ARTICLE
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The Mexican wall of worry

- Opportunities in Mexican credits after Trump-induced sell-off
- Fears of trade war and import taxes were exaggerated
- Focus on value and contrarian approach paid off

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Despite the huge sell-off in Mexican corporate bonds and negative sentiment following the election of Donald Trump, contrarian credit investors Victor Verberk and Reinout Schapers still found investment opportunities. "We invested in Mexican credits last November and can now take profits."

"I will build a great wall and make Mexico pay for it! Mark my words." We all remember those words of the then president-elect Donald Trump. He never made a secret of the fact that he wanted to put globalization on hold and change US foreign trade policies. According to Trump the US current account deficit is the result of bad trade deals in the past and the increasing tendency for cheap foreign labor to replace hard-working Americans. Mexico is in his eyes one of the main culprits. This message resonated well in the Mid-West and other former industrial areas of America and won him the election. Mexico and its companies were the victims.

'We captured an attractive 'Trump premium' on our Mexican credit positions'

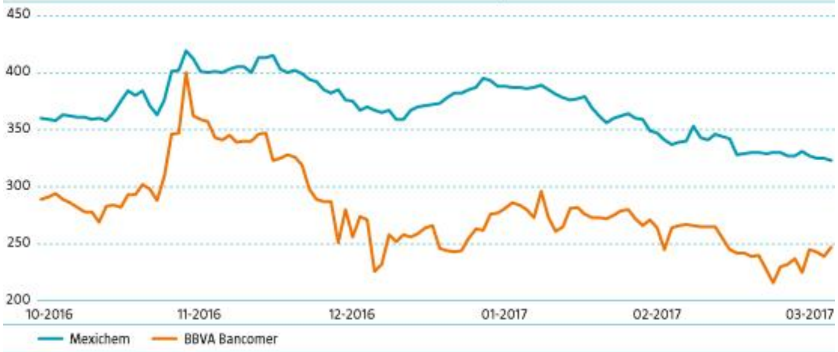
Indiscriminate sell-off

The anti-Mexico rhetoric led to a sell-off in Mexican assets before, during and after the elections. The rout was broad-based, affecting the currency, equity, sovereign and corporate bond markets. In the week after Trump's victory, Mexican credit spreads widened particularly significantly. The graph below shows the spreads of two Mexican credits during this period. They spiked from an already elevated 160 basis points to over 200 bps on the day of the election as hedge funds and asset managers sold their Mexican exposure. The sell-off in Mexican bonds continued in the days that followed. Latin America and especially Mexico have always been favorite off-benchmark positions for US investors and many of them still had significant allocations to Mexico as they expected an election victory for Hillary Clinton.

"The vicious sell-off last November encouraged us to take a sizeable position in Mexican credits", explains Reinout Schapers, lead portfolio manager of Robeco Emerging Credits and co-portfolio manager of Robeco Global Credits. "We took our position based on the fact that the sell-off was indiscriminate, that analysts were painting too gloomy a picture and because our core belief is that credits with solid fundamentals will generally recover. When markets panic we see opportunities, if everybody is selling we look to buy, provided the potential returns compensate the risk we take."

The asset selling was pretty much indiscriminate in the eyes of Verberk and Schapers. Brokers, who were already negative before the elections, became even more so as they expected trade deals to be renegotiated in favor of the US. The Mexican economy was already struggling in terms of its growth prospects and this would hurt it even more. "All these factors triggered us to look at under valuations in the Mexican credit market that we could benefit from", Schapers explains. "We started to ask ourselves a few questions. What did Trump actually say? Which sectors was he targeting? And how many of his plans were actually feasible?"

Spread movement of Mexichem and BBVA Bancomer credits after Trump election



Renegotiation of trade agreements won't happen overnight

Trump is attacking the world outside the US in order to pursue his trade and employment policy and Mexico has come under particularly heavy fire. But he is also targeting large US conglomerates that have moved production south of the border since the 1980s. The fact that there has been an influx of Mexicans into the US taking jobs away from Americans, not to mention the drugs that cross the US-Mexican border just strengthens his case. According to Trump, the North American Free Trade Agreement (NAFTA) should be renegotiated and a security wall built between the two countries.

"Trump has been saying quite a lot about trade, however his key themes are the renegotiation of existing trade agreements like NAFTA and the introduction of a so-called border-adjustment tax of 20%", explains Schapers. "Both would have far-reaching implications for corporates in Mexico if such a tax were to be introduced on products entering the US from the south."

Although there are others, the automobile industry is the key sector that has borne the brunt of Trump's rage, given the fact that automobiles for the US market are increasingly being fully or partially manufactured in Mexico. Trump has had direct conversations with the CEOs of the Big 3 – General Motors, Ford and Fiat Chrysler – to rethink future investment in Mexico. So far this has been successful with various companies, including car makers redirecting production and investment back to the US.

In terms of feasibility there are obviously too many moving parts to be able to look at all the individual stakeholders when it comes to foreign trade. If he wants to keep things simple, Trump could unilaterally end NAFTA by giving a six-month notice period. That would pave the way to introducing additional taxes on imports and certainly make trading more laborious. "However, cross-border trade, especially with Mexico, does not flow in one direction. This in a key factor we should not lose sight of", states Schapers.

US industry supply chains are completely dependent on Mexico. Let's take the example of the car industry. Not all cars are being completely built in Mexico, but almost every car has at least some Mexican-made parts. Some parts are no longer being made in the US at all, while the production of others involves several movements back and forth across the border. Ending NAFTA or a placing a 20% tax on good each time they cross the border would destroy this supply chain.

In addition to the imports, US companies are also major exporters to Mexico. Take, for example, the food and oil industries. A 20% tax by the US would likely lead to similar taxes by Mexico in retaliation. Schapers: "There are many stakeholders in this game. And even though it may look like as if NAFTA is going to end, this won't happen any time soon. Despite the far-reaching powers of the US president when it comes to trade, introducing a new tax is not as easy as it may seem."

Harvesting the 'Trump premium'

"For all these reasons we felt relatively comfortable in selectively adding positions in Mexican credits to the portfolio of Robeco Global Credits. Companies with their home base in Mexico but significant assets outside the country looked particularly attractive", says Schapers. Examples are petrochemical company Mexichem, bank BBVA Bancomer and beverage firm Femsa. But even more domestic Mexico-focused companies and banks looked attractive. "During the course of November and December we purchased several positions in corporates, banks and even the sovereign bond. We setup this trade with a longer term view as we were aware that as long as the negative rhetoric continued, Mexican credits would trade at a premium."

And Trump certainly did not stop talking about ending trade agreements and building walls. Almost immediately after coming into office, Trump cancelled the TTP negotiations and shortly after that he launched his immigration law, another key item in his campaign. The latter was, however, blocked by the US courts for being unconstitutional. Several other laws and ideas met with opposition even from the Republican camp. Trump had to endure several setbacks in February.

The team of Mexican negotiators sent to discuss possible changes to NAFTA, showed their teeth by saying they would walk away from the discussions if a unilateral border tax or wall appeared on the agenda. "We now read in the press that several industry lobbyists are converging on Washington to discuss Trump's far reaching ideas", says Schapers. "Since February we have seen sell-side analysts becoming more balanced on Mexico and have been hearing that the border-taxes are likely to be focused on specific products."

"Since mid-February we have also seen Mexican credits starting to mean-revert", concludes Schapers. "In the case of certain bonds, the 'Trump premium' has slowly disappeared with credit spreads tightening significantly over government bonds. Other Mexican corporate bonds in our portfolio still offer value. We will also take profit on these positions if the Trump premium shrinks still more. Our trade in Mexican corporate bonds in the wake of the Trump election is a good example of how being value-oriented and contrarian can really pay off!"

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