PERSPECTIVE

Mexico Entangled in US Election as Banxico Tightens

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Mexico has a vested interest in the politics and policies of its neighbor to the north, the United States, which is also its largest trading partner. The lead-up to the US presidential election in November has brought a number of issues relevant to Mexico into the spotlight, including immigration and trade, and many observers have noted how the movement in the Mexican peso has acted as a presidential election proxy poll. Here, I share a few of my thoughts on these issues, and on the challenges and opportunities Mexican-based companies face that I learned from my recent travels there.

While the US Federal Reserve kept interest rates steady at its September policy meeting, the Bank of Mexico (Banxico) raised its key short-term lending rate 50 basis points to 4.75%, the third tightening move this year. The Mexican peso has fallen more than 10% versus the US dollar this year, something the rate hikes have aimed to counteract. Mexico's rate hike was not a big surprise since we knew that there was concern about the exchange rate, and the recent weakening of the peso seemed too much for Mexico's policymakers to take. In addition, they were concerned about the inflation knock-on effect from a weak currency. Inflation remains below the 3% target rate, but there is concern it could move up toward the end of the year. I don't view this rate hike as dramatic, and it is not likely to move mountains. But, the 4.75% rate means that Mexico offers an attractive yield for many investors looking at negative interest rates in other countries.

US Politics and Consequences for Mexico

The Mexican peso continues to trade close to all-time lows in spite of Banxico's actions, and it is widely seen as a by-product of the electoral process in the United States more so than specific fundamentals in Mexico. It has been widely recognized among market observers—and indeed Mexico's central bank—that US presidential campaign rhetoric and potential policy changes have impacted the peso. Many observers believe that in order for the currency to trade at a more reasonable level, Hillary Clinton needs to win—and we've seen the peso rise as Clinton's prospects improve in various polls. Even Banxico Governor Agustín Carstens was quoted in the press as stating that a Donald Trump victory would be a "hurricane" for Mexico; Trump has taken a tough stance on immigration and vowed to build a border wall and renegotiate or scrap the North American Free Trade Agreement (NAFTA). To be fair, Carstens also said a Clinton win could also potentially be stormy—for different reasons—although seemingly less troublesome for Mexico.

The way I see it, a lot of the US campaign rhetoric on both sides is just talk and may not result in policy action. Despite the dramatic headlines we have seen, the trade and investment statements of the two US presidential candidates do not seem that far apart in many aspects. Regardless of statements about more restrictive trade, it will be very difficult if not impossible for US-Mexico trade to be destroyed since the links are too deep between the two countries—and of course, there will be policy advisers, Congress, etc. to provide potential checks and balances.

In my view, maintaining NAFTA—which also includes Canada—is important for both Mexico and the United States. NAFTA was a natural outgrowth of what was going on before bi-lateral agreements became popular. I see a pattern where, going forward, bi-lateral agreements rather than multi-lateral agreements could likely be the name of the game since one size simply does not fit all. This could be the case with the United States and Mexico; if NAFTA is ripped up, it will likely be replaced with a bi-lateral agreement that may not, in the end, be very different from the current agreement.

Reforms and Challenges

While the US election is capturing the attention of markets on both sides of the border, regardless of the outcome we will continue to look for investment opportunities in Mexico from a bottom-up perspective. I recently traveled to Mexico to attend a financial conference with my Mexico City-based colleague Rodolfo Ramos. Like many conferences we attend around the world, it offered us a convenient way to meet companies and learn about the local business environment.

Although growth forecasts have been revised downward from the start of the year, Mexico's economy has been doing reasonably well. There are ongoing structural and global issues impacting the country, including depressed oil prices, but continued strength in the US economy should help Mexico, as the United States is its largest trading partner and the destination for 80% of its exports.[1]

Mexico is a very important emerging market, the second-largest economy in Latin America after Brazil. Mexico has been going through some structural reforms in telecommunications and energy, which are expected to have a positive impact on the economy, although the process hasn't always been smooth. Probably the most important reform taking place is the opening of the energy sector in Mexico. For example, Mexico's giant state-owned oil company has been the mainstay of income for the government but also a hotbed of inefficiency and corruption for many years; it is now expected to compete against and in some cases partner with private players. Finally, after much opposition from unions and others, the government realized reform was needed, and the way to reform was toward asset sales to private-sector firms that could operate them more efficiently. The first auction of assets took place in December 2015, with the Hydrocarbon Commission awarding various fields. It has been a challenge to figure out how to open the oil sector and to ensure private investors are incentivized enough to make the necessary investments to produce oil.

Lower oil prices have impacted Mexico since the government has depended on its state-owned oil-company earnings for a large part of its budget, and spending on infrastructure going forward could remain constrained should oil prices remain weak. While low oil prices have reduced some government income, non-oil tax revenues have substantially increased, offsetting some of the oil-revenue declines. Additionally, transportation costs have dropped and there should be more cash in the hands of consumers as the market becomes more liberalized.

In addition to reform in the oil sector, the government has also been embarking on a reorganization of the telecommunications sector. Wireless penetration is still below that of many other Latin American countries, and it was hoped that by allowing more competitors in the market, facilities would be expanded and prices would drop enough to allow telecommunications, particularly Internet-related services, to become more accessible.

However, some of Mexico's plans for reform have been hampered by the waning popularity of President Enrique Peña Nieto, who has been blamed for not doing more to combat growing violence and corruption in Mexico. The corruption scandal called the "white house" scandal involved a construction company that had given the president's wife a loan to purchase a lavish white mansion—the same construction company that had a huge contract to build a high-speed train in central Mexico. The latest unpopular move of Peña Nieto was his meeting with US presidential candidate Donald Trump in late August, which many observers thought was a public relations disaster for Mexico.

Surveying the Investment Landscape

Rodolfo and I had the opportunity to meet with executives of several companies in Mexico, including a major automobile parts manufacturer. With a large automobile manufacturing industry in Mexico focused on exports (primarily to the United States), the need for quality parts is high. The firm specializes in aluminum components, and feels that if US auto sales remain flat or increase slightly, they should be able to do fairly well.

Another firm we visited was a toll-road operator that develops, maintains and operates toll-road concessions in a region with the highest traffic congestion in Mexico. Executives said they have continued to see good growth, and its contracts have a guaranteed return clause that allows for price increases or an extension of the duration of the concession, which is favorable. However, there are clouds on the horizon as the company is being investigated by the authorities regarding improper accounting.

In the consumer products area, we visited one of Mexico's largest beer and soft-drink manufacturers, which also has successful convenience store chains and is expanding into gas stations, among other areas. The firm is an example of how Mexican companies have expanded their market not only in Mexico, but also into the rest of Latin America and even in Asia through a strategic purchase of another company. The officials cited slow economic growth in Mexico as a challenge, but noted that their brand engenders trust among consumers, and they plan to put an emphasis on quality.

We also met with officials at a leading telecommunications company that provides fixed-line telephone services as well as Internet in Mexico. With the entry of new competitors in the space, their strategy is to focus on profitability through tight management of client-acquisition costs. One interesting aspect of this industry in Mexico is the growth in Chinese telecommunications equipment suppliers entering the market. One executive told us if they had problems, they would fly in an army of Chinese technicians to solve them!

Another firm we visited was a manufacturer of consumer food products, and their view was somewhat more pessimistic. The officials believe that the primary explanation for strong same-store-sale figures in recent months was the expansion of credit. Executives did say that retail sales have been helped by remittances from Mexicans working outside the country. This flow of money also may be impacted by US politics; Trump has proposed plans to seize some of these remittances to build a border wall with the United States. This could be quite detrimental to Mexico, as remittances represent more than $US22 billion flowing to Mexico, more than 2% of GDP.[2]

On US election day in November, we can be sure Mexico will be watching!

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1. Source: US Department of State, based on 2013 data.

2. Source: Bank of Mexico, as of July 2016.