BBVA Research

Mexico Economic Outlook

Fourth quarter 2018

Creating Opportunities

01

Global economy

Positive global momentum continues, although the risks are intensifying

Robust global growth, albeit more moderate and less synchronised

The strength of the US economy contrasts with moderation in China and Europe

Divergence of US and EU monetary policy from 2019

The Fed ends its cycle of increases, while the ECB starts its cycle and prepares to withdraw liquidity

Increased financial tensions in emerging markets

With clear differentiation among countries, the most financially vulnerable of them facing abrupt adjustments in their economies

Trade war between the US and China

Impact still limited, but could increase if new measures are taken and confrontation continues

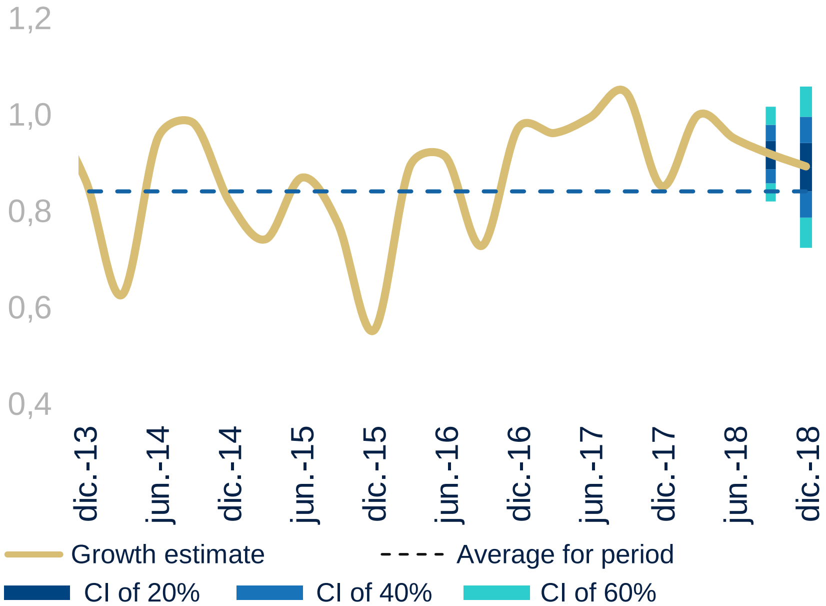
Global risks are intensifying

Added to protectionism and the Fed's normalisation are rising tensions in emerging countries and increased uncertainty in Europe

Moderation of global growth

World GDP growth

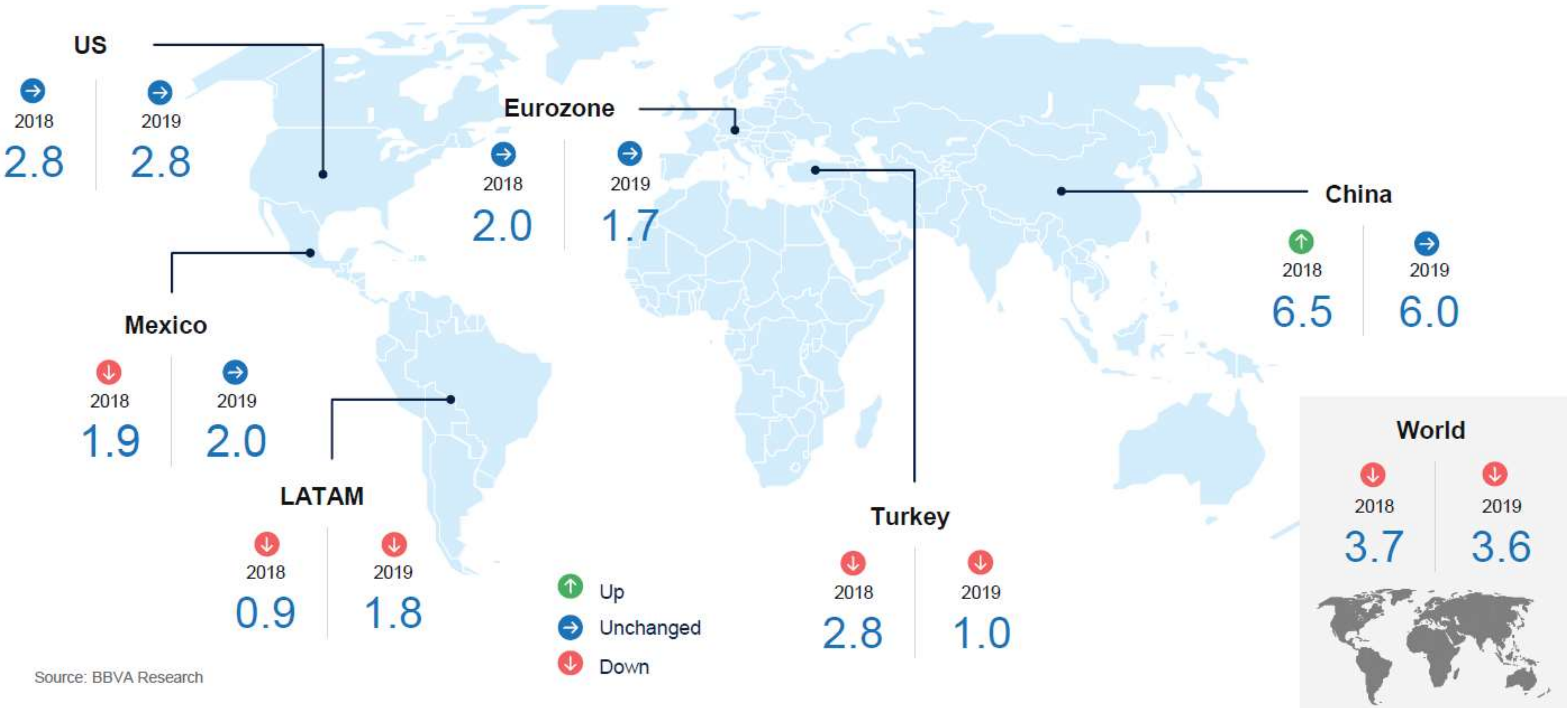
(Forecasts based on BBVA-GAIN, % QoQ)



- Slight moderation of global growth towards rates slightly below 1% QoQ in 2H18
- Activity data remain solid, but have lost momentum, probably as a result of the increase in protectionism weighing down on confidence, trade and investment
- Apart from volatility, world trade has not been badly affected so far

Source: BBVA Research

The downward revision of growth in emerging economies explains the expected moderation of global growth in 2019



Source: BBVA Research

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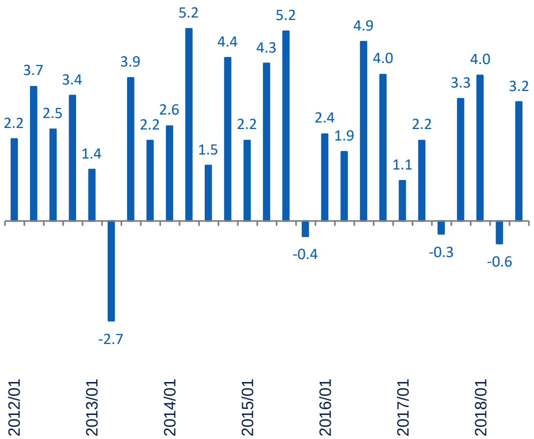
02

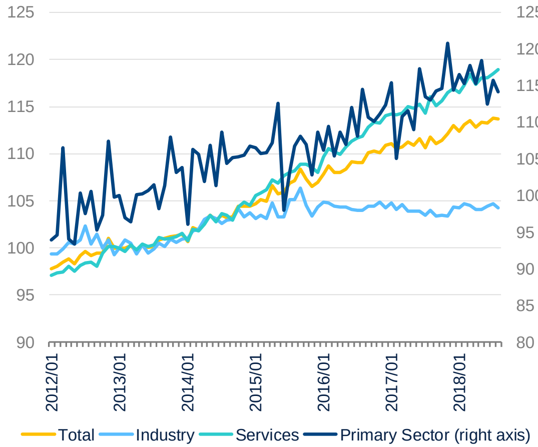
Mexico, Economic Activity

More dynamic GDP growth in 3Q18, driven by services and manufacturing

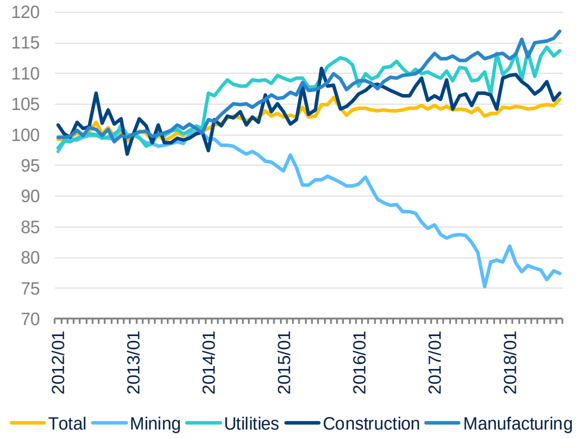
GDP
(% change, quarterly, annualised)



IGAE (Global Economic Activity Index)
(Index 2013/01 = 100)



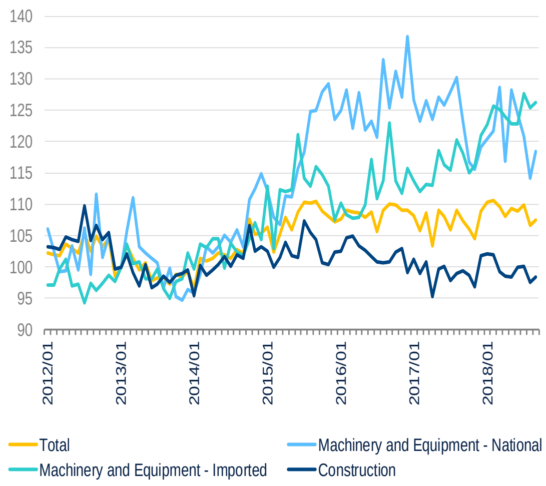
Industrial activity
(Index 2013/01 = 100)



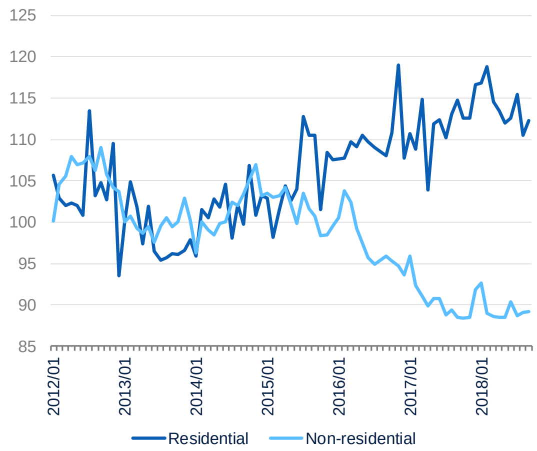
Source: BBVA Research / INEGI (National Statistics Institute)

Private investment remains weak; possible delay in its recovery

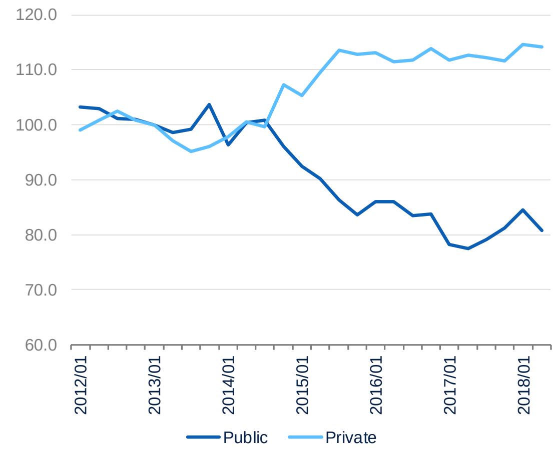
Gross Fixed Investment
(Index 2013/01 = 100)



Construction
(Index 2013/01 = 100)



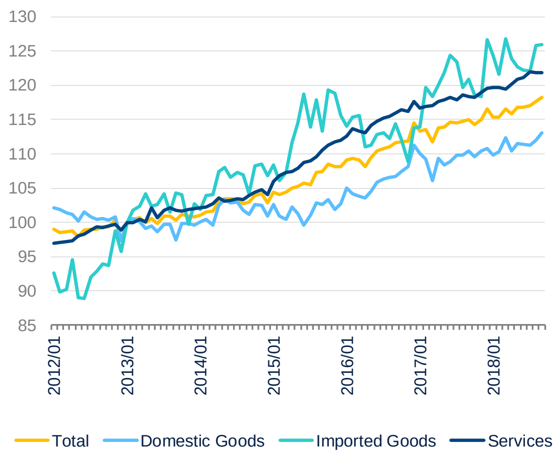
Gross Fixed Investment
(Index 2013/01 = 100)



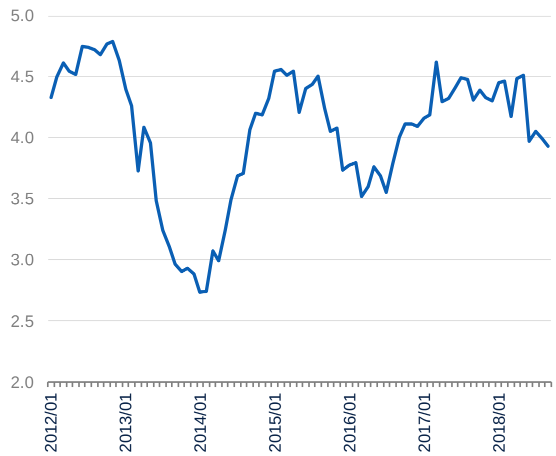
Source: BBVA Research / INEGI

Private consumption remained buoyant in 3Q18

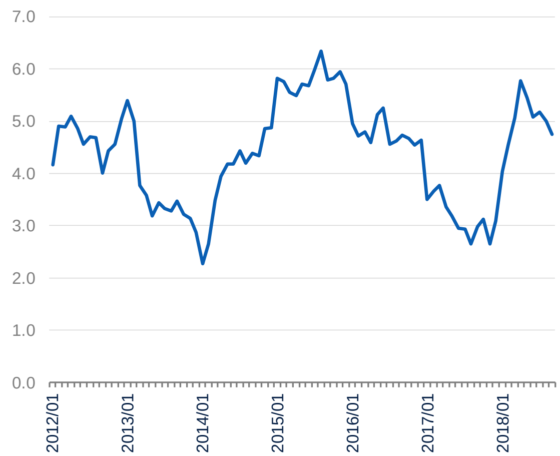
Monthly Private Consumption Indicator
(Index 2013/01 = 100)



Formal employment
(YoY%)



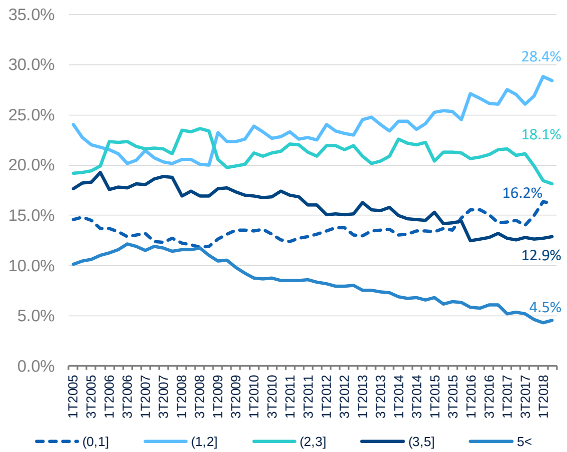
Total formal payroll
(Index 2013/01 = 100)



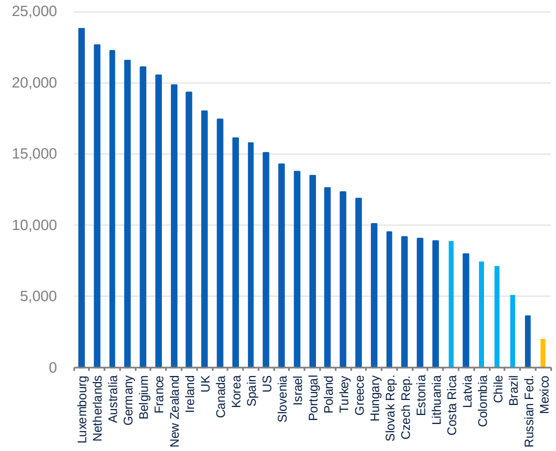
Source: BBVA Research / INEGI

The increase in the legal minimum wage favours recovery of lowest-paid workers' purchasing power

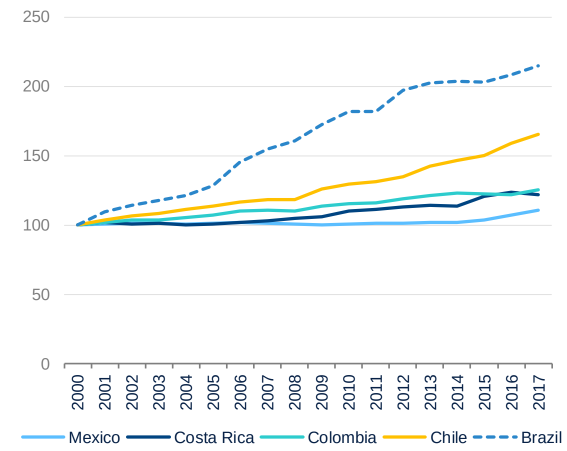
Workers by income level
(Minimum wage intervals, %)



Minimum Annual Wage
(Constant 2017 prices, USD PPP)



Minimum Annual Wage
(Constant 2017 prices, USD PPP; index 2000 = 100)



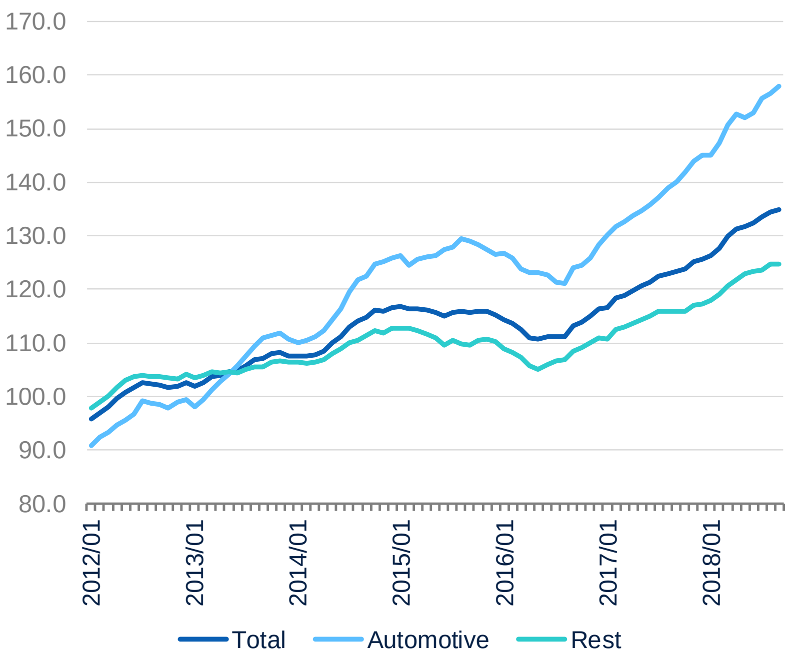
Source: BBVA Research / INEGI

We do not foresee inflationary pressures, given the small percentage of workers in the formal economy on the minimum wage (3.3%) and the lack of domino effect on those earning more than this. Nor do we expect any reduction in employment

Exports remain dynamic, and will continue to be driven by the strength of the US manufacturing sector

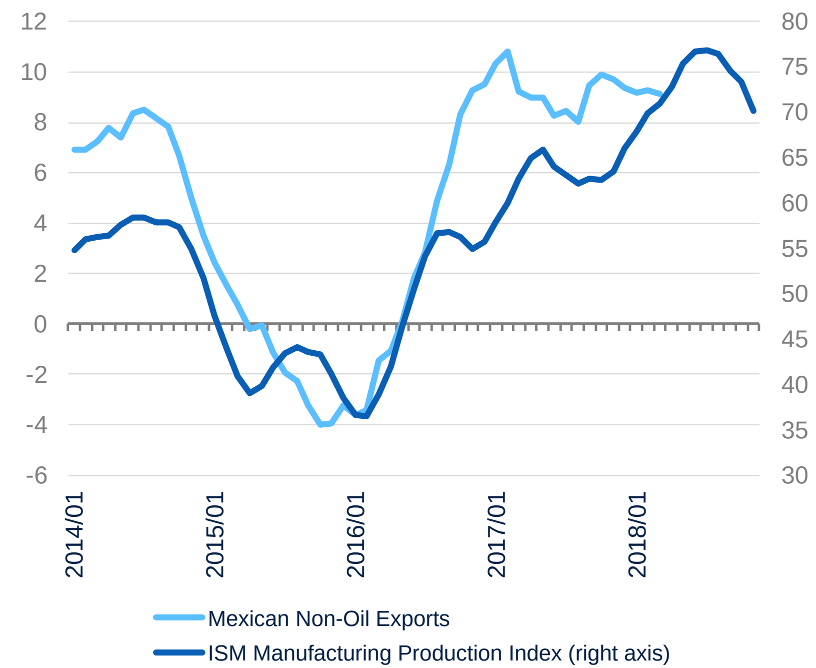
Manufacturing exports

(Index 2013/01 = 100)



Mexico and US, manufacturing exports

(YoY%, moving 6-month average, Mexico 6-month lag)



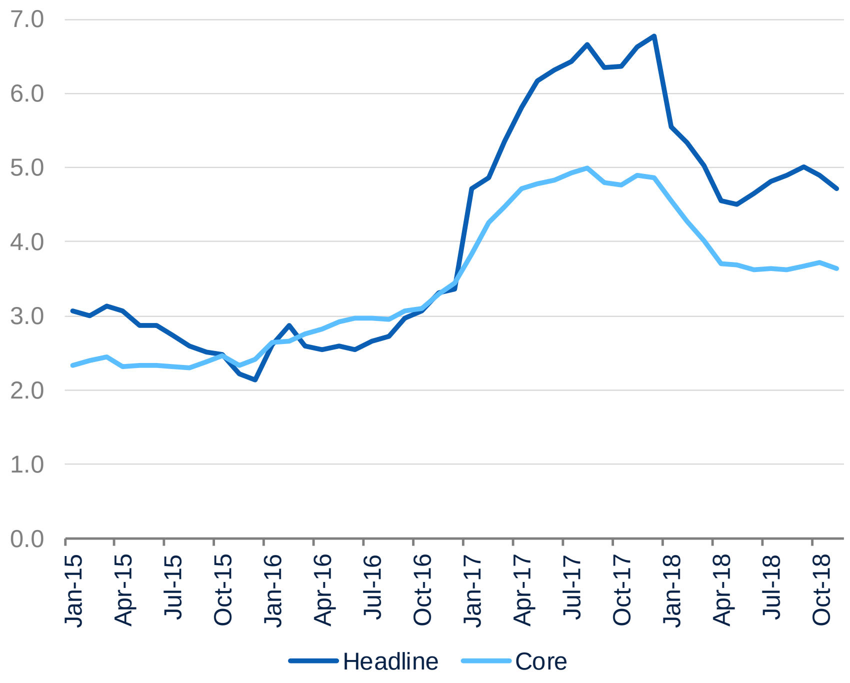
Source: BBVA Research / INEGI

03

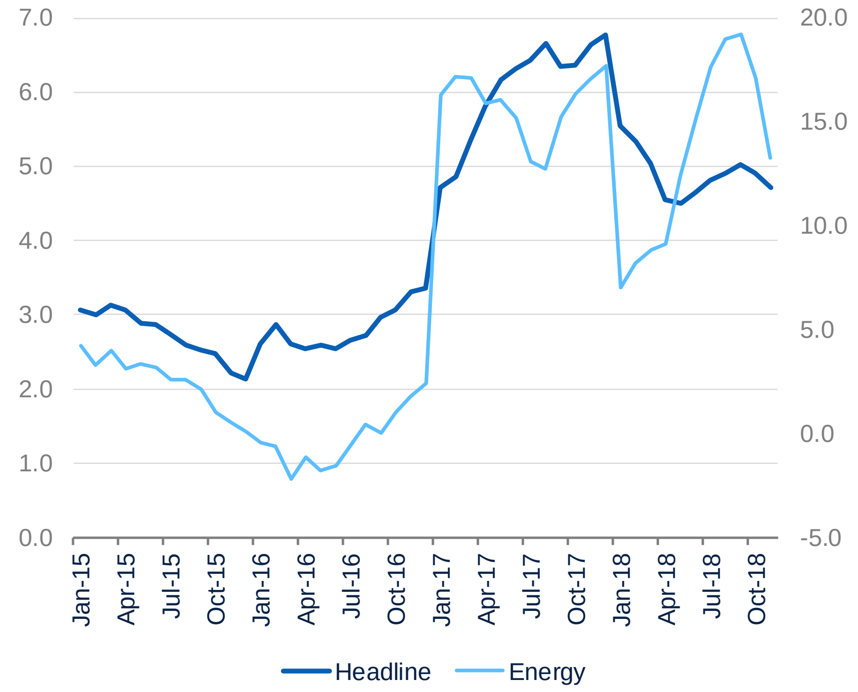
Downward rigidity of core inflation and restrictive stance of Banxico (Banco de México, the central bank)

Fall in headline inflation in 4Q18 as we foresaw, although at a slower pace than expected, due to recent pressure on agricultural prices

Headline and core inflation
(YoY % change)



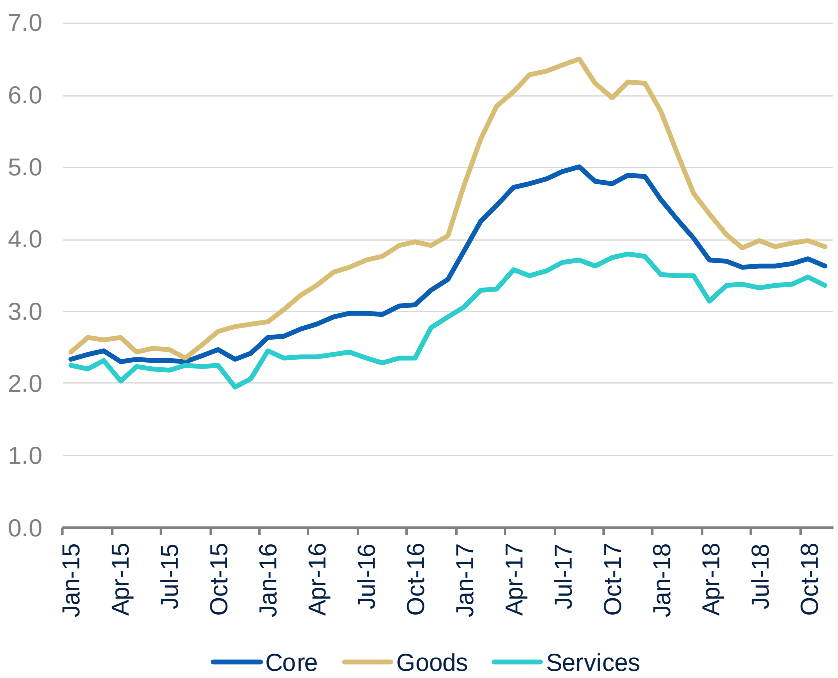
Headline and energy inflation
(YoY % change)



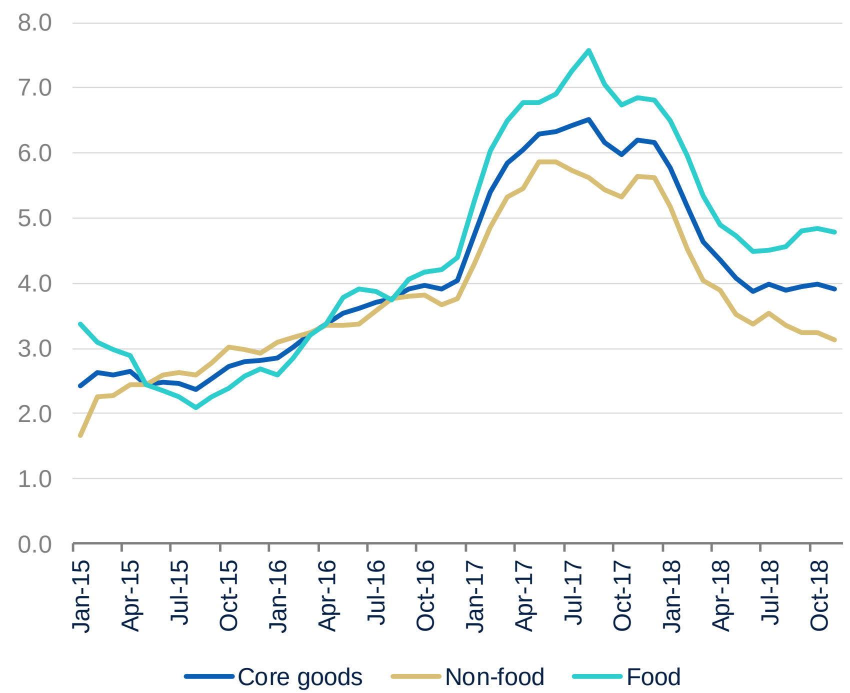
Source: BBVA Research / INEGI

Core inflation stickiness on food core goods and services other than education and housing

Core inflation breakdown
(YoY % change)



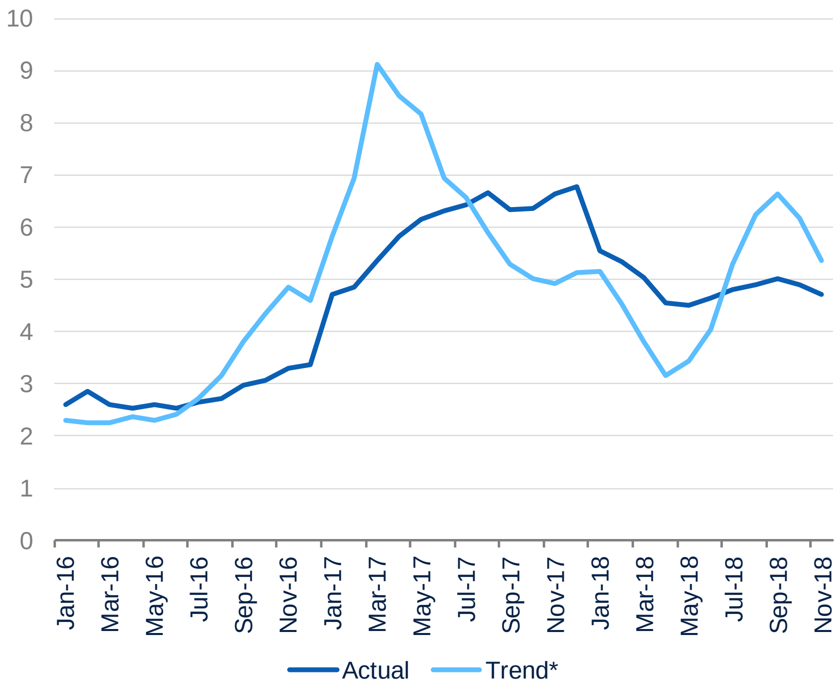
Core goods inflation breakdown
(YoY % change)



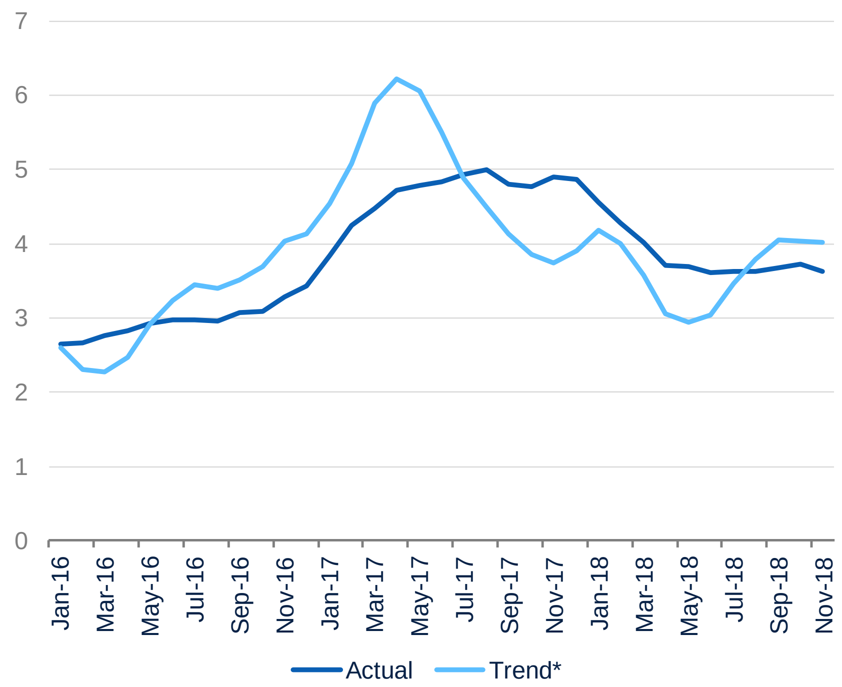
Source: BBVA Research / INEGI

In the short term we expect headline inflation to fall more markedly than core inflation

Headline inflation and trend
(Chge. % YoY)



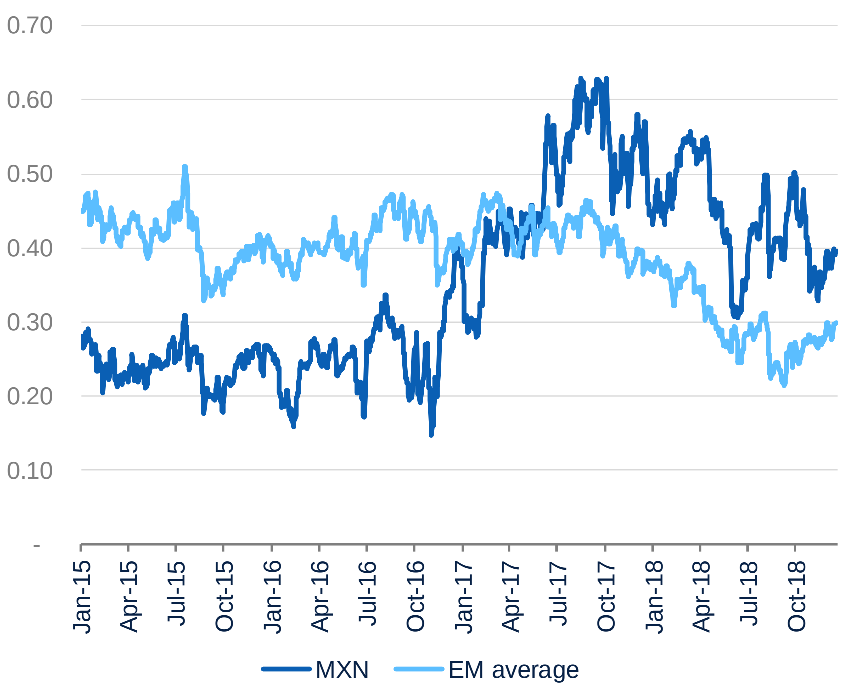
Core inflation and trend
(Chge. % YoY)



Source: BBVA Research / INEGI

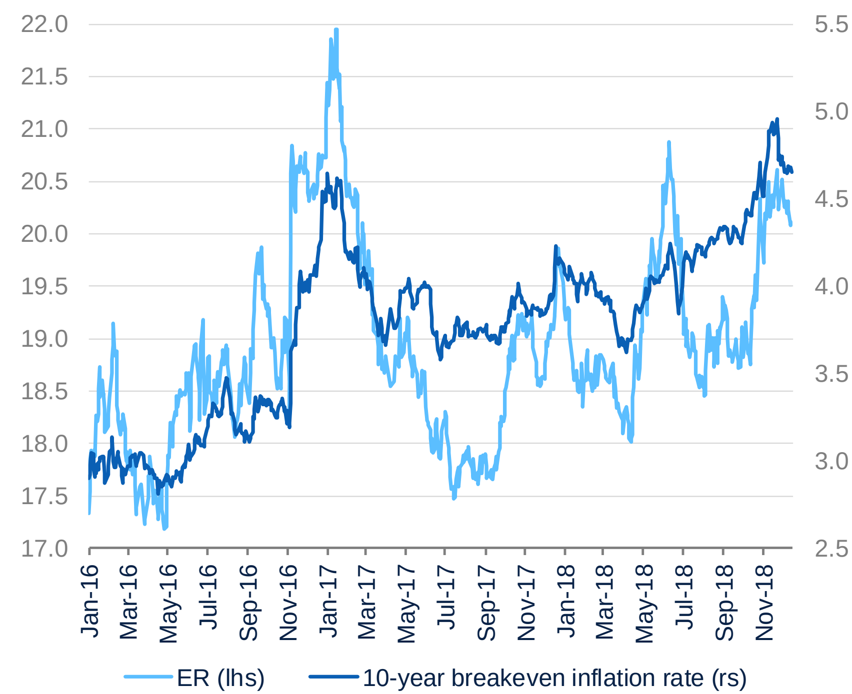
We expect Banxico to increase its base rate by 25 bps to 8.25% in December, since risks for inflation continue to be biased upwards

Risk-adjusted carry trade
(%)



Source: BBVA Research / INEGI

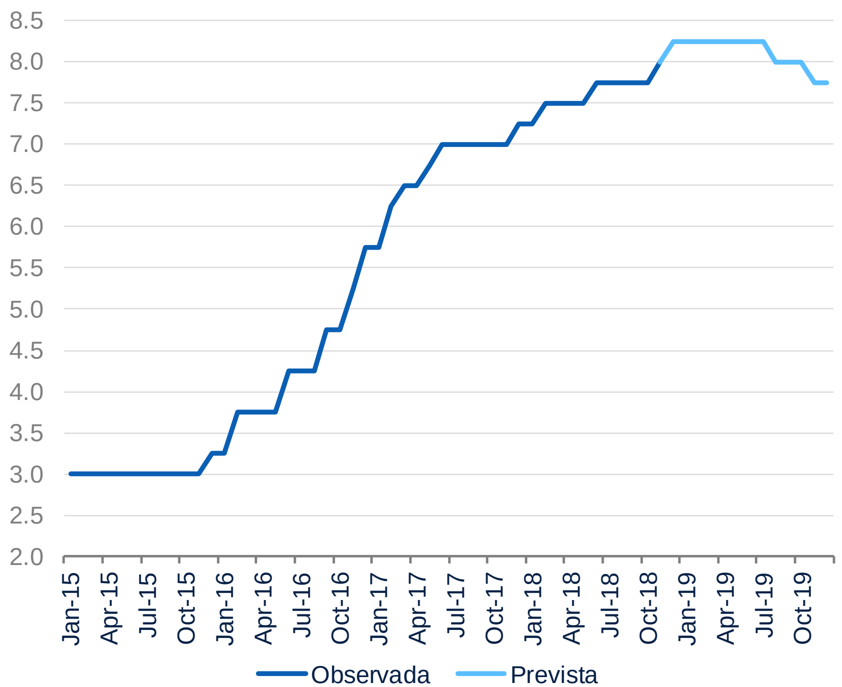
Market-based long-term inflation expectations and exchange rate (% and pesos to the dollar)



Source: BBVA Research / Bloomberg

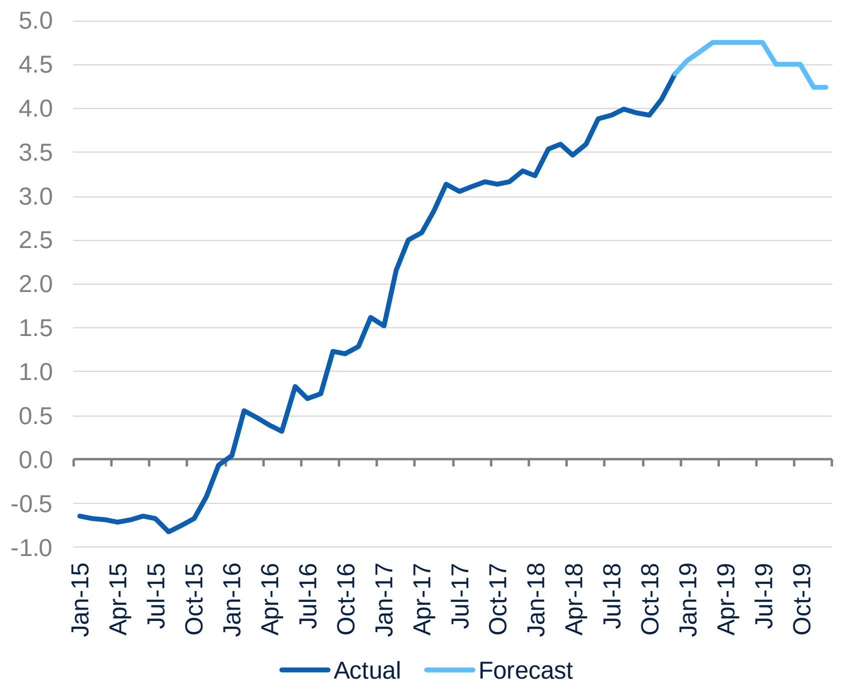
For 2019 we foresee the rate being held steady in 1H and cut by 50 bps to 7.75% in 2H

Outlook for the monetary policy rate
(Nominal, %)



Source: BBVA Research / Banxico

Ex ante real monetary policy rate*
(Chge. % YoY)



* 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

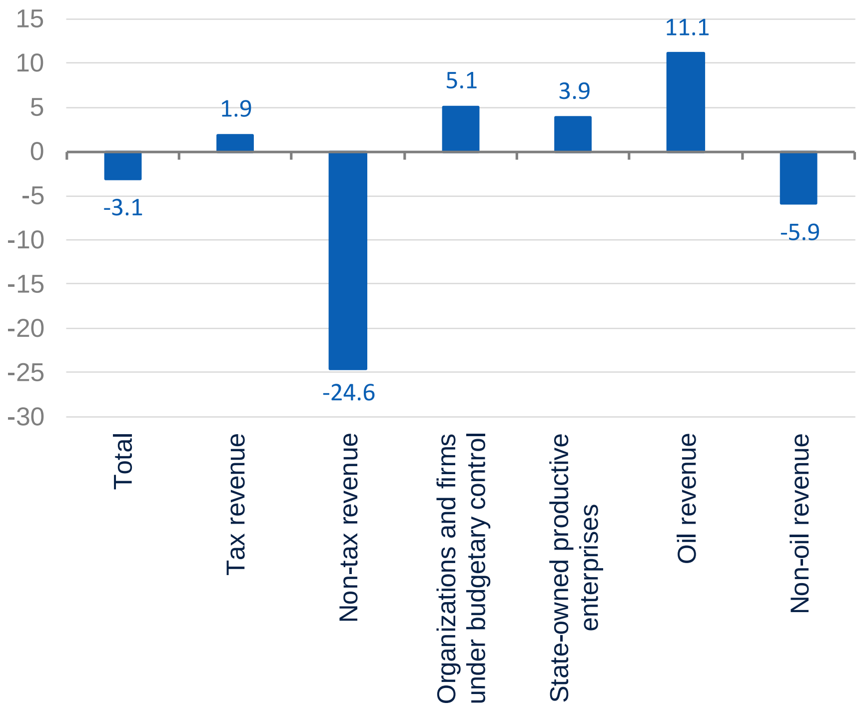
04

2019 public accounts and budget

Total public sector budget revenue showed a real YoY decrease of 3.1% in the period January to October 2018

Public sector budget revenues and components in the period Jan. to Oct. 2018

(real annual change %)



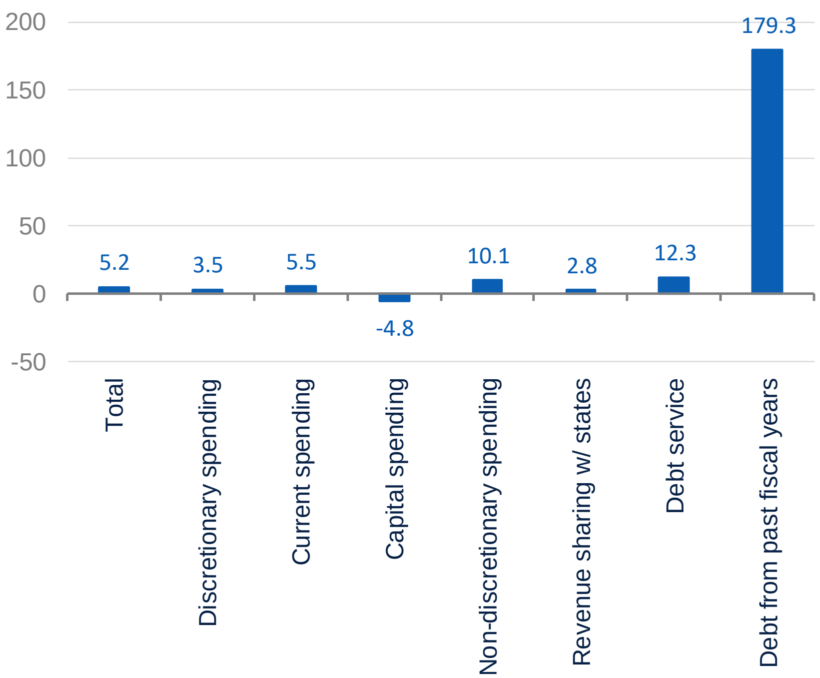
- Stripping out Banxico's Operating Surplus from the year-on-year comparison, total public revenues would have registered a real increase of 5.1% in the first ten months of 2018
- Oil revenues showed real annual growth of 11.1% in the period
- VAT contributed 2.0 percentage points to the real annual variation in tax revenues in the first ten months of 2018, but this was offset by the negative contribution of gasoline and diesel tax of 1.8 percentage points.

Source: BBVA Research based on data from SHCP

Total net spending showed a real annual increase of 5.2% in the period January to October 2018

Public sector paid net expenditure and components in the period Jan. to Oct. 2018

(real annual change %)

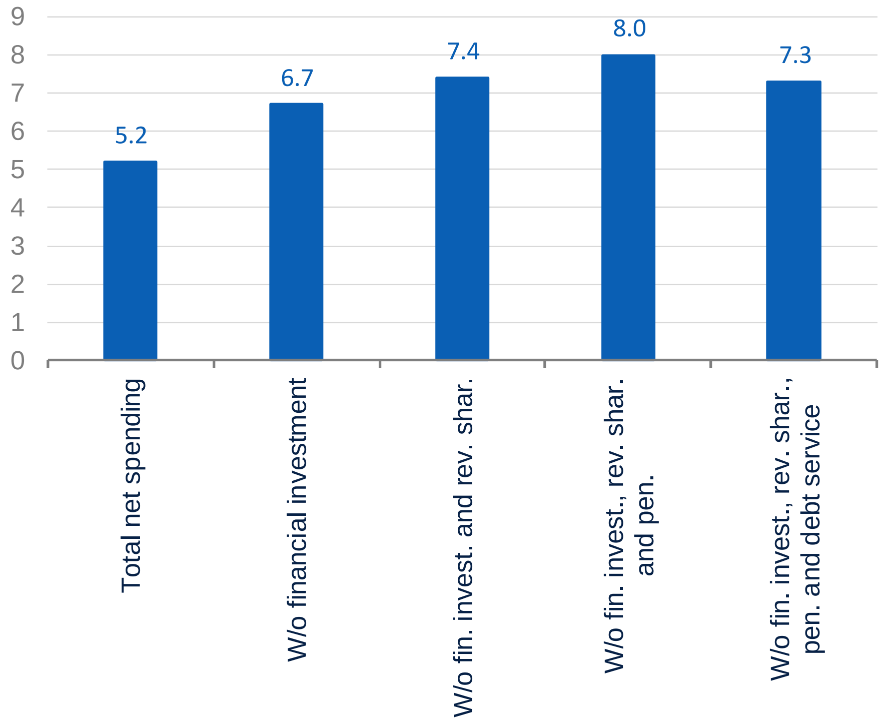


- Programmable and non-programmable expenditure each made similar contributions of 2.6 percentage points to the increase in total spending in the period January to October 2018.
- Current expenditure showed a real annual increase of 5.5% in the ten-month period.
- The financial cost of public debt contributed 4.3 pp to the 10.1% growth in non-programmable spending in the same period.

Source: BBVA Research based on data from SHCP (Secretariat of Finance and Public Credit)

The federal government reduced its commitment to fiscal consolidation in January-October 2018

Public spending indicators in January-October 2018
(real annual change %)

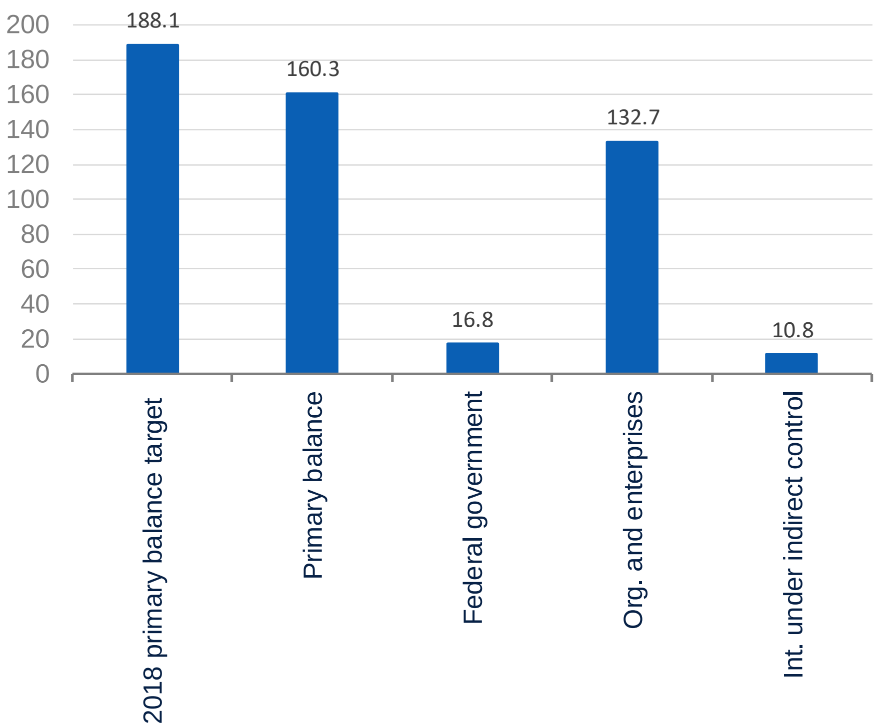


Source: BBVA Research based on data from SHCP

- Stripping out financial investment, federal contributions to the states, public pensions and financial cost, the real annual increase in spending would be 7.3% in the first ten months of 2018.
- The pattern of this limited measure of expenditure shows that the federal government reduced its fiscal consolidation efforts in the period.

The federal government looks set to reach its target primary surplus of 0.8% of GDP in 2018

Primary balance and components in January-October 2018
(MXN billions)



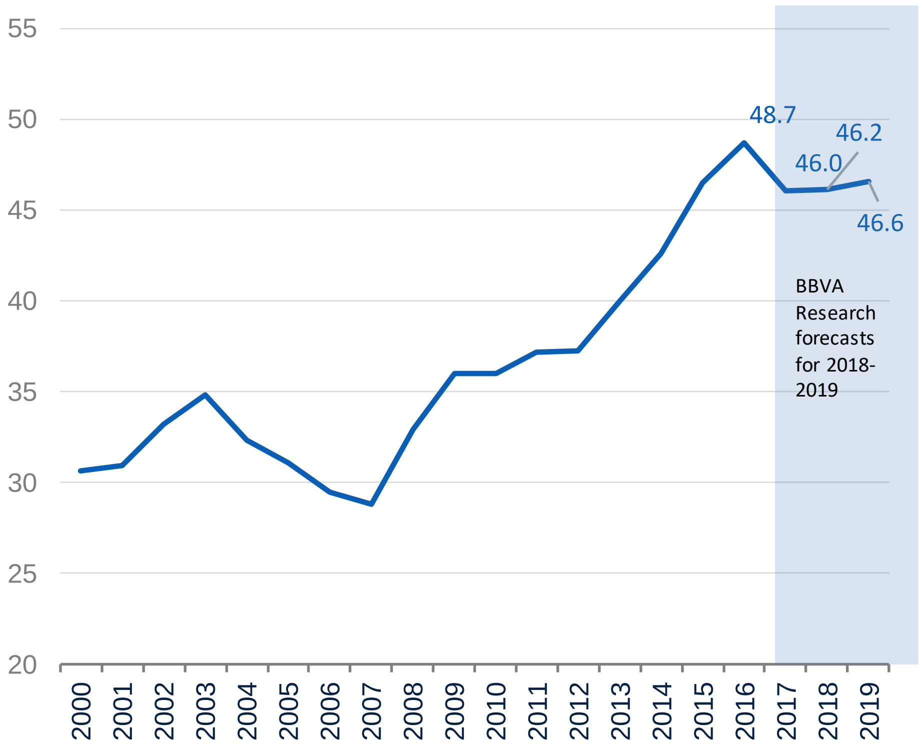
Source: BBVA Research based on data from SHCP

- The primary surplus in January-October 2018 was largely due to the balances of the IMSS and the ISSSTE. (private and public sector health and social services institutions, respectively)
- The primary surplus in January-October 2018 shows 85% attainment of the target of 0.8% of GDP for 2018.

We expect public debt as a % of GDP to increase marginally in 2018 and hold steady in 2019

Historical balance of public sector borrowing requirements

(% of GDP)



Source: BBVA Research based on data from SHCP

- The depreciation of the peso seen in the fourth quarter of the year will cause the SHRFSP (stock of public debt) as a % of GDP to increase from 46.0% in 2017 to 46.2% in 2018.
- We expect this broad measure of public debt to remain stable in 2019 at around 46.6%.

The federal government passes its first big test by basing its 2019 fiscal budget on reasonable economic assumptions

Economic assumptions for the 2019 fiscal budget

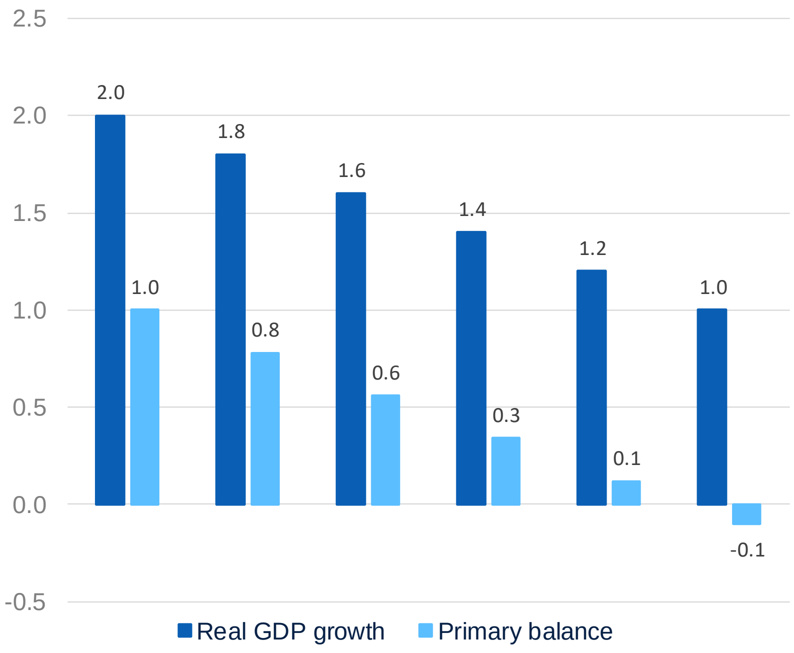
	2019
GDP	
YoY % real growth (interval)	1.5 - 2.5
Point forecast	2.0
Nominal (thousands of millions of pesos)	24,942.1
Deflator	3.9%
Inflation	3.4%
Nominal exchange rate	
End of period	20.0
Average	20.0
Nominal interest rate	
End of period	8.30%
Average	8.30%
Current account	
Millions of USD	-27,326
% of GDP	-2.2
Crude oil	
Average price (USD/barrel)	55
Average production (mbd)	1,847
Average exports (mbd)	1,016

Source: BBVA Research based on data from SHCP

- The fiscal package is solid in macroeconomic terms, but it introduces some distortions at microeconomic level.
- It is based in reasonable economic assumptions in line with those of the market
- Revenue and expenditure projections are conservative.
- As we expected, market reaction has been slightly positive.

Lower economic growth could translate into a smaller primary surplus if the federal government did not adjust its spending plans

Economic growth and primary balance
(change % YoY and % of GDP)



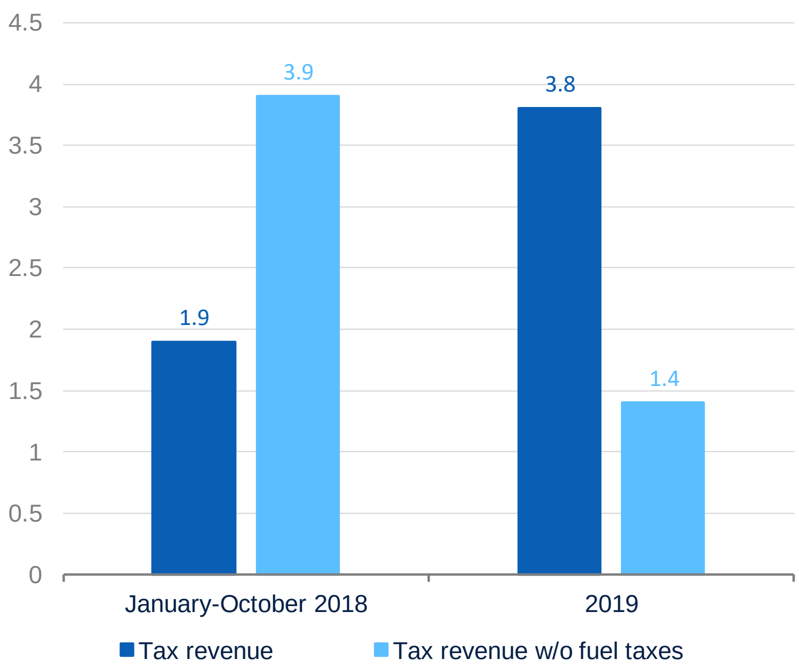
Source: BBVA Research based on data from SHCP

- The federal government has set a target of 1.0% of GDP for the primary surplus in 2019.
- However, lower economic growth could reduce the primary surplus through its impact on tax revenues.
- Also, in an adverse economic scenario, the federal government would have to opt to attain its fiscal target by reducing approved expenditure.

Collection of IEPS excise tax on fuel will have to increase by 42% in real annual terms for tax revenues to grow by 3.8%

Tax revenues with and without IEPS excise tax on fuel

(real % YoY change)



- The freezing of domestic real prices of gasoline and diesel for next year, together with the stable or lower international prices of these fuels should help to increase fuel tax revenues, but uncertainty persists as to whether this objective will be attained.
- As for the tax cuts in municipalities along the border with the US, this is a serious political mistake, which will lead to reduced tax revenues and significant distortions.

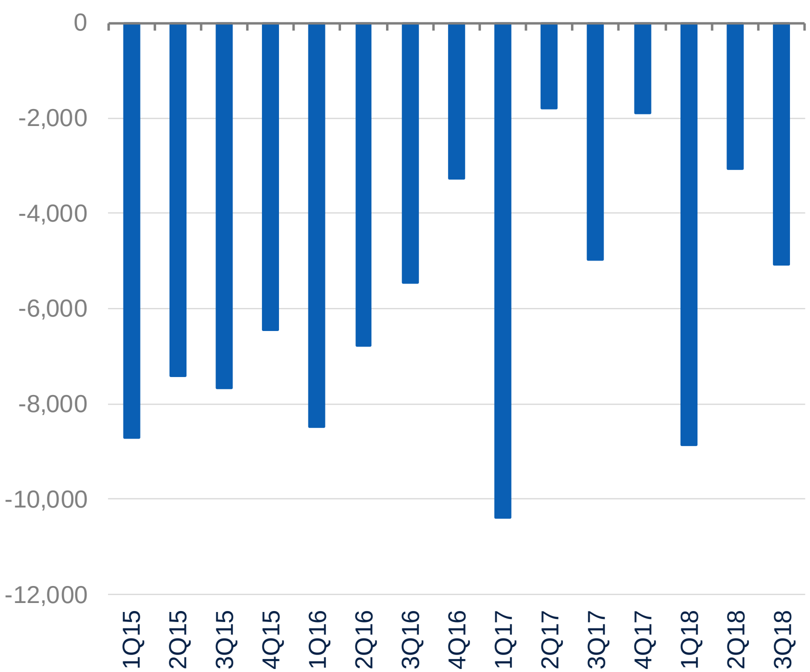
Source: BBVA Research based on data from SHCP

05

External accounts

The current account deficit fell marginally in the first nine months of 2018 relative to the same period of 2017; we estimate that it will end the year at 2.0% of GDP

Current account
(US$ million)

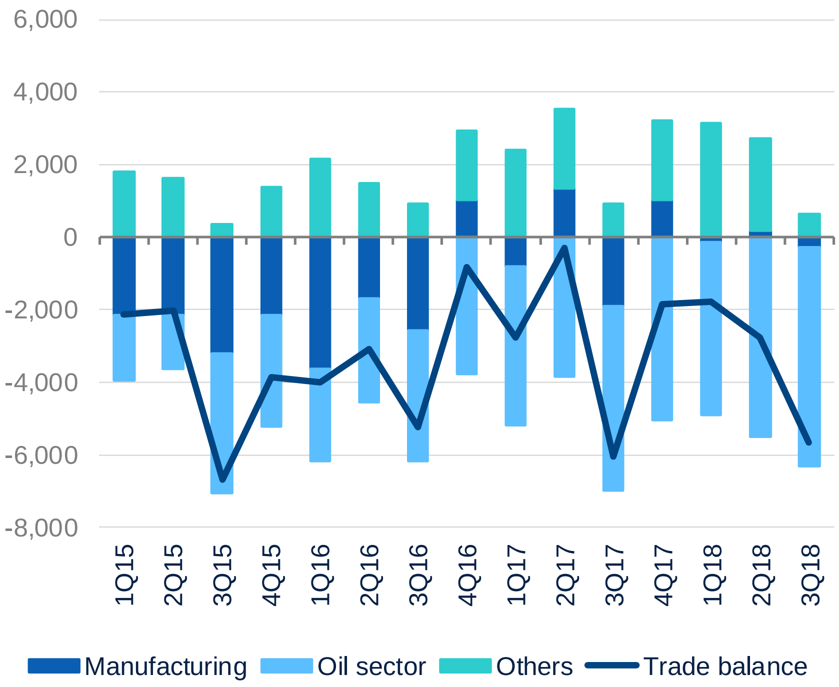


Source: BBVA Research based on Banxico figures

- The current account deficit fell to US$17,020 million in the first nine months of 2018 from US$17,151 million in the same period of 2017
- This is explained mainly by: i) the increased surplus in the balance of secondary revenues and ii) the increased surplus in the balance of non-oil goods
- However, the deficit in oil and petroleum products was US$16,323 million in the nine months the end of 3Q18 as opposed to US$13,263 million in the same period of 2017.

The surplus in the agriculture and livestock sector kept the overall trade balance of non-oil goods positive in the nine-month period

Trade balance and principal components
(US$ million)



- The trade deficit increased to US$10,348 million in the first nine months of 2018, from US$9,116 million in the same period of 2017.
- This was due mainly to the increased deficit in the trade surplus for oil and petroleum products (US$16,323 million in January-September 2018, compared with US$13,263 million in the same period of 2017)
- We expect the trade deficit for 2018 to be US$14 billion, equivalent to 1.2% of GDP

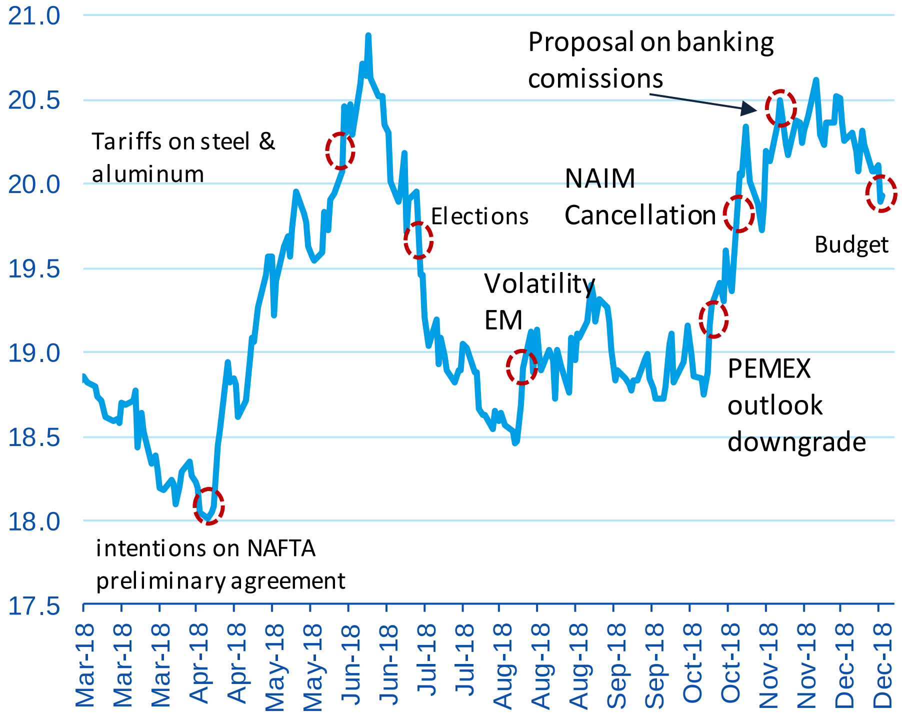
Source: BBVA Research based on INEGI data

06

Domestic assets are being affected by the new administration’s decisions

Currency depreciation deriving from the uncertainty generated by the new administration's decisions

Exchange rate
(Pesos per dollar)

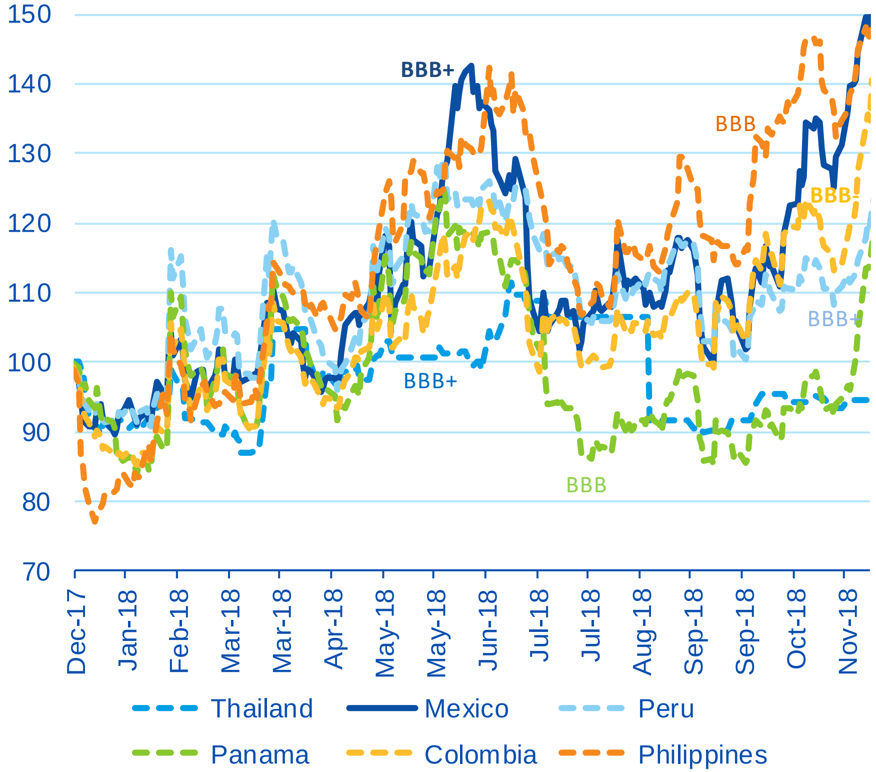


- The peso was the currency that depreciated most in 4Q (6.93%).
- The responsible budget will limit the weakness in the next few weeks, but the risks remain

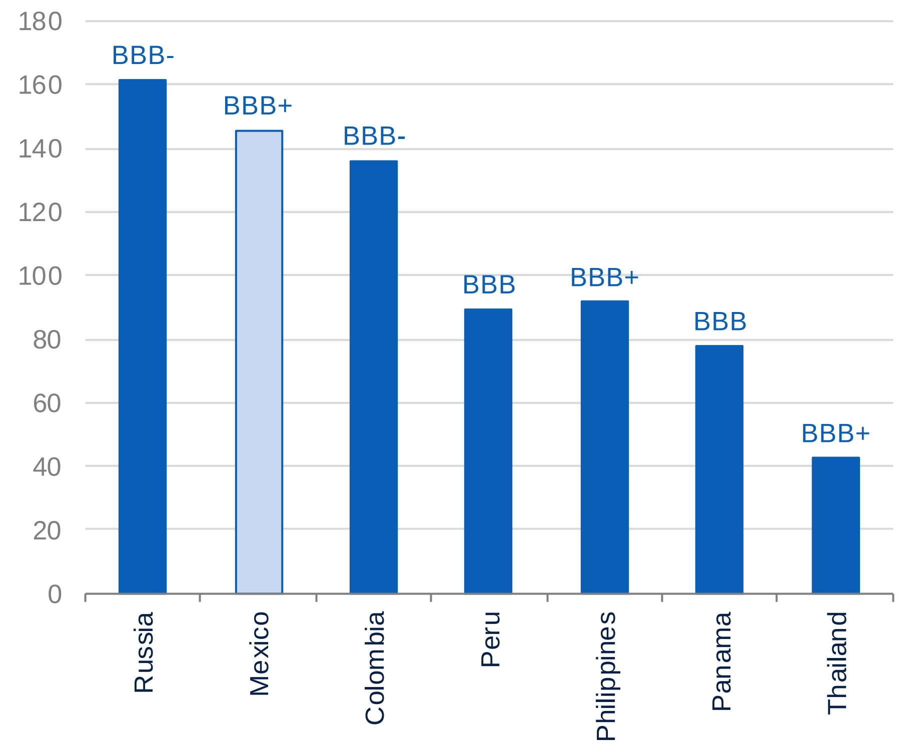
Source: BBVA Research based on Bloomberg data

Mexico's sovereign risk is trading at similar levels to those of countries rated two notches lower

Sovereign risk [5-year CDS spread]
(Index January 2018 = 100)



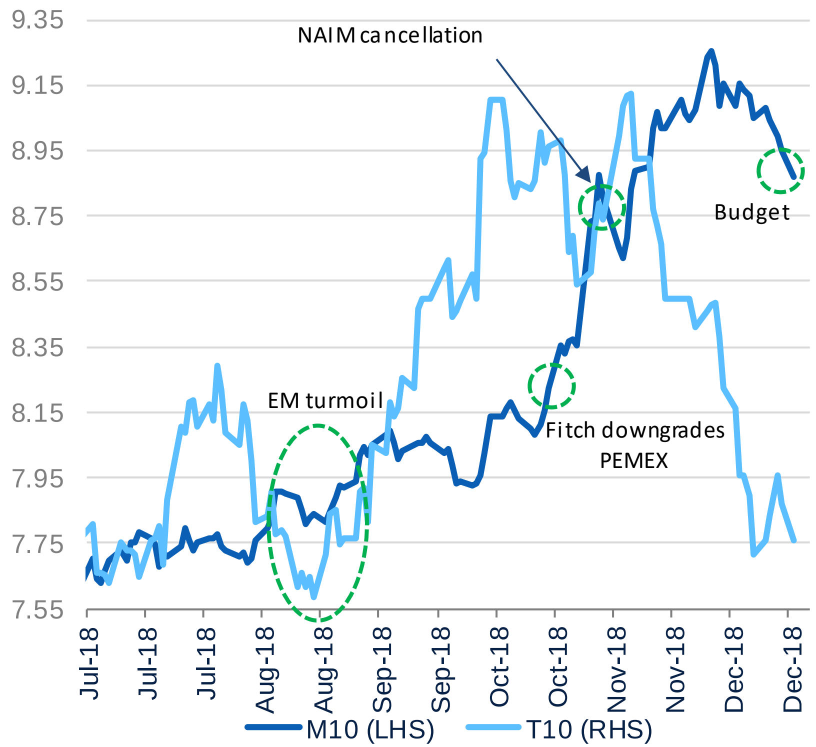
Sovereign risk [5-year CDS spread] at 17 December 2018 (basis points)



Source: BBVA Research based on Bloomberg data

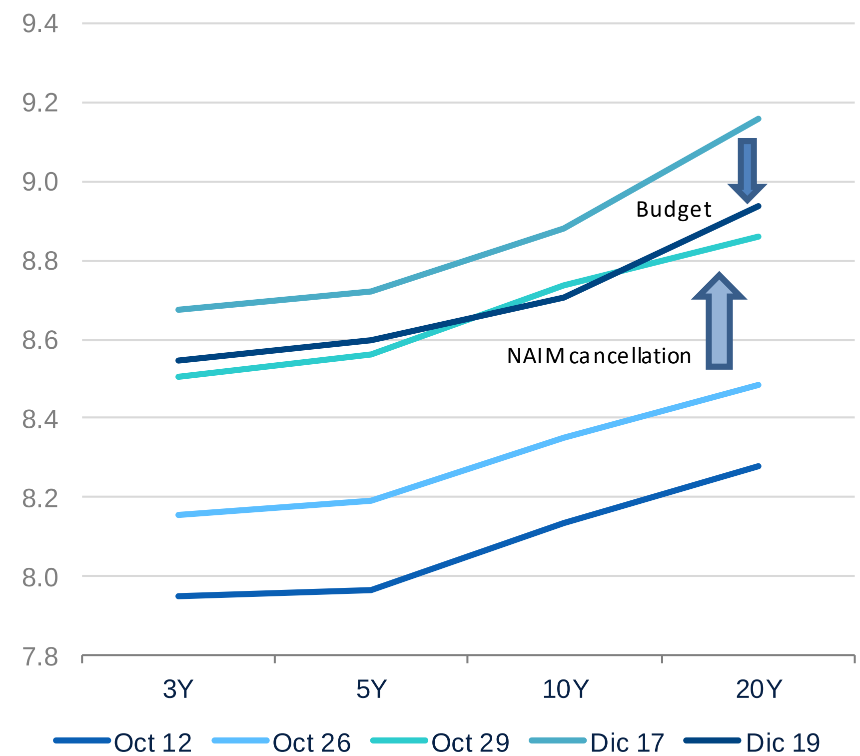
Increased sovereign risk and more restrictive monetary policy lead to higher long-term interest rates

Government 10-year interest rates, USA and Mexico (%)



Source: BBVA Research based on Bloomberg data

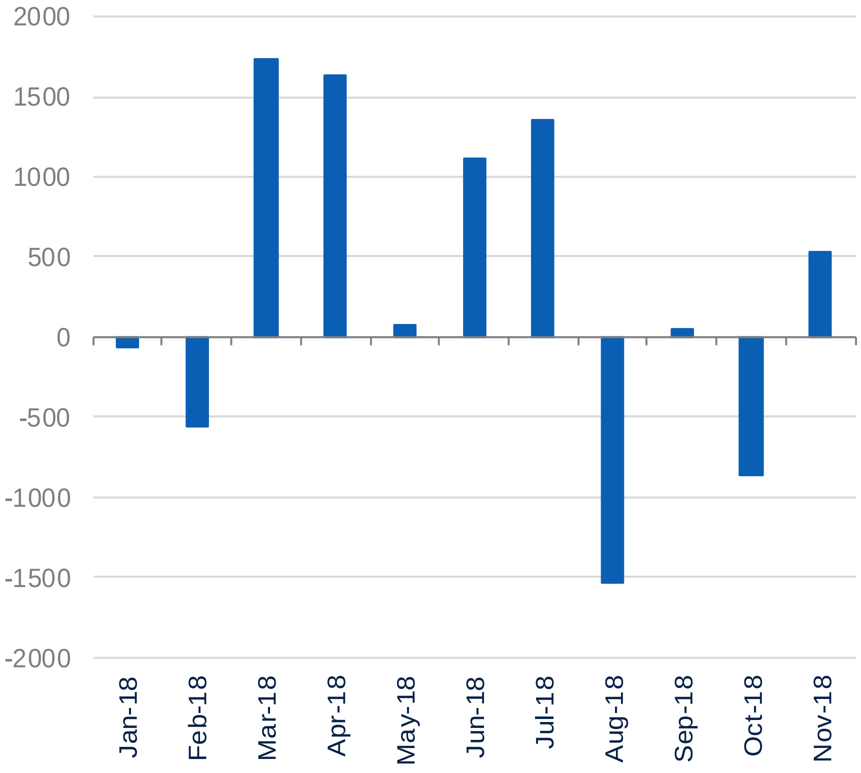
Government bond yield curve (%)



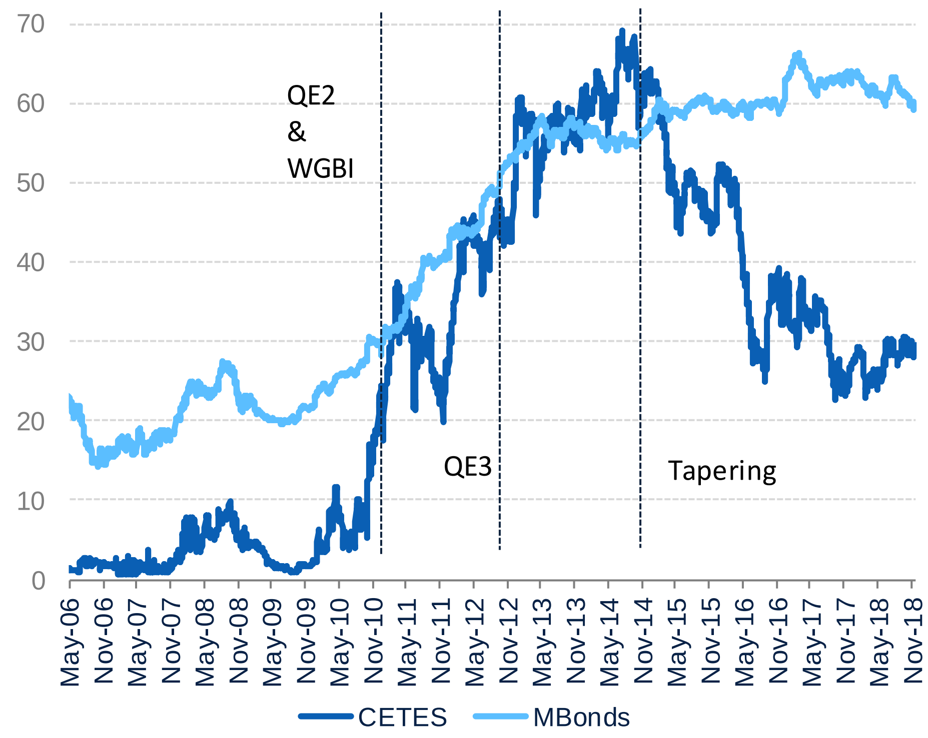
Even though the budget had an effect on the fall in yields, the level attained in the ten-year range is the highest since 2009

Despite the uncertainty, foreigners are maintaining their positions in medium- and long-term bonds

Monthly change in foreigners' holdings of bonds
(US$ millions)



Holdings of CETES (Federal Treasury certificates) and M-bonds by foreigners
(% of total)



Source: BBVA Research based on Bloomberg data

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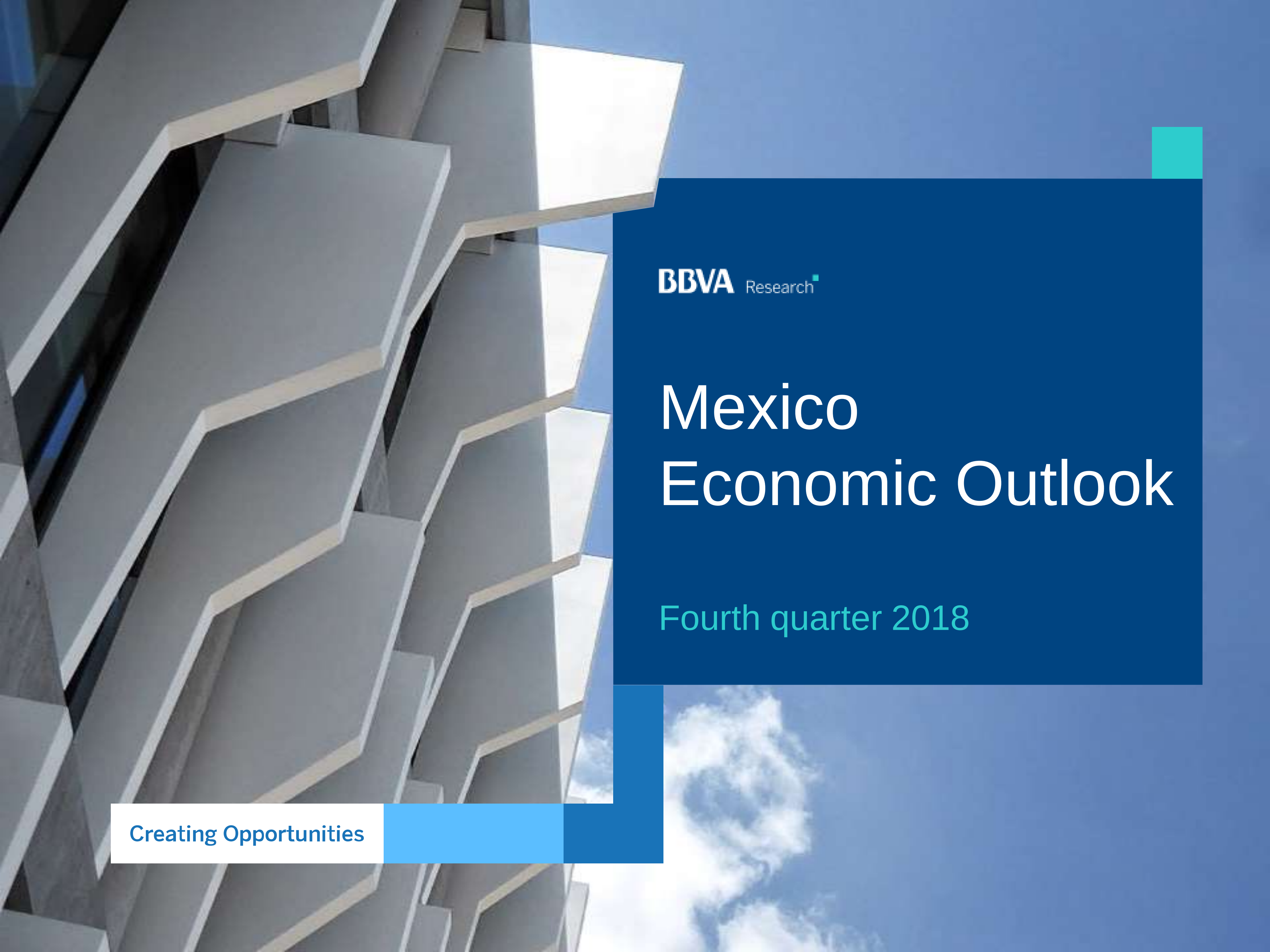

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