

Inflation in October benefitted by lower agricultural prices

November 8, 2018

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- **INEGI just published its inflation report for October**
- **Headline inflation (October): 0.52% m/m; Banorte: 0.51%; consensus: 0.50% (range of estimates: 0.46%-0.61%); previous: 0.42%**
- **Core inflation (October): 0.31% m/m; Banorte: 0.30%; consensus: 0.31% (range of estimates: 0.29%-0.33%); previous: 0.32%**
- **Inflation during the period was driven by the seasonal increase in electricity tariffs, albeit partially compensated by the fall in agricultural prices**
- **Annual inflation stood at 4.9%, lower than the 5.02% of the previous month. Core inflation reached 3.73% from 3.67% in September**
- **We maintain our view that Banxico will hike the reference rate 25bps to 8.00% in its policy meeting next week**
- **Following today's CPI report, we hold our trade recommendation in floating-rate securities.**

Consumer prices increased 0.52% m/m in October. This number was slightly higher than consensus (0.50%) but closer to our forecast (0.51%). Meanwhile, core inflation edged-up 0.31% vs. our 0.30% estimate.

The main deviation from our forecast came from: (1) A higher than expected contribution of other services (+11bps vs. our +10bps); (2) a higher than expected impact from agricultural prices (-7bps vs. our -8bps); and (3) a lower than expected contribution from energy (35bps vs. our 36bps), as shown in the table below.

October inflation by components

% monthly incidence

| | INEGI | Banorte | Difference |
|-----------------------------|-------|---------|------------|
| Total | 0.52 | 0.51 | 0.01 |
| Core | 0.23 | 0.23 | 0.01 |
| Goods | 0.09 | 0.10 | 0.00 |
| Processed foods | 0.05 | 0.05 | 0.00 |
| Other goods | 0.04 | 0.04 | 0.00 |
| Services | 0.14 | 0.13 | 0.01 |
| Housing | 0.02 | 0.03 | 0.00 |
| Education | 0.00 | 0.00 | 0.00 |
| Other services | 0.11 | 0.10 | 0.01 |
| Non-core | 0.29 | 0.28 | 0.00 |
| Agriculture | -0.07 | -0.08 | 0.01 |
| Fruits & vegetables | -0.06 | -0.06 | 0.00 |
| Meat & eggs | -0.02 | -0.03 | 0.01 |
| Energy & government tariffs | 0.36 | 0.37 | -0.01 |
| Energy | 0.35 | 0.36 | -0.01 |
| Government tariffs | 0.01 | 0.00 | 0.01 |

Source: INEGI, Banorte.

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

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Inflation in October was explained by the seasonal adjustment to electricity tariffs, along the increase in other services. In the first case, energy prices increased 3.4% m/m on the back of electricity (+17.8%), given the end of summer discounts in the first half of the month. This added 26bps to the total variation of the index. Low-grade gasoline (1.1%) and LP gas (+0.9%) were also higher. On the other hand, agricultural goods declined 0.7% as a result of lower prices of fresh fruits and vegetables (-1.2%) and “meat and egg” (-0.3%). In this respect, *INEGI* highlighted that 8 out of 10 of the generics with the highest negative contributions were from this latter category, such as potatoes (-16.9%), oranges (-23.1%), and avocado (-9.1%), among others. In contrast, tomatoes (+10.1%) and green tomatoes (+25.1%) were among those with the highest upward contribution.

Core inflation was up by 0.31% m/m, explaining 14bps of the monthly figure, mostly because of services (+0.39%). In this category, professional services picked up 13.2%, followed by air fares at +12.8%. In our view, core prices remain relatively well-behaved in spite of the likely impact that the accumulated increase in gasoline prices could have been having in input costs for companies in the services sector.

In annual terms, inflation fell to 4.9% from 5.02% in September, decreasing for the first time in two months and after reaching a high since March. We maintain our 4.8% year-end estimate in spite of some relief in energy and agricultural prices that has resulted in upward pressures to non-core inflation in recent months. Our forecast is still above consensus, at 4.6% according to the latest Banxico survey. Although the recent reduction in the subsidy to the gasoline excise tax has not translated in renewed upward pressures due to the strong fall in international prices since the beginning of October, we believe the latter would be mostly compensated by the depreciation of the Mexican peso and the policy of smoothing price changes implemented by the Ministry of Finance.

We maintain our view that Banxico will hike the reference rate 25bps to 8.00% in its policy meeting next week. In our view, Banxico will remain very cautious about the inflation path, with the balance of risks still skewed to the upside. In this respect, we note that inflation remains above the central bank’s forecast for average inflation in 4Q18 at 4.2% yoy according to its latest Quarterly Report (Banorte: 4.7%). Moreover, we are waiting for the Fed’s decision today, in which we expect the reference rate to remain unchanged but also to maintain a hawkish bias, suggesting a 25bps rate hike in the next meeting to be held on December 18-19 that the market already discounts with a high probability. Similarly, upside risks to inflation have increased following recent losses of the peso, from around 19.10 per dollar at the previous meeting to 20.06 currently, a driver that remains very important for the central bank, as published in the communique of the decision held on October 4.

From our fixed income and FX strategy team

Following today's CPI report, we hold our trade recommendation in floating-rate securities. Today's figure came virtually in line with our expectations and slightly above market consensus. In our view, inflation dynamics are still reflecting a complex backdrop due to pressures that have primarily come from energy and agricultural goods in recent months, even in spite of moderating in the latest fortnightly prints. Moreover, it is important to consider the recent deterioration in the peso's performance and its potential implications in terms of pass-through risk. In this sense, the market is pricing-in a high probability of a rate hike from Banxico in its next meeting on November 15th, in line with our call of a 25bps hike which would set the repo rate at 8.00%. Moreover, we expect a complex year-end for the Mexican peso. For further details, please refer to: "*Adjusting USD/MXN projections amid a more challenging environment*", [pdf](#), published yesterday. Considering this scenario, we hold our trade recommendation regarding floating rate securities. In respect to real-rate Udibonos and despite carry which remains attractive, its valuation has become expensive, with breakevens trading above 4% along all tenors of the curve and reaching up to 4.5% in the long-end, within a context in which Udibonos' performance has also been contaminated by the widespread adjustment in the local fixed-income market.

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