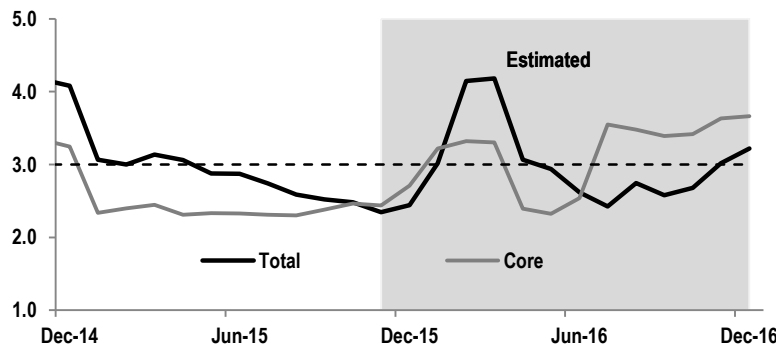


# We expect inflation below 3% in 2015

- **INEGI just published its inflation report for in the first half of November**
- **12-month inflation in the period in question reached a new historical low at 2.27% vs. 2.48% in previous month**
- **We revised down our year-end forecast to 2.5% from 3%; and our 2016 forecast to 3.2% from 3.5%**
- **Headline inflation (Nov): 0.52%2w/2w (Banorte-Ixe: 0.7%2w/2w; consensus: 0.73%2w/2w)**
- **Core inflation (Nov): 0%2w/2w (Banorte-Ixe: -0.01%2w/2w; consensus: 0.16%2w/2w)**
- **Inflation in the first half of November was explained by pressures on electricity tariffs along with increases in the price of fruits & vegetables**
- **Lower inflation readings supporting the positive valuation in the Mexican yield curve**

**Inflation at a new historical low.** According to *INEGI's* report 12-month inflation during the first half of November is at 2.27% vs. 2.48% in the previous month, while core inflation came down to 2.35% from 2.47% in October. With these data, we are revising down our estimate for year-end to 2.5% from 3% previously. The downward trend in energy prices –along with other commodity prices-, has been larger than initially expected. In addition, pass-through from exchange rate depreciation has been limited, with only moderate pressures on prices of durable goods, but with no secondary effect to other prices. For 2016, we expect an inflation rate of 3.2%y/y, below our initial estimate of 3.5%. Our forecast includes a larger pass-through from the exchange rate to prices, especially taking into account a significant recovery in domestic demand and the expected trend in gasoline prices, as shown in the chart below.

**Trayectoria de inflación 2015-2016**  
% variación anual



Source: Banorte Ixe with data from INEGI

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**Consumer prices increased 0.52%2w/2w in in the first half of November, below expectations.** Core inflation was 0% in line with our estimate but way below the 0.16% expected by consensus. The main deviation from our forecast comes from: (1) A lower than expected contribution of energy prices (52.5bps vs. our 64.9bps); (2) a lower than expected contribution of services prices (-3.9bps vs. our 0.4bps); (3) an overestimation of agricultural prices (2.6bps vs. our 5.5bps); and (5) a larger than expected contribution merchandise prices (4.1bps vs. our -1bps), as shown in the table below.

**1H-November inflation by components**

% bi-weekly incidence

	INEGI	Banorte-Ixe	Difference
Total	0.52	0.70	-0.182
Core	0.00	-0.01	0.007
Goods	0.04	-0.01	0.051
Processed foods	0.02	0.01	0.015
Other goods	0.02	-0.02	0.036
Services	-0.04	0.00	-0.043
Housing	0.02	0.02	-0.001
Education	0.00	0.00	0.000
Other services	-0.06	-0.01	-0.044
Non-core	0.53	0.71	-0.175
Agriculture	0.03	0.06	-0.029
Fruits & vegetables	0.03	0.07	-0.038
Meat & eggs	-0.01	-0.02	0.009
Energy & government tariffs	0.52	0.65	-0.135
Government tariffs	0.00	0.01	-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.

**Inflation in the first half of November was explained again by pressures in electricity tariffs and on agricultural prices.** Electricity tariffs increased 24.4%, as a result of the end of summer discounts. Meanwhile, agricultural prices were up 0.28%, with *INEGI* mentioning the prices of *Husk* tomatoes (26.6%), poultry (0.96%), nopales (13.1%) and apples (3.1%) among the products with higher prices. These increases more than offset the sharp declines in the price of products such as tomatoes (-3.3%) and eggs (-2.5%). Meanwhile, merchandise prices increased 0.12%2w/2w on the back of 0.12% and 0.13% higher prices of processed food and other goods, respectively. In contrast, services inflation was at 0.1%, as a result of a contraction of 0.33% in other services, with the report showing the cost of mobile phone services down 8.8%2w/2w.

*From our fixed income and FX strategy team*

**Lower inflation readings supporting the positive valuation in the Mexican yield curve.** Today's inflation report surprised once again on the downside, suggesting that Banxico will be restful taking in consideration a very low FX passthrough effect on prices. This situation suggests that inflation dynamics will give support to the idea of a favorable valuation in the local yield curve. Currently, local rates are trading with a 2-3bps rally following the demand for safe havens globally and positive news on inflation. We continue assessing an attractive valuation in the belly of the Mbonos curve, especially the tenors from Dec'18 to Dec'24. On the other hand, we hold our trade idea opened on November 12<sup>th</sup> of receiving 1-year TIEE-28 IRS (13x1) with an entry level of 3.92%, target of 3.67%, *stop-loss* of 4.10%, and currently trading at 3.85%. For further details regarding this recommendation please refer to "*Trade Idea: Receive 1-year TIEE-28 IRS (13x1)*", [pdf](#).

In the FX market, the Mexican peso gained slightly (from 16.51 to 16.48 per dollar) after the report. With markets pricing-in more decisively a possible rate hike by the Fed next month (implied probability of 74%), the currency's response could be a result of unhedged inflows into Mexico's fixed-income as low inflation and limited evidence of pass-through effects give Banxico more flexibility to keep rates low in a bid to support growth. Moreover, an environment of low short-term implied volatilities make investment in risky assets more attractive. Despite of the latter, we remain defensive as we see the currency as still vulnerable to external shocks, oil prices keep on the downside and markets are not yet fully pricing a rate hike by the Fed. All in all, we are wary of following recent gains as appetite for dollar longs has been increasing (as seen in futures positioning) and the currency still serves as a proxy hedge to broader EM, which have not shown signs of a strong turnaround so far.

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