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MEXICO

## Mexico: Headwinds intensify

The introduction of import tariffs by the US next week along with the negative actions by rating agencies this week should extend the weakening bias for Mexican assets. Incentives to get a compromise solution to the trade conflict seem large, but an imminent solution is needed to avoid intense market volatility and a more lasting damage to Mexico's outlook



### Another blow for US trade relations

Unless a last-minute breakthrough happens in negotiations in Washington today, Mexican imports into the US will be subject to a 5% tariff starting Monday. With President Trump hardening his anti-immigration stance ahead of next year's election, and the short time for Mexico to show results, we suspect tariffs will indeed be implemented.

Integrated cross-border supply chains in the industrial sector (especially autos) suggest that the overall impact of even small tariffs can be substantial for certain segments. And the stakes will get progressively higher in the coming weeks, with tariffs set to rise to 10% on July 1, before topping at 25% in October.

Mexico's President Lopez Obrador has tried to defuse the conflict, adopting a conciliatory stance, and proposing to flesh out a strategy with meetings in Washington this week, led by Foreign Relations Minister Marcelo Ebrard.

It's unclear how negotiations will evolve as "compliance" by Mexico to US demands should remain highly subjective and primarily dependent on President Trump's personal disposition.

We are biased towards further deterioration in the local market environment in the shorter term, under the assumption that Trump will see that maintaining a hardline stance is in his best interest.

While business interests in Mexico and in the US have been hurt and have pressured the government to de-escalate the conflict, we expect Trump to resist initially, as immigration remains a crucial issue for him at next year's election.

Moreover, Trump appears to view Mexico as the weaker party in the negotiation, much more constrained in its ability to retaliate, which increases his incentives to position aggressively for now, in hopes to achieve bigger gains on the immigration-prevention front, despite the risk to business confidence.

The chief demand by the US administration appears to be greater cooperation from Mexico on asylum policy, especially by pushing asylum seekers from Central America to do so with Mexico, as a "safe third country", which Mexico appears to resist.

### **Rating agencies and the risk to financial stability**

Since Lopez Obrador took office, all rating agencies have moved to downgrade Mexico's credit rating outlook to some degree. And the risk of ratings-related financial market volatility has reached a new sense of urgency this week, with Fitch and Moody's downgrading the credit ratings of the sovereign and PEMEX. As earlier this year, agencies justified the shift largely by noting the weaker growth, economic policy uncertainty and the heavy burden represented by PEMEX's deteriorating credit profile, and the potential for rising contingent liabilities.

Fitch's new sub-investment-grade status for PEMEX (BB+, negative outlook) came sooner than expected, as the agency had just announced a two-notch downgrade in January, and this is a particularly troubling development given its ramifications for financial markets.

Moody's now rates PEMEX at Baa3, ie, just one notch above investment grade, and with a "negative" outlook. As a result, the risk of forced selling by investors who cannot hold junk-rated assets has increased sharply. (S&P still rates PEMEX as a BBB+ credit, with a negative outlook.)

Overall, actions by rating agencies confirm the deep scepticism towards the policy choices by the new administration, especially as it tries to boost the state presence in the economy, particularly in the energy sector, with predictably negative consequences for economic activity and the fiscal outlook.

Separately, the announcement by the rating agencies may have increased Mexico's incentives

to pursue a quicker resolution with the US on the trade conflict. If tariffs are introduced, the risk of a more lasting damage to Mexico's medium-term outlook should increase, as it should deepen the weakening momentum in economic activity. In that case, unless energy policy directives turn more business-friendly in Mexico, the risk of negative ratings action should remain elevated.

### **What about the USMCA? It could be a bumpy road**

The Trump administration also submitted to Congress last week the statement of administrative action for the new USMCA trade agreement, which starts the legislative clock for the ratification of the treaty.

The move apparently took the Democrats, who control the House, by surprise, and the consensus among political pundits in Washington is that the two events, ie, the announcement of the tariffs on Mexican imports and the "starting-the-clock" on the USMCA approval, has complicated the outlook for the approval of the USMCA treaty by the US Congress.

And this risk, ie, that the USMCA is not approved by its legislative deadline at the end of September, is a critical factor, in our opinion, that should force the Trump administration to end the conflict with Mexico sooner, in time to make progress on the treaty by August.

As a result, we suspect the administration should be able to introduce the 5% tariff next week and even increase it to 10% on July 1 but, after that, the administration's position should become increasingly hard to sustain, with the risk of an anti-tariff veto-proof majority emerging in Congress increasing significantly.

Overall, even though it appears that all parties want a trade agreement in place, it is clear that the chances of a smooth USMCA process have diminished. Moreover, uncertainty vis-à-vis the evolution of the political incentives for the governments in Mexico and in the US suggests that the risk of mismanagement that results in the failure to approve the trade agreement is no longer trivial.

### **Policy implications for Mexico**

The Mexican peso has reacted strongly to the tariff announcement, selling-off 3% in recent days. And, we suspect, the currency has further to go, with the actual implementation of the 5% tariff becoming the next catalyst that could push the USDMXN decidedly above 20.

As a result of currency weakness, along with the rise of PEMEX-related uncertainties, room for a dovish shift in Banxico's monetary policy stance has been curtailed sharply.

We no longer expect Banxico to cut the policy rate this year, as central bankers should continue to rely on a mix of high rates and still-solid macro fundamentals to anchor the MXN.

Uncertainty on the trade policy front has added further downside to the business investment outlook, which has already contracted in the past two quarters in the context of heightened domestic policy uncertainties and the perception of an anti-business bias by the Lopez Obrador administration.

This, together with reduced prospects for monetary easing, should contribute to extend the sharp drop in GDP growth expectations. According to the central bank monthly survey, 2019 GDP growth forecasts dropped 100 basis points in the past 9 months, from 2.3% to 1.3% now, and the bias is for expectations to drop further, towards our own 1.0% forecast in the coming months.

Overall, our base-case scenario is that Mexico will not be able to avoid tariffs next week, but a solution to the conflict will be reached in July, at the latest, with Mexico maintaining a constructive, non-retaliatory stance. This suggests that even though we are likely to see further intense selling in financial assets, the sell-off should be relatively short-lived, ie, it should correct once an agreement is announced.

We also assume that the USMCA is likely to be approved by the US Congress, but it's clear that uncertainty regarding that has increased, which should continue to weigh on Mexico's business environment and produce a more lasting damage to Mexico's medium-term outlook.

### Author

#### **Gustavo Rangel**

Chief Economist, LATAM

+1 646 424 6464

[gustavo.rangel@ing.com](mailto:gustavo.rangel@ing.com)

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