

## Mexico recovers its “stable” outlook in Moody’s sovereign debt rating

April 12, 2018

www.banorte.com  
@analisis\_fundam

- **Moody’s modified Mexico’s sovereign debt rating outlook to “stable” from “negative”**
- **In its press release, *Moody’s* explains the change of outlook back to “stable” for three reasons:**
  - (1) **Resilience observed in growth rates despite complex NAFTA renegotiation;**
  - (2) **Implementation of structural reforms; and**
  - (3) **Low probability that the next administration will damage public finances**
- **In our opinion, this is a positive surprise for international and local financial markets, because it is very difficult to “shake off” what is often considered a sentence for a credit downgrade...**
- **...especially given the fact that *Moody’s* rating (A3) is one notch above the rating of the other two global rating agencies**
- **We highlight that in its press release, *Moody’s* warned that a key factor that could cause a downgrade of the credit rating would be a reversal of structural reforms**
- **Moody’s assessment is consistent with the strong performance of Mexican assets YTD, pricing in a benign backdrop in terms of NAFTA and acknowledging a stable macroeconomic framework despite several headwinds**

**Positive change of the outlook...** The global rating agency *Moody’s Investors Services* modified Mexico’s sovereign debt rating outlook to “stable” from “negative”. It should be noted that in March 2016, *Moody’s* decided to downgrade the outlook for our country’s debt rating due mainly to the strong deterioration in Pemex’s finances at that time, when the rating agency expressed concerns that this could deteriorate the public finances of the federal government, given the implicit guarantee of the government to the state-owned oil company. Moreover, although Pemex’s finances improved considerably, in April 2017 *Moody’s* confirmed Mexico’s sovereign rating in ‘A3’ but did not change the outlook (“negative”). This was due to *Moody’s* concern about the possible shocks that could be generated by the renegotiation process of the North American Free Trade Agreement (NAFTA). Nevertheless, now *Moody’s* has decided to return the outlook back to “stable” due to three reasons: (1) Resilience observed in growth rates despite complex NAFTA renegotiation; (2) implementation of structural reforms; and (3) low probability that the next administration will damage public finances.

### Gabriel Casillas

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

### Delia Paredes

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

### Alejandro Cervantes

Senior Economist, Mexico  
alejandro.cervantes@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

#### Juan Carlos Alderete, CFA

FX Strategist  
juan.alderete.magal@banorte.com

#### Santiago Leal

Analyst Fixed Income and FX  
santiago.leal@banorte.com

Document for distribution among public

**...reflects the soundness of our economy and our institutions.** In our opinion, the first reason is highly relevant because it makes clear that today the Mexican economy is much more than NAFTA. The second reason warns that any attempt to reverse structural reforms or delay their implementation will imply a credit downgrade. Finally, in the third case, it allows us to know the outlook of the rating agency –one that that we consider that many participants of the international financial markets share–, in terms of the consequences of the election, which will not imply a significant economic or fiscal deterioration in case of an administration with policies that are not market friendly, which supports the strong appreciation of the Mexican peso in recent weeks. It also confirms the confidence that investors have in the soundness of our laws and our institutions, in which, for example, reversing the energy reform would involve having two thirds of Congress and half of the local congresses, which is difficult obtain by any of the parties/coalitions/candidates, significantly limiting the power of the President. We believe that whoever reaches the presidential chair on December 1<sup>st</sup> will be restricted both by institutions and financial markets.

**Moody’s recognizes the good fiscal management of the Mexican government.** In our opinion, by having the credit rating one level above the ratings of the large rating agencies (refer to the table below) and now with a “stable” outlook, Moody’s recognizes the good fiscal management of this administration, especially in terms of tax collection. We believe that the fiscal reform, supported by the ones in the energy sector and labor markets -which has encouraged formalization of labor force-, has made it possible to significantly reduce the fiscal dependence on oil revenues (from around 40% in 2012, to less than 20% at present). Additionally, last year the government managed not only to stop the growing trend of the government debt -which was largely due to the depreciation of the peso and the recognition of pension liabilities-, but it managed to reduce it. While there is room for improvement in the area of investments, as well as in the transparency and management of public spending, tax collection efforts and public spending cuts have undoubtedly to be praised.

**Mexico’s credit ratings**

	Rating	Investment Grade/ Speculative	Outlook	Last change in rating and/or outlook
<b>Fitch</b>	BBB+	Investment	Stable	3-Aug-17
<b>Standard &amp; Poor’s</b>	BBB+	Investment	Stable	18-Dec-17
<b>Moody’s</b>	A3	Investment	Stable	12-Apr-18

Source: Bloomberg

**Credit downgrade if Mexico reverses structural reforms.** It should be noted that in its statement, *Moody's* warned that a key factor that could cause a downgrade of the credit rating would be a reversal of structural reforms. However, they also suggest that they trust the strength of Mexican institutions and that the next president of Mexico will not reverse structural reforms or damage public finances, even though there is a potential change in the type of economic policy implemented.

*From our fixed income and FX strategy team*

**Moody's assessment is consistent with the strong performance of Mexican assets YTD.** Moody's decision to move Mexico's credit outlook from "negative" to "stable" is consistent with previous announcements from S&P and Fitch Ratings, in which credit agencies have recognized the resilience of the Mexican economy to several headwinds in the last years (especially in 2018), the implementation of a sound policy mix, and a more benign scenario in terms of the NAFTA negotiating process. Market participants have acknowledged this situation along 2018, with country risk premia declining in a significant way. The 5-year CDS is trading at 100bps, which compares favorably with the 106bps by the end of 2017 or the average of 121bps last year. The peso-denominated Mbonos curve has rallied 26bps on average year-to-date, depicting a more defensive stance *vis-à-vis* its U.S. and major EM counterparts. This situation has resulted in a spread contraction between Mbonos and Treasuries of 69bps on average during 2018. Foreign investors' holdings in Mbonos has also conveyed this positive view in terms of fundamentals and valuation, moving from US\$ 90.6 billion by 2017-end to US\$ 98.5 billion on April 2<sup>nd</sup>, 2018, the last figure released by Banxico. In our view, local markets are pricing in a benign scenario in terms of NAFTA, however a positive result could steer an additional limited rally. In terms of strategy, we hold a positive view in terms of the mid-end of the Mbonos curve, especially the 7- to 10-year tenors. Current forward rates, country risk premia and embedded real rates compares favorably to other EM bonds with similar credit profile.

The Mexican peso has gained around 0.6% since yesterday's announcement to 18.13 per dollar, very near its YTD intraday high of 18.05 reached last week. In our view, the peso is poised to break the 18.00 psychological in the short-term with its next support at 17.80-17.90, most likely if an agreement on NAFTA is unveiled this month or early in May, as suggested by recent news and optimistic comments from negotiators. According to our estimates and similar to rates, the local currency risk premium has been trending down and is relatively modest already, with the 5-year spread to the US adjusted by Mexico's credit rating (as informed by CDS pricing) closing yesterday at 358bps, lows since the US Election in November 2016 and after reaching a maximum of 471bps by the end of last year. This is also consistent with IMM positioning signaling increased bullishness despite high uncertainty, going from a net short in MXN of US\$ 1.5 billion by year-end 2016 to a net long of US\$ 2.7 billion as of last April 3<sup>rd</sup>, 2018.

Considering the latter, our estimate of short-term fair value (around 18.70) and the upcoming Presidential Election (July 1st), we believe the peso's appreciation potential from current levels and because of the announcement is relatively limited. In our view, the risk premium ahead of the election is low, particularly when compared to the dynamics in past presidential elections at this stage and with investors waiting for the first debate on April 22nd. As a result, we remain cautious and on the sidelines on USD/MXN positions at the current level, recognizing the cross-currents of potentially positive NAFTA news on the one hand but skewed risks in case of negative surprises coming from the presidential race on the other.

**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.

**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 Godínez	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
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
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
Juan Carlos Alderete Macal, CFA	FX Senior Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Strategist Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

**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
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	hugo.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, 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.cebillos@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
Victor Antonio Roldan Ferrer	Head of Corporate Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454