

Mexico: A new era begins

Local market concerns about the seismic shift expected to take place in Congress could weigh on local assets in the very near term. But attractive valuations (FX and rates) and a more constructive policy assessment should lend an appreciating bias to local assets over the second half of the year



Polls proved right as anti-establishment wins by landslide

As polls were indicating, Andres Manuel Lopez Obrador (AMLO) was confirmed as Mexican President-elect with a landslide victory yesterday. Preliminary results suggest a steep 30ppt lead over runner-up Ricardo Anaya, ie, 53% vs 23%.

Despite the consistency in poll results, we suspect some local investors were underestimating the strength of the anti-establishment sentiment propelling AMLO's candidacy. Some also expected that strategic voting or day-of-election factors, such as local party machinery advantages, would chip away some support from AMLO, which apparently did not materialise.

Perhaps, as a result, local assets are underperforming today. But, we suspect, today's price action could also reflect some correction from the sharp pre-election rally seen last week.

Local markets are also probably apprehensive about the seismic shift expected to take place in Congress. The final congressional composition remains inconclusive but preliminary results

suggest that AMLO is likely to count with a working majority in both legislative chambers.

While this is not sufficient to clear the two-thirds threshold for approving changes to the constitution, AMLO's resounding victory suggests a strong popular mandate and political capital that could eventually facilitate the approval of constitutional amendments.

Defections from other parties and potential alliances with other left-leaning parties in Congress could also help boost MORENA's control of the Lower House and the Senate in the coming months.

It's unclear how the new administration will choose to spend this political capital. In a conference call earlier today, the economic advisor in charge of the transition (possible future Finance Minister Carlos Urzua), pledged to follow general market-friendly macro directives, noting a commitment to fiscal discipline, the flexible FX regime and central bank autonomy.

It's unclear if, for instance, overturning the energy reform would be part of the initial agenda but Urzua suggested a "need to create consensus around the reforms and process them through the proper institutional channels". A review of the private sector oil exploration contracts (for evidence of fraud) along with the fuel pricing policy is expected.

The new Congress will be inaugurated on 1 September while AMLO will take office on 1 December.

Policy implications

Despite today's relatively choppy market reaction, we remain constructive about the outlook for Mexican assets. Market apprehension vis-à-vis AMLO's effective Congressional base could lend a more persistent weakening bias over the next few days, but we still expect any underperformance to be short-lived.

As we saw last week, when local assets outperformed considerably, we suspect foreign investors remain particularly inclined to add to their positions. This reflects a conviction that local assets remain attractive under the assumption AMLO will insist on a more pragmatic and conciliatory rhetoric post-election.

We suspect local investors will remain more cautious however. In our view, their concerns are legitimate, but they are more likely to be seen as a long-term issue, to be assessed after AMLO's economic agenda gains firmer shape. For now, we think the favourable pro-market policy signalling should prevail over longer-term concerns.

The chief near-term policy implications should be reflected in terms of monetary policy. Banxico hiked the policy rate less than three weeks ago, to 7.75%, but, with electoral uncertainties out of the way and FX dynamics following a more constructive trend, we would expect monetary policy guidance to shift to a more neutral stance.

Banxico should also finally be able to decouple its policy decisions from the US Fed. The bank continues to list FX and US Fed decisions as primary drivers for their policy decisions and, apart from brief intervals inbetween meetings, the Mexican/US interest rate differential has remained unchanged, at 5.75%, for one year now. This should likely change going forward. In particular, a Fed rate hike in September would unlikely trigger a rate hike by Banxico on 4 October.

The outlook continues to demand caution however, and we expect central bank officials to continue to downplay the risk of rate cuts. A new spike in global risk aversion, perhaps triggered by

further disruptions in global trade, or a credible threat by the US to pull out from the NAFTA agreement would, for instance, likely trigger enough FX volatility to put any prospects for rate cuts to rest.

Any evidence that AMLO would commit to a highly expansionary fiscal programme or a reversal in the pro-market initiatives implemented by the current administration, would also raise alarm. Freezing the rise in private sector participation in Mexico's energy sector would, for instance, damage considerably the outlook for activity, fiscal and external accounts.

But, overall, assuming that the USD/MXN should end the year below 19 (ING forecast: 18.8) and that inflation should re-enter the 2-4% targeted range during 1H19, the arguments for Banxico to start considering rate cuts should gain traction early in 2019. Room for cuts should be relatively limited however. Assuming that the US Fed should aim to hike its overnight rate towards 3%, we suspect the need to bolster FX stability should prevent Banxico from cutting rates below 6.5% over the next two years.