Next
Regional Equity Quarterly Report
Thursday, September 22

Myth Busting The Mexican Peso

- While credit quality has deteriorated, the odds of another peso crisis are very low.
- The peso will nevertheless be sensitive to shifts in Fed rate hike forecasts. Remain underweight in an EM currency basket.
- The peso's correlation with oil prices is unjustifiably high, but will remain a headwind until markets digest the fact that oil's role in the economy is now minor.
- The peso is liquid, but so are other currencies, and should no longer remain a principal proxy for EM currency risk.
- Donald Trump's recent rise in polling has weighed on the peso, and there is some upside if betting markets prove accurate and he is not the next occupant of the White House.

In 2012, Mexico emerged as the poster child for EM structural reforms, and its peso was amongst the most-favored currencies in the EM universe. Sentiment was badly hit by the following year's "taper tantrum" and has seemingly soured permanently following the decline in oil prices in 2014. The currency has been amongst the worst performing of major developed and EM currencies this year, underperforming the EM currency basket by 14%. This has left the peso extremely undervalued and oversold.

This report examines some of the popular narratives surrounding the peso's underperformance, including fears that a Fed rate hike may morph into a 1994-style "Tequila Two" crisis, the peso's use as a hedge against EM risk, its status as a petro-currency, and finally the currency's recent correlation with the Republican candidate's performance in November's U.S. presidential elections. The investment conclusion is that even though there is significant upside for long-term investors, near-run risks overwhelm our forecast of improving export-driven growth momentum and credit quality. We thus will remain underweight the peso in an EM currency basket until U.S. growth and non-oil imports are strong enough to drive global trade higher and boost Mexican exports.

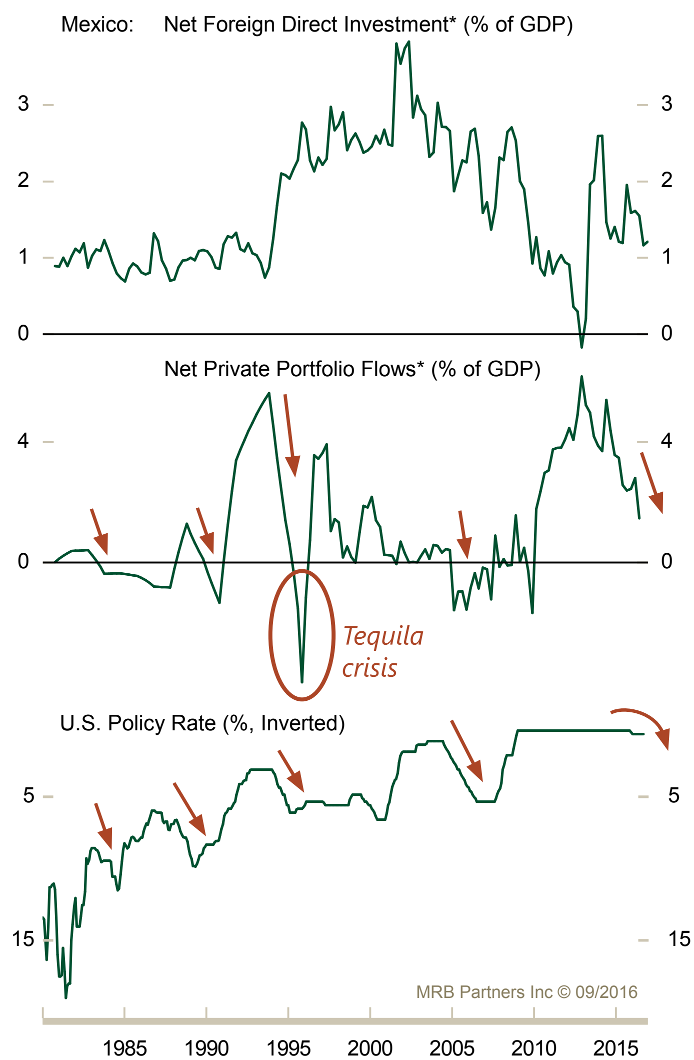
Near-run risks overwhelm our forecast of improving export-driven growth momentum

Is The Peso Hostage To The Fed?

Fears that Fed rate hikes would severely crimp Mexican growth are overstated. While capital flows have historically declined in the runup to such an event (**chart 1**), whenever the Fed hikes in response to better growth, the positive knock-on effects on exports and overall growth momentum, coupled with foreign direct investment (FDI), tend to outweigh the decline in hot money inflows.

As long as global growth is largely driven by the U.S., then Fed rate hikes and the associated rise in global interest rates will hurt the weaker links in the EM universe because global growth momentum is not sufficient to lift all boats. That said, in the case of Mexico, growth momentum is closely tied to the U.S. economy and thus Fed rate hikes will be associated with improving U.S. imports and stronger Mexican exports. To this extent, even though Mexico remains modestly dependent on hot money to finance its external deficit, it is ***relatively*** shielded compared with EM economies with smaller exposure to the U.S.

Chart 1 **FDI To Offset Declining Capital Flows**



* Source: Banco De Mexico

Peso bears draw parallels between the current situation and the Tequila Crisis of 1994-1995. At that time, the Fed was tightening monetary policy aggressively, propelled by very strong growth and rising inflation expectations. The Mexican backdrop included low rates and relatively high foreign ownership of its financial assets, high external financing requirements, domestic political uncertainty and deteriorating credit quality (debt was rising as a share of GDP). That said, Mexico is in a much better position today to withstand the negative effects of capital outflows. Specifically:

- Although debt levels are rising, they remain fairly low and unlike in the 1990s they are mostly long-term and peso-denominated. This limits rollover and currency mismatch risks.

- Mexico's overall dependence on hot money is much lower today. In other words, relatively stable FDI inflows play a much larger role in financing the current account deficit today (**chart 2**).

Mexico remains modestly dependent on hot money in order to finance its external deficit

- The central bank (Banxico) has built a credible and successful track record of targeting inflation, unlike in the 1990s. It can therefore allow a free-floating peso without resort to burning foreign exchange reserves (FXR) in an attempt to control import prices.

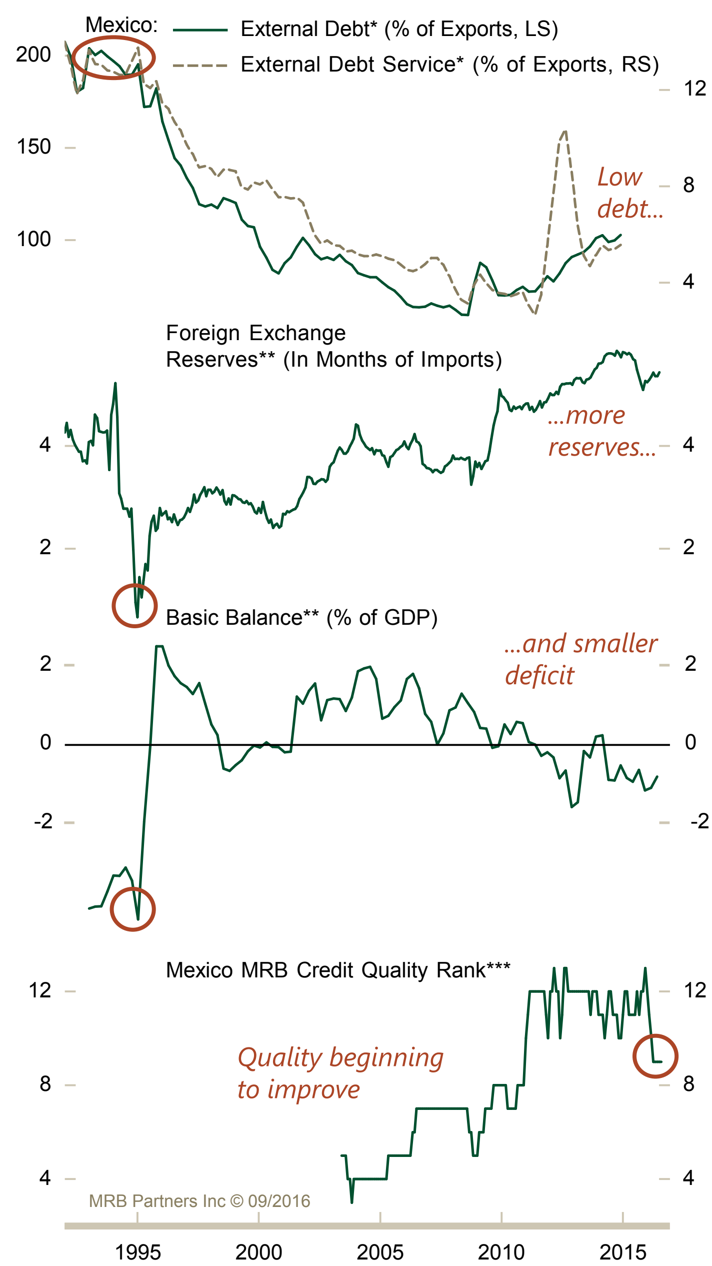
- The FXR position is much stronger today than was the case at the peak of the crisis, and although such reserves can decline quickly and sharply, there is little reason to believe that this will occur given Banxico's policy of limited currency intervention.

- Fed rate hikes will be gradual given that the U.S. remains on a ***moderate*** expansion path. A series of aggressive rate hikes by the Fed similar to the 1994 episode is highly improbable in the post-2008 low inflation and growth-challenged environment.

The balance of probabilities is thus stacked ***against*** another balance of payments or currency crisis. Mexico is better positioned than many of its EM counterparts not only to avoid a crisis, but to withstand Fed rate hikes. This does not exonerate Mexico's credit quality deterioration and rising vulnerabilities. This was partly a result of the structural reform program which kept domestic demand robust at a time of weakening external demand (resulting in widening external deficits and external financing requirements). In addition, the government responded to the growth soft patch by increasing public spending before the fiscal reforms of 2012 yielded fruit, which widened the fiscal deficit and resulted in a sharp rise in the public debt-to-GDP ratio and the deterioration in debt ratios[1].

This negative dynamic is now in the process of reversing as the government implements a more conservative approach to fiscal policy. The austerity drive has already pushed the primary budget balance into positive territory, which in turn will improve credit quality over the next year. Improving export growth will eventually provide another positive catalyst, although this is not imminent. MRB expects the inventory cycle in the U.S. to turn growth-positive, which should signal the beginning of a pickup in investment growth and provide a much more favorable growth backdrop for Mexico.

Chart 2 **Much Better Fundamentals Today**



* Source: Oxford Economics
** Banco De Mexico
*** Based on 13 credit quality metrics; higher number = lower ranking

But until such time, U.S. imports will not be strong enough to accommodate all manufactured goods exporters. Competition for U.S. market share between China and Mexico will likely weigh on exports of both economies. Any narrowing in Mexico's current account deficit that would limit the peso's vulnerability to U.S. monetary policy expectations is thus geared to a recovery in investment spending in the U.S.

[1] See the **MRB *Research Highlight***, "***Assessing Credit Quality For EM Government Bonds***", August 18, 2016 for details of how MRB measures credit quality in the EM universe.

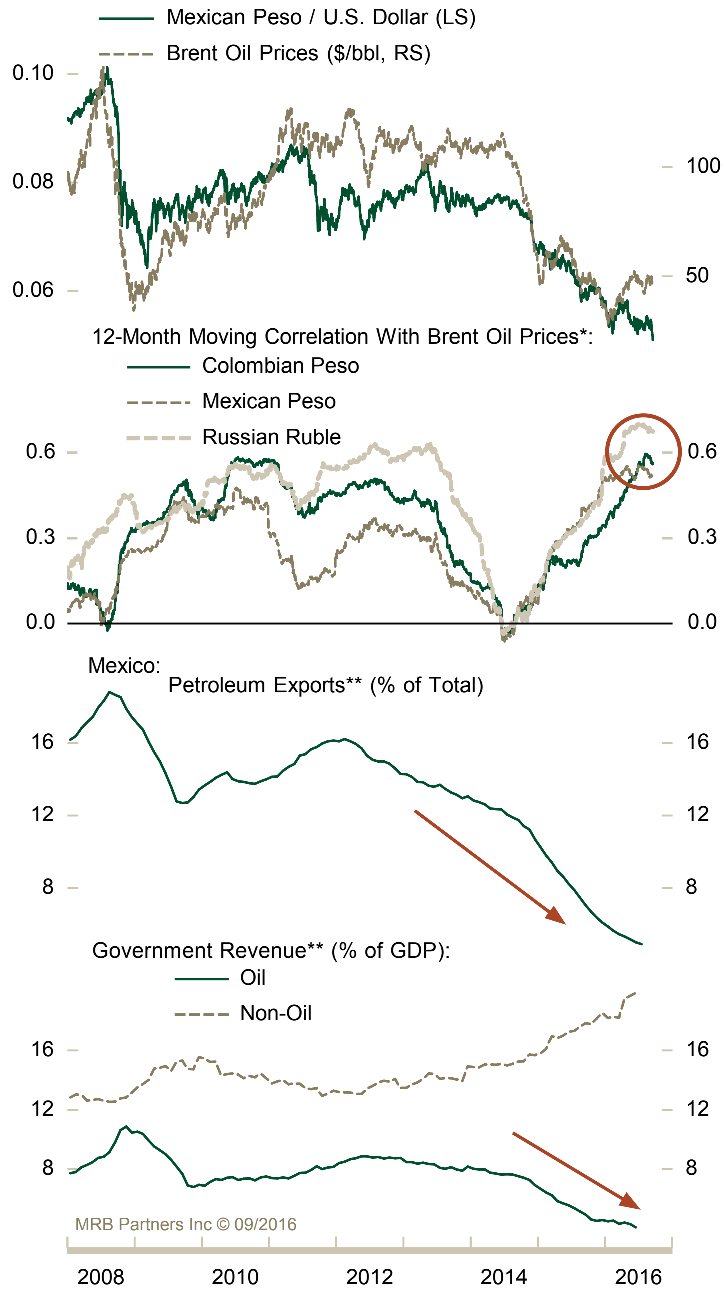
Final Word: *Mexico is in a much better position today to withstand Fed rate hikes than was the case prior to the Tequila Crisis, and aggressive Fed policy will not provide a catalyst, as was the case in 1994. That said, until investment spending picks up in the U.S., Mexico's recovery will remain volatile and weigh on the peso relative to other EM currencies.*

Is Mexico Still An Oil Play?

While Mexico's equity market provides limited exposure to oil, the correlation between changes in currencies and Brent oil prices endow the peso with the status of a petro-currency, trailing only Russia's ruble and Colombia's peso in this regard (**chart 3**). Historically, Mexico was a large oil producer and oil played a dominant role in public finance. Crude oil and petroleum products accounted for a hefty share of total exports, and the sector played an extremely important role as a major source of government revenue (total oil revenues accounted for 40% of government revenue in 2012).

However, oil output has been in secular decline and, together with the impact of lower prices, the sector plays a much diminished role in today's economy. Petroleum now accounts for only 5% of total exports and Mexico is actually ***a net oil importer***. Oil still plays a limited role in generating fiscal revenue, but fiscal reforms since 2012 have contributed to most of the declining dependence on oil revenue. The government raised the maximum income tax rate, increased the sales tax in states along the U.S. border, and has introduced a tax on junk food, among other measures.

Chart 3 The Peso's Correlation With Oil Remains Too High



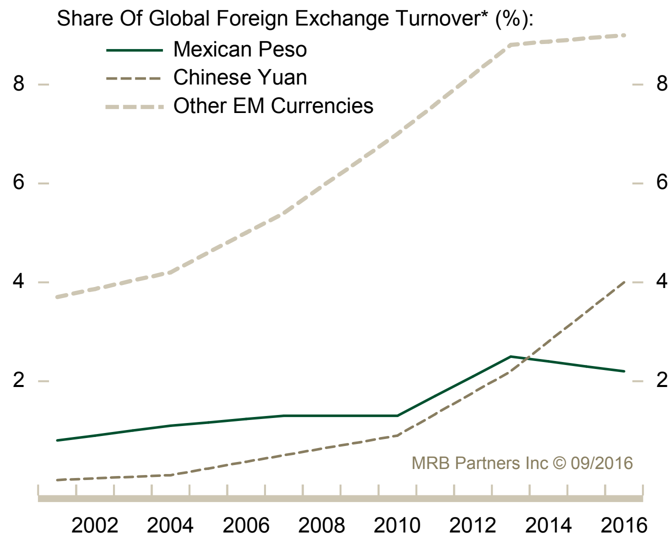
* 261-day rolling correlation of daily percent changes
** Source: Banco de Mexico

As a result, the rise in non-oil revenue far exceeded the decline in oil revenue, and the share of the latter fell from 40% of the total in 2012 to some 15% as of July 2016. This is a welcome development insofar as it reduces the volatility of total government revenue (oil revenue is much more volatile than non-oil sources). It also means that without the fiscal reforms more aggressive spending cuts would have been needed, and sentiment towards the country would have worsened more than has already been the case.

Nonetheless, for as long as global investors continue to undeservedly treat the peso as a petrocurrency, the near-term implication is that the peso's correlation with oil prices will likely weigh on relative performance. We expect oil prices to be range bound because of continuing oversupply, with a negative bias over the next six months. However, this correlation should break down/decline on a 6-12 month view as the markets digest the sector's increasingly smaller role in the economy.

Final Word: *Recent structural reforms have reduced Mexico's vulnerability to oil and thus the peso's high correlation with oil prices relative to EM peers will likely decline on a 6-12 month view. Until then, this remains a near-term headwind for the peso's relative performance given our negative short-term view on oil prices*[2] .

Chart 4 **The Peso Should No Longer Remain A Proxy For EM Currency Risk**



The Peso: No Longer A Stand-In For EM Currency Risk?

The peso's status as the most liquid/traded EM currency is often cited as a reason for its volatility. According to the Bank for International Settlements (BIS), the peso has been one of the most traded EM currencies over the past decade (**chart 4**), often more so than some DM currencies. This, coupled with the high correlation of EM financial assets in general, means that investors have often used the peso as a hedge against EM risk.

Structural reforms have greatly reduced Mexico's vulnerability to falling oil prices...

In our view, such an argument may occasionally explain the peso's divergence from EM currencies, but it much more likely that other factors play a more dominant role[3]. Even though foreigners have recently reduced their holdings of Mexican assets, the latter are still over-owned by foreigners[4], as measured by the relatively elevated level of foreign ownership of government peso-denominated bonds (33%), and by MRB's proxy of foreign equity ownership, which is based on foreign-listed ETF holdings as a share of local market capitalization. In addition, the large current account deficit and basic balance shortfall leave the currency sensitive to the ebb and flow of capital flows. The recent soft patch in growth, lower oil prices and deteriorating credit quality are also more important factors in our view.

...but investors still treat the peso as a petro-currency

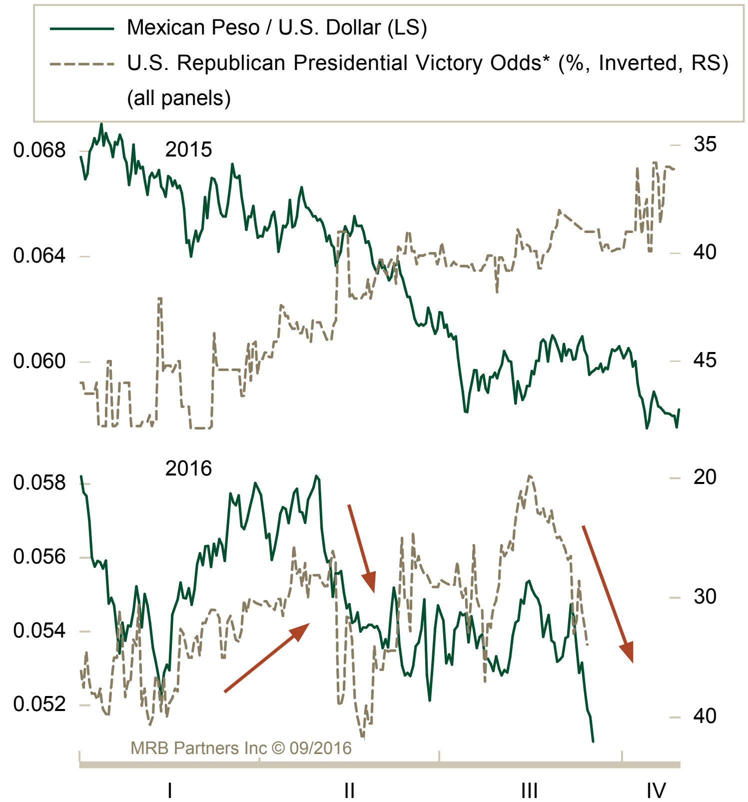
[2] For details of our short and medium-term views on oil prices, see the **MRB *Commodities Research Highlight***, "***Oil Prices: Will The Sideways Churn End?***", July 26, 2016

[3] **MRB *Weekly Macro Strategy Report***, July 8, 2016

[4] **MRB *EM Research Highlight***, "***Are EM Local Debt Markets Over-Loved By Foreigners?***", July 21, 2015

Even putting those factors aside, the most recent data by the BIS shows that the peso is no longer the most-traded EM currency, having passed this poisoned chalice on to the Chinese yuan. The latter's share of global currency turnover has doubled since 2013 to over 4% and now dwarfs the peso's declining share. Other EM currencies are also gaining at the expense of the peso. As China's yuan continues to gain importance after its inclusion in the IMF Special Drawing Rights basket at the end of this month, the peso's share of global currency trading will continue to decline. This source of volatility for the peso will therefore ebb in the longer term, but for now, Mexico's financial markets are still highly liquid which will occasionally weigh on the peso's relative performance in the near term.

Chart 5 Peso Upside If Trump Loses The Presidential Race



* Winner take all; source: Iowa Electronic Markets

The Trump Factor

In recent months, many investors have embraced a narrative that the peso is highly correlated with Donald Trump's poll numbers. The argument is that the peso is the most vulnerable currency to the impact of the policies proposed by a future Trump Administration. The fact that the peso failed to gain versus the dollar at a time when oil prices have rebounded and EM currencies continue to appreciate lends credence to this argument, i.e. another factor must be explaining the peso's relative weakness.

And indeed, **chart 5** shows the peso along with Trump's odds of winning and suggests that his winning odds seem to have been correlated with the peso, but only very recently. A simple quantitative model can gauge the accuracy of this narrative, explaining the peso's performance using a basket of EM currencies, oil prices and the U.S. ISM manufacturing index as independent variables. Until the beginning of this year, the model explains the peso reasonably well[5]. The proxy for Trump's victory is the odds produced by Iowa Electronic Markets "winner-take-all" market. Adding this data to the model suggests that the Trump factor was insignificant for the peso prior to 2016, but since the beginning of the year, the odds of his winning the November election have played an increasingly larger role. Importantly, it helps partially explain the peso's poor performance since August 2016.

The peso is the most vulnerable currency to the impact of policies proposed by a future Trump Administration

[5] The model has a high adjusted R-square, all coefficients have the expected sign and are statistically significant.

The investment implication is that with the election still two months away, near-term performance will remain susceptible to any improvement in Trump's poll numbers. However, because betting odds, statistical models, and state-by-state polling continue to point to Hillary Clinton as the winner in the presidential race (even though the race has been tightening in the past few weeks), the peso will have some upside if these forecasts prove correct[6]. Undoubtedly, a Trump victory would be negative for the peso, but it will be difficult to quantify the damage until there is clarity on his policies and/or ability to implement them .

A Clinton victory today would imply 8% peso upside

Final Word: *The peso has been buffeted by a plethora of factors since 2014, has been unjustifiably punished and is now at extremely undervalued and oversold levels. We see significant upside to the currency but are cognizant that there are many short-term hurdles. Such hurdles overwhelm our forecast of improving export-driven growth momentum and credit quality. The peso will likely continue underperforming EM peers over the coming months. While oil prices are range-bound, its low exposure to China implies that it is missing out on the industrial commodity-driven EM rally on the back of the cyclical recovery in China's housing market.*

Amr Abdelkhalek

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6 Were the election to be held today, resulting in a Clinton victory, the model would suggest peso upside vis-à-vis the dollar of the order of 8%.

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