Mexico – A slightly more constructive view on growth for 2020

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www.banorte.com
@analisis_fundam

Gabriel Casillas
Chief Economist and Head of Research
gabriel.casillas@banorte.com

Delia Paredes
Executive Director of Economic Analysis
delia.paredes@banorte.com

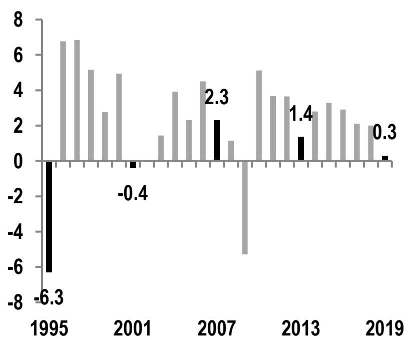
Juan Carlos Alderete, CFA
Senior Economist, Mexico
juan.alderete.macal@banorte.com

Francisco Flores
Economist, Mexico
francisco.flores.serrano@banorte.com

- **The Mexican economy has faced a rough first year of an administration with a more pronounced decline in both public- and private-sector investment**
- **Nevertheless, sentiment seems to start to come around amid a low probability that the global economy falls into recession next year**
- **As a result, we maintain our GDP growth forecast for 2020 at 1.4%, despite revising our projection for 2019 downwards to 0.3%, from 0.8%**

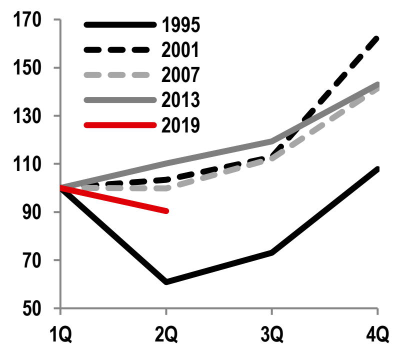
Slowdown in the first year of an administration. As we have been mentioning throughout our publications, Mexico has experienced an economic deceleration every first year of a new administration (please see Chart 1 below on the left). Even though there are certain particularities –such as the *dot-com* bankruptcy in the U.S. and 9/11 back in 2001, as well as the nationwide homebuilder crisis triggered by Mexico's former administration in year 2013–, there is a common factor that happens at the beginning of each six-year term: an important deceleration in public-, and private-sector investment. On the public sector, every new president fully changes the personnel in charge of implementation of government spending and investment and there is a learning curve for new officials that end up in office (Chart 2). On the private sector side, uncertainties rising at the beginning of every presidential race foster businessmen to postpone new investment projects that are resumed at some point in the first or second year of the new administration, depending on how quickly the new president can engender confidence (Chart 3). This is why we were the least optimistic research house for a long time, with a forecast of 1.8% (Chart 4).

Chart 1. GDP Growth
%, yoy



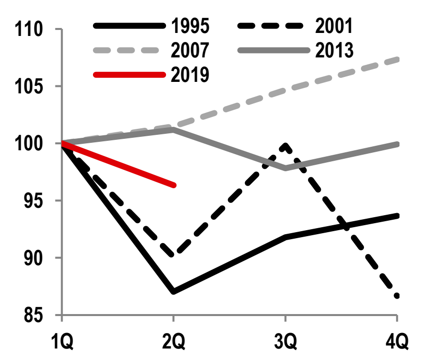
Source: INEGI

Chart 2. Public-sector investment in the first year of government
Index (Q1=100)



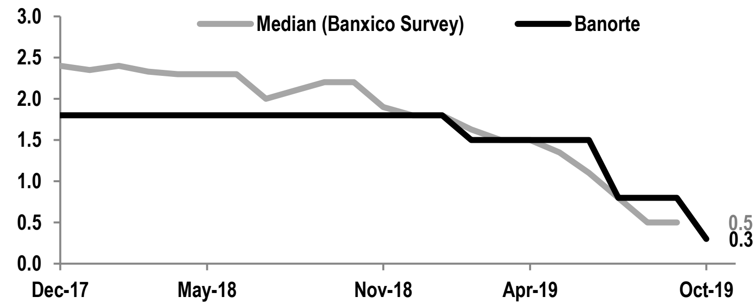
Source: Banorte with data from INEGI

Chart 3. Private-sector investment in the first year of government
Index (Q1=100)



Source: Banorte with data from INEGI

Chart 4. Evolution of 2019 GDP forecasts
%, yoy



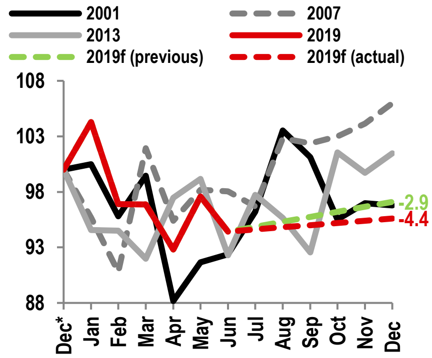
Source: Banorte

A rough start. This year, the country experienced several 'particularities' that have slowed down the economy even further. These begun with three transitory shocks in January and February that fostered us to revise down our GDP growth forecast for 2019: (1) The shutdown of major gasoline distribution pipelines, in order to mitigate fuel theft; (2) general strikes in the '*maquila*' sector in North East Mexico; and (3) blockades of the main railways in South West Mexico. In our view, these made a dent of 33 basis points (bp) to this year's GDP growth rate. Back in February, we revised our 2019 GDP forecast downwards to 1.5%.

'Particularities' have continued... Besides the aforementioned transitory shocks, two issues made us revise further our GDP forecast in July: (1) The ban that the government of Mexico City declared on construction projects, which we first thought would not last for a long time; and (2) uncertainties that emerged from a series of non-market friendly initiatives that Morena (the ruling party) legislators put forward, such as the one proposing to end mining concessions, as well as the others aiming to eliminate banking fees, etc. In this context, we took 36bps from the construction ban in Mexico City, mainly because construction weights 4% of the city's GDP –and half of the construction projects came to a halt–, and because Mexico City has a weight of almost 18% of the country's GDP. Fortunately, the ban has begun to be lifted, albeit gradually. Moreover, we took 31bps as we perceived that private-sector projects were taking longer to be reactivated, mainly due to political uncertainties. This is why we revised our GDP to 0.8% back in July.

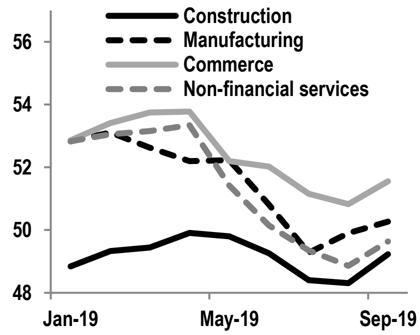
It is taking longer for the private sector to reactivate new projects. Investment has not picked up as much as we previously thought. In fact, gross fixed investment has declined 4.6% year-to-date, with both construction (-3.2%) and machinery and equipment (-6.5%) down, as shown in Chart 5 below. Nevertheless, we start to see business sentiment to come around –anecdotally, in latest data (Chart 6), and in the main stock market index (Chart 7)–, since the central bank cut the reference rate for the first time (Aug 15th), and the government announced the agreement with the private sector regarding natural gas pipelines (Aug 27th), in which the government wanted to renegotiate the related contracts. Moreover, the fact that the abovementioned non-market friendly initiatives have not prospered, has also helped to improve sentiment. As a result, we believe GFI will pick up slightly but not as much as we thought before, ending at-4.4% in 2019.

Chart 5. Gross fixed investment during the first year of a new government
Index (December of the previous year =100), % yoy



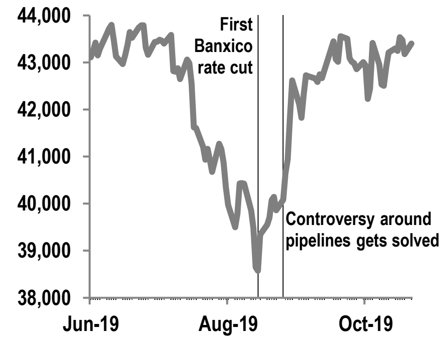
Source: INEGI

Chart 6. Business confidence by sector
Index



Source: Banorte with data from INEGI

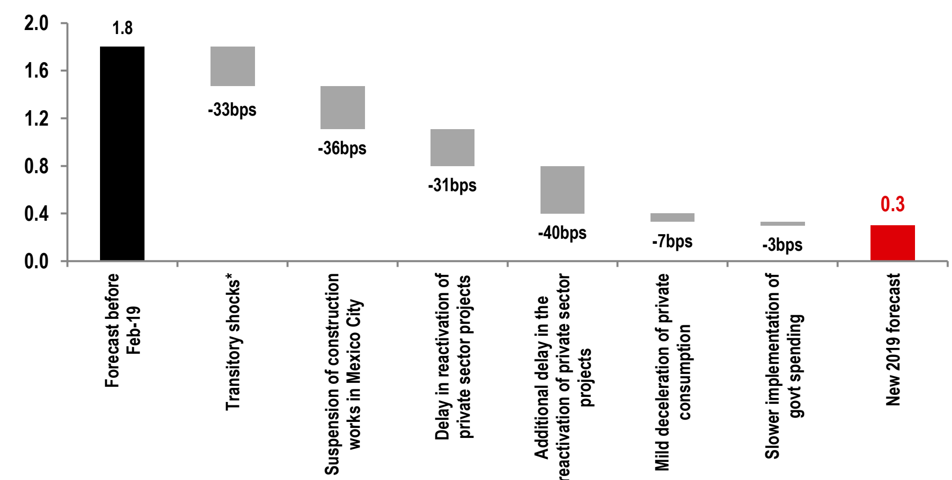
Chart 7. S&P/BMV IPC index
Index



Source: Banorte with data from Bloomberg

Revising down our 2019 GDP forecast. We now believe the Mexican economy will grow 0.3% in 2019, instead of 0.8% projected in July, mainly because of three factors, as shown in Chart 8 (below): (1) Private-sector investment projects, which are taking even longer to be reactivated (-40bps); (2) slower flow of government spending (-3bps); and (3) a mild deceleration in private consumption, mainly explained by the two other factors (-7bps). In this context, we expect GDP to observe annual growth rates of 0.2% and 0.4% in 3Q and 4Q, respectively, to end with full-year growth of 0.3%, lowest since 2009.

Chart 8. 2019 GDP growth forecast explained
% annual



Source: Banorte and Banco de México

Table 1. 2019 GDP growth forecast
% yoy, nsa

	Current					Previous				
	1Q19	**2Q19**	**3Q19f**	**4Q19f**	**2019f**	**1Q19**	**2Q19f**	**3Q19f**	**4Q19f**	**2019f**
GDP (aggregate supply)	**1.2**	**-0.8**	**0.2**	**0.4**	**0.3**	**1.2**	**-0.8**	**1.0**	**1.6**	**0.8**
Primary sector	5.7	1.4	3.2	1.8	2.9	5.7	1.4	3.7	2.4	3.2
Secondary sector	-0.6	-3.0	-1.9	-1.6	-1.8	-0.6	-3.0	-1.5	-0.4	-1.4
Tertiary sector	1.8	0.0	1.1	1.3	1.0	1.8	0.0	2.0	2.4	1.5
GDP (aggregate demand)	**1.2**	**-0.8**	**0.2**	**0.4**	**0.3**	**1.2**	**-0.8**	**1.0**	**1.6**	**0.8**
Private consumption	1.1	-0.3	1.8	2.3	1.3	1.1	-0.3	1.9	2.6	1.4
Investment	-0.8	-7.3	-5.6	-3.7	-4.4	-0.8	-7.3	-2.4	-0.9	-2.9
Government spending	-0.8	-2.3	-0.3	0.6	-0.7	-0.8	-2.3	0.8	0.6	-0.4
Exports	2.7	2.5	3.8	4.3	3.3	2.7	2.5	6.2	6.9	4.6
Imports	1.9	-1.4	-0.5	0.0	0.0	1.9	-1.4	1.2	2.1	1.0

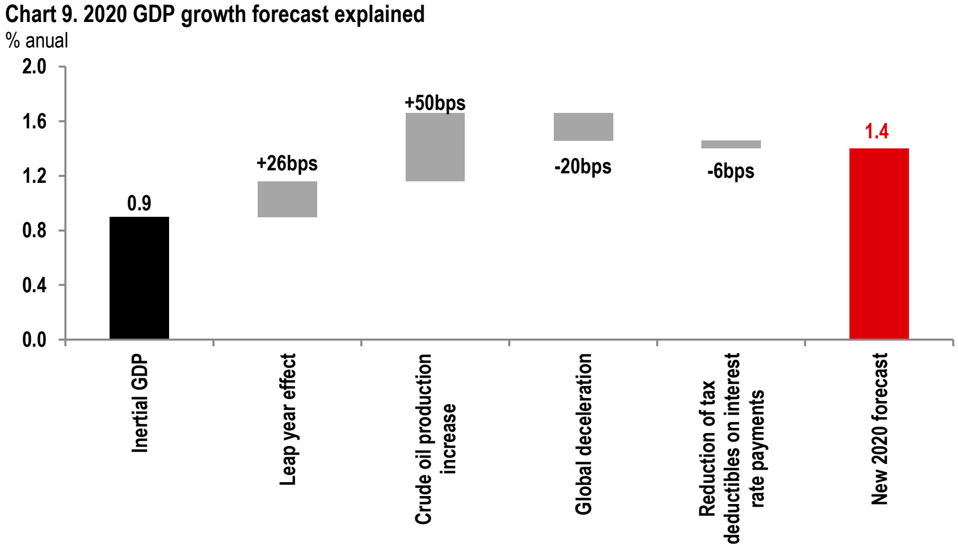
Source: Banorte

Better growth prospects for next year. There are three factors that allow us to be more positive about 2020, reiterating our GDP forecast of 1.4%, despite two factors that are likely to be a drag for the Mexican economy next year (see Chart 9). On the positive side: (1) Inertial growth adds up to 0.9%-pts. This is obtained by assuming zero quarterly growth rates throughout the rest of 2019 and 2020, which yields an annual growth rate of 0.9%. This will be mainly explained by the reactivation of some investment projects by both, the public- and private-sector, as well as some previously postponed durable-goods consumption decisions; (2) the leap-year effect that has historically added 26bps; and (3) higher crude oil output, in which Pemex and private-sector companies will be able to boost the country's crude oil production to 1.9 million barrels per day next year, adding 50bps to Mexico's GDP. These three would boost GDP to 1.7%. Nevertheless, it is our take that two issues will subtract 30bps next year: (1) The reduction in the percentage that firms are able to deduct taxes from interest payments, to 30% from 100%. In our view, this will deter some projects from happening, as it will increase the cost of both actual and future investments. Moreover, this will probably foster firms to use more supplier credit, rather than banking credit, reducing activity in the realm of financial services[1], making a dent on GDP growth next year.

[1] We do acknowledge that this is a recommendation from the OECD, mainly to boost tax collection locally by banning foreign-owned companies to avoid paying taxes due to higher indebtedness levels with parent companies. Moreover, we are taking into accounts that the Ministry of Finance introduced a tax break for IPOs last year, in order to boost the development of the stock market. Both engender an incentive structure to prefer equity over debt issuance. However, policy and institutional uncertainties that the new government has introduced to the firms' investment decisions will probably not help IPOs for the time being. As a result, we believe firms will try to increase their supplier credit facilities, which are already quite high. According to the latest central bank survey of corporate financing (August 2019), around 79% of companies use supplier credit as their main source of funding.

In this context, in the 2013 fiscal reform, the government decided to limit employment benefits' deductions. As a result, a reduction in the historical correlation between public-, and private-sector investments took place. Using this episode to try to quantify the impact of the change in this policy to GDP, we estimate an impact of 6bps of this change in year 2020; and (2) additional global slowdown, particularly feeding into export-related manufacturing activity, which in our view will subtract 20bps of 2020 GDP. This last one is our estimated net result of a global negative income effect from increasing trade protectionism and a positive substitution effect that has attracted investments to Mexico, particularly from Asian companies that see Mexico as a better way to approach the US market *vis-à-vis* their home countries that are facing either tariff or non-tariff trade barriers.

Chart 9. 2020 GDP growth forecast explained



Source: Banorte and Banco de México

Table 2. 2020 GDP growth forecast

% yoy, nsa

	1Q20f	2Q20f	3Q20f	4Q20f	2020f
GDP (aggregate supply)	**1.7**	**1.9**	**1.4**	**0.8**	**1.4**
Primary sector	1.3	1.9	1.5	1.4	1.5
Secondary sector	0.3	0.9	0.9	0.2	0.6
Tertiary sector	2.3	2.4	1.7	1.0	1.8
GDP (aggregate demand)	**1.7**	**1.9**	**1.4**	**0.8**	**1.4**
Private consumption	1.8	2.3	1.7	1.5	1.8
Investment	-1.1	1.8	0.8	-0.3	0.3
Government spending	0.7	1.5	1.0	0.7	0.9
Exports	4.4	3.9	2.8	1.7	3.1
Imports	2.2	2.9	2.6	2.2	2.5

Source: Banorte

Political uncertainties are fading away. The policies President Lopez-Obrador has been implementing are exactly the ones he wrote in his book "*La Salida*" ("*The Exit*") and the abovementioned non-market friendly initiatives have not prospered at all. AMLO's policies are based on four pillars: (1) Building infrastructure projects, actually very few ones, but very specific: the refinery in South East Mexico and the Mayan train, among others; (2) implementing social programs, such as the apprenticeship program for the youth that did not have the opportunity to study and has not been able to get a job along with doubling the monthly stipend for the elderly; (3) the 'undo' polices, such as reverting the education reform and cancelling the new airport of Mexico City; and probably the most important in terms of keeping macro stability: (4) fiscal responsibility and full respect to central bank autonomy, which the president has uphold in the past 11 months of his administration.

In this context, we expect a reactivation of several private-sector projects in year 2020, at least the ones aimed to keep increasing capacity according to activity dynamics. Inflation is well-controlled and very close to the central bank's target of 3%, and we expect that will also be the case next year. Moreover, even though we expect a volatile peso-dollar exchange rate –mainly due to the political noise arising from the US presidential elections–, we do not anticipate it deviating much from the long-run real exchange rate. As a result, we expect the central bank to continue its easing cycle, reducing the reference rate several times in the year, all the way down to 6%.

Weak global growth further ahead. In our view, global economic conditions will remain soft over the next 2-3 years with growth in the area of 3.1% in 2020-2021. Nevertheless, the current economic cycle seems exhausted from many angles, so we cannot rule out the possibility of a recession scenario by the end of next year or the beginning of 2021. Global manufacturing is facing recessionary territory in many regions in the world while capex has continued to decline, and tech companies have not released a disruptive product or service, despite the rampant tech revolution the world is experiencing every day. We are not expecting a major crisis, but a mild recession, such as the one experienced in year 2001. In such a scenario, we would expect the U.S. economy to grow below very close to 0% with the Mexican economy even observing a mild contraction of GDP in the area of -0.4%.

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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, Luis Leopoldo López Salinas, 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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GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Juan Carlos Alderete Macal, CFA	Senior Economist, Mexico	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Miguel Alejandro Calvo Domínguez	Economist, Regional	miguel.calvo@banorte.com	(55) 1670 - 2220
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Luis Leopoldo López Salinas	Analyst, Global Economist	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Santiago Leal Singer	FX Senior Strategist	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Fixed Income and FX Strategist	leslie.orozco.velez@banorte.com	(55) 5268 - 1698

Manuel Jiménez Zaldivar	Director Equity Research — Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Technical Analysis	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Equity Research – Conglomerates / Financials/ Mining / Petrochemicals	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research – Airlines / Airports / Cement / Infrastructure / REITs	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Manager, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Commercial Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454