FFTW Weekly Commentary

FOR PROFESSIONAL INVESTORS

by Bryan Carter
Head of Emerging Markets Fixed Income
bryan.carter@bnpparibas.com

Is Mexico cheap yet?

January 23, 2017

by Hardeep Dogra
Portfolio Manager, Emerging Markets Sovereign Credit
hardeep.dogra@bnpparibas.com

Key takeaways

- We do not believe that these assets have cheapened sufficiently to offer a compellingly attractive risk/reward
- It is conceivable that Mexico experiences the first-ever local currency debt crisis, in which its strength (having redenominated the bulk of government debt into locally denominated bonds), becomes a liability (as this market has been heavily sponsored by foreigners historically, and these investors are not bound to the local market and can choose to exit en masse)
- The situation Mexico faces is of an unprecedented potential exogenous shock to its business model – a shock, as it were, of bright orange hair

Full commentary

The short answer is no.

A longer answer necessarily distinguishes between different Mexican assets. Some may argue, and indeed traditional valuation metrics such as Purchasing Power Parity (PPP) and the Big Mac Index demonstrate, that the Mexican peso is arguably cheap and has been for some time. There is no indication that the peso, which has been weakening nearly continuously for four years now, has reached a bottom, however. For clearer signals, we look from the perspective of sovereign risk, and in particular dollar-denominated bonds and credit default swaps. **We do not believe that these assets have cheapened sufficiently to offer a compellingly attractive risk/reward.**

Mexican dollar bond spreads (for 10-year external issues) have repriced 40 basis points (bps) since the tight levels of the third quarter last year. They currently appear to only incorporate a (valid and warranted) additional risk premium reflecting the implications of a potentially more protectionist U.S. trade and immigration policy. In our view, these spread levels remain far from pricing in the consequences of a downside scenario should those risks materialize. Any compression in the risk premium requires clarity in the U.S. policy framework. Mexico stands at risk of suffering both on the trade side, with an as yet uncertain prospect for tariffs on imports from Mexico, as well as on the investment side, where we see a far more challenging environment for new foreign investment in Mexico.

Why is this so important? Mexico's economic model can be summarized as essentially a factory for the U.S., funded externally either via direct investment or portfolio flows. Both pillars of this model have suffered from Trump's pronouncements, with potentially weaker exports and an impaired financial account via less foreign direct investment (FDI) as base case expectations over the next few years.

The policy prescription? Mexico faces two solutions to the imbalances caused by the U.S. policy change. First, it can incentivize a reorientation of the economy away from imports in order to offset the negative trade balance effects of U.S. barriers. This is achieved most directly by interest rate hikes, which slow the domestic economy. Second, it can increase the relative attractiveness of Mexican peso-denominated debt for foreigners by raising the rate of interest paid on such issues. **Either way, we end at the same solution: only further interest rate hikes can help absolve Mexico of its northern neighbor's actions.**

Upside versus downside? On the positive side, Mexico's relative costs of production have cheapened enormously. Additionally, the tightening in fiscal and monetary policy already underway in response to the situation will assist in rebalancing external accounts and reduce Mexico's vulnerability to financing. The policy response domestically is entirely orthodox (other than an attempted currency intervention) and if it coincides with a scenario where U.S. protectionism turns out benignly, from an investment perspective, Mexico certainly has the potential to be the "Brazil" of 2017: higher real rates, weaker domestic demand, slower growth and an improved external balance. On the negative side, Mexico's vulnerability arises from the build-up of enormous liabilities in its international investment position: the stock of potential outflows is very significant should the worst materialize. **Indeed, it is conceivable that Mexico experiences the first-ever local currency debt crisis, in which its strength (having redenominated the bulk of government debt into locally denominated bonds), becomes a liability (as this market has been heavily sponsored by foreigners historically, and these investors are not bound to the local market and can choose to exit en masse).**

This week's market developments

Monday, January 16

- Japan Machine Tool Orders growth increased to 4.4% y.o.y. (s.a.) for December

Tuesday, January 17

- UK CPI growth increased to 0.5% m.o.m. (s.a.) for December
- UK PPI Output growth increased to 0.1% m.o.m. for December
- US Empire Manufacturing decreased to 6.5 for January

Wednesday, January 18

- Eurozone CPI growth increased to 0.5% m.o.m. (s.a.) for December
- US CPI growth increased to 0.3% m.o.m. (s.a.) for December
- US Industrial Production growth increased to 0.8% m.o.m. (s.a.) for December

Thursday, January 19

- US Housing Starts increased to 1,226,000 for December

Friday, January 20

- UK Retail Sales ex Auto/Fuel decreased to -2.0% m.o.m. (s.a.) for December

Source: Bloomberg, as of January 23, 2017

Some numbers around this from Haver Analytics. As of the third quarter 2016, the country has $1.1 trillion of external liabilities. Of that, just under half ($500 billion) is FDI and thus assumed to be stable (assuming protectionism does not prompt divestment here, but rather just a slowdown in new FDI). The important numbers are the potential "hot money" liabilities that are vulnerable to reversal: portfolio and other investment into debt (and, to some extent, equity). The country has $612 billion of such liabilities in total, of which around $476 billion is in debt instruments and $136 billion in equity. At least $180 billion of that exposure in debt instruments is to the general government.

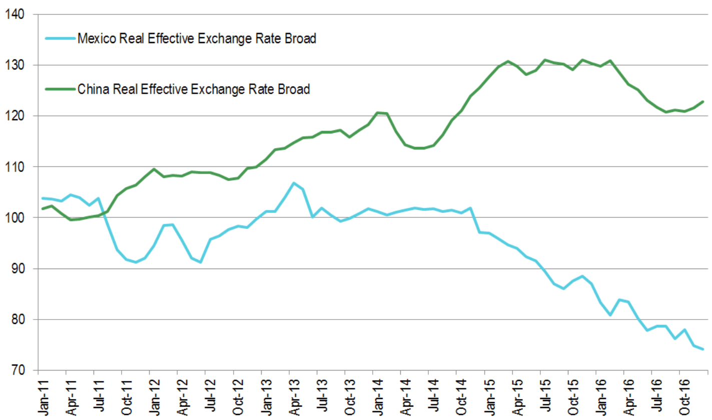
In summary, the situation Mexico faces is of an unprecedented potential exogenous shock to its business model – a shock, as it were, of bright orange hair. Any scenario whereby the immense stock of debt held by foreign investors is divested or not rolled over holds significant downside potential for Mexican assets. Is there value in Mexican assets? Potentially there is value in the peso, not yet in (local currency) bonds with interest rates still on the rise, and certainly not in external credit.

For additional information please refer to the [The Intelligence Report]

Chart of the Week

Mexico Real Effective Exchange Rate vs China

An enormous gain in competitiveness for Mexico over the past 5-years via FX weakness and low inflation (thus far)



Sources: Bloomberg, as of December 31, 2016

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on March 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	December 14, 2016	0.50% - 0.75%	0.68%	February 1, 2017
ECB	-5 basis points	March 10, 2016	0.00 %	-0.18%	March 9, 2017
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.06%	January 31, 2017
BoE	-25 basis points	August 4, 2016	0.25%	0.38%	February 2, 2017

Sources: Bloomberg, as of January 23, 2017

Next week's market developments

Monday, January 23

- Eurozone Consumer Confidence (advanced estimate) is expected to decrease to -4.9 for January

Tuesday, January 24

- Markit Eurozone Manufacturing PMI (prelim estimate) is expected to decrease to 54.8 for January
- Markit Eurozone Services PMI (prelim estimate) is expected to increase to 53.8 for January
- Markit US Manufacturing PMI (prelim estimate) is expected to increase to 54.5 for January
- US Existing Home Sales are expected to decrease to 5.51 million for December

Wednesday, January 25

- German IFO Business Climate is expected to increase to 111.3 for January

Thursday, January 26

- UK 4th Quarter GDP (advance estimate) is expected to decrease to 0.5% q.o.q.
- US Wholesale Inventories growth (prelim estimate) is expected to decrease to 0.1% m.o.m. for December
- Markit US Services PMI (prelim estimate) is expected to increase to 54.5 for January
- US New Home Sales are expected to decrease to 586,000 for December
- Japan National CPI growth is ex expected to decrease to 0.2% y.o.y. for December

Friday, January 27

- UK Retail Sales ex Auto/Fuel is expected to decrease to -0.4% m.o.m. (s.a.) for December
- US 4th Quarter Annualized GDP growth (advance estimate) is expected to decrease to 2.2% q.o.q.

Source: Bloomberg, as of January 23, 2017