GDP 2016 – Stronger FDI flows, a more dynamic domestic demand, but lower public spending

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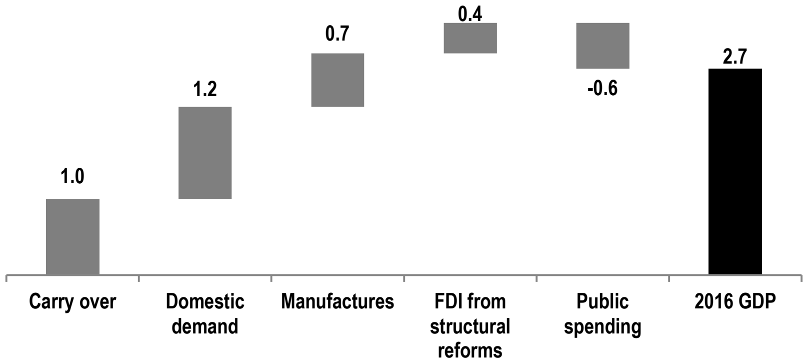
- **We now believe that Mexico's GDP will grow 2.7% in 2016 (previous estimate: 5%)**
  - **(1) In our view, persistently low oil prices will not foster the investments we previously in 2016; moreover,**
  - **(2) We do not expect that certain factors which have boosted economic growth in 2015 will be present next year**
- **Against this backdrop, Mexico's economic growth in 2016 will be explained by the following factors:**
  - **(1) Lower inertial growth rate. In fact, next year's carry-over growth rate will only contribute with 1%-pt**
  - **(2) Stronger domestic demand which will contribute with 1.2%-pts**
  - **(3) Better growth prospects for external demand and Mexico's manufacturing sector, in which we anticipate a 0.7%-pts incidence on total GDP**
  - **(4) A 0.4%-pts contribution derived from the first investment projects derived from the energy and, to a lesser extent from the telecommunications reforms**
  - **(5) Lower public spending given the budget cuts announced for 2016, along with lower levels of oil output could subtract 0.6%-pts to next year's GDP expansion rate**

We now expect an economic expansion of the Mexican economy of 2.7% in 2016. We revised our forecast from our previous 5% yoy on the back of: (1) Slower investments in the energy sector will be considerably less than what we expected before, amid persistently low oil prices (please refer to: *"Mexico after the oil price decline"* [Here]); and we do not expect that certain factors which have boosted economic growth in 2015 will be present next year.

Balanced engines of growth. We expect economic dynamics in 2016 to be driven by five factors: (1) Lower inertial growth rate. In fact, next year's carry-over growth rate will only contribute with 1%-pt; (2) stronger domestic demand which will contribute with 1.2%-pts; (3) better growth prospects for external demand and Mexico's manufacturing sector, in which we anticipate an incidence of 0.7%-pts on total GDP; (4) a 0.4%-pts contribution derived from the first investment projects derived from the energy and, to a lesser extent, the telecommunications reforms; and (5) lower public spending given the budget cuts announced for 2016, along with lower levels of oil output could subtract 0.6%-pts to next year's GDP expansion rate (please see the chart below).

Figure 1: 2016 GDP growth projection
%-pts.



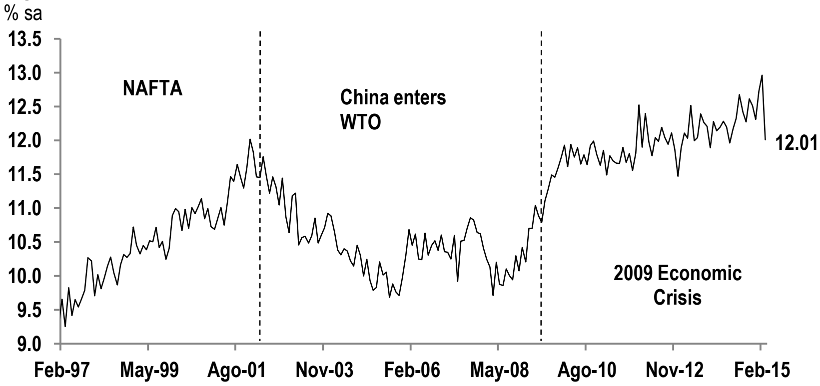
Source: Banorte-Ixe

(1) Carry-over growth will contribute with 1%-pt. Back on May 21, when *INEGI* released its 1Q15 GDP report, we learnt that economic activity decelerated more than expected, with a growth rate of only 0.4% q/q saar, resulting in a 2.5% annual expansion of GDP in 1Q15. Moreover, with the release of the first quarter figures, the statistics team at *INEGI* re-ran their seasonal adjustment model, allowing us to see the new "*carry-over*" growth rate which, by the way, came in well below what we obtained from *INEGI's* previous model. The "*carry-over*" rate of growth takes into account both, the inertia of economic activity, as well as the base of comparison effects. For 2016 –and taking into account our 2015 quarterly estimates–, lower inertial growth is dominating the favorable effects that could have come from a relatively low base of comparison. This is why we revised down the contribution of the inertial growth rate to 1%-pts, from 1.7%.

(2) Stronger domestic demand. For 2016, we believe that better growth prospects for domestic demand will have a positive incidence of 1.2%-pts on total GDP. In particular, we believe that private consumption will show a more visible recovery in 2016 driven by the following factors: (*i*) the recovery in consumer confidence levels, which will eventually lead to a higher growth in private consumption; (*ii*) better growth dynamics in the Mexican labor market, which will likely result in a significant drop in the unemployment rate and higher incomes; (*iii*) the fact that inflation will remain around 3% will encourage a greater expenditure of Mexican households; and (*iv*) the better growth prospects for the economy driven by the expansion manufacturing output and the first investment projects arising from the energy and financial reforms.

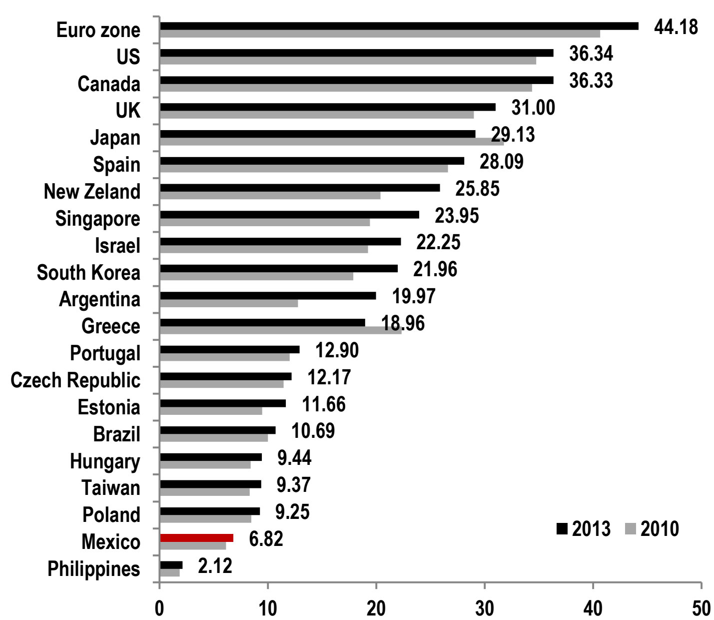
(3) Manufacturing production will continue to grow. While manufacturing output will post a visible recovery in 2015 (about 3.1% yoy), we believe that this sector will keep a fast pace in 2016 on the back of an increased competitiveness of Mexico's manufacturing sector, particularly in the automotive industry. In the first case, Mexico's workforce has become more competitive within this sector in recent years which has explained the greater share of Mexican exports in total U.S. imports (refer to Figure 2). However, in the past months, Mexico has managed to further increase its competitiveness thanks to the static behavior of dollar-measured-wages within the manufacturing sector in part given the significant depreciation of the Mexican peso (refer to Figure 3). In this regard, we believe that the depreciation of the Mexican currency will continue throughout 2016, which will further increase Mexico's market share within the U.S. market and production levels in the manufacturing sector.

Figure 2: Mexico's share of exports within total U.S. imports
% sa



Source: Banorte-Ixe; US Census Bureau

Figure 3: Manufacturing labors costs
Dollars per hour



Source: The Conference Board – Labor Comparison Program (December 2014)

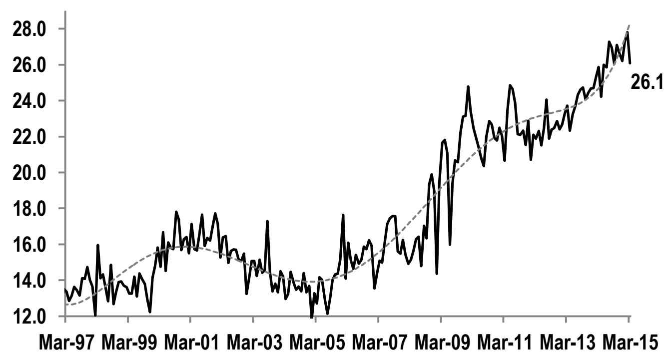
Solid performance of the automotive industry. We believe that the better performance of the auto industry will explain part of the 2.7% growth in the Mexican economy. In recent years, Mexico's vehicle production has experienced a strong momentum which has been substantiated by the significant flows of foreign direct investment (refer to Figure 4). Thus, Mexican auto-exports have managed to increase its share of the US market from 11% to 26% over a 10-year period (refer to Figure 5). In this regard, thanks to the most recent FDI flows, Mazda will increase its auto production to 230 thousand units in 2016 from 140 thousand units in 2014. Moreover, Kia will begin with a production of 300 thousand units next year; while Audi will begin with the production of 150 thousand units in 2016. Taking the sizeable increase in Mexico's vehicle-production, we believe that the greater growth prospects for the auto-industry will explain part of the increased contribution of manufacturing production.

Figure 4: FDI flows in the auto-industry
US$ millions

	Date of announcement	US$ million	State
BMW	1Q13	500	-
Fiat	1Q13	1,000	Coahuila
Pirelli	3Q13	400	Guanajuato
Honda	2Q13	470	Guanajuato
Hyundai	2Q14	1,000	Nuevo León
BMW	2Q14	1,000	San Luis Potosí
Mercedes & Nissan	2Q14	1,400	Aguascalientes
Kia Motors	2Q14	1,000	Nuevo León
Volkswagen	1Q15	1,000	Puebla
Toyota	2Q15	1,000	Guanajuato
Ford	2Q15	2,500	Chihuahua

Source: Banorte-Ixe

Figure 5: Mexico's share of auto-exports within total U.S. imports
%, sa



Source: Banorte-Ixe; US Census Bureau

(4) FDI flows in the energy and the telecommunication sectors in the short term. Even though we recognize that it will take some time for structural reforms to show in economic activity numbers, we expect that in the case of the energy reform, low levels of oil prices increase the appeal of projects in shallow water, as well as conventional on-shore and mature fields, which will be the first ones in which private investment will be allowed, particularly in Mexico relative to the U.S. where shale fields have now less potential. In addition, we also expect to see investments in other energy sectors such as petrochemicals, which could have an overall contribution of 0.3%-pts to GDP in 2016. In the case of the telecommunications reform, we believe that investment in new TV channels, along with the auction of part of the radio spectrum, could add another 0.1%-pts to growth. Moreover, and to a lesser extent, the asset reduction of *America Movil* –as it was considered a preponderant mobile phone carrier-, could boost net investment in the sector, particularly in terms of infrastructure needs in the sector.

(5) Government spending cut will lower 2016's growth prospects. In January, the MoF announced a MXN$ 124,300mn fiscal cut (US$ 8,220mn or 0.7% of Mexico's GDP) to Mexico's spending budget for 2015 in order to face the lower oil prices. This was only a preemptive measure, given that the MoF contracted a $79 dpb hedging program for Mexico's oil production. However, the federal government committed itself to reduce the public deficit to 0.5% of GDP in 2016 from 1% in 2015 (excluding Pemex investments). Because the MoF did not have an oil hedging program put in place quite for 2016, a significant MXN$135 bn (US$ 8,772mn) spending cut for 2016 has been already announced to keep the commitment to end the year with a 0.5% fiscal deficit. Since the federal government has also made a commitment to establish additional criteria for prioritizing public investment projects, we believe that this cut will be focused on reducing the public sector's current expenditure. Thus, although this fiscal cut represents around 0.8% of GDP, in terms of growth we believe that next year's fiscal cut will subtract around 0.6%-pts to Mexico's GDP.

Budget cut will have a bigger impact in 2016. We highlight that unlike the spending cut announced for 2015 –which we believe will have a limited impact on growth, given that it mostly covers investment projects that were not contemplated in the economists' growth forecasts–, we do consider that 2016's fiscal cut will have a significant negative impact on growth, given that it will probably contemplate laying off staff, as well as a significant cut in public spending in relation to 2015's fiscal program.

Lower growth than in 2015, but higher than in 2013-2014. In conclusion, we revised our 2016 GDP forecast to 2.7%, from 5% because we now anticipate a lower impact of FDI related to the energy reform given the downward trend in oil prices. We also believe that the budget cut that will take place in 2016 will have a significant negative impact on Mexico's economic growth dynamics. However, we do believe that the Mexican economy will grow more than in 2013 and 2014, and will aim to grow more than the average observed in the past twenty years.

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