



“México Lindo y Querido”: Our Views on the Mexican Economy and Markets



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Many of us may have heard of the song “México Lindo y Querido,” best performed by Jorge Negrete, loosely translating to “Beautiful and Beloved Mexico.” Its citizens have long held this view of their beautiful country, and lately, regional investors have been doing the same. Its equity market has been strong, its economy has proven resilient, and its currency more stable than in previous years. Today, we will delve into a more nuanced analysis of Mexico to further emphasize the beauty that lies therein.

Macro environment

Banxico, Mexico’s Central Bank, has maintained its policy rate stable since March of this year at 11.25%, following the same trend observed in other countries where the Central Bank is doing everything in its power to tame inflation while trying to sacrifice the least amount of growth possible. In its latest monetary policy meeting, the Committee announced that it still considered rate stability for a prolonged period as the right path to achieving inflation convergence to its target, which Banxico expects will be reached in 4Q24 despite the complex inflationary backdrop. However, the

Committee highlighted the potential persistence of inflationary pressures as one of the main existing risks to its outlook. The next monetary policy meeting will occur on September 28th, and consensus expectations are that the Mexican central bank will remain on hold.

In terms of economic activity, Mexico’s IGAE activity index has maintained its recovery trend since September of last year. Although the 2Q23 GDP print exhibited a setback in annual terms, it reflected strong domestic demand and positive gross fixed investment figures. Moreover, these data were released amid a rebasing exercise, leading to upward revisions for full-year GDP prints for 2021 and 2022. Meanwhile, inflation has maintained its downward trend since its peak in September of 2022, mainly due to a reversal in energy prices, even if those had a slight reversal in the August reading. Moreover, fresh fruit and vegetables exhibited a positive contribution to inflation for a second consecutive month after several months of muted influence. According to the latest Banxico survey, inflation expectations reflect a mild improvement, with the headline figure reaching the higher end of its target range of 4.0% by the end of 2024. This trend in inflation expectations is a variable that could be considered at the

next meeting, but as previously mentioned, Banxico has affirmed that the threshold for another rate hike is quite high.

The Peso

Banxico's relatively conservative monetary policy has led to the Peso's outperformance in the region. With one of the most favorable carry trade profiles in Latin America, the Peso posted a return close to 15% over the past year on a spot price basis, making it one of the best-performing currencies in the region. Although the Peso can give back some of its gains, we believe that Banxico's relatively more conservative monetary policy approach could maintain the currency's relative outperformance in the foreseeable future. This is due in great part to the relative attractiveness of the Peso compared to other currencies, such as the Brazilian Real, which is likely to be pressured by more aggressive monetary easing policies in that country.

Another attractive quality of the Peso is its decreasing volatility. For the past 20 years, investors looking to get exposure to emerging market currencies would also purchase an additional one or two currencies, equally volatile but with inverse correlations to their holdings, to serve as a hedge. One of these currencies was the Mexican Peso, as its many past crises engendered volatility. Yet, the country's close ties to the United States and Canada made the Peso behave inversely to other emerging market currencies. However, this inverse correlation has become less prominent over the past few years as the Mexican economy continues to develop in a positive way, gaining stability and conveying that stability to its currency. Studying the correlation between the Mexican Peso and the MSCI Emerging Markets Currency Index sheds light on this picture. This index sets the individual currency weights to be equal to the corresponding country weights in the MSCI Emerging Markets Index. As a refresher, a correlation of +1 would mean that the Peso and the

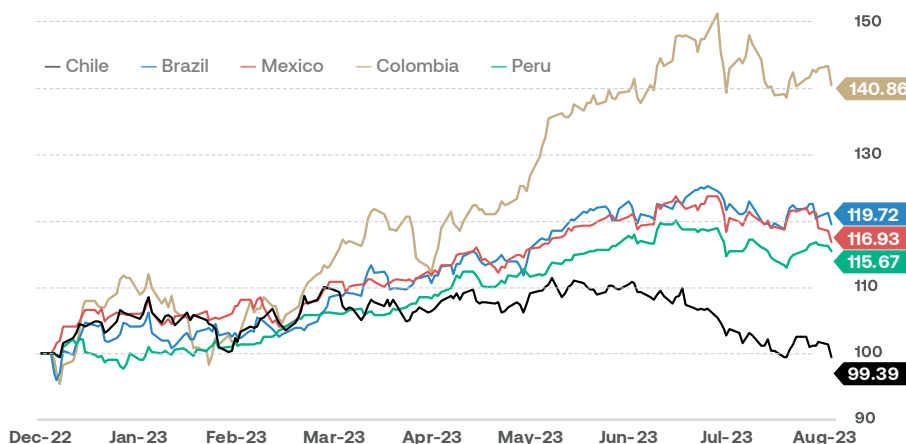
basket of emerging market currencies move in perfect synchrony, meaning if one goes up 1%, the other would also rise exactly 1%. Inversely, a correlation of -1 would mean that if one goes up by 1%, the other one would go down by exactly 1%. In contrast, a correlation of 0 would mean that both variables move entirely independent of each other. Over the past 15 years, the inverse correlation between the index and the Peso has been approximately -0.55, on average, but at times reaching extremes of -0.70. As of the end of August, this negative correlation had narrowed to -0.16. In fact, 2023 has seen the narrowest correlations between both variables in the last 15 years. We believe that the main reason for this steep narrowing in correlations is not because the Peso is behaving more like the rest of its currency peers but because the Peso has become less volatile. Think of it this way: in years past, when emerging markets currencies were volatile, the Peso was also volatile but moved in the opposite direction of its peers due to its perceived relative safety. Its relative safety has not changed, what has changed is that the Peso itself has become less volatile. We believe this decrease in volatility is mainly due to two reasons: a greater degree of stability in the Mexican economy and an increase in Foreign Direct Investments (FDI) into the country due to nearshoring. This does not mean that the Peso will be immune to periodic price swings, it just means that, over the long term, it is likely to be less volatile than in years past.

The Fixed Income Market

In terms of fixed income, the Bloomberg EM Local Currency Mexico Total Return Index Value Unhedged, which in this case works as a proxy for Mexican sovereign bonds, has returned 16.93% as of September 5, 2023, above some of its peers in the region like Peru or Chile but below the returns that Brazil or Colombia had.

When comparing Mexico and Latam to their EM peers, it is worth highlighting that the region has performed

Latam’s fixed income markets portray positive YTD returns



Source: Bloomberg (data as of September 5, 2023. 100 = December 30, 2022)

better than the overall EM benchmark, the Emerging Markets Local Currency Government Universal Index. In aggregate, Latam’s fixed income USD index has gained 18.93% YTD (as of September 5) return, whereas the EM index is up only 1.39% YTD (as of September 5) return. As we have stated on previous occasions, Latam has been a great market to be exposed to this year, even if it may have seemed too risky at the beginning of the year when most were avoiding the region.

In terms of Mexican corporate bonds, and now that the earnings season has largely ended, we were pleased to see positive results from companies like BBVA Bancomer, Grupo Financiero Banorte, and Grupo Bimbo – all those being issuers we have favored by having those bonds in our Fixed Income Focus List. More specifically, the bonds from those issuers that we have on the list have displayed positive returns YTD as of September 5: BBVASM 4 ¾ 04/10/24 (+2.76% YTD), BANORT 6 ¾ PERP (+5.26% YTD), and BIMBOA 4 ¾ 06/27/44 (+4.48% YTD). On the other hand, the petrochemical sector, a prominent one within the Mexican economy, faced a daunting environment in terms of prices and volumes sold, leading to negative reports from issuers like Alpek and Orbia.

One issuer that we continue to favor is Banorte, more

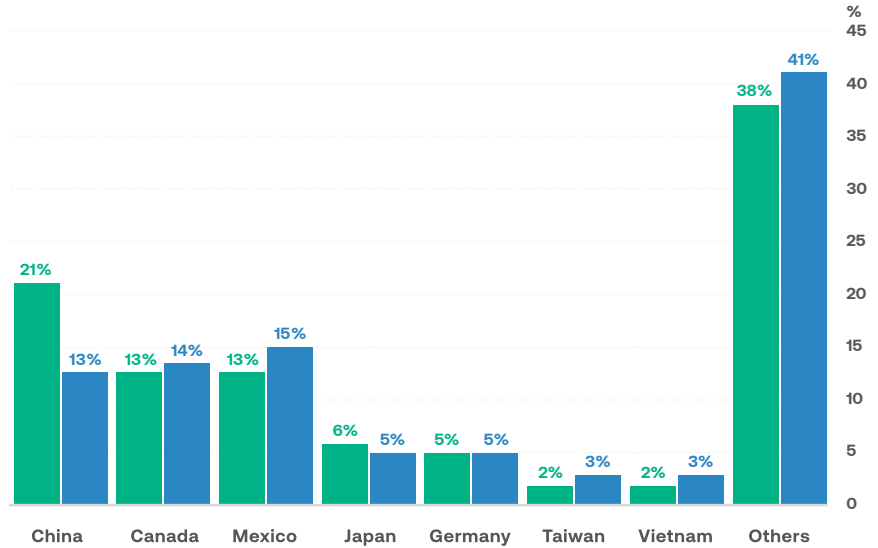
specifically, most of its perpetual bonds. Their option-adjusted spreads are wide versus other peers when compared to their corresponding regression curve, and they could offer an attractive investment opportunity. We expect the bonds to continue benefiting from the strong results of Banorte’s earnings report on July 20. Still, these recommendations should be considered case-by-case and largely depend on each client’s risk appetite and specific needs.

Nearshoring and the Equity Market

Post-COVID-19 pandemic supply chain restructuring, geopolitical tensions in Asia, and friendly trade policies between the United States and Mexico are leading to increased Foreign Direct Investment in the country due to the nearshoring phenomenon. In fact, due to its geographic proximity to the United States, Mexico should prove to be the biggest beneficiary of nearshoring in Latin America, potentially seeing incremental exports almost five times greater than the next beneficiary in the region, Brazil. Mexico’s share of imports into the United States, excluding oil and gas, now stands at a five-year high of 14.8%. Put another way, virtually 15% of everything that the United States imports, that is not oil and gas, comes from its next-door neighbor

Share of US Imports by Country of Origin

- 2018
- Q1 2023



Source: Deloitte Insights, US Census Bureau, Insigeo (as of July, 2023)

to the south. To give some context to this number, let’s examine the graph above. As of the first quarter of this year, China’s share of US imports stood at 13%, down from 21% in 2018. At the same time, Mexico’s share increased from 13% to 15% over the same period. In fact, Mexico now stands as the single largest exporter to the United States. In years past, most of the country’s exports were generally agricultural products and other goods requiring relatively unskilled labor. However, the advent of nearshoring has turned this dynamic on its head. Approximately 33% of Mexico’s exports to the United States now consist of transportation equipment, with 20% being comprised of computer and electronic products and 10% of appliances and other electrical equipment components. Nearly two-thirds of Mexico’s exports to its neighbor to the north are now technology-oriented goods that require highly skilled labor. As we can imagine, highly skilled labor jobs lead to higher labor income, leading to an increased standard of living for the overall population over time. In Mexico’s northern region, cities like Monterrey are already seeing a boost in the technology industry. Local universities, such as the Tecnológico de Monterrey, are producing well-trained engineers capable of handling specialized, tech-oriented roles previously handled in Asia. According to a report by Deloitte, the states of Chihuahua,

Coahuila, Nuevo León, San Luis Potosí, and Guanajuato alone account for 65 projects worth up to \$11 billion related to nearshoring.

An increased need for infrastructure to support increased demand should also lead to job creation, further helping the local economy. In a recent article, Rafael Gayol from Bloomberg noted that measures of spending on fixed assets in Mexico rose close to 30% in June on a year-over-year basis, marking the fastest increase in this type of spending since 2021. Figures recently released by the country’s national statistics agency indicate that construction-related investments increased almost 40% on a year-over-year basis. Companies such as Tesla, Volkswagen, and BMW continue expanding their regional presence. We are seeing railway companies such as Canadian Pacific expand their networks from Canada to Mexico in an effort to reduce lead times and get products to market quickly and efficiently.

Local companies are likely to be meaningful beneficiaries of the nearshoring phenomenon. Banks like Banorte are investing heavily in Mexico’s northern region to support its booming industries. The bank foresees a migration of workers from the south to the

north of the country, as opportunities brought about by nearshoring create more employment. In fact, Banorte could add more than 800 jobs in northern Mexico to have the capacity it needs to meet increased demand for mortgages, business loans, and general banking services. Already commanding a 15% share of the Mexican loan market, loan growth is expected to expand Banorte's market position even more in the foreseeable future. Cemex is another company that is also seeing the benefits of nearshoring. Cemex's end markets are diversified across the globe. However, the company's key markets are in the United States and Mexico, both countries whose economies are proving more resilient than expected. At the same time, Cemex is heavily involved in supplying much of the construction materials that are being used in the infrastructure buildup boom. Companies such as Walmart de México, Fomento Económico Mexicano, and Kimberly Clark de México should also benefit, as rising incomes in the region could lead to higher consumer spending.

The Mexican equity market, represented by the Mexbol, is trading at 13X current earnings, higher than in previous years, but not at extreme long-term valuations. However, this market does trade at a premium to other markets in Latin America that trade between 8x-9x earnings, such as Brazil's Ibovespa. Historically, a positive correlation exists between the beginning of an

easing monetary cycle and equity market performance. The same correlation is present in Mexico, so there is a high probability that Mexican equities will rise as Banxico cuts interest rates. However, given that the first rate cut is not expected until next year, there is a possibility that the Mexbol will trade sideways in the short term as investors digest a rich valuation relative to the region and the expectation of upcoming rate cuts. Despite potential near-term headwinds, we believe that the future easing of monetary policy and the benefits of nearshoring make Mexico's equity market an attractive long-term holding for investors with the appropriate risk tolerance. The iShares MSCI Mexico ETF (EWW) and select mutual fund and portfolio strategies represent potential investment vehicles through which an investor could get exposure to this market.

Deloitte estimates that the nearshoring opportunity in Mexico could add approximately 3% to its GDP and create 1.1 million jobs for the country over the next five years. The potential rewards of the nearshoring phenomenon, coupled with the country's relatively stable economy and currency, have made it a darling for investors in the Latin American region. It is now up to Mexico to embrace this opportunity and live up to the aforementioned song, not only regionally but also globally. ■

House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
US Equities ¹	OVERWEIGHT	OVERWEIGHT
European Equities	UNDERWEIGHT	NEUTRAL
Japanese Equities	OVERWEIGHT	OVERWEIGHT
Emerging Market Equities	UNDERWEIGHT	UNDERWEIGHT
Chinese Equities	NEUTRAL	UNDERWEIGHT
US Treasuries ²	NEUTRAL	OVERWEIGHT
Investment Grade Fixed Income	NEUTRAL	UNDERWEIGHT
High Yield Fixed Income	NEUTRAL	UNDERWEIGHT
Emerging Market Sovereign	OVERWEIGHT	NEUTRAL
US Dollar	OVERWEIGHT	OVERWEIGHT
Energy ³	NEUTRAL	OVERWEIGHT
Precious Metals	NEUTRAL	OVERWEIGHT
Cash	UNDERWEIGHT	NEUTRAL

¹ Relative to global equities in USD

² Relative to aggregate fixed income markets in USD

³ Relative to an overall commodity allocation

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