Economic Analysis

The MXN's rough ride may well calm somewhat after the US election, but the external balance points to continued underperformance in 2017

Javier Amador / Carlos Serrano

- **Markets are treating the Mexican peso (MXN) "like a piñata"**
- **Relative to other EM currencies, the peso has underperformed by about 17% in 2016**
- **From a short-term standpoint, oil prices seem to have been playing a smaller role since early April 2016**
- **The peso's outperformance reached a peak in August 2014: the shift from the "Mexican moment" to the major slide in oil prices**
- **The MXN started to underperform in 4Q14 and has sharply underperformed since Dec 2015**
- **Three factors seem to be driving the recent sharp underperformance: i) reduced expectations of US growth; ii) weakening economic fundamentals, particularly related to the external and fiscal balances; and iii) the Trump factor**
- **Against such a challenging backdrop, we now expect Banxico to widen the interest rate spread by 50 basis points on 29 September**

Markets are treating the Mexican peso (MXN) "like a piñata"

A few days before the Brexit vote, Stephen Foley highlighted in an article[1] for the Financial Times how the Mexican peso (MXN) was starting to move in line with sterling as traders were using it as a Brexit hedge. The author explained how whenever emerging market (EM) risks go up, the MXN "gets whacked". He came up with a great way to express how markets treat the MXN: "like a piñata". That's true: as a highly liquid currency[2], the MXN is used to hedge against all kinds of risks (see chart 1). You name it, an EM risk goes up and the MXN weakens, often by more than the average depreciation of other EM currencies. Whenever there is something new to worry about, markets short the peso. Indeed, as Chart 1 suggests, the performance of the MXN has generally followed the broad swings in the CME Mexican peso net non-commercial (i.e. speculative) positions in 2016 (even if it cannot explain every turning point). In other words, speculative positions against the MXN seem to have been a drag. Foley brightly summed up the MXN's 2016 performance until then and its likely fate in the short term in one sentence: "There always seems to be some other reason to give the piñata a whack". The result of this piñata treatment is that the peso is by far one of the worst performing EM currencies of 2016 (see chart 2). That said, the use of the MXN as a hedge for most risks does not explain its weakening trend. At most it should help to explain its most ugly days but not its mid-term weakening trend. For the proxy hedge theory to be a good explanation for the underlying MXN trajectory in recent months, one would have to observe both

1: "No end of reasons to whack Mexican peso" by Stephen Foley. Financial Times, June 22, 2016.

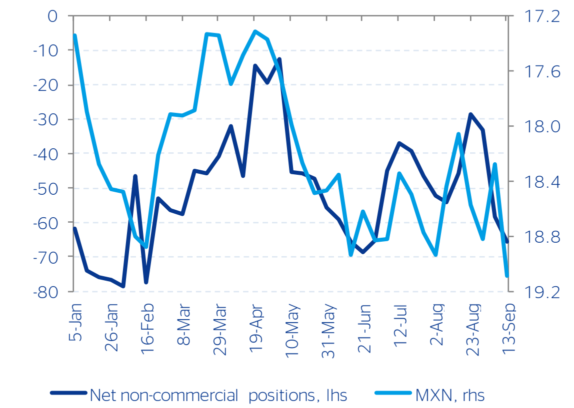
2: The Mexican peso is one of the most liquid of the EM currencies, trading about US$135bn a day, 24 hours a day.

depreciatory and appreciatory trends as investors unwind their short MXN positions whenever risks decrease (when oil prices rise, worries on China ease, expectations of Fed rate hikes decrease, etc.) and that has not fully happened. In fact, Chart 1 shows that in many periods during the year, the MXN leads the movements of speculative positions and not the other way around. To understand the persistent depreciatory trend it is necessary to look at macroeconomic fundamentals, as we explain later in this note.

It is important to highlight that the real effective exchange rate is at its lowest level since 1995. Its trend has closely followed that of the nominal effective exchange rate (see Chart 3). Therefore, the conclusions we draw in this note also apply to the real exchange rate i.e., inflation in Mexico has remained stable despite the peso's depreciation and hence, it has not been a contributing factor to explain its weakness and underperformance.

Whenever an EM or idiosyncratic risk goes up, the market shorts the peso…

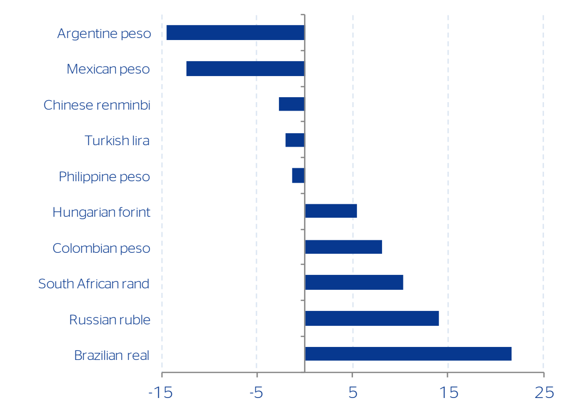
Chart 1
MXN & CME Mexican peso net non-commercial positions (2016, pesos per dollar, inverted scale & no. of contracts, thousands)



Source: BBVA Research / Bloomberg

… and the peso doesn't seem to fully recover when risks ease

Chart 2
Best and worst performing EM currencies in 2016 (+ / - for appreciation / depreciation of EM currencies versus the USD; year to date)



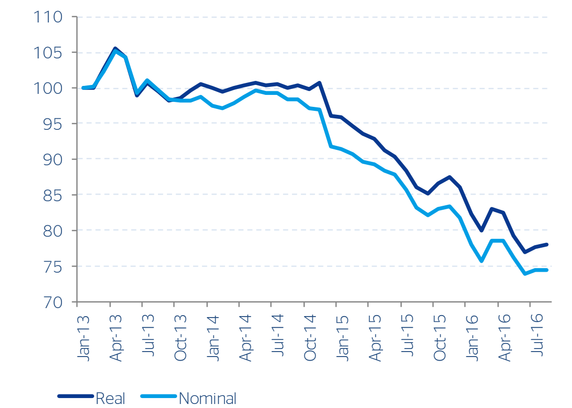
Source: BBVA Research / Bloomberg

Relative to other EM currencies, the MXN has underperformed by about 17% in 2016

As chart 2 shows, the MXN is one of the few EM currencies that have not rallied in 2016. Year-to-date, the MXN is down about 14% versus the USD, which compares poorly with the better performance of other EM currencies. In particular, the MXN has failed to rally along with other oil-sensitive EM currencies when oil prices have recovered. If we take the JP Morgan Emerging Market Currency Index, re-weight it after taking out the MXN (which has a relative weight of 11.11% in the original index) and rebase it to Jan 1, 2016 = 100, we can clearly and easily compare the MXN's performance with that of other EM currencies to get a clear and quick picture of the two different tales so far this year: one of strengthening for most of EM currencies and other of significant weakening for the MXN (see chart 4). Indeed, as Chart 5 shows, relative to the better performance of other EM currencies, the MXN has underperformed by about 17%.

The real effective ER trend has closely followed that of the nominal effective ER

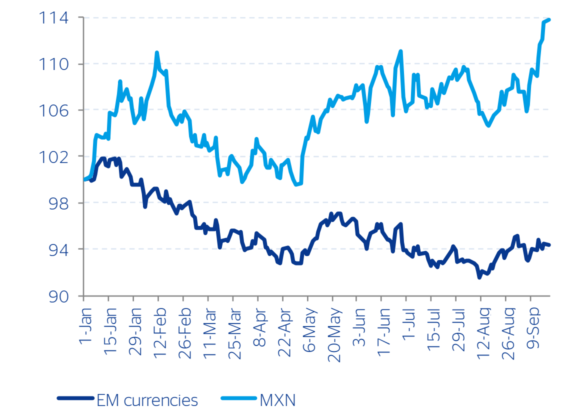
Chart 3
Real & nominal effective exchange rates (Jan 2013 = 100)



Source: BBVA Research / BIS

Sell-out of MXN vs. rally of EM currencies in 2016

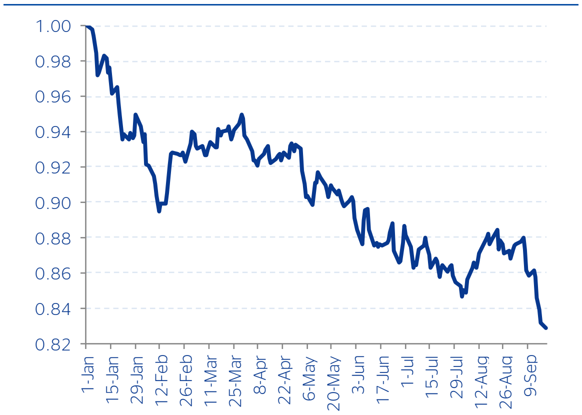
Chart 4
MXN & other EM currencies* (Jan 1, 2016 =100; + / - for depreciation / appreciation versus USD)



Source: BBVA Research / Bloomberg
* Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN

The MXN has plunged in 2016

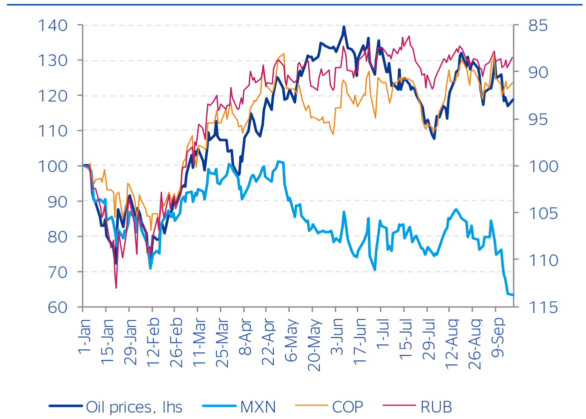
Chart 5
MXN relative to EM currencies*, 2016 (Jan 1, 2016 = 1)



. Source: BBVA Research / Bloomberg
* Ratio > 1 / < 1 for MXN absolute outperformance / underperformance & increasing / declining trend for MXN relative outperformance / underperformance. Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.

Oil prices vs. oil-sensitive EM currencies in 2016

Chart 6
MXN, COP & RUB* vs. WTI prices (1 Jan. 2016 = 100, + for depreciation versus USD inverted scale, rhs & dollars per barrel)



Source: BBVA Research / Bloomberg

From a short-term standpoint, oil prices seem to have been playing a smaller role since early April 2016

Has the MXN become less sensitive to shifts in oil prices? The MXN's current weakening trend dates back to October 2014 when oil prices took a slide. Until recently, when oil prices went down, the peso was hit, while when oil prices went up, the peso recovered somewhat, but almost always less than the recovery of other oil-sensitive EM currencies such as the Colombian peso (COP) and the Russian rouble (RUB). However, there is evidence to suggest that significant shifts in oil prices continue to play a large role for the COP and the RUB, but seem to be no longer explaining either the major turning points for the MXN or its performance since early April (see Chart 6). Chart 6 shows that the recovery in oil prices reached a peak on 8 June, and that both the COP and the RUB remained on a positive trajectory through June and since then seem to have continued to track the path of oil prices. By contrast, the trajectories of the MXN and oil prices seem to have drifted apart since early April. Until that date, the peso had recovered all the lost value during 2016. Since then, it has lost about 13% even as oil prices are about 19% higher. Even though the MXN continues to take a hit whenever oil prices go down (e.g. 13 September, an ugly day for both the MXN and oil prices), other drivers seem to be taking a larger role. That said, as we will cover in coming sections, oil is likely to remain a key driver for the MXN and is essential to explain some of the structural changes in the Mexican economy that are behind the peso's weakness.

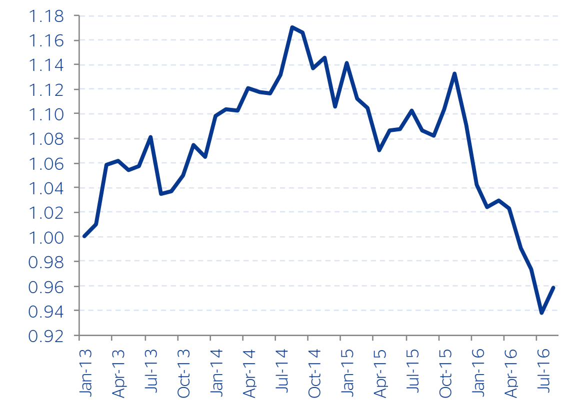
The peso's outperformance reached a peak in August 2014: the shift from the "Mexican moment" to the major slide in oil prices and its negative effects on fundamentals

When did the MXN underperformance start? To better understand what is driving the underperformance it is useful to set the date when it began. Although it is now obvious from previous sections that it has underperformed throughout 2016 (see Chart 5), we need to pin down the date when the relatively poor performance kicked in to get a feel for the main underlying factors of that underperformance and to see whether it is justified by some developments and if so, whether there is scope for catching up and what factors could trigger a recovery.

As Chart 7 shows, the peso sharply outperformed from January 2013 to August 2014 when its outperformance peaked. What drove this? We can think of global macro-drivers as well as local factors. From a global standpoint, worries about the Chinese economy were weighing on other EM currencies with economies more closely tied to the commodities boom associated with China's strong pace of growth. Meanwhile, US growth was looking better than growth in other developed economies and the Mexican economy is after all, among emerging economies, the most closely tied with the US. From a local standpoint, Mexico approved a set of structural reforms that would boost future growth (while growth in other emerging economies was supposed to slow down). Also, macroeconomic fundamentals (fiscal, external, and monetary-related) looked solid at that time. All in all, together the global and local factors briefly shifted market views toward Mexico to such an extent that the perception was that we were about to witness the "Mexican Moment". After registering record inflows in 2012 (of US$44 bn), foreigners' appetite for the local debt market remained strong throughout 2014 (with total inflows of US$34 bn and US$27 bn in 2013 and 2014 respectively). Unsurprisingly, the peso outperformed other EM currencies during that period. Then, the major slide in oil prices kicked in and changed the landscape for the MXN (see Chart 8).

The MXN started to sharply underperform in December 2015

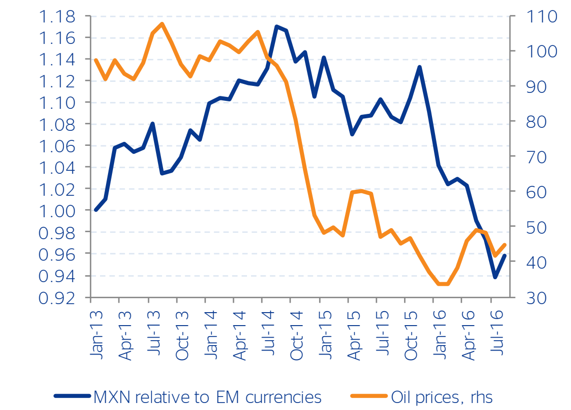
Chart 7
MXN relative to EM currencies*, 2013-2016 (Jan 2013 = 1)



Source: BBVA Research / Bloomberg
* Ratio > 1 / < 1 for MXN absolute outperformance / underperformance & increasing / declining trend for MXN relative outperformance / underperformance. Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.

The major slide in oil prices in 4Q14 seems to be behind the key shift in MXN relative performance

Chart 8
MXN relative to EM currencies* & WTI, 2013-16 (Jan 2013 = 1 & dollars per barrel)



Source: BBVA Research / Bloomberg
* Ratio > 1 / < 1 for MXN absolute outperformance / underperformance & increasing / declining trend for MXN relative outperformance / underperformance. Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.

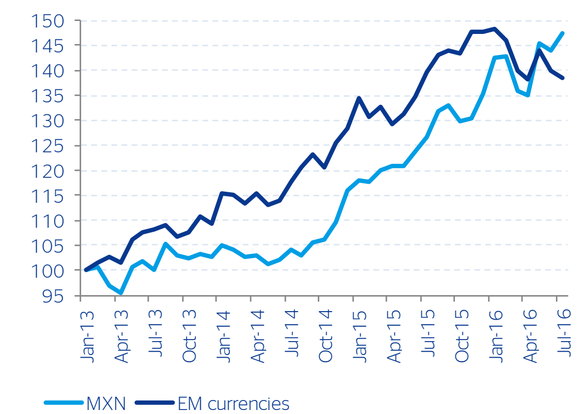
The MXN started to underperform in 4Q14 and has sharply underperformed since December 2015

From September 2014 to November 2015, the MXN's absolute outperformance continued (ratio > 1 in Chart 7) but over that period its relative performance began to show signs of underperformance (declining trend in Chart 7), particularly during the period from September 2014 to March 2015 when WTI oil prices almost halved (declining from US$91 to US$48). As Chart 8 shows, from April to October 2015, the relative stabilisation in oil prices seems to have allowed the peso's relative underperformance to ease temporarily. Oil prices took a dive again in November 2015 and the peso felt the brunt of it. All in all, oil prices seem to be behind the major shift in sentiment towards the peso but are not in themselves enough to explain all the tweaks in its path, particularly those of 2016 as already discussed in the previous section (see Chart 6).

Taking January 2013 as a starting point, the MXN's outperformance began to shrink in 4Q14 and turned negative in May 2016 (see Chart 9). This implies that the MXN started to underperform in 4Q14 (see Chart 10) and took a dive in December 2015 that does not seem to have hit the water yet (see Chart 11). From Charts 10 and 11, it seems clear that the MXN has sharply underperformed since December 2015. Up to now, it seems that the major slide in oil prices triggered the shift in the MXN's relative performance in late 2014, but what has led to such a sharp underperformance since December 2015? Oil prices alone are not a sufficient explanation.

Taking January 2013 as a starting point, the MXN's outperformance began to shrink in 4Q14 and turned negative in May 2016…

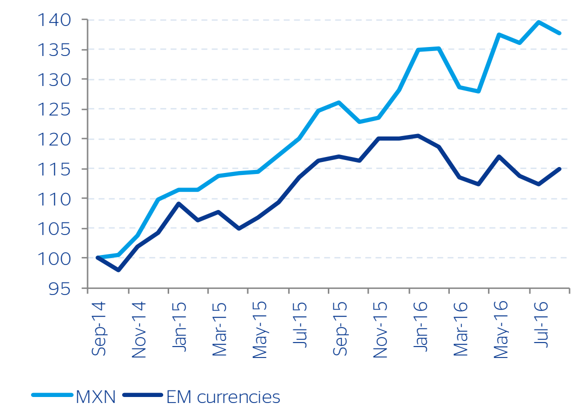
Chart 9
MXN & other EM currencies* (Jan 2013 = 100; + for depreciation versus USD)



Source: BBVA Research / Bloomberg
* Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN

… That is, the MXN started to underperform in 4Q14…

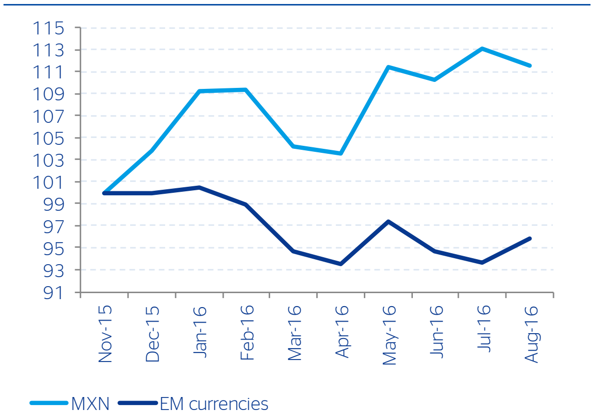
Chart 10
MXN & other EM currencies* (Sep 2014 = 100; + for depreciation versus USD)



Source: BBVA Research / Bloomberg
* Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN

… And took a dive in Dec 2015 that does not seem to have hit the water yet

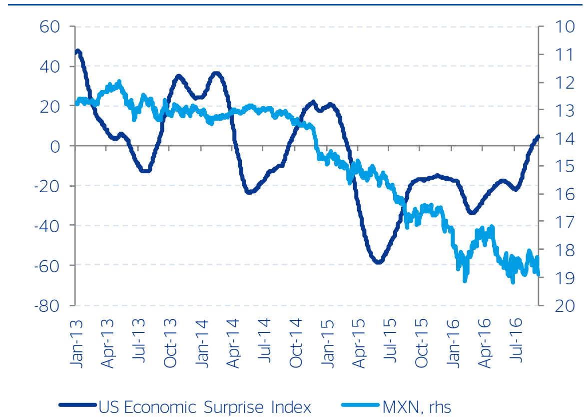
Chart 11
MXN & other EM currencies* (Nov 2015 = 100; + for depreciation versus USD)



Source: BBVA Research / Bloomberg
* Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN

A part of MXN underperformance can be attributed to the significant slowdown in the US economy…

Chart 12
Citi US Economic Surprise Index* & MXN (3mma & pesos per dollar, inverted scale)



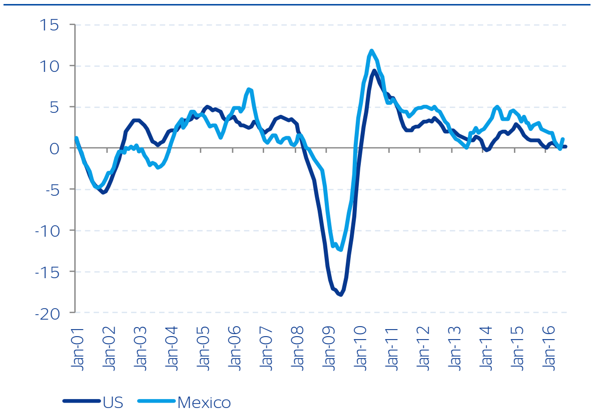
Source: BBVA Research / Bloomberg
* A positive reading suggests that economic releases have on balance been beating consensus.

Three factors seem to be driving the recent sharp underperformance: i) reduced expectations of US growth; ii) weakening economic fundamentals, particularly related to the external and fiscal balances; and iii) the Trump factor

i) Reduced expectations of US growth. Part of the MXN underperformance, we think, can be attributed to the significant slowdown in the US economy over the past two years. As Chart 12 shows, if we consider the 3-month moving average (3mma) of the Citi Economic Surprise Index daily data, US activity indicators have on balance been consistently below consensus expectations. In fact, the index has remained negative (on a 3mma basis) since early March 2015. It seems to have taken a toll on the peso (see Chart 12). The Mexican economy is most closely tied to the US manufacturing sector (see Chart 13). The sharp slowdown in the US manufacturing sector began in 4Q14, matching the time that the MXN started to underperform (see Chart 14). All in all, the slide in the US economy broadly resembles the MXN's plunge (see Chart 15). However, Charts 14 & 15 show that before August (when the US economy seems to have turned for the worse once again), from April to July 2016, the MXN seems to have lagged behind the recovery path of the US economy. The MXN did not recover, but weakened further. Is there scope for a catch-up in the MXN's relative performance? Not so fast! There are other factors in play.

... Particularly of the manufacturing sector, the most closely tied to the Mexican economy

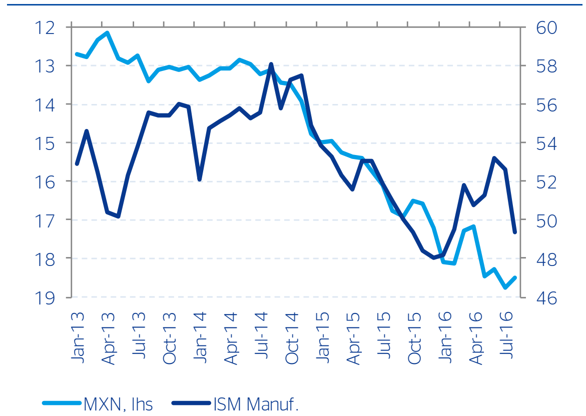
Chart 13
Manufacturing production (YoY % change, 3mma, sa)



Source: BBVA Research / FRED economic data & INEGI

The sharp slowdown in the US manufacturing sector began in 4Q14, at the same time as the MXN started to underperform

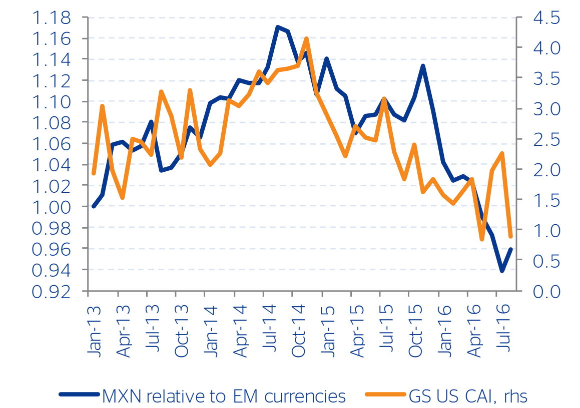
Chart 14
ISM Manufacturing & MXN (Index & pesos per dollar, inverted scale)



Source: BBVA Research / Bloomberg
* > / < 50 means expansion / contraction

All in all, the slide in the US economy broadly resembles the MXN's plunge

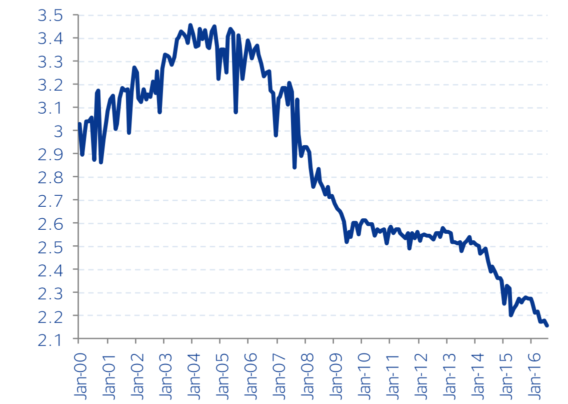
Chart 15
MXN relative to EM currencies* & Goldman Sachs US Current Activity Indicator (Jan 2013 = 1 & index)



Source: BBVA Research / Bloomberg
* Ratio > 1 / < 1 for MXN absolute outperformance / underperformance & increasing / declining trend for MXN relative outperformance / underperformance. Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.

Oil production keeps falling

Chart 16
Mexican oil production (Millions of barrels per day)

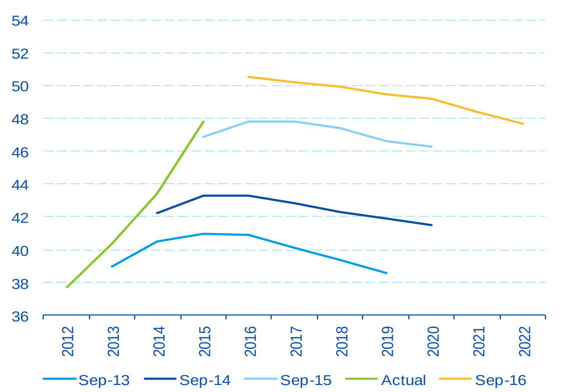


Source: BBVA Research / Energy Information System with PEMEX's data

ii) Weakening economic fundamentals, particularly related to the external balance. The major slide in oil prices has taken a toll on both public finances and the external balance. With respect to the first, one can sum up what has happened in one phrase: tragedy strikes us when we least expect it. The energy reform was supposed to bring major investments to the oil sector within a few years that would not only boost oil production but also lead to a higher potential rate of growth for the Mexican economy. Although we still think the reform is likely to bring at least some of the expected benefits to the Mexican economy, tragedy struck and public finances have taken a hit from the combination of lower oil prices and falling oil production (see Chart 16). Before the major slide in oil prices, oil represented around one third of fiscal revenues and it was the country´s second source of foreign exchange. That said, in our opinion the government should probably have taken a more conservative approach to public finances and should not have relied on something that was uncertain. Hope is an unsafe friend and economic growth forecasts have been largely biased on the optimistic side over the past few years. Making plans based on optimistic assumptions can lead to disappointment. In our opinion, the government should not have counted on rapid growth in the way it did. As a result, the Mexican debt-to-GDP ratio has climbed higher by around 10% of GDP over the last three years on a combination of falling oil production, lower oil prices and lower-than-expected economic growth (see Chart 17). On the bright side, the government is projecting a primary surplus for 2017 (see Chart 18). It is key to reach that goal. All in all, although debt-to-GDP remains at moderate levels, it has recently increased at a very rapid pace and the backdrop for public finances still seems challenging in a context of low growth, falling oil production (the government expects production to fall further to 1.9 million barrels per day in 2017) and likely low-for-long oil prices.

The Mexican debt-to-GDP ratio has climbed higher by around 10% of GDP over the last three years

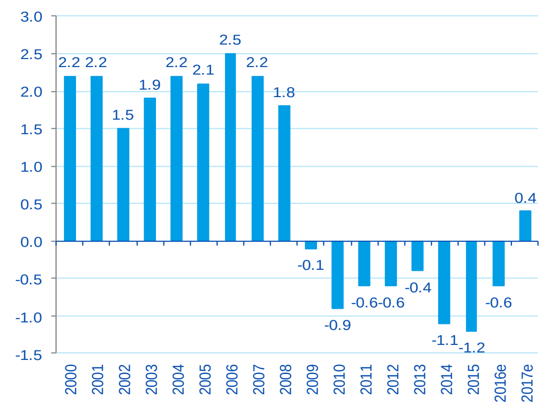
Chart 17
Observed and estimated debt-to-GDP ratio (PSBR; estimated by SHCP)



Source: BBVA Research / SHCP

Government's goal to reach a 0.4% of GDP primary surplus should help stabilise the debt-to-GDP ratio

Chart 18
Primary fiscal balance (% of GDP)



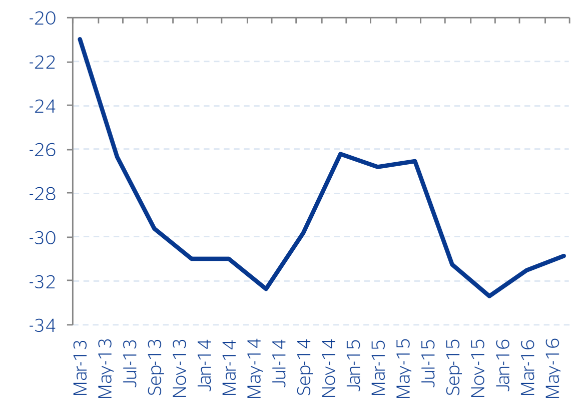
Source: BBVA Research / SHCP

As regards the external balance, the same factors affecting public finances together with a weak external demand –mainly due to weakness in the US manufacturing sector– have resulted in a widening of the current account deficit (see Chart 19). The aftermath of the oil price slide implies a structural change for Mexico's external balance, at least until oil production begins to show the positive impact of the energy reform, which is unlikely to happen in the short-term. In fact, Mexico's oil balance has been in deficit since 4Q14 and is likely to remain in deficit through 2017, especially considering the government's estimate of a further 200K barrels per day drop in oil production and the corresponding -98K change in oil exports. The short-term outlook is undoubtedly challenging. The financing of the current account deficit has become more challenging and that has been a drag on the MXN (see Chart 20). Back in 2013 this deficit was more than financed by net FDI; whereas now less than 69% is[3]. The structural changes previously described suggest continued weakness for the current account balance at least until 2017, which limits any potential upside in that time horizon. Besides, portfolio inflows have dried up in 2016 (see Chart 21) and the context for attracting additional inflows is likely to remain challenging in the foreseeable future. That said, the third factor might provide a boost to the peso by year-end if current probabilities (implied by US election surveys and calculated by the likes of Fivethirtyeight) hold on US Election Day on 8 November.

3: Considering the four-quarter average of the Broad Balance of Payments as in Chart 18, i.e., of the sum of the current account and net FDI.

The current account deficit has widened…

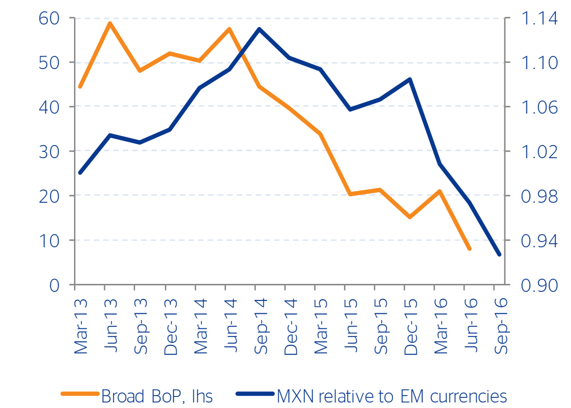
Chart 19
Current account balance (4-quarter sum, USD billion)



Source: BBVA Research / Banxico

… And its financing has become more challenging

Chart 20
Broad Balance of Payments & MXN relative to EM currencies* (4-quarter sum of the current account, net FDI and portfolio flows, USD billion & 1Q13 2013 = 1)

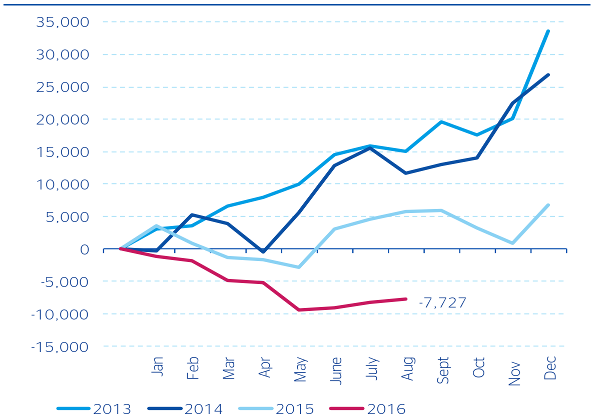


Source: BBVA Research / Bloomberg and Banxico
* Ratio > 1 / < 1 for MXN absolute outperformance / underperformance & increasing / declining trend for MXN relative outperformance / underperformance. Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.

iii) The Trump factor. The third factor that seems to be affecting the MXN is the possibility of a Trump presidency. Hillary Clinton is leading Trump in opinion polls, though her edge has narrowed (see Chart 22). As if the backdrop for the MXN were not already challenging enough, the potential negative implications for Mexico of a Trump presidency seem to be an additional factor contributing to the MXN's weakness and underperformance. Although whether Mr. Trump will ever turn his rhetoric on Mexico into action is uncertain, the potential consequences are not by any means small and the markets seem to have taken note. What if Trump is elected? On the one side, he has insisted on building a wall on the border with Mexico and has pledged that Mexico is going to pay for it, arguing that if Mexico refuses to do so, he will impose taxes on remittances sent to Mexico (which are key to avoiding a further widening of the current account deficit). On the other side, although the US President cannot renegotiate NAFTA (it is a prerogative of Congress) he can withdraw from it with a six month notice. It seems that the stakes of the US election for Mexico have never been higher. Considering that, it is unsurprising that the peso seems to fare better whenever Hillary Clinton's lead is widening and seems to weaken whenever Mr. Trump narrows Clinton's lead (see Chart 23). Also, it is reasonable to consider that the MXN will increasingly be used as a hedge against a Trump victory as Election Day approaches.

Foreign holdings of local currency debt have declined in 2016

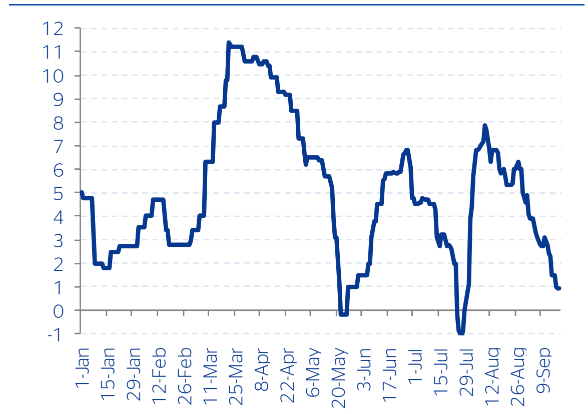
Chart 21
Net change in foreign holdings of local currency debt (CETES (treasury certificates) + M-Bonds, cumulative figures for each year, USD)



Source: BBVA Research / Banxico

Hillary Clinton is leading Trump in opinion polls, though her edge has narrowed

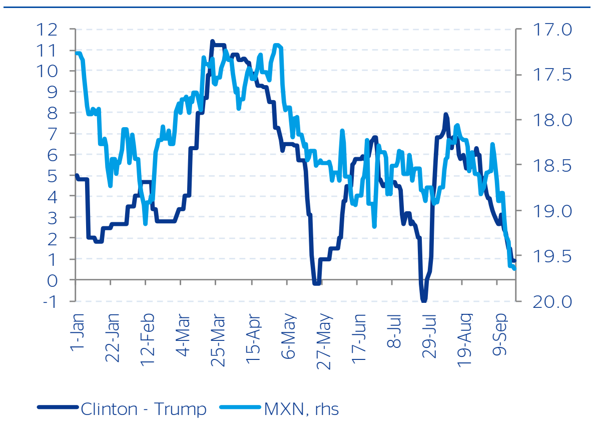
Chart 22
2016: US Election Survey Results (Clinton minus Trump preferences*)



Source: BBVA Research / Real Clear Politics
* A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

The MXN seems to fare better when surveys suggest that Clinton's lead is widening, and the converse also holds true

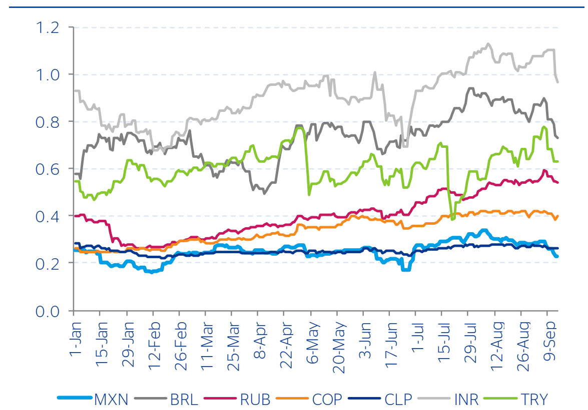
Chart 23
2016: US Election Survey Results & MXN (Clinton minus Trump preferences*)



Source: BBVA Research / Real Clear Politics and Bloomberg
* A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

The risk-adjusted carry trade remains low in both absolute and relative terms

Chart 24
Risk-adjusted short-term rates carry trade (Adjusted for ER volatility)



Source: BBVA Research / Bloomberg

The MXN's rough ride may well calm somewhat after the US election, but the external balance points to continued underperformance in 2017

Bottom line: a Clinton victory on 8 November may well calm the MXN's rough ride and provide a boost to its value by year-end. However, and albeit that result might ease pressures on the peso, once that risk fades away, reality would still be there and the challenging backdrop of a widening current account deficit and potentially increasing difficulties to finance it – portfolio inflows are now needed – are likely to continue to weigh on the MXN in 2017. Therefore, a significant and permanent reversal of recent MXN underperformance might prove difficult. Indeed, we expect the MXN underperformance to continue at least for another year.

Over time, assuming Clinton wins the election, the peso can appreciate if: i) the government pursues an effective fiscal consolidation path and deals with the financial difficulties in PEMEX; and ii) the US manufacturing sector recovers, fostering Mexican exports. These factors would contribute to narrowing the current account deficit.

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Against such a challenging backdrop, monetary policy flexibility is likely to stay low in the foreseeable future. Before the MXN's significant additional depreciation seen over the last few trading days, our thinking was that Banxico should at least match the Fed's hikes in coming months. The possibility of a narrowing interest rate spread in the short term was out of the question. Albeit it is true higher policy rates are unlikely to attract flows from foreigners into CETES and/or M-Bonds (the more so considering that foreigners already own a high share and given Mexican long-term rates' correlation with US rates, the Fed's cycle of rate hikes probably implies higher local rates going forward), Banxico cannot risk significant outflows from the bond market in a context in which the risk-adjusted carry trade remains low in both absolute and relative terms (see Chart 24). In our opinion, this risk has increased further over the past two weeks. Therefore, we are changing our call on monetary policy. We now expect Banxico to widen the interest rate spread by 50 basis points (bps) on 29 September. That is, if the Fed holds rates on 21 September, Banxico will increase its policy rate by 50 bps, whereas if the Fed hikes rates (by 25 bps), Banxico will raise its rate by 75 bps.

We expect this even though we do not expect any inflationary pressures on the horizon – with very limited FX pass-through and no second-round effects –, we anticipate weak economic growth, and considering that from the perspective of a larger current account deficit, a real depreciation of the peso may be desirable to drive a decline in imports. However, the risk of abrupt portfolio outflows that can bring disorderly adjustments in the balance of payments outweighs all other considerations. Besides, the main factor behind the additional spike in pressures seen over the past two weeks seems to be related to the US elections, and Banxico will not meet again before US Election Day: its following meeting will take place on 17 November.