# The next stumbling block for the Mexican peso

As the peso recovers from Trump's unexpected presidential win, could forex drivers be the next stumbling block

## What happens if investor appetite weakens

The recent improvement in the Mexican economy's fundamentals, such as stronger-than-expected GDP growth and strict policy decisions have contributed to the Mexican peso's (MXN) appreciation. In particular, the high interest rates should continue to keep the peso among the most attractive carry trades across emerging markets, extending foreign inflows, as long as risk appetite remains healthy.

A potential deterioration in the willingness to take risks is perhaps the greatest short-term threat to the peso valuation. In particular, the heavy reliance on foreign inflows to finance the current account deficit, together with foreigners holding large investments in the peso, suggest it would be one of the most affected emerging market currencies if investors become more risk averse.

Foreign inflows into the local government debt market have stabilised after the first-quarter surge, while data provided by exchange operator, the CME Group, shows a remarkable rise in speculative long-MXN positions in recent months. Outstanding long-MXN speculative contracts at the CME are trending close to the highs seen in mid-2014, both in absolute terms and as a percentage of open contracts.

## Can the peso continue to push higher

In the near term, if the risk appetite remains consistent, the Mexican peso should continue to benefit from investors seeking higher returns. Investing in the Mexican peso is also supported by the attractive carry and the lower volatility of the currency compared to, for instance, the Brazilian Real (BRL).

In such a scenario, the exchange rate of the US Dollar against the Mexican peso (USDMXN) could still move towards the 17-17.50 range over the next couple of months.

## NAFTA and election uncertainties all spell volatility

However, the currency could become more volatile towards the year end, as current valuation assume a very favourable outcome on two key challenges looming ahead:

- NAFTA negotiations
- 2018 election uncertainties

Thanks to the policy adjustments, Mexican assets should still perform well, even if either of the above factors turns out to be less favourable than anticipated.

But local assets would still underperform if there was a more confrontational or delayed NAFTA negotiation. Financial markets should also become more sensitive to electoral polls early next year and could fall if the left-wing candidate, Lopez Obrador, gains the upper hand. The heated rhetoric surrounding US-Mexico relations could give Obrador a significant advantage and a decent chance of winning this time around.

> *The reliance on foreign inflows to finance the deficit makes the peso highly vulnerable if investors become more risk averse*

This suggests the peso could depreciate further closer to year end, with the pair probably ending the year in the 18-18.50 range. But the first half of 2018 could prove to be the most problematic when the currency could return to the 19-20 range due to increasing electoral uncertainties. Following the elections on July 1, 2018, and assuming a market-friendly result in the presidential race, the peso could gradually return towards its medium-term fair value, close to 18.

## Peso movement will dictate policy changes

Given that Mexico's monetary and fiscal policy adjustments are now likely near the end, Banxico should be able to launch a gradual rate-cutting cycle only after July 2018.

With the US Federal Reserve continuing to raise rates in the foreseeable future, Banxico will be forced to remain cautious, lowering rates in 25 basis point increments, which could result in up to 100bp rate cuts during the second half of next year. The frequency of the cuts, or the total number of cuts, should mainly depend on movements in the forex markets.

For now, we expect rate cuts to stay in the 50-100bp range during the second half of 2018, with concerns about Banxico Governor Carstens' replacement in November adding uncertainties to the rate-cut outlook. The local yield curve seems fairly priced, with 65bp in total cuts priced for the second half of 2018.

## Our view

We think bank officials should downplay the risk of a quick reversal in monetary policy even though investors expect such a rate reduction shortly simply because the uncertainty of next year's elections will make the peso even more volatile therefore ruling an interest rate cut until August 2018.