

Mexico got Trumped!

Low growth and weaker peso, but no balance of payments crisis

In the wake of Donald Trump's election, Mexico, together with China, appears to be the country most exposed to Trump's economic policy.¹ Trump's proposed fiscal stimulus has already led to a strong increase in inflation expectations, and his pledges to restrict imports and immigration has spurred a record broad EM selloff. Mexico has been at the eye of this storm given its vicinity and close trade relations with the US. The Mexican peso has depreciated by 10% relative to its pre-election day closing level, the stock market is down 6% and the local currency sovereign 10-year rate has shot up by 112bps. The Mexican central bank had already pre-emptively tightened policy rates to mitigate the impact of a declining peso on headline inflation.

Since election day, the president-elect has adopted a more reconciliatory tone, downplayed trade protectionism, and focused on deporting illegal immigrants and securing the US/Mexico border. Downside risks for Mexico are mainly exports and remittances, with implications on the current account deficit and economic growth. The US is Mexico's main trading partner, shipping 81% of its total exports, or 27% of GDP, to the US, mainly consisting of machinery and transport equipment. Mexican exports to the US stood at 10% of GDP in 1994, before the implementation of the North American Free Trade Agreement that president-elect Trump argued in favour of renegotiating during the election campaign.

Remittances are an important component of Mexican household income, and a significant source of the hard currency flows which support the current account balance. The latter recorded a deficit of 2.8% of GDP in 2015, which would have been 5% of GDP without the remittances from the US. Remittances from Mexicans living abroad equate to 2%-3% of GDP over the last decade. Of these Mexicans living abroad, 95% reside in the US, 23% of which do so as illegal immigrants. Remittances to Mexico from the US would be curbed, also, if levies on remittances for securing the US-Mexican border were to be imposed.

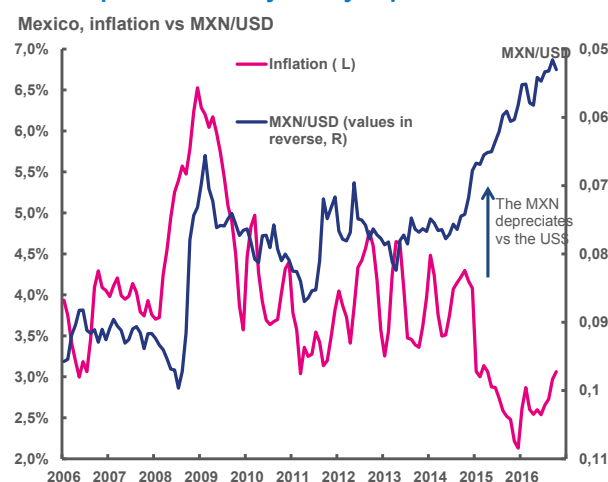
FX forwards suggest that the Mexican peso will depreciate (against the US dollar) by another 2.5% by year-end, bringing total year-to-date peso depreciation to 25%. This could top up inflation by 0.4pp to 3.4% in 2017 after 2.9% in 2016.

The impact on headline inflation will force the central bank to raise interest rates in order to defend the currency and safeguard financial stability. We expect the central bank to take the policy rate to 5.75% (from 5.25%) by end-2016 and to 6.5% by end-2017 in order to curb inflation. Moreover, we expect another year of subpar real GDP growth at 1.5%, after 1.6% in 2016, below the 3% potential growth.

Peso depreciation would also inflate the external debt service, which we expect to increase by 0.6pp of GDP to 3.2% of GDP in 2017, with the burden mostly felt by non-financial corporates. Here the debt service would amount to 2.1% of GDP from 1.7% in 2017, with the government's debt service at 1% of GDP. The foreign currency short term external debt (external debt due in the next two years) is 3% of GDP or 20% of Mexico's FX reserves, with the total dollar debt at 13% of GDP. This ranks among the highest in EMs.

A balance of payment crisis is not expected, though, as 73% of the current account deficit (3% of GDP) is financed by difficult-to-unwind foreign direct investment, mostly from the US, while foreign exchange reserves are sufficient to cover foreign capital outflows (equivalent to Mexico's money supply M2).

Exhibit 1
MXN depreciation not yet fully captured in inflation



Source: Datastream and AXA IM Research

¹ Davradakis, M. and A. Yao, "US trade protectionism is bad for emerging markets", AXA IM Research, 21 September 2016.

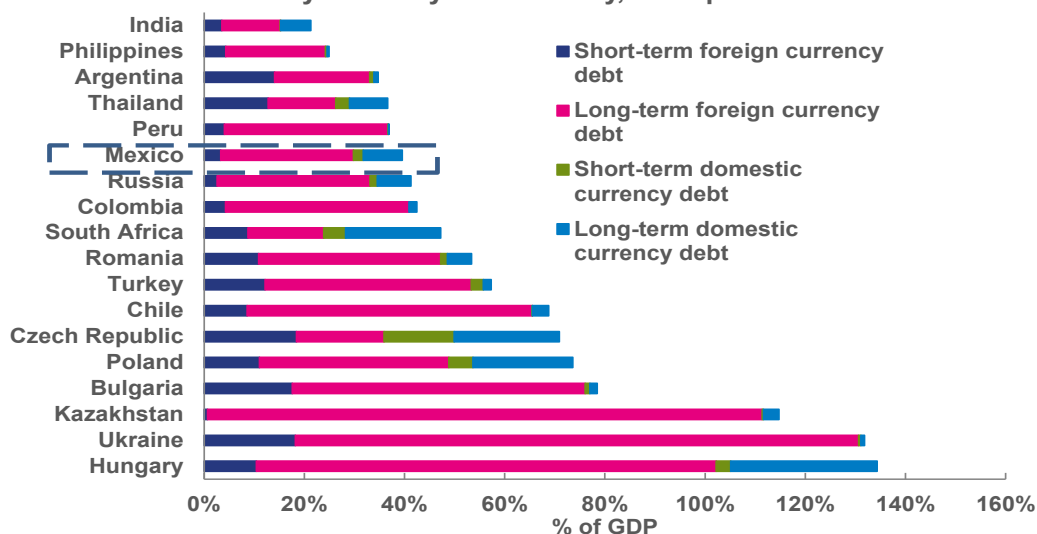
Concerns of a balance of payments crisis will also be mitigated by a flexible FX rate and a two-year Flexible Credit Line (FCL) of US\$88bn which was renewed by the IMF in May 2016. Meanwhile the negative impact of the peso depreciation will be offset by the expected rise in the oil price due to reflationary re-pricing. Nevertheless, Pemex, Mexico's state-owned petroleum company, will remain a concern due to its heavy contingent pension liability (6% of GDP), and its capex and government royalties funding requirements (the latter is equal to 20% of the State budget's revenues). If energy prices rise in line with the overall reflation theme, concerns over Pemex may ease, too. Already, the very conservative 2017 government budget pencils in a non-financial public sector primary budget surplus of 0.4% of GDP for 2017, versus a deficit of 0.6% of GDP in 2016, with spending cuts mostly on Pemex.

In conclusion, given the limited extra burden that the peso depreciation will add, and the significant external buffers that the economy has in place (FX reserve coverage of M2, IMF's FCL, credible fiscal and monetary policy, flexible exchange rate), a balance of payments crisis is unlikely.

Exhibit 2

Low FX and maturity risk for Mexico relative to other EMs

Gross external debt by currency and maturity, 2016q2



Source: World Bank and AXA IM Research

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