Mexico Trip Notes: What to Expect from the New Administration

CONTACTS

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- **How to sort political noise from actual policy priorities? It will be a bumpy road, but we were given some good ideas.**
- **Short term risks: Pemex, and execution. Long term risks: institutions—and potentially sovereign ratings. Key latent risks: can AMLO hold his movement together? How much further can the government's human capital be weakened and how does this affect implementation?**
- **Banxico's policy decision tree seems much more complex than markets seem to see.**
- **There is a scenario where Mexico could lose its investment grade in the next 6 years, but the administration must make several mistakes. This is by no means a base case.**
- **Opportunities: Developing south-east Mexico, and a larger domestic market.**

With the government crossing the official 100-day mark, we organized an investor trip to get an update of what the future holds in Mexico (we can argue it's been in power longer, as the Peña administration retreated ever since the July-2018 election). During a 3-day span, we met with senior officials at the Central Bank, the FinMin, leaders in the legislative, private sector leaders, the political opposition, and civil society—as well as members of the last administration. After the trip, we went on a 5-day roadshow to discuss the trip take-aways with global investors, on which we got additional sense of investor's sentiment. This note is the summary of the Mexico trip, and our notes from the road-show.

Two main challenges were constantly mentioned as urgent challenges: 1) solving the financial problems in Pemex—and avoiding a loss of the company's investment grade credit rating, and 2) restoring private sector confidence so that currently very weak investment does not cripple the new administration due to perpetually weak growth. In addition, we sense that the seemingly "consensus view" in markets that weak growth and falling inflation must lead to monetary policy loosening over the next year, risks falling flat, as the monetary policy decision making tree seems quite more nuanced.

In terms of longer term challenges, we see a couple of important issues to monitor: 1) how the loss of human capital in the government will affect the new administration's functioning, and 2) how much the country's institutions and checks & balances will be affected by the loss human capital—and by what seems to be a clear agenda in the new administration to centralize power. It's also a recurring local topic to talk about the difference between the Morena movement and traditional political parties—and the implications of this.

AMLO has named his government the 4T, and speaks about a 4th Transformation of the country… at times in the trip we got the sense that for some, 4T really stands for 4th Titanic. Which side of the debate is the correct one? AMLO wants to change many things about what Mexico used to look like, and has an ambitious agenda both for institutional, economic and political changes. However, it's worth always stepping back and asking 2 questions:

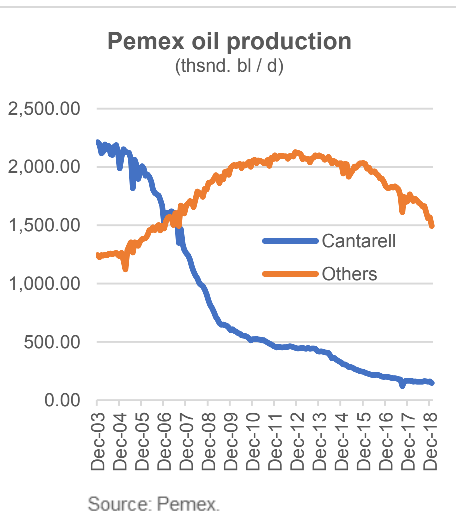
- Has change already happened, or is it merely a risk? What has been broken refers to things such as the Texcoco airport. What may be broken still applies to Pemex—more on this later. At the end of the day, the new administration has only been in power for 100-days, and although there seems to be an ambitious agenda to change the country—change is still mostly plan, and not yet a reality.

- Step back and think about the relevance of the measure—as many changes are drastic, but apply to marginally relevant sectors: key changes are often in areas such as energy policy and infrastructure, while drastic changes to marginal areas include some of the agricultural programs—which are too small to make a difference in the economy overall. Mexico has a large and diversified economy (of about US$1.2tn), and many of the new administration's plans are relatively marginal in their overall impact.

PEMEX: THE MOST URGENT PROBLEM

Pemex is quickly approaching the edge of the "loss of investment grade cliff", and its towering US$100bn of debt looms as the most urgent issue for the government to tackle. True, the AMLO administration did not "cause the problem", this has been an issue built up over a couple of decades of under-investment, poor allocation of capital, as well as over taxing the company. The decline of the Cantarell field (one of the two most productive oil fields ever discovered in the planet), has led to a major drop in the country's oil output. Whereas back in 2004, Cantarell used to produce 2.2mn b/d, it now contributes a marginal 150k b/d. This large drop in the super oil-field's output is the major reason why the company has lost such a large share of its once much more significant output, and explains part of the company's struggle. However, there are some reasons why, if the right decisions are made—and these are implemented correctly, Pemex can still step back from the brink: 1) Cantarell's output cannot drop below 0, meaning that once it gets to that level—and assuming the growth in other field output continues to rise—or at least remains stable, the Pemex story could improve somewhat. 2) even though the amount of investment necessary and the company's large debt service burden are estimated to eat up about US$10–US$20bn of capital per year (my colleague Joe Kogan put that number at US$14bn), the Peña Nieto energy reform gave the company some tools it can use to attract private investment—which could reduce the pressure on Pemex to raise its own investment rate—particularly given the so called "round-0" gave Pemex assets to put up for join ventures, and different models of joint production, etc.

Chart 1: Is there a chance for output stability post-Cantarell?



Source: Pemex.

Solving Pemex starts with very basic questions?

Ex-Cantarell, Pemex has actually managed to increase output since 2004, but production looks "investment dependent". Two key choices lie ahead for Pemex:

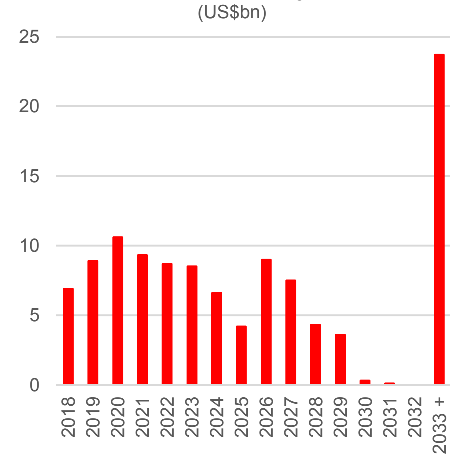
- Develop a flexible model for private sector to step in and invest what Pemex can't. This means potentially further flexibility for private participation. Our sense is this path is the more viable.

Provide enough relief for Pemex to become self-sustaining.

- Key additional questions remain:
- Is AMLO willing to let the private sector play a leading role?
- Does Pemex have the human capital it needs?

In the short term, there are several alternatives we see as possibilities for supporting the company, which include: 1) the government could use tax breaks to support Pemex—but this would imply either raising taxes elsewhere to compensate for lost Federal resources—which would mean breaking an AMLO campaign pledge, or contaminating the sovereign's credit. Given that estimates of the necessary support the company needs, the "contamination of the sovereign's balance sheet could imply either raising 1–2 points of GDP in extra tax revenues, which is not an easy task, or it could mean turning what is a roughly 2.5% of GDP deficit into a 3.5%–4.5% of GDP deficit. The later number could risk downgrades to the sovereign's ratings. 2) As a temporary "stop-gap", the government could decide to use its fiscal stabilization funds to provide short term support for the company. The funds currently have about MXN300bn (US$15bn), so they could not provide more than a couple of years of support. In addition, using "rainy day savings" for funding the company's debt service needs—as well as plugging holes related to what are seen as "political pledges without economic and financial support"—such as the Dos Bocas refinery plan AMLO pledged in the campaign—and apparently plans to move forward with—seems likely to further undermine the new administration's credibility. 3) A third alternative, and one we like better, would be to estimate what debt amount the company can carry, and execute a debt swap, where the government buys the predetermined amount of Pemex debt from those holders who tender at the most attractive level, and switch those for a basket of UMS / m-bonos. 4) another alternative that was mentioned, was taking a page out of some of the Brady bond restructurings, and guarantee Pemex debt with oil. 5) Finally, there is also the possibility that the sovereign could guarantee Pemex debt, which we fear would take away one of the few market discipline mechanisms the company has.

Pemex Debt Maturity Profile
(US$bn)



Source: Pemex.

Regardless which alternative is taken to fix the short term financing problems, the long term viability of the company must be addressed. Given that Pemex has not proven it has the capacity to develop more complex oil fields—which represent the majority of the country's oil, a model which makes private global players comfortable stepping in is critical. A first step in this direction is clarity on plans for the industry (investments don't like uncertainty), but next steps must include refining public-private involvement contracts, as well as restarting the oil rounds—in their various forms.

A troubling development which arose from the energy sector, but which can have broader and worrying implications was the denial by President Lopez Obrador, of the postponement of the Dos Bocas refinery program, following suggestions of this possibility by senior FinMin officials. In an FT interview, Deputy FinMin Herrera said that to help support Pemex, the resources earmarked for Dos Bocas (a refinery estimated to cost US$10–20bn, but which is seen as unviable given an estimated IRR of close to 5%—for a company with a cost of capital north of 10%) could be used to prop-up Pemex. The postponement was seen as a good sign of pragmatism by the new administration. However, within hours, Energy Minister Nahle, and later President Lopez Obrador strongly contradicted the possibility. This decision by the Energy Secretary and the President have 2 concerning implications for market players: 1) it destroyed the nascent sign of pragmatism, and more importantly 2) it stoked concerns over how long the moderates in the cabinet will put up with a government that has now at least twice thrown what are arguably its most credible private sector players "under the bus": first, with Chief of Staff Romo, when the airport was cancelled, and now Herrera, with the Dos Bocas issue. The AMLO administration does not have too many market spokespeople, and these two issues undermine their credibility (a very risky path), and in an extreme scenario, could trigger their departure. The departure of any of the handful of officials that have market trust would be serious.

AIRPORT—THE EPIC MISTAKE, FROM WHICH THERE SEEMS TO BE NO DESIRE OF TURNING BACK

We did not hear a single convincing argument of why cancelling the Texcoco airport had any benefit, outside of the further solidifying AMLO's support among what is already the core of his supporter base. We think that if the new government wanted to rebuild investor trust, the masterstroke is to backtrack on the cancellation. Why?

- It could actually boost AMLO's popularity. Based on the latest poll by El Economista, the new government's LEAST popular decision was Texcoco. There is almost a 2:1 ratio of those who think it was a mistake vs those who approve.
- It would send investors the signal that AMLO can backtrack on mistakes, for the sake of what makes sense.
- The US$15bn project is estimated to have a 15% IRR—selling that concession would give the new government substantial financial firepower that could be used for other items in the AMLO agenda.

- However, this seems likely to be the AMLO administration's easy win, that is not to be. The responses we got from the government, when we asked if there was a sliver of chance that Texcoco could be revived, were resounding NOs.

THE CABINET GETS MIXED REVIEWS

The cabinet has mixed reviews, with some of the areas that are making the private sector increasingly nervous, including energy and labor policy. On the positive side, the Finance Ministry team is a bright spot, which has not only delivered strong results in its "traditional role", but has also proven valuable at putting out various policy-fires, including: 1) getting a friendly outcome with creditors of the cancelled Texcoco airport project, 2) converting the 10 point referendum that was held in November, into a relatively credible budget that helped restore investor confidence, and 3) the ongoing efforts to keep Pemex from sliding into a downward spiral. One concern is that with AMLO now overturning moderate pledges that investors have received well from the moderates in the Administration (i.e. the cancellation of the airport following Romo's comments that it would likely be a concession, and not postponing the Dos Bocas refinery after Herrera told the FT that it likely would be), the moderates may either depart the cabinet, or that their credibility will be weakened. Our sense from talking to investors across several countries is that Herrera's shoes would arguably be the toughest to fill for the AMLO cabinet, and that his departure would be the most costly for the new administration's credibility. Herrera has done a fantastic job as deputy-FinMin. On the rest of the cabinet, Foreign policy gets mixed reviews, with the more dangerous policy so far being the large number of refugees the country is getting seen as a political and security risk—although everyone agreed it's the right approach from a humanitarian side.

CAN MEXICO REALISTICALLY LOSE ITS INVESTMENT GRADE RATING OVER THE COMING 6 YEARS?

Yes, but by no means the base case—yet. Most agree that the line in the sand for rating agencies to cut Mexico to sub-investment grade is debt-to-GDP climbing above 70%. To get there, we think there are 2 major paths, and both require very poor decisions and implementation:

- Epically messing up energy: Mexico's debt/ GDP sits just south of 50%, and if the government has to step in and provide the necessary support of 1–2% of GDP to Pemex on an annual basis, the public deficit would rise to 3.5%–4.5% of GDP. For this, we need to assume that the government does not trim spending. Adding to this, if confidence fades, and debt service costs rise (say another 50bps—100bps of credit premium), getting to 70% debt/GDP can be managed, but it would still require additional help from other public finance shocks—such as allowing Pemex production to keep falling due to poor investment decisions which add to the amount of support the company needs. We see this scenario as requiring an epic amount of energy policy mis-management, and also requiring a poor fiscal policy response. We assign a very low probability to this path, based on what we've seen so far—particularly given the FinMin staff has proven very competent.

- The mixed shock approach to losing investment grade: a more plausible scenario is a combination of the government needing to step in with most of the recurring US$10bn–20bn of support for Pemex, combined with the government failing to restore private sector confidence—leading to very weak investment, which eventually contaminates employment, and with it consumption. This negative growth spiral can lead to the type of depressed growth environment we saw in Brazil the past few years. Persistent low growth contaminates fiscal accounts, and can lead to adverse debt dynamics, particularly if low growth is accompanied by a high interest rates environment as monetary policy is needed to keep financial stability—and investors fail to see a credible positive confidence shock. This can be further complicated if the cabinet's market contact points have their credibility undermined by events such as the airport and Dos-Bocas refinery communication mis-steps. For this scenario to materialize, we need to see poor energy policy management, erratic decisions on labor policy (such as the issues we are seeing in the maquila industry in the north—discussed later—spreading more broadly, and bad infrastructure decisions (i.e. Texcoco) to remain the norm. While this scenario is possible, we assign a low probability to it still.

Taking this into account, we'd say a loss of investment grade for the country over the next 6 years at this stage looks difficult. However, if it does arrive, the shock would likely prove massive, as our estimates suggest that out of the roughly US$180bn of m-bonos held by foreigners, about half would not be able to hold onto the bonds, while at the same time, we doubt the IMF would renew the Flexible Credit Line (FCL) for a country that implemented policies that led to an investment grade loss. The combination of massive capital outflows, and the loss of the US$90bn of FX liquidity the FCL loss would entail is the financial market equivalent of a nuclear meltdown for Mexico. Fortunately, this scenario for now looks far fetched—even if a path to it, is imaginable.

BANXICO: THE PATH TO RATE CUTS IS MORE NUANCED AND UNCERTAIN THAN MARKETS SEEM TO BELIEVE

At this point in time, markets are assuming that because growth looks quite sluggish (potentially a negative print for 19Q1), and inflation is falling rapidly, it's a given that a monetary policy easing cycle will kick-off at some point in 19H2. While we don't dismiss the possibility that Banxico will eventually cut (markets have over the past couple of weeks priced-in cutting of nearly 100bps in the next 2-years), we think that for now, the bank is still quite cautious. Why?

- It's not clear that the current slowdown can be addressed by rate cuts: at this point in time, the drivers of the Mexican deceleration seem to be: 1) an uncertain policy and business environment paralyzing investment (the cancellation of the Texcoco airport doesn't help the public sector's contribution to investment), and 2) slow execution of the budget by the new administration (which hopefully starts getting reversed in 19H2). Can these two adverse growth shocks be corrected by monetary policy? We doubt it, and our sense is that senior people at Banxico share the view.
- Banxico has more limited tools: Ever since Mexico's oil trade balance swung into negative territory, replenishing spent FX reserves is tougher (most of the reserve stockpile was accumulated from oil trade surpluses). The central bank added NDFs to its policy tool-kit, but these should be less effective than spot intervention in FX. Having less ammo suggests it's wise to be more cautious with its use.
- Chasing inflation is costly: Given the narrow channel through which rates policy transmits to the economy (credit/GDP just north of 40%), it's risky for Banxico to fall behind on inflation fighting. Hence, patience is warranted to make sure inflation will indeed continue dropping. The stickiness of high-ish core-inflation is a lingering concern.
- Uncertainty over Mexico's right "risk-premia": It's not clear at this point, how much Banxico can cut rates without risking destabilizing MXN. There have been quite a few negative shocks to Mexico-sentiment, yet MXN has proven remarkably stable. This stability is likely dominated by the peso's high carry. Would cutting rates make the peso more vulnerable? We think it would.

Can Banxico cut rates, without risking MXN volatility rising? If the peso sells-off, how much FX-inflation pass-through can we expect? Can we expect a scenario where growth does not improve despite rate cuts, as the policy environment remains uncertain, but at the same time a sliding peso stokes inflation? In that scenario, does Banxico get forced to undertake another tightening cycle? To us, all these questions mean that for Banxico, patience is now a very valuable virtue. We would not be surprised if Banxico stays on hold longer than markets currently expect.

AMLO'S MORNING RESPONSE TO TRUMP'S TWEETS, AND MORENA'S "DEMOCRATIC USE OF THE MICROPHONE" IN THE LEGISLATIVE

In several meetings, we head concerns related to AMLO's daily morning press-conferences, where he addresses difficult to predict topics, adding a lot of uncertainty. These are akin to Trumps tweets in the sense they provide guidance for the media and market discussions, without traditional policy and institutional filters. Will, as happened with Trump's tweets, AMLO's press conferences lose importance with time? AMLO's conferences have the risk that much of the content is driven by reporter questions, which is seen as adding the risk that decisions are taken in important topics, without serious previous discussion within the cabinet. One clear example of this risk triggering negative shocks to markets and investment is the recent episode where the postponement of Dos-Bocas was derailed. AMLO seems to have strong opinions on a very wide range of topics, without always having deep knowledge of the policy world related to said topics. This in turn carries the risk that decisions can be made on topics that are serious—but without an adequate consideration of the path that needs to be taken, and the consequences of such decisions. A question that follows from this issue is "Can AMLO reverse decisions that are seen as mistakes?". That question is among the most important to determine the outcome of the current presidency, and so far, evidence is mixed:

- AMLO the pragmatist: AMLO initially said the energy reform would be fully reversed. However, his stance on the topic has materially softened, with the potential for new private sector participation rounds still in play. An additional issue where AMLO has toned down in the face of pressure was refineries, where he initially spoke about 5, but then toned down to 2 (Campeche and Dos Bocas in Tabasco), and now seems to see only 1. A third moderation was the airport, where the first reaction was to push for steeper hair-cuts for bond-holders of Mexcat bonds, before a more pragmatic negotiation took place.

- AMLO's darker side: the airport cancellation was one of the areas where a bad decision was made, and AMLO did not show the capacity to re-consider. A second episode appears to have taken place last week, when the Dos-Bocas postponement saw the door shut in its face.

Which side of AMLO will win? Our sense is that things will likely continue as they have done—we'll sometimes see pragmatic AMLO, and sometimes the more ideological side. This means that policy uncertainty will likely remained a constant problem for investment. One way this should be reflected is through a higher hurdle-rate for investment, leading to a lower overall private investment rate. A key date to monitor whether AMLO is willing to hurt his political base, for the sake of the overall well-being of the country is expected to come in the next couple of months, when the bill to repeal the previous administration's Education Reform. The key points to watch are: 1) will AMLO deliver to the teachers' unions their desire to scrap evaluations that seek to ensure teachers actually know what they are supposed to be teaching (because teacher positions were inherited, many teachers have no teacher training and weak academic knowledge), and 2) will AMLO give the unions back control of the budget, to as was the case, use education money with full discretion and no transparency. The way the education reform is unwound will give us a clear signal of how much of the country's future AMLO is willing to sacrifice for the sake of delivering on promises to his core political base.

Morena's democratic-microphone in the legislative is another angle where the way politics works within Morena generates lots of uncertainty. What do we mean by this? We need to start by seeing Morena more as a broad based social movement, as opposed to a more organized political party. One of the problems with this lack of party discipline, is that the more radical parts of Morena keep sending legal initiatives to Congress that cause lots of uncertainty (i.e. the bank commission bill in December, and the rating agency bill last month), even when they sometimes are not really part of the party's agenda. One filter that was suggested to us in order to identify what is noise, was looking who signed the bill. Initiatives that are a core part of the party's agenda are likely to be backed by a broader set of legislators.

DON'T FORGET MEXICO IS PART OF EARTH

On top of the domestic questions, there are several external sources of uncertainty that were recurrently mentioned as risks, with the major one we fear being USMCA approval. The logic of this concern flows along this line: the first debate of the Democrat party election in the US is taking place June-2019. At this point in time, polls suggest former VP Biden is the clear front runner, with around 30% of voter intentions. Biden is also among the more pro-trade of the current list of potential contenders, which suggest there is at least a risk, that with Biden being the front runner—and likely target of attack from the rest, trade could become a politicized topic in the primaries, putting USMCA approval at risk of delay if it's not ratified by June. Ultimately, we think USMCA will be ratified, but uncertainty related to its politization could created waves for Mexican markets. Don't forget that NAFTA has usually been a political piñata in US elections: Clinton campaigned against NAFTA (to later ratify it), Obama was also critical of NAFTA in the campaign (his "update" of the deal was seen as TPP), and Trump also used the deal as electoral ammo.

Besides the risk of USMCA uncertainty coming back, we can't dismiss the possibility that other shocks could complicate fiscal and economic dynamics in Mexico, with contenders that were mentioned including, but not limited to: EM capital flow shocks, uncertainty over US monetary policy, Brexit being more disruptive than currently reflected in markets, global protectionism, a global/US economic slowdown more serious than that we currently expect.

Bottom line: I wish that the crystal ball were less cloudy, but at this stage the most we can honestly say is: there are too many pieces on the board, and too many players moving them to make an accurate read of how things will play out. However, it's hard to build a story of why today Mexico is a more predictable country, with a more stable economic and financial outlook than it was 1-year ago. The strong mandate AMLO was given by voters means that on one hand, he has political legitimacy to implement change (which was after all a large part of the presidential campaign's theme), and an ambitious agenda to implement social and political institution re-design. Change will create opportunities, but it also entails a material amount of risks. At this point in time, we see the biggest opportunities for upside surprises being related to growing the domestic market (through social transfers and developing the South East of the country—the poorest and least productive part)—but for that to happen, both the policy design and implementation needs to work—both of which have material downside risks at this point in time. One early area which already seems to be experiencing negative pressures is institutions and counter-balances, not only because of government's agenda to re-centralize power (not unlike PRI practices of the 1970s), but also due to the use of "public consultations" outside of the legal referendum law, and because the new administration is using direct adjudications of projects as opposed to open bids relatively often—which are less transparent.