# Macro Keys

## Reassessing the Weakness in MXN and Banxico's Reaction Function

Economics

Americas

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**The peso continues to trade poorly**

Despite the Central Bank's surprise 50bp hike in February, the peso remains the worst performing currency across EM this year. We think deteriorating external sector fundamentals are largely to blame. While the external deficits may not appear large, particularly in an environment of low oil prices, the slide in the deficit is also driven by a fall in manufacturing exports that have failed to get much traction from the weak exchange rate. Moreover, if we add Mexico's large and persistent unexplained outflows captured in the errors and omissions term of the balance of payments, the current account deficit grows close to 5% of GDP. Other EMs with similar deficits offer considerably higher carry compensation than the MXN does today.

**Ongoing dependence on portfolio flows**

Mexico's external vulnerability is exacerbated by the continued reliance on portfolio inflows for its external financing. With FDI increasing only gradually, a reduction in portfolio inflows - rather than outright outflows - may suffice to pressure the MXN. The dominance of debt over equity flows also implies that the MXN may not be an effective pro-cyclical play on the US economy, a worry given the low level of US real rates today.

**Lingering fiscal concerns, especially vis à vis Pemex**

Beyond the deterioration in the external accounts, lower oil prices have also put pressure on the government's fiscal accounts and the public debt level. While the authorities have pro-actively announced adequate spending cuts, doubts remain as to whether Pemex will be able to implement its restructuring plan in an orderly and timely fashion.

**Should the Central Bank hike interest rates?**

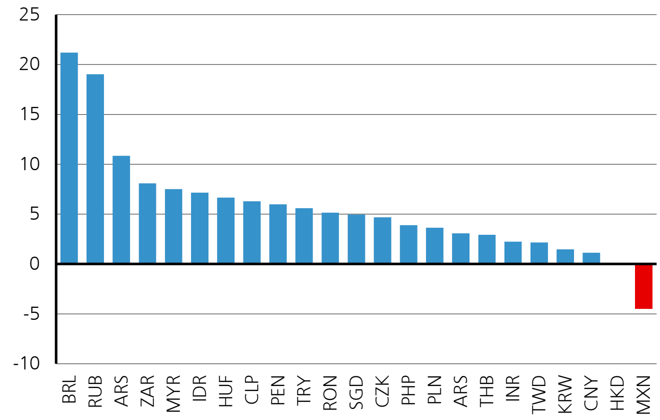
Given the limited success the surprise 50bp February hike had on the MXN, we think the monetary authorities will interpret peso weakness as more fundamental than speculative in nature, and try to steer monetary policy expectations to a more predictable policy stance, motivated by inflation, the output gap, and US-Mexico policy rate differentials, more so than the level and volatility of the MXN. Aggressive rate increases may have unintended consequences of unsettling the bond market if they raise FX hedging costs too far. The threshold at which a weaker MXN forces rate hikes is likely now higher than it was in February.

**Less may indeed be more**

In this vein, and despite the recent move in the peso, we think Banxico will likely stay on hold for longer, moving more in line with Fed unless a bond market disruption or increased FX pass-through push it into action. We see the CB delivering two 25bp hikes this year, one in Sep and one in Dec, in line with our FOMC view. We see further peso weakness over the coming 1-3 months, and recommend staying long USD/MXN against receiving 1y1y swaps

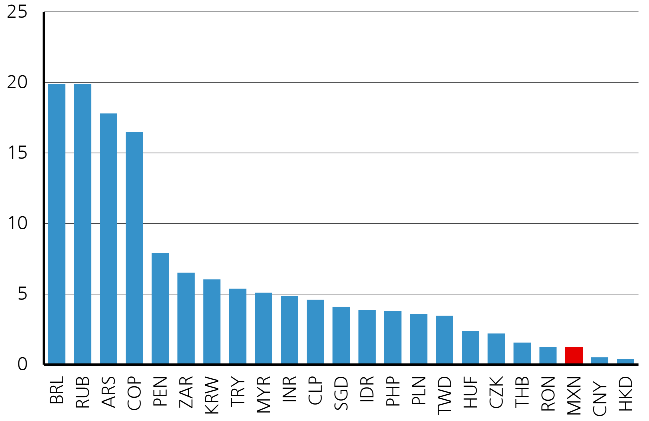
The MXN has been the biggest underperformer in EM FX this year. Given the rather benign global context - recovering oil prices, stronger global equity markets, and improving US financial conditions - coupled with Banxico's 50bp surprise rate hike in February, many would find this price action unsettling. What ails the peso and what, if anything, can Banxico do about it?

**Figure 1: Total returns YTD in EM FX, %**




Source: Bloomberg, UBS

**Figure 2: Total returns in EM FX since Banxico Feb 17 hike, %**



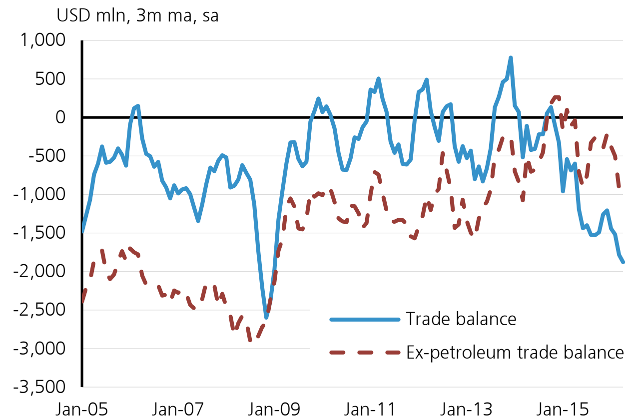

Source: Bloomberg, UBS

We believe four factors in particular have weighed on the MXN.

1. **The sticky current account deficit**

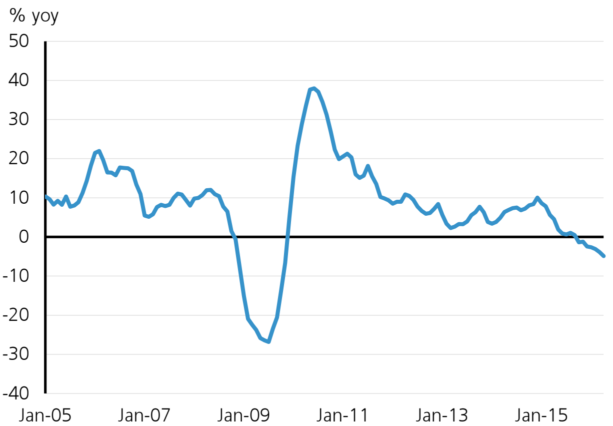
Running at -2.7% of GDP, saar as of Q1-16 (or -2.8% of GDP, 12m rolling), Mexico's current account deficit has shown limited signs of compression despite the weaker peso. In particular, the goods trade deficit remains under pressure, doubling to -2% of GDP (saar) in Q1 from a year earlier. Clearly, lower oil prices have been a big part of this trade deterioration, especially in the context of Mexico's declining oil production. But oil isn't the full story: Mexico's ex-petroleum trade balance has also deteriorated over the past 18 months, driven by a "two-speed" economy – stable, consumption-fuelled imports vs. weakening manufacturing exports.

**Figure 3: Mexico's trade balance remains under sequential pressure. Most, but not all of this is due to lower oil**




Source: Haver, UBS

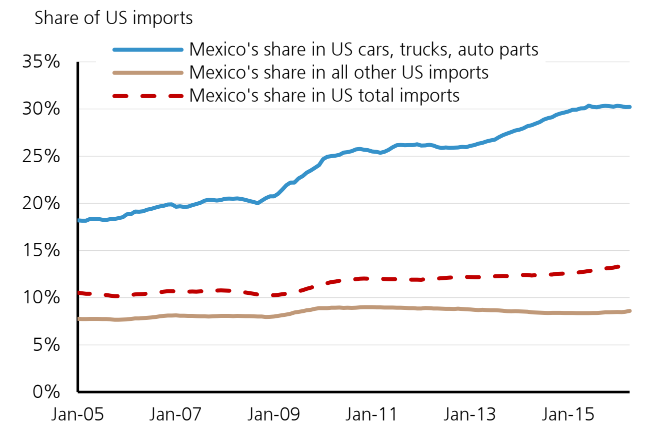
**Figure 4: Manufacturing exports have decelerated**




Source: Haver, UBS

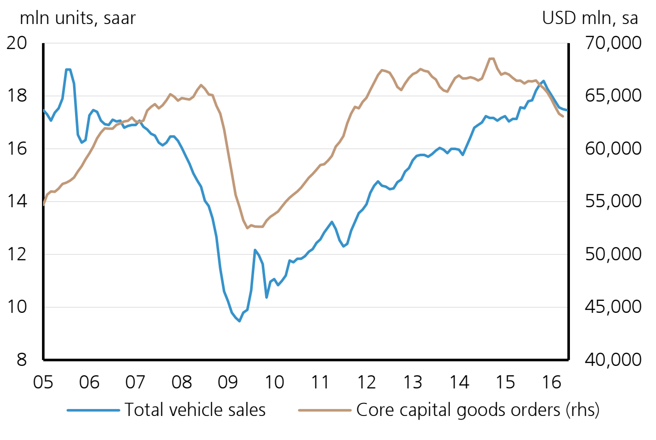
The weakness in Mexican manufacturing exports is important. While oil today represents just 5% of Mexican exports (from over 15% in 2012), manufacturing accounts for a record 90%. In particular, post-crisis Mexico has benefited from rising export penetration into the US automotive sector – cars, trucks and vehicle parts now account for 36% of Mexican exports to the US, up from 25% in 2010. However, recently the trends of Mexico's increasing market share in this sector, and absolute growth momentum in US vehicle sales, have both lost momentum (Figure 5 and Figure 6). UBS' auto sector analysts are forecasting flat US vehicle sales into 2017, implying that this drag can persist for some time, limiting the responsiveness of Mexican exports to the weak peso and keeping the threat of a sticky current account persisting, despite higher oil prices.

**Figure 5: Post-crisis, Mexican exports have gained share in the US. The auto sector has been central to this**




Source: Haver, UBS estimates. Data is based on 12m moving averages

**Figure 6: Momentum in US auto sales has decelerated, weighing on Mexican exports**



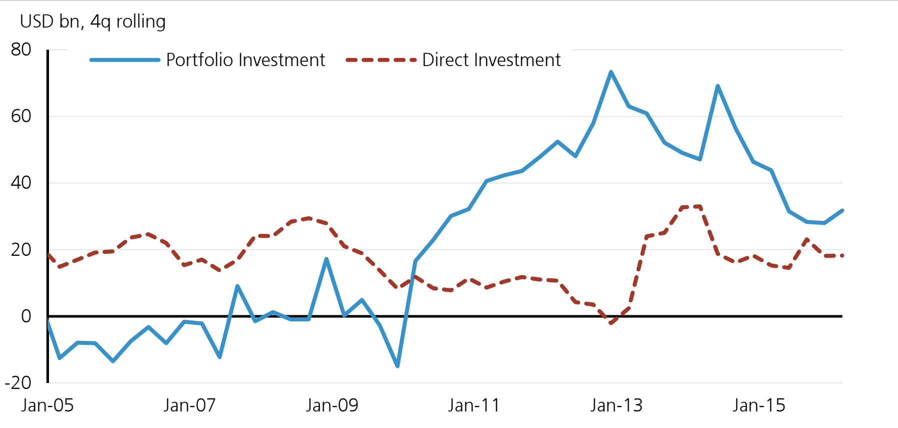

Source: Haver, UBS estimates. Data is based on 3m moving averages

But to us, more troubling than the magnitude of Mexico's current account deficit per se is a) its financing structure and b) the persistence of large unexplained capital outflows, that go over and above the current account deficit. We turn to these factors next.

## 2. Over-dependence on portfolio (debt) financing

While FDI is an important source of Mexico's external financing, portfolio flows have consistently played the dominant role post crisis (Figure 7).

**Figure 7: Portfolio flows continue to dominate current account financing**




Source: Haver, UBS

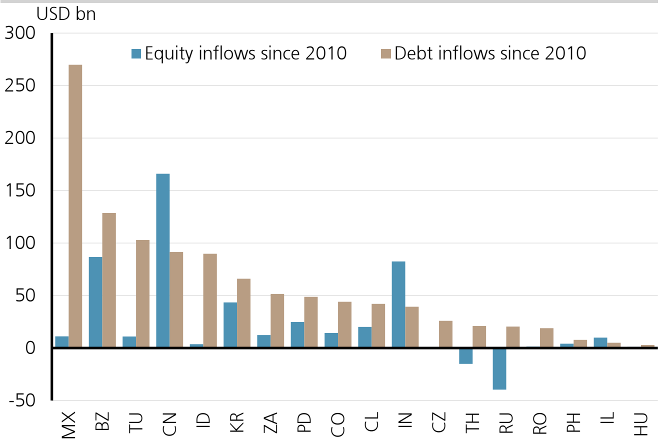
These portfolio inflows have been notable for two reasons.

First, the size of these inflows into Mexico has been stellar – almost twice that of Brazil and China (Figure 8), the next highest portfolio flow recipients in EM over this period. This likely speaks to the high weight that Mexico continues to command in EM portfolios (especially debt portfolios). Foreign investors still own close to 60% of the MBONO market, a ratio close to record highs (Figure 9).

Second, as these flows have overwhelmingly favoured debt over equity, likely motivated by declining US real rates over this period and the inclusion of Mexican debt in the World Government Bond (WGBI) index in 2010, they will likely make the MXN less pro-cyclical with respect to US growth and more sensitive to broader EM fixed income flow dynamics. With US 10y real rates only a shade above zero, a stronger US recovery may thus not be an unmitigated positive for the MXN.

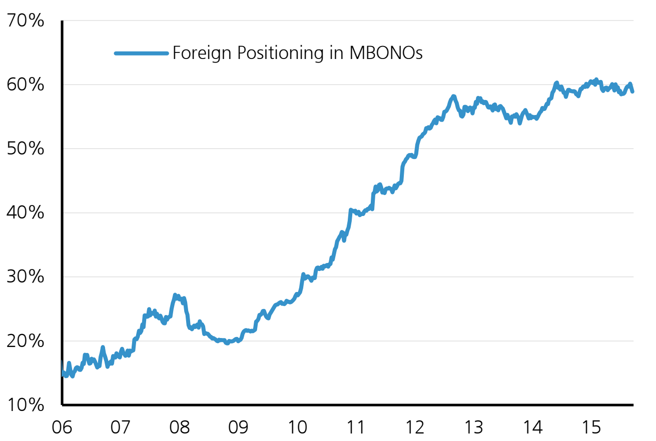
As such, while our local rates scorecard identifies the MBONO market as relatively attractive by EM standards, the texture of Mexico's current account financing continues to leave the peso vulnerable. Absent a commensurate lift in net FDI (which is likely to happen only slowly, particularly in a still-low oil price environment and with the 2018 elections looming) or in other investment flows (which have traditionally never been a source of sustainable inflows for Mexico), the peso would weaken even if portfolio inflows merely moderated.

**Figure 8: Equity & debt inflows into EM since 2010**




Source: Haver, UBS

**Figure 9: Foreign positioning in Mexican local govt. bonds**



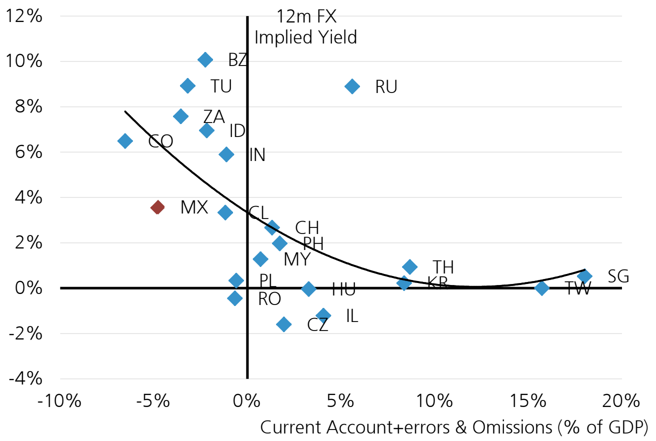

Source: Haver, UBS. Data to end-2015

### 3. The persistence of abnormally large unidentified outflows

Any discussion of Mexico's balance of payments would be incomplete without reminding readers that Mexico records the highest share of "unidentified" capital outflows in EM, at -2% of GDP (12m rolling, Q1-16). While the origins of such outflows are, by definition, uncertain, many would thus fear that Mexico's true current account shortfall is thus close to 5% of GDP, rather than the officially reported 2.7% of GDP. Other emerging markets with similar external deficits offer significantly higher yields than the 3.5% annual carry that MXN provides against the USD today (Figure 10).

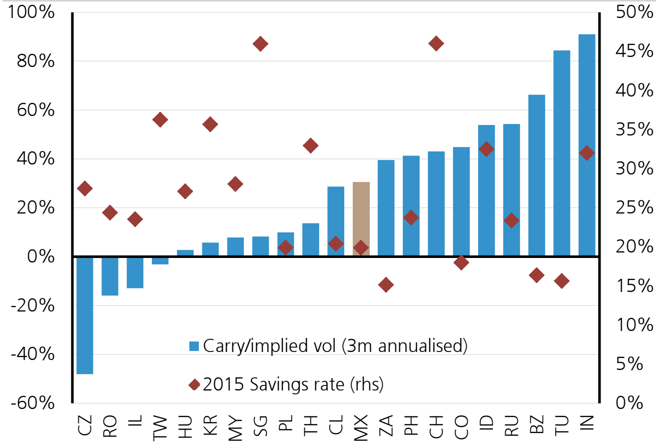
Indeed, despite Banxico's 50bp hike in February, MXN carry relative to implied volatility remains distinctly average by EM standards, especially when one takes its low savings rate into account (Figure 11).

**Figure 10: MXN carry not high relative to the current account deficit and other capital outflows**




Source: Bloomberg, Haver, UBS

**Figure 11: Relative to other low savings economies, MXN offers low carry/vol**

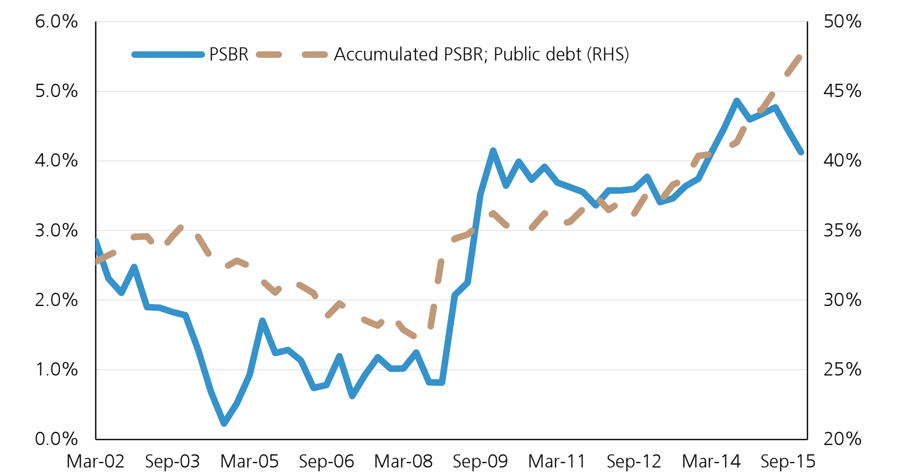



Source: Bloomberg, Haver, UBS

### 4. Pemex as a contingent liability

In the face of lower oil prices, the Mexican authorities have pro-actively announced spending cuts to ensure that the consolidated fiscal deficit converges to lower levels in a bid to stabilise the public debt-to-GDP ratio, which has risen from 28% of GDP in 2008 to close to 48% of GDP (Figure 12). However, the bulk of the 0.7% of GDP cut in spending announced in February needs to come from Pemex, and more specifically, from the company's ability to reduce costs through its association with private firms or through outright asset sales. While such savings would be a step in the right direction towards restructuring Pemex' operations, it remains to be seen whether these farm-outs and sales can be done sufficiently quickly. True, the large transfer of CB profits to the Treasury earlier this year (1.2% of GDP) suggests that the fiscal accounts will not be at risk this year, but given the one-off nature of these unrealised FX gains, questions remain surrounding the stability of the public debt going forward. With both Pemex and the sovereign now subject to increased scrutiny by the rating agencies and the market, further fiscal transparency would be desirable, including the release of revised PSBR targets in light of the CB transfer and the recent recapitalization of Pemex.

**Figure 12: Public debt dynamics and the budget deficit**



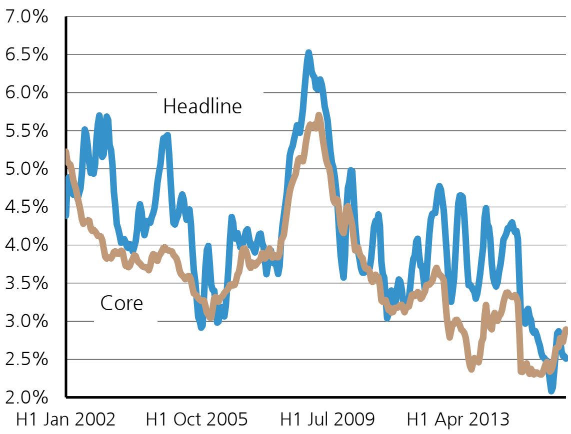

Source: SHCP

## What is the correct policy response from Banxico?

Given the ongoing weakness in the peso and Banxico's inability to change its direction (despite its change in FX intervention policies and the emergency intra-meeting hike in February), what might the appropriate policy response from the Central Bank be at this stage?

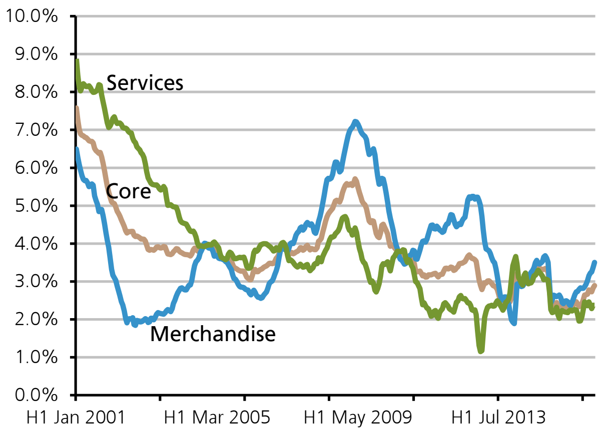
In recent weeks, we perceive that Banxico has tried to shift market expectations as to how it will react going forward back to a more predictable path, one driven by interest rate differentials with the US, by the effects of FX weakness on actual inflation, and by the size of the output gap. Judging by recent market pricing - which until the latest more dovish bend from the Fed included 50 bps of hikes in 3 months and over 100 bps within a year, the most aggressively hawkish profile in EM - these efforts do not appear to have been fully successful. The surprise 50bp hike in February still drives the market's expectation that Banxico fundamentally worries about USD/MXN trading at current or higher levels.

**Figure 13: Headline CPI vs core CPI, biweekly y-o-y**




Source: Haver, UBS

**Figure 14: Core inflation and its components, 12m**

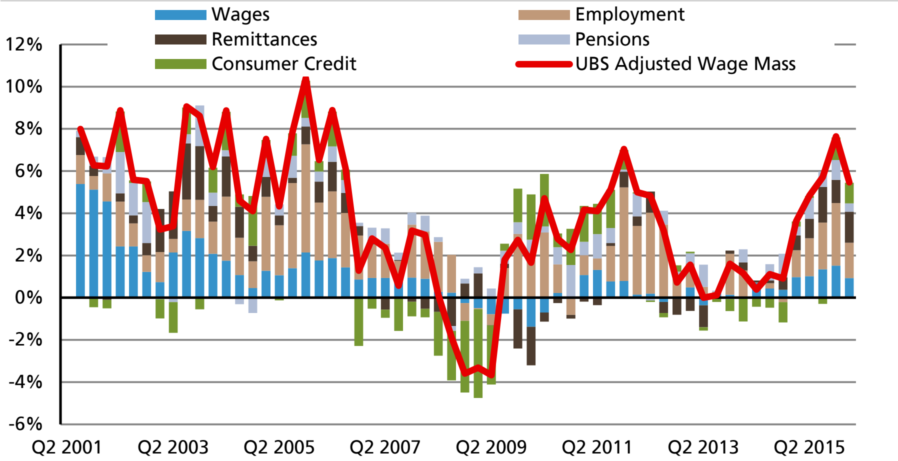



Source: Haver, UBS

Banxico appears caught between a rock and a hard place. Fundamentally, the state of the domestic economy does not warrant additional tightening at this stage, in our view. Inflation remains well-controlled, with both headline and core measures trading below the CB's 3% target (Figure 13). While some pressure on tradable goods prices from the weaker exchange rate is visible (particularly on durables), on the whole the FX pass-through to inflation remains low, with no signs of spillover to non-tradables (read services) at this stage (Figure 14).

Meanwhile, the economy continues to operate with a negative output gap which the Central Bank does not see closing until late this year. True, we witnessed some acceleration in economic activity in Q1'16 with GDP expanding by 0.8% q-o-q on the back of stronger domestic consumption. And equally true, this very strength in consumption may test the Central Bank's conviction that the labor market continues to exhibit slack. Still, we think the fortunes of consumption cannot be divorced from the current weakness we are seeing in the manufacturing export sector, on account of this sector's important role in employment generation. Indeed, our different estimates of the wage mass appear to have peaked, pointing to slower consumption growth ahead.

**Figure 15: Contribution to household purchasing power growth**




Source: INEGI, IMSS, Haver, UBS

### When in doubt, less may be more

The Central Bank may need to weigh its mandate of keeping inflation in check against that of safeguarding financial stability. The authorities' single biggest concern on the latter front is that the large foreign positioning in the local market we mentioned above could ultimately lead to a disruptive exit by foreigners, exacerbating the weakness in the currency and dislocating the local bond market in the process. The weaker and more volatile MXN becomes, the greater the risk of this sell-off, or so the thinking goes. To make matters worse, the short term risks for MXN would appear to be skewed to further weakness on account of: i) ongoing softness in Mexico's manufacturing exports; ii) increased risk of protectionism on the part of the US after the Nov presidential election; and iii) the risk that Pemex fails to deliver on its restructuring plan.

However, it is unclear that pre-emptive rate hikes would do much to stabilise the currency. For one thing, foreign ownership of bonds has remained relatively steady even in times of pronounced MXN weakness. Moreover, larger than anticipated rate hikes may actually spark the very sell-off in fixed incomes securities that the authorities are trying to avoid. One of the main allures of the Mexican local bond market to investors is the steep curve which allows investors to hedge currency risks away while still earning a coupon superior to US Treasuries. But if FX implied yields were to rise by a further 80bps, this would no longer hold true. It is thus not obvious that Banxico tightening at this juncture would have the intended consequences.

Banxico was fortunate for a while that its February rate hike coincided with a broader recovery in market sentiment - oil prices and US stock markets rose and the USD weakened, helping to lift the peso: the months ahead do not promise to be as kind.

In this regard, we are of the view that in the face of continued FX weakness, specifically one that does not feed through to prices or lead to major bond market dislocation, Banxico should take more of a wait-and-see attitude to raising interest rates. Following a more dovish tone from Janet Yellen in the wake of the weak May payroll number in the US, and despite Banxico's reminders that it could move independently of the Fed, we stick to our long held base case that Banxico will raise rates only in line with the Fed. Given the expectations of our US economists, **we see Banxico delivering two 25bp hikes in the remainder of the year,**

**one in September and another in December**. We will be watching long-dated bond yields, breakeven inflation and MXN implied volatility near term as signposts for when the Central Bank may choose to come in more forcefully. If concerns are centred exclusively on increased FX volatility, we would expect the CB to favour one-off FX intervention in size to interest rate hikes. The recent decision to renew the Flexible Credit Line with the IMF six months early and to increase its size from USD67bn to USD88bn suggests that Banxico may be stocking up on ammunition for precisely this purpose.

**In terms of trade recommendations, we remain long USD/MXN as one of our top trades for 2016 against receiving 1y1y swaps.** With c.87bps of Banxico tightening priced over the coming 12 months vs. just 27bps for the Fed, we think that receiving 1y1y rates offers a useful hedge against an extended period of consolidation in the USD, which could lead to a downward revision of Banxico tightening expectations. Our stronger view, though, is for a higher USD/MXN over the next 1-3 months as fundamental pressures re-emerge. We expect the currency to trade through our long-held 18.75YE 2016 target in this period.

### What could turn the peso around?

Looking forward, what could ultimately drive the peso to appreciate? Fundamentally, we look for the following factors to stabilise the peso more structurally:

- A recovery in US capex and manufacturing (specifically vehicle) sector growth momentum, helping to turn around the widening goods trade deficit.
- FDI will need to structurally increase, and punch above the weight of portfolio investment in funding the current account deficit.
- A more ambitious pace of structural fiscal consolidation to anchor confidence in the bond market
- A moderation of Mexico's unidentified capital outflows could also ease investor concerns about the true current account trajectory.

**Manik Narain**

**Rafael de la Fuente**

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Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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