



# The Mexican Reality After the Elections



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## Executive Summary

Even if the markets already priced in a Sheinbaum victory, Morena's landslide victory in Congress disrupted them by reviving a more latent possibility of constitutional modifications, even if Sheinbaum emphasized policy continuity. Her incoming administration will face a challenging macroeconomic backdrop and fiscal deficit monitoring.

As long as the new administration continues healthy internal policies, supports the consumer, nurtures nearshoring, and, more importantly, does not implement sweeping reforms, we believe that the Peso will retain its leadership position in the region over the long term.

Fixed income investment in Mexico is still a fundamental story, leading us to maintain our preference for issuers that should benefit from the nearshoring phenomenon. In the case of Pemex, its capacity to prove its financial stability is crucial since the three rating agencies have expressed their concerns about the government's constant support for the company.

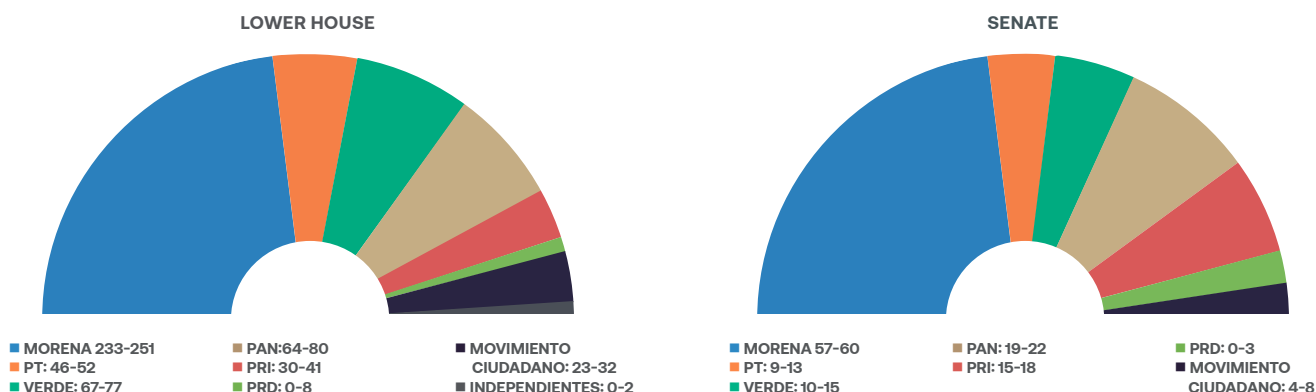
Mexico's equity market could see a period of increased volatility. However, the underlying strength of the Mexican equity market should remain present as long as the new administration continues the policies of the previous Administration.

## Political and Macroeconomic Backdrop

After a long campaign that was closely followed around the world, Mexico went to the ballot box on June 2, not only to elect its new president but also to take part in the largest election in the country's history. Its outcome would decide over 20,700 positions at all levels of government nationwide.

Although the market had priced in a Sheinbaum victory, seeming to favor continuity in terms of the ruling party, we deemed it fit to look further into the aftermath of this election. In more specific terms, we want to delve into what the new Mexican president brings to the table in terms of proposals and how these could affect Mexican assets.

### Projected Congress composition confirms the dreaded “full car” thesis



Source: INE – PREP (Conteo rápido), Bloomberg Línea

Ultimately, the presidential elections on Sunday proved the polls to be accurate after Claudia Sheinbaum won in a landslide. According to the latest preliminary data at the time of this report, Sheinbaum garnered 58.7% of the total votes, followed by Xóchitl Gálvez, who got 28.3%. Coming in third place was Jorge Álvarez Máynez with 10.5% of the votes, in line with what the polls had predicted. According to the latest Oraculus poll aggregator, Sheinbaum had led the race with 53% of the voting intention, followed by Gálvez with 36% and Álvarez Máynez with 11%.

Morena’s landslide victory was reflected in Congress where, according to the preliminary data (PREP) published by the National Electoral Institute - or INE for its Spanish acronym -Morena had garnered 346 to 380 seats, while the opposition coalition was projected to get between 94 and 139 seats, and Máynez’s smaller Movimiento Ciudadano between 23 and 32 seats. As a result, the government coalition is expected to overcome the two-thirds majority in the House. In the Senate, Morena is expected to win between 76 and 88 seats, whereas the opposition is projected to garner 34 to 43 seats, and Movimiento Ciudadano is expected to get 4 to 8 senators. If these results hold, the ruling coalition is projected to be just a few senators

short of the qualified majority, which could eventually imply a thin two-thirds majority in the Senate as well. This phenomenon is what analysts have denominated the “full car” - a scenario where a political force obtains an overwhelming result both in the executive and legislative branches.

Another point worth keeping in mind is that even if Sheinbaum takes office on October 1, Congress will do so one month earlier - leaving September as a month in which AMLO will virtually have a constitutional majority in the two chambers of Congress. Importantly, the market is trying to assess whether AMLO will try to present again his slate of reforms initially presented in February with hopes that, this time, he will face less resistance.

In the first hours after her victory, Sheinbaum stressed her stance of continuity in her administration while maintaining AMLO’s fiscal austerity and social programs. However, the market’s reaction told us otherwise as it began discounting a more environmentally friendly stance than her predecessor. This could come in the form of a cleaner energy policy that could include a potential ban on fracking and a tilt towards renewable energy.

Meanwhile, the incoming administration faces a more challenging macroeconomic backdrop than what AMLO faced in 2018. President AMLO is leaving office with an approval rating of 65%, having built his popularity on record spending on social programs, which in turn led to his endearment with the Mexican people — even if his management of some of the country’s most crucial issues, such as corruption and violence, could be seen as unsuccessful. It is these issues, like the surging cartel violence, together with an increase in perceived corruption and the observed political polarization, that are setting the stage for a more daunting environment for the upcoming administration. This narrative contrasts with a more benign view that Mexicans have of the economy and their personal financial situation, which is closely related to the subsidies we previously mentioned.

Moreover, the challenges that face the new administration also come from the macroeconomic front: Mexico’s economy has exhibited sluggish growth in the last few quarters, having printed a languid 1.6% YoY real GDP growth for 1Q24. In addition to waning economic activity, Banxico appeared to exhibit a less sanguine outlook for the Mexican economy, reflected in its latest Quarterly Inflation Report. The bank downgraded its GDP projections for 2024 and stated that it expects growth to remain below trend, with consumption moderating. Nonetheless, Banxico maintained its 2025 growth projections. On the inflation front, Banxico expects to reach inflation convergence by 4Q25, with both headline and core inflation remaining stickier throughout 2024.

Furthermore, Mexico’s inflation has been stickier than initially expected, with the last two prints from March and April exhibiting slight increases in its yearly variation. Thus, Banxico has exhibited a more cautious approach when deciding to implement an easier monetary policy. During its last meeting, the Committee decided to maintain its monetary policy rate stable against a backdrop of higher inflation expectations and a balance of inflationary risks tilted to the upside.

Another issue the upcoming administration will have to address is managing the country’s foreign trade policies, especially when the free trade agreement between the US, Mexico, and Canada is poised for renegotiation. As a result, some market analysts consider that some of the main risks for Mexico do not stem solely from the initial worries of the upcoming Sheinbaum administration, but from the US elections in November and the relationship between the two countries.

Lastly, investors will be monitoring closely the upcoming budget negotiations that will take place in November, which are expected to be led by FinMin Rogelio Ramírez de la O. In yet another sign of continuity, both incoming president Sheinbaum and outgoing president AMLO stressed that Ramírez de la O was expected to stay in his position, at least for the beginning of the Sheinbaum administration. This point is crucial, as due to AMLO’s heightened spending in the last leg of his administration, Mexico is poised to exhibit an estimated fiscal deficit of 5.9% of GDP for 2024. The task of narrowing this deficit was deemed crucial by the three major credit rating agencies.

## The Mexican Peso

The “Super Peso,” as it has come to be known, has proven to be one of the strongest major currencies in the world over the past few years. In past publications, we espoused the idea that the Mexican Peso would most likely be affected by two important variables in 2024: The economic outlook of the United States and the direction of interest rates in Mexico. We continue to believe that this is the most likely scenario, with uncertainty around the new administration adding volatility to our base case. The U.S. economy is proving to be more resilient than originally expected, but the possibility of recession, in some form or another, remains on the table. At the same time, Mexico’s strong commercial ties with the United States have only strengthened with the onset of nearshoring. Mexico’s

exports to the US have risen to levels that have moved Mexico ahead of Canada and China as the top trading partner of the United States. These strong ties have acted as a shield for the Peso against a stronger US Dollar, especially when compared to other emerging market currencies. We believe that the economic performance and ensuing demand from the United States will continue to have an impact on the Mexican Peso.

More importantly, the pace and direction that Banxico sets for domestic interest rate policy will also exert influence on the Peso. Over the past year, the governing body’s conservative monetary policy was a major contributor to the currency’s outperformance in the region. In an attempt to strike a balance between stubborn inflation and a less constructive consumption backdrop in the short term, we would not be surprised if interest rate cuts will continue to be implemented in 2024, albeit at a more moderate pace. As a result, we would also not be surprised if the Mexican Peso’s incredible outperformance of 2023 would give back

some gains as interest rates in the country continue to trend lower.

The reality is that volatility is likely to be exacerbated in the short term because of the elections this past weekend. However, regardless of the direction of rates or the outlook for the US economy, we continue to believe that, over the long term, the Mexican Peso will not be as volatile as it was in past years. The growing stability of the Mexican economy, coupled with an increase in Foreign Direct Investments (FDI) into the country as a result of nearshoring, as well as a relatively orthodox central bank, should continue to decrease the volatility in this currency. As we can see on the graph below, the Peso actually rose during AMLO’s administration, defying market concerns. In fact, the number of billionaires in the country rose towards the top quintile of the world rankings during his administration, in large part due to a stronger domestic currency.

As long as the new administration continues healthy internal policies, supports the consumer, nurtures

### The Trajectory of the Peso over Mexico’s Previous Four Administrations

(In USD/MXN, so a lower number implies a stronger Peso)



Source: Bloomberg

near-shoring, and more importantly, does not implement sweeping reforms, we believe that the Peso will retain its leadership position in the region over the long term. This does not mean that it will be immune to periodic price swings, as we are currently experiencing, and could continue to trend lower in the short term. However, as we believe that over the long term, the Peso is likely to be less volatile than in years past, the current pullbacks in price could potentially create attractive entry points for long-term investors with a relatively high tolerance for risk. Again, the important assumption here is that the Sheinbaum administration does not implement sweeping reforms that could dramatically change the country's economic outlook.

## Fixed income and the case for Pemex

Even if the initial market reaction to the presidential election was not positive across the different asset classes, we continue to believe that investing in Mexico is a story of fundamentals, and those should hold steady amid the heightened volatility. If the nearshoring thesis maintains its course, and the inflows of foreign direct investment that we have witnessed continue, those companies that have been ahead of the curve in attracting foreign interest should keep on reaping the benefits. More specifically, we still favor having exposure to issuers like Cemex or Fibra Uno that are key players in the nearshoring sphere, as well as financial institutions like Banorte that are expected to maintain a strong loan growth trend.

One of the main discussion points during the presidential campaign was how each of the candidates was going to address the government's stance regarding state-owned enterprises – more specifically, Pemex and the Comisión Federal de Electricidad, or CFE for its Spanish acronym.

Pemex was one of the main discussion topics during

the presidential debates, primarily due to the importance of government funding for the company to continue operating. At that point in time, Claudia Sheinbaum expressed her intention to maintain her support for Pemex, although that could be tied to a commitment from the company to improve its efficiency. Furthermore, it has been known that Sheinbaum's main interest is to advocate for green, renewable energy and to strive away from oil refining. This exhibits a clear divergence from AMLO's focus on the latter business line, which was the one that continued to report losses and needed additional monetary support.

— “According to market expectations, **support for Pemex should be included in Mexico's budget through 2024, which could bode well for the shorter-dated bonds by removing the uncertainty related to upcoming debt maturities.**”

According to market expectations, support for Pemex should be included in Mexico's budget through 2024, which could bode well for the shorter-dated bonds by removing the uncertainty related to upcoming debt maturities. Going forward, we continue to believe that the company needs to prove its capacity to generate profits without government intervention.

Pemex's capacity to prove its financial stability is crucial since the three rating agencies have expressed their

concerns about the government's constant support for the company. Fitch stated that in case Pemex's operating efficiency fails to improve, the agency expects federal government transfers to occur on an ongoing basis, with the government's support for Pemex becoming a potential contingent liability for the country's sovereign debt rating. In the case of S&P, the agency warned that the upcoming debt payments for Pemex will continue to exert pressure on Mexico's finances in 2025 and 2026, when the company will have to honor maturities of USD 6.8bn and USD 10.5bn, respectively. The agency could share Fitch's perspective and consider Pemex a contingent liability in case the oil giant's situation does not improve, which in turn could weaken Mexico's fiscal profile and, eventually, impact its sovereign rating.

## Equities

Mexican equities posted a strong year in 2023, with the iShares MSCI Mexico ETF (EWW) rising 39% for the year. This was followed by a natural pullback this year, leaving the ETF 4% lower in 2024 as of the end of May. A large portion of last year's gains can be attributed to the near-shoring phenomenon and increasing stability in the Mexican economy. 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. As we have mentioned in previous publications, we continue to believe that due to its geographic proximity to the United States, Mexico should prove to be the biggest beneficiary of nearshoring in Latin America, as both the quantity and quality of exports from Mexico to the U.S. continues to increase. A move away from agricultural and commodity-oriented exports and towards technology-oriented, value-added products benefits the local consumer, as technology-oriented jobs require highly skilled labor. This dynamic leads to increasing wages, in time, improving the overall standard of living of the population. We

believe that companies associated with the benefits of nearshoring are likely to continue to post gains in the years ahead.

Additionally, a continued reduction in interest rates, although slower than expected, should also benefit the Mexican stock market. Higher consumer spending engendered by lower rates and the continued effects of nearshoring could propel the Consumer Staples and Discretionary sectors higher, benefiting companies like Walmart de Mexico, Kimberly Clark de Mexico, and Fomento Economico Mexicano. At the same time, lower rates and increased nearshoring could also benefit companies in the Materials sector, such as Cemex, that could potentially have cheaper access to capital. Additionally, Financial companies, such as Grupo Financiero Banorte, could continue to reap the gains associated with nearshoring, particularly given its presence in Northern Mexico.

After a strong year, the Mexican equity index Mexbol traded near 17x forward earnings at the beginning of May 2024. Things changed quickly after election weekend. The Mexican equity market, as represented by the EWW ETF, closed almost 11% lower the Monday after the election, leaving the country's equity market down nearly 15% for the year as of the time of this writing. Markets do not like uncertainty, so, much like the Peso, the country's equity market got spooked, not by Sheinbaum's victory but by the magnitude of her victory and the possibility that a super-majority could lead to sweeping, market-unfriendly reforms. The best electoral result for equity markets tends to be one where there is a balance between the executive and legislative branches of government, allowing a system of checks and balances to moderate governmental overreach. Sheinbaum's government could potentially be tilted all toward one side of the aisle, potentially giving her extraordinary powers that even AMLO himself did not enjoy.

Uncertainty is never welcomed by the markets. Howev-

er, the current downturn in the country's equity market could provide a much-needed pullback from previously high levels, bringing it down to a more reasonable valuation. After trading near 17x earnings a month ago, the election pullback has driven Mexbol down to its long-term average near 15X. If Sheinbaum continues to implement policies that encourage Foreign Direct Investment and support the consumer, many of the industries and companies previously mentioned should continue to benefit over the long term. In this scenario, companies like Cemex and Grupo Financiero Banorte, which saw their ADRs trade down close to 10% and 20%, respectively on Monday, could potentially reach attractive entry points for long-term investors with a high tolerance for risk.

Volatility will likely remain high, and the market could trend lower in the short term. However, all things being equal, the underlying strength of the Mexican equity market should remain present as long as the new administration continues the policies of the previous Administration. In this scenario, the current pullback and continued volatility of the country's equity market could potentially create an opportunity for an investor with adequate risk parameters. However, this is contingent on the new administration not rocking the boat, which at this point, remains to be seen. At the end of the day, a diversified approach to investing in the Mexican equity market will likely prove to be the best way to get risk-adjusted exposure to this promising market over the long term. ■

# House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
<b>Global Asset Allocation</b>		
Equities	UNDERWEIGHT	NEUTRAL
Fixed Income	OVERWEIGHT	OVERWEIGHT
Cash	OVERWEIGHT	UNDERWEIGHT
<b>Regional Breakdown</b>		
US Equities <sup>1</sup>	OVERWEIGHT	NEUTRAL
European Equities	OVERWEIGHT	NEUTRAL
Japanese Equities	OVERWEIGHT	NEUTRAL
Emerging Market Equities	UNDERWEIGHT	NEUTRAL
Chinese Equities	NEUTRAL	NEUTRAL
US Treasuries <sup>2</sup>	OVERWEIGHT	OVERWEIGHT
Investment Grade Fixed Income	NEUTRAL	UNDERWEIGHT
High Yield Fixed Income	NEUTRAL	UNDERWEIGHT
Emerging Market Sovereign	NEUTRAL	NEUTRAL
US Dollar	UNDERWEIGHT	NEUTRAL
Energy <sup>3</sup>	UNDERWEIGHT	UNDERWEIGHT
Precious Metals	NEUTRAL	NEUTRAL

<sup>1</sup>Relative to global equities in USD

<sup>2</sup>Relative to aggregate fixed income markets in USD

<sup>3</sup>Relative to an overall commodity allocation

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