

Downward surprise in 1H-Jan inflation in spite of high uncertainty over short-term dynamics

- **INEGI** just published its inflation report for the first half of January
- **Headline inflation (1H-Jan): 0.11% 2w/2w; Banorte: 0.26%; consensus: 0.25% (range of estimates: 0.11% - 0.43%); previous: -0.06%**
- **Core inflation (1H-Jan): 0.08% 2w/2w; Banorte: 0.18%; consensus: 0.20% (range of estimates: 0.08% - 0.26%); previous: 0.07%**
- **Inflation in the period was explained by a renewed pickup in fruits and vegetables after moderating in the previous fortnight, compensated by lower energy prices and the seasonal decrease in other services**
- **Moreover, we believe the downward surprise relative to consensus could have been driven by lower taxes at the Northern Border, particularly impacting gasoline, and considering that the four cities with the highest price reductions are in this region**
- **With these figures, annual inflation stands at 4.52 % from 4.83%. On the other hand, core-inflation edged-down to 3.64% from 3.68% in December**
- **Strong positive reaction in local rates in the aftermath of today's CPI report, benefiting our trade recommendation in Mbonos Jun'22 and Dec'23**

Consumer prices increased 0.11% 2w/2w in the first half of January. This number was considerably below consensus at 0.25%, which was practically in line with our 0.26% forecast. Core inflation rose 0.08% vs. our 0.18% estimate.

The main deviation from our forecast came from: (1) A lower than expected contribution from energy (-13bps vs. our -5bps); (2) a lower impact from other services (-5bps vs. our 1bps); (3) a weaker contribution from fresh fruits and vegetables (14bps vs. our 18bps); and (4) a higher than expected impact from meat and egg (0bps vs. our -3bps), as shown in the table below.

1H-January inflation by components

% bi-weekly incidence

	INEGI	Banorte	Difference
Total	0.11	0.26	-0.15
Core	0.06	0.13	-0.07
Goods	0.08	0.09	-0.01
Processed foods	0.06	0.05	0.01
Other goods	0.02	0.04	-0.02
Services	-0.02	0.04	-0.07
Housing	0.02	0.02	0.00
Education	0.01	0.01	0.00
Other services	-0.05	0.01	-0.06
Non-core	0.05	0.12	-0.07
Agriculture	0.14	0.15	-0.01
Fruits & vegetables	0.14	0.18	-0.04
Meat & eggs	0.00	-0.03	0.03
Energy & government tariffs	-0.09	-0.03	-0.06
Energy	-0.13	-0.05	-0.08
Government tariffs	0.04	0.02	0.02

Source: INEGI, Banorte.

Note: Contributions might not add due to the number of decimals allowed in the table.

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Inflation in the period was explained by a renewed pickup in fruits and vegetables after moderating in the previous fortnight, compensated by lower energy prices and the seasonal decrease in other services. Specifically, agricultural prices increased 1.3% 2w/2w, adding 14bp to the headline index. We note that three out of the last four bi-weekly figures in this category have surprised significantly to the upside relative to recent history. Five out of the ten products with the highest increases belong to this sector, highlighting serrano chilies (46.6%), onions (15.5%), and tomatoes (3.1%), among others. On the other hand, energy fell 1.2% in spite of the delay in fuel distribution in several states in central Mexico, in line with the information coming from our price monitoring. This category subtracted 9bps to the headline. Low- and high-grade gasoline decreased by 1.4% and 1.5%, respectively. Meanwhile, LP gas fell 2.0%.

Core inflation edged-up 0.08% 2w/2w, broadly in line with the 0.07% of the previous print. Airfares (-30.6%) and tourism services (-9.6%) contributed with -12bps to the headline, driven by the typical seasonality after the end of the holiday season. Additionally, processed foods and other goods increased 0.3% and 0.1%, in the same order, lower than observed in the last two years.

We believe that at least some part of the downward surprise relative to consensus could have been driven by lower taxes at the Northern Border, particularly its impact on gasoline in these cities. In this respect and according to *INEGI*, the four cities with the steepest price reductions are in this region, including Tijuana (-1.4% 2w/2w), Mexicali (-1.3%), Matamoros (-1.2%) and Ciudad Juarez (-1.1%). This possibility is strengthened by the fact that out of the five cities in the sample at this region, only Acuña (-0.04%) was not among the ten top cities with the highest price decreases.

Annual inflation fell from 4.83% in December to 4.52%, while core inflation also decreased from 3.68% to 3.64% in the same period. In our view, Banxico will maintain a prudent stance given the resistance of core inflation to extend its downward trend, a situation which has been clearer since June 2018. In particular, and following its decrease from 4.83% by year-end 2017 to 3.59% in June, core inflation has exhibited a consolidation pattern above the 3.50% psychological barrier. We believe that today's print will be welcomed by the central bank. Nevertheless, more evidence is likely needed for a potential change in the balance of risks to inflation. Considering the latter, we reiterate our expectation that Banxico will keep the reference rate unchanged at 8.25% at least during 1H19.

Excluding recent dynamics in agricultural prices, we believe today's report suggests a healthy evolution in prices taking into account a backdrop in which a series of factors helps explain the wide divergence in market forecasts for this print. Among them, we have highlighted: (1) The delay in fuel distribution, both directly and its potential indirect impact to other goods, especially agricultural; (2) the strong increase in the minimum wage starting on January 1st; and (3) tax cuts at the Northern Border. In spite of today's print, we stay focused on the possible impact from one or all of these in coming months. So far, it is our take that there is no clear evidence of a sizable effect on price dynamics. We still believe risks to be skewed to the upside, both in terms of potential shocks to current inflation and to mid- and long-term expectations. All in all and considering a context of lower global liquidity, we expect Banxico to remain vigilant despite of the likely moderation in global and local growth this year.

From our fixed income and FX strategy team

Strong positive reaction in local rates in the aftermath of today's CPI report benefiting our trade recommendation in Mbonos Jun'22 and Dec'23.

The first inflation report of 2019 came with a strong positive surprise, printing a 0.11% increase in January's first bi-weekly reading, significantly below market consensus at 0.25% and our 0.26% forecast. In this sense, the annual rate moved from 4.82% to 4.52%. Moreover, core inflation also printed below expectations at bi-weekly 0.08% (consensus 0.20%, Banorte 0.18%). Under this dynamics, CPI is holding the downward trend in its annual reading, a situation that will probably continue in forthcoming quarters. Starting today's session on a strong footing due to a strong performance in global bonds, the local fixed-income market is extending the rally in nominal rates, locating a 7-10bps appreciation in Mbonos, while the TIIE-28 swap curve strongly flattens as it rallies 5-12bps with long-end securities outperforming. In contrast, real-rate Udibonos register a 7bps sell-off. This contexts adds to our vision of a more stable repo rate going forward, mainly when compared to 2018 dynamics, a scenario which has been also underpinned by the recent Fed's dovish tone and a strong performance in the Mexican peso during 2019 first weeks (+3.5% YTD). As a result, the yield curve is only pricing in 3bps of cumulative implied rate hikes for 1H19 and -19bps for year-end. In this sense, conditions still favor our trade recommendation in 3-year Mbonos, mainly Jun'22 and Dec'23, which we opened on January 9th, 2019. We hold a less optimistic view for Udibonos, with current breakeven readings suggesting a more favorable relative valuation for short-term Mbonos vs. Udibonos. Moreover, despite a more favorable implicit inflation in long-term Udibonos, the inverted yield curve does not benefit these securities due to the negative carry for greater duration.

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