34 in January. In this context, we believe that inflation will remain around 3% in the coming months.

From our fixed income and FX strategy team

Local rates remain pressured despite lower CPI but following concerns regarding Fed. The Mexican fixed-income market observed a strong sell-off last week (33bps on average along the yield curve) in the aftermath of a solid labor market report in the U.S., which has triggered strong concerns about the likely normalization process from the Federal Reserve starting June this year (Banorte-Ixe call). At today’s session the market remains cautious, extending last week’s losses in a magnitude of 2-3bps, despite favorable news on the inflation front (lower than expected CPI figure in February published this morning). Market has acknowledged that inflation dynamics will be favorable this year (Banxico likely to reach 3% target by year-end). However, fears about FX pass-through (MXN depreciating 4.4% this year) has deteriorated sentiment between investors as they start digesting this risk. In this regard, local rates have started pricing in a more aggressive response from Banxico this year, with implied rate hikes of 31bps in 2Q15, 59bps in 3Q15 and 88bps in 4Q15. In terms of valuation, the Mexican yield curve is turning extremely attractive, especially in 10- to 20-year Mbonos (Dec’24 to Nov’34). The spread of the curve is attractive in these tenors and spreads between the U.S. has increased towards attractive marks (Dec’24 vs. 10-year Treasury at 383bps actually vs. 12-month mean at 348bps and mid-term equilibrium at 360pbs). However, we acknowledge that market dynamics could provide better entry levels for directional long positions in these securities, especially with investors bearing in mind a possible change in the forward guidance embedded inside Fed’s communiqué to be published on March 18th. In terms of Mexican linkers, valuation is extremely attractive in Udibonos, especially the mid and long ends. Inflation breakevens are hovering 3% in every tenor. The most attractive breakevens are the 10-year (2.98%) and 30-year (3.06%). Risk rewards in these strategies could be 60-75bps. However, an important issue to take into consideration is the negative carry of Mexican linkers in the 1H15. In this regard, we consider that in April/May the market is likely to swap long strategies from Mbonos to Udibonos.

MXN could benefit from lower inflation in the medium term. Our currency has appreciated 0.5% from Friday's close, currently trading at 15.42 per dollar. Focusing on the potential effects for the currency, inflation has had a steep fall in the first two months of 2015 as it has gone from 4.2% to 3.0%yoy (in line with our and Banxico's expectations), and which could benefit the peso going forward. In particular, short-term real interest rates have increased (3-year Udibono YTM from 1.2% to 1.6% year-to-date), the "purchasing power" component of consumer confidence picked up strongly in February, and exports to the US continue advancing strongly. In our view, the MXN could find stronger support if these trends consolidate and external volatility moderates, with the currency's accumulated depreciation (especially since 4Q14) helping to moderate the current account deficit. Nevertheless, we warn that these developments should be gradual and could be a clearer driver until 2H15, with investors still cautious ahead of the next Fed meeting. In this context, we reiterate our suggestion to buy USD for trading purposes despite last week's significant fall and an oversold peso according to technical indicators, a backdrop that could induce a moderate reversal and higher buying interest for the peso above 15.50 per dollar.

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