Mexico Watch

Group Economics
Emerging Markets Research

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Still waiting for stronger growth

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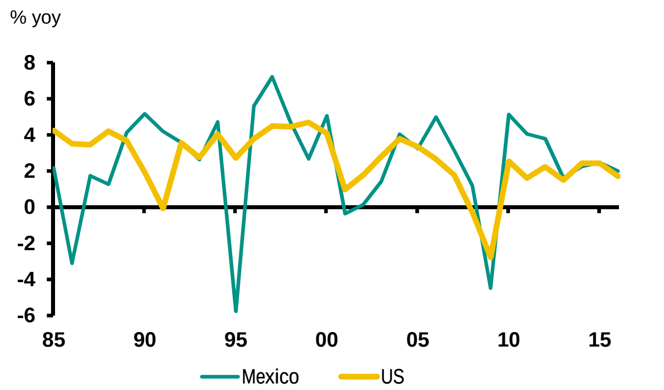
- **US remains single most important determinant for growth**
- **Economic fundamentals have deteriorated, but remain solid**
- **US elections increase risks**
- **But no major impact of eventually changes in NAFTA expected**
- **Modest appreciation of peso expected, after recent strong fall**

Reforms have not raised economic growth prospects
Broad-scale reforms helped to improve the competitive position of the country, but so far have not led to a surge in economic growth. Recent economic figures are not very promising and the Mexican peso has been a major disappointment over recent years. With the US presidential elections approaching, and both Donald Trump and Hillary Clinton making negative statements on future cooperation with Mexico, risks have increased.

Growth in US and Mexico remains largely similar



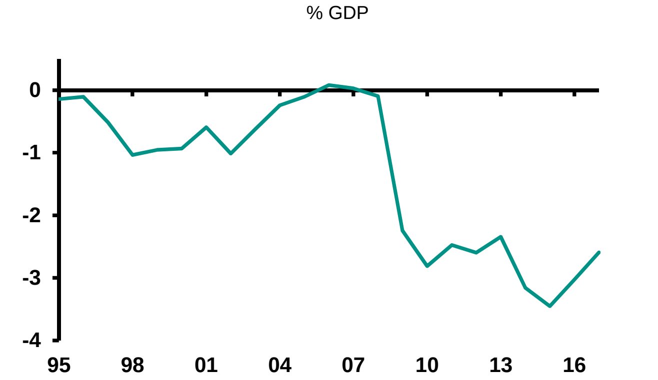
Source: EIU, Group Economics

With an export share to the US of around 80% and high levels of remittances, tourist receipts and foreign direct investments originating from the US, Mexico remains extremely dependent on developments in the US economy and vulnerable to changes in US monetary policy. That is why, looking at the trend in economic growth, it is no coincidence that Mexico closely tracks the US. In the period from 1995 to 2015, average GDP growth in Mexico (2.5%) was almost equal to that in the US (2.4%). Time for a closer look at Mexico.

Fundamentals now much stronger than before peso crisis in 1994
Since the peso crisis in 1994, Mexico has made considerable progress in creating sound economic policies. The central bank of Mexico became independent and a floating

exchange rate was introduced. In 2003 an inflation target of 3%, with a band of 1%, was adopted as well. Although the target is occasionally overstepped, the targeting has helped to keep the rate below 10% from 2000 onwards, after an average inflation rate of around 20% in the 1990s. At the same time, government debt and foreign debt levels improved. In addition, the North American Free Trade Agreement (NAFTA) with the US and Canada took effect in January 1994. The economic structure was given a new boost in 2012 after Enrique Peña Nieto of the Institutional Revolutionary Party (PRI) took over the presidency, after 12 years of having led the opposition. A variety of reforms in areas ranging from social security and education, to competitiveness, employment and energy were introduced. The energy reform put an end to more than 70 years of state monopoly in the oil sector and opened the door to (foreign) private investments. That said, the ongoing drug war, wide-spread corruption (Transparency International, Corruption Perception Index rank 95/168) and huge wealth differences remain weak spots.

Fiscal deficit has deteriorated slightly…



Source: EIU

… resulting in rising government debt levels

Source: EIU

The improved fundamentals made the country less vulnerable to external shocks and led to an improvement in its competitive position as well as a strong improvement in its credit rating. Mexico now ranks a handsome 38th place (out of 189) in the World Bank's ease of doing business index and 57th (out of 140) in the Global Competitiveness ranking. S&P rates the country at BBB+ and Moody's has even awarded Mexico an A3 rating. Still, all this did not result in an increase in economic growth. Rather the contrary is the case: comparing average economic growth between 1995 and 2015 with that between 1985 and 1994, the growth rate marginally decelerated from 2.6% to 2.5%.

Fundamentals have deteriorated again since 2015, but they remain solid

Despite a weak currency, inflation has remained remarkably stable, having stayed below the target rate of 3% since May 2015, helped by low energy and food prices. Inflation reached a low of 2.1% in December and hovered around 2.6% for most of 2016. Other economic fundamentals did in fact deteriorate. Earnings from the oil industry generate around one-third of government revenue. Hence the strong fall in oil prices since mid-2014 not only dragged down investments, but also put severe pressure on the government budget and resulted in a surge in government debt levels.

The fiscal deficit rose from -2.3% in 2013 to 3.2% in 2014 and 3.5% in 2015, while the government debt rose from 38% in 2013 to 47% in 2015. At the same time, the current account deficit, which hovered around 1.5% on average between 1995 and 2014, surged from 1.9% in 2014 to 2.8% in 2015. While still not alarming, these figures raise the risk of a downgrade of Mexico's credit ratings. In March of this year, Moody's accompanied its A3 rating with a negative outlook.

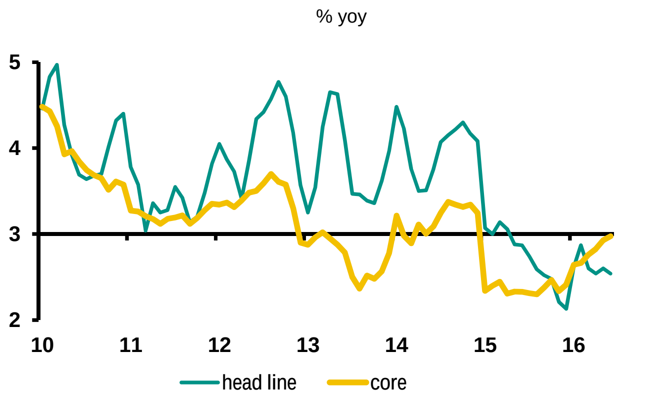
Negative economic growth in second quarter

According to preliminary figures, Mexico's GDP contracted by -0.3% qoq and slowed to 2.4% yoy in the second quarter. A breakdown of the figures is not available yet, but looking at the latest monthly data, investments continued to slow, while retail sales remained strong. After very weak investment growth in 2013/14, investments grew by about 4% yoy for full-year 2015, but there has been a sharp downturn since the last quarter, which continued into 2016.

Investments in the oil sector have dwindled and the low oil prices are also putting a damper on public revenues. This constrains the scope for budgetary stimulus which, in turn, is hitting investments in sectors such as non-residential construction (infrastructure). In May (the most recent figure) the twelve months moving average fell to 2.3% yoy. Compared to a year earlier, investments grew a mere 0.7%, which is also a much lower growth rate than the 1.6% expected in the Bloomberg survey.

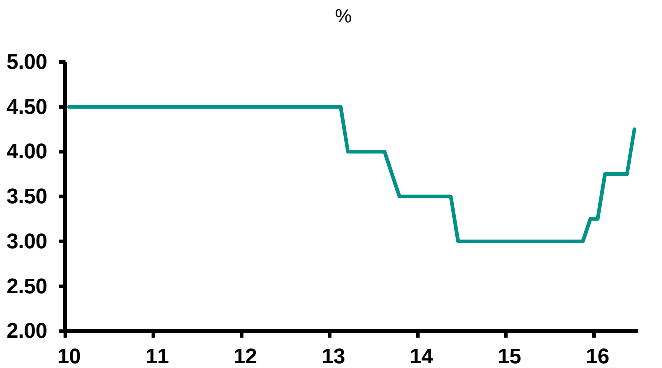
Residential construction saw a sharp increase by 5.7% yoy, while non-residential construction contracted by 5.4% yoy, leading to an overall decline in construction investment of -0.6% yoy. Industrial production remains very weak as well, with the twelve months moving average falling below 1% yoy since the start of 2016. Retail sales on the other hand still grew by a stellar 8.6% yoy in May, but consumer confidence remains subdued and has basically moved sideways at relatively low levels since mid-2014.

Inflation remains well within target range…



Source: Thomson Reuters Datastream

… while policy rates have moved up



Source: Thomson Reuters Datastream

Further slowdown in growth expected this year

Forward-looking indicators do not bode well for economic growth in the coming months. The Markit PMI fell from a temporary high of 53.6 in March to just 50.6 in July, while the IMEF (Instituto Mexicano de Ejecutivos y Finanzas) manufacturing index dropped below the 50 benchmark in June and fell further to 48.9 in July.

Room for fiscal stimulus will stay subdued during the year. What is more, monetary policy will remain tight. In spite of relatively favourable inflation developments and amid sluggish growth, the central bank of Mexico rose its policy rate by 25 basis points in December 2015, increasing it to 3.25% in line with the Fed. This first move since June 2014 brought an end to an easing cycle that started back in January 2009. Since June, the policy rate has been increased further in two steps to 4.25%.

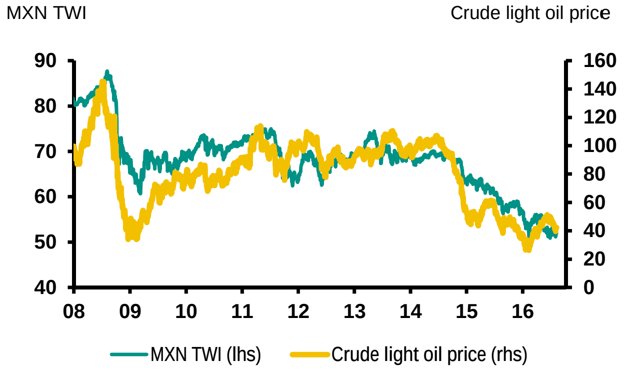
We expect one more rate hike this year to 4.50% and two steps next year to 5%. Despite all the recent rhetoric, we expect no major negative impact of eventually changes in the NAFTA agreement whoever wins the US presidential elections. NAFTA not just benefits Mexico, but US-based multinationals assembling their goods in Mexico before re-exporting them to the US do well by it too. However, uncertainty with regard to the outcome of the US presidential elections in November will negatively impact sentiment, and that applies all the more to the continued subdued growth levels in the US.

Overall, we expect growth to slow further in the second half of this year and to reach 2% for the year as a whole. With oil prices set to recover and assuming no major changes in US policy towards Mexico, this trend could be reversed next year. Still, given the constraints mentioned above, growth will not pick up beyond the long-term average growth rate of 2.5%, while risks remain tilted to the downside.

Strong fall in peso

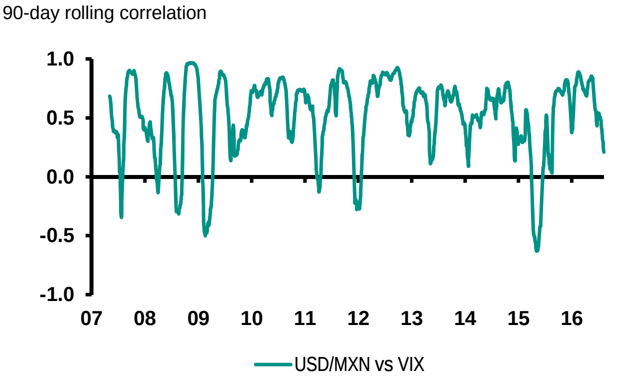
The Mexican peso has been a major disappointment over recent years. Since the start of 2013, it has lost more than 30% of its value versus the US dollar and has been one of the weaker emerging market currencies over this period. Whereas currencies such as the Brazilian real and the South African rand have recovered strongly this year, the peso has remained under heavy pressure. By nature, the peso is a currency that performs well when the investor climate is more optimistic, when oil prices are rising and when the US economy is doing well.

MXN has a positive relationship with oil prices…



Source: Bloomberg, ABN AMRO Group Economics

… and a negative one with equity market volatility

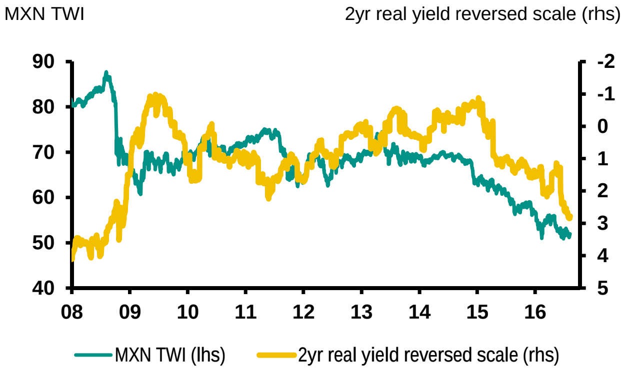


Source: Bloomberg, ABN AMRO Group Economics

The peso has a tendency to rise when US equity market volatility declines. Moreover, the peso often rises when Mexican stock exchange rises. In periods that the investor climate was positive this year, the peso received support. Earlier in the year, the sharp recovery in oil prices also supported the peso, but this proved to be temporary. Mexican equities have also done relatively well. So why has the peso not rallied like other emerging market currencies?

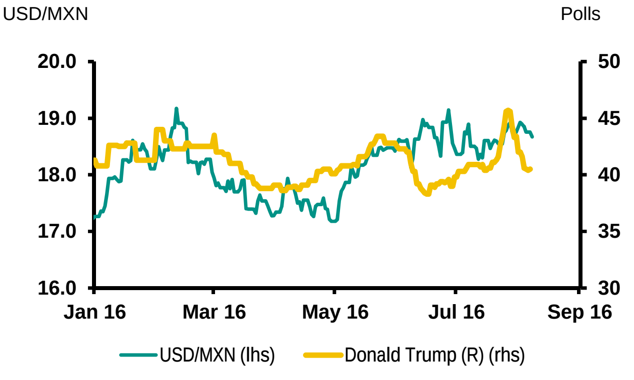
First, investors seem to be reluctant to invest in the peso asking for a yield pick-up. This is reflected in the unusual negative relationship between the Mexican peso and 2y Mexican real yield (see chart below). Another important factor holding back the peso lies in US politics and comments made by Donald Trump in particular. USD/MXN has a tendency to move in tandem with Mr Trump's rating in the polls (especially between January until May of this year).

MXN TWI and 2yr real yield



Source: Bloomberg, ABN AMRO Group Economics

USD/MXN and Trump's rating in the polls



Source: Bloomberg, Real Clear Politics, ABN AMRO Group Economics

Modest appreciation of peso expected next year

Our base case starts from a Democratic victory of the White House in November and this will likely support the peso. First, we expect the economy to fare better than if Mr Trump were to win, given that the Mexican economy is highly dependent on the US economy. Second, overall investor sentiment will likely be more constructive in case of a Democratic win. Further, as mentioned above, we do not believe that NAFTA will be renegotiated in the short and medium term (even though both Hillary Clinton and Donald Trump have said they would). If this does happen, however, it will probably not be in favour of Mexico. In addition, we expect oil prices to rise to USD 65 by the end of this year and to USD 70 by the end of next year. This should support the peso as well. However, we expect the Fed to hike rates by a total of 75 basis points in 2017. Financial markets will likely start to anticipate these rate hikes at the end of 2016 and the start of 2017. This will support the US dollar versus Mexican peso, even though, in anticipation of the Fed hikes, we foresee further increases in the Mexican policy rate as well. We also expect that investors will not be eager to run to the peso because of earlier disappointments. In view of the above, we have adjusted our MXN forecast to reflect only modest upward potential in 2017. We maintain our year-end forecast in USD/MXN for 2016 at 18.50 and raise our year-end forecasts for 2017 to 17.5 (from 17.00).

Key forecasts for the economy of Mexico

	2013	2014	2015	2016e	2017e
GDP (% yoy)	1.6	2.2	2.5	2.0	2.5
CPI inflation (% yoy)	3.8	4.0	2.7	2.7	3.1
Budget balance (% GDP)	-2.3	-3.2	-3.5	-3.0	-2.5
Government debt (% GDP)	38	42	47	50	51
Current account (% GDP)	-2.4	-1.9	-3.0	-2.5	-2.5
Gross fixed investment (% GDP)	21.1	21.0	22.2	22.6	22.5
Gross national savings (% GDP)	19.3	19.6	19.9	20.3	20.6
USD/MXN (eop)	13.1	14.7	17.3	18.5	17.5
EUR/MXN (eop)	18.0	17.8	18.8	20.4	19.3

Economic growth, budget balance, current account balance for 2016 and 2017 are rounded figures
Source: EIU, ABN AMRO Group Economics

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