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Policy Rates & Politics To Support Mexico's Currency Rebound

Economist(s)

Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.McKenna@wellsfargo.com | 212-214-5637

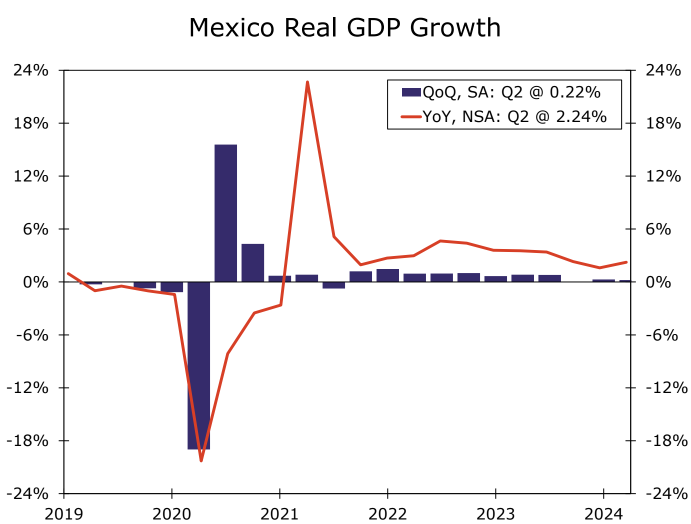
Summary

Mexico's central bank restarted its easing cycle last week and signaled a tentative preference to ease monetary policy further going forward. Policymakers seemed focused on slowing growth and core inflation rather than currency volatility, and as a result, we have adjusted our Banxico policy rate forecast lower. With the direction of monetary policy clearer, financial markets are now likely to be focused on politics. Debates around constitutional amendments and fiscal policy will come to the forefront in Mexico in the coming weeks, while the U.S. presidential election is around the corner. Political developments are key risks to our constructive long-term Mexican peso outlook; however, we remain optimistic that worst case scenarios will be avoided and continue to believe the Mexican peso can recover over the long-term.

Policymakers Pave The Way For Easier Policy...

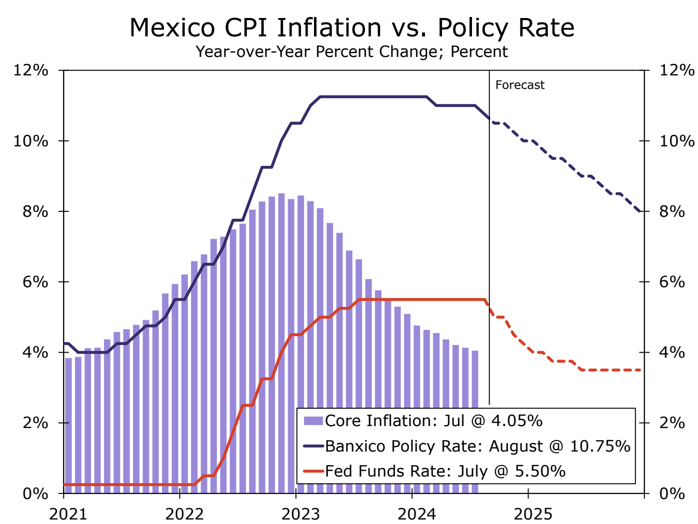
Banxico's latest rate decision was always going to be a close call. Markets and economists alike were split on whether policymakers would keep rates unchanged or resume the easing cycle. In a 3-2 split vote, policymakers opted to restart the rate cutting cycle by delivering 25 bps of easing, lowering the overnight rate to 10.75%. The official statement highlighted that policymakers are most concerned with slowing economic prospects. Indeed, Mexico's economy has demonstrated signs of deceleration over the course of this year, which, combined with a slowing U.S. economy, means growth prospects in Mexico are under a bit of pressure (Figure 1). Also, policymakers revealed that while headline inflation risks are still tilted to the upside, core inflation is tame and contained enough to warrant easier monetary policy. In a mild surprise, at least to us, Banxico barely mentioned Mexican peso depreciation and volatility nor did voting members indicate any form of concern related to political risks either domestic or external. We interpret Banxico forward guidance to mean additional rate cuts are on the way; however, we got the impression that policymakers will still approach monetary policy decisions with a degree of caution. In that sense, despite our base case being that the Federal Reserve delivers back-to-back 50 bps rate cuts starting in September, we believe Mexico's central bank, at least for the time being, will lower interest rates by 25 bps at each meeting through the end of this year. Our revised Banxico outlook now means we forecast Mexico's policy rate to fall to 10.00% by the end of this year. We also believe policymakers will ease monetary policy further in 2025, and now forecast a year-end 2025 policy rate of 8.00% (Figure 2). As far as risks to our Banxico forecast, risks are tilted toward more aggressive easing, especially if the Fed does indeed deliver the 50 bps cuts we forecast or Mexico's economy decelerates more quickly than we expect.

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Econonmics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

...And The Focus Now Shifts to Politics

With the path for Banxico monetary policy now clearer, financial markets are likely to shift focus toward political developments. Mexico's political backdrop has been unsettled following elections in June; however, in the coming weeks we will get clarity on the political appetite for amending Mexico's constitution and for fiscal consolidation. Newly elected congress members will take office next month and overlap with incumbent President AMLO during the last month of his term. Technically, AMLO's MORENA does not have a congressional supermajority, falling three seats short in the senate; however, congress members have been known to support policies outside their party's agenda in an effort to seek concessions for other political agenda items. Should opposition policymakers support constitutional amendment proposals, MORENA would likely be able to cobble together enough support in both houses of congress to adjust Mexico's constitution. With that said, even if MORENA does reach across the aisle and get support from opposition policymakers, MORENA policymakers themselves would still have to vote in favor of amendments. In 2018, MORENA won a supermajority under AMLO and many of AMLO's policies that required amending Mexico's constitution were voted down in congress. Mexico's political dynamics can still evolve in a variety of ways, and we will get insight into the direction of political risk and Mexico's governance backdrop in the coming weeks. Mexico will also have to submit a budget for 2025 in the near future. As of now, the government is running a relatively wide fiscal deficit of ~5% of GDP. On the campaign trail Sheinbaum preached fiscal consolidation and responsibility; however, since winning the presidency she has commented on expanding welfarism and social spending. Deficit targets have also been widened with Sheinbaum recently referring to a 2025 fiscal deficit of ~3.5% of GDP, up from the 3% target mentioned during her campaign.

While the possibility of weaker institutions and a wider fiscal deficit are concerning, we believe Mexico will avoid worst-case scenarios on both fronts. In short, our view comes down to the idea that Mexico has too much to lose by moving forward with constitutional amendments that disrupt the governance framework and by not exercising fiscal discipline. Since the pandemic, Mexico has gained headway as the preeminent nearshoring destination for corporations shifting operations closer to the United States. Reconfiguring legal frameworks, democratic workings, as well as Mexico's checks and balances system risks disrupting nearshoring-related investment and the economic benefits of supply chains landing in Mexico. Some other drivers of Mexico's economic growth have dwindled over the years as Pemex oil production has declined sharply and political uncertainty in the United States has become more prevalent. At a time when a new avenue for growth is needed, we have our doubts Mexico's policymakers would jeopardize the economic growth nearshoring could generate. Also, constitutional amendments, in combination with wider fiscal deficits, puts Mexico's investment grade credit rating at risk. Losing investment grade status could result in forced selling of sovereign debt and broader capital outflows that could lead to financial instability. From a political perspective, Sheinbaum as well as MORENA could see damaged credibility as policymakers by losing the coveted investment grade rating, risking the longer-term perception of MORENA and future presidential candidates. In our view, these are risks the new political leadership will ultimately be unwilling to take. We believe cooler heads will prevail, political risk will simmer to pre-election levels, and fiscal consolidation will be eventually pursued.

Peso Shouldn't Fear Another Trump Presidency

While challenges for the Mexican peso are present from multiple angles, we continue to believe the Mexican peso can experience a recovery and strengthen over the long term. For most of the last few years the Mexican peso has been a notable outperformer relative to the U.S. dollar. That trend was upended as a result of elections in June, and the peso has recently experienced renewed depreciation pressures due to the global unwind of the FX carry trade following the Bank of Japan's rate hike and concerns that the U.S. Federal Reserve is behind the curve on pivoting to interest rate cuts. But, while political and carry trade risks may linger for the time being, we believe the Mexican peso is still a fundamentally sound currency that can experience long-term strength. On the local politics front, we believe our “cooler heads prevail” scenario can be the initial catalyst for a peso recovery. If policy continuity manifests itself, as opposed to a weakening of Mexico's institutions via constitutional reforms, a lessening of political risk can improve sentiment toward the Mexican peso. At the same time, a shift back toward fiscal responsibility can support Mexico's investment grade credit rating and prevent rating agencies from taking a more negative view on Mexico's rating trajectory. A combination of reduced political risk and increased fiscal responsibility can be, in our view, key drivers of the Mexican peso's long-term strengthening trend against the U.S. dollar. In addition, we continue to believe the U.S. dollar is set to embark on a period of cyclical depreciation against many foreign currencies, including the Mexican peso. With the U.S. economy decelerating, but likely to achieve a “soft landing”, and the Fed ready to shift to more accommodative monetary policy, the combination of more robust growth abroad and lower U.S. interest rates should support global risk sentiment. As risk sentiment improves, demand for safe haven currencies such as the dollar should fade, improving prospects forthe Mexican peso. Finally, despite an easing bias from Banxico, policy rates in Mexico relative to the U.S. should remain attractive. With U.S. rates on track to move lower, a “search for yield” dynamic may unfold across financial markets. As mentioned, carry trade risks may persist to some extent, but the peso is still likely to be associated with a healthy degree of carry that can act as a supportive factor for the peso over the longer-term. We will provide a forecast profile for the USD/MXN exchange rate in our August International Economic Outlook, but as of now, we can say the long-term view for the peso is one where the currency strengthens over the course of 2025.

We would also be remiss to not mention the risks to our Mexican peso outlook that stem from the upcoming U.S. presidential election. Yes, the long-term outlook for the peso can be challenged by an adverse U.S. policy mix following the outcome of this year's election. Should U.S. policy toward Mexico be defined by stricter border control, tariffs and harsher trade terms, Mexico's real economy could be damaged and sentiment toward the peso could suffer. This scenario is perhaps more likely under former President Trump as opposed to Kamala Harris; however, we are not, at this time, convinced a second Trump term will materially disrupt the long-term peso trend. We say this for a few reasons. First, should former President Trump win in November, his victory would not be a surprise the same way his win was in 2016. The peso responded particularly poorly to Trump's win in 2016 largely due to the shock factor. This time around, while the election remains a close call as of mid-August, a Trump victory would not be a shock reminiscent of 2016. Second, should Trump win the election he will not have to worry about being re-elected in 2028 or beyond. A win this year terms out Trump, which in our view, at least introduces the idea that he will not be as driven to keep playing to his base of supporters with populist-style and hawkish rhetoric. Two sides to this argument certainly exist, but without a need to reinforce support from his base, Trump may gravitate more toward the center of the political spectrum rather than move further right. And finally, the USMCA trade agreement is up for review in 2026. A theory exists that Trump can use the USMCA review process to secure concessions on immigration and border control with Mexico. Keep in mind Trump negotiated the USMCA, and if he were to seek modifications, there would be some degree of public acknowledgement of flaws in the original trade deal. We have our doubts as to whether Trump would admit to flaws in a deal he negotiated and his administration ratified. For these reasons, and for the time being, we continue to forecast a stronger Mexican peso regardless of who wins the U.S. presidency this year. That said, if the U.S. policy mix does in fact turn more aggressive toward Mexico, our assumptions would have to be reconsidered and our long-term peso view would likely change.

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Jeremiah Kohl	Economic Analyst	212-214-1164	Jeremiah.J.Kohl@wellsfargo.com
Aubrey George	Economic Analyst	704-410-2911	Aubrey.B.George@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Ali Hajibeigi	Economic Analyst	212-214-8253	Ali.Hajibeigi@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

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