

Economic Watch

The US elections & the MXN: “It ain’t over till it’s over”

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- **Trump has made meaningful gains since the FBI reopened the investigation on Clinton’s emails**
- **“It’s déjà vu all over again”:** anxiety amid the possible outcome of the US election is hard-hitting the MXN again
- **Next Tuesday the MXN will either see a brighter future or it will not be “what it used to be”. We anticipate a dichotomous and asymmetric scenario: MXN appreciation with a Clinton win but a more significant depreciation with a Trump victory**
- **What’s next for the MXN after the US elections? What to expect after picking the low-hanging fruit? What needs to be done?**

Trump’s odds of winning the election have almost doubled since the FBI reopened the investigation on Clinton’s emails

As we explained in two previous documents (see “Our take on the MXN”, September 19, 2016, and “The aftermath of the first US presidential debate: a tipping point for the MXN?”, October 6, 2016), the Trump factor has been one of the main drivers of the MXN during 2016 and by far the biggest one over the last three months. Indeed, Trump’s odds of winning the presidency are behind every shift in the MXN (ie, every episode of a spiking or easing in pressures on the MXN) seen since early August. Whenever Trump closes in on Clinton in election polls, the MXN takes a hit as the exchange rate (ER) increasingly prices in the risk (for the MXN and the Mexican economy) of a possible Trump presidency.

On September 26, the date of the first presidential debate, Clinton’s probability of winning¹ the election had reached a recent low at that time of 54.8% whereas by the day of the second debate (Oct 9) FiveThirtyEight forecasts’ were giving Clinton an 81.5% chance of winning (see Chart 3). In short, she made meaningful gains after the first presidential debate. By contrast, both the second (on Oct 9) and third (on Oct 19) debates were relatively uneventful. A significant turning point in the chance of winning was not seen following these debates, and if anything, Hillary Clinton widened her lead just slightly. We argued in the aftermath of the first debate that it likely represented a turning point for the MXN. And in fact it did and it was clear until the FBI announced on October 28 that it had decided to reopen the investigation on Clinton’s emails. But there continue to be twists and turns along the way.

What happened after that announcement? Trump has been closing in on Clinton since her email investigation was reopened. In fact, Trump’s chances of winning the election have almost doubled since October 28 according the polls-only model of FiveThirtyEight. That explains why the FBI’s decision is already labelled as an

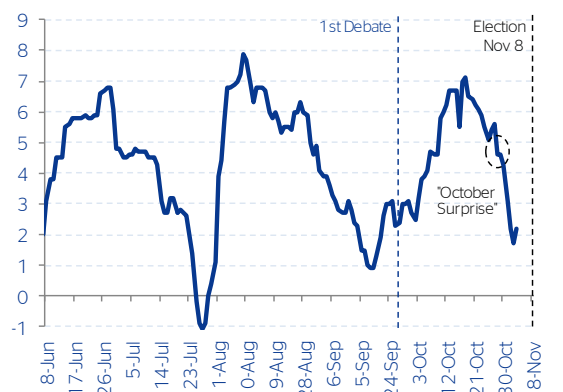
¹ See http://projects.fivethirtyeight.com/2016-election-forecast/?ex_cid=rrpromo

“October surprise” ie, it is a last-minute news event that can cause a shift in public opinion. Indeed, as Chart 1 shows, the race between Clinton and Trump appears to be getting closer with just four days left before the election. An average of polls² shows that Clinton is now just 1.7 percentage points (pp) ahead of Trump (as of Nov 4). More importantly, according to FiveThirtyEight Clinton’s chance of winning has dropped 17.2 pp (from 81.5 to 64.3%) since October 28 (see Chart 3).

It can be argued that the trend in preferences and implied chances of winning should still not be as worrisome for Clinton (and the MXN!) if we consider that she still has a 2 out of 3 chance of winning. However, a 64.3% chance is not a sure thing and the race has become more uncertain. Reinforcing that view we can consider, as Nate Silver of FiveThirtyEight explains, that although Hillary Clinton is holding on to leads in her “firewall” states³, which are enough to win the Electoral College, “Clinton’s leads are narrower than they were a few weeks ago, and any further tightening — or a modest polling error in Trump’s favor — could put her win in jeopardy”⁴. To be even clearer, Hillary Clinton does not need to win any of the other competitive states⁵ in the race but needs to win her “firewall” states. Besides, if she can manage to win any of the competitive states that seem to be up for grabs (Nevada, North Carolina and Florida) the election will tilt more comfortably on her side ie, her margin for error is larger than Trump’s. Thus, the electoral map still seems much more challenging for Trump and Hillary Clinton is still in a much better position to win the election. For Trump to win he has to win all the states where he is leading (including those where the race is pretty close), and he would still need to win at least one of Clinton’s “firewall” states with a large number of electoral votes (states in which Clinton is ahead with a relatively safe margin). That being said, as Nate Silver argues, “there’s a lot of disagreement in the polls, which speaks to the uncertainty in the race”: so buckle up and hold on tight.

Clinton’s lead has markedly narrowed since the “October Surprise”...

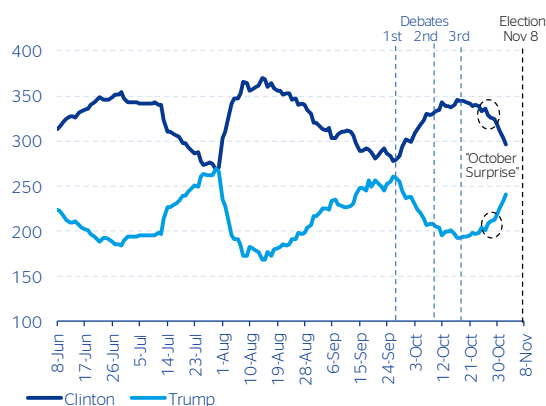
Chart 1
US Election Polls: Popular Vote*
(Clinton minus Trump preferences*)



Source: BBVA Research / Real Clear Politics / Bloomberg
 * Average of all polls calculated by Real Clear Politics. A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

... as a result, Clinton’s lead in expected electoral votes has also become slimmer...

Chart 2
US Election: Electoral Votes*
(Polls-only forecast*, number)

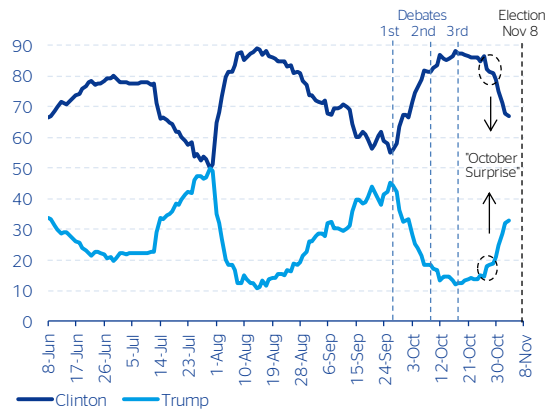


Source: BBVA Research / FiveThirtyEight / Bloomberg
 * What polls alone tell 538 about Nov.8 according to its model

² Calculated by Real Clear Politics
³ Maine, Minnesota, Virginia, Wisconsin, Michigan, New Hampshire, Pennsylvania and Colorado.
⁴ See FiveThirtyEight’s Election Update: The How-Full-Is-This-Glass Election.
⁵ Nevada, North Carolina, Florida, Ohio, Iowa, Arizona, Georgia and Utah.

... which explains the decline in the implied probability of a Clinton win

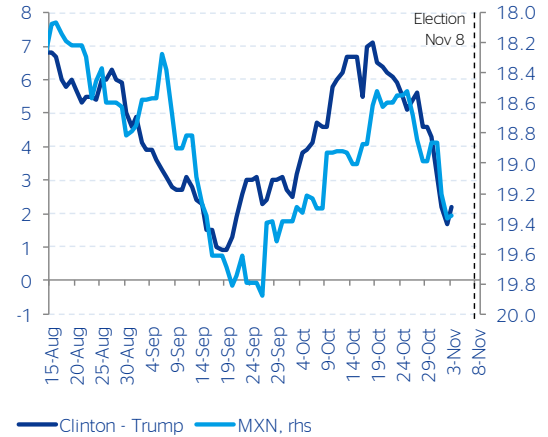
Chart 3
US Election: Chance of winning* (Polls-only forecast*, %)



Source: BBVA Research / FiveThirtyEight / Bloomberg
* What polls alone tell 538 about Nov.8 according to its model

Trump's improved odds have weighed heavily on the MXN

Chart 4
US Election Polls* & MXN (Clinton minus Trump preferences* & pesos per dollar, inverted scale)



Source: BBVA Research / Real Clear Politics / Bloomberg
* Average of all polls calculated by Real Clear Politics. A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

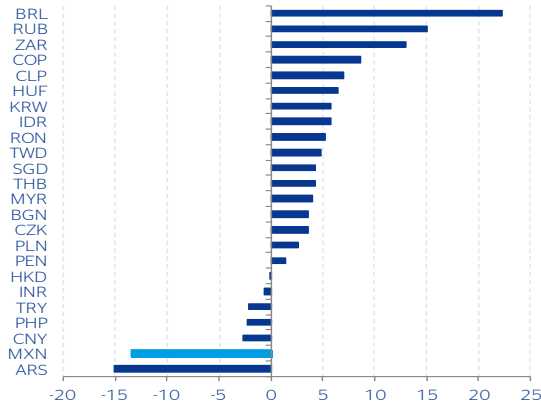
“It’s déjà vu all over again”: anxiety amid the possible outcome of the US election is hitting the MXN again

As we have said, the MXN has very closely resembled Trump’s odds over the past three months (see Chart 4). This time is no different: Trump’s improving odds have weighed heavily on the MXN. Markets are repricing what they thought was an almost sure outcome only two weeks ago to allow for the possibility of a different one. In fact, it seems that the relation between Trump’s implied probability of winning and the MXN has become tighter as we approach Election Day. The peso is down about 4.5% versus the USD since October 28. From year-end 2015 to September 26 (the date of the first presidential debate), the MXN weakened sharply and was the second-worst performing EM currency (see Chart 5). The first presidential debate marked a turning point for the MXN (see Chart 6), and in the aftermath the peso’s performance shifted from second-worst to best (see Charts 5 and 6). However, it is now again among the worst performing EM currencies following the FBI’s announcement (ie, since October 28; see Chart 7).

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 easily see these twists and turns for the MXN over the last few weeks (see Chart 8). It is obvious that the MXN has outperformed / underperformed in line with Clinton’s / Trump’s odds. 2016’s sharp underperformance bottomed out on 26 September, the date of the first US presidential debate. The peso then outperformed other EM currencies until Trump’s odds began to improve after the FBI announcement. Summing up, although it is true that, in general, risk assets, and especially EM FX, have been positively affected when the implied probability of a Clinton win increases and negatively affected when a Trump win has become more likely, the MXN stands out as the most affected by either turn of events.

Until the date of the first presidential debate, the MXN was the second-worst performing EM currency...

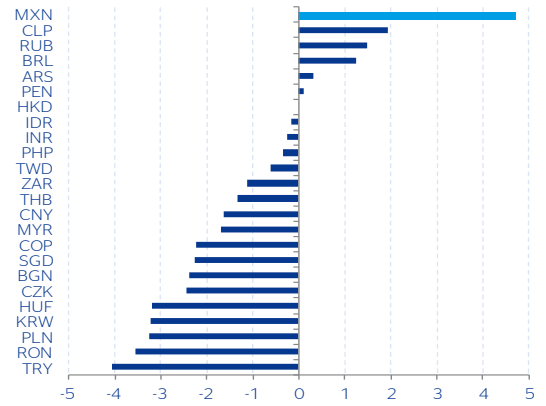
Chart 5
EM currencies' performance from year-end 2015 to September 26
(+ / - for appreciation / depreciation of EM currencies versus the USD; year to date)



Source: BBVA Research / Real Clear Politics / Bloomberg
* Average of all polls calculated by Real Clear Politics. A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

... Clinton's improved odds in the aftermath of the first debate resulted in a turning point of the MXN...

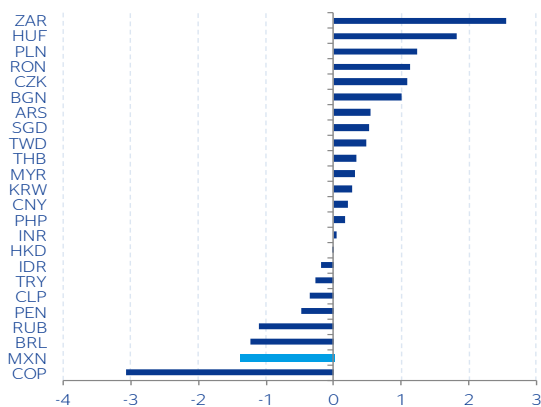
Chart 6
EM currencies' performance from September 26 to October 28
(+ / - for appreciation / depreciation of EM currencies versus the USD; year to date)



Source: BBVA Research / Real Clear Politics / Bloomberg
* Average of all polls calculated by Real Clear Politics. A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

... the "October surprise" represented another twist and turn for the MXN along the way of the US elections

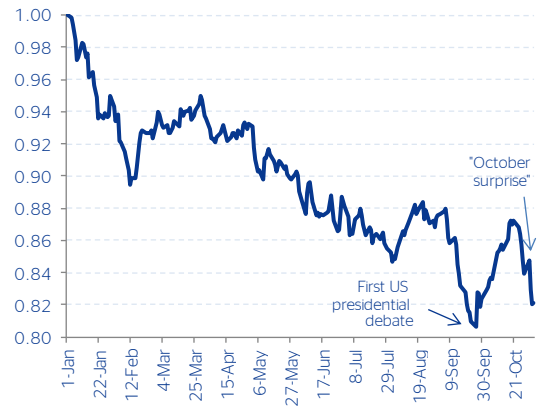
Chart 7
EM currencies' performance from October 28 to date
(+ / - for appreciation / depreciation of EM currencies versus the USD; year to date)



Source: BBVA Research / Real Clear Politics / Bloomberg
* Average of all polls calculated by Real Clear Politics. A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

Trump's odds of winning are behind MXN's recent turning points

Chart 8
MXN relative to EM currencies*, 2016
(Jan 1, 2016 = 1)

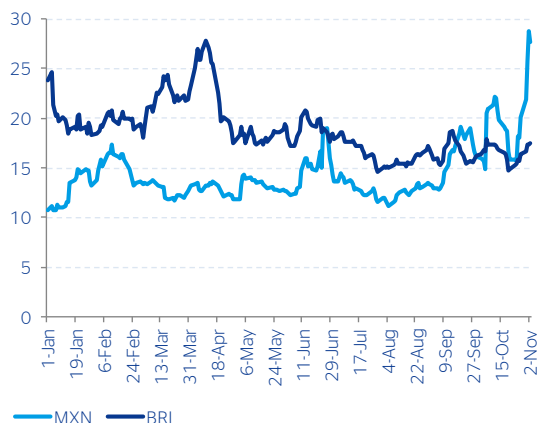


Source: BBVA Research / Bloomberg
* Ratio > 1 / < 1 for MXN absolute outperformance / underperformance & increasing / declining trend for MXN relative outperformance / underperformance. Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN

That can be seen in the recent evolution of certain risk measures. For example, MXN's 1-month implied volatility, which typically is lower than that of currencies associated with higher carry-trade, has sky rocketed (see Chart 9). Besides, the 1-month implied volatility, which is only above longer-term measures during risk-episodes, is now significantly above the 1-year equivalent metric (see Chart 10). A similar spike in risk can be seen in the latest readings of the 25D risk reversal⁶. Indeed, as Chart 10 shows, the MXN risk reversal has spiked, reaching levels significantly above the BRL metric and the short-term risk reversals are above the 1-year metric (see Chart 11). In short, the peso is clearly underperforming when the implied probability of a Trump win rises. All these metrics suggest that as the election approaches the market has increasingly priced in a potential Trump presidency. But this can change drastically if Hillary Clinton ends up winning the election, as current implied probability suggests, there would be a significant reversion in the spike of both the MXN and its related risk-measures.

MXN's 1m implied volatility is sky rocketing...

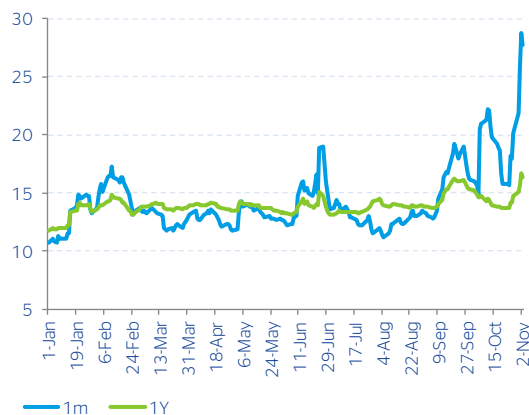
Chart 9
1m implied volatility: MXN vs BRL
(%, annualized)



Source: BBVA Research / Bloomberg

... and the increase has been so large that counter-intuitively is significantly above the 1Y implied volatility

Chart 10
MXN 1m vs 1Y implied volatility
(Clinton minus Trump preferences* & pesos per dollar, inverted scale)

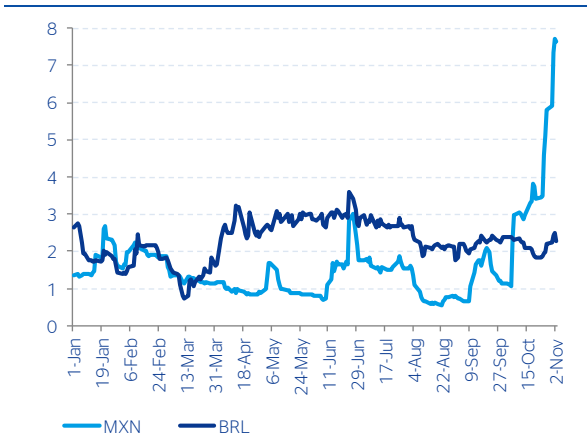


Source: BBVA Research / Real Clear Politics / Bloomberg
* Average of all polls calculated by Real Clear Politics. A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

⁶ The risk reversal is a measure of the skew in the demand for out-the-money options at high strikes compared to low strikes and can be interpreted as the market view of the most likely direction of the spot movement over the next maturity date. It is defined as the implied volatility for Call Options minus the implied volatility for Put Options on the base currency with the same date.

The MXN 25D risk reversal is now way above the BRL similar metric...

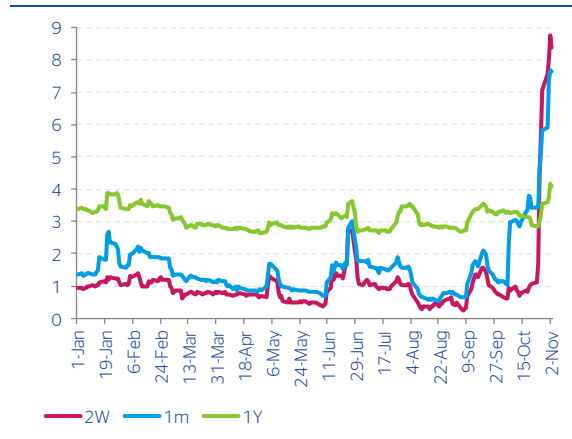
Chart 11
25D risk reversals: MXN vs BRL
(%, annualized)



Source: BBVA Research / Bloomberg

... and MXN's short-term measures are atypically above the longer-term ones

Chart 12
25D risk reversals: MXN vs BRL
(%, annualized)



Source: BBVA Research / Real Clear Politics / Bloomberg
* Average of all polls calculated by Real Clear Politics. A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

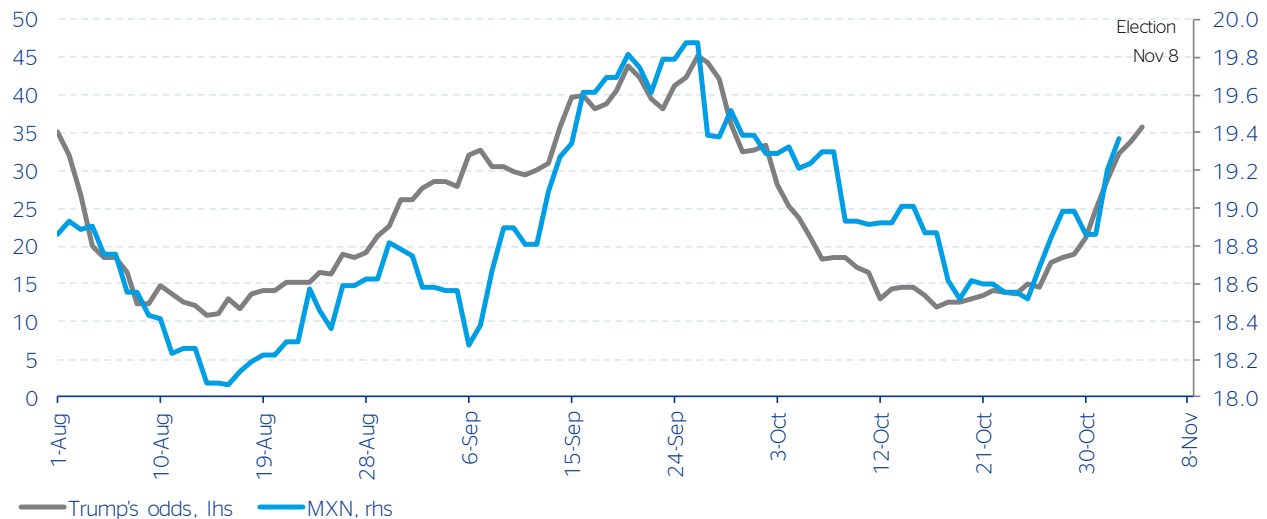
Next Tuesday the MXN will either see a brighter future or it will not be “what it used to be”. We anticipate a dichotomous and asymmetric scenario: MXN appreciation with a Clinton win but a more significant depreciation with a Trump victory

This is it. The US election is around the corner. The stakes could not be higher for the MXN. As we have showed, the MXN has resembled Trump’s odds of winning the US election over the past three months. Thus, the near-term fate of the MXN lies in the outcome of the US election. The MXN response to this outcome is likely to be asymmetric, with more significant weakening expected in a Trump compared to the strengthening in a Clinton victory. As Chart 13 shows, the ER had reached levels around 18.5ppd before the “October surprise” gave a significant boost to Trump’s odds of winning the election. We estimate that a market sell-off in response to a victory for Trump next Tuesday could push the ER to around 22ppd. Likely rhetoric after the outcome of the election is known could drive the ER even higher, conditional on the expected repercussions of possible actions. By contrast, the effect of a Clinton victory on the MXN would likely be lower but nonetheless sizable. As can be seen in Chart 13, when Trump’s odds of winning reached a recent low in late October, the ER dropped to as low as 18.5ppd and this level likely did not fully price in a Clinton victory in part as a result of the “Brexit feeling” (ie, the outcome was neither expected by polls nor priced in by markets on the date the referendum took place) but also driven by the potential asymmetric outcomes after the election: even a small probability of a Trump win should be priced in the MXN (i.e. a low probability event multiplied by a very large adverse outcome). In this sense, a movement towards at least that level following a Clinton victory would represent an appreciation of around 3.5%, but a further strengthening to even –slightly– lower levels seems likely. We think that an additional 2% appreciation is possible. Summing up, under a scenario of a Trump victory a larger than 10% weakening of the MXN is likely, whereas under a Clinton win, we would expect a MXN strengthening of between 3.5 and 6% to levels between 17.9 and 18.4ppd.

A brighter future or “not what it used to be” for the MXN?

Chart 13

Trump's chance of winning* & MXN
(Polls-only forecast*, % & ppd)



Source: BBVA Research / FiveThirtyEight / Bloomberg

* What polls alone tell 538 about Nov.8 according to its model

What's next for the MXN after the US elections? What to expect after picking the low-hanging fruit? What needs to be done?

On November 8, a Clinton win (ie, the better of the two possible outcomes for Mexico) would no doubt remove a big cloud from the horizon for the MXN. That scenario, still the most likely, would likely bring the ER down to levels around 17.9-18.4ppd. Under that scenario, the MXN is likely to remain undervalued (ie, relatively weak) in the foreseeable future at least until the US growth pace picks up and the recent weakening of fundamentals is gradually reverted. That is, even if a possible outcome next Tuesday will allow the MXN to outperform other EM currencies in the near-term, we do not expect a further strengthening to levels closer to our estimated equilibrium ER (ie, a range between 16.5 and 17.3ppd). We expect the MXN to average levels in the high 17s to low 18s during 2017.

Indeed, we do not foresee any strong drivers for the MXN in either direction in the next few quarters. A significant strengthening is unlikely under a still challenging scenario going forward in a context of US monetary policy normalization, a reduced pace of inflows into emerging markets and weaker fiscal and external accounts (compared to recent years). Likewise, a significant weakening also seems unlikely as the prospect of a resumption of tightening by the Fed will not take markets by surprise this time around in contrast to the two previous episodes in which it changed its policy. The current situation is different from 2013 when the prospect of slowing bond purchases by the Fed took a toll on risk assets. It is also different from the last interest hike (in December 2015), when Fed's decision increased market unease, at a time when concerns over China's economy were on the rise. In fact, EM currencies were hit only after angst over China's outlook rose the following month (January 2016). In this sense, anxiety about a Fed hike seems to have eased somewhat. More to the point, the certainty of a gradual approach to policy normalization might be even welcome. We are not arguing that policy normalization by the Fed will support risk-assets, what we think is that the resumption of policy tightening could have a lesser impact on them. In addition, the MXN in particular has moved a lot over the

past two years and it is well undervalued. Moreover, Banxico has raised its policy rate 150bp during 2016 and will likely at least match Fed's hikes in the foreseeable future.

What needs to be done? Going forward, the key is to improve fundamentals. The government should not relax if the outcome of the US election is favourable for Mexico, on the contrary, they should not forget that one should hope for the best but prepare for the worst. There will always be a new risk on the horizon. In this sense, improving the fiscal outlook is of the utmost importance. More to the point, achieving this goal does not depend on external factors.

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