S&P Global Ratings revises Mexico's outlook to negative from stable

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- **Last Friday, *S&P Global Ratings* modified Mexico's credit rating outlook of 'BBB+' from 'stable' to 'negative'**
- **According to the rating agency, this means that there is at least a one-in-three probability of a downgrade of the rating over the coming year**
- **On the reasons behind this change, they highlight the risk that the recent shift in government policy to reduce private-sector involvement in the energy sector, along other developments that have led to a decline in investor confidence**
- **In our view, Mexico will not lose its investment-grade rating. In this context, revisions in the outlook that do not lead to a cut in the rating have been observed in the past**
- **Given the relevance that the administration has placed in maintaining macroeconomic stability, we anticipate that the government will take the necessary actions to avoid a downgrade**
- **Mexican assets trading with a higher risk premium *vis-à-vis* its credit rating, with market participants acknowledging that investment grade should continue ahead**

***S&P Global Ratings* modified Mexico's credit outlook to 'Negative' from 'Stable'.** Last Friday, the agency affirmed the credit rating at 'BBB+', revising the outlook to 'negative' from 'stable' (see table below). This means that there is at least a one-in-three probability of a downgrade of the rating over the coming year. In line with this change, the agency modified today the outlook for Pemex to be consistent with the sovereign. In this respect, it is worth remembering that the last time in which this agency made a modification to the sovereign was in July 2017, when they upgraded the outlook to 'stable' after the revision to 'negative' in August 2016. Moreover, in March 2018 they reaffirmed both the rating and its outlook at 'Stable', after mentioning that their base-case scenario contemplated that Mexico, the US, and Canada would reach an agreement that would preserve to a great extent the trade relationships that strengthen the economies of North America.

Mexico's credit ratings

	Rating	IG / Speculative	Outlook	Last change in rating and/or outlook
Fitch	BBB+	Investment grade	Negative	31-Oct-18
Standard & Poor's	**BBB+**	**Investment grade**	**Negative**	**01-Mar-19**
Moody's	A3	Investment grade	Stable	11-Apr-18

Source: Bloomberg

Main risk factors. The rating agency mentioned that the revision reflects the risk that the recent shift in government policy to reduce private-sector participation in the energy sector, along other events that have diminished investor's confidence, could lead to higher contingent liabilities for the country and lower growth prospects. If this were to happen, the weakening of the financial profile could lead to a credit rating downgrade.

In particular the new strategy for the energy sector places an additional burden on Pemex, which carries a considerable fiscal weight in spite of a recent change in its taxing policy. The combination of a weak financial profile and the need to take a more active role in the sector could increase the risk of higher contingent liabilities for the sovereign, which S&P currently considers to be limited. Taking into account previous policies and recent events, the agency assumes that there is a certain likelihood of extraordinary support from the Federal Government, so they match Pemex rating to the sovereign.

In addition, there is also a risk that lower private investment could lead to lower economic growth, thus generating greater uncertainty (especially in financial markets) and fiscal deterioration. In this context, they highlight that several of the actions by the new administration have taken a toll on confidence and could pressure growth and investment expectations to the downside in the medium-term. In particular, they mention that the government intends to modify the law on public consultations, which could result in more frequent votes on public policies, probably inducing more uncertainty. On the contrary, a prudent fiscal stance –with moderate fiscal deficits–, boosting investment, bolstering confidence among investors, and a further control on contingent liabilities from Pemex would help strengthen the scenario for growth, supporting a return for the credit outlook to 'Stable'.

Macroeconomic stability will be maintained. The agency expects the new federal administration to pragmatically implement economic policies that balance social priorities with the need for macroeconomic stability. In particular, they expect broad continuity in monetary, exchange rate, and trade policies and moderate changes in fiscal policy. Mexico's external profile will remain stable in the coming three years, with gross external needs around 90% of current account receipts and usable reserves. Moreover, the current account deficit will remain around 2-2.4% of GDP in the next two years and FDI would be just below 2% of GDP. In terms of growth, they estimate GDP in 2019 at 1.8% yoy, slightly above our forecast of 1.5% (consensus: 1.6%) and inflation at 3.5%, in line with our forecast.

In spite of the latter, taking into account changes proposed so far by the federal administration, the agency considers that:"…*the risk that poorer-than-expected economic growth and greater centralization of political decision-making could weaken macroeconomic stability amid difficult policy trade-offs and potentially affect institutional effectiveness*…"

In our view, Mexico will not lose its investment grade rating. Specifically, we reiterate our view that our country's rating will maintain the investment grade rating with a rating of 'BBB-' or above. It is important to say that the current rating is three steps above this limit (see table below), while the government has promised and delivered on fiscal responsibility. Moreover and as already mentioned, in the past we have seen downward revisions to the outlook by the same agency that ultimately fail to materialize in a rating cut.

Global rating scale

S&P Global Fitch Ratings		Moody's	
A-		**A3**	
BBB+		Baa1	
BBB	3 notches	Baa3	4 notches
BBB-		Baa3	
BB+		B1	

Source: S&P Global, Fitch Ratings, Moody's
Note: The rating in bold represents the current credit rating by each agency

Nevertheless, we recognize that the government will need to tackle some issues if they wish to avoid a rating cut. In particular, the agency is very clear in two themes: (1) The need to provide confidence to private investments; and (2) the challenges faced by Pemex. On the latter, we consider that the recent actions of the Ministry of Finance to capitalize the company and provide some tax relief are positive. For details, see: "*The MoF announcement on Pemex – A step in the right direction towards strengthening Pemex*", January 28th, 2019, <pdf>. We believe that it is very important to provide confidence not only in terms of the sources of financing, but also in their uses. Pemex's creditors, analysts and rating agencies demand certainty that their debt investments will pay off in the mid- and long-term.

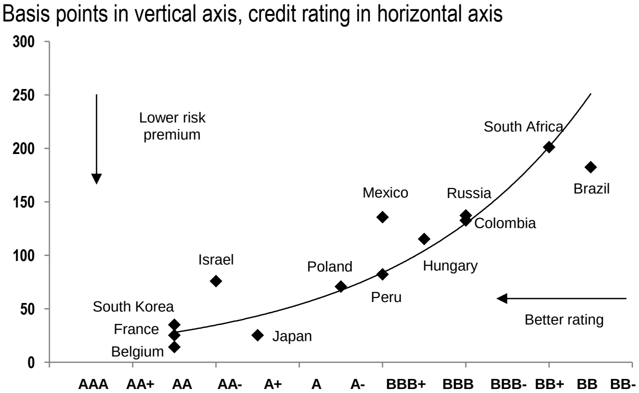
In this respect, we see two main options. First, choose only financially profitable projects that ensure the repayment of debt obligations (such as the last administration's scheme). Or second, a new paradigm in which resources can be invested in projects that are not necessarily profitable in financial terms, but with the government providing their full and explicit guarantee to Pemex debt. In our view, investor concerns can be effectively resolved. Given the importance that the president has placed in maintaining macroeconomic stability, we anticipate that the government will take the necessary actions to avoid a credit rating downgrade.

From our fixed income and FX strategy team

Mexican assets trading with a higher risk premium *vis-à-vis* its credit rating, with market participants acknowledging that investment grade should continue ahead. Sovereign bonds and the peso are trading with modest pressures today following *Standard & Poor's* decision on Friday afternoon to move Mexico's sovereign credit outlook from "Stable" to "Negative". This defensive performance suggests that this type of news is already discounted in Mexican assets. Country risk premium is trading 50bps abover other EM peers with similar credit profile (*e.g.* Peru) or similar to "BBB-" countries (*e.g.* Colombia), with an expectation of holding investment grade for longer.

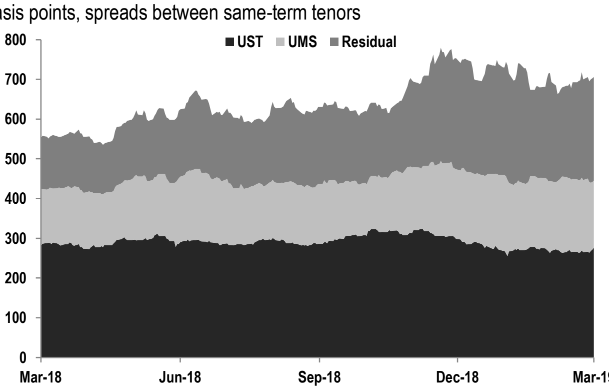
Market participants are aware of the headwinds stressed out by the credit agency but remain optimistic that fiscal and external accounts, in addition to the macro framework, will remain stable. In addition, attractive carry-gains given current levels of rates are supportive for a more benign view from investors. Nevertheless, they will remain vigilant of the performance of Pemex and its implications to fiscal accounts, something that has increased the risk premium of the oil company as observed in the RHS chart below. Overall, we acknowledge that current levels of country-specific risk premiums are consistent with Mexico's actual conditions, which suggests that risk-adjusted carry will remain attractive for global investors.

5-year CDS and S&P's credit rating
Basis points in vertical axis, credit rating in horizontal axis



Source: Banorte with data from Bloomberg and S&P

10-year Pemex USD bond by premium component
Basis points, spreads between same-term tenors



Source: Banorte with data from Bloomberg

Oil companies in Latam
Basis points, data as of March 4th, 2019

		Credit rating			CDS		Spread against Treasuries	
		Moody's	S&P	Fitch	5 years	10 years	5 years	10 years
Pemex	Mexico	Baa3	BBB+	BBB-	301	358	335	449
Ecopetrol[1]	Colombia	Baa3	BBB-	BBB	--	--	145	181
Petrobras	Brazil	Ba2	BB-	BB-	203	293	238	306
YPF[1]	Argentina	B2	B	B	--	--	630	638
PDVSA	Venezuela	C	D	C	8,140	8,140	3,916	2,762

Source: Banorte with data from Bloomberg
1. 7-year tenor instead of 10-year bond

Disclaimer

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We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Francisco Duarte Alcocer, Jorge Antonio Izquierdo Lobato and Leslie Thalía Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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	Reference
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HOLD	*When the share expected performance is similar to the MEXBOL estimated performance.*
SELL	*When the share expected performance is lower than the MEXBOL estimated performance.*

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