

Mexico: Lower growth to pressure ratings but prudent Banxico should support peso

Domestic policy uncertainties and the perception of an anti-business bias by the government are continuing to weigh on Mexico's economic prospects. We see a sharply higher risk for a technical recession and have revised our 2019 GDP growth forecast down to 0.7%



Weaker economic activity and a dovish shift by the Federal Reserve now point to a cut at the 15 August Banxico policy meeting. That said, a prudent course and the high rate differential with the US should remain stabilising factors, keeping USD/MXN trading in a 19-19.5 range.

As a crucial element in Mexico's energy policy, investor focus has recently been on PEMEX. The recently presented business plans have been largely met with scepticism, with the consensus looking for further downgrades. This could have substantial ramifications should PEMEX lose investment grade status (currently rated currently Baa3/BBB+/BB+), probably triggering forced selling of more than US\$10 billion in bonds and weighing on future financing costs of the company and the sovereign. Among the drivers that could see PEMEX losing investment grade status, a sovereign-induced downgrade at Moody's (from A3 to Baa1) by year-end would have an almost

certain knock-on effect on PEMEX being cut to Ba1 (from Baa3).

Energy policy drives concerns with regard to investments and PEMEX

President López Obrador (pictured) took office with a focus on re-orienting private and public-sector relationships and redefining the roles each would play in the coming years. So far, the focus has been on questioning existing agreements and a preference for state ownership in the systemically important energy sector, after the brief opening overseen by the previous administration.

Among the chief initiatives announced since taking office were the termination of the construction of the new Mexico City airport, the cessation of future rounds of oil exploration auctions, the announcement of fiscal support to PEMEX, and the decision to seek arbitration remedy against gas pipeline owners, in hopes of better terms for the state-owned power utility.

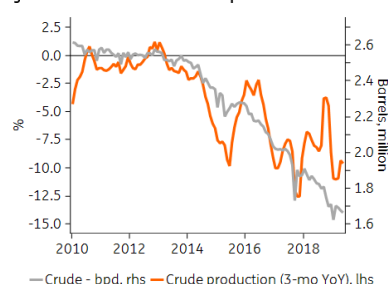
The consequences of these actions were: the deterioration in the outlook for private investment and GDP growth, financial market instability and credit rating downgrades for the sovereign and for PEMEX, due to the weaker fiscal stance and perception of misguided corporate strategy.

The recent abrupt resignation of Finance Minister Carlos Urzua also served to highlight the growing divergence of opinions inside the cabinet, with energy policy appearing a particular source of contention. Known for his commitment to sound fiscal policy, Urzua's exit highlighted the risk that ideology is prevailing over pragmatism, raising the risk of unpredictable and heavy-handed domestic policy decisions, dampening the outlook for business sentiment and fiscal policy in the foreseeable future.

Getting energy policy right is crucial because it affects all major aspects of Mexico's macro outlook. Over the past five/six years:

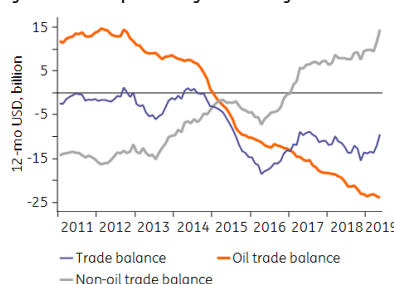
- 1) oil production has fallen by 34%, exacerbating the drop in PEMEX's contribution to the government's budget, which fell by almost 40% (in real terms)
- 2) output from PEMEX's refineries has dropped by almost 50%, dragging industrial activity sharply down over the period
- 3) the oil-sector external trade balance has deteriorated by more than US\$30bn in annual terms, moving from a US\$9bn surplus to a US\$24bn deficit, damaging the outlook for external accounts.

Fig 1 Persistent decline in crude production



Source: Macrobond, ING

Fig 2 Oil consumption now generates large trade deficits



Without private sector investment in energy, it's unclear the government and PEMEX would have the resources to alter this landscape in any meaningful way, without jeopardising fiscal sustainability. In fact, market reaction to the recently-announced business plan and government support for PEMEX, suggests that widespread scepticism continues to prevail.

According to its business plan, the government will support PEMEX with a total of close to 1% of GDP in tax breaks and capital injections during 2020-22. According to the company, this should help expand crude production at a double-digit rate annually, starting next year. As a result, PEMEX would completely reverse the output drop seen in recent years by the end of the AMLO administration, in 2024. The company also plans to keep debt levels stable and, after posting financial losses in recent years, the aim is to generate profits starting in 2021.

By relying completely on PEMEX, the government severely restricts the energy sector's potential to generate investment and, as a result, the risk is that Mexico's macro outlook will continue to deteriorate gradually. This reflects the greater downside to economic activity, and to the outlook for fiscal and external accounts, the latter also due to diminished prospects for foreign direct investment.

We are especially concerned about the outlook for economic activity, which has become the crucial near-term catalyst to watch, to assess the risk of additional credit-rating downgrades. Despite the public commitment to a sound fiscal trajectory, diverse fiscal priorities and lower GDP growth should increasingly test the administration's commitment to fiscal discipline.

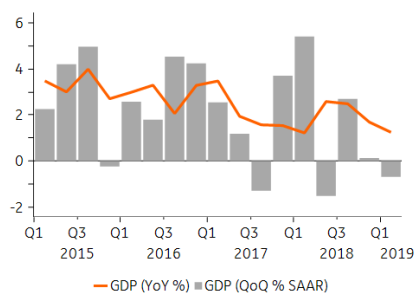
Risk of recession has increased, altering policy outlook

Heightened domestic policy uncertainties and the perception of an anti-business bias by the government helps explain the significant deterioration in the outlook for economic activity seen this year.

GDP contracted in 1Q, after staying flat in 4Q18, and recent data, especially the sharp drop seen in industrial production in May, suggest that the risk of another GDP drop in 2Q has increased sharply. The confirmation that the economy entered into a technical recession would, judging by recent public remarks, take the AMLO administration by surprise, and help extend the drop in growth expectations.

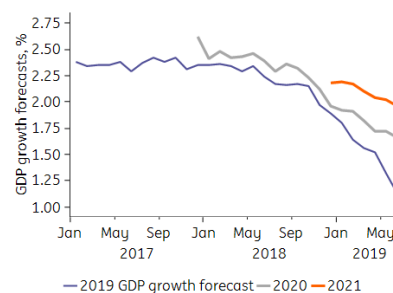
As seen in the central bank monthly market survey, 2019 GDP growth forecasts dropped 1.2ppt over the past year, from 2.3% to 1.1% now, and the bias is for expectations to drop further in the coming months, towards our new 0.7% forecast. As the chart below shows, 2020-21 expectations have also been contaminated, but have fallen more moderately so far.

Fig 3 GDP prints show activity on the brink of recession



Source: Macrobond, ING

Fig 4 GDP growth expectations turn worrisome



Apart from the poor dynamics seen in investment, discussed above, lower GDP growth is also consistent with the incipient signs of weakness seen in labour markets, together with the lukewarm bank lending data. Tight financing conditions also suggest that domestic consumption, which has been the primary and most consistent source of growth, is unlikely to make up for weakness in investment, while external trade should remain an uneven source of GDP growth.

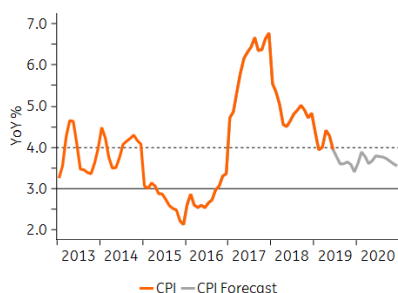
Overall, recent decisions added material downside to Mexico's economic growth outlook, and complicated the assessment of Mexican financial assets, including FX, which remains a crucial driver for monetary policy in Mexico.

Citing sticky inflation and the elevated policy uncertainty, the Mexican central bank (Banxico) has, until now, resisted calls to ease monetary conditions. It appears, however, that growing evidence of weakness in economic activity, and the dovish shift by the US Fed are now tipping the balance in favour of rate cuts. Judging by the bank's latest statements, it now appears likely that Banxico should cut the highly-restrictive 8.25% policy rate in its 15 August meeting if: (1) FX dynamics remain relatively stable, (2) near-term inflation trends match the bank's forecasts, and (3) the US Fed eases on 31 July.

With inflation consolidating inside the targeted range during 2H, Banxico would have considerable room to ease policy conditions beyond any move implemented by the Fed. However, persistent risks of financial market instability triggered by PEMEX/fiscal concerns, or renewed US-Mexico trade-related tension, suggest that bank officials should proceed cautiously.

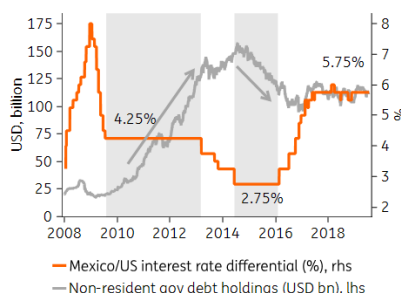
The neutral level for the nominal policy rate is likely close to 6%, but FX considerations will remain crucial in Banxico's reaction function. In practice, central bank policy should continue to act as the chief anchor for the Mexican Peso. As a result, a critical element in Banxico's assessment of FX risks will be the level of Mexico's interest rate differential with the US, with policymakers aiming to maintain a large interest-rate differential between Mexico and the US, to keep local assets attractive and prevent outflows.

Fig 5 Inflation should finally consolidate within the targeted range during 2H19



Source: Macrobond, ING

Fig 6 Mexico/US interest rate differential to remain high even with 75bp in cuts in Banxico



As seen in the chart above, Banxico increased that differential from a low of 2.75% to 5.75% now. This relatively high differential has been in place for more than two years now, a period that coincided with fairly steady non-resident holdings in the local market, as also seen in the chart. As a result, we believe this high rate differential has played a critical role in the stabilization of the MXN over the past couple of years, a period of heightened uncertainty north and south of the border.

It's unclear if an "ideal" rate differential level exists. But, looking over the levels that prevailed over the past decade, two levels stand out to us. The first is 4.25%, which prevailed over a long stretch from 2009-13, and coincided with substantial foreign inflows and a largely stable peso.

The second is 2.75%, which prevailed from mid-2014 to early 2016 and was, arguably, seen as too small a differential that left the peso especially vulnerable, coinciding with substantial outflows and the subsequent FX sell-off.

As a result, considering the heightened level of uncertainties often highlighted by Banxico officials, we would expect the bank to prefer to keep that rate at least above 4.25%, which implies a cycle of 150bp beyond what the Fed does. So, assuming a 50bp cut by the Fed in the coming months, Banxico could, in principle, consider a cycle as large as 200bp (to 6.25%) and still possibly provide enough cushion to bolster FX stability.

This compares with the curve pricing close to 50bp in cuts by year-end and a total of about 175bp by mid-2021. Analyst surveys show, meanwhile, a considerably shorter cycle, of between 100-125bp in the same time period, with a majority expecting just one 25bp cut before year-end.

Persistently high macro uncertainties suggest that Banxico will prefer to proceed with caution. Rate cuts by the Fed should provide windows of opportunity for the bank to re-calibrate its policy rate sooner than surveys indicate, with a cut in August for instance. But we believe the bias is for a much shallower cycle than the yield curve is currently pricing. For now, we believe a moderate cycle of 100-125bp, which would bring the policy rate to 7.25-7.0% over the next couple of years, should be considered an appropriate trajectory.

For the Mexican peso, even though the risk of episodes of high volatility remains high, as seen in recent months, our expectation is that high interest rates should remain an important stabilising factor, which should keep the USD/MXN trading near-equilibrium, in the 19-19.5 range in the foreseeable future.

Fitch downgrade leaves PEMEX bonds in state of limbo

The latest rating actions saw Fitch cutting PEMEX's rating by a notch to BB+ (from BBB-) on 6 June and Moody's placing the company's Baa3 rating on outlook negative (from stable) a day later. Both decisions coincided with similar rating actions on the Mexican sovereign on 5 June (Fitch downgrade to BBB and Moody's outlook revision to negative).

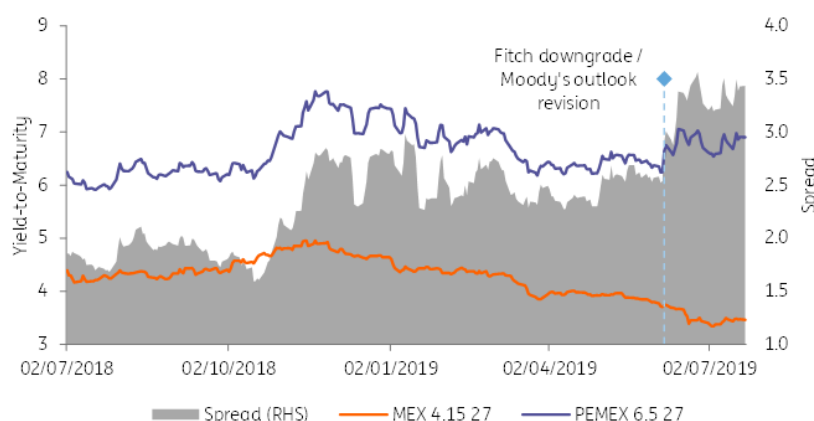
Looking beyond the surface, Moody's and Fitch's rating actions however went a step further to also reflect PEMEX's weakening standalone credit profile:

- Moody's cut the Baseline Credit Assessment (BCA; i.e. the company's standalone rating) to caa1 (from b3) on "ongoing negative free cash flow at PEMEX and declining proved reserves, despite efforts to cut costs and boost capital spending".
- Fitch highlighted PEMEX's severe underinvestment in its upstream business "which could lead to further production and reserves decline", as well as pressure on cash flow generation and reinvestment ability due to "very high level of transfers" to the government. In contrast to the sovereign, PEMEX's outlook therefore remained on negative (vs stable for sovereign) to reflect the potential for a deterioration of the company's stand-alone credit profile (SCP) from currently ccc.

The downgrade by Fitch has left PEMEX bonds in limbo: With only two investment grade ratings (Baa3 at Moody's and BBB+ at S&P) and negative outlooks across all three rating agencies, PEMEX is at risk of further downgrades and the loss of its investment grade status.

Concerns thereof have arguably weighed on PEMEX bonds for some time now, given the company's gradually deteriorating operational profile and a more ambitious energy policy under the current policy administration. Nonetheless, the recent rating actions bring us a step closer to such a scenario and we have therefore seen a further increase in the spread differential between US\$-denominated bonds of the Mexican sovereign and PEMEX (see chart below for yield differential between MEX 4.15% 27 and PEMEX 6.5% 27 widening from c.2.5ppt to nearly 3.5ppt).

Fig 7 MEX vs PEMEX: Spread differential widens on recent rating actions



Source: Bloomberg, ING

Base case sees Moody's downgrade in late 2019

Among the drivers that could see PEMEX losing investment grade status, we consider a sovereign-induced downgrade at Moody's as the most likely path. The rating agency rates the sovereign and PEMEX at A3 and Baa3, respectively. The negative outlook in place since early June provides Moody's with a period of up to 18 months to "assess the credit consequences of the uncertainties and tensions inherent in government policy and their interaction with investor sentiment."

Since then, Urzua's resignation and the PEMEX business plan have added further pressure albeit still insufficient to trigger an imminent rating action. As our base case, we see a Moody's downgrade by year-end on a combination of lower growth expectations and a weaker fiscal trajectory. Notwithstanding, we believe there is a chance for an earlier downgrade by S&P although less consequential as both, the sovereign and PEMEX's ratings, are firmly in investment grade territory (BBB+).

Most notably, persistent domestic policy uncertainties and a looming contraction in 2Q GDP would further weigh on growth expectations going forward and leave Moody's growth forecasts of 1.5% in 2019 and 1.8% in 2020 appearing too optimistic (1.8% and 2.0%, respectively, for S&P). Externally, US trade and immigration policies continue to pose risks for Mexican trade and sentiment.

The combination of a subdued growth outlook, social policy priorities and required support for PEMEX beyond current commitments will further test the government's commitment to fiscal discipline and increase the risk of policy mistakes.

PEMEX's loss of investment grade status has far-reaching consequences beyond outflows from rating constrained investors:

- **Outflows:** PEMEX has c.US\$81bn of bonds outstanding (thereof c.89% in FX), with US\$-denominated bonds forming part of the J.P. Morgan EMBI Global and Bloomberg Barclays US Aggregate Bond (US Agg) indices and sub-indices. Funds following the latter benchmark and other institutional investors face rating constraints, meaning that the loss of investment grade status would trigger forced selling. In a simple exercise, we went through the top 200 funds with the largest ownership of PEMEX \$ bonds in Bloomberg which are reported to own a combined 30% of \$ bonds outstanding. Among them, investment grade funds hold more than US\$7bn in PEMEX bonds. While this exercise provides an incomplete picture (not least due to the backward looking nature and a skew to larger benchmark funds), this points to us that the amount of bonds at risk of forced selling is north of US\$10bn, consistent with figures [stated by the FT in the US\\$10-15bn region](#). Additionally, we are also likely to see forced selling in PEMEX €-denominated bonds. Assuming the supportive market backdrop holds, demand from EM investors will mitigate the impact albeit insufficiently given the large amount of bonds expected to be sold.
- **Increasing financing costs for PEMEX and the sovereign:** The deterioration in the credit profile has weighed on financing costs of PEMEX, with the yield on PEMEX 6.5% 27s US\$-denominated bonds having increased from 5.5% in early 2018 to currently 6.9%, trading in line with B rated sovereign/quasi sovereign issuers. With the risk premium vis-à-vis sovereign bonds having increased and likely to remain elevated, it becomes more pragmatic for the government rather than PEMEX to incur future investment and debt burdens. In line with this, we note that PEMEX has abstained from the primary bond market this year to raise a syndicated loan instead (US\$8bn in June). All in all, PEMEX's high leverage and punitive financing costs imply increasing government support for PEMEX and fiscal indebtedness, which should also weigh on financing costs for the sovereign further down the line.