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Economics Group

Special Commentary

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Mexico: More Trouble in Store

Executive Summary

- The Mexican economy contracted last year, the first annual contraction since the 2008-2009 financial crisis. Given the likely economic impact of COVID-19 and sharp decline in global oil prices, we now expect the economy to experience another annual contraction in 2020.
- Policy choices made by the current administration towards the end of 2018 weighed on the economy in 2019, and while President Obrador did not make any overly concerning decisions last year, recent announcements led us to believe elevated political risk could once again hurt the economy.
- In response to the further economic deceleration that is likely imminent, we believe the Central Bank of Mexico will need to continue easing monetary policy. The central bank has already cut policy rates; however, we believe it will need to get more aggressive with rate cuts in an effort to offset the dual shock the economy is now facing.

Going Back to Back

For the past few years, the Mexican economy has struggled to gather any significant momentum. Since experiencing an annual growth rate of 2.6% in 2015, GDP growth has been slowly deteriorating, with the economy slowing every year since. The deceleration was most evident in 2019, with the economy falling into recession and contracting on a full-year basis for the first time since the peak of the financial crisis in 2009. Over the course of the year, the economy experienced multiple quarterly contractions and registered an annual growth rate of -0.1%.

We can point to a few reasons for the sharp slowdown in the economy last year. The first being that, in our view, policy rates were too high and have been restrictive of growth for some time now. While the central bank lowered its main policy rate 100 bps over the course of 2019, the Central Bank of Mexico still maintained one of the highest policy rates in the emerging world. In addition, uncertainty surrounding the ratification of the USMCA likely led to a slowdown in cross-border trade with the U.S., while a general slowdown in U.S. industrial production likely also weighed on activity in Mexico. However, perhaps the most influential factor over the slowdown is elevated political risk associated with the administration of Andres Manuel Lopez Obrador (AMLO). Following AMLO's decision to cancel construction of a major airport, negatively impacting both local and foreign investor capital, local Mexican businesses and foreign investors have been hesitant to deploy capital in the country, also putting pressure on the local economy.

We feel many of the same factors that hurt Mexico's economy in 2019 are still present.

As far as growth in 2020, we feel many of the same factors that hurt Mexico's economy in 2019 are still present. While trade policy uncertainty has receded now that the USMCA has been formally ratified, and despite the central bank cutting interest rates a bit more aggressively this year, we still believe elevated interest rates are holding back the economy, similar to the view expressed by the IMF in its most recent Article IV assessment of the economy. Not only will these factors likely weigh on activity again this year, the economy is also likely to come under pressure from the effects of COVID-19.

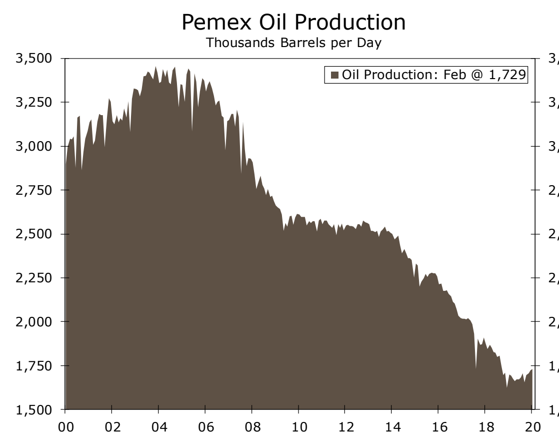
While data suggesting the potential impact from the virus are still scarce, some initial indications suggest the effect of the virus will be severe. PMI data from China and the Eurozone have fallen significantly, while initial jobless claims in the United States spiked signaling U.S. unemployment may rise significantly. Deteriorating data in the United States has significant implications for Mexico given that over 80% of Mexico's exports go to the U.S. and 45% of imports come from the United States. In addition, about 40% of Mexico's total incoming foreign direct investment comes from the United States, and with the uncertainty of COVID-19 lingering over the U.S. economy, it is likely that American companies will reconsider making direct investments into foreign countries, which could act as a drag on the Mexican economy.

Aside from COVID-19, tensions between Saudi Arabia and Russia over oil production are also likely to have knock-on effects for Mexico. In the aftermath of Saudi Arabia and Russia not being able to agree on a deal to cut oil production, global prices have collapsed over 65% this year. As of now, WTI crude oil is trading around $20 per barrel, and with Mexico being a significant oil producer, oil prices at these levels should be yet another drag on Mexico's economy. Mexico's oil production primarily comes from its state-owned energy company, Pemex. Pemex facilities have been deteriorating for some time now, with oil production on a downward trajectory for over 15 years. As of February 2020 oil production was just 1.75 million barrels per day, down from close to three million barrels per day in 2004, and has Pemex's credit rating on the verge of being downgraded to junk status by S&P. The combination of sharply lower oil prices and declining production will likely decrease oil related revenue for the government and also contribute to a slowdown in Mexico's economy.

Mexico's economy is headed for an extended recession.

Looking ahead, we feel the combination of an already fragile economy, likely to be impacted further by the effects of COVID-19 and lower oil prices means **Mexico's economy is headed for an extended recession and even deeper contraction. As of now, we believe GDP will contract around 5% this year.**

Figure 1



Source: Bloomberg LP and Wells Fargo Securities

Politics as Usual

As mentioned earlier, elevated political risk associated with the AMLO administration also likely hurt Mexico's growth prospects last year and we expect political risk to weigh on the economy this year as well. Following his cancellation of the construction of the Texcoco airport in 2018 through a referendum, which had negative implications for foreign capital used to finance the project, investors inside and outside of Mexico have been hesitant to deploy capital in the country as concerns surrounding investments in Mexico have increased. While AMLO has made other concerning decisions which could impact investor capital, such as limiting private participation in the oil sector and limiting the amount of commissions banks can earn, to date AMLO has not made any further policy choices as significant as the airport cancellation.

However, late last week AMLO hosted yet another referendum, this time as it relates to the cancellation of a brewery being built by Constellation Brands in the Northern city of Mexicali. Reports suggest the construction of the brewery has been cancelled as Mexicali residents believe the brewery is using an excessive amount of water in a typically dry area for a product that eventually gets exported. As of now, AMLO has said the outcome of the referendum, which only 5% of the registered voters in Mexicali participated in, is binding and the decision to cancel is final. In response, pro-business lobbyists within Mexico have rebuffed this decision and suggested this policy decision will damage investor confidence in Mexico at a time where the Mexican economy needs foreign investment the most. More specifically, a top pro-business lobbyist firm stated:

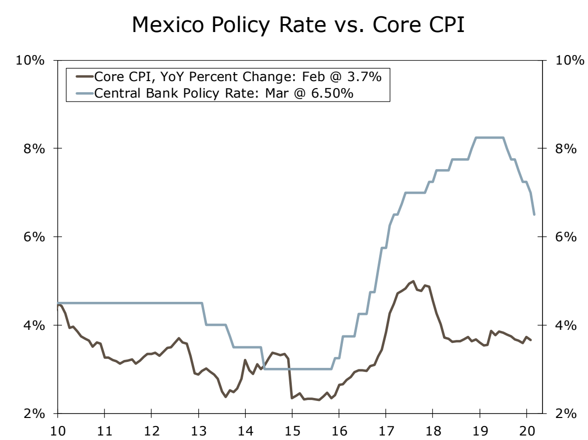
> "This poll damages Mexico's ability to attract investment and increases the economic risk that we are facing because of financial market instability, the oil price and the international convulsion caused by the Covid-19 pandemic."
>
> "Global competition for investment needed to reactivate the economy will be intense and Mexico will be at a disadvantage if it continues generating uncertainty and not respecting the legal framework."

In our view, this decision, along with similar future policies, will continue to negatively impact the economy and Mexico's financial markets. The uncertainty these types of policies create likely contributes to excessive risk for investors and companies to manage, and will probably result in a lack of business investment and foreign direct investment flowing into Mexico. When making our GDP forecasts we also take into account an elevated level of political risk, with policies similar to this considered and playing a role in our GDP forecast for 2020.

Rate Cuts Can Come at a Cost

In response to the slowdown in the domestic economy, and the potential economic effects from the virus and oil price shock, the Central Bank of Mexico has started lowering policy rates a bit more aggressively. In just the last three months, the central bank has cut its main overnight rate a cumulative 75 bps, which has included an emergency unscheduled 50 bps cut in March. These 75 bps of cuts are in addition to the 100 bps in 2019, and in our view, the Central Bank of Mexico will likely continue easing monetary policy in an effort to offset the numerous shocks the economy is currently facing.

Figure 2



Source: Bloomberg LP and Wells Fargo Securities

In our opinion, the central bank has additional room to cut interest rates and **we believe at least another 100 bps of easing is likely during the remainder of this year.** Inflation has been relatively contained, currently at 3.7% year-over-year, and given the decline in oil prices and general slowdown in economic activity, we expect inflation will fall over the course of the year. As of our most recent forecast, we see inflation falling below 3%, which coupled with a still high policy rate of 6.50%, provides adequate monetary policy room for the central bank to cut rates significantly in 2020, in our view.

We believe at least another 100 bps of easing is likely during the remainder of this year.

Despite this view, we believe risks are tilted towards less easing than we expect. The challenge for the central bank becomes the potential impact lower rates could have on the currency. Amidst the volatility in financial markets over the last three months, the Mexican peso has come under extreme pressure, selling off over 20% this year. Should the central bank move forward with 100 bps of rate cuts or more, the impact on the peso could be severe and the currency could depreciate much more sharply than it has year-to-date. Limiting rate cuts to less than 100 bps would likely still result in some downside pressure for the peso, though we believe the selloff would nonetheless be contained to some extent in that scenario.

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