Inflation during February driven by higher automobile prices

- ***INEGI*** **just published its inflation report for February**
- **Headline inflation (Feb): 0.58% m/m; Banorte-Ixe: 0.58% m/m; consensus: 0.54% m/m (range of estimates: 0.47% to 0.62%); previous: 1.7% m/m**
- **Core inflation (Feb): 0.76%m/m; Banorte-Ixe: 0.76% m/m; consensus: 0.75% m/m (range of estimates: 0.67% to 0.77%); previous: 0.58% m/m**
- **Inflation February was explained by pressures on other goods prices, where we highlight the increases in automobile prices**
- **With these numbers, annual inflation is at 4.86% vs. 4.72% in previous month**
- **We continue to expect year-end inflation at 5.7%**
- **Today's CPI report supports the inflation premia embedded in Mexican securities**

Consumer prices increased 0.58%m/m in February. According to *INEGI*, consumer prices posted a 0.58% m/m increase in February, in line with our estimate but above market consensus (0.54%). In addition, core inflation was 0.76% m/m, also in line with our estimate (consensus: 0.28% m/m).

February inflation by major subcomponent
Monthly incidence, %

	Observed	Banorte-Ixe forecast	Difference
Headline	0.58	0.58	0.00
Core	0.56	0.56	0.00
Goods	0.38	0.37	0.02
Processed foods	0.16	0.15	0.01
Other goods	0.22	0.22	0.01
Services	0.19	0.20	-0.01
Housing	0.06	0.05	0.00
Education	0.02	0.02	0.00
Other services	0.11	0.13	-0.02
Non-core	0.01	0.01	0.00
Agricultural	-0.09	-0.08	-0.01
Fresh fruits and vegetables	-0.10	-0.09	0.00
Meat and egg	0.01	0.02	-0.01
Energy and government regulated	0.10	0.09	0.01
Energy	0.06	0.05	0.01
Government regulated	0.04	0.04	0.00

Source: INEGI, Banorte-Ixe
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

March 9, 2017

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Inflation in February was explained by pressures on other goods prices along with increases in processed foods prices. According to *INEGI*, among the items with the most change in prices were other goods (1.19% m/m), mainly due to the 1.58% monthly increase in automobile prices. Moreover, another sub-index with substantial changes was processed foods (1% m/m), mainly driven by increases in tortilla prices (2% m/m).

On the other hand, the biggest decreases were seen in the fresh fruits and vegetables prices, which declined 2.89% monthly, driven by lower prices of tomatoes (-31.64% m/m) and onions (-19.76% m/m), among others.

With these numbers, annual inflation stands at 4.86% vs. 4.72% in January. Moreover, core inflation in February increased to 4.26% from 3.84% seen last month. Looking ahead, we consider that inflation will be impacted by: (1) The increase and liberalization of gasoline prices; and (2) second round effects stemming from the higher pass-through effect of the depreciation of the Mexican peso and higher energy costs to prices. We continue to expect inflation to close 2017 at 5.7% yoy.

From our fixed income and FX strategy team

Today's CPI report supports the inflation premia embedded in Mexican securities. Local rates are extending early losses by 4bps, with the mid-end outperforming the extremes of the yield curve. Recent inflation data worldwide suggests that inflation premiums are likely to soar, most likely resulting in steeper curves, mainly in countries with expectations of higher growth (*e.g.* United States). In Mexico, annual inflation has surged in a significant fashion given the negative effects of energy prices (mainly gasoline) and FX passthrough, moving from 3.36% by 2016-end to 4.86% observed at today's February print.

This scenario has a twofold effect. In terms of the nominal yield curve, the market is pricing in 35bps of implied hikes in Banxico's reference rate for the meeting on March 30th (Banorte-Ixe 25bps). However, despite the drawback of current inflation dynamics, market reduced the implied hikes for the whole year by nearly 25bps after the Foreign Exchange Commission announced the hedging mechanism from 99bps to 74bps actually ("*Reassessing our rates and peso forecasts after the FEC's new mechanism*" <pdf>, February 21st, 2017). In terms of CPI-adjusted securities, breakevens are trading at 4.00% in 3- and 5-year horizons, while 10- and 30-year tenors are trading at 3.87%. This performance suggests that the market has already priced in a complex CPI scenario for 2017 but with an effect that is likely to water down in the mid- and long-term. In our view, there is a non-attractive relative valuation in Udibonos.

Taking into accounts these conditions, we hold our trade idea opened on February 15th, 2017 of a 5y10y steepener position in TIIE-IRS (long/receive 5y TIIE-IRS (65x1) and short/pay 10y TIIE-IRS (130x1)), with an entry level of 28bps, target of 43bps, stop-loss of 18bps, and currently trading at 29bps. More details in our research note "*Trade Idea: 5y10y TIIE-IRS steepener*" <pdf>.

In FX market, the Mexican peso is 0.5% weaker at 19.77 per dollar in a context of broad USD strength. In our view, the currency did not react much to the report. Considering our outlook that inflation will remain pressured at least for the rest of 1H17 and a less hawkish tone by Banxico, support for the peso from real rates and valuations suggest more limited room to appreciate strongly at least in the short term. Additionally and after the recent rally that pushed USD/MXN towards the 19.50-19.55 support zone, last Monday we recommended taking profit on speculative peso longs first suggested on February 13 around 20.34 per dollar, shifting from a positive to a neutral stance in the currency at least until the Fed's meeting next week.

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