1H-November inflation explained by the end of summer discounts in electricity tariffs

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- ***INEGI* just published its inflation report for the first half of November**
- **Headline inflation (1H-Nov): 0.92% 2w/2w; Banorte-Ixe: 0.72% 2w/2w; consensus: 0.75% 2w/2w; (range of estimates: 0.68% to 0.8%); previous: 0.19% 2w/2w**
- **Core inflation (1H-Nov): 0.28% 2w/2w; Banorte-Ixe: 0.17% 2w/2w; consensus: 0.14% 2w/2w (range of estimates 0.06% to 0.19%); previous: 0.13% 2w/2w**
- **Inflation in the first half of November was explained by the end of the summer discounts on electricity tariffs as well as the rebound in the prices of public transportation and mobile phone services**
- **With these numbers, annual inflation is at 6.59% vs. 6.37% in the previous month**
- **Rally in Udibonos as inflation dynamics remain complex and at a relatively high level**

Consumer prices increased 0.92% 2w/2w in the first half of November, in line with our forecast. Core inflation was 0.28% 2w/2w vs. our 0.17% 2w/2w estimate. The main deviation from our forecast comes from: (1) A higher than expected contribution of agricultural prices (10bps vs. our 4bps); (2) a higher than expected contribution of other goods (7bps vs. our 3bps); (3) a greater than expected impact of energy (58bps vs. our 55bps); and (4) a greater contribution of other services (8bps vs. our 6bps) as shown in the table below.

1H-November inflation by major subcomponent
Bi-weekly incidence, %

	Observed	Banorte-Ixe forecast	Difference
Headline	0.92	0.72	0.20
Core	0.21	0.13	0.08
Goods	0.11	0.06	0.06
Processed foods	0.04	0.03	0.02
Other goods	0.07	0.03	0.04
Services	0.10	0.07	0.02
Housing	0.02	0.02	0.00
Education	0.00	0.00	0.00
Other services	0.08	0.06	0.02
Non-core	0.70	0.59	0.11
Agricultural	0.10	0.04	0.07
Fresh fruits and vegetables	0.09	0.07	0.03
Meat and egg	0.01	-0.03	0.04
Energy and government regulated	0.60	0.56	0.05
Energy	0.58	0.55	0.03
Government regulated	0.01	0.01	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

Inflation in the first half of November was explained by the end of the summer discounts on electricity tariffs as well as pressures on agricultural prices. Particularly, energy prices grew 5.78% 2w/2w, mainly driven by the increase in electricity (24.69% 2w/2w), LP gas (4% 2w/2w) and low-grade gasoline (0.49% 2w/2w). In addition, prices of fresh fruits and vegetables rose 2.48% 2w/2w on the back of higher prices of tomatoes (7.12% 2w/2w), and husk tomatoes (14.82% 2w/2w). However, these were offset by decreases in the prices of avocados (-6.94% 2w/2w) and squash (-4.82 2w/2w). Moreover, we highlight the 0.18% 2w/2w increase in the prices of meat and egg, which was mainly explained by the 1.68% 2w/2w rise the price of eggs.

Regarding the core index, other goods rose 0.38% 2w/2w, given the 1.83% 2w/2w in the price of detergent. On the other hand, other services increased 0.47% 2w/2w on the back of a 15% 2w/2w rise in the price of airfares and 4.1% of tourism services.

With these numbers, annual inflation edges down to 6.59% vs. 6.37% in October. Moreover, core inflation decreased to 4.85% (vs. 4.77% in October). 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. Additionally, considering the upcoming increase to the minimum wage, we expect inflation at 6.5% by year-end 2017.

From our fixed income and FX strategy team

Rally in Udibonos as inflation dynamics remain complex and at a relatively high level. Inflation in the 1st half of November printed significantly above consensus (+0.75% 2w/2w) and our forecast (+0.72%), inducing a strong rally in short-term Udibonos of 8 to 10bps, with other tenors gaining 2bps on average. In contrast, Mbonos are depreciating about 3bps at the beginning of today's session. In our view, today´s figure shows that inflation dynamics remain complex, with the annual metric even increasing from 6.445 to 6.59%. The report argues in favor of a prudent monetary policy stance by Banxico, as suggested by the more hawkish bias in its latest monetary policy decision back on November 9 and the Quarterly Inflation Report published yesterday, and due to a more cautious outlook about inflation the rest of this year and in 2018. Notwithstanding and based on our forecasts, UDIS's carry in the short term will likely be much lower as inflation converges to a level closer to the central bank's target next year. On the other hand and as of yesterday's close, breakeven inflation stood near 3.69% along the curve, slightly below its twelve-month average around 3.75% but closer to the median at 3.68%. In this context, it is our take that valuations in Udibonos are not attractive enough for long positions. We continue recommending a defensive stance through relative value strategies on the back of our expectation of a potential re-pricing higher in risk and term premiums, favoring steepeners in 2/5 and 2/10 tenors in TIIE-IRS.

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