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VIEWS FROM THE BRICK

MEXICO PRIMER

FALL, 2017

If you are reading this, then you too are interested in what is happening in Mexico on several fronts. We intend to cover many of the themes that are driving investments within Mexico today, ranging from macro trends, equities, fixed income to currency. At the conclusion of this briefing, we look to bring much needed transparency to the second largest economy within Latin America, and the tenth largest in the world.

MACRO

The global economic recovery continues to push ahead in 2017 with growth engines that investors have grown accustomed to historically making way for new drivers. Growth in the first quarter of 2017, globally, came in ahead of most world economic outlook forecasts thanks to markets such as Brazil, China and Mexico. Brazil's growth forecast for 2017 is now higher in light of the strong first quarter. However, ongoing weakness in domestic demand and an increase in political and policy uncertainty will be reflected in a more subdued pace of recovery, resulting in lower projected growth in 2018. Mexico's growth forecast for 2017 is revised up from 1.7 to 1.9 percent on the back of strong activity in the first quarter of the year, with an unchanged forecast for 2018 (2.0%).

ECONOMICS

SENTIMENT

Mexican PMI readings have come in above the 50 threshold in 11 of the last 12 months, including every month thus far in 2017. Business confidence has continued to trend higher after reaching trough levels early on in 2017. July's reading of 48.8 registers the highest confidence level since August of last year. Confidence has rebounded, but has struggled to regain the 50 level with

Source: [1] Data Provided by Bloomberg database, JPMorgan Research, IMF.

uncertainty surrounding the future of NAFTA and 2018 elections looming. Sentiment has also faced issues such as a 20% surge in the price of gasoline. Early on in the year, concerns of sentiment rattling the economy to the core were stronger than today, and we believe that initial concerns might have been overblown.

Consumer confidence has historically tracked consumer spending very closely in Mexico. Private consumption accounts for nearly 90% of total consumption. In terms of its share of GDP, private consumption has stabilized around 68% in recent years. While we've yet to see a complete rebound in confidence we once saw in 2000, a trend higher since 2014 has continued into 2017.

TRADE

Mexico has significantly expanded its free trade agreements (FTAs) with the rest of the world, including the EU in 2000 and Japan in 2005. Mexico has 12 FTAs encompassing over 46 countries, as well as other forms of trade agreements with a handful of countries. Despite Mexico's expansive global trade, over 80% of exports are shipped to the U.S. This number is down form 90% in 2000. Mexico's major exports are electrical goods (37%), cars/auto parts (24%) and oil (5%). Together they account for 66% of total exports.

Most of the attention between the U.S. and Mexico has been directed towards the future of this trade relationship as leaders begin to discuss NAFTA negotiations this summer. President Trump's stance on NAFTA while on the campaign trail was a harsh one, which still impacts sentiment today. As the discussions have transitioned from the campaign to the deal making stages, passions have cooled. We do not expect a radical transformation of the trade agreement, which is in the best interest of each party involved. We expect this to remain a sensitive issue, however, which could see a strongly worded tweet from the Oval Office that may spook markets. The U.S. is aiming to conclude NAFTA discussions by January of 2018.

Representatives of U.S. companies and organizations from different sectors spoke in favor of changes to NAFTA but urged to maintain the commercial relationship between the three countries. They also emphasized the competitiveness of the region and the importance of supply chains. The US Chamber of Commerce highlighted five points to modernize the agreements: (1) maintain the stability of the markets; (2) quick negotiation; (3) trilateral agreement; (4) smooth transition; and (5) consultation with the Trade Promotion Authority.

CENTRAL BANK

Banxico reduced the reference rate to a historical minimum of 3.0% in June 2014. After keeping rates at this level for a year and a half, Banxico began to normalize and eventually tighten its

Source: [1] Data Provided by Bloomberg database, JPMorgan Research, IMF.

policy stance. Since December 2015, Banxico has hiked its policy rate by 400bp to 7.0%, and we expect the bank to potentially further increase its rate to 7.25% by the end of 2017. Multiple factors have driven Banxico to hike aggressively, spanning from monetary conditions relative to the U.S., to external shocks and a likely transitory, but steep rise in inflation. With the current central bank governor's term coming to an end this year, the transition will be a focal point heading into 2018 along with presidential elections.

INFLATION

Inflation has been gradually converging to the Central Bank's 3% target over the past decade. The jump in inflation expectations earlier this year amid rising gasoline prices spurred a trigger happy central bank. We've now seen inflation stabilize since May coupled with promising growth and positive hard data throughout the year.

Inflation is still likely to remain above the 3% target set by the central bank and isn't completely under control just yet. Further volatility with the peso surrounding NAFTA talks and next year's election may prove to be problematic. However, aside from these two time-sensitive events, we see enough data to support the thesis that inflation will continue to converge toward the central bank's target in the medium term without extreme monetary measures.

FIXED INCOME

As a result of recent economic data, Mexico has been rewarded in the bond market. The nation's five-year credit-default swaps fell recently to the lowest level since March 2015, showing improving investor confidence in the nation's financial outlook. On top of that, Mexico has issued a new benchmark 10-year bond as part of a debt refinancing operation that did not increase government debt levels and underscored increasing confidence in the country's assets after a recent rally in the peso and stocks. The issue was 3.2 times oversubscribed as 380 international investors participated.

The positive sentiment has also trickled over into the corporate bond market as new issues in local bonds have increased each month this year. June saw MXN 99B in new issues, surpassing the amount brought to market in June of 2016; an 18% increase from the same period last year. Sentiment toward local debt has been boosted by resilient economic growth, a rebound in the peso, attractive sovereign borrowing costs and the strongest equity market in Latin America in 2017.

The inflation the region has experienced in the near term, coupled with seven consecutive rate hikes, drove borrowing costs higher in the last 12 months. But longer term rates remain attractive

Source: [1] Data Provided by Bloomberg database, JPMorgan Research, IMF.

given the benign outlook for continued inflation pressures.

EQUITIES

In terms of the market's composition, 46% of the weight of the Mexbol is in defensive stocks (including Consumer Staples, Telecom, Utilities and Health Care). The MSCI Mexico's return beta to EM is 0.9, significantly below Brazil's 1.5. However, measuring Mexbol's returns beta to MSCI EM (i.e., excluding currency effect), the beta is much lower at 0.5. This is due to the currency's liquidity and continuous use as a hedge for other EM positions[1].

So far in 2017, we've seen a rally that has been second to none within Latin America following a brief period of fear following the U.S. election. Looking ahead to the remainder of 2017 and into 2018, there are two exogenous risks to the Mexican market that we've addressed: NAFTA negotiations and the 2018 Presidential election. Volatility within the region is likely to pick up as these two issues are hypersensitive in nature. The market appears to be split into two camps on these issues: domestic and foreign point of views. Foreign flows were up 13% in the first half of 2017 vs. the same period a year prior while domestic institutional investors have been reducing their exposures.

We'd expect the Mexican market to move in line with broader EM equity indices in the short term. While we see the correction to, what appeared to be, irrational selling within the market as a positive, the year-to-date outperformance of the broader asset class is likely to tighten. This outlook is largely predicated on the uncertainty and unpredictability of the NAFTA negotiations and the upcoming presidential election.

PESO

The Mexican peso is the second most liquid currency within the collection of global emerging markets behind the Chinese renminbi. Daily turnover is estimated at ~$100bn. This allows for the peso to be one of the most popular EM hedges in the market. The ease of access to the currency often times introduces excess volatility to the currency and Mexican market when issues arise.

We've seen dollar weakness as a primary driver behind several asset classes in 2017, with emerging market FX being one of the primary beneficiaries of this move. With the Fed not being the only central bank to appear to be on a hawkish path moving forward, dollar strength took a hit. But often times, when price moves this far this fast, some sort of reversal is in the cards. The re-rating of the USD vs. its developed and developing peers has been relatively swift within the markets. Its decline has been especially pronounced against the euro, 11%, and the Mexican peso, 14%. In the short term, this sets up a scenario where the dollar appreciates.

Source: [1] Data Provided by Bloomberg database, JPMorgan Research, IMF.

After the June 4 elections, the MXN reached levels unseen since pre-Trump times. When he won the presidency, the MXN reached 18.42 per USD and after his inauguration it reached levels of 21.93 per USD. On August 14th, the currency reached levels of 17.73 per USD. This appreciation, in turn, reduces inflationary pressure. Moving forward we expect the MXN to exhibit some volatility for reasons that are not directly tied to the fundamentals of the country or currency themselves. As clarity emerges as to just how tough the U.S. will be on Mexico with NAFTA, one of the most feared causes should dissipate. Currently, the implied volatility for the peso is at two-year lows on a three-month and six-month forward-looking basis. Global sentiment remains the most important determinant for the USD/MXN pairing's direction moving forward. Moving the time horizon out beyond the 2018 presidential election, we think the fundamentals support a strengthening Mexican economy and currency. The unknowns that will come to the fore with a new president represents the next potential headwind for the pairing.

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