

## Mexico: Initial Thoughts About the Gasoline Shock

- A good cause gets messy due to improvisation?
- How is Mexico-sentiment holding up?

### A GOOD CAUSE GETS MESSY DUE TO IMPROVISATION?

*“Hell is full of good meanings, but heaven is full of good works” – Aphorism*

The main story in Mexico this week is the growing problems in gasoline supply. The government launched a campaign to fight fuel theft, which involved shutting the main pipelines that supply gasoline to Mexico City and the Bajío region, which is increasingly seen as a major risk to both growth and inflation for 2019—as its driving important problems in gasoline supply. The scarcity is leading to large lineups in petrol stations, shutdowns of large shares of the gas-stations in important cities, and in some cases lines of several hours to fill a tank. We have also heard anecdotal evidence of gasoline theft affecting private citizens.

At this stage, it's hard to put hard data to this issue, but we have heard lots of anecdotal evidence from different sectors of disruptions in their business, including some in the agriculture world, who are seeing risks in losing part of their crops due to higher freight costs making selling their products unviable. The 10 states affected, where gasoline supply has been restricted for over 2 weeks in some cases, represent around 45% of Mexican GDP, and in most cases, are also among the fastest growing entities in the country. We don't discount this shock having simultaneous downward pressure on growth, and upside pressure on inflation. If the shock last 2–3 more weeks (twice its current duration), 10% of the year would see disruptions to activity and prices in states that represent 45% of national GDP.

So far, disruptions have lasted about 2 weeks, but some comments from the government suggest that reduced dependence on pipelines for gasoline transportation may be here for some time: such as reports yesterday of plans to buy 500 gasoline trucks to substitute gasoline movement through pipelines, and plans to move gasoline by train. Some estimates we've seen / heard, suggest that moving gasoline by truck, as opposed to pipeline, could push prices at the pump up by up to 3 pesos per liter (about 1/7 of the current price).

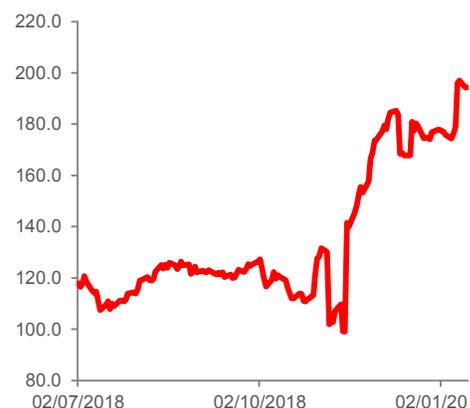
An interesting read, to get a sense of why this decision has been a strong irritant in the country, is Monday's article (in Spanish) by local columnist Raymundo Rivapalacio—[linked here](#). Basically, one of the issues is that this once again appears to be an issue of a good cause ([about 90% of Mexicans back the decision to fight fuel theft](#)), turned into a nightmare due to improvised actions and lack of expertise (the cancellation of the Mexico City Airport was another which was taken against the recommendations of experts). At this juncture, there does not appear to have been prior infiltration of criminal organizations before carrying out the pipeline shut-downs, and it also appears that the government did not approach other countries where this battle has been waged to draw upon their

### CONTACTS

**Eduardo Suárez, VP, Latin America Economics**  
 52.55.9179.5174 (Mexico)  
 Scotiabank Economics  
[eduardo.suarez@scotiabank.com](mailto:eduardo.suarez@scotiabank.com)

Chart 1

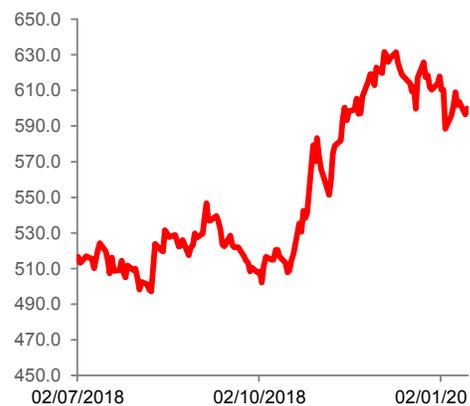
#### Pemex-UMS Spread (5yr CDS)



Sources: Bloomberg, Scotiabank.

Chart 2

#### Mexico - US 10yr Swap Spread



Sources: Bloomberg, Scotiabank.

expertise (i.e. Colombia). Hence, as opposed to previous energy related raids (such as the termination of Luz y Fuerza del Centro, which was meticulously planned over several months, and contingency plans were set up—this time around, the gasoline scarcity shock is largely the result of a good cause being undermined by sloppy execution and planning. A local concern is that outside some exceptions, the country is in the hands of people with limited experience and technical knowledge, for roles that are technical in nature, such as last week’s roadshow in NY (see below).

### HOW IS MEXICO-SENTIMENT HOLDING UP?

Mexican assets have had a fairly volatile couple of months, with the Mexico City Airport project cancellation kicking off a bout of risk aversion, followed by relief when an agreement was reached with MEXCAT bondholders and a fairly prudent budget was submitted. However, relief proved short-lived followed by another bout of concerns over recent energy related trouble. The energy related turmoil is the result of the gasoline distribution shock we discussed above, plus a road-show gone awry that Pemex had in NY last week—where global media cited participating investors as coming out concerned from ([see here](#)).

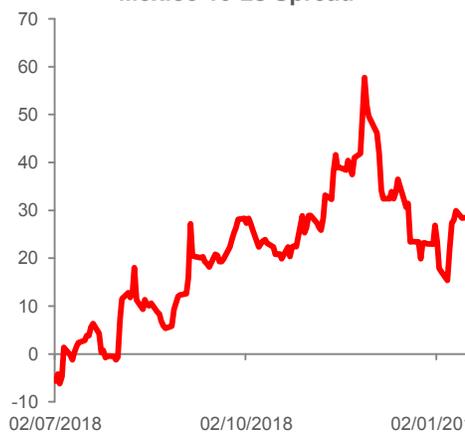
Looking at a few “sentiment indicators”, we see that Pemex centric concerns are now at the top of where they’ve been since last July’s Presidential election. This comes back to the twin shocks we mentioned. Simultaneously, the spread between Mexican and US 10 yr yields is also near its widest since last July (we go to the long end, to reduce distortions due to current inflation dynamics—focusing instead in long term inflation premium and credit premium). This suggests that despite the MEXCAT bond resolution, we still face jittery markets. The last indicator we look at today is the Mexican yield curve slope. The slope has once again started steepening—despite the high overnight rate from Banxico—suggesting there are some concerns either due to credit spreads, or alternatively we could see some inflation concerns in the longer end of the curve. Still—this last indicator is much lower than its post-election highs. Overall, we believe the epicenter of investor concerns regarding Mexico is the energy sector, but the sovereign is not immune, as among other risks—a loss of investment grade at Pemex looks like a much nearer-term risk that a sovereign downgrade—but a shock to Pemex is hard to envision not hitting the sovereign.

Our sense at this point, is that volatility in Mexican markets will be higher than normal, as markets need to adjust to a new reality of less policy predictability. Once this lower predictability is absorbed, we will have a clearer idea of what the new price for Mexican assets should be.

On the currency front, MXN has staged a dramatic comeback, from the sell-off that was triggered by the cancelation of the Mexico City airport. Since the airport referendum announcement, to the days following the announcement of the project’s cancellation, USDMXN went from 18.75 to 20.65 in early December, but the cross has recovered to close to its starting point, trading around 19.0 at this time. What was behind this rebound in the peso over the last month? We think there are 3 main factors: 1) the carry on MXN makes it expensive to short it, and attractive to own it, 2) the MEXCAT bond agreement, and a sensible budget for 2019 lifted investor sentiment, and 3) a much less hawkish consensus on the Fed—but without recession fears triggered strong EM appetite.

Chart 3

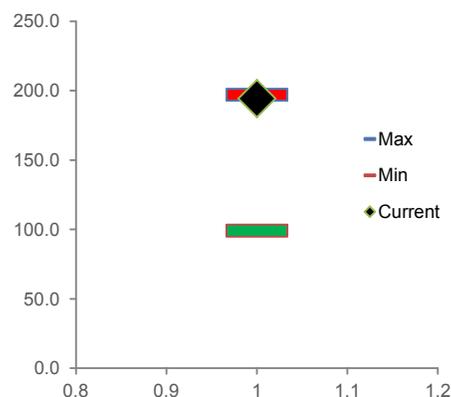
Mexico 10-2s Spread



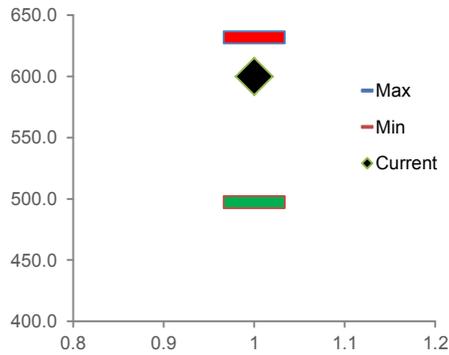
Sources: Bloomberg, Scotiabank.

Chart 4

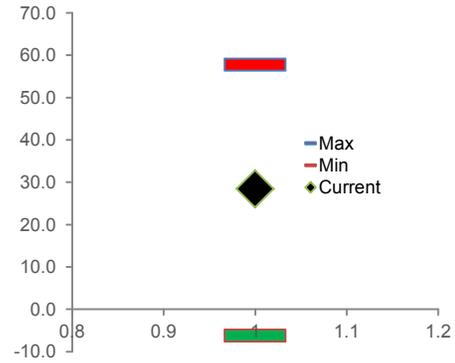
Pemex-UMS Spread (5yr CDS),  
Relative Performance July 1, 2018



Sources: Bloomberg, Scotiabank.

**Chart 5**
**Mexico - US 10yr Swap Spread, Relative Performance July 1, 2018 to-date**


Sources: Bloomberg, Scotiabank.

**Chart 6**
**Mexico 10-2s Spread, Relative Performance July 1, 2018 to-date**


Sources: Bloomberg, Scotiabank.

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

**This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.**

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.