4 Mexico: whereto from here?

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Mexico facing strong external headwinds in a lower growth environment

The optimism surrounding Pena Nieto's 2013 all-encompassing reform agenda has now given way to pessimism about Mexico, especially, since the election of Donald Trump as the next US president. While Mexico's strong trade and economic ties with the US are well known, what the future US president may do, particularly in the trade relations area, relative to what he said before the election remains to be seen.

During this period of uncertainty, negative investor confidence may continue to weigh on Mexican assets, the currency, domestic investment, FDI, and GDP growth. In the meantime, it is essential that Mexico continue on the path of fiscal consolidation and energy sector reforms in order to gain market confidence, and avoid rating agency downgrades.

On the positive side, measures have finally been taken to strengthen Pemex's financial position and stabilise oil production. In this connection, the recent success of the oil auctions is very promising for Pemex's finances, future oil production and FDI.

> Some facts

- The US president has almost unlimited constitutional powers over foreign affairs to impose trade restrictions or withdraw from existing treaties without congressional approval via various exiting Acts.
- A trade war (with Mexico or China), would be negative for US growth and employment since most Mexican exports to the US are intermediate goods (such as inputs to the auto industry).
- **Mexican exports to the US represent annually around 20% of GDP or 80% of exports**, and the sector most impacted by trade protectionism would be the high value-added manufacturing sector.
- **Remittances from the US represent 2% of Mexican GDP**, but not all of those come from illegal Mexican immigrants.

For the time being, a lot of uncertainty remains regarding future US policy and the potential impact of the measures. Even if the US were to withdraw from NAFTA, impose tariffs or other trade restrictions or limit the flow of remittances, the **exact impact of such measures on the Mexican economy would need to be calculated**.

MAIN ECONOMIC INDICATORS				Population: 127 mn			
	2011	2012	2013	2014	2015	2016E	2017F
Real GDP (% change)	3,9	4,0	1,4	2,2	2,6	2,1	2,0
CPI (% change)	3,4	4,1	3,8	4,0	2,7	3,2	3,4
Gen. Gov. Balance (% of GDP)	-3,4	-3,8	-3,8	-4,6	-4,1	-3 ,0	-2,9
Gen. Gov. debt (% of GDP)[1]	37,5	37,7	40,4	43,2	47,6	50,5	50,2
Current account balance (% of GDP)	-1,1	-1,4	-2,4	-1,9	-2,8	-3,1	-3,0
Gross external debt (% of GDP)	24.0	29.1	31.4	32.8	36.5	42.0	42.4

[1] *Includes the Federal Government, Pemex and Development banks.*

Source: Amundi Research / IMF / Hacienda / Rating agencies

The essential

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> "Measures have finally been taken to strengthen Pemex's financial position and stabilize oil production. The recent success of the oil auctions is very promising for Pemex's finances, future oil production and FDI"

Why has Mexico disappointed?

1. **Mexico's public finances have deteriorated and public debt has grown over the past few years**, partly as a result of the drop in the oil price and its negative impact on budgetary revenues.
2. **Energy reform has been delayed,** resulting in continued drop in oil production and deterioration of Pemex's financial situation.
3. **Short-term and medium-term growth prospects have diminished** with the delays in structural reforms, especially in the energy sector, and due to external factors.
4. **External accounts are showing larger imbalances** especially taking into consideration the negative errors and omissions, which to some extent explain peso weakness.

Credit ratings will remain under pressure

As a result of some of these trends, **the rating agencies** - which had upgraded Mexico in 2013/14- **took negative rating actions in 2016**.

- Moody's currently has a negative outlook on the A3 rating, and S&P a negative watch on its BBB+ rating.
- Both of these rating actions were related to a number of factors: the oil shock, declining oil production, deteriorating public finances, the growing public debt burden and potential contingent liabilities from Pemex.
- A combination of unfavourable domestic policies and serious protectionist measures from the US would likely to lead to more negative rating actions and downgrades via their negative impact on growth, and hence on public finances.

While downward pressure will remain on credit ratings, we believe that Mexico should remain an investment grade credit for the time being. What happens in the medium-term will depend both on the path of domestic policies and international politics.

Lacklustre GDP growth should get a moderate boost from structural reforms in the medium- term

GDP growth has been lacklustre over the past few years, partly due to lower oil prices, and slower US and global GDP growth. GDP growth on average remains below Latin American peers.

Looking forward, the new direction of US policy, potentially lower FDI, and a restrictive monetary policy stance, do not augur well for growth. Most economists are forecasting GDP growth below 2% for 2017 and less than 2.5% in 2018.

According to a very recent IMF report[1], Mexico's potential GDP growth should increase slightly in the medium-term to 2.75%, thanks to the structural reform agenda announced in late 2012. The IMF estimate of potential GDP growth was much higher a couple of years ago, at 3.5% to 4%.

If trade relations with the US are not altered significantly, Mexico's GDP growth should remain highly correlated with US industrial production / GDP growth, and should hence benefit from the acceleration in US growth.

MXN weakness likely to persist despite restrictive monetary policy

The Mexican peso (MXN) was the worst performing EM currency in 2016. The currency depreciated by 17% against the USD and by 13% since the US elections.

The central bank has managed to keep inflation close to the 3% +/-1% target despite the strong depreciation of the peso. This has been achieved via five 50bp hikes in 2016, bringing the policy rate to 5.75%, with more hikes likely to come.

Given the continued uncertainty regarding US policy and the rather unfavourable balance of payments trends mentioned below, we expect MXN weakness to continue.

[1] *IMF: "Mexico 2016 Article IV Consultation", November 2016.*

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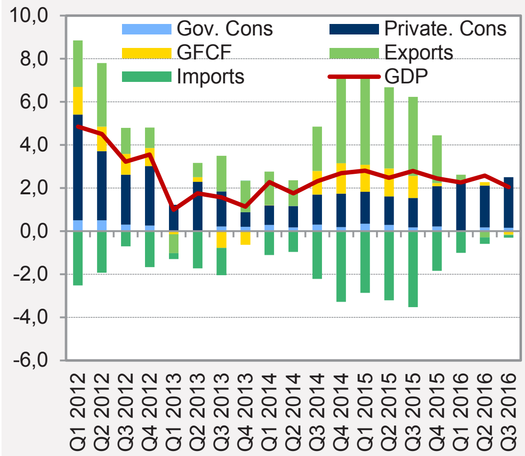
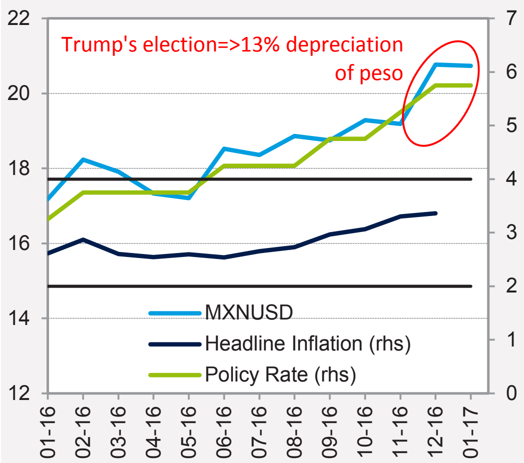
1 GDP Growth and its Components



Source: Datastream, Amundi Research

2 FX and Monetary Stance

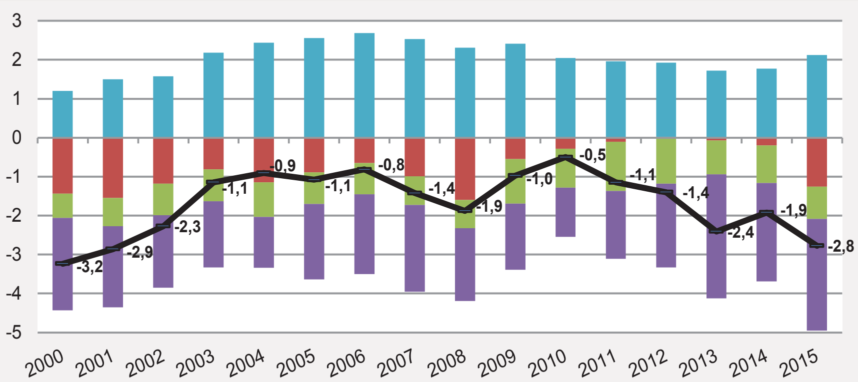


Source: Datastream, Amundi Research

Wider current account deficits and high negative errors and omissions not covered by net FDI inflows

The current account deficit has been widening since 2013, due to a larger trade deficit partly owing to the oil trade balance which has gone into deficit since 2015. **Non-oil (non-auto) exports have also been shrinking** mainly due to the slowdown in the manufacturing sector in the US, as the US is Mexico's largest trade partner.

Current account balance and its components



Source: IFS / Amundi Research

The CA deficit is expected to remain close to 3% of GDP in the next few years. Net errors and omissions (E&O) have averaged around -1.5% of GDP per annum since 2012. Adding the two negative numbers together implies **external funding needs of over 4% of GDP per annum versus net FDI inflows of around 1.5% of GDP. The persistent negative net E&O may be part of the explanation for the weakness of the Mexican peso – a factor usually not taken into consideration in most models.**

The implication of these trends is that Mexico's external debt and net external liabilities will be growing over time, which is not positive for the credit. In fact, external debt- to- GDP (includes non-resident holdings of domestic government securities) increased from 29% of GDP in 2012 to 42% in 2016.

Successful reform of the energy sector, combined with a non-protectionist attitude from the US would improve net FDI inflows, while the opposite would diminish net FDI over time.

Net portfolio flows turned negative in Q2-2016 largely as a result of outflows, mainly from short-term debt instruments. In this context, a floating exchange rate remains key to helping the economy adjust to external shocks.

Declining international reserves but adequate external liquidity

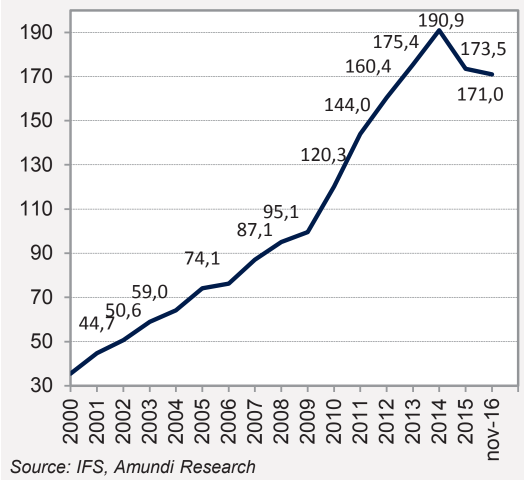
Mexico has a flexible credit line of USD85bn from the IMF and international reserves of USD174bn (including gold). **Total reserves have been declining since late 2014 due to a wider current account deficit and slower portfolio inflows (the latter have turned negative recently).**

Reserves amount to 5 months of imports of goods and services, 15% of GDP, 110% of the IMF's reserve adequacy metrics (ARA) and 120% of gross external financing needs[2].

Non-resident holdings of government securities amount to $105bn, and hence are largely covered by the existing external liquidity cushion in case of a sudden

> "Total international reserves have declined since 2015, due to a larger current account deficit and slower portfolio inflows"

3 FX Reserves excl Gold (US$bn)



Source: IFS, Amundi Research

[2] *Source: IMF. Gross external financing needs are defined as the sum of the current account deficit, plus amortization of long and short-term external debt over the next 12 months. This ratio would be lower if large negative errors and omission were to reappear in 2017.*

outflow. **However, the portion of local currency government debt held by non-residents is high** – 35% of total local currency debt and close to 50% of total public debt—**making the BOP vulnerable to sudden outflows of capital.**

A fiscal consolidation plan to reduce deficits and lower reliance on oil revenues

The public sector debt burden has been growing, as a result of larger fiscal deficits in 2014 and 2015, the drop in the price of oil, and weak GDP growth. The lower oil price of oil has reduced revenues from the energy sector (currently at 3.4% of GDP or 13.5% of revenues, versus 8.9% of GDP and 39% of revenues in 2012).

On the positive side, the **fiscal reforms of 2013, recent plans to redress Pemex's finances, combined with the government's fiscal consolidation plans are expected to reduce fiscal deficits, stabilise the debt- to- GDP ratio, as well as stabilising oil production which has been falling since 2009**.

The 2017 budget - based on a GDP growth of forecast of 2-3% in 2017, an additional rate hike of 100bps and an oil price of $42/bbl. – provides for **a reduction of the budget deficit to 2.9% of GDP in 2017 and to 2.5% in 2018** (from 3.0% in 2016), and a primary surplus of 0.4% of GDP. The government has about 0.5% of GDP of resources in the Stabilisation Fund that it could use in case of a budget shortfall. Moreover, the central bank surplus generated by the MXN depreciation is not included in the revenue numbers. **Hence, we believe that even if GDP growth were below the 2-3% range in 2017, the budgetary targets would be likely to be met.**

According to government forecasts, general government debt is expected to surpass 50% of GDP in 2016, remain stable in 2017, and decline thereafter. Debt to GDP was at 40% in 2013.

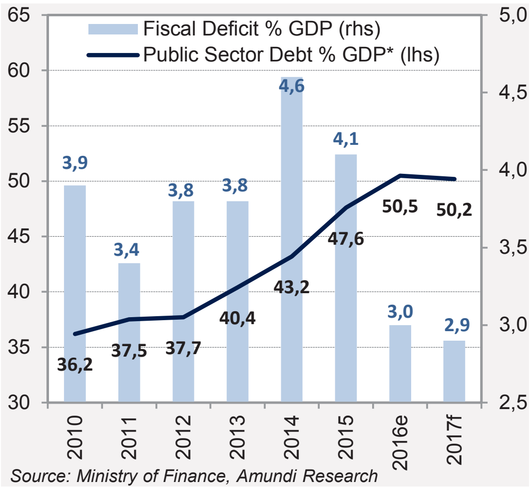
The fiscal adjustment is of utmost importance for credit quality and the sovereign rating, as rating agencies cite the continued growth in the debt burden, the increase in the interest burden (currently 9% of general government revenues) and the materialisation of contingent liabilities from Pemex as potential triggers for a downgrade.

Conclusion

Mexico has been making efforts to continue its reform agenda and regain market confidence via structural reforms, including public finances and the energy sector. While the fiscal adjustment remains of utmost importance for credit quality and the sovereign rating, external factors -- such as US trade policy and protectionism, and the price of oil -- will be important determinants of the direction of the economy and of the performance of Mexican assets.

> "Currently, less than 14% of budgetary revenues are from the oil sector, versus 39% in 2012"

4 **Fiscal stance**



Source: Ministry of Finance, Amundi Research

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