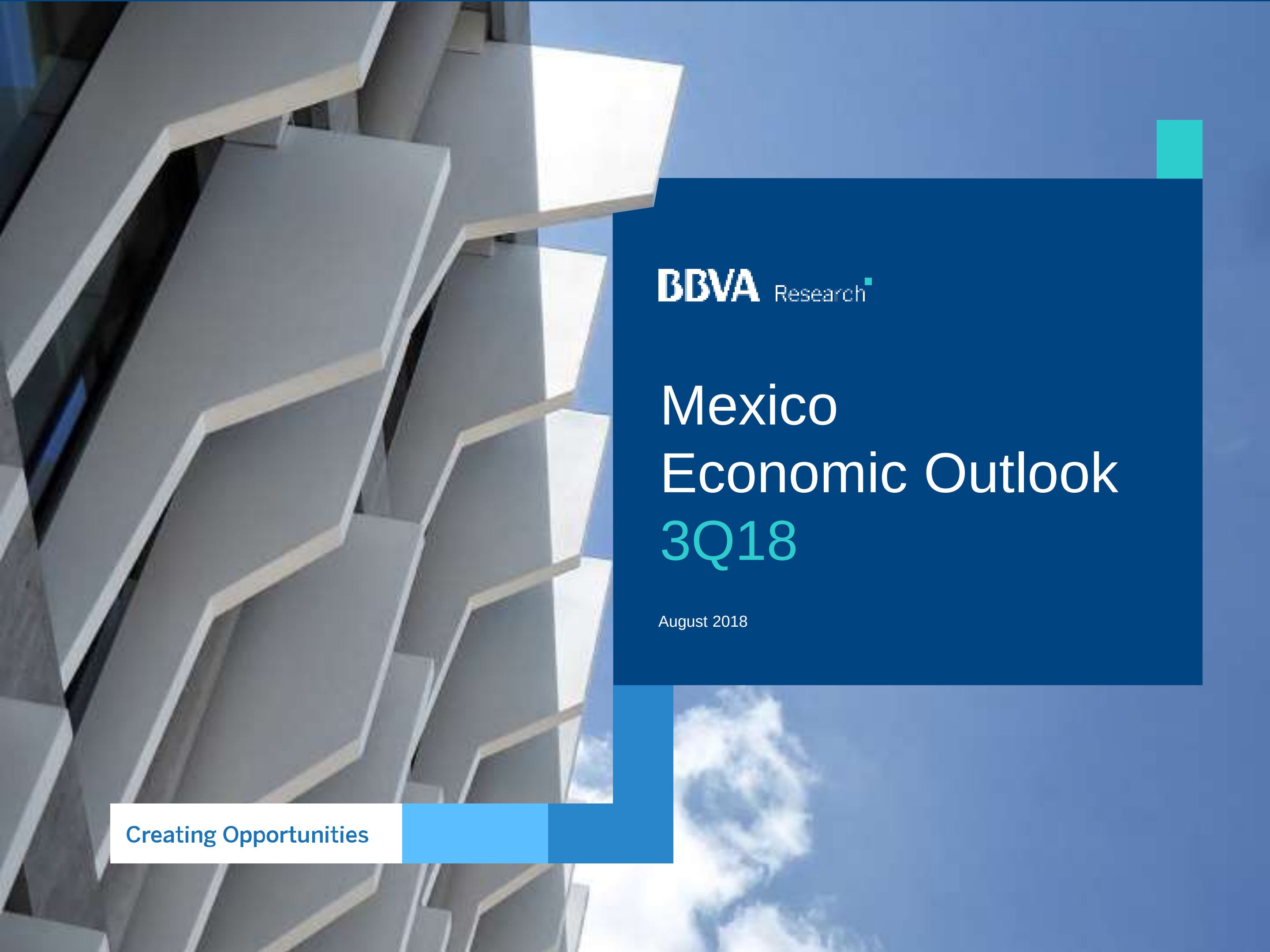


BBVA Research

Mexico Economic Outlook 3Q18

August 2018

Creating Opportunities

Key messages

- Global growth continues, but risks are intensifying.
- The economy grew 2.1% in the first half of the year.
  Downward bias in our growth forecast for 2018;
  no change for 2019
- Inflation will be slightly above 4.0% at the end of the year; we do not expect additional interest rate adjustments for the rest of the year.
- Slight deterioration of fiscal and external accounts in the first half of 2018.
- Trade tensions are the main factor behind the changes in financial variables. The main short-term risk is a possible 25% tariff on automobiles

01

International context

Global growth continues, but risks are intensifying

01

The pace of global expansion is being maintained, but is less synchronised

Growth is strong in the US due to the fiscal stimulus and stable in China, but is declining in Europe

02

Increased protectionism

Its impact on growth is limited for the time being, but it could be greater if the measures under discussion were to be implemented

03

Increase in the price of oil

Higher inflation and drag on growth in oil-importing countries

04

Monetary standardisation at different rates between the Fed and the ECB

Strengthening of the dollar and tightening of global financial conditions

05

More volatility in emerging markets

Increased tensions over the rising cost of financing and the threats of the trade war

06

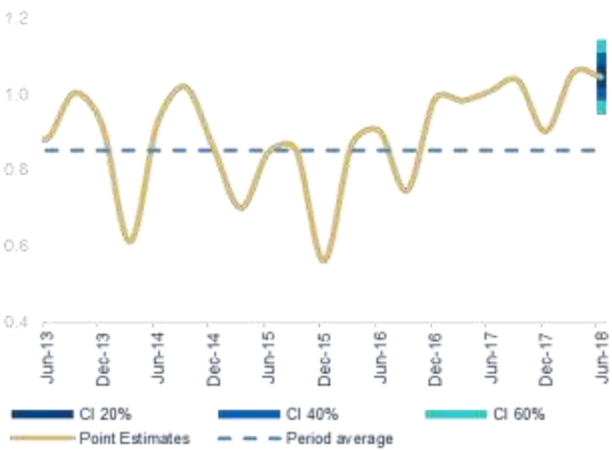
Global risks are intensifying

With a trade war come greater risks in emerging economies and in Europe

Robust global economy despite growing uncertainty

World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)



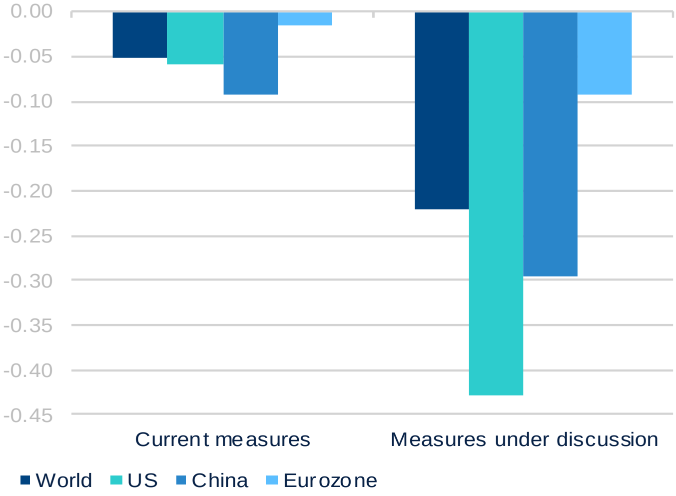
- Global growth continues, supported by private consumption and investment, but with growing differences by region
- World trade remains strong despite losing some momentum after the strength displayed earlier this year, and does not yet reflect increased protectionism
- Confidence indicators show some moderation, but remain at high levels

Source: BBVA Research

The tariff measures approved have a limited effect, one that would be much greater if they included those being discussed (autos)

Effect on GDP growth of US tariff increases and the response by other countries

(2018-19, pp)

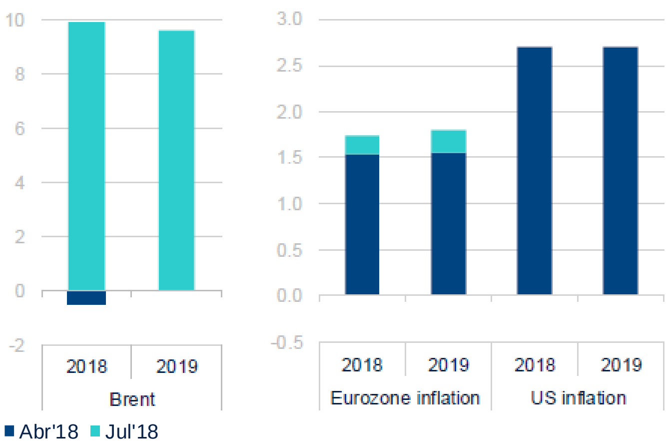


Measures announced: tariff increase to 25% on steel, 10% on aluminium and 25% on Chinese imports for a value of US$50 billion
Measures under discussion: tariff increases up to 20% on cars and Chinese imports for a value of US$200 billion
Source: BBVA Research

- The tariff increases approved by the US would have a limited direct impact. But the indirect effects, via economic confidence and financial channel, could be felt in 2H18
- With escalating protectionism, the negative effect on growth would be significant in the US.
- The growth of global GDP could be reduced by around 0.2 pp through the trade channel alone

The rise in oil prices will push inflation upwards and could weigh down growth

Upward revision of the price of oil and inflation
(%)



- The increase is due to reduced supply, and the price will remain relatively stable in 2018 and 2019
- In the US, the increase in oil prices will not prompt a significant increase in inflation.
- The exit strategy of the Fed and the ECB is reinforced

Source: BBVA Research

The strength of the US dollar and higher interest rates are causing an adjustment in emerging markets, an effect which is greater in the most vulnerable ones

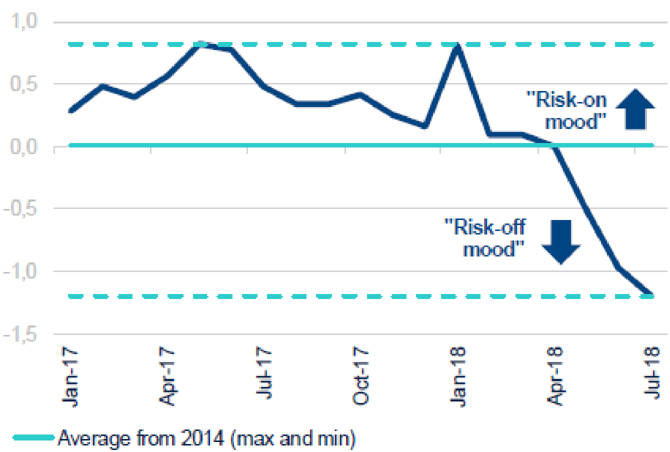
EUR-USD exchange rate and BBVA index of financial tensions in emerging markets

- The most vulnerable countries are those with the greatest trade deficits and thus the greatest need of external financing
- Shift towards a tightening of monetary policy in emerging countries to avoid further depreciation of their currencies
- The increase in financial tensions also reflects the intensification of the trade dispute

Source: BBVA Research based on Bloomberg

Protectionism and political factors lead to a growing risk aversion

Risk appetite/aversion indicator

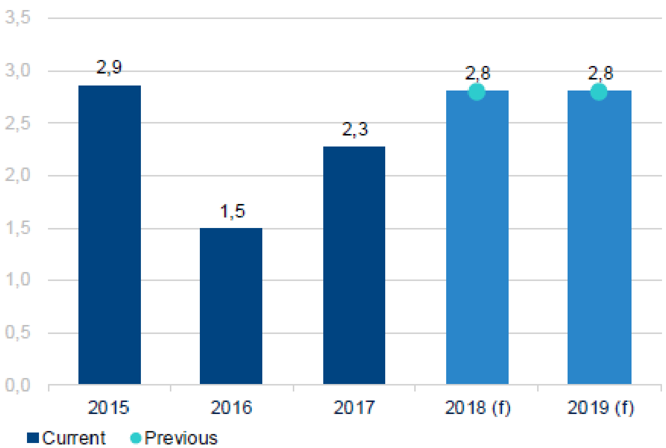


- Investor sentiment has shifted from risk-taking mode (and even a certain complacency) to one of risk aversion
- The change is prompting a rotation of flows between assets: from emerging markets to developed ones, and from equities to bonds
- Trade tensions, with a focus on China, but threats on several fronts, can lead to a flight to quality

Source: BBVA Research

U.S. supported by fiscal stimulus, but approaching the end of the expansionary cycle

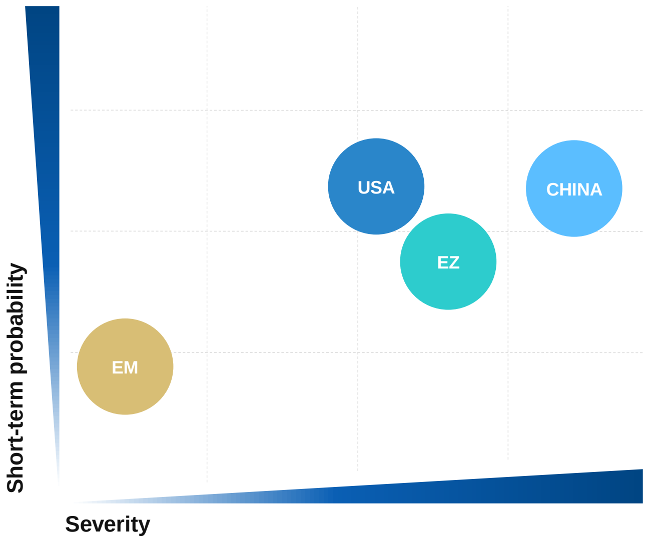
USA: GDP growth
(% YoY)



(f) Forecast
Source: BBVA Research based on BEA (Bureau of Economic Analysis) figures

- Growth has accelerated in the first half of the year, boosted by the fiscal stimulus and the improvement in the labour market
- Trade tensions could weigh on production and global demand
- The absorption of the idle capacity of the economy foreshadows the end of the expansive phase of the cycle
- Inflation will temporarily exceed the Fed's target due to the higher energy prices, but inflation expectations remain anchored

Global risks: The main one is a trade war, but risks associated with emerging economies and Europe are also on the rise



CHINA

- High indebtedness: more contained but still high
- Protectionism: upwards (retaliation) with possible impact on domestic policies (financial stability, reforms)

USA

- Protectionism: upwards
- The Fed exit strategy: high. Aggressive interest rate hikes in the face of a temporary increase in inflation
- Signs of over-valuation of certain financial assets

EURO ZONE

- Political uncertainty: on the upswing, led by Italy. Brexit: risk of no-deal
- Protectionism: on the upside, with a focus on the auto sector
- Exit strategy by the ECB: on the downside (delay of rate hikes)

EMERGING ECONOMIES

- Upward. Global risks and domestic vulnerabilities in some countries are raising the risk of a systemic crisis

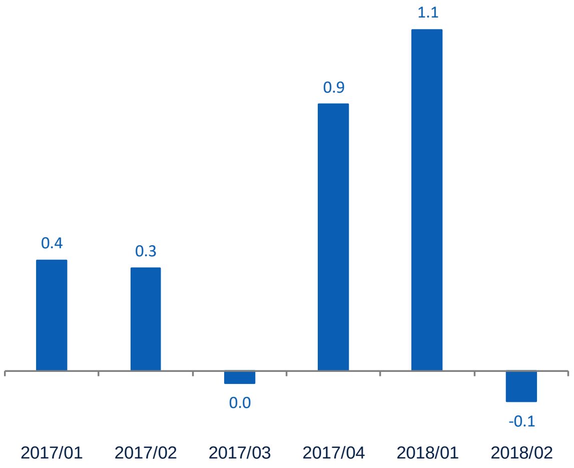
Source: BBVA Research

02

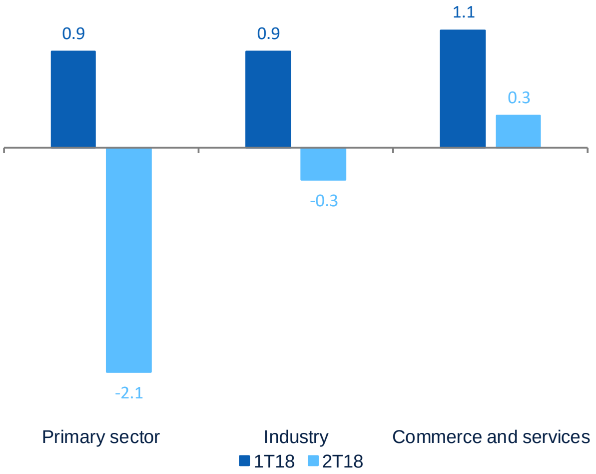
The economy grew 2.1% in the first half of the year.

Mixed performance in 1H18: 1.1% growth in 1Q18 and -0.1% in 2Q18. Deterioration in the primary sector and industry; slowing growth in the tertiary sector.

GDP
(% QoQ, sa)



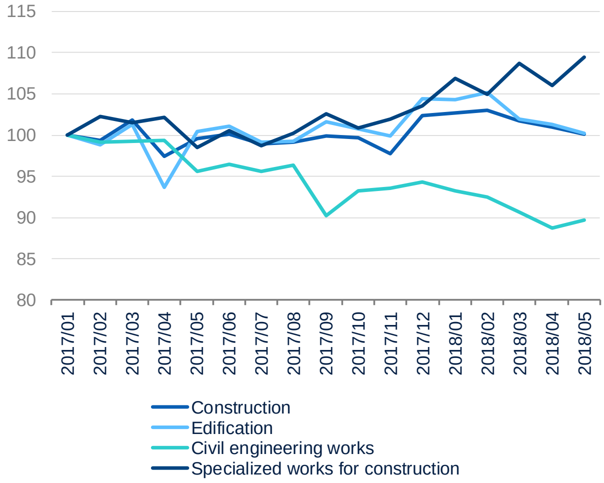
Components of GDP Supply
(% QoQ, sa)



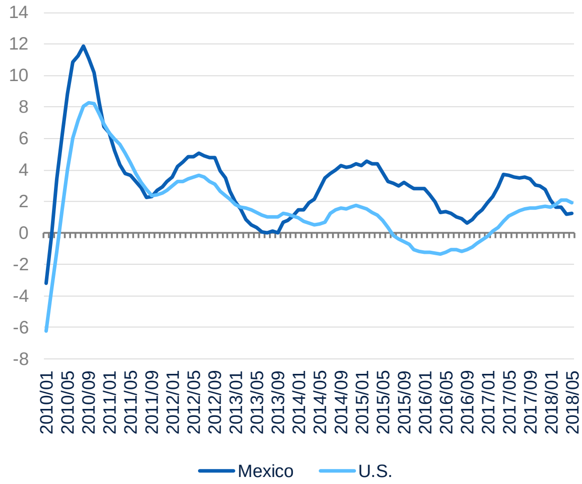
Source: BBVA Research / INEGI (National Statistics Institute)

2Q18: agricultural production affected by intense heat waves and slowdown in construction, extractive industries and automotive sectors

Industry activity indicator
(% MoM, sa)



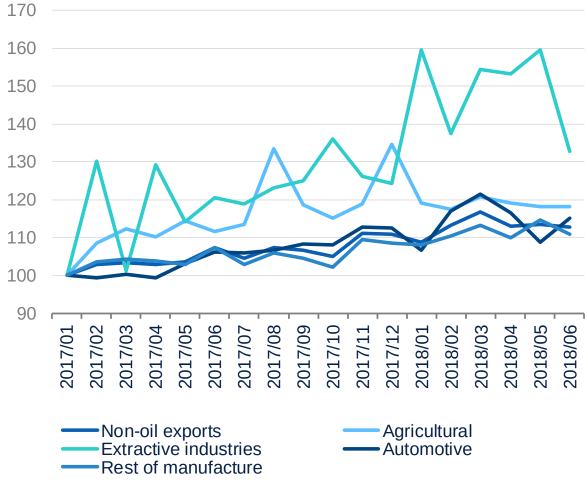
Manufacturing production
(Year-on-year growth rate %, 6-month moving average, sa)



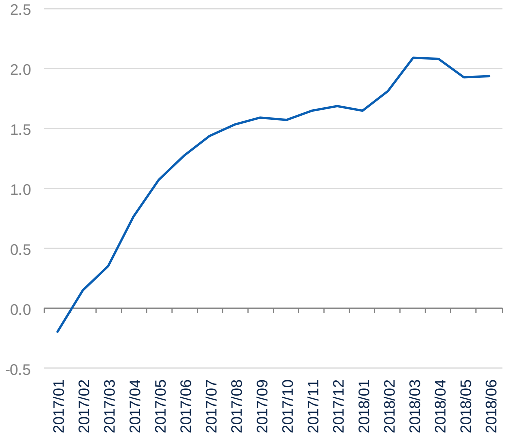
Source: BBVA Research / INEGI (National Statistics Institute)

2Q18: exports show deterioration especially in extractive industries and the auto sector; possible deterioration in U.S. manufacturing production.

Exports from Mexico
(Index base 2017/01 = 100)



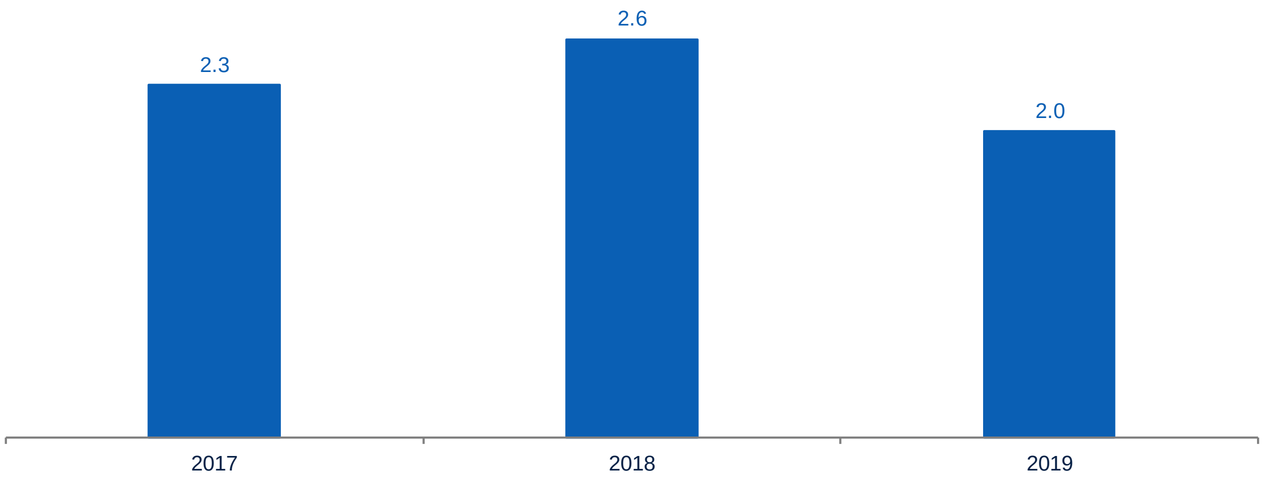
Manufacturing production. USA
(Year-on-year growth rate, 6 month moving average)



Source: BBVA Research / INEGI (National Statistics Institute)

Downward bias in our growth forecast for 2018; no change for 2019

GDP.
(YoY %, sa)



Source: BBVA Research / INEGI (National Statistics Institute)

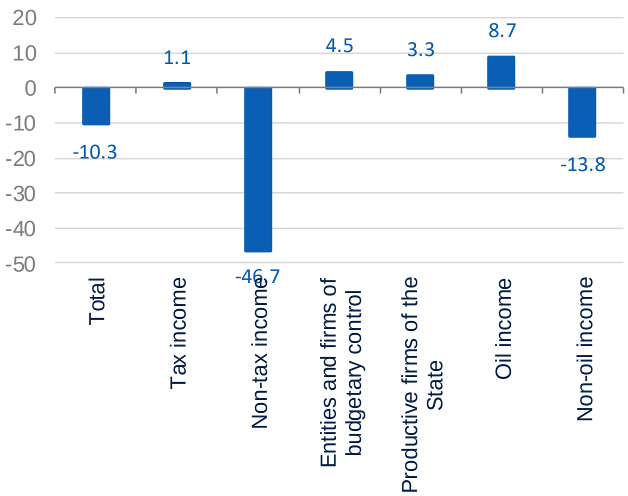
03

Slight deterioration in fiscal and external accounts in 1H18

Total public sector budget revenue showed a real annual decrease of 10.3% in the first half of 2018

Public sector budget revenues and components in 1H18

(real chg. % YoY)

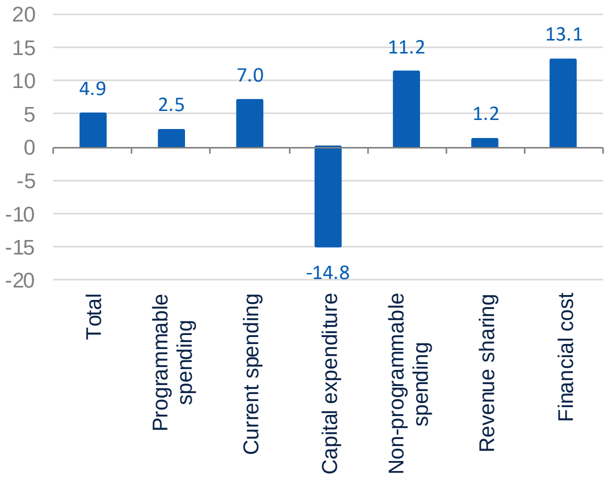


Source: BBVA Research and Ministry of Finance

- Stripping out Bank of Mexico Operating Surplus from the year-on-year comparison, total public revenues would have registered a real increase of 2.1% in 1H18
- Oil revenues reported real annual growth of 8.7% in 1Q18
- VAT contributed 2.7 percentage points to the real annual variation in tax revenues in 1H18, but was offset by the negative contribution of gasoline and diesel tax of 2.1 percentage points.

Total net spending showed a real annual increase of 4.9% in the first half of 2018; we expect a significant contraction in the second half of the year

Public sector net expenditure and components in 1H18*
(real chg. % YoY)



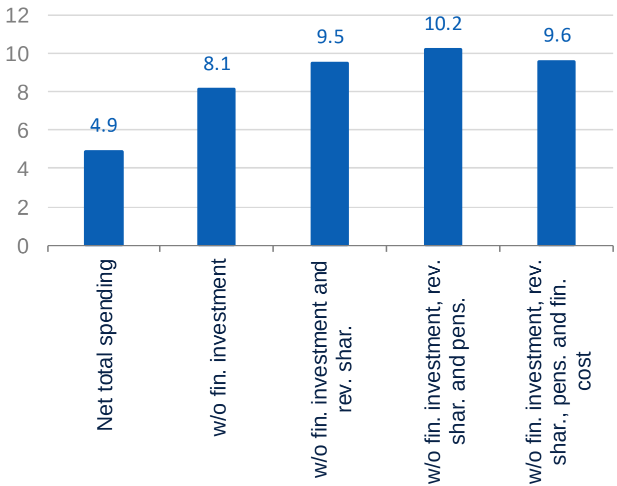
- Total spending in 1H18 was mainly driven by non-programmable spending, which contributed 3.2 percentage points to total expenditure growth
- Current expenditure showed a real annual increase of 7.0% in 1H18
- The Adefas contributed 5.4 percentage points to the growth in non-programmable spending of 11.2% in 1H18

The Adefas showed a real annual increase of 158.5% in 1H18 and accounted for 7.9% within non-programmable expenditure.
Source: BBVA Research and Ministry of Finance

The federal government reduced its commitment to fiscal consolidation in the first half of 2018

Public spending indicators in 1H18

(real chg. % YoY)

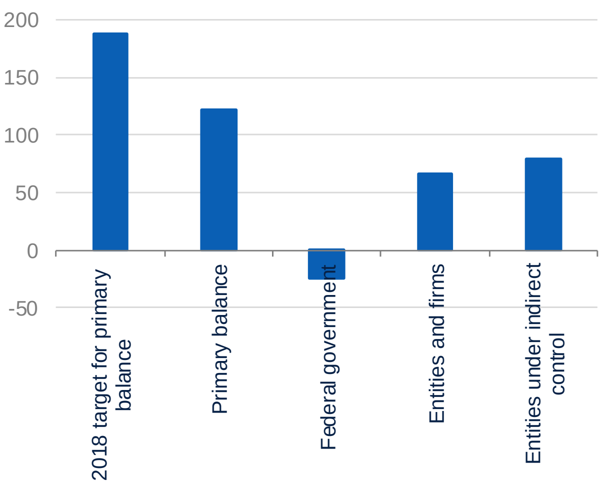


Source: BBVA Research and Ministry of Finance

- Stripping out financial investment, revenue sharing, public pensions and financial costs, the real annual increase in spending would be 9.6% in 1H18
- This limited concept of expenditure shows that the federal government reduced its fiscal consolidation efforts in 1H18

The federal government will have to ramp up its fiscal consolidation efforts to reach the primary surplus target of 0.8% of GDP in 2018

Primary balance and components at 1H18
(Billions of pesos)

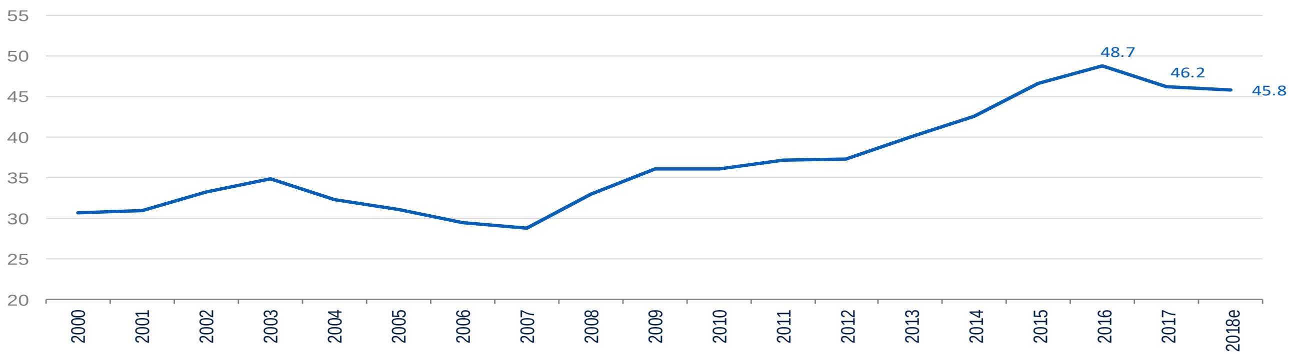


Source: BBVA Research and Ministry of Finance

- The primary surplus in 1H18 was largely due to the balance sheets of both entities under indirect budgetary control and the Mexican Institute of Social Security
- The primary balance of the federal government will need to have a surplus in the July-December 2018 period to meet the target of 0.8% of GDP for the primary surplus

We expect government debt (% of GDP) to show a marginal decline in 2018

Historical balance of public sector borrowing requirements
(% of GDP)

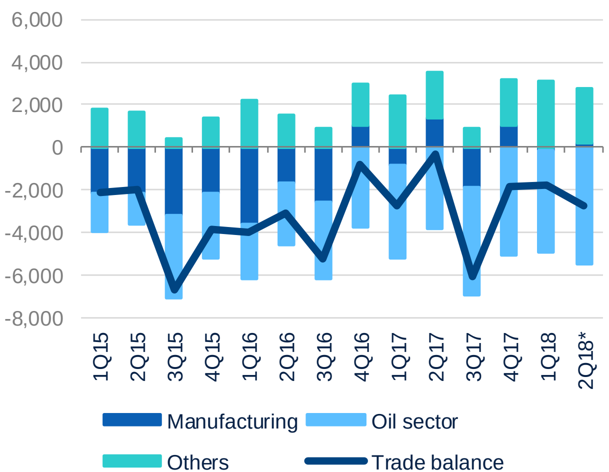


Source: BBVA Research and Ministry of Finance

We expect fiscal consolidation efforts and MXN appreciation to be reflected in a marginal reduction of the historical balance of public sector borrowing requirements (% of GDP) from 46.2% in 2017 to 45.8% in 2018

The trade deficit reached US$2.773 billion in the second quarter of 2018 as the deterioration in the oil balance took a toll on it

Trade balance and principal components
(US$ million)



Manufacturing and other balances do not represent observed data, but own estimates.
Source: BBVA Research / INEGI (National Statistics Institute)

- The trade deficit increased to US$ 2.773 billion in 2Q18 from US$ 302 million in 2Q17
- This is due mainly to the deterioration in the oil trade balance (with a deficit of US$5.497 billion in 2Q18 vs. US$ 3.826 billion in 2Q17)
- We expect the trade deficit for 2018 to be US$ 12.8 billion

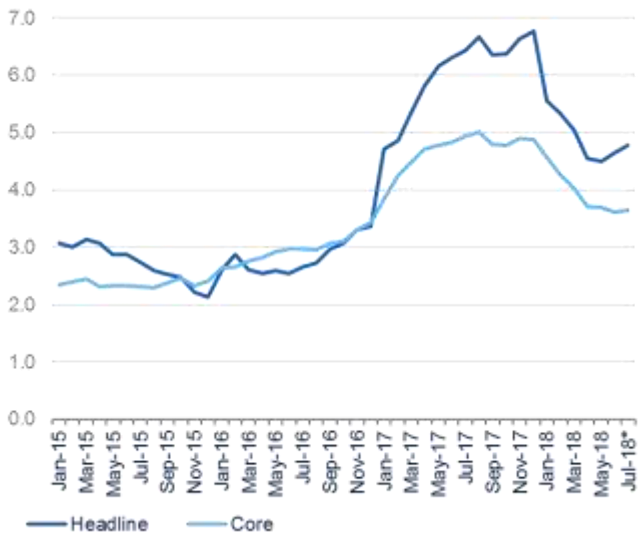
04

Temporary rebound in inflation; monetary pause for the rest of the year

Headline inflation: the increase during June-July will be temporary, but the pace of convergence towards the target will be slower

Headline and core inflation*

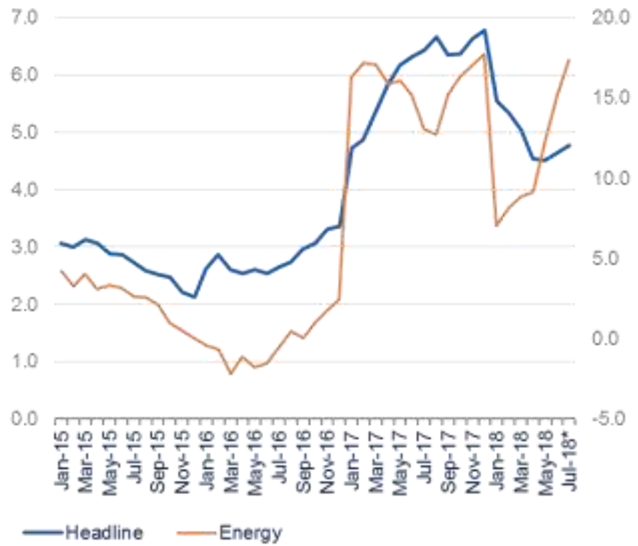
(YoY % change)



* The July figure is a forecast, but is based on the known data from the first half of the month.
Source: BBVA Research / INEGI (National Statistics Institute)

Headline and energy inflation*

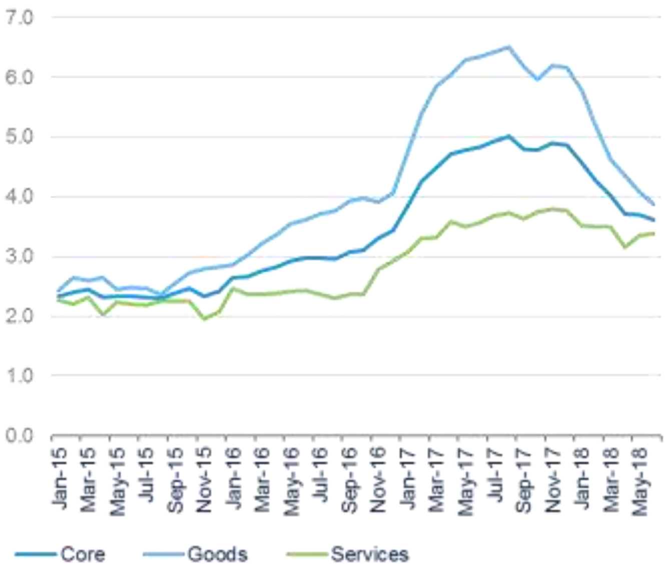
(YoY % change)



* The July figure is a forecast, but is based on the known data from the first half of the month.
Source: BBVA Research / INEGI (National Statistics Institute)

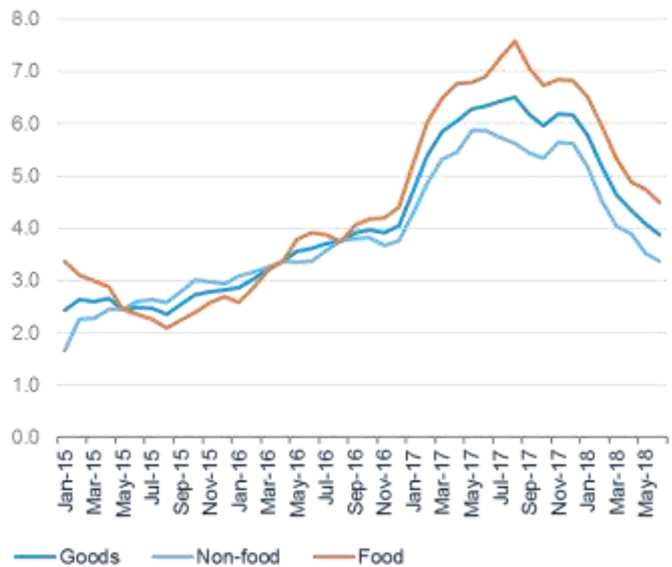
Core inflation remains on a downward trend...

Core inflation and components*
(YoY % change)



Source: BBVA Research / INEGI (National Statistics Institute)

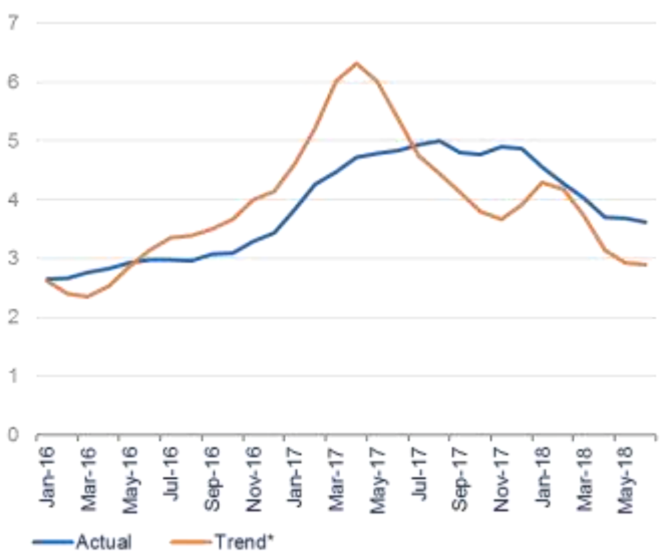
Core inflation of goods and components*
(YoY % change)



Source: BBVA Research / INEGI (National Statistics Institute)

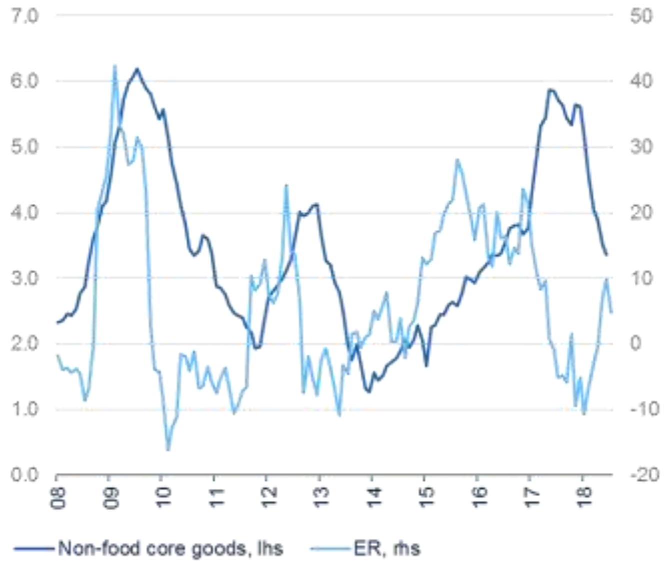
... which we anticipate will continue uninterrupted

Core inflation and components*
(YoY % change)



* Own calculations based on the deseasonalisation of the core inflation index
Source: BBVA Research / INEGI (National Statistics Institute)

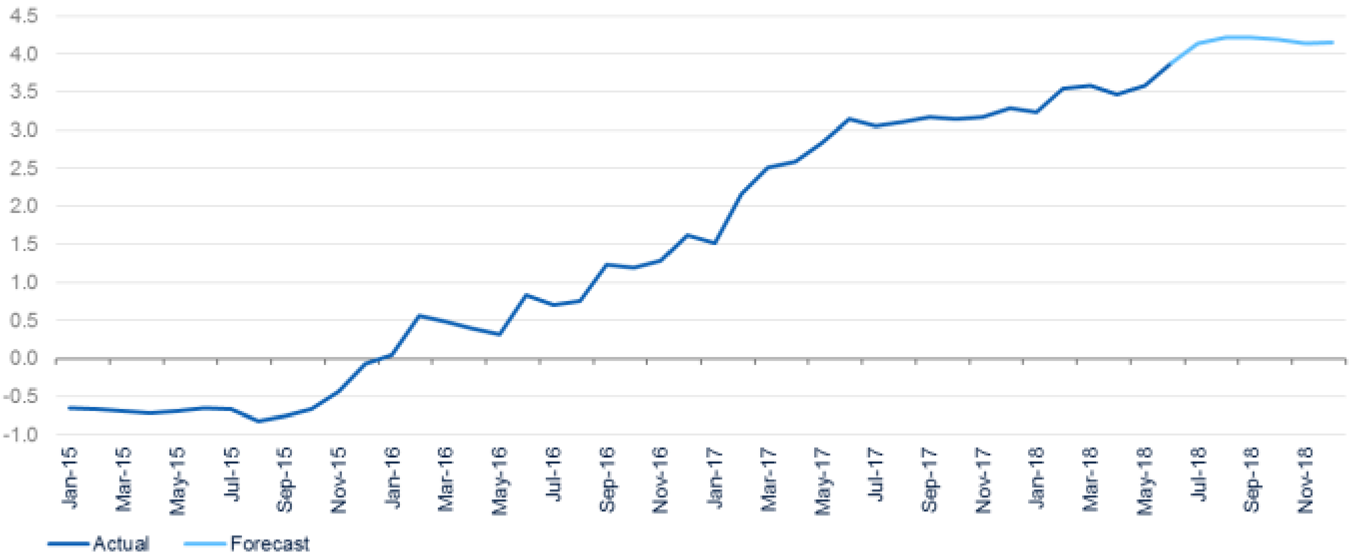
Core inflation of goods and components*
(YoY % change)



Source: BBVA Research, INEGI and Bloomberg

Monetary policy: pause for the rest of the year

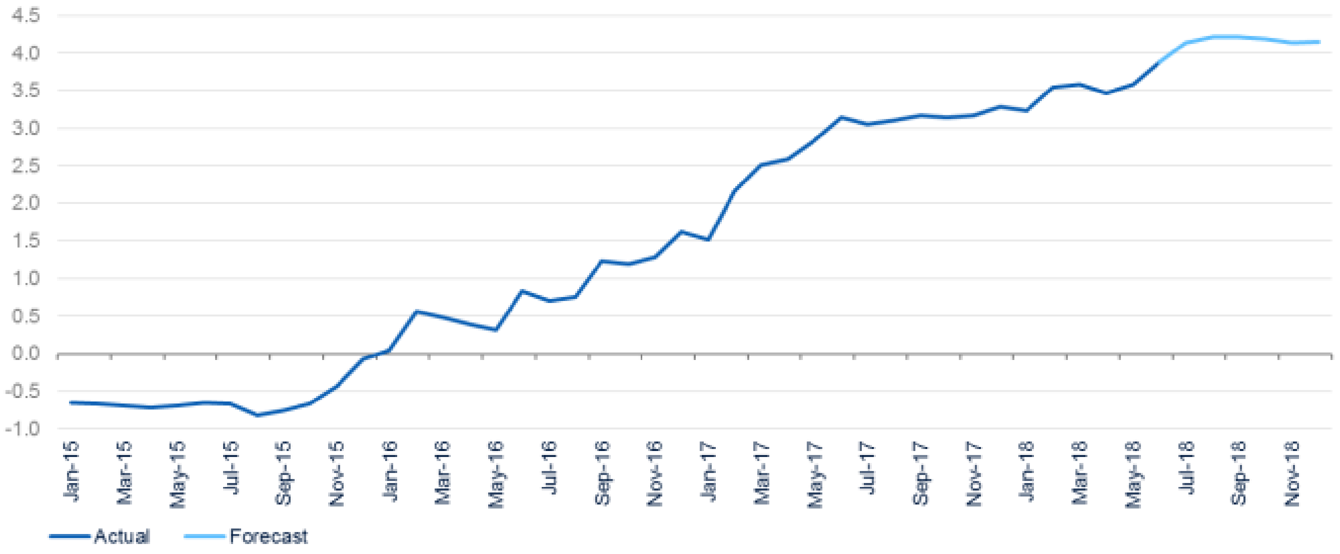
Ex ante real monetary policy rate*
(%)



* Own calculations based on 12-month inflation expectations from the Banxico analysts' survey and using our inflation expectations for projected data
Source: BBVA Research / INEGI / Banxico

In 2019 we expect a reduction of 75bp to 7.0% in the monetary policy rate

Outlook for the monetary policy rate
(Nominal, %)



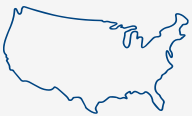
* Own calculations based on 12-month inflation expectations from the Banxico analysts' survey and using our inflation expectations for projected data
Source: BBVA Research / INEGI / Banxico

05

Domestic asset prices influenced by commercial tensions

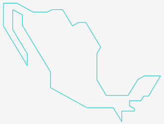
NAFTA: Bilateral negotiations between Mexico and the U.S. prompt optimism, but as yet no specific deals have been made.

USA



- 40% of auto value (45% trucks) from high-wage regions
- Implementation: 4 years cars and 2 years trucks
- Obligation to use steel and aluminium from North America

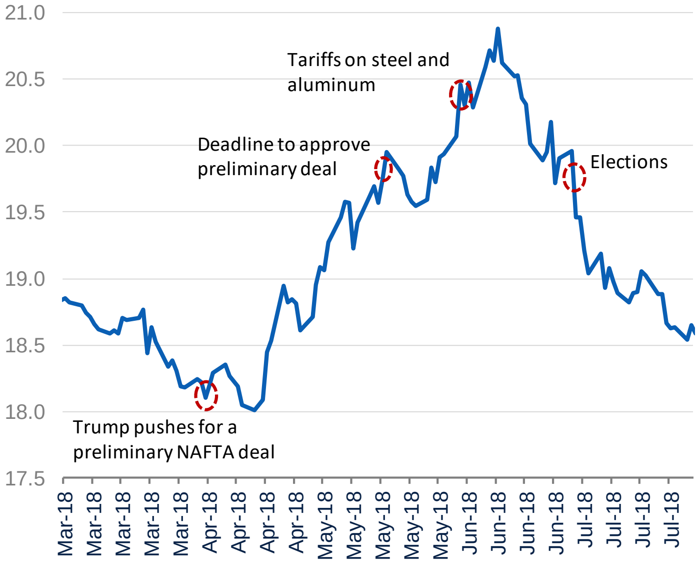
Mexico



- 20% of the value of the car made in high-wage regions
- 10 years for implementation
- Bonus for using steel and aluminium from North America
- **No progress on controversial issues (e.g. *sunset clause*)**

Process of appreciation of the peso due to lower commercial tensions, not interrupted by the electoral result (already anticipated)

Exchange rate
(Pesos per dollar)

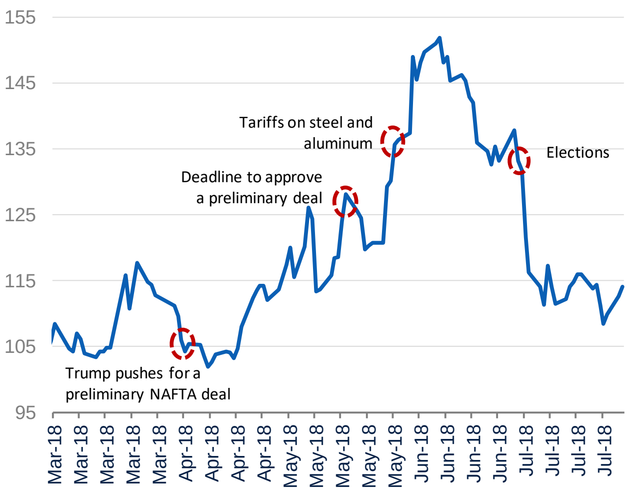


Source: BBVA Research and Bloomberg

- AMLO's conciliatory stance and optimism regarding NAFTA have had an impact on the appreciation
- 25% duty on U.S. auto imports is the main short-term risk.
- Global trade tensions will continue to adversely affect emerging market currencies

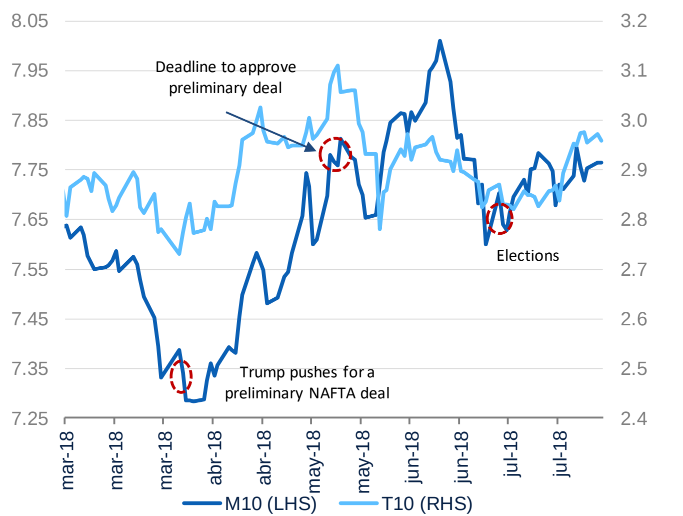
Interest rates and sovereign risk also fall in light of idiosyncratic risk reduction

Sovereign risk, 5-year CDS spread
(Basis Points)



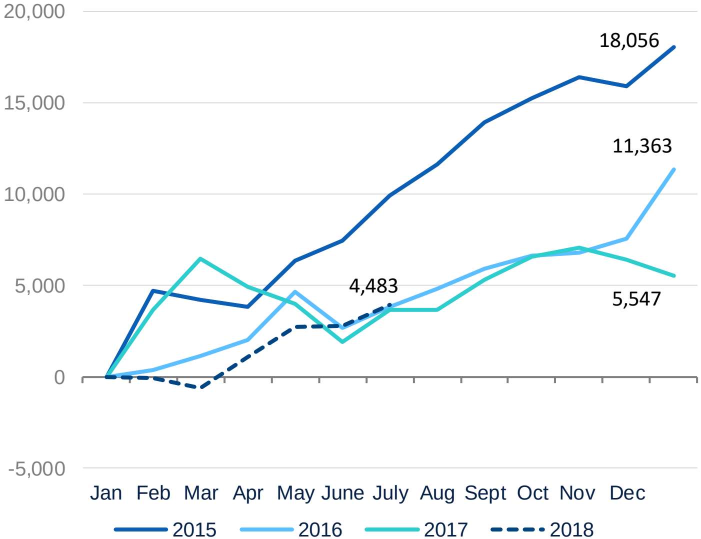
Source: BBVA Research / Bloomberg

10-year interest rates, US and Mexico
(%)



The inflows of medium- and long-term bonds by foreigners continues despite uncertainty

Change in foreigners' holdings of M bonds
(Millions of dollars)

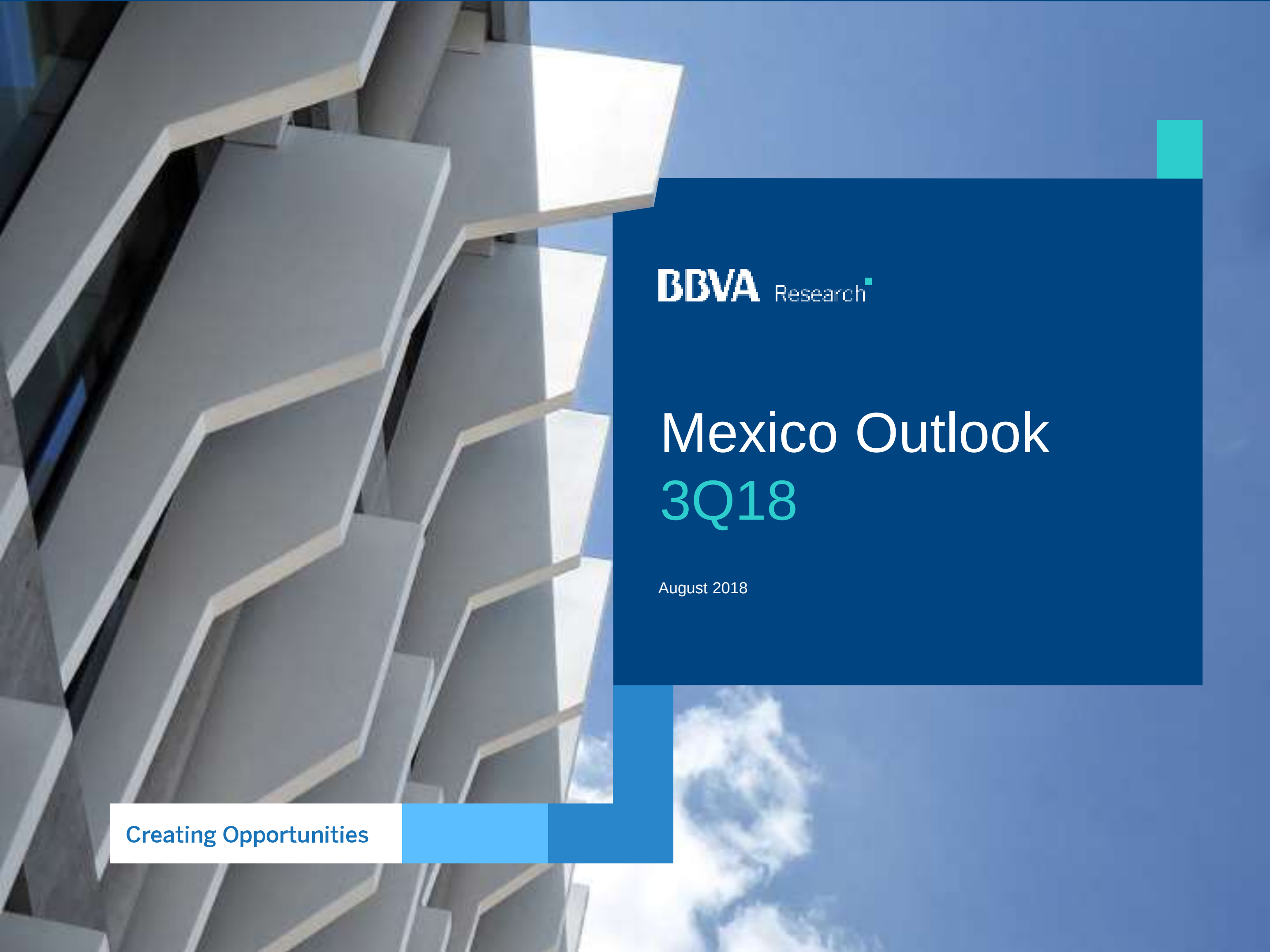


Source: BBVA Research / Banxico

- Holdings of medium- and long-term bonds have increased despite uncertainty
- This increase stands out among the emerging nations that have recorded outflows in recent months
- The pace of inflows has slowed down in the face of lower global liquidity

Key messages

- Global growth continues, but risks are intensifying.
- The economy grew 2.1% in the first half of the year. Downward bias in our growth forecast for 2018; no change for 2019
- Inflation will be slightly above 4.0% at the end of the year; we do not expect additional interest rate adjustments for the rest of the year.
- Slight deterioration of fiscal and external accounts in the first half of 2018.
- Trade tensions are the main factor behind the changes in financial variables. The main short-term risk is a possible 25% tariff on automobiles



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