(UBS)

Has Mexico's moment finally arrived?

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Nearly twenty thousand newly appointed politicians in the 2 June elections—including a new president, all members of both chambers of Congress, nine governors, and numerous local legislators—will lead Mexico through a "sexenio" rich in opportunities to accelerate the country's economic development. While the country will also be forced to confront pressing sources of vulnerability, we think Mexico's economic and financial outlook is bright.

The economic integration with the US is unstoppable
The global geopolitical map is experiencing its deepest reconfiguration in decades. Global trade is being rerouted, supply chains are being redesigned, and new security alliances are being forged.

Mexico possesses unique advantages in this context: geographic proximity to the largest economy in the world, ample networks of free trade agreements, and a young and skilled workforce with a high number of people graduating as engineers and technicians every year.

Mexico has already become the US's largest trading partner. US remittances are flowing into Mexico at a record USD 60 billion annually. And this process of economic integration has more room to run, in our view.
Just consider how recent flagship US industrial policy initiatives benefit Mexico. The Inflation Reduction Act (IRA) promotes electric vehicle production in Mexico, as it grants tax credits provided that a certain percentage of a car and its battery components are sourced from a US free-trade partner. Similarly, the CHIPS and Science Act enacted encourages semiconductor production on both sides of the border.

Strong immune system against economic disease

In addition, Mexico's current macroeconomic indicators paint a picture of resilience and stability. Economic activity is expanding at a steady clip. The central bank has been able to operate independently from political pressures and is guiding inflation down via tight monetary policy.

Mexico's government debt levels are also hovering around a modest 50% of GDP. More important, the vast majority of this debt matures in the long term, is denominated in local currency, and remains in the hands of domestic investors. This favorable debt structure helps mitigate economic shocks.

Almost USD 220 billion in international reserves and a USD 35 billion flexible credit line with the International Monetary Fund provide further buffers against macroeconomic instability.

For all the positives, Mexico does face serious medium-term challenges the next administration will need to address.

Poor institutional quality and public safety trends
Governance indicators that measure progress in areas such as rule of law, control of corruption, political stability, voice and accountability, government effectiveness, and regulatory quality, have on average been declining in recent years.

Organized crime has also deepened its penetration into the country, and public safety gauges are in bad shape and worsening.

Fiscal yellow flags
While Mexico demonstrated fiscal discipline in the early years of President López Obrador's administration, recent developments indicate a more troubling trend. The Ministry of Finance estimates that the public deficit will reach almost 6% of GDP this year, the highest in over three decades. There is a serious need for tax reform in order to raise low federal revenues.

The new administration will also need to revisit Pemex's strategy, as the national oil company has been receiving on average 1% of GDP in financial assistance per year from the central government. With a pickup in debt amortizations in 2026, higher investment needs, oil production at historical lows, and refining remaining a loss-making operation for the company, structural changes are paramount.

Investment implications
"Super peso" here to stay: The Mexican peso will likely experience heightened volatility as the US election draws near. We believe investors should look through electoral noise, and expect the peso to remain resilient and trade around 17 against the USD looking 12 months out.

Corporate bond opportunities: Mexico is home to world-class companies, many of which enjoy healthy balance sheets with low refinancing risk over the foreseeable future. We favor telecommunication services providers with a continental footprint, geographically diversified petrochemicals, cement producers, high-tech auto parts makers, and leading refrigerated-food producers. We strongly believe the state-owned entities we cover will receive government support when needed. US dollar-denominated sovereign bonds are, for their part, trading at fair valuations, with longer-dated bonds appropriately reflecting fiscal risks.

Mexican stocks driven by earnings growth: We expect Mexican companies to deliver healthy earnings expansion in the coming quarters. That said, valuation multiples have already re-rated from their 2023 lows and foreign positioning is rather heavy at the moment. We expect Mexican stocks to trade in line with emerging market peers in coming months.

Main contributors: Alejo Czerwonko, Solita Marcelli

For much more, see **Investing in Emerging Markets: Supportive backdrop makes a comeback**, 29 May 2024.