

Fitch revises Mexico's credit outlook to negative

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- Fitch revised Mexico's sovereign debt credit outlook from 'stable' to 'negative', keeping the rating at 'BBB+'
- The rating agency considers that the revision reflects increased downside risks to growth prospects with the challenges this poses to the stabilization of the public debt to GDP ratio
- Mexico's growth has been underperforming peers with similar credit ratings, while government debt has increased steadily over the past few years
- Moreover, Fitch considers that domestic demand and economic growth will slow down on the back of the uncertainty generated by:
 - (1) NAFTA renegotiation and US immigration policies;
 - (2) FX volatility;
 - (3) Decrease in oil output; and
 - (4) Restrictive economic policies
- We consider that the change in the credit outlook will not necessarily imply a change in the credit rating in the medium-term due to Mexico's prevailing macroeconomic strengths
- No pricing adjustment following the change of Fitch's credit outlook, as the market has already priced in a lower risk profile

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Fitch unexpectedly revised Mexico's sovereign debt credit outlook from "stable" to "negative", keeping the rating at "BBB+". Today, the rating agency changed Mexico's credit outlook arguing downside risks to growth prospects and the challenges this poses for the stabilization of the public debt to GDP ratios. We highlight that Mexico still holds an investment grade rating from all three main rating agencies, as shown in the next table.

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Mexico's Credit Ratings

	Rating	Investment grade	Outlook	Las change of rating and/or outlook
Fitch	BBB+	Investment grade	Negative	09-dic-2016
Standard & Poor's	BBB+	Investment grade	Negative	23-ago-2016
Moody's	A3	Investment grade	Negative	31-mar-16

Source: Bloomberg

The rating agency argued that Mexico's growth has been underperforming peers with similar credit ratings. In this context, not only GDP growth will continue lagging (2% forecast for 2017 v. 3.1% median for "BBB" countries), but also the government debt burden has steadily increased (47% forecast for 2017 vs. 40.3% 'BBB' median).

Downside risks to growth. The growth forecast of only 2% during 2017 for the Mexican economy is based on the impact that both internal demand and general growth will experience from: (1) NAFTA renegotiation and US immigration policies; (2) FX volatility; (3) the decrease in oil output; and (4) restrictive

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economic policies. Moreover, higher inflationary pressures could impact private consumption.

Government debt burden has increased steadily over the past few years.

This came as a result of weak economic growth, as well as primary fiscal deficits in recent years. In addition, *one-off* issuance of debt to the government's productive companies has contributed to the problem. Looking ahead, the slow growth forecast, currency weakness, and volatility pose a major risk to the stabilization of the public debt.

However, Mexico's credit rating is underpinned by strong macroeconomic fundamentals. Mexico is a diversified economy with a record of disciplined economic policies which have increased the country's macroeconomic stability and curbed imbalances. These strengths counterbalance rating constraints, which includes, among other things: moderate economic growth, structural weaknesses in public finances –such as low fiscal buffers, due to dependence on oil revenue-, relatively low levels of financial intermediation and institutional weakness highlighted by the high incidence of drug related violence and corruption.

In our view, the change in the credit outlook will not necessarily imply a change in the credit rating in the medium-term due to Mexico's prevailing macroeconomic strengths. In addition to what Fitch mentioned in its *communiqué*, we highlight that the strengths of the economy include: (1) A well-capitalized banking system; (2) a moderate corporate sector leverage, with a comfortable maturity profile; and (3) we still expect government to achieve its fiscal targets for 2017 generating a primary surplus and curbing the upward trend in debt-to-GDP ratio–, in spite of the negative outlook. In this context, we highlight that the loss of tax revenues coming from lower economic growth could be offset by a higher exchange rate level and the fact that the government will likely receive Banxico's operational surplus next year.

From our fixed income and FX strategy team

No pricing adjustment following the change of Fitch’s credit outlook, as the market has already priced in a lower risk profile

Mexican markets depicted a muted reaction to Fitch’s decision to change the country’s credit outlook from neutral to negative, as investors have been acknowledging a new paradigm of the credit risk profile. Mexican assets have been trading with an additional risk premia *vis-a-vis* current ratings (Moody’s A3, S&P BBB+, Fitch BBB+) at least during the last 12 months, suggesting that the market has already priced in with a strong likelihood a scenario of a lower credit level, but holding investment grade. Mexico’s 5-year CDS has observed an important change since mid-2014, when oil prices initiated a significant adjustment, moving from 64pb to current levels of 161pb (with a 6-year maximum level of 231pb reached in early February). This measure is trading near the BBB- spectrum when compared to a vast group of emerging markets. Mexican bonds have also observed a significant increase in country risk premium, mainly in MXN-related securities (*e.g.* MBonos). The 10-year spread between MBonos and U.S. Treasuries is currently hovering around 485pb. This rate differential has been averaging 348bps in 2014, 383bps in 2015 and 440 in 2016. As observed in our research note “*Fixed-Income, FX, and Commodities Update – The Trump Aftershock*” [<pdf>](#), published on December 2nd, 2016, we expect the 10-year spread to trade around 500bps during 2017. It is important to highlight that despite the significant high probability of lower credit ratings next year, we expect Mexico to preserve the “*investment grade*” category. Given these dynamics, we anticipate that foreign investors’ holdings in MXN-denominated securities will remain relatively stable taking into consideration current valuations, carry and fundamentals. Holdings of foreigners in MBonos are 59.1% of the total amount outstanding and in Cetes around 32.4%. Likewise, the Mexican peso showed a muted reaction, briefly going from 20.33 to 20.40 on the news but reverting back quickly around its level before the announcement. We highlight that this contrasts with the pressure on March 31st when Moody’s also cut Mexico’s outlook to “negative”, signaling that investors have already discounted a greater probability of a rating cut in 2017. In this respect, we note that our measure of the local currency premium has been increasing almost all year-long, with a minimum of 164bps in mid-February and currently at 373bps, with the most significant shock after the US election as it surged from 326bps to 348bps. We maintain our preference for USD/MXN longs into year-end on persistent and high external uncertainty, believing it is unlikely to see a break below 20.00 at least this month and with the current level as attractive to re-engage gradually in dollar purchases.

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