International Commentary — February 18, 2025

Mexico Travel Takeaways

Summary

The International Economic research team recently traveled to Mexico to meet with a range of market participants. During our visit, we discussed topics such as U.S. tariff policy and economic conditions with local policymakers and corporates, and in this note, we summarize the key takeaways of those conversations. We are also making adjustments to our Banxico forecast as well as our long-term Mexican peso outlook to reflect our new perspective.

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No public nor private sector entity we engaged with believe direct tariffs will be imposed on Mexico. Tariffs are top of mind for local policymakers and businesses. With that said, no one we spoke with believes the Trump administration will impose the proposed 25% tariff when the 30-day delay expires in March. Also, the consensus during our conversations was that direct tariffs would be avoided over the entirety of the Trump administration. All take the view that tariff threats and escalations are the same negotiating tactics used during Trump's first term in an effort to receive larger concessions. As far as what those concessions may be, our counterparts suggested immigration and drug security are most important to the Trump administration. We shared our view that border control and disrupting the cross-border flow of narcotics are important, but ultimately part of a larger strategy aimed at countering China. In that sense, we shared our belief that Trump is taking aim at Mexico in an effort to shape Mexico's geopolitical and economic relationship with China, and integrate Mexico more with the United States instead of shifting toward China. Attempts at reconfiguring the Mexico-China relationship may include creating incentives for Mexico to purchase U.S. goods rather than Chinese products, reject Chinese foreign direct investment and create an overall dynamic where China is the common foe of both the U.S. and Mexico. We raised the possibility of Mexico shunning those U.S. attempts and forming a closer alliance with China, which all local peers strongly pushed back on. One corporate shared their view that the U.S. escalating trade threats as well as designating cartels as terrorist organizations and stepping up military surveillance of narco groups was preparation for a U.S. invasion similar to the mid-1850s. While impossible to know for certain, we expressed our doubts the Trump administration is laying groundwork for military intervention in Mexico.

Wells Fargo International Economics is more pessimistic on Mexico's economy than everyone we spoke with. As of now, we forecast Mexico's economy to grow just 0.5% and enter recession in 2025. No forecaster we engaged with believed Mexico's economy would enter recession, and all forecast Mexico's economy to grow over 1% this year. Part of that divergence is due to our assumption that the Trump administration imposes tariffs on most U.S. trading partners, and the combination of U.S. levies and foreign retaliation weighs on local growth. But the bigger divergence comes from our view that Mexico will no longer be a nearshoring beneficiary going forward. Data suggest Mexico saw a notable uptick in inbound investment post-COVID as efforts to reconfigure supply chains got under way. However, after elections in June of last year yielded an erosion of Mexico's governance structure, we believe those investment inflows will diminish. We also believe risks emanating from potential U.S. trade policy—in particular a renegotiation of the USMCA—will reduce the attractiveness of Mexico as a nearshoring option. All of our counterparts challenged our thesis that Mexico will not benefit from nearshoring going forward, although many did admit that risks to nearshoring have accumulated over the past nine months. We also noted how Trump administration changes to U.S. immigration policy will disrupt remittance flows and push Mexico's unemployment rate sharply higher. Fewer remittances and a higher jobless rate will weigh on consumption and result in short-term recession, and combined with reduced foreign direct investment, in our view, pushes potential GDP growth lower to ~1%-1.5%. While all acknowledged downside risks to Mexico's potential growth rate, most still believe potential growth is closer to 2%.

Banxico is likely to lower policy rates more aggressively. Leading into our meetings, we forecast Banxico to reach a terminal rate of 8.50% by the middle of this year; however, peer economists predict Mexico's policy rate to fall well below our forecast. Only one private sector economist was in line with our view, while most believed the overnight rate would fall closer to 7.50% by the end of this year. Even in a downside scenario—defined by a 25% U.S. tariff imposed on Mexico and sharp peso depreciation—local forecasters believed Banxico would cut rates deeper relative to their base case. Most believed FX pass-through to CPI would continue to be limited, while financial instability risk is low as foreign currency debt across the sovereign, state-owned enterprises and corporate sector is limited. In their view, this combination gives policymakers space to deliver robust easing as activity softens or should recession risks rise. We are taking a portion of the local view on board, and we are now adjusting our Banxico terminal rate forecast lower to 8.00% by the middle of this year. This adjustment implies policymakers deliver another 50 bps cut at the May meeting and two subsequent 25 bps cuts through August. At the same time, in the downside tariff scenario, we believe Banxico would exercise caution rather than deepen the easing cycle. In our view, financial instability risks may be higher than our counterparts view. Banxico's FX reserves are on the lower end of adequate, and if the interest rate differential with the Fed narrows too much, capital flight will likely ensue. Reduced foreign investor participation in sovereign debt markets and contained financing vulnerabilities should keep the probability of sovereign default low should the tariff scenario materialize, but we believe policymakers will not be willing to test market participants' risk appetite, especially in an environment of a less dovish Federal Reserve.

We are revising our long-term FX targets to reflect less Mexican peso depreciation. Tariff headlines have arguably been the biggest driver of the peso since U.S. elections and inauguration day. With the likelihood of direct Mexico tariffs and a universal tariff, in our view, having receded in terms of timing and magnitude, a degree of risk premium has been lifted from the peso. While we retain our view that the Mexican peso will weaken this year, we now believe a year-end target of MXN23.50 is overly pessimistic, despite our rather negative outlook on Mexico's economy and a forecast for a lower Banxico terminal rate. We will provide formal USD/MXN exchange rate forecasts in our February International Economic Outlook set to be published next week, but we can say, barring some exogenous shock, that our Mexican peso forecast will show a somewhat less adverse outlook for the currency. However, risks surrounding our revised Mexican peso outlook will remain tilted to the downside as uncertainty associated with the U.S. administration persists. One takeaway we made from local conversations is that an elevated degree of tariff complacency may exist. A shared assumption of no direct tariffs leaves us to believe investors are reengaging with long peso positions, and corporates may be less hedged for potential peso depreciation. Should tariffs be imposed at the end of the 30-day timeline, the peso could see outsized volatility and come under extreme pressure. Also of note, we interpreted conversations with public sector officials as indicating little likelihood of FX intervention in the event the peso comes under sharp depreciation pressure. The exchange rate is flexible and market driven by design, and should fundamentals suggest the peso needs to weaken, local authorities would not look to interrupt any FX revaluation. Intervention to smooth volatility could be delivered, but efforts to change the direction of the currency would likely not come to fruition. Latin American central banks have been particularly active in FX markets to stabilize respective currencies; however, the fact Banxico intervention is viewed as unlikely also keeps peso risks tilted toward a greater degree of peso depreciation.

“Black swans” exist, but are low probability event risks at this point. Discussions did reveal a few “black swan” event risks. First, and a risk we have mentioned in prior notes, is the potential for President Sheinbaum to be recalled from office. During former President Lopez-Obrador's term, he instituted a constitutional amendment aimed at offering the voting population the chance to “recall” the president via referendum. The referendum is not scheduled until 2027, but catalysts for Sheinbaum being removed from office via referendum vote include, but are not limited to, reduced social spending, a perceived “loss” in negotiations with the U.S., and if the Sheinbaum-AMLO relationship deteriorates. The second risk would be a Pemex default. Pemex is a cash flow negative enterprise that often relies on sovereign financial support to repay debts and stay solvent. Sheinbaum is a proponent of green energy and, to a degree, fiscal consolidation. A scenario exists, although with low probability, where she allows Pemex to default in order to preserve fiscal tightening efforts and transition more toward clean energy. We have our doubts Pemex would be allowed to default, given the nationalism surrounding the company, but more importantly, that financial markets would likely treat a Pemex default as a sovereign default. And finally, some form of demonetization. By demonetization, we refer to removing legacy cash from the economy with the aim of having more transactions captured in the formal sectors of the economy. During our visit, policymakers and local economists flagged how Mexico is a very informal and cash-dependent economy. Informalities across the economy limit federal tax revenues at a time when revenue collection is needed most. Efforts to formalize the economy have gathered momentum recently. We asked whether a 2016 India-style demonetization was possible in the coming years, and while everyone said tax reform—either raising taxes or improving collection methods—was more likely, all said demonetization was an option that has been discussed. Any momentum for demonetization, tax reform or allowing a Pemex default would all likely take place after the 2027 referendum, although, just to reiterate, are very low probability event risks as of now.

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