

Moody's changed Mexico's outlook to "negative" but affirms A3 rating

- Moody's changed Mexico's sovereign debt outlook from "stable" to "negative", while affirming the A3 rating
- The drivers behind the decisions, according to the document released by the rating agency is:
 - (1) Fiscal and economic challenges to achieving consolidation objectives and stabilizing debt ratios ; and
 - (2) Consolidation objectives face risks from Pemex challenges
- In the next 12 to 24 months, *Moody's* will assess the progress made in fiscal consolidation and implementation of Pemex spending cuts
- We believe that today's decision does not necessarily imply that a downgrade will follow in the near future
- Local rates and the Mexican peso building losses after Moody's announcement

Moody's changed Mexico's sovereign debt outlook from "stable" to "negative", while affirming the A3 rating. The rationale behind the rating agency's decision has to do mainly with two factors: (1) Fiscal and economic challenges to achieving consolidation objectives and stabilizing debt ratios; and (2) consolidation objectives face risks from Pemex challenges. Nevertheless, Moody's affirmed the rating for Mexico in A3, maintaining investment grade. We highlight that Mexico maintains investment grade by the three major rating agencies, as seen in the following table.

Mexico's credit ratings

	Rating	Investment Grade/ Speculative	Outlook	Last change in rating and/or outlook
Fitch	BBB+	Investment	Stable	08-May-13
Standard & Poor's	BBB+	Investment	Stable	19-Dec-13
Moody's	A3	Investment	Negative	05-Feb-14

Source: Bloomberg

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(1) Fiscal and economic challenges to achieving consolidation objectives and stabilizing debt ratios. Amid a combination of low oil prices and subdued economic growth, Moody's expects government revenues to fall to 18.5% of GDP in 2016, from 19.3% in 2015. They also forecast an economic expansion of 2.5% for the next two years, while government deficit is expected to decline from 2.8% of GDP in 2015 to 2.5% in 2016 and a gradual decline through 2018 when the deficit is likely to narrow to 2%. In the meantime, the agency expects federal government debt to GDP ratio to stabilize at around 37% in 2018, from 34.4% in 2015, which would be consistent with an A3 rating. The negative outlook reflects the risks that lower growth and revenues along with heightened pressures on expenditures cause the debt burden to continue to rise beyond that horizon.

(2) Consolidation objectives face risks from Pemex challenges. The possibility of support from the federal government to Pemex could further weaken the process of fiscal consolidation. Pemex is implementing a budget cut of MXN100bn (~0.5% of GDP) in 2016 and plans to increase operational efficiency over the medium term to ensure financial sustainability. However, such adjustment faces significant challenges, which are likely to persist through 2018. Given the size of these financing needs, the agency believes that the fiscal impact of support from the federal government could limit progress in fiscal consolidation, increasing the debt of the federal government for the year 2018 over 40% of GDP.

Over the coming one to two years, Moody's will assess the progress achieved on fiscal consolidation and implementation of Pemex's spending cuts. The downside risk to the outlook comes from the possibility of stalled fiscal consolidation efforts, and the crystallization of contingent liabilities from Pemex, which could drive government debt ratios to levels around 40% of GDP. In this scenario, Moody's would evaluate the credibility of the government's plans to address the further rise in debt and the lower growth likely to be associated with it. Nonetheless, despite this downside risks, the rating agency mentions that it would revise up Mexico's sovereign rating if growth is higher than expected driven by continuing structural reform efforts, which would result in the creation of fiscal buffers by the government, and a faster than expected reversal of the upward trend in government debt metrics.

We believe that today's decision does not necessarily imply that a downgrade will follow in the near future. In our view, Mexico's macroeconomic fundamentals stand out from the emerging economies universe. Among others, the economy has a strong correlation with the U.S. economy, which continues to recover, while the relationship with China –whose economic activity is decelerating-, is relatively low. In addition, since this was just a change of outlook and not a downgrade, both the government and Pemex have some leeway to make more detailed announcements and further actions to give greater certainty on how deficit targets and public sector borrowing requirements will be met in the near future.

Moody's decision does not affect global investment mandates. Moody's continues to be the rating agency that has awarded Mexico with the highest sovereign rating. As shown in the table below, the A3 from Moody's is one notch above the BBB+ by S&P and Fitch. The difference is in the "stable" outlook of the other two rating agencies vs. the "negative" from Moody's today. In our opinion, the market reaction has been relatively moderate –and probably would also be in the event of a downgrade-, because it did not (and would not) involve changes in global investment mandates. In fact, we highlight that to access investment mandates that only accept paper with a minimum grade of "A", it is necessary to have such a rate by at least two rating agencies, which is not the current case for the Mexican sovereign, as mentioned previously.

Sovereign credit ratings*

Moody's	S&P	Fitch	
Aaa	AAA	AAA	Investment grade
Aa1	AA+	AA+	
Aa2	AA	AA	
Aa3	AA-	AA-	
A1	A+	A+	
A2	A	A	
A3	A-	A-	
Baa1	BBB+	BBB+	
Baa2	BBB+	BBB	
Baa3	BBB-	BBB-	
Ba1	BB+	BB+	Speculative grade
Ba2	BB	BB	
Ba3	BB-	BB-	
B1	B+	B+	
B2	B	B	
B3	B-	B-	
Caa1 a C	CCC+ a C	CCC+ a C	

Source: Bloomberg

*Shadowed area are Mexico's current ratings

From our fixed income and FX team

Local rates and the Mexican peso building losses after Moody's announcement. The immediate reaction was modest, although both rates and FX are gradually building losses when compared to yesterday's close. Going forward, we believe that the expected announcement by the Ministry of Finance regarding the use of Banxico's operational profits for debt reduction and/or financial support for Pemex will gain additional relevance, with investors focused on the details to assess its potential effect on the evolution of public sector debt metrics. In spite of the reaction so far, we reiterate our most recent recommendations in both asset classes. Local rates were about 2-3bps lower in the Mbonos curve before the report, supported by a risk-on environment. These gains have reversed, now losing about 3-4bps in the short end and 2-4bps in the belly and long-end; TIE-IRS is also adjusting, although with a more modest impact (1-2bps). Moreover, the implicit accumulated hike of Banxico's reference rate by year-end in these instruments is broadly unchanged relative to yesterday's close, at about 50bps. In our view, this suggests that investors are not considering a strong response by Banxico (such as a more restrictive hiking cycle), still very vigilant to the Fed and FX dynamics. In terms of Mbonos, we observe an attractive relative valuation in 10- and 20-year area, especially Jun'22, Dec'24, Mar'26 and May'31 tenors. In addition, we expect Udibonos to recover going forward as inflation dynamics could improve the embedded carry in the 2H16, and valuation remains compelling according to breakeven levels. The tenor of the Udibonos curve with the most attractive valuation is the 10-year security (mainly Jun'22 and Dec'25); however we suggest waiting for better entry levels. In the FX market, the Mexican peso dropped from 17.12 to 17.36 per dollar, a 0.8% loss and the worst among EM currencies. Nevertheless, we maintain a neutral directional stance on MXN but a more positive bias for trading purposes, which we have been suggesting since the latest Fed meeting on March 15-16. After trying to break an immediate support at 17.20 (last year's close), we do not discard a further fall towards 17.10/17.05 (Fibonacci level / 200-day MA) and even to 17.00 (psychological), with this latter level likely showing greater appetite for long dollar positions.

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