

Investing in Mexico

Investing in Mexico: Gradual but steady worsening ahead

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- Andrés Manuel López Obrador (AMLO) became Mexico's president on Saturday. In his inauguration speech before Congress, he struck a firm and defiant tone, promising to transform Mexico through a government that exercises stronger control and further regulatory reach.
- Our baseline scenario, to which we assign a 60% probability, sees a gradual but steady worsening of macro policies, accompanied by a more challenging micro and regulatory environment. That said, the negative effects of AMLO's policies, which we believe to be ill-conceived, will take time to weigh on the country's outlook.
- Although we recognize that Mexican assets have adjusted to partially price in the new domestic reality, we expect additional weakness relative to emerging market peers in our baseline scenario in 2019. We therefore recommend investors to take advantage of periods of strength in Mexican assets to reduce positions in the year ahead.

Andrés Manuel López Obrador became Mexico's president on Saturday. In his inauguration speech before Congress, he struck a firm and defiant tone, promising to transform Mexico through a government keen to exert greater control and expand its regulatory reach.

Our outlook for the Mexican economy and institutional framework for the year ahead is summarized in Table 1. In our baseline scenario, we see a gradual but steady worsening of macro policies, accompanied by a more challenging micro and regulatory environment. However, less benign fiscal dynamics, a more challenging set of rules in the mining sector, or a less independent central bank, to name a few, are unlikely to materialize overnight. The negative effects of the AMLO administration's set of policies – many of which are ill-conceived, in our view – will thus take time to weigh on the country's outlook. As illustrated by the probabilities we assign to the bull and bear scenarios in Table 1, the balance of risks is also tilted to the downside.

Fig. 1: Key signposts

USMCA congress approval

1H19

2019 budget proposal

Dec. 15, 2018

IMF credit line expiration

Nov. 2019

Banxico rate decisions

Dec. 20, 2018

Feb. 7, 2019

Mar. 29, 2019

May 16, 2019

Jun. 27, 2019

Aug. 15, 2019

Sept. 26, 2019

Nov. 14, 2019

Dec. 19, 2019

Source: UBS, as of 4 December 2018

One policy area markets will be paying close attention to is fiscal dynamics. The new government will unveil its 2019 budget proposal next week. In his inauguration speech, AMLO reemphasized an economic plan promising large spending programs in infrastructure – a high-speed train in the southeast, a new oil refinery, the refurbishing of six more, and a multimodal link between the Gulf of Mexico and the Pacific Coast, among others – and a wider and stronger social safety net spanning education, healthcare, and pensions. Taken together at face value, these initiatives carry an estimated fiscal cost of 2.5% of GDP for 2019 alone. Some of them have already been endorsed by the public – albeit controversially – during the late November round of public consultations AMLO had called for.

AMLO and his team have said they are committed not to spend more than the available revenues and not to raise taxes. They propose financing the increased spending plans by eradicating corruption and operating the public sector more efficiently (involving wage cuts, a reduction in procurement costs, and a reduction in discretionary transfers to states). We think these efficiency gains will fall short of expectations and ultimately prove insufficient to fund the proposed increase in expenditures. The primary fiscal surplus of 1% of GDP likely to be promised in the upcoming budget presentation is unlikely to be met in our view.

As highlighted in Table 1, other key areas of concern are the possibility that the government will use quasi-sovereign firms as instruments of policy with limited focus on profitability, abuse "public consultations" as a tool to sidestep traditional institutional decision-making bodies, and worsen the regulatory environment for private-sector initiatives in industries such as mining, banking, and energy, among others.

In addition, although Mexico's bilateral relationship with the US has so far started off on the right foot, given the complex interaction between the economies and societies of the two countries, future schisms cannot be ruled out.

Table 1: Scenario analysis across key areas

CIO assesment

	Base case (60% probability)	Bear case (25% probability)	Bull case (15% probability)
Fiscal policy	Gradual worsening of fiscal dynamics. AMLO's cornerstone policy initiatives imply sizable spending increases, while his fiscal savings proposals will be much harder to realize. We expect AMLO to underdeliver on his promise of a primary fiscal surplus close to 1% of GDP in 2019. Fiscal disappointments will likely only come gradually, as incoming administrations have historically found it difficult to execute budgets during their first year in office - something that should be particularly true for the current administration given the ongoing talent exodus from the public sector on the back of drastic wage cuts for higher earners. Further fiscal slippage likely in 2020 and beyond. Debt-to-GDP ratios grind higher.	Faster and more pronounced worsening of fiscal dynamics. The incoming administration moves to fulfil the majority of its campaign promises, triggering a fast increase in fiscal outflows, which possibly leads AMLO to tap pockets of liquidity, such as pension funds savings, in an unorthodox manner, with dire market and credit rating consequences.	Responsible management of fiscal accounts. AMLO and his team consistently deliver primary fiscal surpluses of 1% of GDP or above on the back of only partially implemented campaign promises and successful rationalization of expenditures. Sovereign debt-to-GDP ratios trend sideways to lower.
Monetary policy	Banxico remains largely independent and current president remains in place. Further policy rate hikes take place in the next six months, followed by a pause at high rate levels. Tighter monetary policy in response to the expected easier fiscal stance.	The relationship between Banxico and the executive becomes more tense, leading to changes in the composition of Banxico's board (Diaz de Leon possibly departing) and a loss of independence and institutional quality at the central bank. Use of international reserves for alternative purposes becomes a possibility.	Banxico remains independent and president remains in place. Banxico stays on holds for the next six months and starts an easing cycle in 2H19.
Ease of doing business	Worsening. Increased regulation and public sector involvement. Mining, banking, and energy join other sectors to experience a less favorable regulatory environment.	Marked worsening. Increased regulation and public sector involvement. Confiscation threats.	Stable. Private sector activities allowed to take place without major impediments.
SOE outlook	Worsening. Government interference in state-owned enterprises (SOEs) increases and corporate governance weakens. Quasi-sovereigns are run by political appointees and employed as instruments of policy with limited focus on profitability. Energy-reform-related contracts signed to-date likely to remain, but further implementation unlikely.	Marked worsening. Quasi-sovereigns run by political appointees and employed as policy tools with broad disregard for profitability. Material deterioration in credit metrics of SOEs.	Stable. Although run by political appointees, SOEs surprise by operating with comparable levels of efficiency as today. AMLO-MORENA administration realizes that by relying almost solely on the country's national oil company, Mexico risks underexploiting its natural resources, and brings energy reform back to the table.
Quality of institutions	Worsening. Possible constitutional changes and abuse of "public consultation" tool.	Marked worsening. AMLO concentrates power, legitimizes "public consultations" through Congressional support, and employs them as a staple in decisionmaking. He eventually signals intentions to seek a second term.	Stable. AMLO and MORENA moderate their proposals, allow for institutional checks and balances to run their course.
Credit ratings	Worsening, likely downgrades. Sovereign IG rating maintained. SOEs should experience credit rating downgrades, but we expect them to remain IG-rated over the next 12 to 18 months.	Marked worsening, faster downgrades. Sovereign IG rating in serious risk. SOEs suffer multi-notch credit rating downgrades, probable loss of IG status.	Stable. Sovereign ratings largely unchanged. SOE credit ratings should stabilize, and we could see some upside in cases where an SOE is rated below the sovereign.

Source: UBS, as of 4 December 2018.

Investment implications

Mexican assets may be reassured this month by encouraging news on China-US trade talks and a more dovish Federal Reserve. But given Mexican assets' performance since his election, AMLO has lost much of the benefit of the doubt in the eyes of the markets, and his inauguration speeches did little to recover it. As highlighted above, his first test will be the upcoming 2019 budget negotiations. But even if he proposes a reasonable fiscal plan, markets will be left to wonder whether he will deliver on it, or whether his leftist support base and personal ideological veneer will win out in the end.

Table 2 summarizes our views across Mexican assets, including equities, USD-denominated bonds, and the currency. In sum, although we recognize that Mexican assets have adjusted to partially price in the new domestic reality, we expect additional weakness relative to emerging market peers in our baseline scenario in 2019. We therefore recommend investors to take advantage of periods of strength in Mexican assets to reduce positions in the year ahead. The balance of risks to the country's financial assets remains tilted to the downside, in our view.

Table 2: Scenario analysis across assets

CIO assessment

	Base case (60% probability)	Bear case (25% probability)	Bull case (15% probability)
Equities	We remain cautious as we expect further derating. Market sentiment has been badly bruised by unorthodox initiatives AMLO recently proposed. We favor defensive businesses with USD inflows, domestic consumption stocks, and market leaders with solid dividend yields.	Sizable additional downside. Continuation of populist measures impacting key sectors such as financials and mining. Drop in public and private investments impacting economic growth and the currency. Higher interest rates impacting consumer confidence.	Rerating takes place. AMLO reverses some measures and manages to reinstate investor confidence. Market-friendly implementation of pro-growth policies via high public investment and higher minimum wages.
Credit	Sovereign spreads are fair to expensive. We expect additional underperformance of Mexican sovereign bonds relative to BBB rated EM peers in 2019. Mexican sovereign bonds are trading at a 30bps premium compared to BBB peers. This should partially fade as Mexico's rating outlook worsens. Quasi-sovereign spreads over sovereign to trend sideways to slightly tighter since worsening outlook seems mostly priced in.	Sovereign spreads are trading at expensive valuations. Sizable underperformance of Mexican sovereign bonds relative to BBB rated EM peers takes place in 2019. Quasi-sovereign spreads over sovereign likely to widen.	Sovereign spreads are trading at fair to attractive valuations. Sovereign spreads outperform EM peers in 2019 and SOEs stage a stronger rally as the threat of credit rating downgrades dissipates.
FX	We maintain a neutral allocation on the country in our EM credit strategy, staying geared toward export-oriented and geographically diversified issuers that generate a material portion of their revenues outside Mexico.	AMLO's policies force credit rating agencies to cut ratings, leaving Mexico close to junk territory, dealing a major blow to the asset class. SOEs could lose their investment grade (IG) status. Based on precedents in other countries, notably Brazil, rating agencies may allow export-oriented and geographically diversified issuers that generate a material portion of their revenues outside Mexico to be rated a few notches above the sovereign.	
	Recent political dynamics weighed on the Mexican peso and further setbacks look likely as investors assign a higher risk premium to Mexico. In 2019, we expect USDMXN to trade mostly at levels of 20-21 amid elevated volatility.	A more radical policy stance increases depreciation pressure on the peso and levels above USDMXN 22 should be expected, especially if central bank independence is affected.	As recent investor concerns about the structural outlook diminish, fundamental conditions (e.g., growth-inflation dynamics, interest rate carry, long-term valuation) should support the peso outlook, and levels below USDMXN 18.5 can be reached again.

Source: UBS, as of 4 December 2018.

CIO GWM View

All bonds in this publication are flagged by one of the following labels: 'attractive', 'fair', 'expensive', or 'sell'. These labels reflect our assessment of the relative attractiveness of a bond when compared to issues with a similar credit rating, similar duration and denominated in the same currency.

Attractive attr.

Bonds rated "attractive" are expected to generate a total return exceeding the average return of a broad bond benchmark consisting of instruments with a similar credit and duration risk, and issued in the same currency.

Our recommendation can stem from a positive view on the issuer's credit profile not fully reflected in the price, unduly high risk premiums, the probability of the issuer calling the instrument or deferring interest payments, and external factors like regulatory intervention.

Fair fair

Bonds that we view as fairly valued are expected to produce a total return in line with the average return of a broad bond benchmark consisting of instruments with a similar credit and duration risk, and issued in the same currency.

Expensive exp.

We anticipate bonds that we designate as expensive to earn a total return that lags the average return of a broad bond benchmark consisting of instruments with a similar credit and duration risk, and issued in the same currency.

Our recommendation can stem from a negative view on the issuer's credit profile not fully reflected in the price, unduly tight risk premiums, the probability of the issuer calling the instrument or deferring interest payments, and external factors like regulatory intervention.

Sell sell

While we expect our relative value preferences to produce a positive excess return, avoiding positions that default or incur large total return losses is of primary importance for a bond portfolio, in our view. When we think the risk of an adverse outcome for an instrument exceeds what is reflected in its current valuation, we issue a Sell recommendation. Such situations can include those in which the instrument appears likely to post negative total returns until redemption, either due to a highly negative yield to maturity or an imminent call at a price below market valuations. Depending on the specific situation, we may refrain from publishing a general Sell recommendation on all bonds of an issuer and only do so for individual bonds, for all bonds of a specific ranking or for all bonds with a specific remaining term to maturity.

Appendix

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Appendix

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