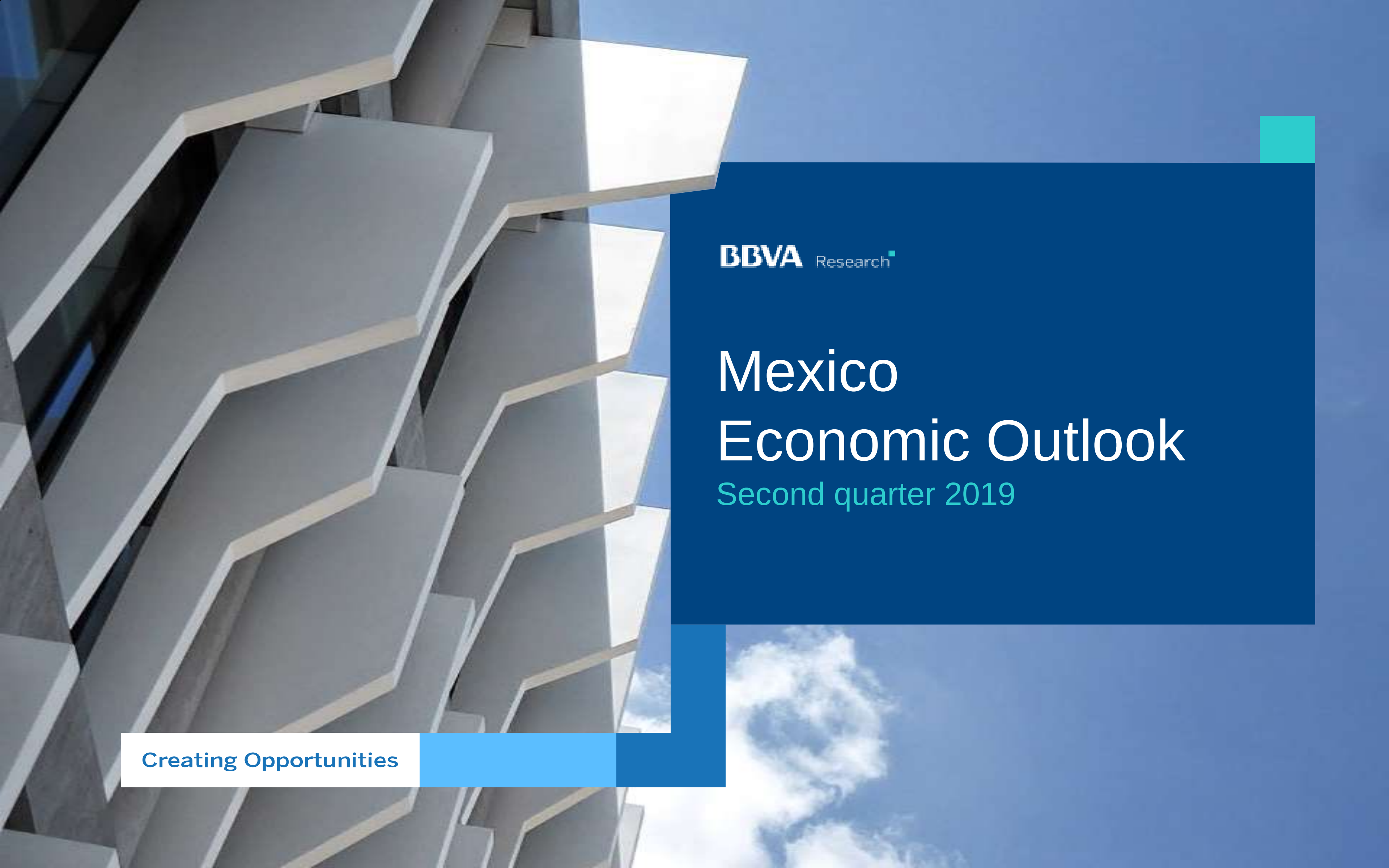


BBVA Research

Mexico Economic Outlook

Second quarter 2019

Creating Opportunities

BBVA Research

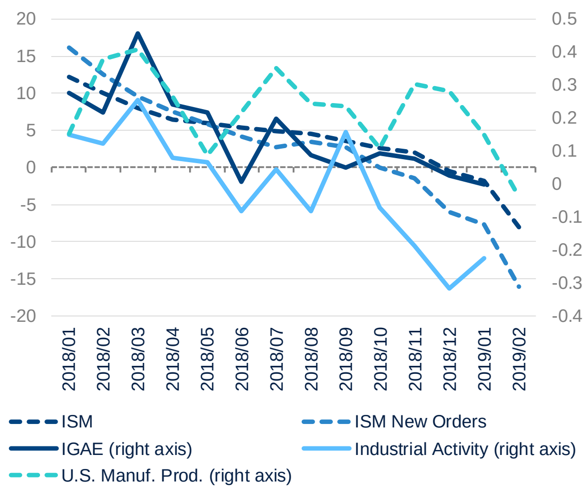
Contents

01

Economic outlook: lower growth, inflation and interest rates

Jan and Feb available data points towards a downturn in 1Q19

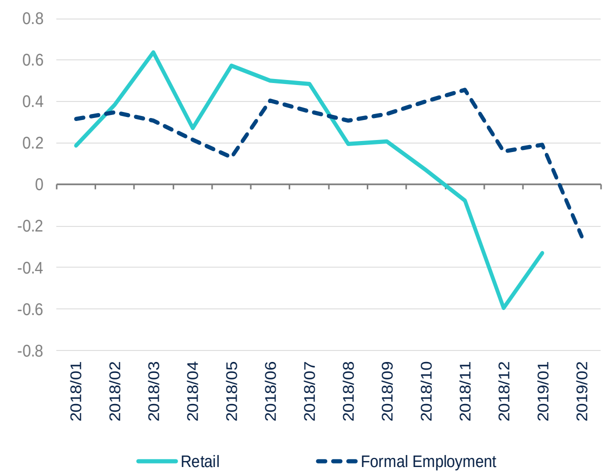
Hard Indicators: Industry*
(MoM % change, 6mma)



US manufacturing sector sector shows signs of deepening

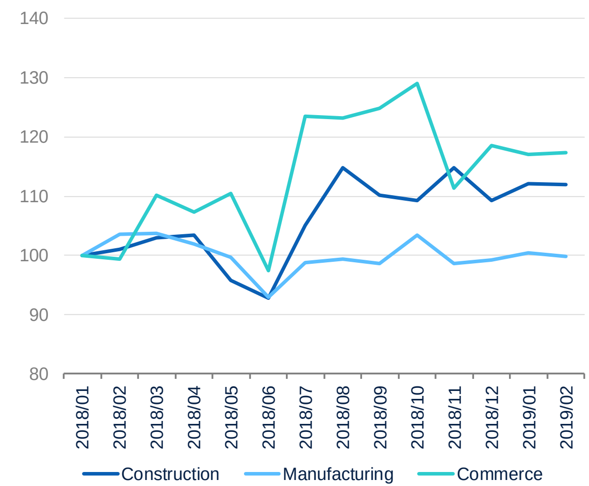
*Solid line: available until January
Dotted line: available until February

Hard Indicators: Commerce & Employment*
(MoM % change, 6mma)



Formal job creation is decelerating; the Feb growth print is the lowest in 5 years

Soft Indicators: Right Time to Invest
(Index 2018/01 = 100)



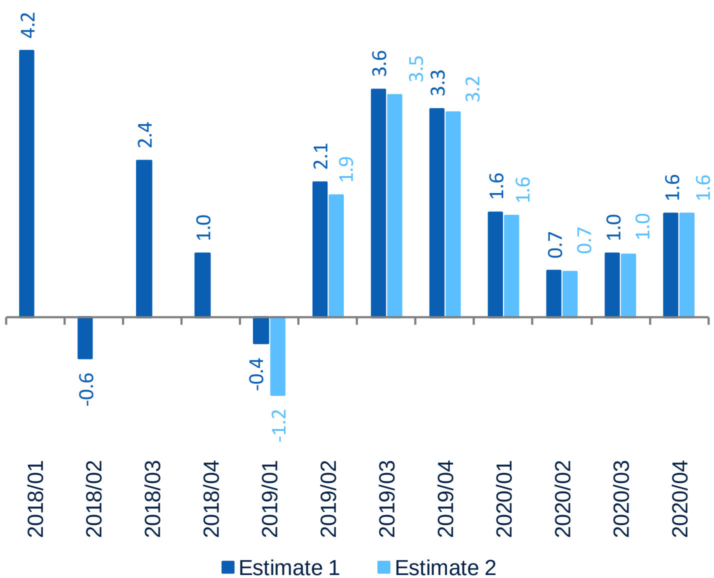
Firms confidence in investing shows signs of stagnation in 1T19

Source: BBVA Research / INEGI.

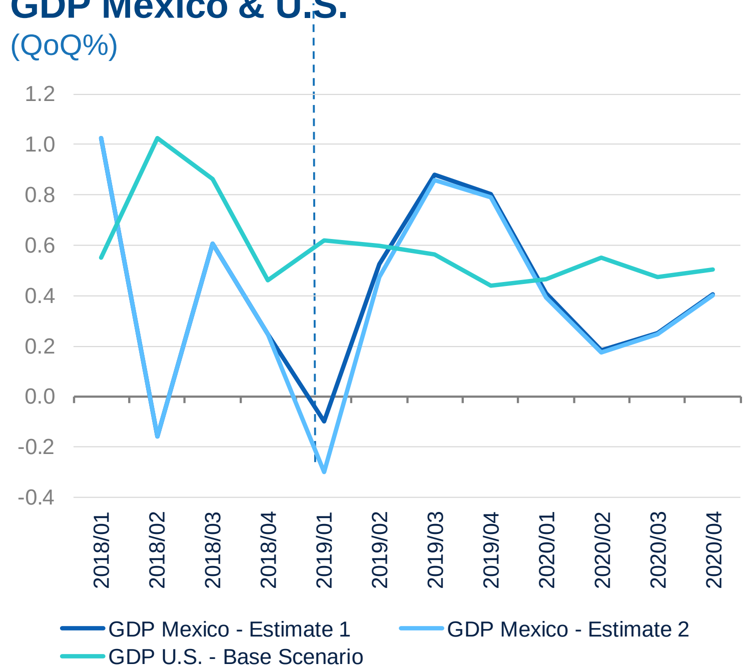
Our tracker point to GDP declining between -0.4 and -1.2% saar in 1Q19. If confirmed, the US growth path points to annual growth in Mexico of 1.1%-1.4%

If the US economy performs worse than our base scenario or the US manufacturing sector decouples as in 1Q, growth might be closer to the lower end of our forecast

GDP
(SAAR%)



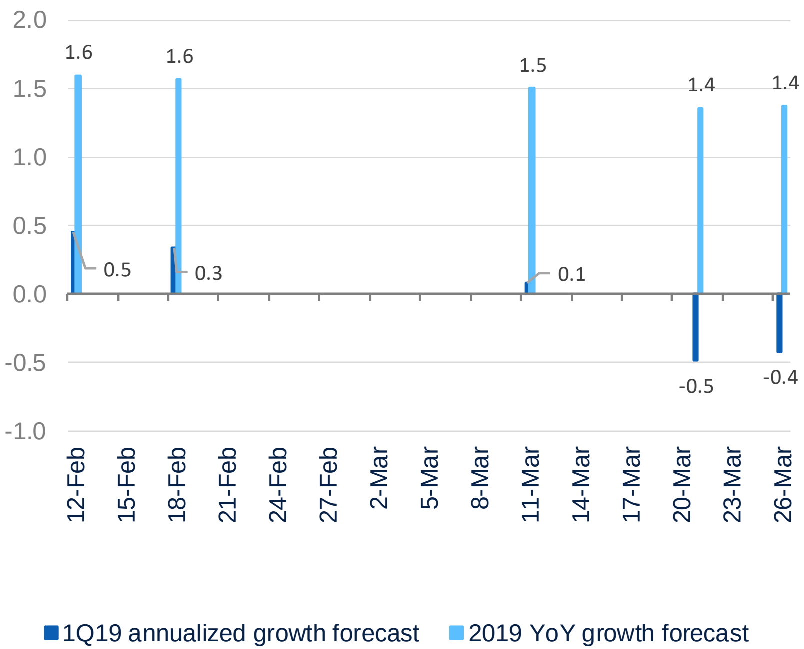
GDP Mexico & U.S.
(QoQ%)



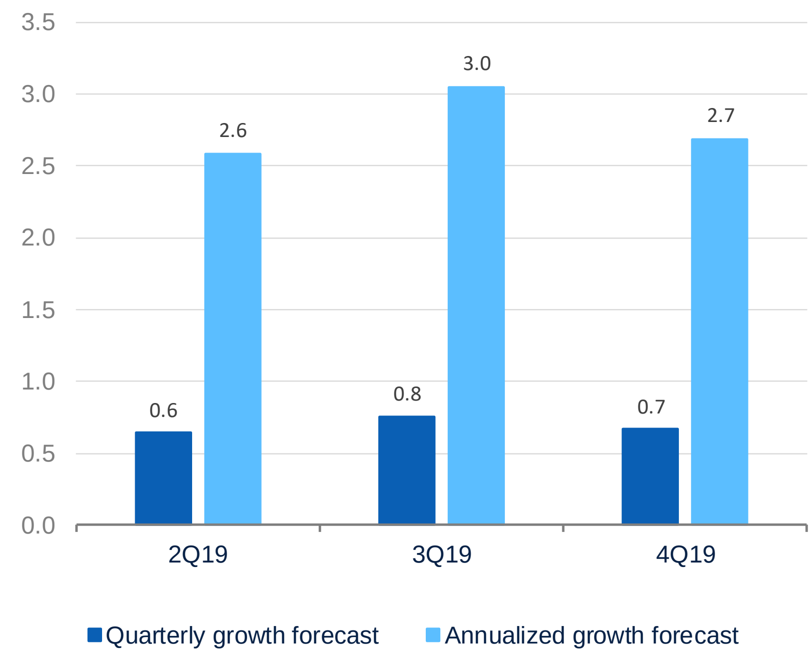
Source: BBVA Research / INEGI.

1Q19 growth forecasts from MICA indicate weakness in economic activity

GDP growth forecasts for 1Q19 and 2019 from MICA
(saar % and YoY%)



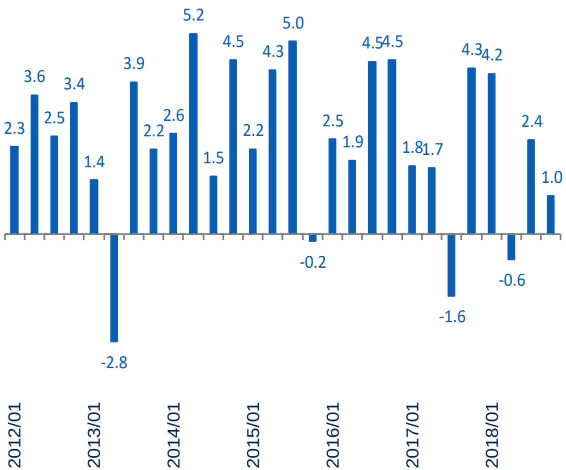
GDP growth forecasts for 2Q19-4Q19
(QoQ% and saar%)



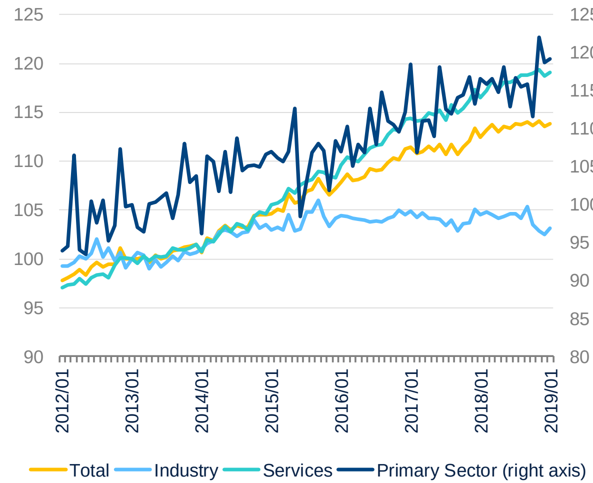
Source: BBVA Research / INEGI

The services sector continues to offset a weak industrial sector

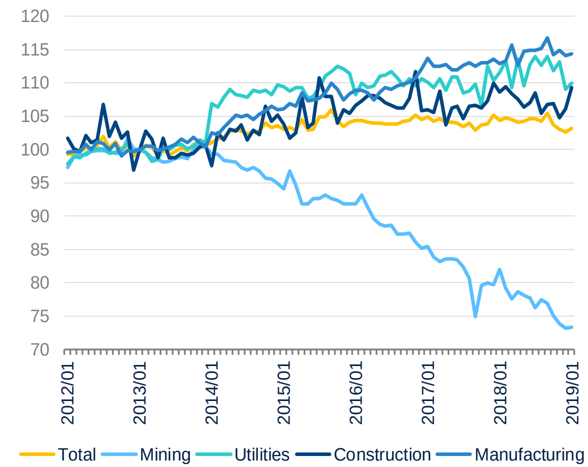
GDP
(SAAR, %)



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



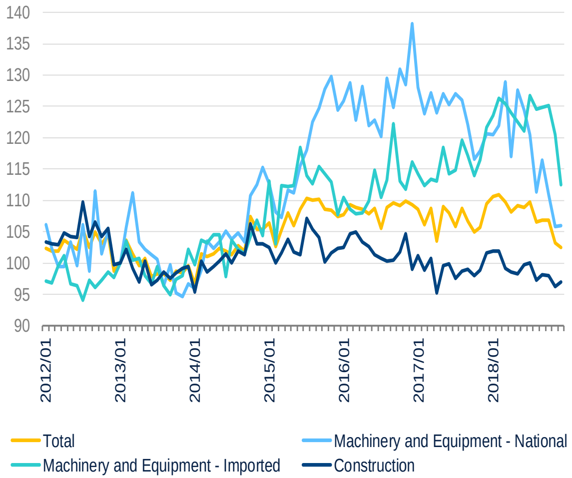
Industrial activity
(Index 2013/01 = 100)



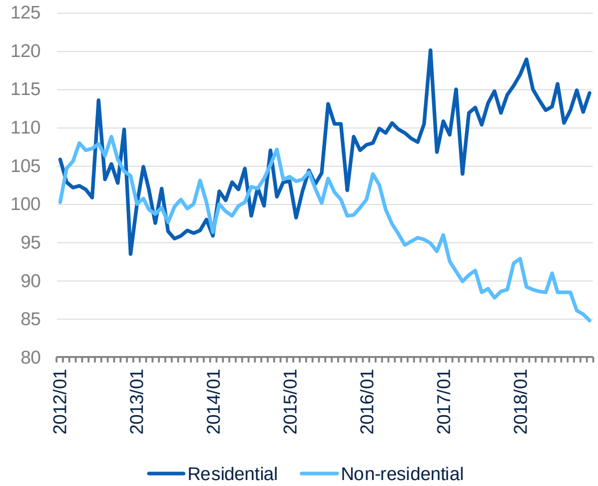
Source: BBVA Research / INEGI.

Private investment remains weak; likely delay in its recovery

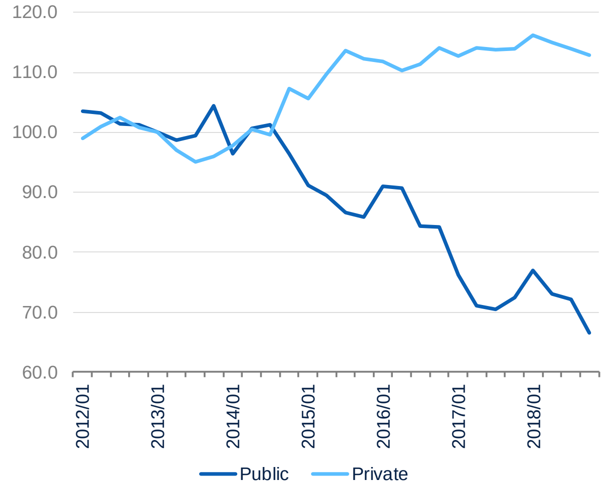
Gross Fixed Investment
(Index 2013/01 = 100)



Construction
(Index 2013/01 = 100)



Gross Fixed Investment
(Index 2013/01 = 100)

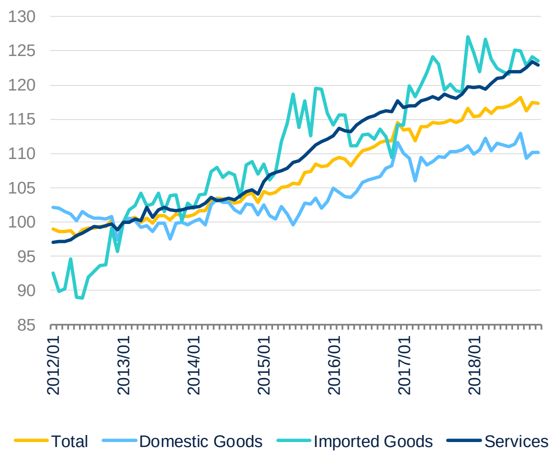


Source: BBVA Research / INEGI

Private consumption remained strong but the job creation points to lower growth ahead; real wage gains are an offsetting factor

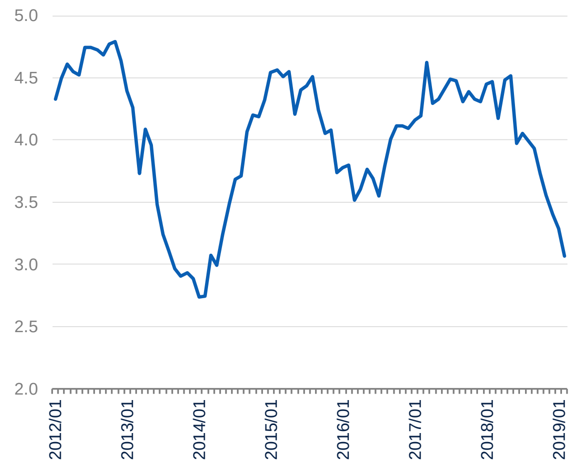
Monthly Private Consumption Indicator

(Index 2013/01 = 100)



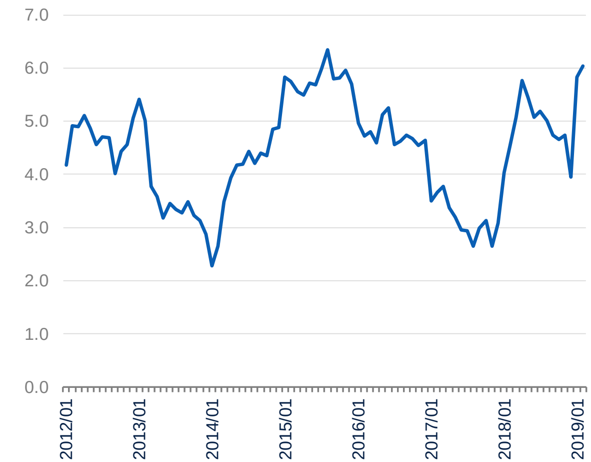
Formal employment

(YoY % change)



Total formal payroll

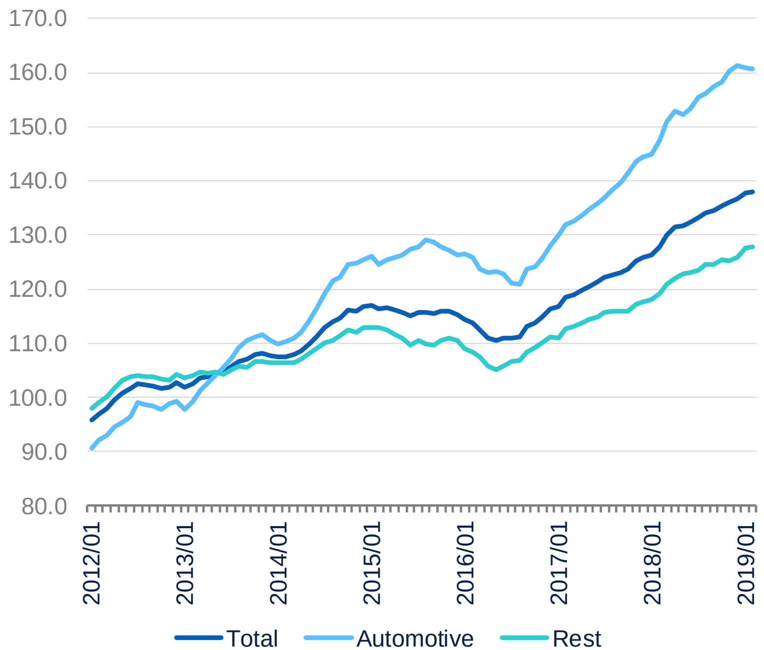
(YoY % change)



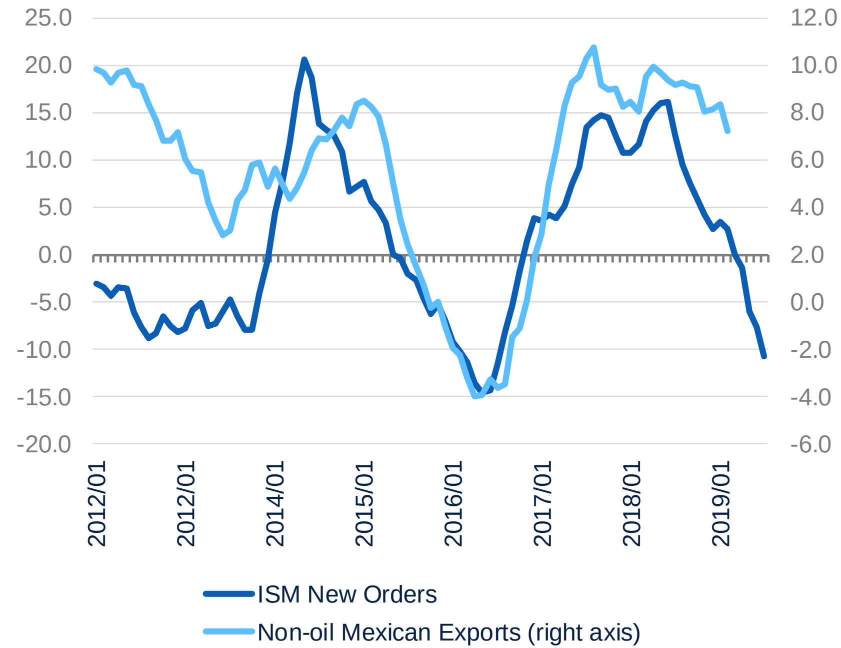
Source: BBVA Research / INEGI

The US manufacturing sector has weakened more than anticipated

Manufacturing exports
(Index 2013/01 = 100, 6-month moving average)



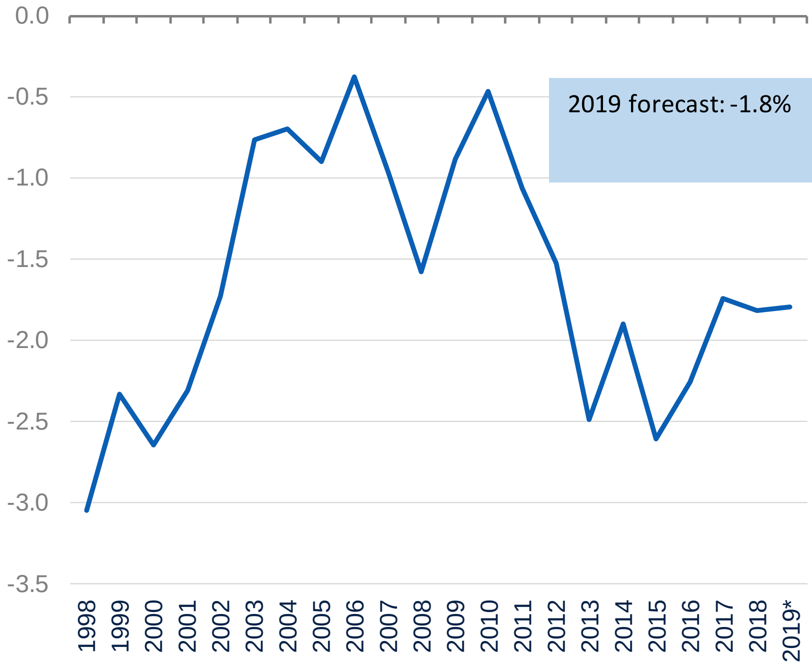
Mexican Non-Oil Exports and ISM New Orders Index
(YoY%, 6-month moving average, ISM 6-month lead)



Source: BBVA Research / INEGI

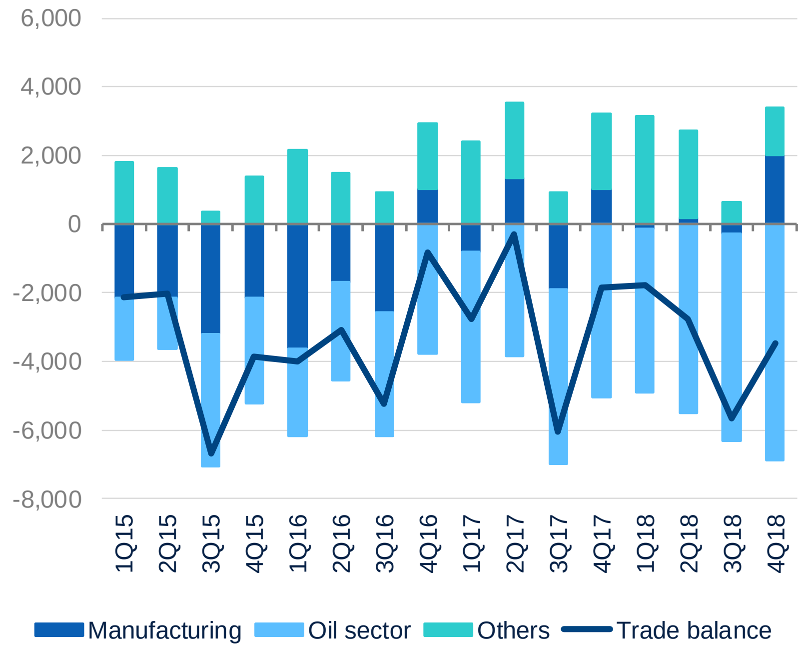
Manufacturing and agriculture have contributed to stabilizing the current account deficit despite the increasing oil-related commercial deficit*

Current account
(% of GDP)



Source: BBVA Research / Banxico
*/External demand from US manufacturing and real exchange depreciation have been the main drivers

Trade balance and principal components
(US$ million)

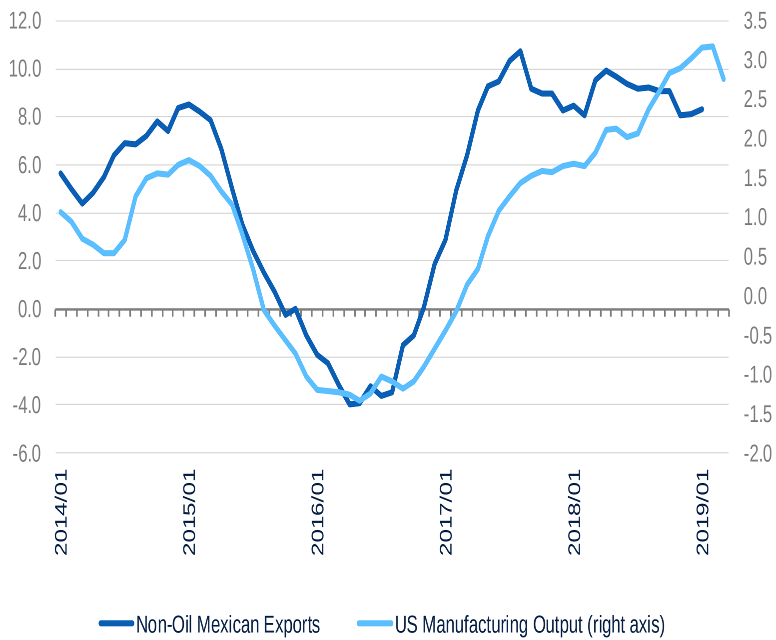


Source: BBVA Research / INEGI

Lower growth in 2019 (1.4%) on weakening signs in late 2018 and early 2019, along with a surprisingly weak US manufacturing sector and a delay in the expected recovery of investment

Mexican Non-Oil Exports and US Manufacturing Output Index

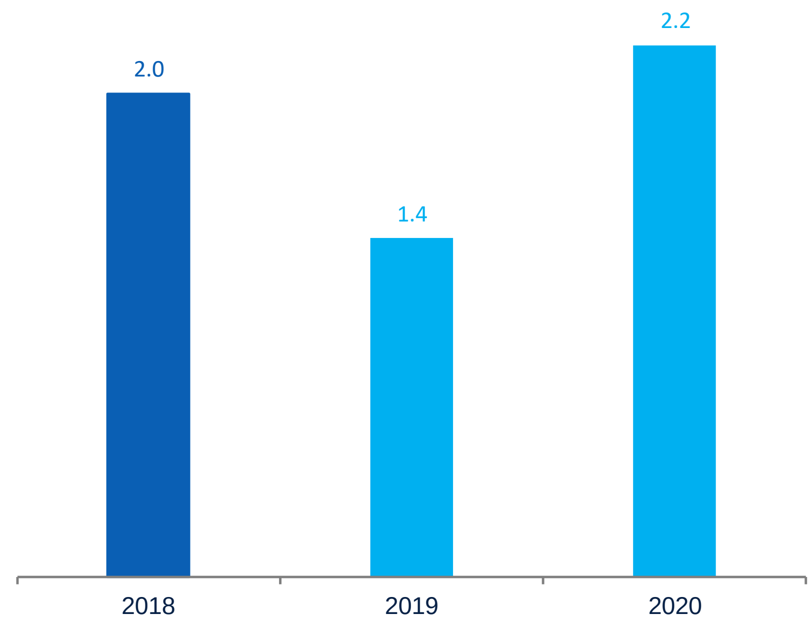
(YoY % change, 6-month moving average, US 1-month lead)



Source: BBVA Research / INEGI

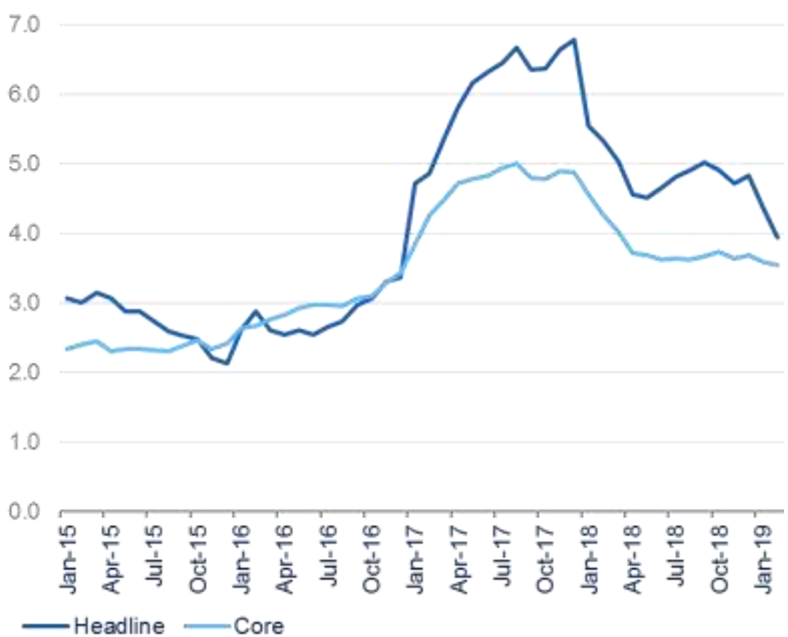
GDP

(Annual % change)



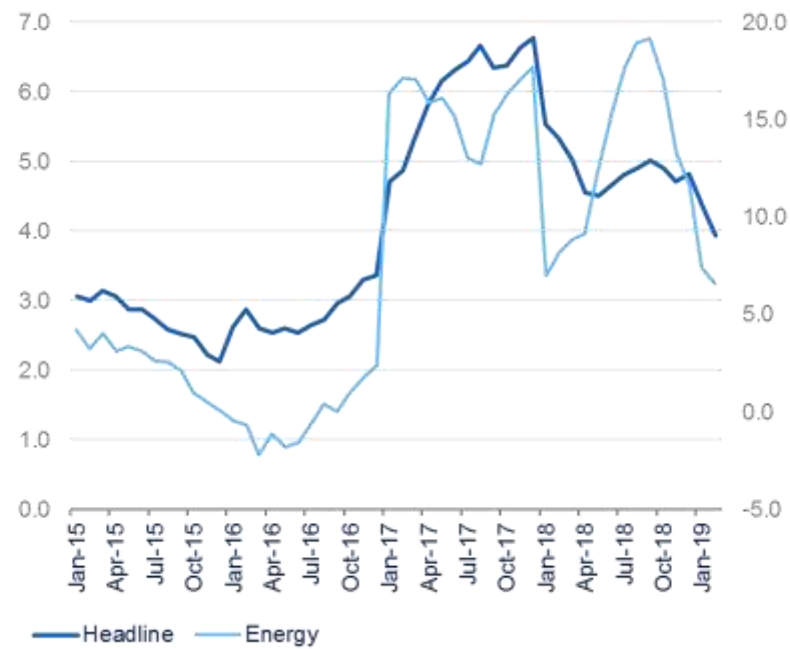
Inflation is off to a great start in 2019: the 0.1pp increase over Jan-Feb is the lowest since 2015, when inflation reached an all-time low

Headline and core inflation
(YoY % change)



Source: BBVA Research / INEGI

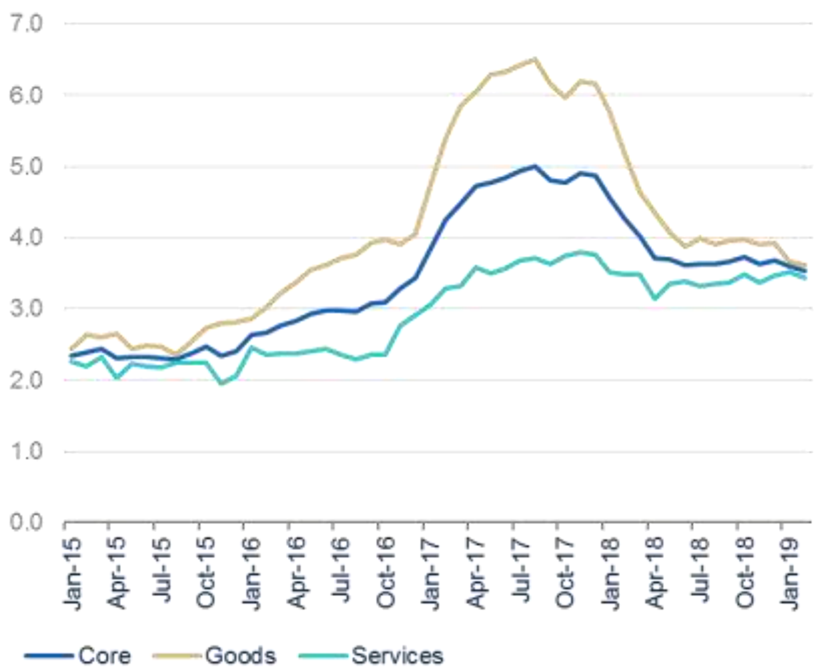
Headline and energy inflation
(YoY % change)



Source: BBVA Research / INEGI

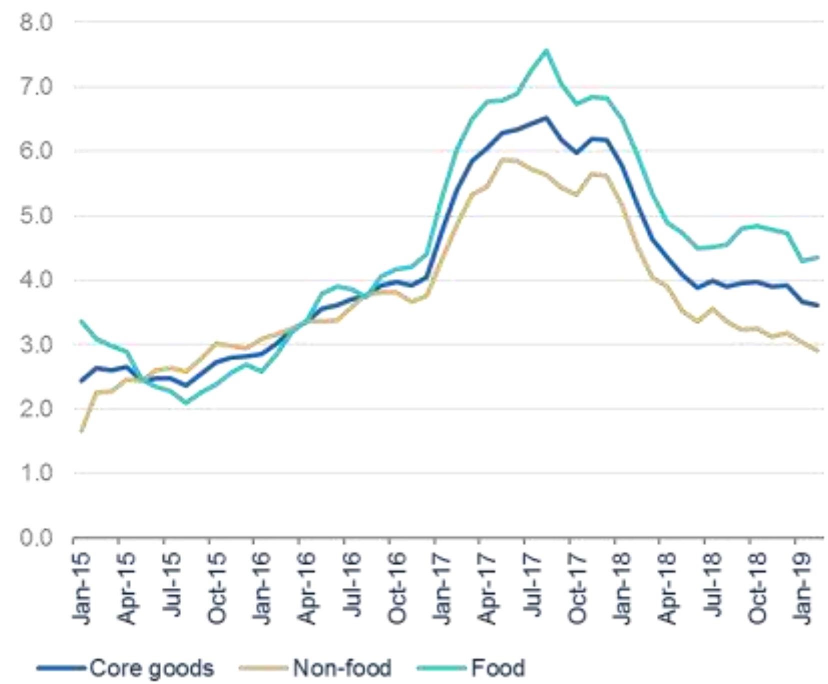
Core inflation annual rate edged down to 3.5%, barely breaking to the downside the narrow 3.6%-3.7 range in which it fluctuated since Apr18

Core inflation breakdown
(YoY % change)



Source: BBVA Research / INEGI

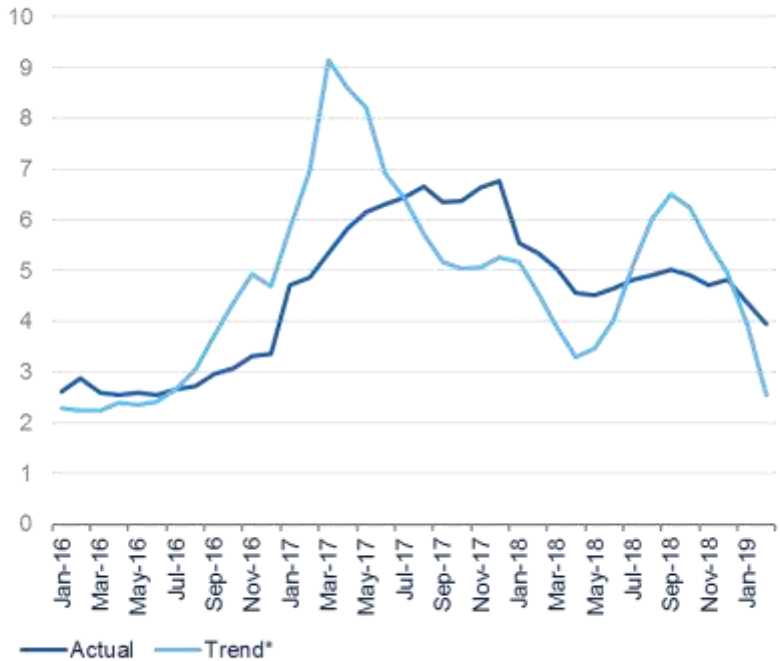
Core goods inflation breakdown
(YoY % change)



Source: BBVA Research / INEGI

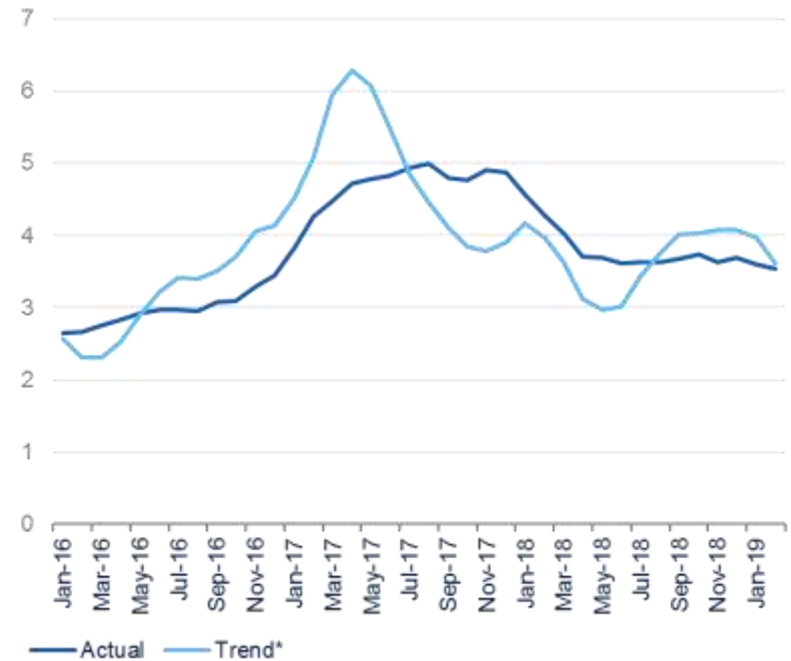
Inflation trends suggest lower headline with stable core…

Headline inflation & trend
(YoY % change and)



Source: BBVA Research / INEGI

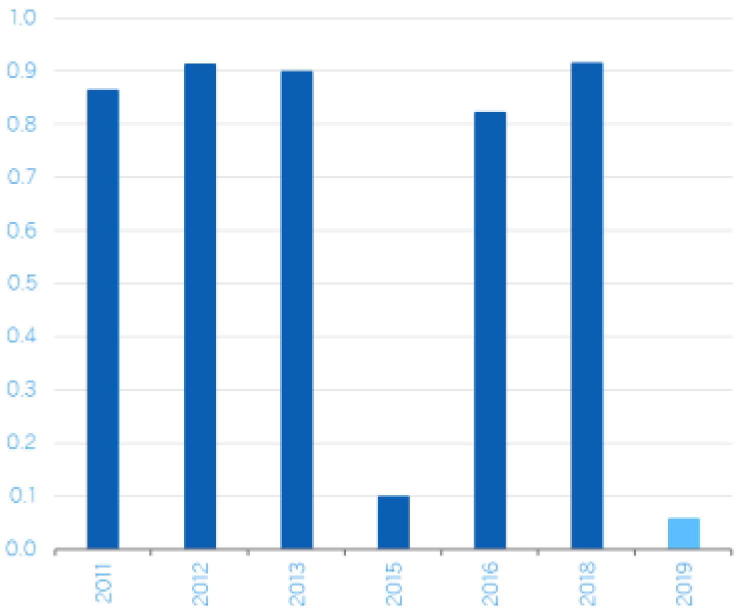
Core inflation and trend*
(YoY % change)



Source: BBVA Research / INEGI

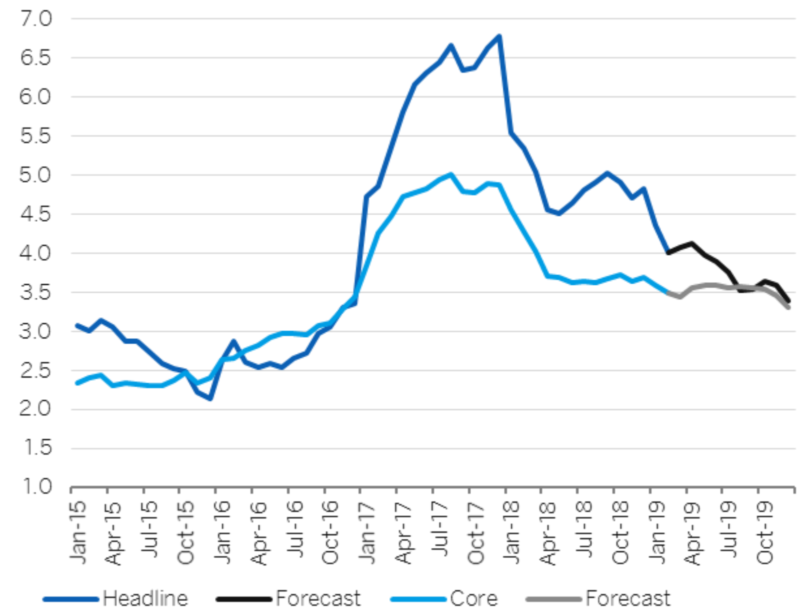
… yet, headline inflation is likely to rebound in 2Q19 before declining more than previously expected by year-end (to 3.4%)

Cumulative inflation in Jan-Feb
(pp)



Source: BBVA Research / INEGI

Inflation Outlook
(YoY % change)



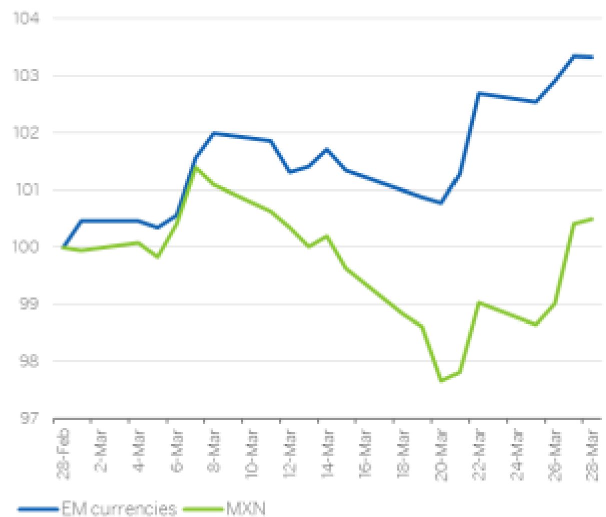
Source: BBVA Research / INEGI

Banxico not ready to change its stance, but likely to shift to an easing mode sooner rather than later as inflation risks continue to ease…

MXN vs EM currencies*, Oct18-Mar19
(Index 1Oct2018=100)

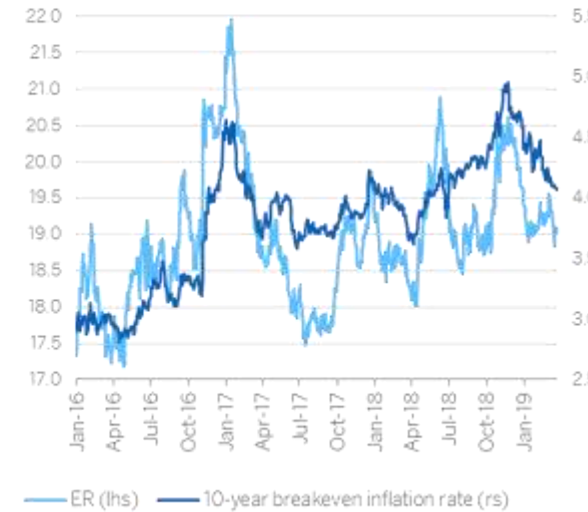
*Own calculations based on a reweighting of the JP Morgan Emerging Markets Currency Index after taking out the MXN
Source: BBVA Research / Bloomberg

MXN vs EM currencies*, March 2019
(Index 28Feb2019)



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

Long-term market based-inflation expectations and exchange rate
(% & ppd)



Source: BBVA Research / Bloomberg

… the Fed is on the sidelines, the carry-trade is high… but Banxico is likely to wait some months on PEMEX related concerns

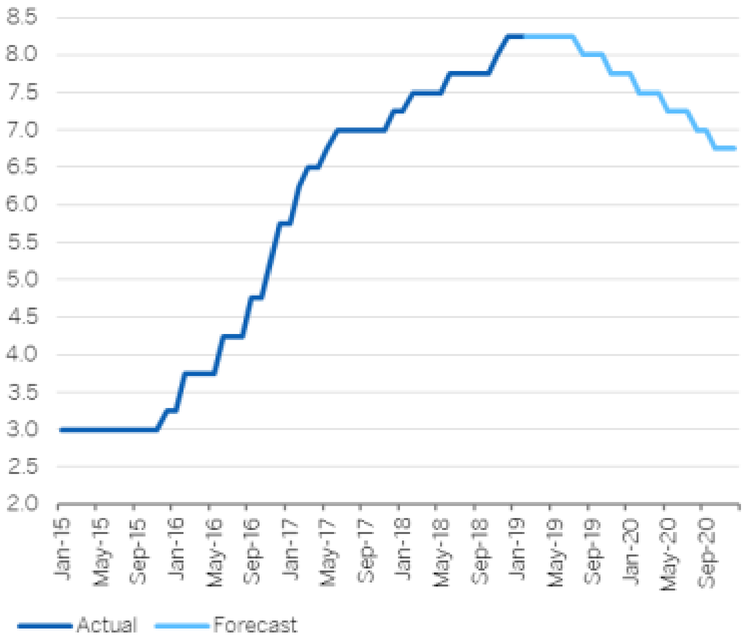
Risk-adjusted carry-trade
(%)

Source: BBVA Research / Bloomberg

- MXN relatively stable in spite of risks
- Headline inflation should fall below 4.0% in the Summer
- Weakening economy / widening output gap
- The real exante monetary policy rate is clearly restrictive

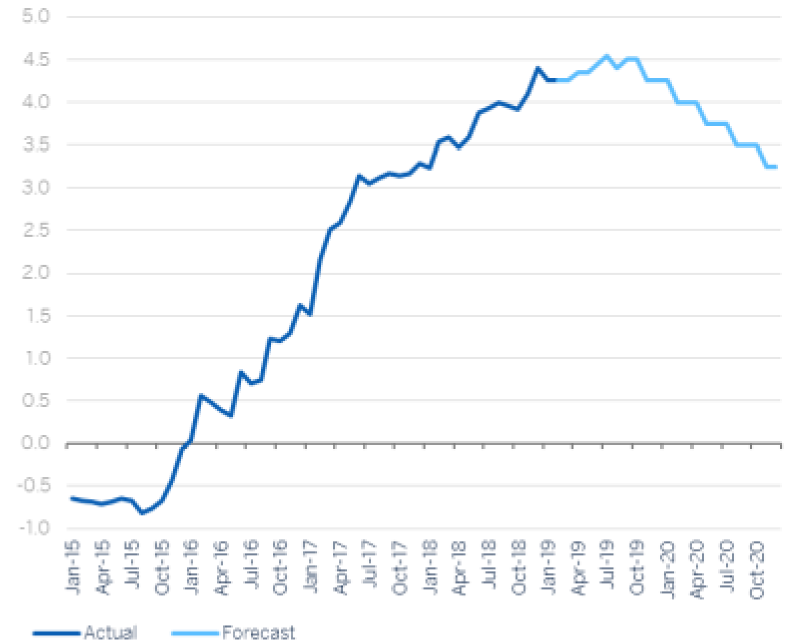
The case for an easing cycle will become strong in a few months' time. We forecast 50bp of rate cuts this year (to 7.75%) and another 100bp of cuts next year (to 6.75%)

Monetary policy rate outlook, nominal
(%)



Source: BBVA Research / Banxico

Real exante monetary policy rate outlook
(%)



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

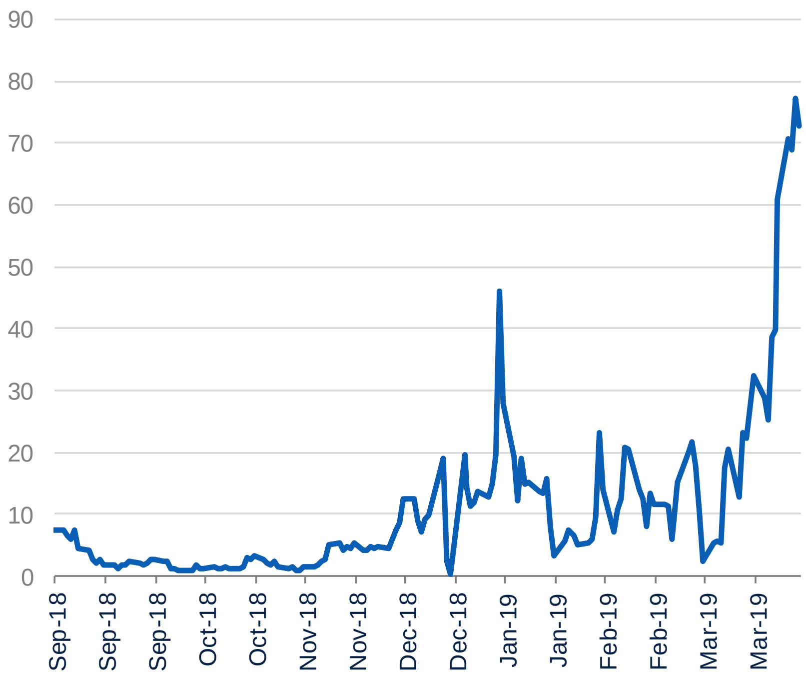
02

Lower long-term rates and steady USDMXN

So far, as the market discount a more dovish FED, EM currencies appreciate influenced by the US economy slowdown

Futures' market implied probability of a FED rate cut in 2019

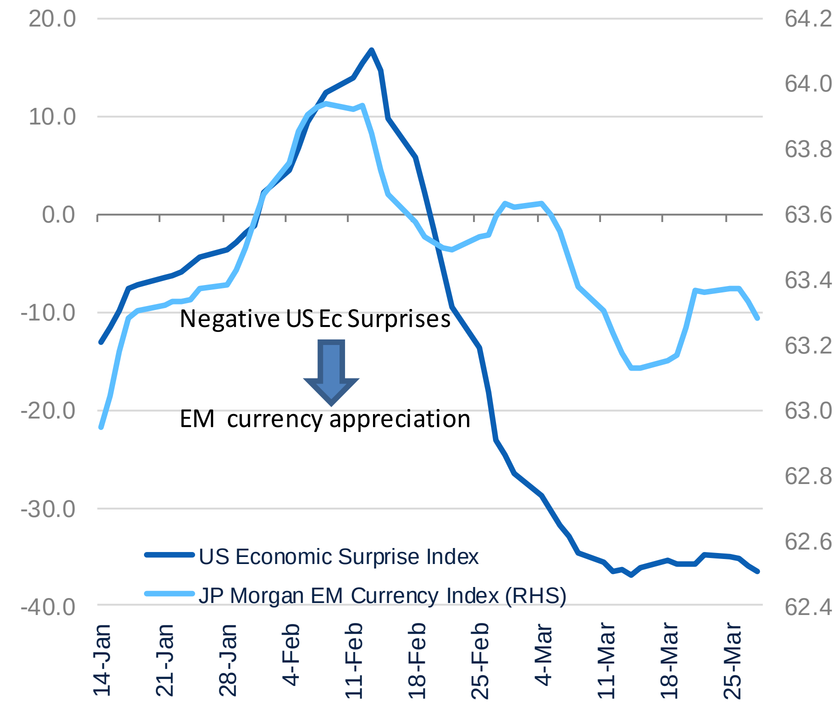
(%)



Source: BBVA Research based on Bloomberg data

US Economic Surprise Index* and EM currencies

(Index MA(10))

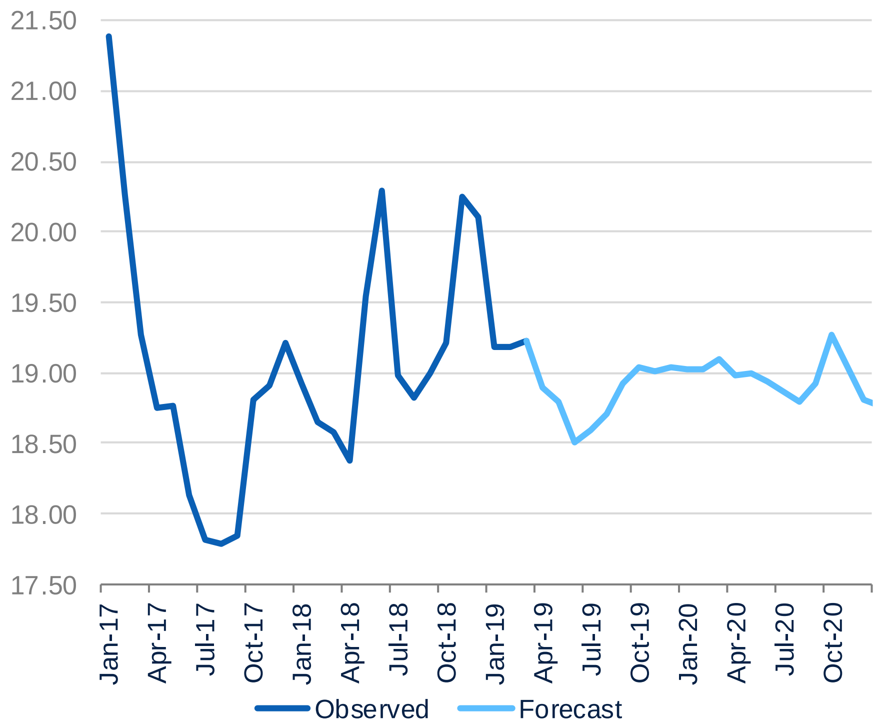


Source: BBVA Research / Bloomberg

* A positive reading of the Surprise Index means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected

Against this backdrop we maintain our fx forecast

USDMXN
(PPD)

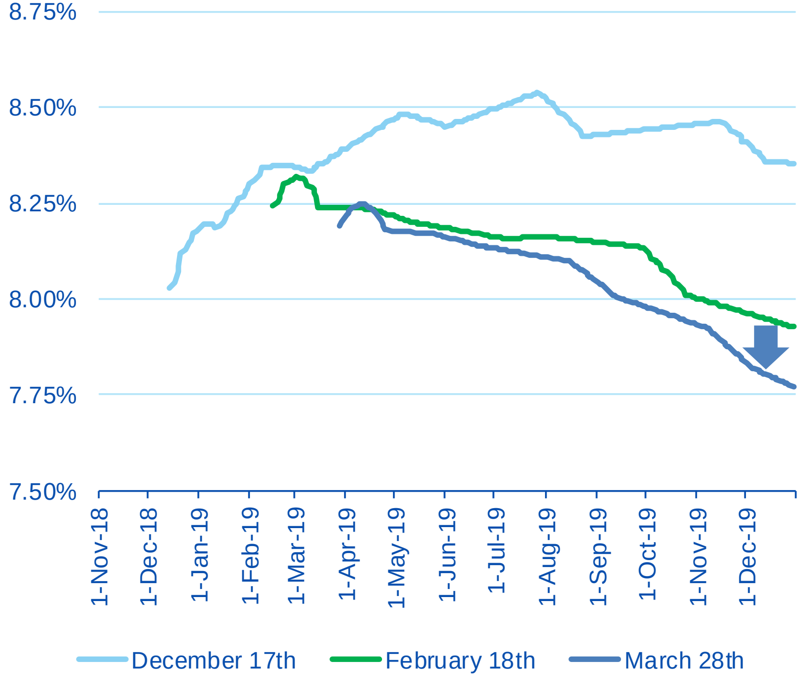


Source: BBVA Research / Bloomberg

As the market discount a looser monetary policy and as US 10Y Treasuries forecasts have been revised downwards …

IRS Monetary policy rate expectations

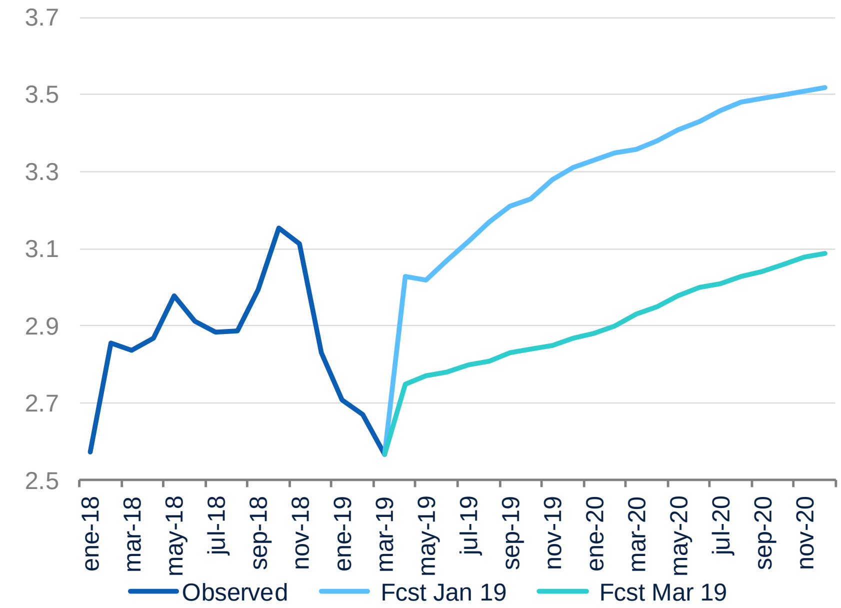
(%)



Source: BBVA Research / Bloomberg

UST 10Y YTM

(%)

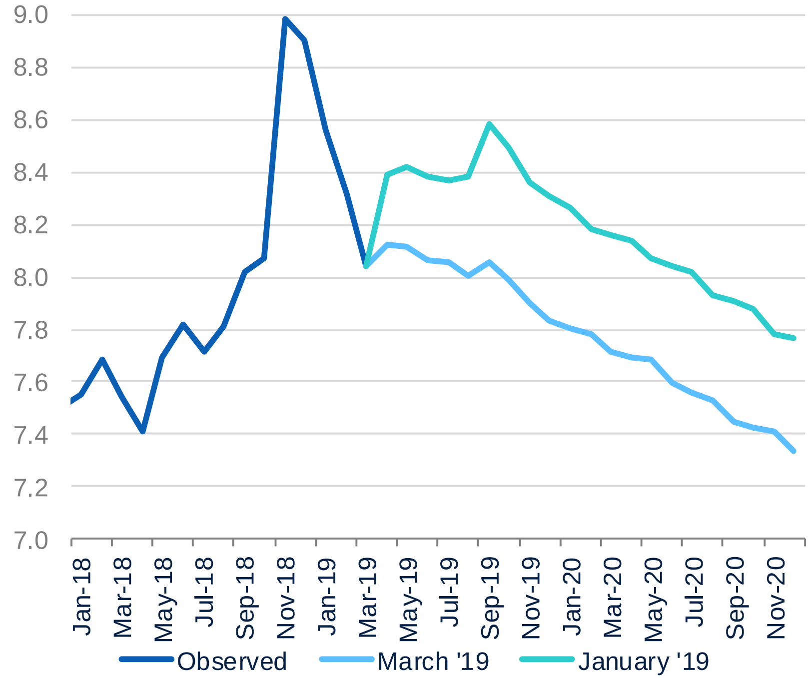


Source: BBVA Research / Bloomberg

Against a backdrop of a stable MXN and positive inflation surprises, markets discount that Banxico will cut 50bp this year

… we revise downwards too our 10Y forecast. We expect 10Y to close 2019 below 8.0%

Mbono 10Y YTM
(%)



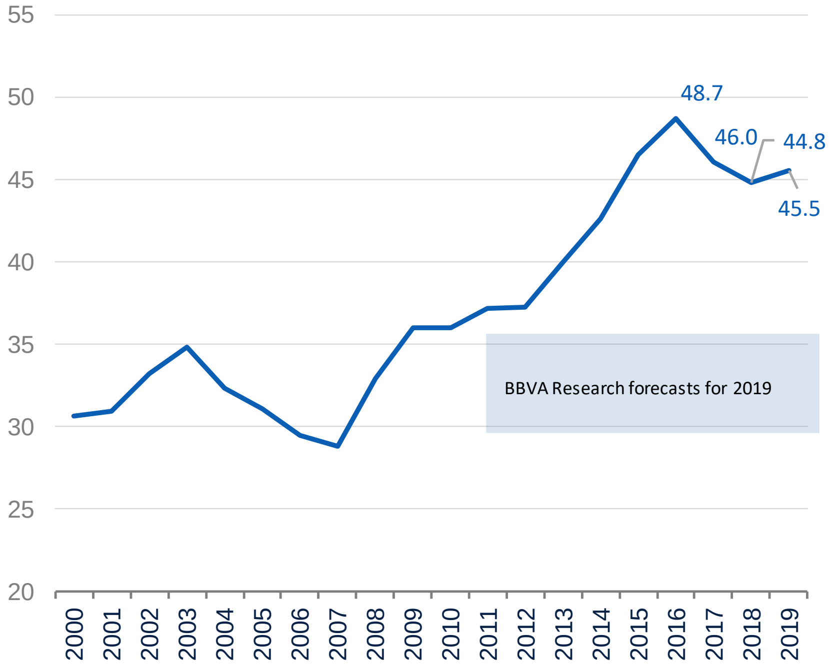
Source: BBVA Research / Bloomberg

03

Fiscal policy / PEMEX, the biggest macroeconomic risk

As a reaction to lower-than-expected public revenue, it is positive that the government is preparing cuts to public spending

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



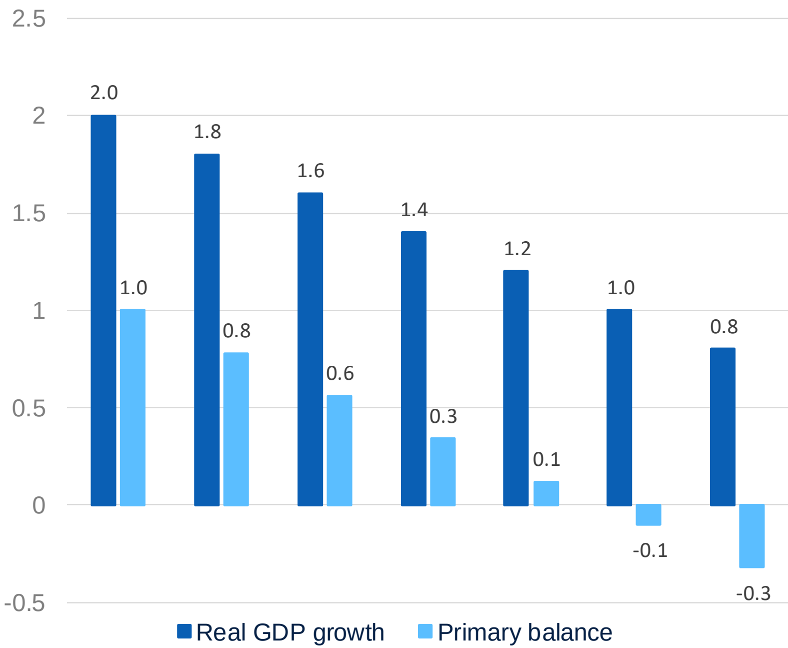
Source: BBVA Research / SHCP / INEGI

- Primary balance goal of 1.0% of GDP will not be modified
- Cuts to public spending will only affect current spending
- Austerity measures for Pemex include layoffs of around 16,000 employees
- Using FEIP resources is positive to avoid a downgrade to Pemex's debt

Yet, lower GDP growth and Pemex's problems pose a challenge for meeting fiscal targets

GDP growth and primary balance

(YoY % change and % of GDP)



Source: BBVA Research / SHCP / INEGI

Federal government's measures to improve Pemex's financial balance in 2019

	2019 Financial support from the federal government	Amount	
		MXN (billion)	USD (billion)
1	Capitalization	25	1.3
2	Cash-out of pension liability promissory notes	35	1.8
3	Additional fiscal relief	15	0.8
4	Expected additional revenue from fight against fuel theft	32	1.7
	Total	107	5.6

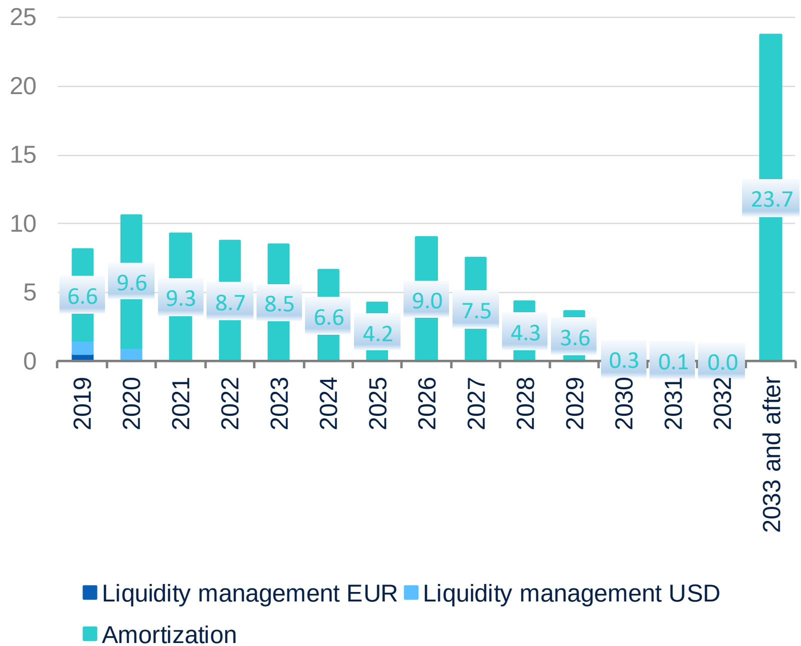
5. The government is contemplating to use around USD 7 billion from FEIP to help Pemex lower its debt issuance for this year

Source: BBVA Research / Pemex

The maturity debt profile for 2020-2023 will become an important challenge to keep the credit rating unchanged

Maturity profile of Pemex's financial debt for the following years

(USD in billions)



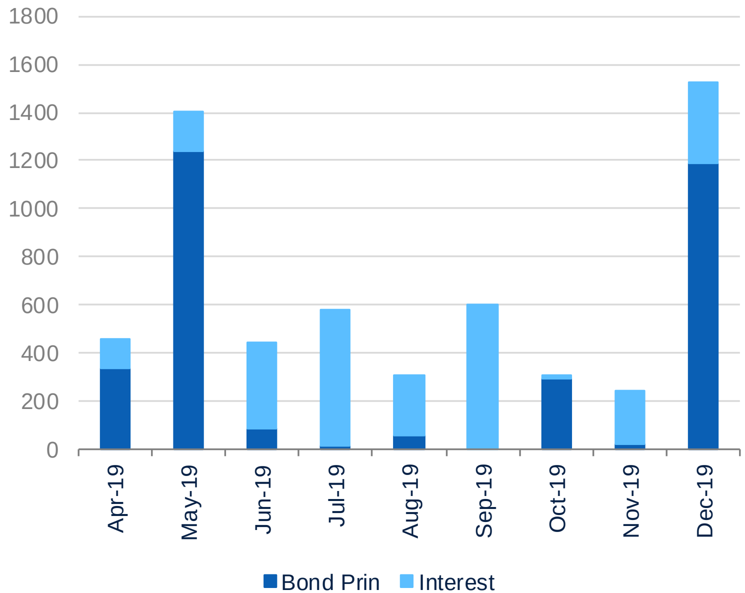
- **To keep the credit rating unchanged**, both Pemex and the federal government will have to effectively deal with the maturity debt profile of the years to come.
- **These relative big amounts of debt amortization** will affect the future resources allocated to capex.
- **The continuation of the farmout business model will be key** to deal with capex's restrictions imposed by future debt amortizations.

Source: BBVA Research with Pemex data

However, using FEIP will help PEMEX avoid issuance to pay for 2019 debt amortizations

Maturity profile of Pemex's financial debt for 2019

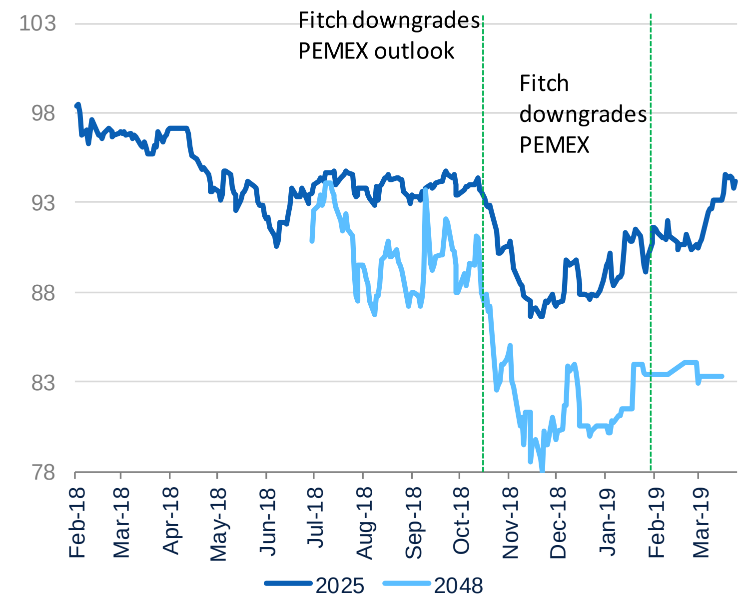
(USD in millions)



Source: BBVA Research / Bloomberg

Pemex bond prices

(USD)



Source: BBVA Research / Bloomberg

Pemex: a slightly improvement in its financial balance but worrisome signals for the years ahead

Among the worrisome signals, we have the following:

- **More resources will be allocated to refining**, which has caused big financial losses of around MXN 100,000 million a year
- **Farmouts were pushed back to October 2019**
- **O&G field auctions were suspended for three years** and possibly will get canceled for good afterwards
- **Pemex will have a hard time to significantly increase its capex in the coming years** given the relative big amounts of debt amortization for 2020-2023 and the restriction to limit its financial debt growth
- Consequently, **not only will it be difficult to reverse the fall in crude oil production, but also to stabilize it**
- **The maturity debt profile for 2020-2023 will become an important challenge** to keep the credit rating unchanged