

## Inflation in the 1st half of April – The season of low fortnightly inflation levels begins

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- **INEGI just published its inflation report for in the first half of April**
- **Headline inflation (Apr): -0.45% 2w/2w; Banorte-Ixe: -0.61%2w/2w; consensus: -0.21%2w/2w (range of estimates: -0.61% to -0.10%) previous: 0.37%**
- **Core inflation (Apr): 0.03% 2w/2w Banorte-Ixe: 0.06% 2w/2w; consensus: 0.1% 2w/2w (range of estimates: 0.14% to 0.5%) previous: 0.18%**
- **Lower prices are explained by the start of summer discounts on electricity tariffs, along with falling agricultural and other services prices**
- **With these numbers, annual inflation stands at 3.03% vs. 3.14% in the previous month**
- **Market prices in the first hike of Banxico by 4Q15 in the aftermath of low inflation in Mexico and U.S. current conditions.**

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**Consumer prices decreased -0.45%2w/2w in the first half of April, below our expectations.** Core inflation was 0.03% vs. our 0.06% estimate. The main deviation from our forecast comes from: (1) A lower than expected contribution of services prices (-6bps vs. our 0.7bps); (2) an underestimation of agricultural prices (-5bps vs. our -7bps); (3) an underestimation of merchandise prices (8.1bps vs. our 3.5bps); and (4) a larger than expected contribution of energy prices (-45bps vs. our -58bps), as shown in the table below.

#### 1H-April inflation by components

% bi-weekly incidence

	Observed	Banorte-Ixe	Difference
Headline	-0.45	-0.61	0.157
Core	0.02	0.04	-0.023
Goods	0.08	0.04	0.046
Processed foods	0.03	0.03	0.000
Other goods	0.06	0.01	0.046
Services	-0.06	0.01	-0.068
Housing	0.02	0.02	0.001
Education	0.00	0.00	0.001
Other services	-0.08	-0.01	-0.072
Non-core	-0.48	-0.65	0.169
Agricultural	-0.05	-0.07	0.020
Fresh fruits and vegetables	-0.07	-0.08	0.003
Meat and egg	0.02	0.01	0.019
Energy and government regulated	-0.44	-0.58	0.139
Energy	-0.45	-0.58	0.130
Government regulated	0.00	0.00	0.001

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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**Prices fall sharply in the first half of April.** The negative inflation rate in the first half of April was explained by three factors: (1) The start of summer discounts in electricity tariffs; (2) a sharp decline in agricultural prices; and (3) lower costs of “*other services*”, given the end of the Easter holiday season. Energy prices declined 4.15% 2w/2w on the back of a 14.1% reduction in electricity tariffs, and lower low-grade gasoline prices. Moreover, agricultural prices fell 0.54% 2w/2w as a result of sharp declines in the price of products such as tomatoes (-12.2%), zucchinis (-15.5%), bananas (-4.22%) and Husk tomatoes (-3.3%). Similarly, the price of services declined 0.15% 2w/2w derived from a fall of 0.47% in “*other services*”. INEGI mentions tourism services (-12.16%) and air transportation (-15.2%) among the products with falling prices. By contrast, merchandise prices increased 0.24% 2w/2w derived from a 0.24% increase in the processed food sub-index and higher prices of other goods. The report highlights significant increases in toilet paper and tissues (1.49%), soft drinks (0.62%), tennis shoes (1.16%) among the products with increasing prices.

**With these numbers, annual inflation stands at 3.03% vs. 3.14% in the previous month.** Moreover, core inflation is at 2.23% from 2.45% in March. We expect annual inflation to remain around 3%, falling even below this level in the coming months.

*From our fixed income and FX strategy team*

**Market prices in the first hike of Banxico by 4Q15 in the aftermath of low inflation in Mexico and U.S. current conditions.** The CPI report released this morning has supported the idea of no evidence of FX pass-through effect on prices. Annual inflation remains well anchored, near to Banxico’s 3% target with dynamics that suggest the lack of relevant inflationary pressures ahead that could trigger concerns in terms of monetary policy assessment. Under these circumstances, and taking into consideration U.S. current conditions, market is currently pricing in implied cumulative hikes in Banxico’s reference rate of 0bps in the 2Q15, 12bps in the 3Q15 and 41bps in the 4Q15. Following today’s report, local bonds are rallying 4pb along the Mbonos and TIEE-IRS curves. On the other hand, Mexican linkers continue to be affected by this benign inflation scenario, depicting losses around 8bps, especially in short-term tenors. It is our take that inflation scenario will continue to be supportive for local rates, easing part of the pressures resulting from the uncertainty about Fed’s future path. As a result, we hold a positive view in 20-year Mbonos (May’31 and Nov’34), tenors that continue portraying an appealing valuation in terms of the shape of the curve and the country risk premia embedded in these securities. Nevertheless, we consider appropriate to wait for better entry levels in coming days for long directional strategies. 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 (2.96%) and 30-year (2.98%). Risk rewards in these strategies could be around 65bps. 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 May the market is likely to swap long strategies from Mbonos to Udibonos.

In the FX market, the Mexican peso did not react strongly to the inflation report, reversing a weak opening earlier today and currently accumulating a 0.2% gain to 15.42 per dollar, following less upside for the USD after the jobless claims report. In our view, the higher-than-expected fall in prices and recent losses could help explain this limited reaction as both of them favor a more attractive valuation for the peso in real terms. Nevertheless, we believe that the confirmation of limited pass-through effects that drove inflation virtually at Banxico's target build upon our view that local monetary policy will not be a supportive factor for the currency in the short term. This data favors our outlook that Banxico will wait for the Fed to consider rate hikes, maintaining low carry when compared to other emerging markets. In addition to its high beta to global factors and overall market volatility, the latter keeps the peso vulnerable to bouts of risk aversion due to the attractiveness of MXN shorts as a hedge to other risky exposures. After profit taking in USD/MXN longs this week (see: *"Profit taking in our USD/MXN directional long after negative surprises in US data"*, April 20, 2015, [PDF](#)) we recommend a neutral stance in MXN as we cannot discard additional pressures due to the complicated external environment (with concerns over global growth and Greece, among others) even if risks of another dollar correction remain and our currency observes a more attractive valuation at current levels.

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