

Mexico – Fitch changes Mexico’s sovereign rate outlook to ‘stable’

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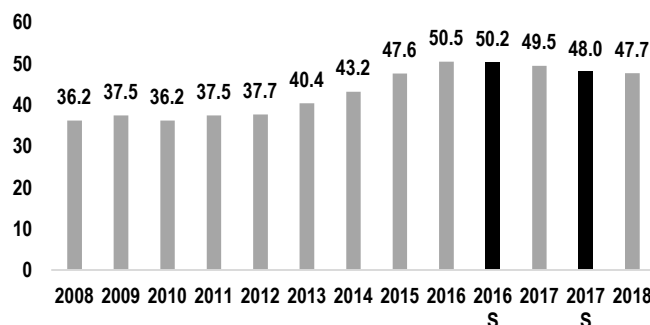
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- Rating agency Fitch changed the outlook on Mexico's sovereign debt from ‘negative’ to ‘stable’;
- Fitch justifies its decision with two main arguments:
 - (1) The risks of a disruptive scenario for the Mexican economy has diminished; and
 - (2) The government continues the deliver on fiscal consolidation, which together with the recent appreciation of the exchange rate is expected to put public debt on a downward path in the medium term
- With this change of outlook, only *Moody's* has a ‘negative’ outlook for the Mexican sovereign debt, view that was ratified last April
- In our view, with Fitch's decision, the risk of a reduction in the sovereign credit rating is now gone
- Mexican rates and the peso did not react strongly, similar to the dynamic observed with the recent outlook change by S&P
- We reaffirm our mid-term positive view on rates and year-end USD/MXN forecast of 18.10 per dollar

Stable outlook. Fitch has just announced a change in Mexico's sovereign debt outlook from ‘negative’ to ‘stable’. Back in December, the rating agency had a ‘negative’ outlook highlighting the risks for growth and the challenges that this could pose for the stabilization of public debt. Now Fitch believes that the risks of a scenario in which the competitiveness of Mexican exports hurts the potential growth rate, or in which the flow of remittances is jeopardized, have diminished. In addition, it argues that the Mexican government continues to deliver on fiscal consolidation which, together with the recent appreciation of the exchange rate, puts public debt in a downward path in the medium term, as shown in the chart below.

Debt-to-GDP ratio
% of GDP



Source: Ministry of Finance
1. HBPSBR - Historical Balance of Public Sector Borrowing Requirements
2. S - Central bank operational surplus

Mexico sovereign debt ratings and outlook

	Rating	Last chg	Outlook	Last chg
S&P	BBB+	19-Dec-13	Stable	18-Jul-17
Moody's	A3	5-Feb-14	Negative	31-Mar-16*
Fitch Ratings	BBB+	8-May-13	Stable	2-Ago-17

Source: Rating agencies
*Moody's confirmed rating and outlook last April 2017

Growth forecast based on lower levels of uncertainty. Fitch estimates a growth rate for Mexico of 2% in 2017 and 2.4% for 2018-2019 based on the following factors: (1) A competitive Mexican peso; (2) a reduction of external uncertainty; (3) the recovery of oil prices; and (4) the continued implementation of structural reforms. Among the downside risks they mention a larger-than-expected deceleration in consumption, volatility in global markets and a further dampening of investment, possibly reflecting greater caution about the U.S.-Mexico relationship and/or the electoral process of 2018.

Solid fundamentals in spite of an adverse backdrop. According to the document published by the rating agency, the restrictive cycle applied by Banxico reinforces the credibility of the central bank to maintain macroeconomic and financial stability. In addition, external accounts have shown resilience, especially during the episode of volatility that followed the electoral process in the United States. On the fiscal front, while acknowledging limited flexibility to confront shocks given the increase in public debt and moderate fiscal buffers, they consider that the government has demonstrated its adherence to the medium-term fiscal goals. Nevertheless, beyond 2018, they expect that additional adjustment measures to cope with spending pressures – pensions, higher interest payments among others-, and reduce the squeeze on capital spending should be implemented.

In our view, the change in Fitch's outlook completely dissipates the risk of a reduction in the sovereign credit rating. With this change, only *Moody's* maintains a 'negative' outlook for Mexican sovereign debt, view that was ratified in April this year. Nevertheless, although *Moody's* argued then that its concern about the debt dynamics in Mexico had significantly diminished, there was a risk that the modifications to the NAFTA would be more severe or even there was the possibility of terminating the agreement, which we consider to have substantially diminished, especially after the release U.S. government's negotiating objectives a couple of weeks ago. Additionally, it is important to consider that that to lose the current status of 'BBB +' requires the reduction by at least two rating agencies.

From our fixed income and FX strategy team:

Mexican rates and the peso did not react strongly to the news. From yesterday's close, Mbonos are trading with a 1-2bps gain along the curve and the currency is losing 0.3% at 17.88 per dollar, both broadly unchanged relative to the moment when the announcement hit the wires. In this sense, the market reaction is very similar, albeit more modest, to S&P's outlook change to Stable on July 19th. In our view, this is mostly because of the steep reduction in risk premium and strong rally in local assets since the beginning of the year that has reduced the valuation advantage in both rates and FX, already trading broadly in line with other BBB+ rated countries. Nevertheless, this is not to say that it isn't good news going forward, more so if other risk-events such as the upcoming NAFTA renegotiation with the US and Canada goes relatively well, as is our base-case.

Considering the latter, we continue waiting for better entry levels for new long positions in rates, with a more attractive relative valuation in the *belly* of the Mbonos curve. We believe the short-end is expensive given that markets are still discounting rate cuts by Banxico sooner than we believe is most likely, expecting the central bank to maintain a stable reference rate for longer. In the long-end, we see duration premium as very low. On a mid-term basis, we reiterate our positive view in the rates market. Regarding FX, we maintain a positive bias on the peso in the short-term without discarding a new attempt to break a strong support at 17.50 per dollar. Nevertheless, the room for further appreciation seems more limited after this year's rally and ahead of important risk events, stretched long positions in MXN according to futures, and low short-term implied volatilities. On the other hand, this development helps us reaffirm our year-end USD/MXN forecast of 18.10 per dollar, slightly below current consensus around 18.30-18.40 per dollar.

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