January 16, 2019

Mexico: Initial Thoughts About the Gasoline Shock

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

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A GOOD CAUSE GETS MESSY DUE TO IMPROVISATION?

"Hell is full of good meanings, but heaven is full of good works" – Aphorism

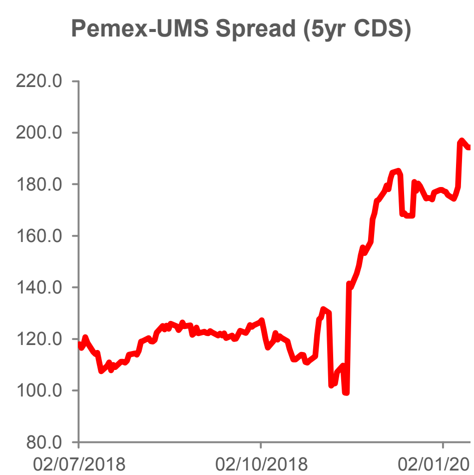
The main story in Mexico this week is the growing problems in gasoline supply. The government launched a campaign to fight fuel theft, which involved shutting the main pipelines that supply gasoline to Mexico City and the Bajio region, which is increasingly seen as a major risk to both growth and inflation 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).

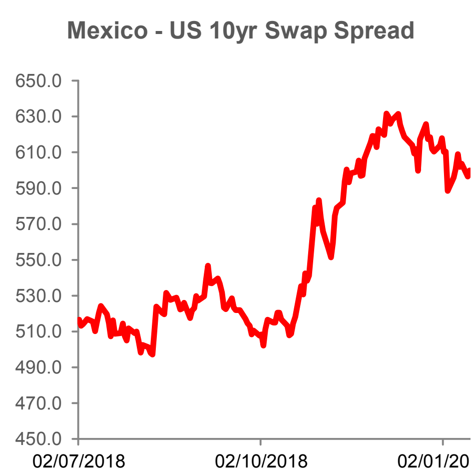
An interesting read, to get a sense of why this decision has been a strong irritant in the country, is Monday's article (in Spanish) by local columnist Raymundo Rivapalacio—linked here. Basically, one of the issues is that this once again appears to be an issue of a good cause (about 90% of Mexicans 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

Chart 1



Sources: Bloomberg, Scotiabank.

Chart 2



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?

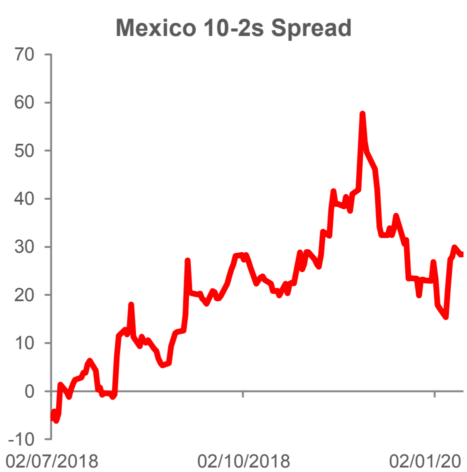
Mexican assets have had a fairly volatile couple of months, with the Mexico City Airport project cancellation kicking off a bout of risk aversion, followed by relief when an agreement was reached with MEXCAT bondholders and a fairly prudent budget was submitted. However, relief proved short-lived followed 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.

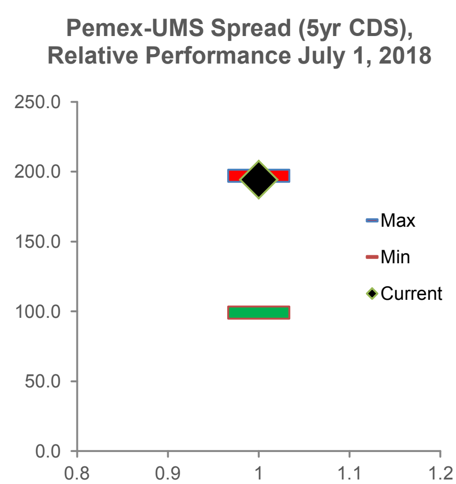
On the currency front, MXN has staged a dramatic comeback, from the sell-off that was triggered by the cancelation of the Mexico City airport. Since the airport referendum announcement, to the days following the announcement of the project's cancellation, USDMXN went from 18.75 to 20.65 in early December, 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



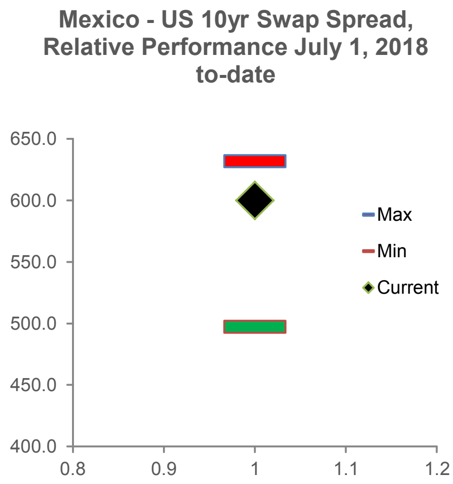
Sources: Bloomberg, Scotiabank.

Chart 4



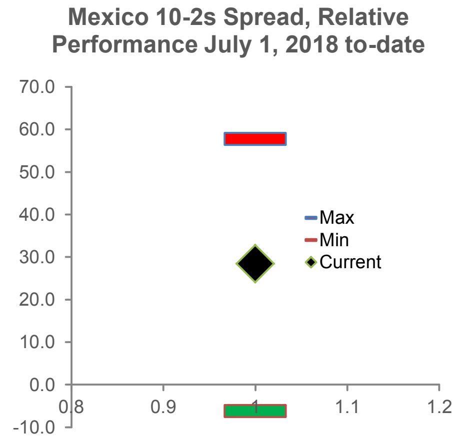
Sources: Bloomberg, Scotiabank.

Chart 5



Sources: Bloomberg, Scotiabank.

Chart 6



Sources: Bloomberg, Scotiabank.