Economic Analysis

Mexico is not out of the woods yet, but things could go well

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The outlook has improved notably in the last two months

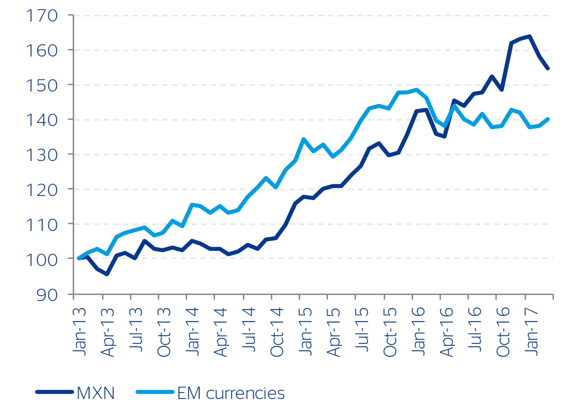
The challenge to Mexico's US-oriented economic model led the MXN to all time lows when a negative outcome was priced in

Taking January 2013 as a starting point, the Mexican peso's (MXN) outperformance began to shrink in 4Q14 and turned negative in May 2016 (see charts 1 & 2). As charts 1 and 2 show, 2016 was a tale of strengthening for most emerging market (EM) currencies but one of significant weakening for the MXN. Three factors seem to have driven that underperformance: i) reduced expectations of US growth; ii) weakening economic fundamentals, particularly related to the external and fiscal balances; and iii) the "Trump factor" (see "Our take on the MXN"). The third one has been the main driver since April 2016 (see "The aftermath of the first US presidential debate: a tipping point for the MXN?" and "The US elections & the MXN: "It ain't over till it's over").

The US election result put at risk the link between the US and Mexican economies, and thus, challenged Mexico's export-led and US-dependent economic model, which added to external sustainability concerns. Although our baseline scenario has been that economic rationality would end up prevailing – given that NAFTA is beneficial to both economies (see "What is the US trade deficit with Mexico really saying?"), the MXN has been pricing in a negative outcome as markets have remained focused on downside risks and what could go wrong. Perceived downside risks intensified in early January as the protectionist rhetoric of the US administration intensified and focused increasingly on NAFTA and particularly trade relations with Mexico. Understandably, markets priced-in a negative outcome for NAFTA.

Chart 1

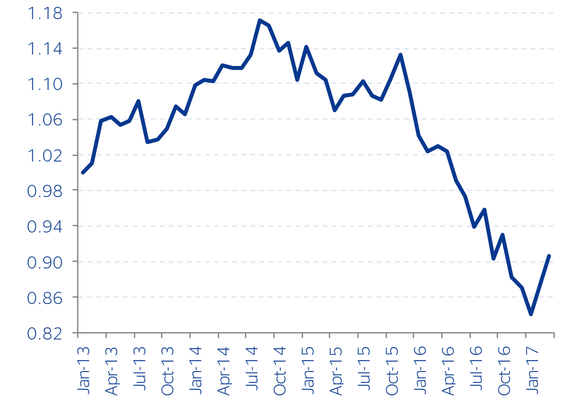
MXN relative to EM currencies*, 2013-2017
Jan 2013 = 100; + for depreciation versus USD



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

Chart 2

MXN relative to EM currencies*, 2013-2017
Jan 2013=1



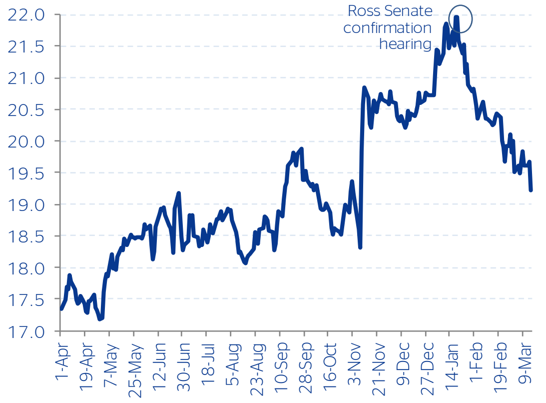
Source: BBVA Research / Bloomberg
*Ratio > 1 / < 1 for MXN absolute outperformance / underperformance & increasing / declining trend for MXN relative outperformance / underperformance. Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.

Peso hit by protectionist rhetoric and BAT risks. On top of the protectionist rhetoric came the expectation that US trade policy would be linked to fiscal policy, in particular to the corporate tax reform. Concerns related to a possible corporate tax reform increased when markets perceived that the one along the lines promoted by House Speaker Paul Ryan was gaining momentum. Under this reform, corporate taxes would shift from origin-based to destination based (i.e. point of sale) and would contain a border adjustment tax (BAT) which would essentially subsidize exports (by allowing deductions of costs for export goods) while raising the cost of imported goods (by disallowing the cost deduction of imported goods). The result, in our view, would likely be equivalent to a tariff on imports. The link between trade and fiscal policies is that the inclusion of the BAT in the latter would at the same time offset loss of revenue arising from a lower corporate tax rate (by taxing imports) and tend to reduce imports over time (as importers are worse off, firms are unlikely to be undisturbed by the imposition of a BAT). That is, if lower corporate taxes are partially financed through a BAT and/or higher tariffs, incentives for firms to relocate manufacturing production to the US could increase.

Shifting incentives potentially to a significant extent (by giving US producers a potential large edge) would likely lead to lower Mexican exports and investment in the manufacturing sector. The result could translate into a lower potential output for the Mexican economy and would lead to increased external sustainability concerns. Apparently those concerns reached a peak on the day of Wilbur Ross's senate confirmation hearing on 18 January and on the following day on the eve of Trump's inauguration (see charts 3 and 4).

Chart 3

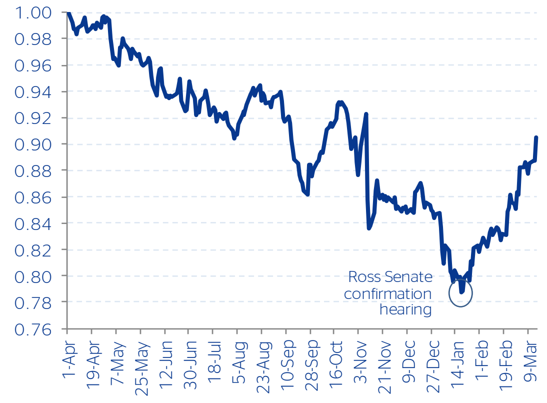
MXN, April 2016-2017
Exchange rate, ppd (pesos per dollar)



Source: BBVA Research / Bloomberg

Chart 4

MXN relative to EM currencies*, Apr 2016-2017
1 Apr. 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.

From what is likely to go wrong to what could go right

Over the past two months a more conciliatory tone from Trump's administration towards NAFTA and Mexico seems to have increased the probability of a more positive outcome for the Mexican economy. In our view, several factors have come into play. On one side, stakeholders in the US private sector have voiced their concerns about probable protectionist measures. On NAFTA, for example, important players in the food sector have opposed significant changes to NAFTA, while retailers are against the BAT. Not only lobbying efforts against the implementation of border taxes have begun but several senators have come out against them and the level of support within the Trump administration is unclear judging by the conflicting statements on the subject. On the other hand, within Trump's administration, pro-trade moderates like Gary Cohn (who leads the National Economic Council) seem to be gaining influence in recent weeks and have taken a more prominent role in discussions over the renegotiation of NAFTA[1]. It is also relevant that the administration seems to be focused on repealing Obamacare at this time, which has delayed both the US trade policy agenda and the corporate tax reform, giving some relief and breathing space to EM assets, particularly to the MXN.

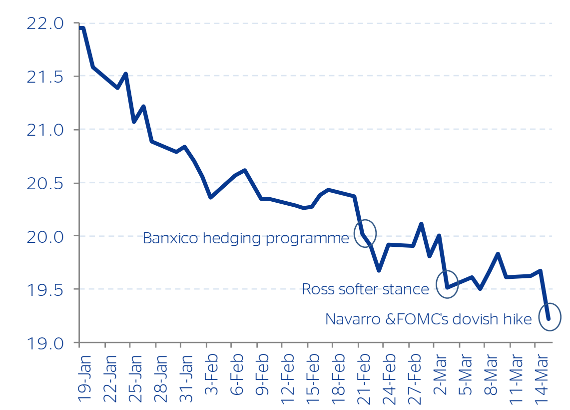
1: See "White House civil war breaks out over trade". Financial Times, 13 March 2017.

Overall, the situation seems to be less worrying than it was two months ago. Recent signs point to a more positive outcome. The probability of the negative one seems to be decreasing steadily as moderating signs accumulate. We continue to think that an outcome in which the bilateral industrial link is impaired is low, and we now think that it is lower than it was just two months ago. A scenario involving a permanent decline in exports and investment now seems unlikely, although we continue to believe that- due to uncertainty- this year we´ll see a contraction in investment.

Markets have taken notice. Since reaching an all time low on 19 January, the MXN is by far the best performing EM currency, with a 14.6% appreciation followed by a distant second, the South African Rand which has strengthened 6.4% over the same period. As charts 5 and 6 show, the MXN has strengthened steadily since overshooting to 22.0 ppd (pesos per dollar) as the market perception and focus has gradually shifted from what is likely to go wrong (i.e. a negative outcome was increasingly priced in) to what could go right (i.e. a lower probability of a negative outcome). As such, the exchange rate has declined from 22.0 to 19.2 ppd (see chart 5). Over this period, we can highlight two developments that have eased concerns: i) the MXN surged 2.4% on 3 March after Wilbur Ross signalled a softer stance[2] possibly implying that he was on the pragmatic side of the US administration; and ii) on 15 March after Peter Navarro (perceived as a less pragmatic, more protectionist figure of the US administration) said that he wanted the US, Canada and Mexico to form a trade “powerhouse”, boosting the MXN more than 1.0%. Later that day, a “dovish hike” by the Fed further strengthened the MXN. In addition, and although the main driver for the MXN continues to be related to US trade and fiscal policies, the MXN was also supported by the $20bn foreign exchange hedging programme announced by Banxico on 21 February.

Chart 5

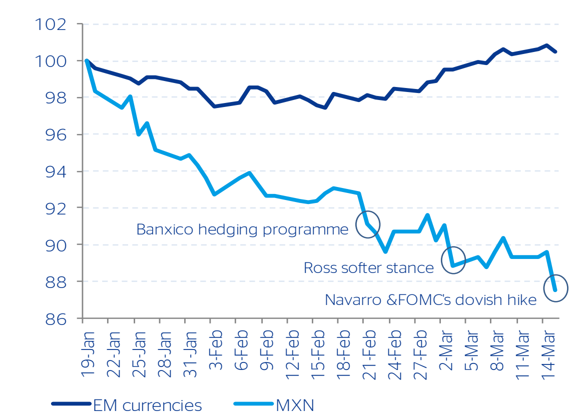
MXN, 19 January to date
Exchange rate, ppd



Source: BBVA Research / Bloomberg

Chart 6

MXN relative to EM currencies* since 19 Jan.
19 Jan. 2017 = 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.

2: By stating that the MXN would recover if a sensible NAFTA deal was reached

There are still two possible outcomes… but things are now more likely to go well

The peso would weaken sharply in the event of a negative outcome of NAFTA's renegotiation. An overshoot of the USD to levels close to 23.0 ppd would be possible in a negative scenario in which there is an overhaul of NAFTA, imposition by the US of high tariffs (which would mean a violation of WTO rules) and the bilateral industrial link is broken. In this scenario there would be tariff restrictions to trade and a 20% BAT would be approved by the US Congress. The impaired bilateral relation would translate into lower exports and investment, which would ultimately reduce growth potential. External sustainability concerns would jump. We think that the probability of this scenario has decreased to 20% and is likely to decrease further in the coming quarters.

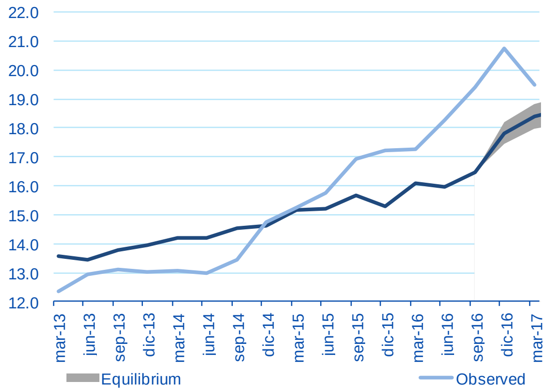
The peso would further strengthen in the event of a positive outcome of NAFTA's renegotiation. An undershoot of the USD to levels close or below 18.0ppd would be possible in a positive scenario in which the new NAFTA does not impair the trading relationship with the US, before returning to levels consistent with our estimated equilibrium ER (i.e. in a range around 18.0 and 18.5 ppd). We now think that the probability of this scenario has increased to 80%, but there are two possible scenarios within this positive outcome: one in which there are some tweaks in the US trade and fiscal policies (a combination of some trade restrictions and a BAT at a relatively low rate, possibly In the range of 5-10%) and one even more positive with no trade restrictions and no BAT[3]. In any case, even if with a positive outcome of NAFTA 2.0 and the US fiscal reform the MXN could strengthen to levels around our estimated equilibrium ER, this outcome will not materialize in 2017 as NAFTA renegotiation is likely to take much longer, given that is unlikely to begin before this summer and to conclude before the summer of 2018. Therefore, we estimate that ER levels of around 19.5 ppd are likely to continue for the remainder of the year, and we assign an 80% probability to this scenario. However, we have to take into account levels consistent with a negative scenario (i.e. 23.0 ppd), to which we now assign a 20% probability. As such, **considering the weighted average of the two most likely scenarios previously mentioned we get a number of 20.2ppd**. **That is, we now expect an ER of around 20.2 by year-end 2017.**

Beyond 2017, as risks fade away, the MXN could eventually price out current concerns that are still reflected in the current ER. Given that exports are more sensitive to demand than price, the possibility of a stronger pace of US growth would boost both exports and FDI, probably boosting the MXN. The level consistent with our estimated equilibrium ER[4] (i.e. in a range around 18.0 and 18.5 ppd) is somewhat higher than that which would likely have prevailed if the MXN had not priced in the possibility of an impaired trading relationship with the US. As explained in the first section, the "Trump factor" has been the main driver since April 2016. To obtain a number, we simulate an MXN path similar to that followed on average by the EM currencies in the JP Morgan Emerging Market Currency Index from 1 April 2016 to date (see chart 8).

3: We believe that the BAT would not end up having enough political support.
4: An estimate of where the ER would need to be to balance the current account given existing flows.

Chart 7

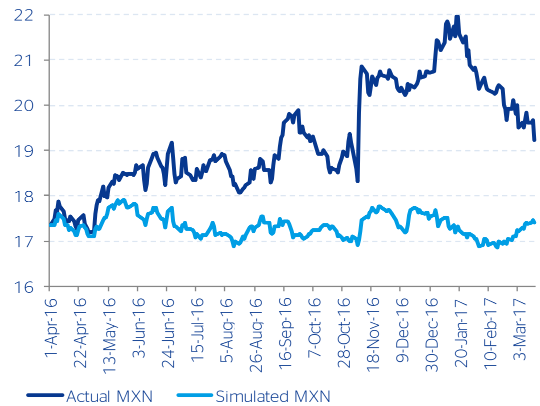
Actual MXN & Estimated equilibrium ER
Exchange rate, ppd



Source: BBVA Research / Bloomberg

Chart 8

Actual MXN vs. simulated MXN path replicating the average performance of EM currencies* since 1 Apr 16
Exchange rate, ppd



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

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