On Mexico's triplet news...

June 5, 2019

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

Fixed income and FX Strategy

Alejandro Padilla
Head Strategist – Fixed-Income and FX
alejandro.padilla@banorte.com

Santiago Leal Singer
Fixed-Income and FX Strategist
santiago.leal@banorte.com

Leslie Orozco
Fixed Income and FX Strategist
leslie.orozco.velez@banorte.com

Document for distribution among public

- **A few hours ago, Mexico was shaken with the following news:**
  - **(1) No agreement was reached on the threat to impose a 5% tariff on Mexican imports to the US;**
  - **(2) *Moody's Investors Service* (*Moody's*) modified the outlook for the rating of Mexico's sovereign debt to *'negative'* from *'stable'*; and**
  - **(3) *Fitch Ratings* (*Fitch*) cut the rating of Mexico's sovereign debt to 'BBB' from 'BBB+', while it also modified the outlook to *'stable'* from *'negative'***
- **In our view, it is highly probable that a short-lived 5% tariff will be implemented next June 10th, although we expect talks to continue**
- **President López Obrador's government has made a very important effort to maintain healthy public finances and the rating agencies recognize it**
- **Nevertheless, the reasons why the agencies modified the rating (*Fitch*) and the outlook (*Moody's*) have to do with underperformance of growth and the deterioration of growth prospects, as well as the lack of clarity regarding the debt repayment capacity of Pemex**
- **Regarding the actions of the rating agencies, the market dynamics had already anticipated these modifications to the outlook and the rating**
- **Two positive aspects are that the risk *'is over'* for market participants and that *Fitch* modified the outlook to *'stable'*, removing pressure on local markets**
- **Looking ahead, we consider that it is very feasible for Mexico to reach an agreement with the United States on tariffs by the end of the month and that the upcoming Pemex business plan will be enough to prevent further deterioration of debt ratings**
- **We continue to consider that explicit support from the federal government for Pemex's debt, as well as announcements aiming to give confidence to private investment, could even support a change of outlook of the sovereign rating and investors worldwide**
- **Pricing of Mexican assets should reflect new idiosyncratic risks**

Three recent pieces of news. A few hours ago, Mexico experienced three news: (1) No agreement was reached on the threat to impose a 5% tariff on Mexican imports to the US; (2) *Moody's* modified the outlook for the rating of Mexico's sovereign debt to *'negative'* from *'stable'*; and (3) *Fitch* cut the rating of Mexico's sovereign debt to 'BBB' from 'BBB+', but changed its outlook to 'stable' from 'negative'.

Mexico's credit ratings

	Rating	IG / Speculative	Outlook	Last change in rating and/or outlook
Fitch	**BBB**	**Investment grade**	**Stable**	**5-Jun-19**
Standard & Poor's	BBB+	Investment grade	Negative	1-Mar-19
Moody's	**A3**	**Investment grade**	**Negative**	**5-Jun-19**

Source: Bloomberg

Unlikely agreement in the short-term given President Trump's political incentives. In our opinion, it is very unlikely to reach an agreement to prevent the imposition of the 5% tariff on June 10, despite the efforts of the Mexican government. Nevertheless, the application of this measures would be short-lived, with Mexico reaching an agreement with the U.S. government by the end of the month. In our view, Trump's decision to threat Mexico is part of its political agenda, particularly given his upcoming reelection campaign kick off on June 18th (see our notes: *Mr. Trump's trade wars – Opening the Mexican front* and *The economic consequences of the new US tariffs* and *The economic consequences of the new US tariffs*).

***Fitch Ratings* downgraded Mexico's sovereign rating to 'BBB' from 'BBB+' with '*stable*' outlook.** The rating agency's decision reflects *"...a combination of the increased risks of sovereign's public finances from Pemex's deteriorating credit profile along with ongoing weakness in the macroeconomic outlook and external threats from trade tensions, some domestic policy uncertainty and ongoing fiscal constraints*…". *Fitch Ratings* considers that *"...the contingent liability represented by Pemex weighs increasingly on the country's credit profile*…". In this context, the fiscal cost of the government's support to the state-owned company amounts around 0.2% of GDP in the form of capital injections and lower effective taxes, which they consider that *"...are not enough to provide a long-term solution or prevent continued deterioration in Pemex's credit profile*…". Moreover, growth continues to underperform, and downside risks are magnified by recent threats by President Trump to impose tariffs on Mexican imports. The rating agency considers that fiscal targets will become increasingly difficult to meet in 2020 and could result in tighter policy, creating a further headwind to growth in a context in which the president has pledged not to raise taxes before 2021. Furthermore, *"...the government plans a change to the fiscal rules framework that would increase counter-cyclical space and, by reducing potential over-spending, the credibility of fiscal targets*…". Finally, *"...it remains to be seen whether the new administration, which has pledged action against crime and corruption, can reverse the trend of deteriorating governance, which began under its predecessors…"*.

On the positive side, *Fitch ratings* considers that the president has a stronger mandate than prior administrations, and his coalition has a majority in the lower House of Congress, and close to a majority in the Senate, giving him the ability to effect change. Moreover, Mexico's ratings are supported by the country's diversified economic structure and a track record of disciplined economic policies that has anchored macroeconomic stability and contained imbalances. While some of the Lopez Obrador administration's microeconomic policy decisions have proved contentious, macro policy choices have been orthodox to date. These strengths counterbalance Mexico's rating constraints, which include economic growth below the 'BBB' median, structural weaknesses in its public finances (a low revenue base compared with peers), shallow credit penetration, and governance scores among the lowest in the 'BBB' category.

***Moody's* changes outlook to '*negative*' from '*stable*', while affirming 'A3' ratings.** This change reflects the rating agency's concern that the policy framework is weakening in two key respects: (1) Investor confidence and medium-term economic prospects are being undermined by unpredictable policymaking; and (2) lower growth, together with changes to energy policy and the role of PEMEX, have introduced risks to Mexico's medium-term fiscal outlook, notwithstanding the government's near-term commitment to prudent fiscal policy. According to *Moody's* communiqué, the 'A3' rating affirmation recognizes the country's large and diversified economy, its high fiscal strength and low susceptibility to event risk, against ongoing challenges related to weak growth rates, weaker-than-peers institutional strength and a large informal sector.

Factors that could change the rating. As we have already mentioned, *Moody's* reaffirmed Mexico's 'A3' rating recognizing that *"…the size and diversification of the economy, which together with prudent macroeconomic policies, have allowed it to face various shocks in recent years…"*. In this context, the agency argues that a return to an '*stable*' outlook could come as a result of *"...greater confidence in the government's ability to establish and implement predictable policies*…". However, additional evidence that medium-term growth is decreasing and the increase in fiscal deficits could lead to a downgrade in the rating.

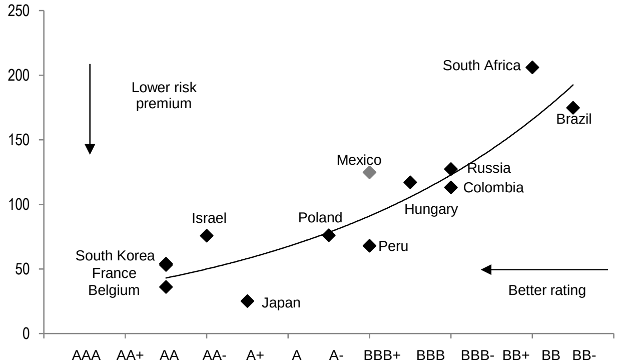
Sound public finances: one of President Lopez Obrador core commitments. The new administration has made a very important effort to maintain healthy public finances, without increasing the deficit and debt, as the president himself promised during his campaign. In addition, there has been certainty about the policies that the president is carrying out in the sense that Mr. López Obrador is fulfilling exactly what he promised in the campaign and that is written in his book "*La Salida"* (2017). Similarly, an effort has been made to capitalize Pemex, without compromising public finances. Unfortunately, as expressed by rating agencies in their press releases today, there is still no clarity on what can guarantee the repayment of Pemex's debt in the medium term. While capitalization efforts have been relevant, doubts from rating agencies and investors lie in the use of resources. To guarantee the payment of the debt of a company that does not have the explicit support of the federal government, such as Pemex, it is necessary to invest the resources it has in highly profitable projects, such as those related to exploration and production, including farmouts. However, for the time being, the government is opting to invest in expanding the refining capacity, projects that are not as profitable, although they may appear to be from the point of view of national security. In this context, we consider that one of the options on the table is for the federal government to grant its explicit guarantee to Pemex's debt, in order to continue with the efforts in the refining sector, without the company or the country facing deterioration in its credit ratings. In this context, the rating agencies and investors would focus not only on Pemex's projects, but a much broader set of variables, such as tax collection, among others, to evaluate the company's payment capacity.

Regarding the actions of the rating agencies, market dynamics had already anticipated these modifications to the outlook and rating. We believe that the decisions made by the rating agencies have two positive aspects. Somehow the risk of a downgrade of the rating *'is over'* while *Fitch* modified the outlook from *'negative'* to *'stable'*, which takes the pressure off the local markets. Looking ahead, we believe that an agreement between Mexico and the United States on trade issues is highly feasible at the end of the month which, together with a new plan for Pemex, will limit the possibilities of having a further deterioration in debt ratings.

From our fixed income and FX strategy team

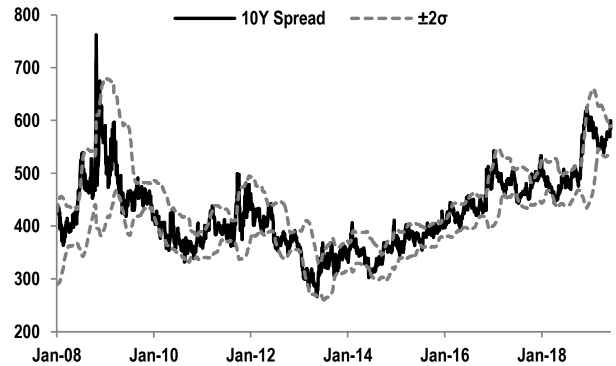
Pricing of Mexican assets should reflect new idiosyncratic risks. Mexican assets are likely to show an additional adjustment, reacting to the most recent negative news from credit rating agencies: the combination of a 1-notch downgrade from Fitch (to BBB from BBB+) and the shift to 'negative' from 'stable' outlook by *Moody's*. The rationale behind these decisions is based on a weaker performance of the Mexican economy (with less resilience to several global risks), the current landscape in Pemex and the implications for fiscal accounts, in addition to the soar of trade threats from President Trump. Although this is not a surprise for investors as they have been pricing local Pricing of Mexican assets should reflect new idiosyncratic risks instruments as a BBB- country, we expect an adjustment in the country risk premium as some idiosyncratic factors are starting to materialize. It is worth stressing out that Mexico continues trading as a solid Investment Grade EM economy as market participants continue acknowledging sound fiscal and external accounts as of today. There are several implications for sovereign bonds. On one hand, local assets have been strongly affected since last Friday after President Trump announced his threat to impose a 5% tariff on Mexican exports to the U.S. starting June 10th. In an initial stage, the peso could portray an effect of 5% in competitiveness-adjusted basis, which suggest the next relevant level towards USD/MXN 20.00, with a relevant convergence of a Fibonacci retracement figure of 19.98, a psychological effect, and short-term options' strikes. This could decrease the implied probability of rate cuts by Banxico currently priced in the yield curve. On the other hand, we expect an additional increase of current risk premium embedded in Mexican sovereign bonds. The spread between Mexican bonds and U.S. Treasuries have augmented considerably, reaching once again levels not observed since the 2008 crisis. This spread reached its highest level since late January at 606bps on Monday, surpassing the +2σ upper range (590bps), a similar movement to that of 2008. Moreover, this reading has averaged 569bps during the year, while the 12-month mean hovers at 552bps. In the aftermath of this landscape we hold a cautious stance in terms of Mbonos, waiting for better entry levels and market conditions for new long positions, as we expect an additional correction.

5-year CDS and S&P's credit rating
Basis points in vertical axis, credit rating in horizontal axis



Source: Banorte with data from Bloomberg and S&P

10Y Spread between Mbonos and Treasuries
Basis points



Source: Banorte with data from Bloomberg

The Mexican peso experienced in the last sessions a weaker and notoriously volatile performance, following a relatively sideways trading throughout 2019. This situation has been a reflection of the uncertainty associated with the tariffs threats from President Trump towards Mexico, triggering an MXN sell-off that has ended with a currency paring its year-to-date gains. The cross currently trades close to USD/MXN 19.75, 4.4% weaker in respect to its strongest level in May at 18.92. Moreover, the underlying structure of the currency has also revealed relevant stress, captured by an at-the-money volatility curve pressured by 136bps on average during the last 5 days, with a significant flattening which reached a surge of up to 228bps in the 1-month maturity. In an initial phase we see MXN reflecting a 5% effect in competitiveness-adjusted basis. This performance would imply 20.00 as the next relevant technical figure.

During this year, the peso's dynamics have also been a clear reflection of the anchorage effect given the level of Banco de Mexico's repo rate, which is high when compared with other emerging markets, providing a key support in relative terms. This backdrop has been an important dissuasive factor for speculative positions and allowed the cross to hold a positive performance in 2019. Although the peso's recent activity is an expression of Mexico-specific factors starting to weigh more (*i.e*. trade and rating agencies), in our view the currency's carry will remain compensating for additional pressures.

The global landscape has also joined as a headwind recently. USD has been widely supported by a more robust monetary and economic position *vis-á-vis* other G10 countries, coupling to a stronger risk-off mode that has spread aversion to the EM currency asset class. Themes such as the trade war between the U.S. and China, uncertainty regarding global deceleration, the European political context, and strong adjustments in crude-oil prices are a highlight. In this sense, 1-month betas of the MXN against Brent are currently printing 0.15 from its lowest point in the year at -0.06, whereas the same reading against the renminbi marks -0.80 from -1.54. Together with other similar metrics and correlations, and considering its historic performance, the current backdrop suggests space for further contamination. Under this scene, we stress a Mexican peso holding a more favorable performance during 2019 when compared to other EM currencies.

However, latest pressures have broadly limited this decoupling with MXN yielding just marginally above an aggregate of comparable currencies in 2019.

In terms of strategy we hold a cautions vision for trading purposes, opting to favor USD long positions. Following the recent sideways and resilient trading, MXN constructed few technical history, reason why from levels close to 19.00, and once breaching to the upside the 200-day MA at 19.36 (which we now see as the central short-term resistance), the main support will locate at the 20.00 handle. Should the cross breach the latter, next supports print at 20.20 and 20.36 (Fibonacci). We reaffirm our USD/MXN forecasts for year-end 2019 and 2020 at 20.30 and 21.30, respectively, as an expression of our view that foreign and local conditions could develop into a higher risk premium embedded in the currency.

Reference:

López Obrador, Andrés Manuel. *"2018 La Salida. Decadencia y Renacimiento de México*". Mexico City; Ed. Planeta, 2017

Disclaimer
The information contained in this document is illustrative and informative so it should not be considered as an advice and/or recommendation of any kind. BANORTE is not part of any party or political trend.

Analyst Certification.

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, Francisco Duarte Alcocer, 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.

Relevant statements.

In accordance with current laws and internal procedures manuals, analysts are allowed to hold long or short positions in shares or securities issued by companies that are listed on the Mexican Stock Exchange and may be the subject of this report; nonetheless, equity analysts have to adhere to certain rules that regulate their participation in the market in order to prevent, among other things, the use of private information for their benefit and to avoid conflicts of interest. Analysts shall refrain from investing and holding transactions with securities or derivative instruments directly or through an intermediary person, with Securities subject to research reports, from 30 calendar days prior to the issuance date of the report in question, and up to 10 calendar days after its distribution date.

Compensation of Analysts.

Analysts' compensation is based on activities and services that are aimed at benefiting the investment clients of Casa de Bolsa Banorte and its subsidiaries. Such compensation is determined based on the general profitability of the Brokerage House and the Financial Group and on the individual performance of each analyst. However, investors should note that analysts do not receive direct payment or compensation for any specific transaction in investment banking or in other business areas.

Last-twelve-month activities of the business areas.

Grupo Financiero Banorte S.A.B. de C.V., *through its business areas, provides services that include, among others, those corresponding to investment banking and corporate banking, to a large number of companies in Mexico and abroad. It may have provided, is providing or, in the future, will provide a service such as those mentioned to the companies or firms that are the subject of this report. Casa de Bolsa Banorte or its affiliates receive compensation from such corporations in consideration of the aforementioned services.*

Over the course of the last twelve months, Grupo Financiero Banorte S.A.B. C.V., has not obtained compensation for services rendered by the investment bank or by any of its other business areas of the following companies or their subsidiaries, some of which could be analyzed within this report.

Activities of the business areas during the next three months.

Casa de Bolsa Banorte, Grupo Financiero Banorte or its subsidiaries expect to receive or intend to obtain revenue from the services provided by investment banking or any other of its business areas, by issuers or their subsidiaries, some of which could be analyzed in this report.

Securities holdings and other disclosures.

As of the end of last quarter, Grupo Financiero Banorte S.A.B. of C.V. has not held investments, directly or indirectly, in securities or derivative financial instruments, whose underlying securities are the subject of recommendations, representing 1% or more of its investment portfolio of outstanding securities or 1 % of the issuance or underlying of the securities issued.

None of the members of the Board of Grupo Financiero Banorte and Casa de Bolsa Banorte, along general managers and executives of an immediately below level, have any charges in the issuers that may be analyzed in this document.

The Analysts of Grupo Financiero Banorte S.A.B. of C.V. do not maintain direct investments or through an intermediary person, in the securities or derivative instruments object of this analysis report.

Guide for investment recommendations.

	Reference
BUY	*When the share expected performance is greater than the MEXBOL estimated performance.*
HOLD	*When the share expected performance is similar to the MEXBOL estimated performance.*
SELL	*When the share expected performance is lower than the MEXBOL estimated performance.*

Even though this document offers a general criterion of investment, we urge readers to seek advice from their own Consultants or Financial Advisors, in order to consider whether any of the values mentioned in this report are in line with their investment goals, risk and financial position.

Determination of Target Prices

For the calculation of estimated target prices for securities, analysts use a combination of methodologies generally accepted among financial analysts, including, but not limited to, multiples analysis, discounted cash flows, sum-of-the-parts or any other method that could be applicable in each specific case according to the current regulation. No guarantee can be given that the target prices calculated for the securities will be achieved by the analysts of Grupo Financiero Banorte S.A.B. C.V, since this depends on a large number of various endogenous and exogenous factors that affect the performance of the issuing company, the environment in which it performs, along with the influence of trends of the stock market, in which it is listed. Moreover, the investor must consider that the price of the securities or instruments can fluctuate against their interest and cause the partial and even total loss of the invested capital.

The information contained hereby has been obtained from sources that we consider to be reliable, but we make no representation as to its accuracy or completeness. The information, estimations and recommendations included in this document are valid as of the issue date, but are subject to modifications and changes without prior notice; Grupo Financiero Banorte S.A.B. of C.V. does not commit to communicate the changes and also to keep the content of this document updated. Grupo Financiero Banorte S.A.B. of C.V. takes no responsibility for any loss arising from the use of this report or its content. This document may not be photocopied, quoted, disclosed, used, or reproduced in whole or in part without prior written authorization from Grupo Financiero Banorte S.A.B. of C.V.

GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy

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

Economic Analysis

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
Francisco Duarte Alcocer	Analyst, Global Economist	francisco.duarte.alcocer@banorte.com	(55) 1103 - 4000 x 2707
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

Fixed income and FX Strategy

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

Equity Strategy

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

Corporate Debt

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

Wholesale Banking

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 Asset Management	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 Corporate Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454