

## Here's why we should not get too down on Mexico

We offer a contrarian view on how to deal with judicial reform. Can things go wrong? Sure they can. But for that to happen, the mapping of the bad smell from judicial reform would need to be tracked to more definitive macro damage. So far the market has been presumptively assuming such damage. It shouldn't. At least not until the link is more clear cut



### Here's why the whole market is worried about Mexico, and why perhaps it need not be

It's not been easy to get enamoured with Mexico of late. Since judicial reform became the dominant narrative post the June elections, there has been a storm of negativity. And it's been practically unanimous, from sell-side research to academic thinking, all the way to relatively recent domestic protestation on the streets. Plus, Mexico as a credit has been in a slippery state for some years now. Remember, a decade ago Mexico was a solid single A-rated credit. It's now stretched through the BBB category for the three major rating agencies, and it might not take much in the current environment for one of them to go ahead and nudge Mexico into sub-

investment grade status.

The missing element here is the direct link to the economy. Such a link *can*, if needed, be mapped out. For example, external direct inward investment could be curtailed, delayed or abandoned, even if based on supposition. A souring in internal politics could manifest in damage to growth ambitions, and fiscal policy slippage. There is precedent. The tequila crisis of the mid-1990's coincided with political instability, a part-policy-induced-collapse in the peso and a spike in inflation to 50%, and, unsurprisingly, delivery of a sub-investment grade rating.

Mexico has been back at investment grade since the turn of the millennium. The big question now, with judicial reform ringing in our ears, is how bad things can get from here?

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*We ask a better question – is it right to automatically extrapolate negativity for the economy?*

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Key point – not all administrations that have done "strange stuff" result in a manifestly bad outcome for the economy. Many do of course. One could point to economic calamities of various guises in the likes of Argentina and Venezuela. And to an extent, the likes of Turkey. And in Latin America, the likes of Brazil has had its issues from the top down. On the other side of the coin, there are many examples of top-down policies that had a bad smell, but did not manifest in material damage to economies. In Europe, the likes of Hungary and Poland have had policies deemed against European Union ideals, frustrating receipt of EU funds; but not frustrating performance of respective economies. India is, in a way, another example.

Arguably, Mexico, even in previous years, has been another example of an economy that has had to deal with policy prescriptions that fall foul of the classic menu of liberal economics and solid law. But should we now argue that Mexico is about to lurch beyond the precipice. Or should we ask the following simple but critical question – is there a clear and present danger to the economy coming from judicial reform and the bad smell it leaves? Or should we not just hold our nose(s), and look at things in a more cold and calculated manner. Given what we know, we argue for the latter.

## **Here's how we build the base for a relatively constructive view, albeit based off technicals**

A first point of objective positivity centres on the protective screen being offered by the elevated policy rate. Banxico has done no more than match the Fed in the current rate-cutting cycle, delivering one 25bp before the Fed's 50bp cut, and one 25bp after. So the rate differential cushion remains as was. Based off the last decade and a half, we calculate that the Banxico policy rate differential versus the Fed funds rate is currently 0.8% above average. For Banco Central do Brasil (BCB), which has cut far more, it's -2.7%. Similar for the real domestic policy rate. For Mexico it's 4.1% above average. For Brazil it's 2.7%. These differences are in the region of 2-3%, and act as protective screens for Mexican assets.

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*There is a sizeable cushion in Mexico relative to Brazil on these*

*policy rate differential measures.*

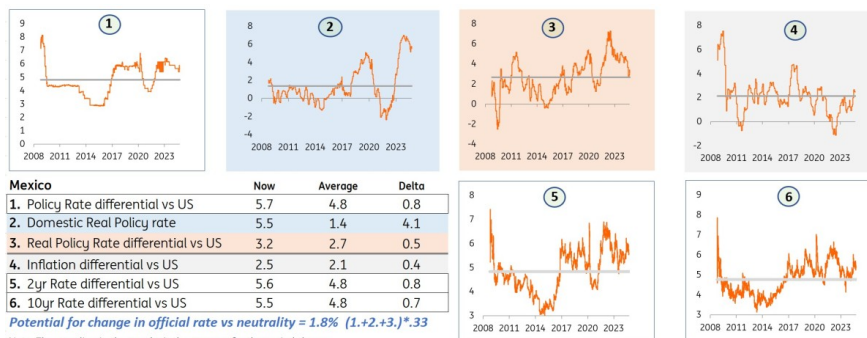
The counter argument is the Brazil policy rate, at 10.75%, is just 25bp above the Mexico policy rate at 10.5%. Based off that, is there a cushion? Yes. It's the 15yr average used as a reference that generates the cushion. For example, the average Mexico policy rate in the past 15 years is 5.9% – versus 9.7% for Brazil. It could be argued that those averages are overestimates for Brazil and underestimates for Mexico. However, current market circumstances beg to differ. The latest market discount has the Brazil policy rate under rising pressure while there is cutting pressure discounted for Mexico. Those structural averages are still doing their job.

In fact, our estimates identify an interest rate cushion in Mexico at around 1.8% (how that's calculated is shown here, and comes from the table below). In other words, Banxico could have its policy rate some 1.8% lower than it is now if it so chose. It tends to choose not to overdo it. We find that Banxico likes to have a cushion. Contrast that with Brazil where there is no cushion. Despite the fact that Brazil has hiked by 25bp recently even as the Fed cut by 50bp (implying a 75bp swing), there is a "cushion" of -0.3% (yes, negative). Our models are telling us that there is a circa 2% cushion in the Banxico policy rate over the BCB policy rate (despite the fact that the BCB rate is 25bp above the Banxico rate).

Why is this important? It provides important optics of prudent policy, and by extension, protection for peso assets. Beyond whiffy politics, this acts as a support.

**Here's how we calculate the Banxico cushion (now at 1.8%)**

One-third the rate difference to the Fed, one-third the domestic real rate and one-third the real policy rate differential to the Fed



Source: ING estimates, Macrobond

**We identify a protective cushion generated by Banxico, but we also see what the peso's been doing**

In many circumstances, having higher rates than necessary can be seen as a point of weakness. It can co-exist with a structural weakening in the currency, typically alongside an elevated inflation circumstance. But we don't view that being the case for Mexico, where the rate buffer is more a protective overlay, coming at things from a point of strength rather than weakness.

*If true, why then has the peso been under pressure of late? Fair question.*

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Key point – the movement of the Mexican peso has been back towards fair value. Essentially the judicial reform shenanigans have offered the peso an excuse to unwind some of the extreme richness that Banxico facilitated in the first place. We've not moved to the point where the peso is really running scared and building a risk concession. So far, this points to a glass half full outcome. Has net asset peso exposure been painful recently? Sure. But it can't be a huge surprise given its prior richness.

Importantly, market rates have not felt the need to ratchet higher. In fact, Mexican market rates have fallen relative to Brazilian ones for example, manifesting in Mexican rates outperformance. Specifically, long Mexico versus short Brazil in swaps have been performing, especially as these vanilla interest rate derivative structures don't have a material currency exposure. In contrast, for non-funded bond positions, there is an FX exposure, and these have been hurt by Mexican peso underperformance – as have cross currency derivative trades that ended up generating a synthetic peso asset. But most of the rot here may well be tailing off.

We see the peso underperformance of recent months. And we see how it has hurt net asset peso exposures (after a period of material FX outperformance; arguably overshoot). However, we also stand back and observe the relative stability in market rates. That in turn has been helped by the concession built from the Banxico policy rate. And looking forward we see a material discount for Banxico rate cuts ahead. And we continue to identify a cushion that can be eaten into.

In the background, to the extent that the Federal Reserve delivers some 200bp of rate cuts, we'd fully expect Banxico to deliver the same, if not more (given the cushion). Contrast that with Brazil where there is no cushion and an opposite discount (even on higher rates to begin with). And given that, we identify value in Mexican market rates. The tables above identify deltas in the region of 75bp. That's what can be achieved without an overshoot.

Can things go wrong? Sure they can. But for that to happen, the mapping of the bad smell from judicial reform would need to be tracked to definite macro damage. So far the market has been presumptively assuming such damage. It shouldn't. At least not until the link is more clear cut. A contrarian view? Sure is!

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