

Fitch affirms Mexico’s credit rating at BBB+ but revises outlook to negative

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- Earlier today, Fitch affirmed Mexico’s credit rating at BBB+. However, they downgraded their outlook from ‘Stable’ to ‘Negative’
- Also today, Moody’s decided not to take any action on Mexico’s rating or outlook in the short term
- Stop-loss in our short-term tactical trade in the CPI-linked Udibono Jun’22 given the sell-off in the local market; we now recommend more defensive strategies in floating-rate securities. In the FX market, the MXN was also affected

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Fitch downgrades Mexico’s credit outlook from ‘Stable’ to ‘Negative’. In Fitch’s view, the outlook revision “...reflects the deteriorating balance of risks confronting Mexico’s credit profile associated with scope for policy uncertainty and deterioration under the incoming administration, and growing risks for contingent liabilities for the sovereign from Pemex, against a background of persistent economic under-performance relative to peers...” In this respect, it is worth remembering that on October 19th, Fitch downgraded Pemex’s credit outlook to ‘Negative’ from ‘Stable’, with its current rating at BBB+. It should be noted that the outlook has the goal of indicating the direction of a possible rating change, which could materialize over a one- to two-year period.

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Mexico’s credit ratings

	Rating	Investment Grade/ Speculative	Outlook	Last change in rating and/or outlook
Fitch	BBB+	Investment	Negative	31-Oct-18
Standard & Poor’s	BBB+	Investment	Stable	18-Dec-17
Moody’s	A3	Investment	Stable	12-Apr-18

Source: Bloomberg

Resilient macro fundamentals... In the agency’s view, Mexico’s rating is supported by the country’s diversified economic base and a track record of disciplined economic policies that has anchored macroeconomic stability. Moreover, external imbalances are moderate and fully funded by FDI (with a current account deficit of 1.7% of GDP in 2017), well-anchored inflation expectations around the 3% target partly given Banxico’s credibility, a flexible exchange rate regime, and an adequate level of international reserves (including the IMF’s Flexible Credit Line).

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...but risks on the fiscal front and previously approved reforms have increased. Fitch expects that the incoming administration will continue embracing the core aspects of the macro framework, including budget discipline and the autonomy of the central bank. Nevertheless, the rating agency points to risks due to: (1) The incoming administration's fiscal stance; (2) that previously approved reforms could stall, for example in the energy sector; and (3) *“...proposals that Pemex invest in new refining capacity to substitute for gasoline imports would entail higher borrowing and larger contingent liabilities to the government...”*.

On watch of incoming fiscal proposals. According to law, the budget for 2019 must be presented to Congress by December 15th, 2018 at the latest. Incoming officials of the new administration have affirmed that the budget framework will be guided by the criteria published by the current administration in April. Moreover, the future Minister of Finance, Carlos Urzúa, has stated that the 2019 budget will aim for a 0.8% of GDP primary surplus. In this respect, Fitch highlighted that some of the promises discussed by the transition team so far, such as increasing social transfers and pensions, as well as investing in new refinery capacity in Pemex to substitute gasoline imports, may be difficult to accommodate within the budget. Last but not least, the agency believes there are downside risks related to the expectation regarding stabilization of oil production in 2019, which could continue to weigh on growth. Considering all these factors, Fitch estimates that the general government debt ratio stood at 41% of GDP as of year-end 2017, and will remain broadly stable in 2019 and thereafter. Nevertheless, *“...risks remain given the uncertain fiscal policy settings of the incoming administration and possible economic under-performance if policy uncertainty persists...”*.

USMCA agreement is positive, but uncertainty over its approval in the US remains. The agency states that the revised trade agreement with the US and Canada reduces the risk of a disruption in trade with Mexico's biggest market in spite of tougher rules of origin, particularly in the auto sector. In this respect, President Peña-Nieto is expected to sign the agreement at the end of November and Mexico's Congress is also likely to ratify it. Nevertheless, ratification by US lawmakers will fall to the next Congress, which will be elected on November 6th, raising some uncertainties.

Moody's decided not to take any action on Mexico's rating or outlook in the short term. Also today at 2:00pm EST, Moody's held a conference call focused on their views about the NAICM and Mexico's sovereign rating, with the latter currently at A3 with a 'Stable' Outlook. It is worth reminding that on Monday, the agency downgraded the Mexico City Airport Trust Senior Secured Notes' rating to Baa3 from Baa1, under review for a further downgrade (MEXCAT bonds, outstanding: US\$ 6 billion). Moody's decided not to take any action on Mexico's rating or outlook, saying that "...the downgrade of the bonds does not have a direct impact on the sovereign, but it is a sign with long-term implications that reduces incentives for investment in the economy going forward...". Moreover, the agency believes that there could be some indirect contingent liabilities for Mexico's fiscal accounts in the medium term. Nevertheless, and banning an unexpected shock, Moody's does not plan to change the sovereign rating or outlook in the short-term, but they remain vigilant on the new administration's proposals, particularly its fiscal stance.

Events in coming months. Although the timing of a possible rating change is uncertain and dependent on future events (as explained above), markets will closely follow some key events before year-end, among which we highlight: (1) Mid-term elections in the US on November 6th, (2) Banxico's policy meetings, on November 15th and December 20th; (3) the G20 Summit in Argentina on November 30th, in which the USMCA could be signed by Presidents of all the three countries; (4) the "review of qualification" of Mexico's Flexible Credit Line, at some point in November; (5) AMLO's inauguration day on December 1st, and; (6) the 2019 Budget, which has to be submitted on December 15th at the latest, with approval due on December 31st.

From our fixed income and FX strategy team

Stop-loss in our short-term tactical trade in the CPI-linked Udibono Jun'22 given the sell-off in the local market; we now recommend more defensive strategies in floating-rate securities. Mexican sovereign bonds are depicting a weekly loss so far of 25bps in the short-end and 38bps in longer tenors. The cautious stance among local and foreign investors grew in the aftermath of credit rating agencies' recent actions. *Fitch Ratings* held stable the sovereign grade at "BBB+" but changed its outlook from "stable" to "positive" which resulted in a higher risk premia embedded in local assets. *Moody's* stayed put but stressed out the risks to Mexico's rating.

As a result, the 10-year Mbono Jun'27 is trading at 8.90% (+57bps), with a performance in recent sessions. This security breached the rolling 2σ band, locating at 4.2σ above its 90-day moving average, similar to what has happened in previous moments of market risk aversion, for example the U.S. elections in 2016 with 5.5σ or NAFTA negotiating process (e.g. a more radical position from the U.S. in October 2017 with 4.1σ). In our view, market participants will depict a higher sensitivity to any announcement in following days, in addition to Banxico's next policy decision on November 15th, with a stronger likelihood of a 25bps increase (88% of implied probability) given the current performance of the Mexican peso and its possible pass-through effect on inflation. We acknowledge the global risk off effect, affecting several assets in the EM spectrum. However, the abovementioned backdrop has contributed to the headwinds analyzed by several investors. The 10-year spread between Mexican and U.S. bonds prints at 580bps (+55bps), a maximum level not observed since March 9th, 2009 when it reached 597bps. These conditions leave us to suggest a stop-loss strategy in our most recent short-term tactical trade in the CPI-linked Udibono Jun'22, despite having a more defensive performance *vis-à-vis* other local assets and portraying an attractive carry given current inflation dynamics. On the other hand, we hold a negative view in terms of Mbonos and recommend positioning in defensive floating-rate securities.

MXN also affected. The Mexican peso is depreciating 4.9% so far this week, registering 5 straight weeks of losses, moving from USD/MXN 19.35 to 20.31, conveying the worst performance among EM. The MXN weakness was explained by the combination of risky events in the global landscape in tandem with the uncertainty highlighted by credit agencies. The most significant short-term technical levels that we could observe are located between the Fibonacci retracement of 20.24 followed by the psychological of 21.00 which is the maximum level so far in 2018. The peso has passed a rolling 2σ band, similar to what has been observed in the fixed-income market. The currency is 3.8σ above its 90-day moving average, the maximum level observed in recent years, similar to the one observed during the U.S. elections (3.8σ) and slightly above the most controversial discussions surrounding the NAFTA deal in October 2017 (3.5σ) and the hedge observed 1 month previous to the Mexican elections this year (3.1σ). This is a sign of a stressed valuation, which will continue incorporating the information that will come out in following days. The ATM volatilities are standing at 15.96%, 15.31% and 15.07% for the 1-, 3- and 6-month tenors, respectively, with a 10% increase this year. Taking into account current market conditions we hold our short-term tactical trade idea of long USD, which we opened on October 16th with an original target of USD/MXN 19.30, which we have decided to extend given the recent performance of the local currency.

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