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# Mexico Outlook and Challenges

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Scotiabank Mexico

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# Key Points



## **2021 growth outlook looks quite strong but may not be sustainable:**

- Re-opening of services sector to boost tourism & entertainment
- Record remittances from the US helping prop up consumption
- Record trade surplus—with a jump in net exports—due in large part to weak domestic demand



## **Main problem for the “4<sup>th</sup> Transformation” is self-inflicted decline in confidence:**

- Growth was already weak historically (2.1% 20 yr. avg.)
- Texcoco Airport cancellation & uncertain business environment reduced investment
- With weakening investment came lower employment creation
- “Mexico costs” are rising



## **Weaker growth outlook in turn spells trouble for public finances:**

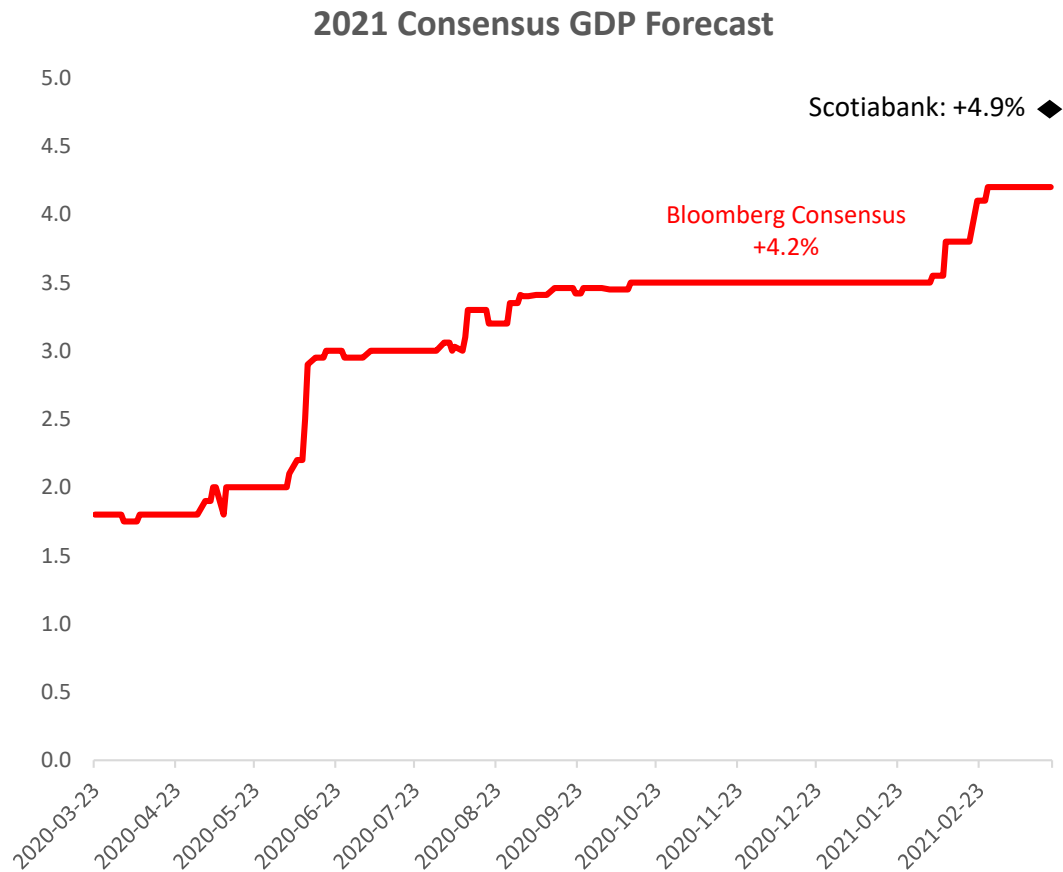
- Permanent Primary Surplus analysis suggests tax reform or growth boost are necessary
- Add Pemex trouble to the mix
- How will the 2022 tax reform impact investment?



## **Despite all this, Morena still popular with voters:**

- AMLO approval rebounding, approaching 2/3
- Clever election tactics + weak opposition suggest at least absolute majority in Congress for Morena
- 2/3 (Constitutional) majority may be in the cards for AMLO H2

# First some good news: 2021 growth looks solid

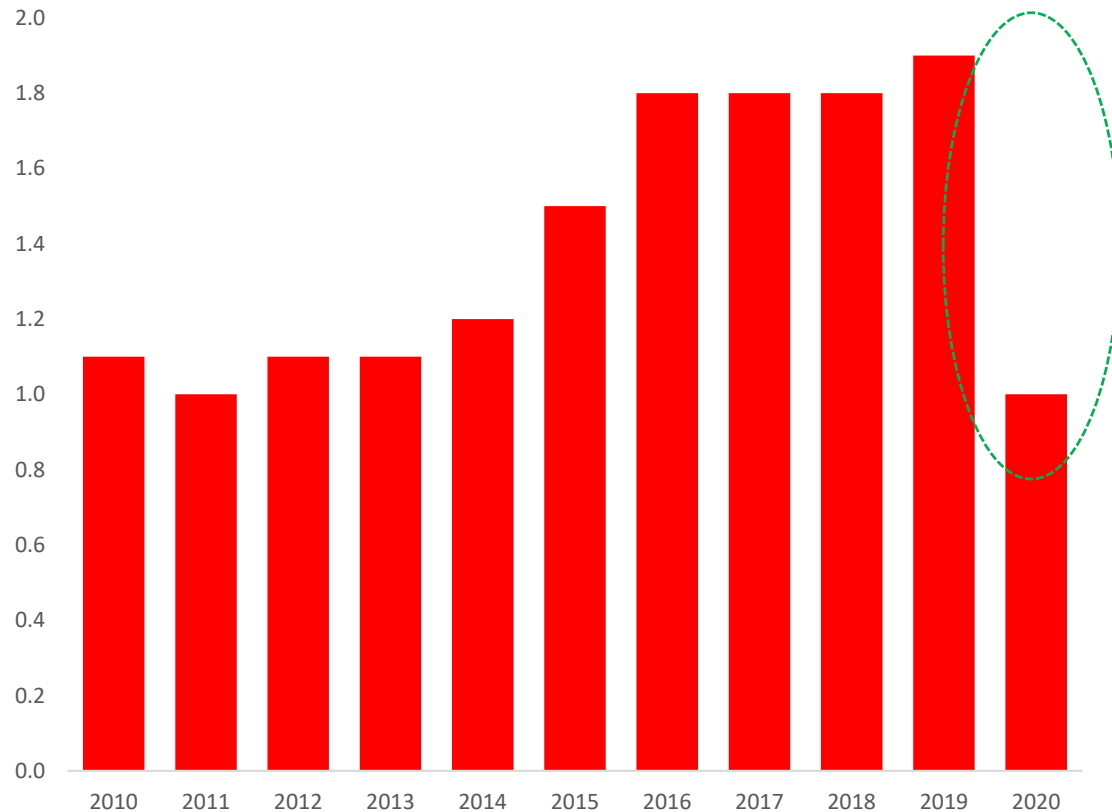


2021 growth forecasts have been rising:

- Consensus +4.2%
- Banxico +4.8%
- **Scotiabank +4.9%**
- FinMin +5.0-5.5%

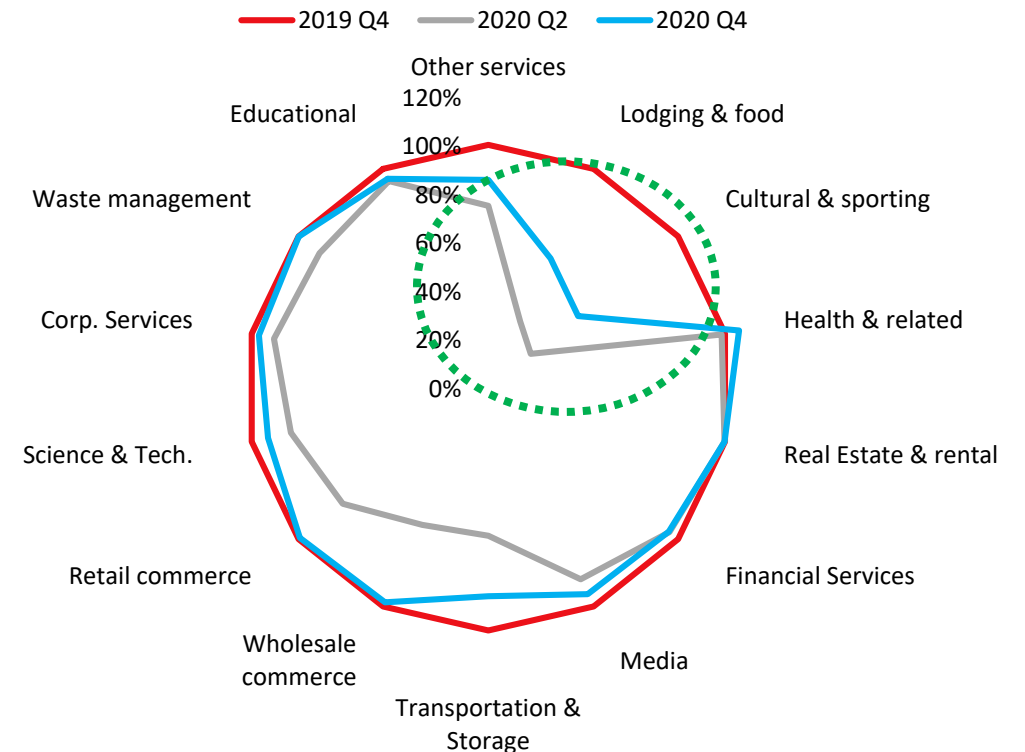
# Base effects / vaccination should drive a big jump in 2021 GDP; particularly in tourism

Foreign Tourist Receipts (% of GDP)



Sources: Scotiabank Economics, Banxico.

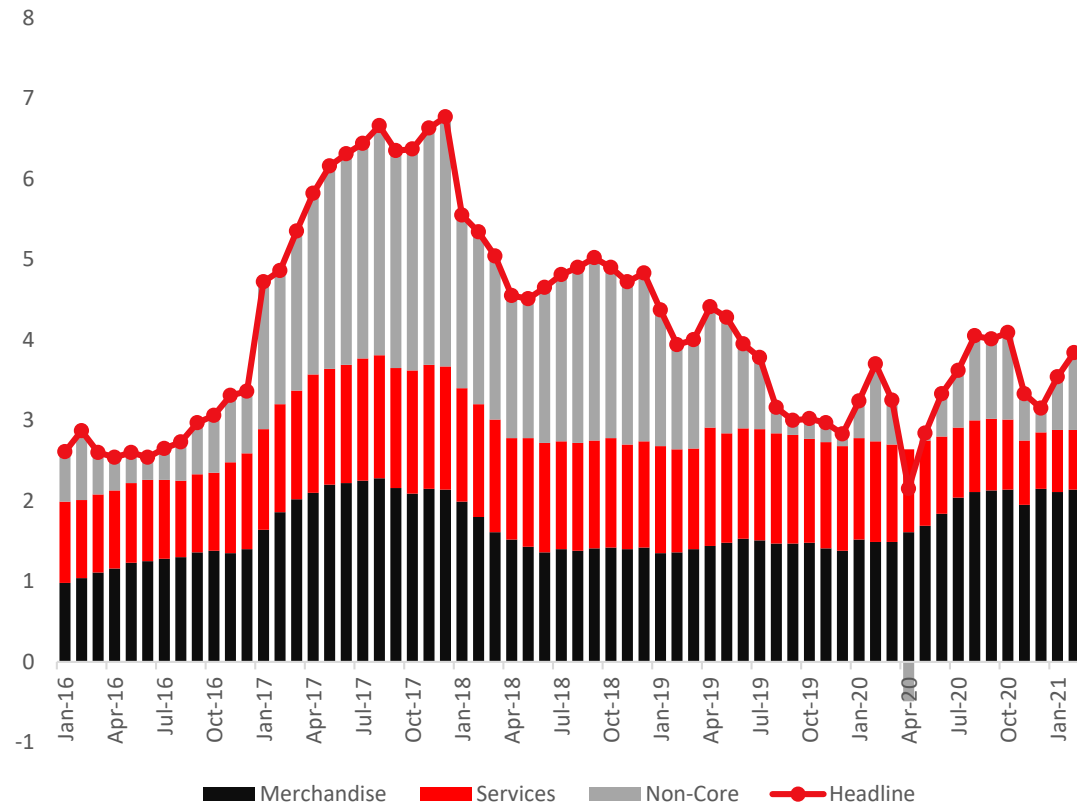
Services activity as % of their level in 2019 Q4 (real terms)



Sources: Scotiabank Economics, INEGI.

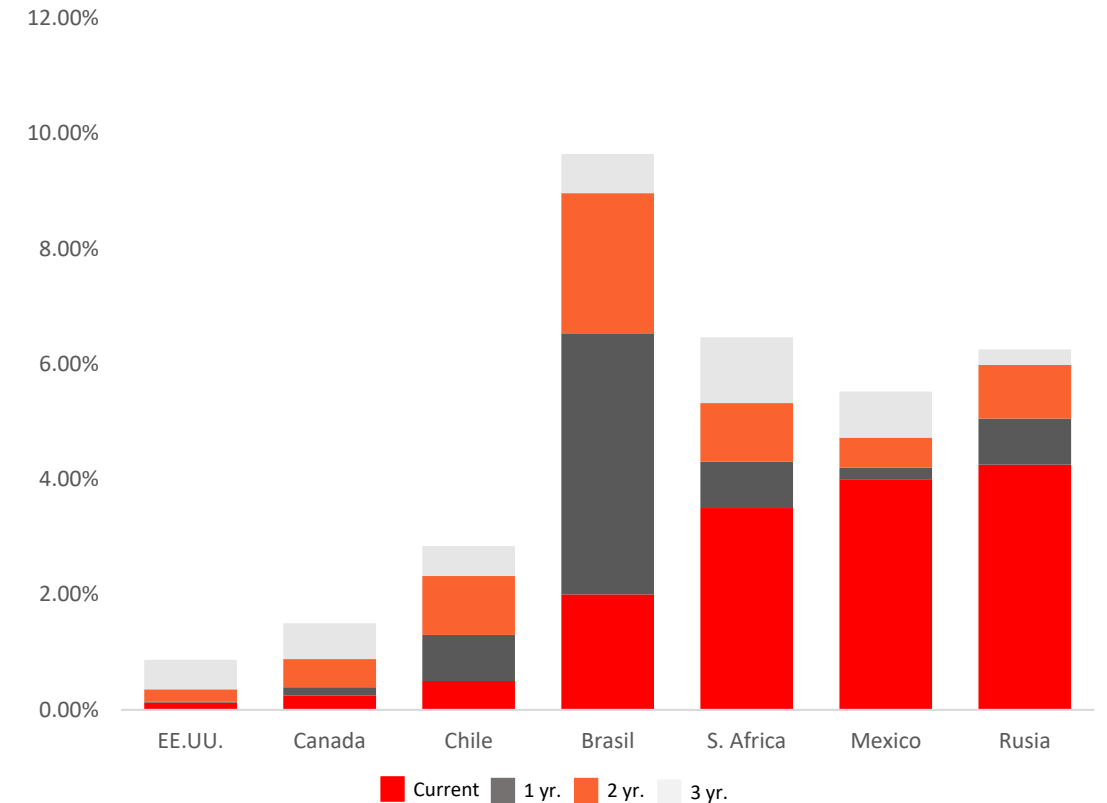
# Re-opening to cause services price shock?

Contributions to CPI Inflation (pps & % y/y)



Sources: Scotiabank Economics, Bloomberg.

Monetary Policy Rate & Implied Change



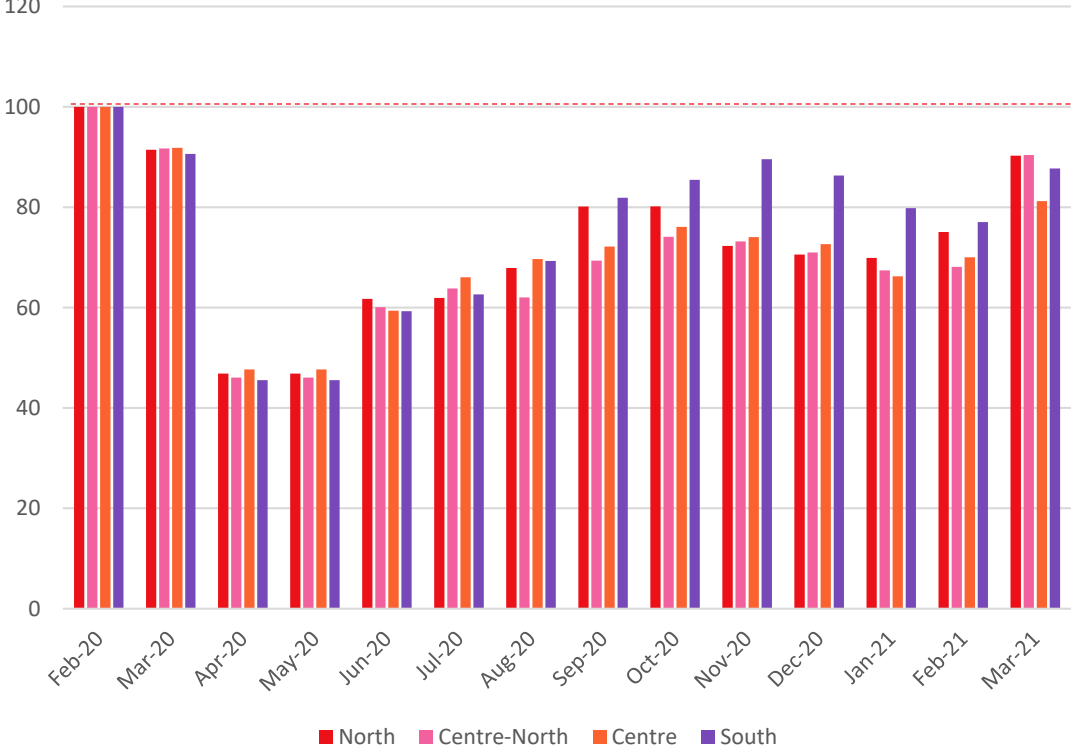
Sources: Scotiabank Economics, Bloomberg.

# The “K-shaped” recovery story has legs, weakness in tourism & construction

Regional Performance of Economic Activity  
(20Q4 as % of 20Q1)



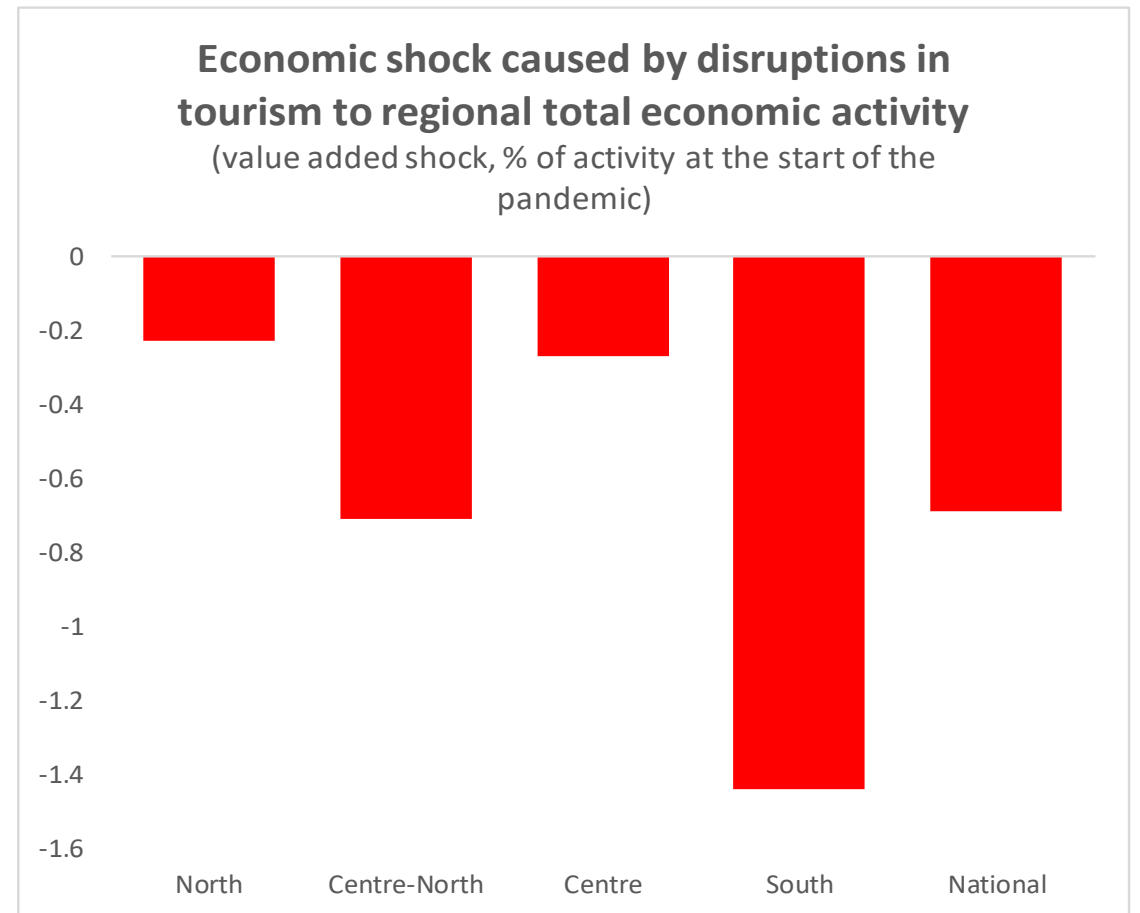
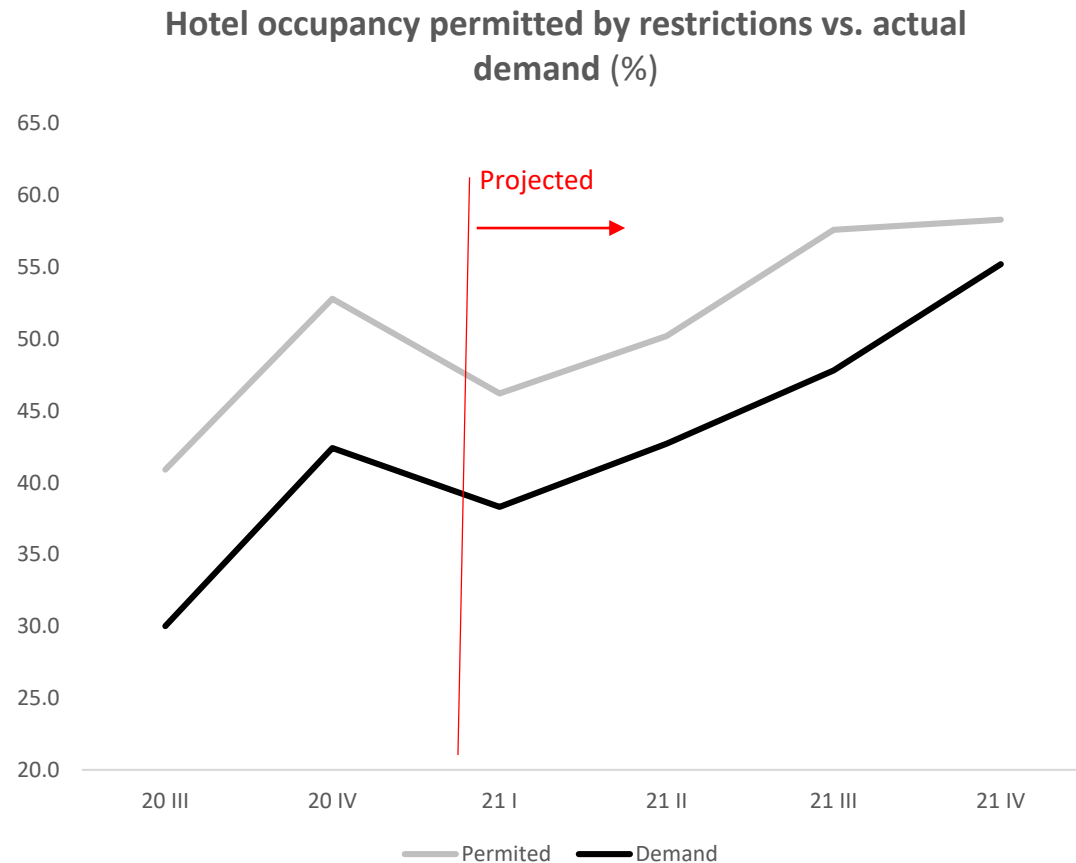
Traffic Lights System Induced Reductions in Activity (% of activity in Feb-2020)



Sources: Scotiabank Economics, Banxico.

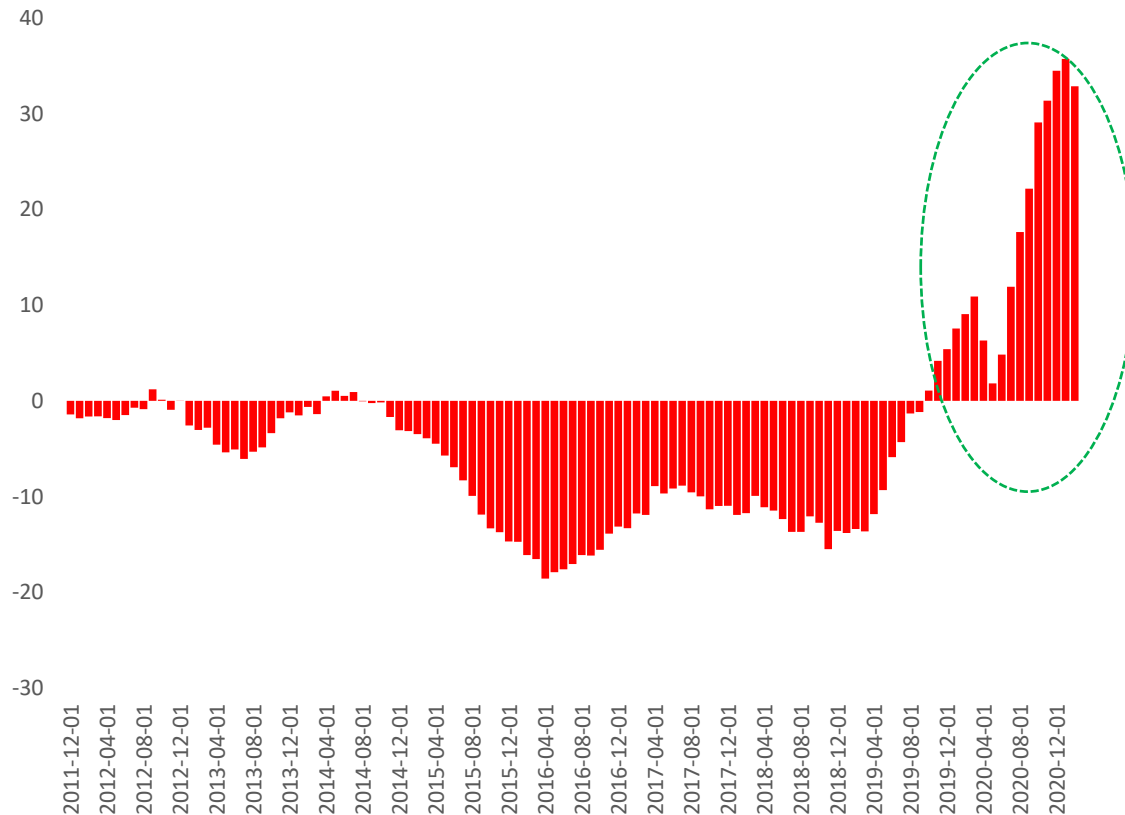
Sources: Scotiabank Economics, Banxico.

# Shock caused by tourism decline hit regions unevenly



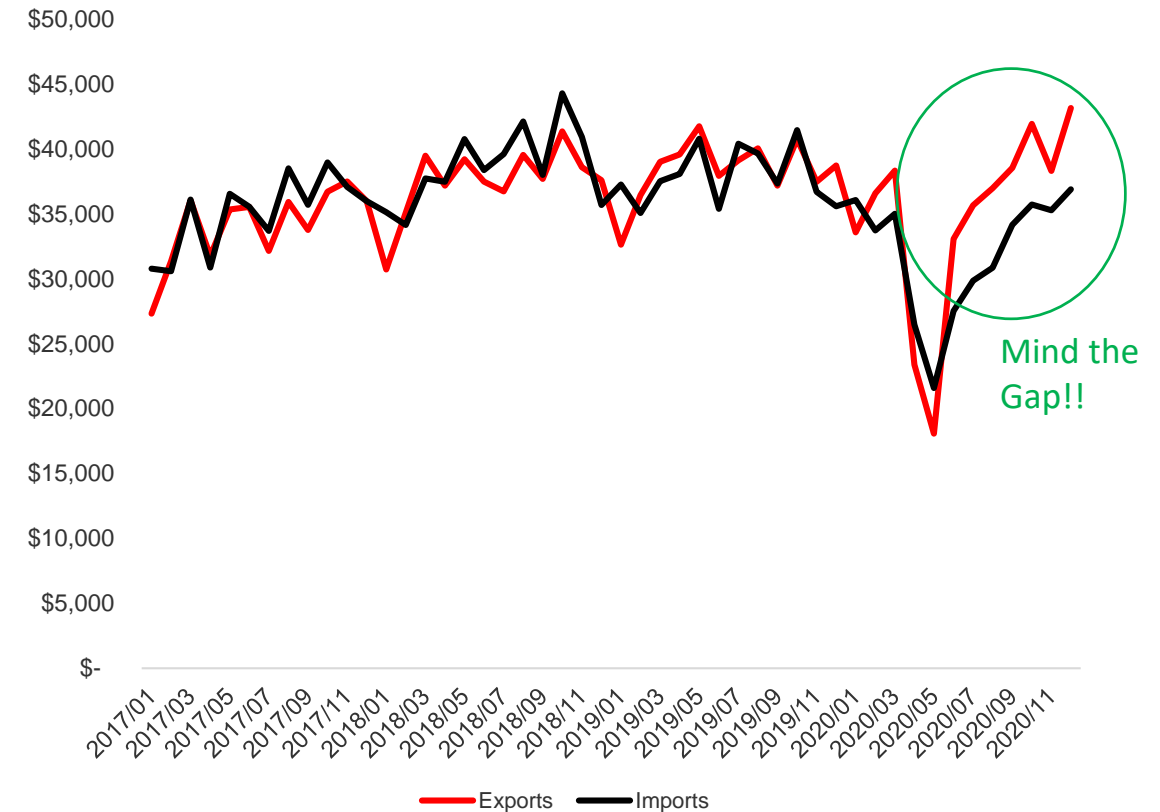
# Net exports boosting growth, partly due to demand recovery lag

Mexican Trade Balance (12 mo. rolling sum, USD bn)



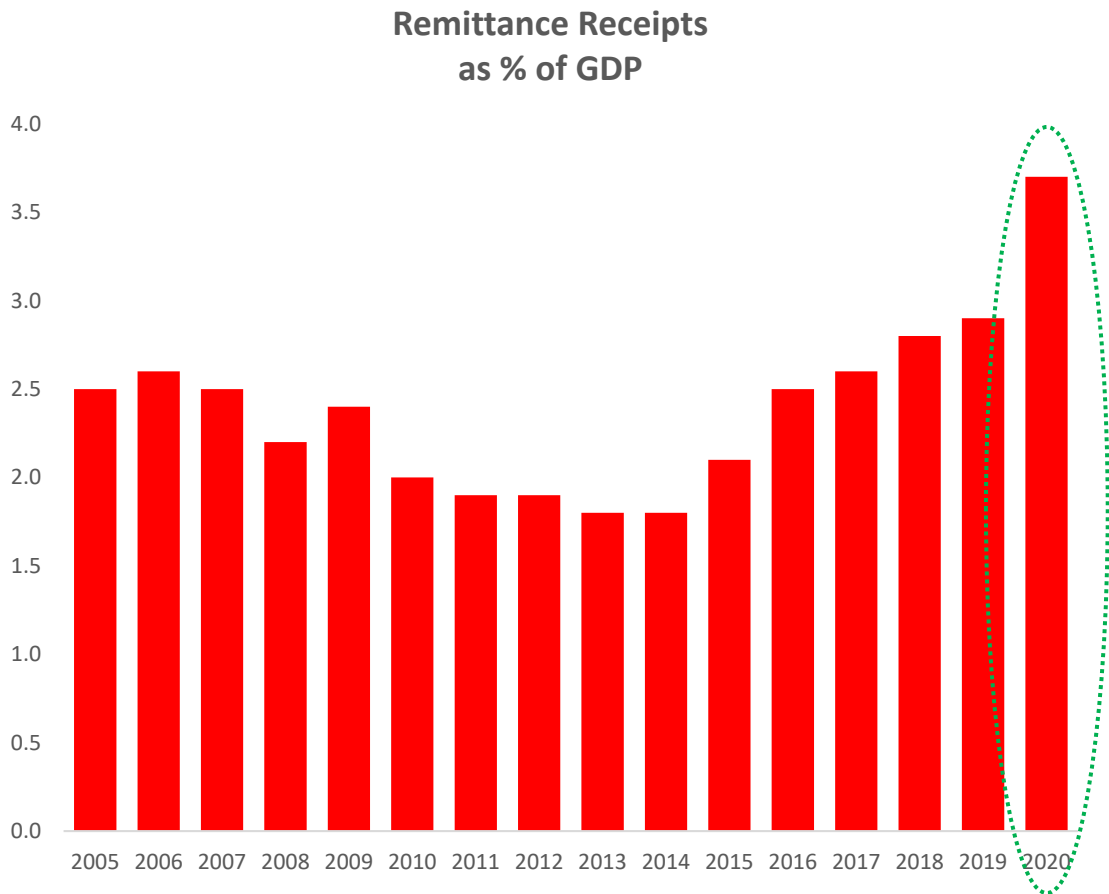
Sources: Scotiabank Economics, Bloomberg.

Merchandise Trade Balance (USD mn)

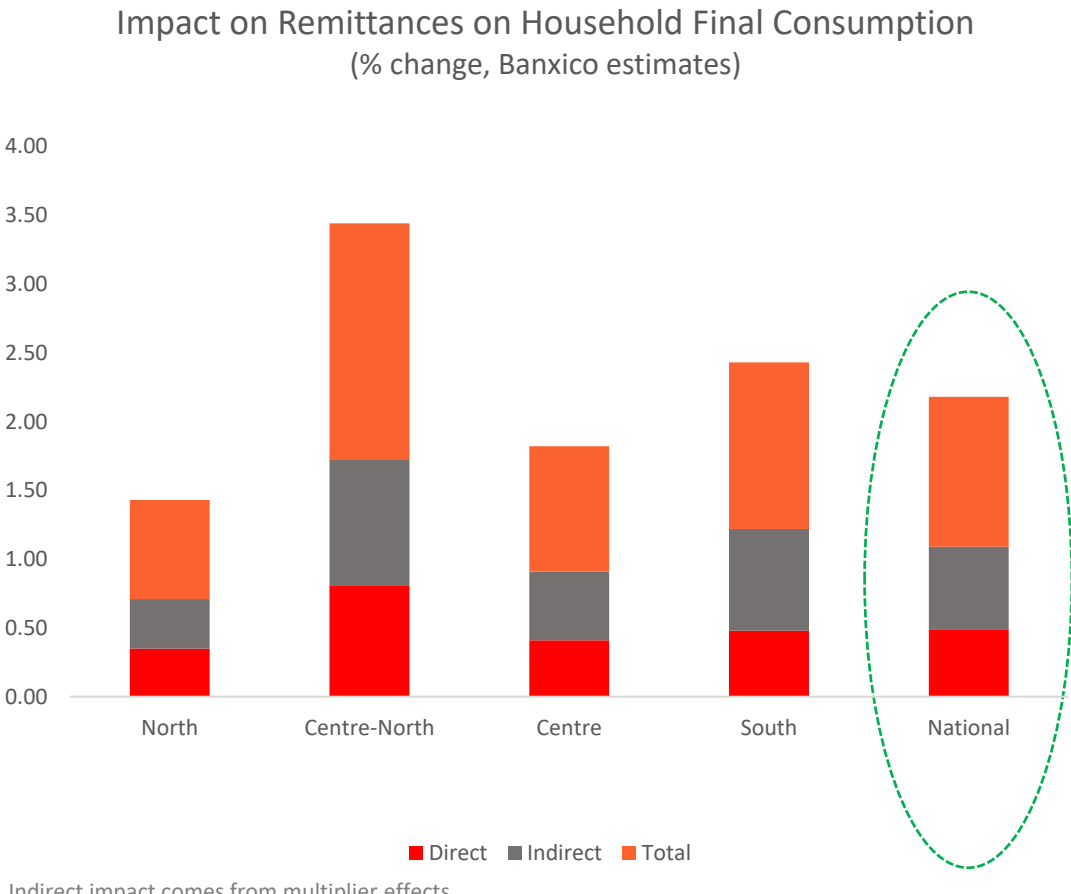


Sources: Scotiabank Economics, INEGI.

# Remittances providing important boost to consumption



Sources: Scotiabank Economics, Banxico.

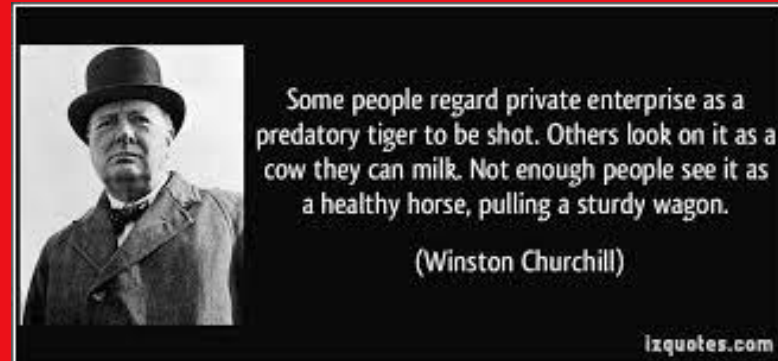


Indirect impact comes from multiplier effects.  
Source: Banxico estimates.

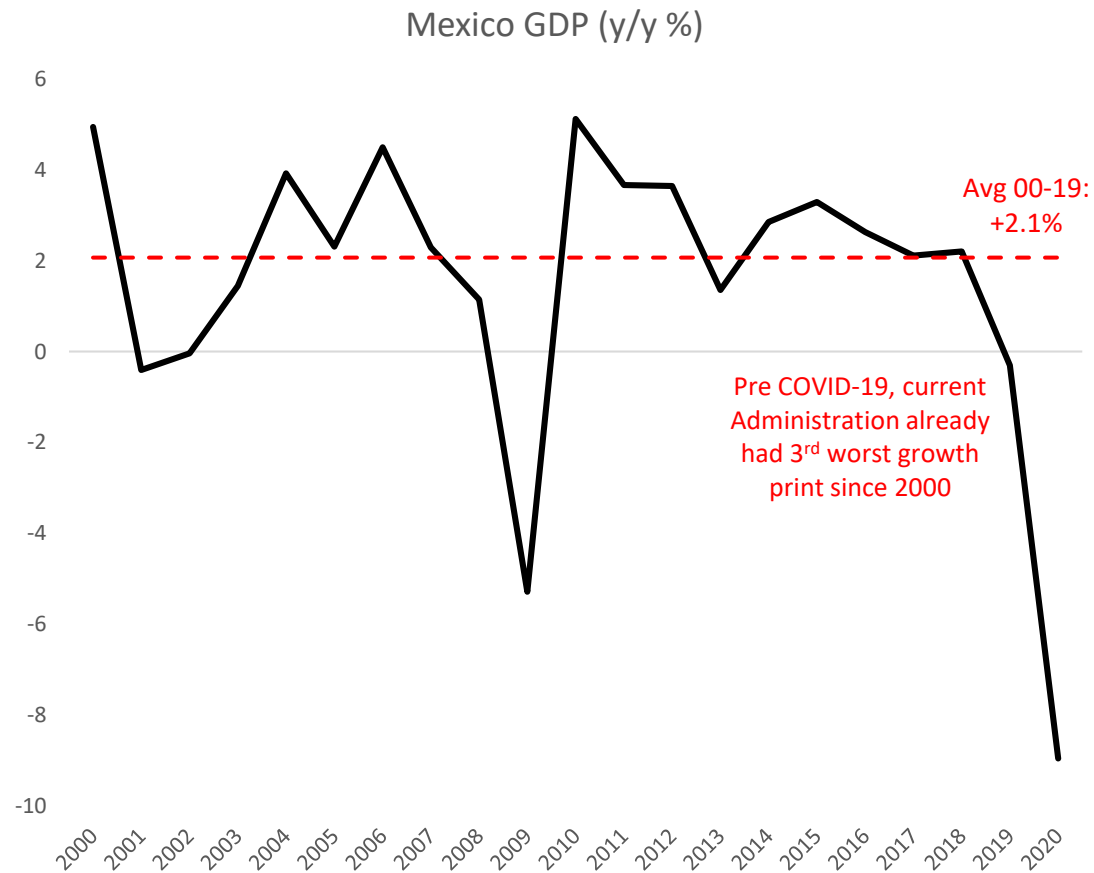
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Long term fiscal sustainability  
comes down to:

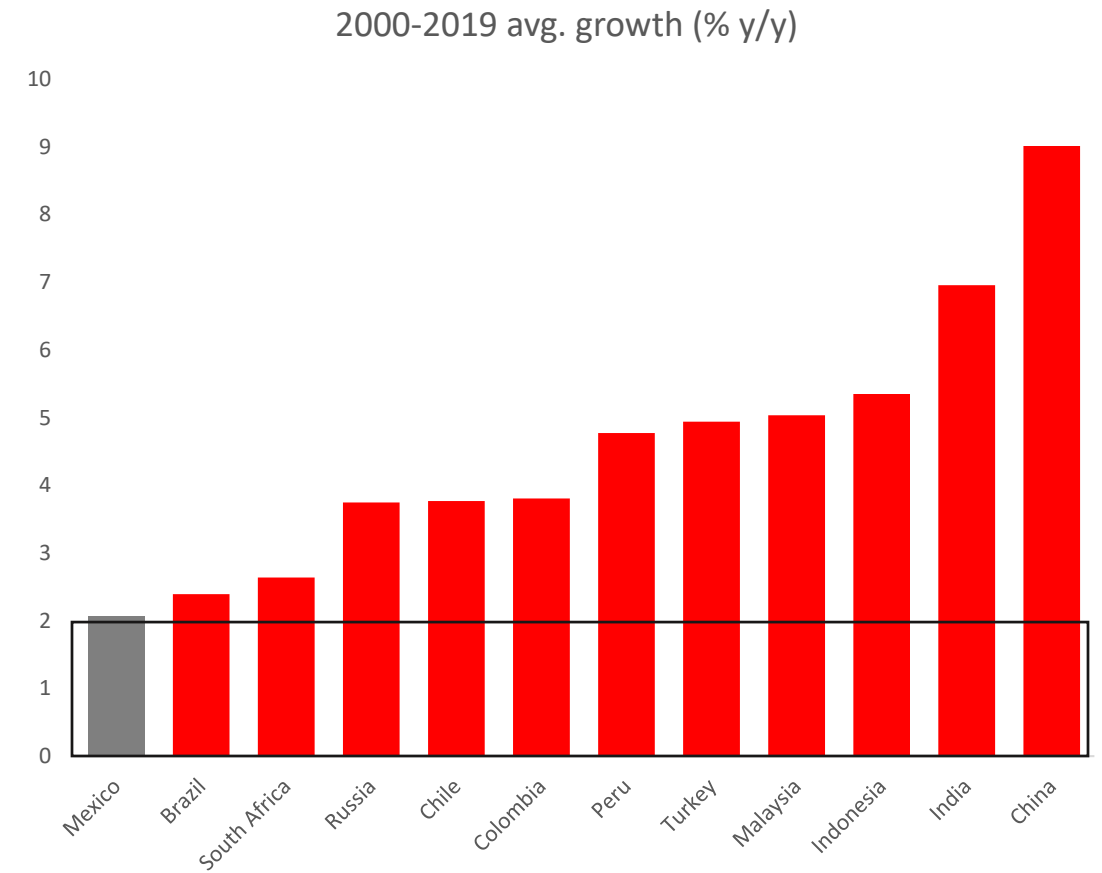
$$D * i = Y * t * g$$



# Pre AMLO, Mexico already had weak growth

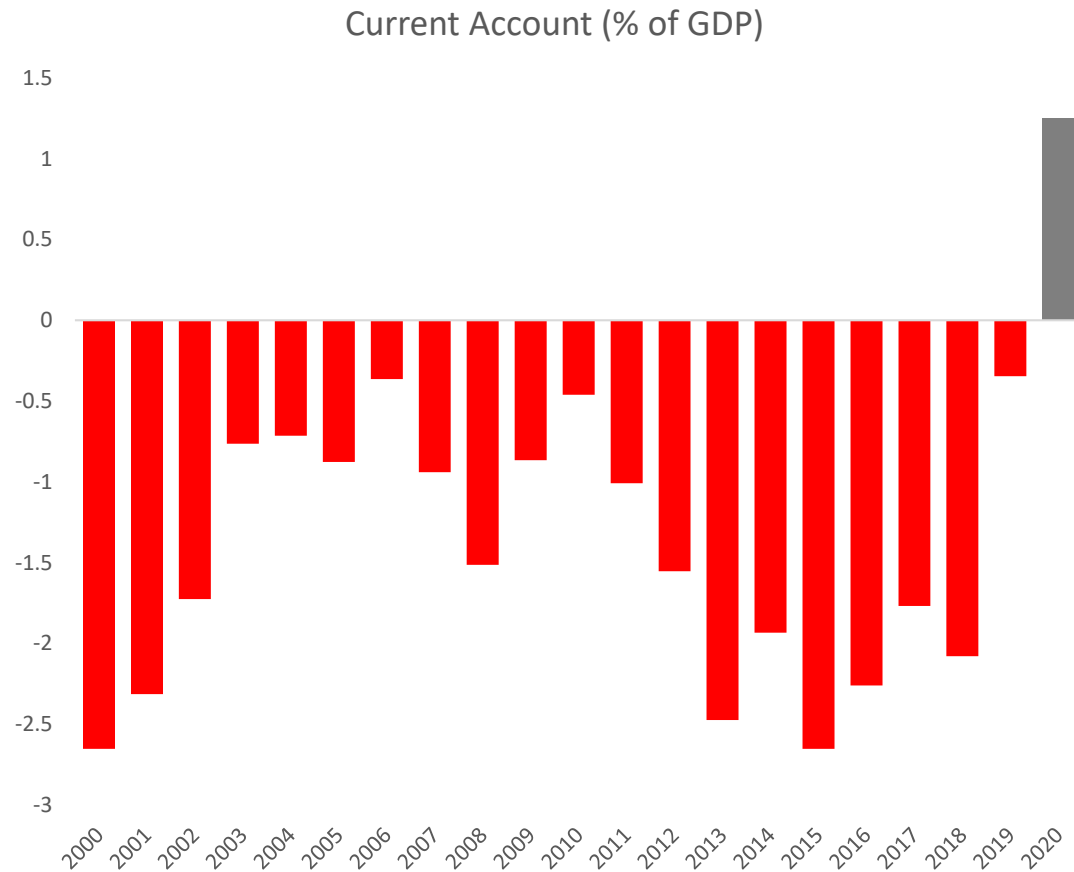


Sources: Scotiabank Economics, IMF.

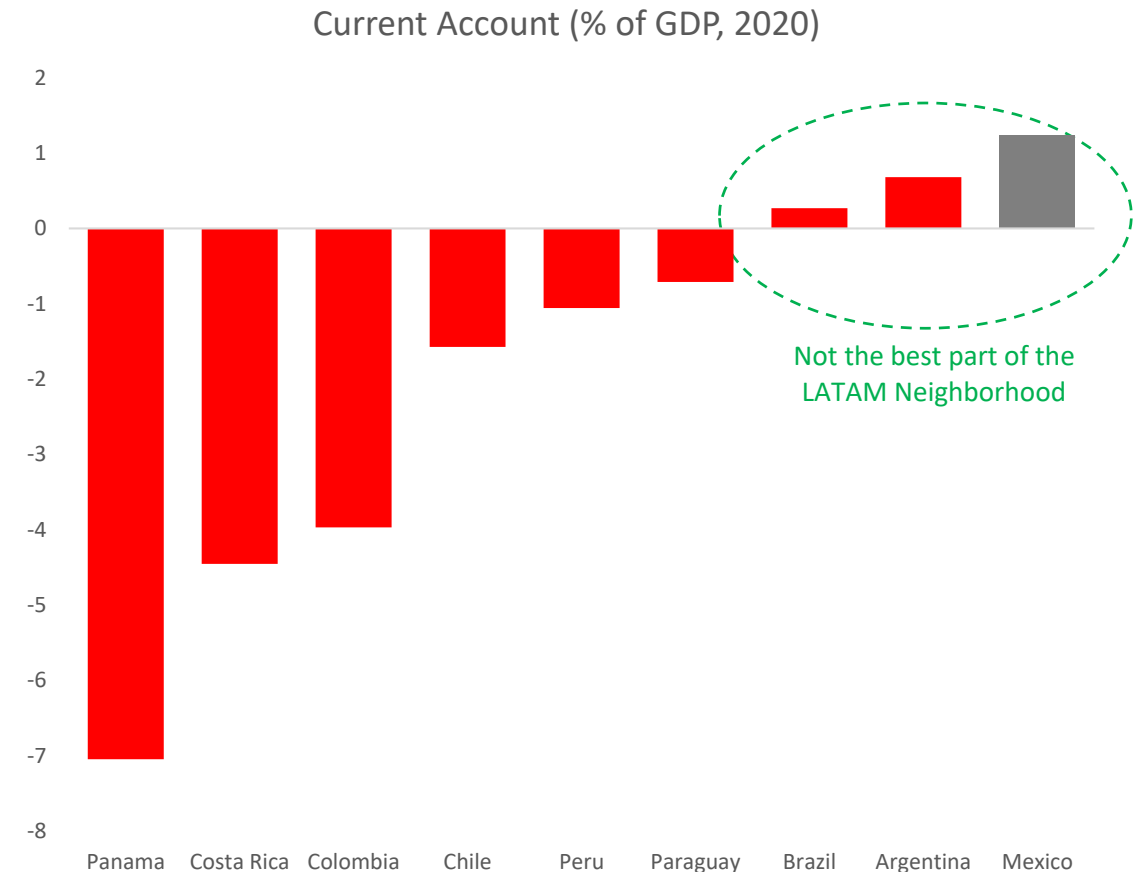


Sources: Scotiabank Economics, IMF.

# Current Account = Savings – Investment ....

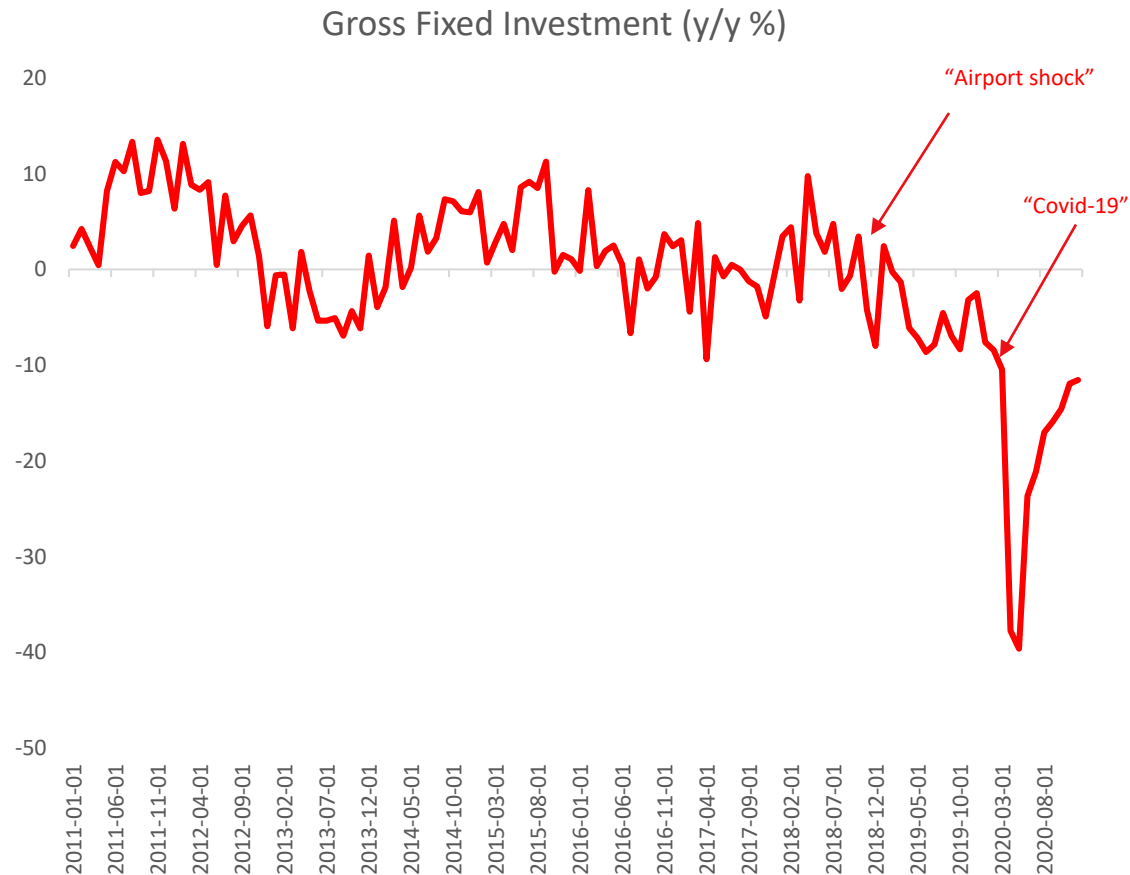


Sources: Scotiabank Economics, IMF.

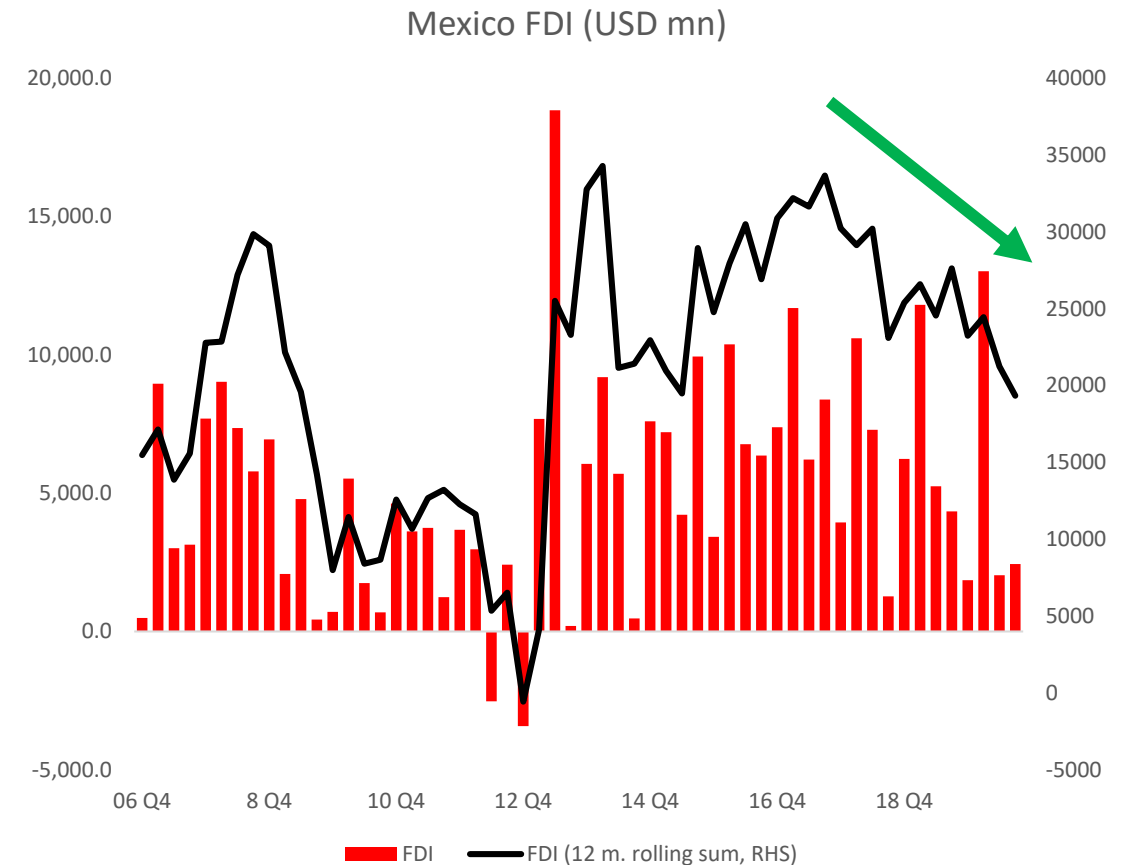


Sources: Scotiabank Economics, IMF.

# Investment has been falling under AMLO



Sources: Scotiabank Economics, Bloomberg.

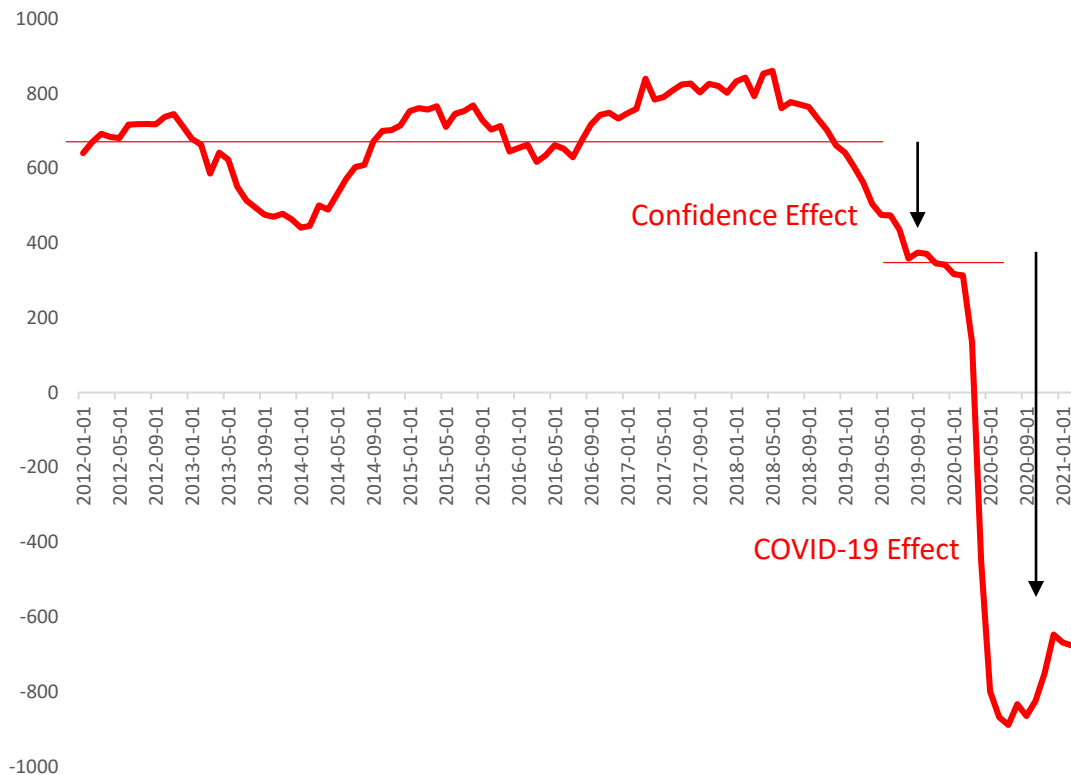


Sources: Scotiabank Economics, INEGI.

# With low investment comes weakening employment, though reopening will help

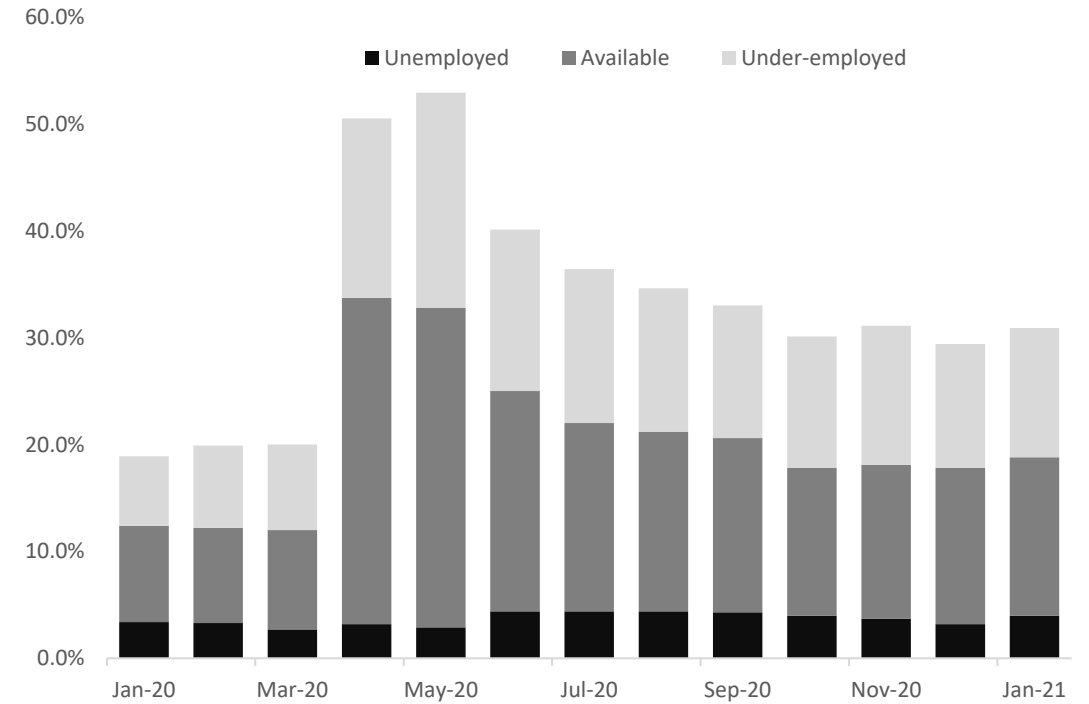
**New Formal Jobs**

(000s, 12m rolling sum)



Sources: Scotiabank Economics, IMCO.

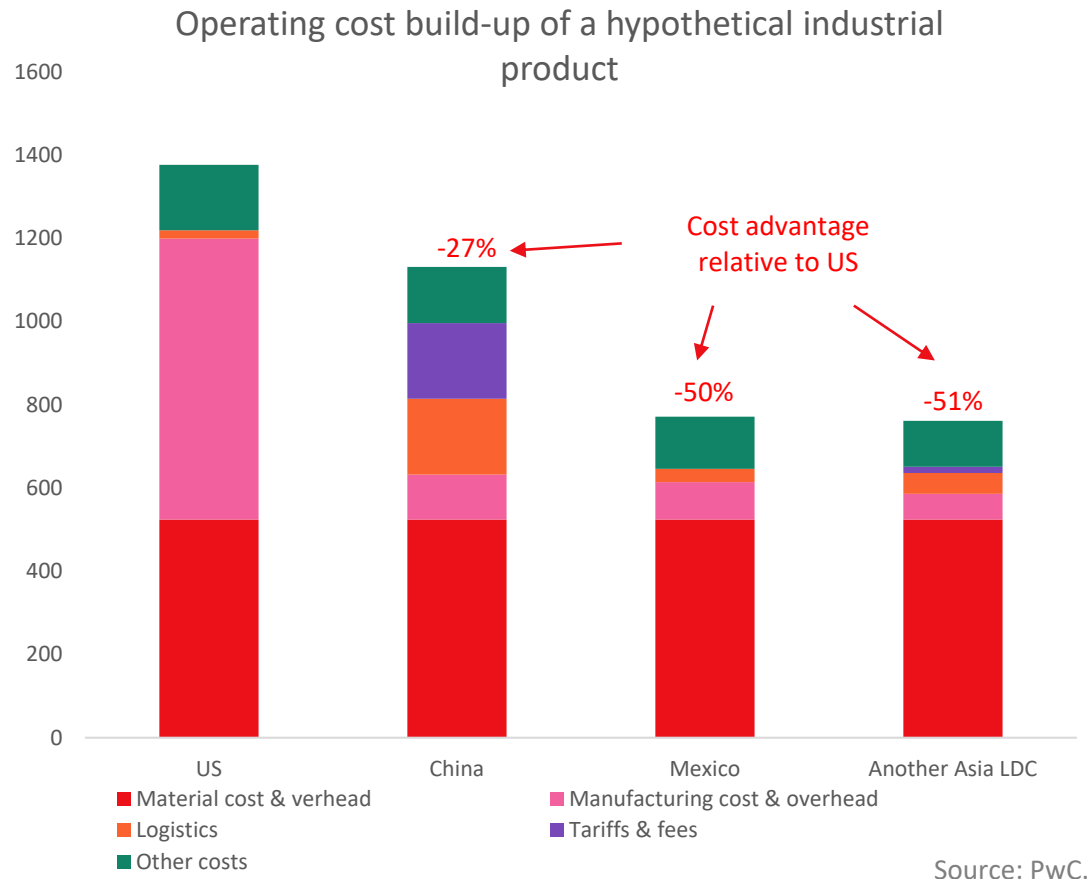
**Mexico's Labour Gap by Component**



Labour gap is defined as the unemployed, plus those available to work, plus those willing to work more hours.

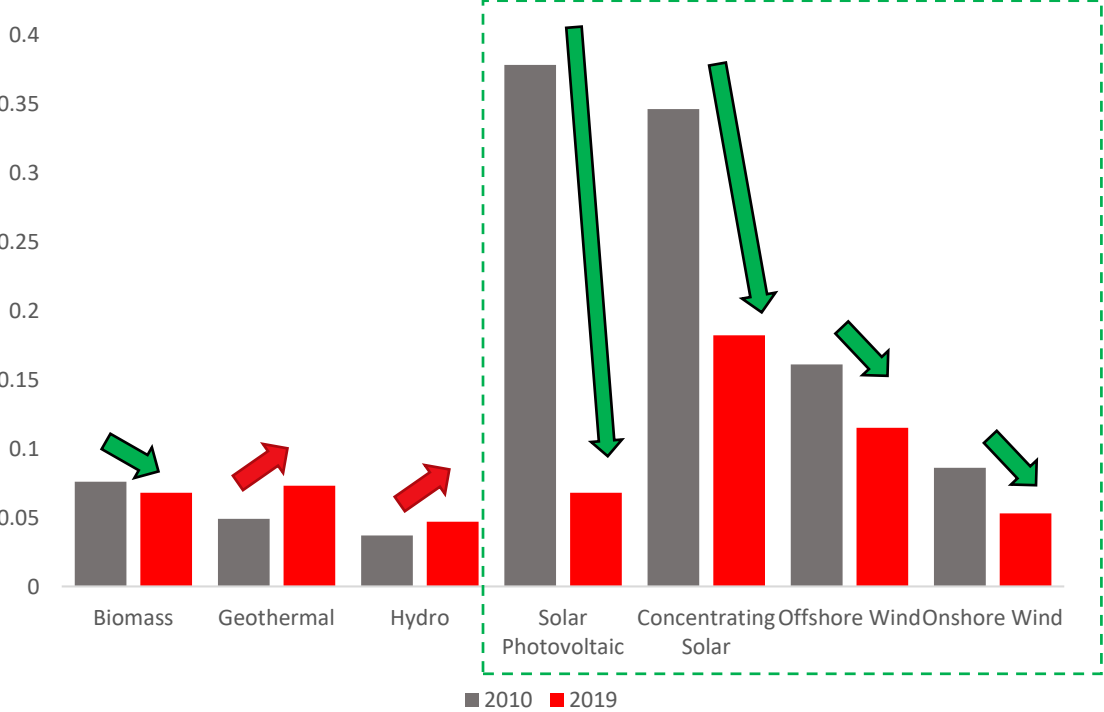
Sources: Scotiabank Economics, IMCO.

# Lower costs of production still substantial advantage



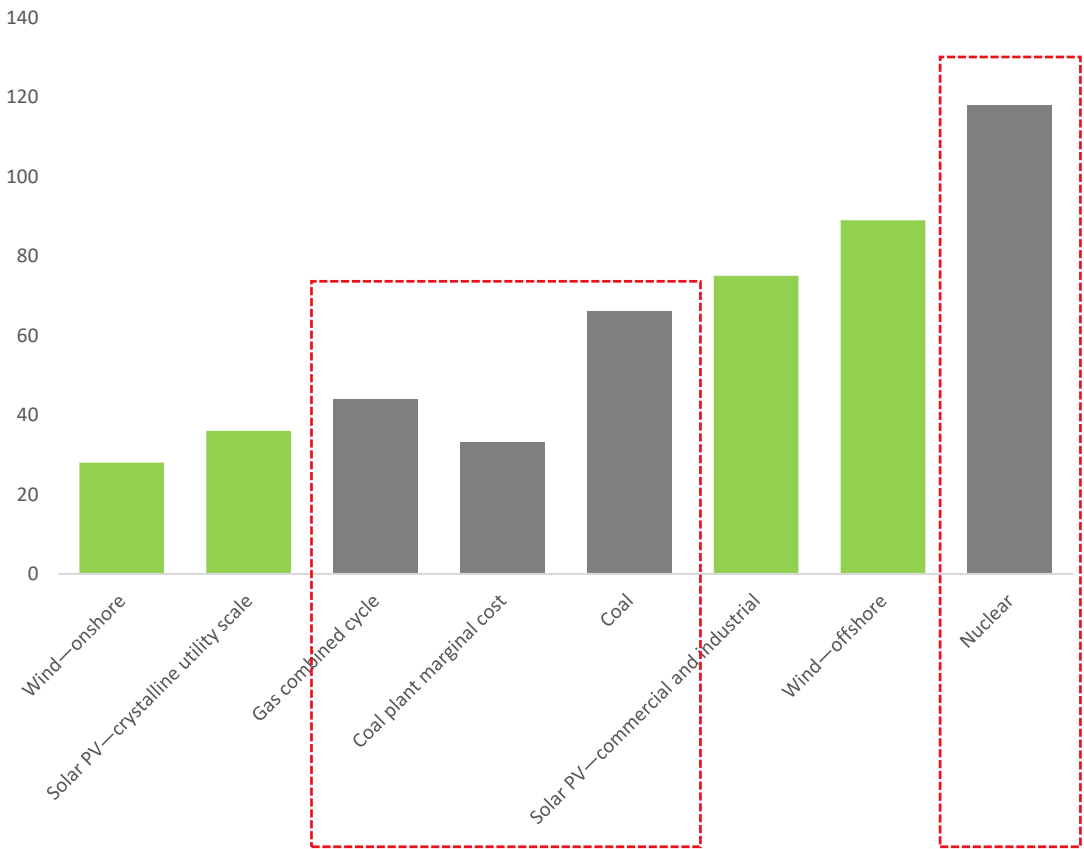
# Energy reform: pushing on the wrong types of power?

Renewable Energy Trends: Global Weighted Average Cost of Electricity from Utility Scale Renewable Power Generation Technologies (2019 USD/KWh)



Sources: Scotiabank Economics, IRENA.

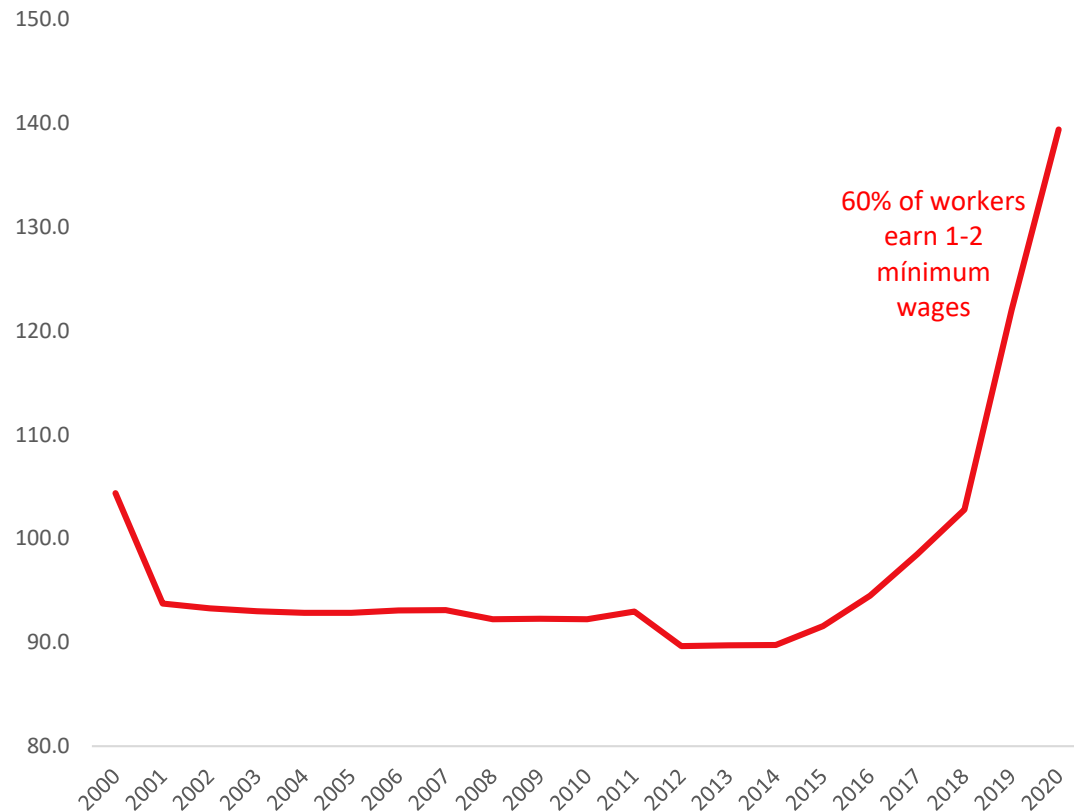
Levelized Cost of Electricity for New Investment (2019 US dollars / MWh)



Sources: Scotiabank Economics, IMF.

# 2 years of very strong minimum wage gains eroding competitive advantage

Mexico: Real minimum wage (Dec-18=100)



60% of workers  
earn 1-2  
minimum  
wages

## “Mexico Costs” rising:

- Minimum wage hikes
- Likely power shortages & cost increase
- Will relying on dirty power cause “capital cost increase”?
- Outsourcing Bill (up to 20% of total formal workers affected; 10-30% increase in costs)
- Pension reform (gradual increase from 5.15% to 13.875% in employer contributions over 8-year span)
- Tax reform the “last shock”?

“

**Long term fiscal sustainability  
comes down to:**

$$D * i = Y * t * \underline{g}$$

Houston, we found the problem

# Mexico's credit ratings & Pemex

## Mexico's Credit Ratings

	Credit Rating	Outlook
Moody's	Baa1 (Inv. Gr.)	Neg.
S&P's	BBB (Inv. Gr.)	Neg.
Fitch	BBB- (Inv. Gr.)	Stable

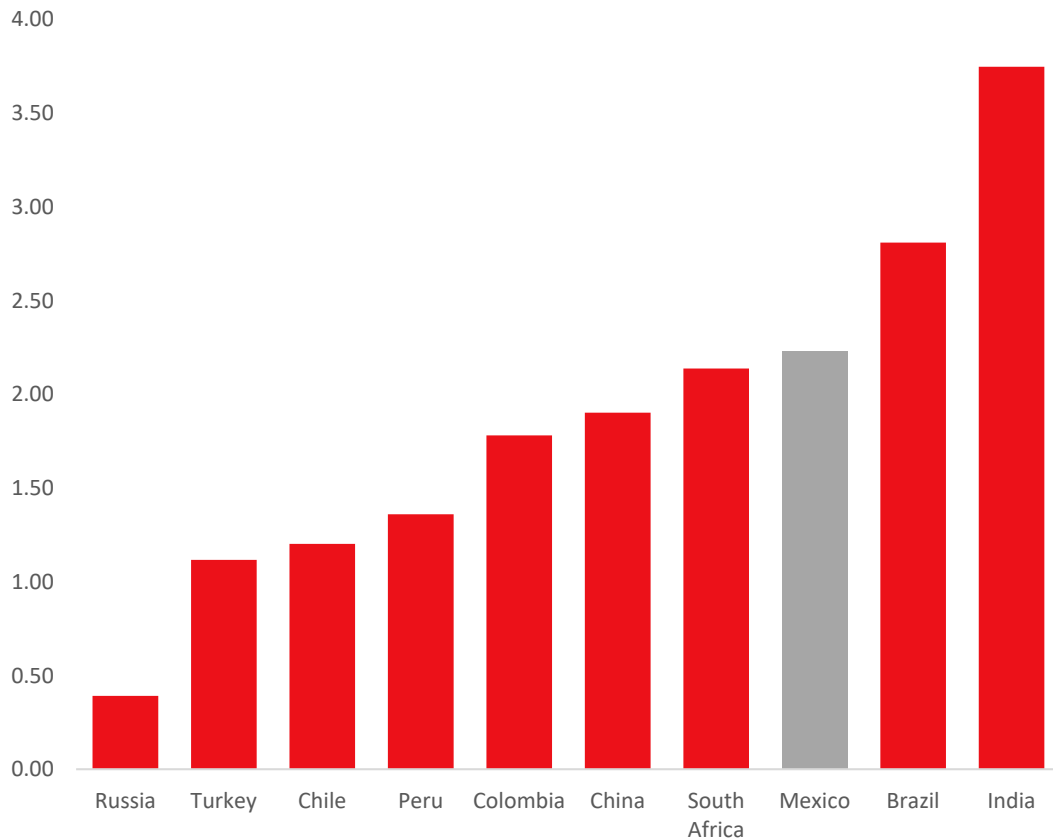
Sources: Scotiabank Economics, Bloomberg.

Government has hinted a tax reform is coming for the second half of the Administration (2022 onwards), and simultaneously that tax relief for Pemex is part of it. Topics to include in the tax reform are a subject of contention.

- Mexico's 2 **main credit rating risks** appear to come from:
  - **Support for Pemex**, which is not only the world's most indebted oil company, but also fails to generate positive cash flows (in part due to a very onerous tax burden).
  - **Growth**. Over the past 20 years, Mexico has averaged a modest 2.1% growth, but the recent decline in investment, and with it in job creation, may have pushed potential growth even lower.
- An analysis of Mexico's long term debt sustainability suggests that to anchor debt levels, 1 of the following is needed:
  - Boosting growth by about 2-3 points.
  - Increasing the primary surplus by 2-3 points.
  - A fiscal reform that levies an additional 2-3 points.
  - A combination of the 3 points above.

# Rating agencies have flagged a fiscal reform as important to securing the country's investment grade—expected for 2022

General government gross debt / revenues (2019)



Sources: Scotiabank Economics, IMF.

- Fiscal reform will likely be necessary entering 2022. It is key that it's balanced to protect private sector confidence.
- Our estimates, based on the "Permanent Primary Surplus" method suggest a tax reform in the order of 2.0–3.0% of GDP will be needed—including about 1 ppt of GDP for Pemex.

Mexico: fiscal revenue composition by type of tax, % of GDP

	Mexico	LAC*	OECD
Personal income tax	3.5	2.1	8.2
Corporate income tax	3.5	3.7	2.9
Social sec. contrib.	2.1	3.4	9.2
Property taxes	0.2	1.0	1.9
VAT	3.7	6.6	6.8

\* LATAM & Caribbean  
Sources: Scotiabank Economics, OECD.




# Pemex overview & challenges

## Pemex Credit Ratings

	Credit Rating	Outlook
Moody's	Ba2 (Junk)	Neg.
S&P's	BBB (Inv. Gr.)	Neg.
Fitch	BB- (Junk)	Stable

Sources: Scotiabank Economics, Bloomberg.

## Pemex Financial Metrics

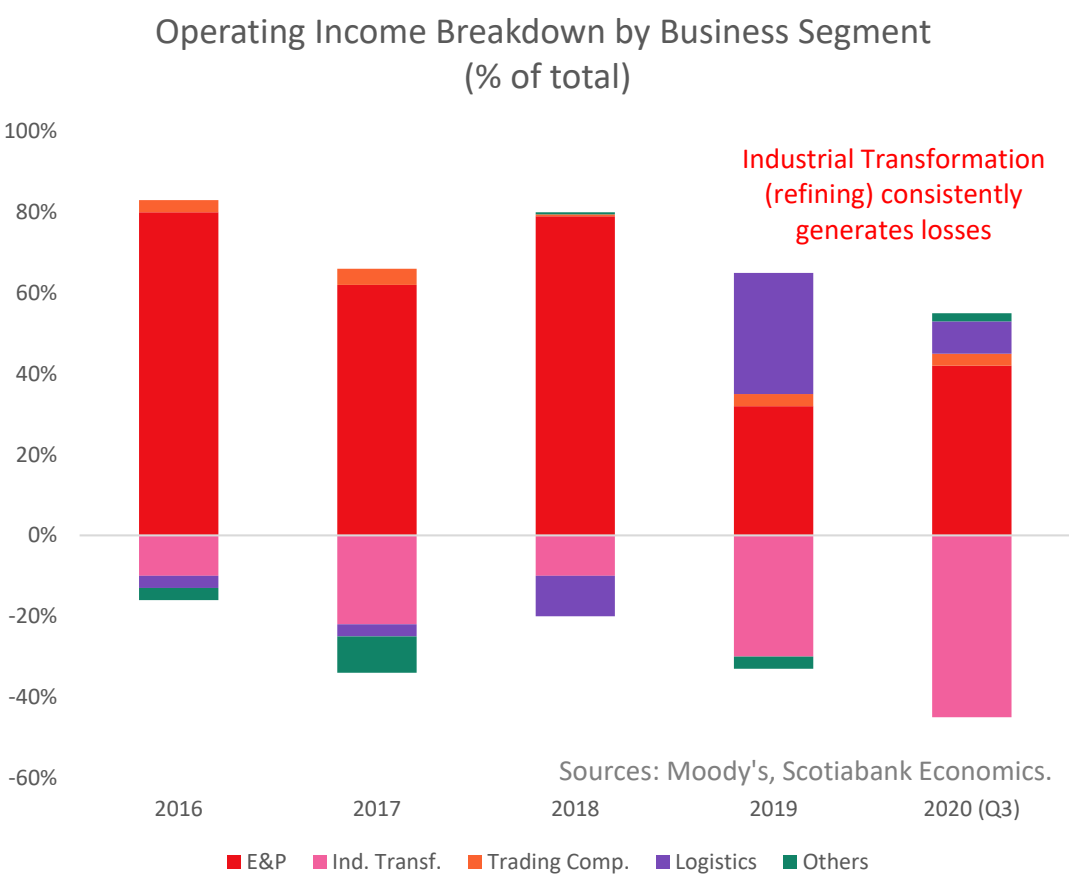
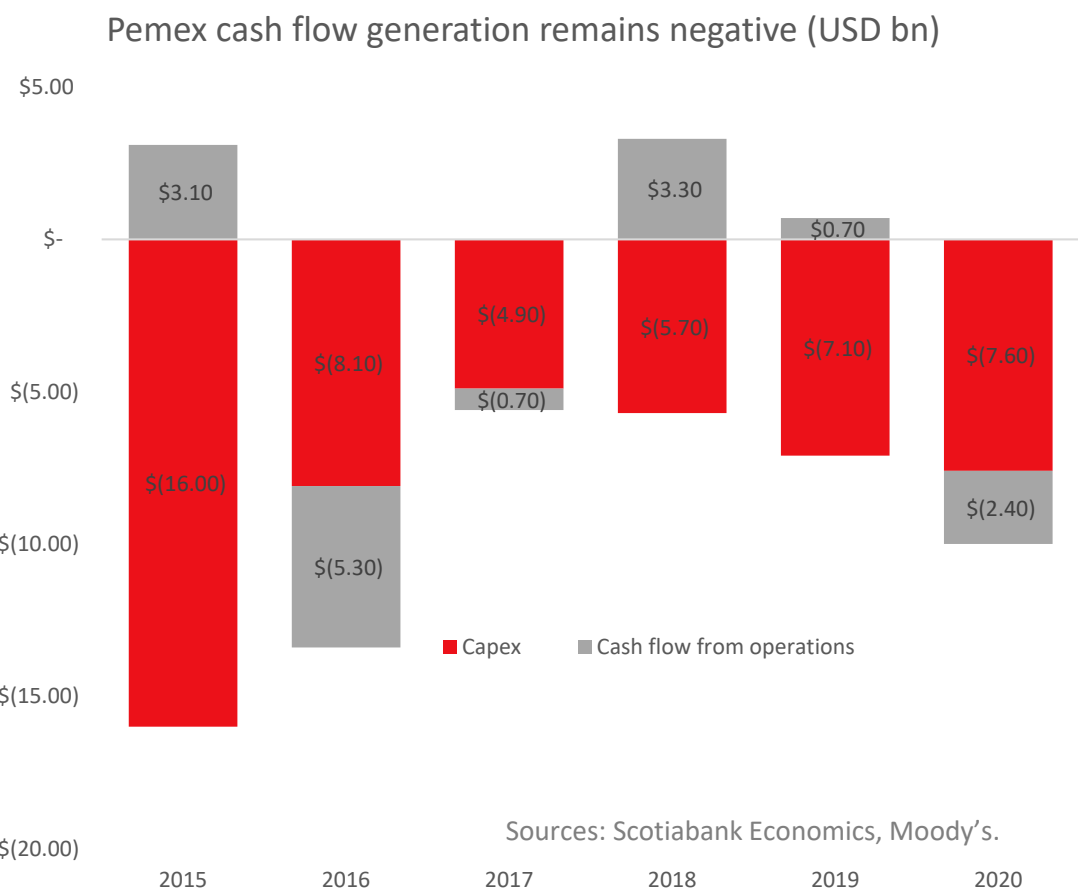
	2019	2020 e	2021 f	
Avg. Prod. (mboe/d)	2,284.1	2,050.0	2,100.0	
Total proved reserves (Mboe)	7,019.2	6,500.0	6,000.0	
EBIT / Interest expense	1.4x	0.5x	1.0x	

Sources: Scotiabank Economics, Moody's Investor Services.

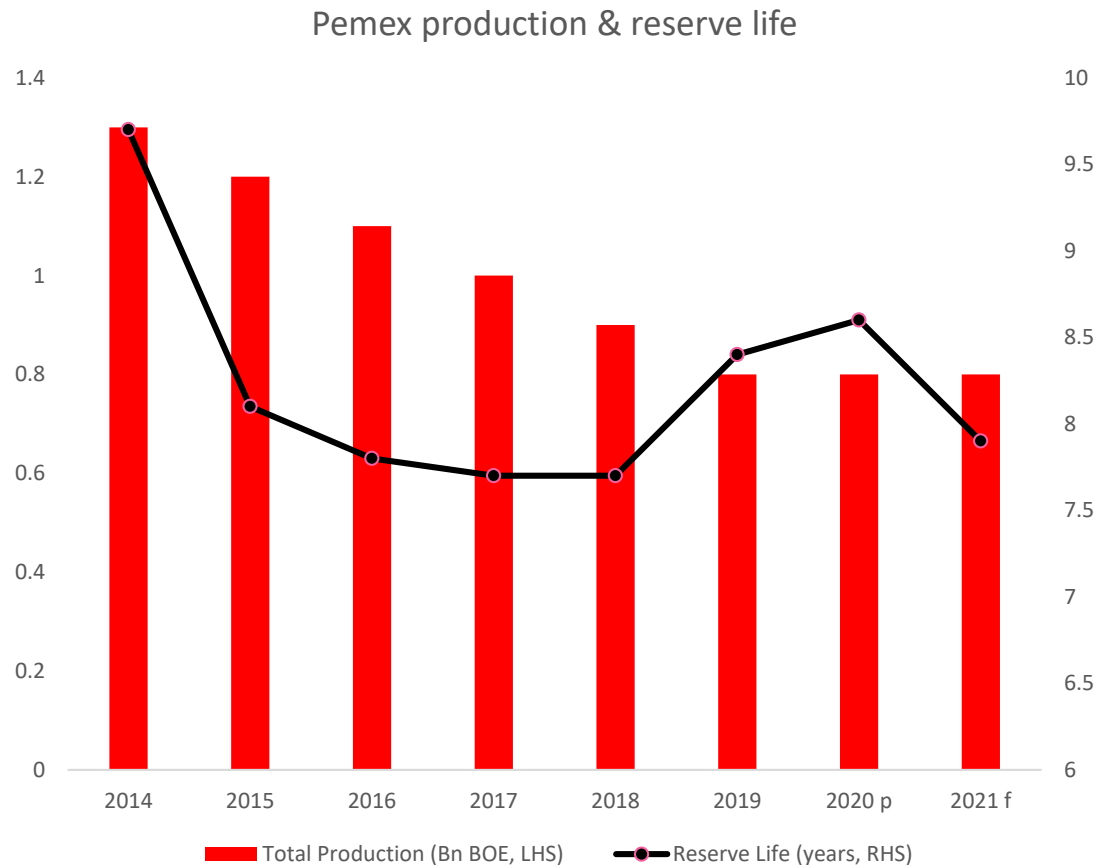
## Challenges:

- Very high debt burden.
- Needed support (and/or tax relief) estimates seem to range from USD 10 bn to USD 20 bn (Scotiabank USD 14 bn).
- Weak credit metrics & liquidity.
- Downstream business lines consistently fail to generate positive cash flows.
- Oil output could be touching bottom, but proven reserves continue to drop, raising some concerns over long term viability.

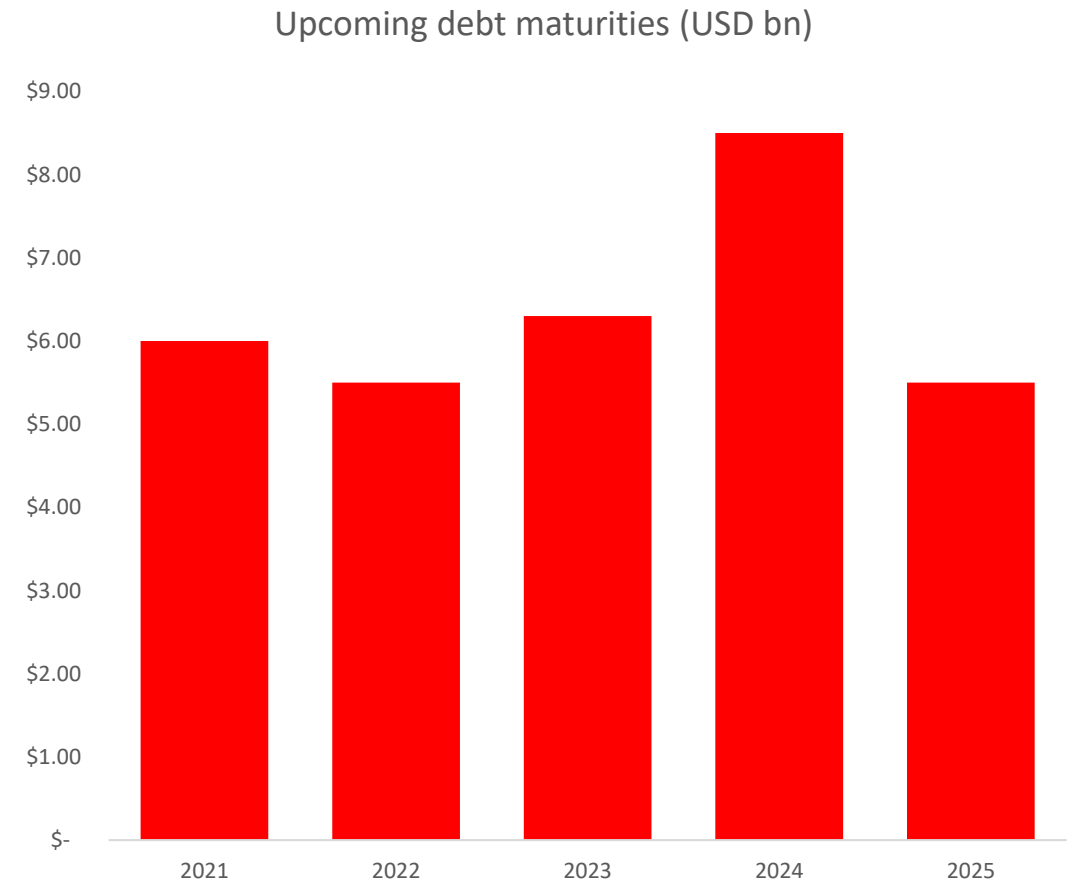
# Pemex’s challenged cash flow generation capacity



# Pemex production metrics & debt maturity profile



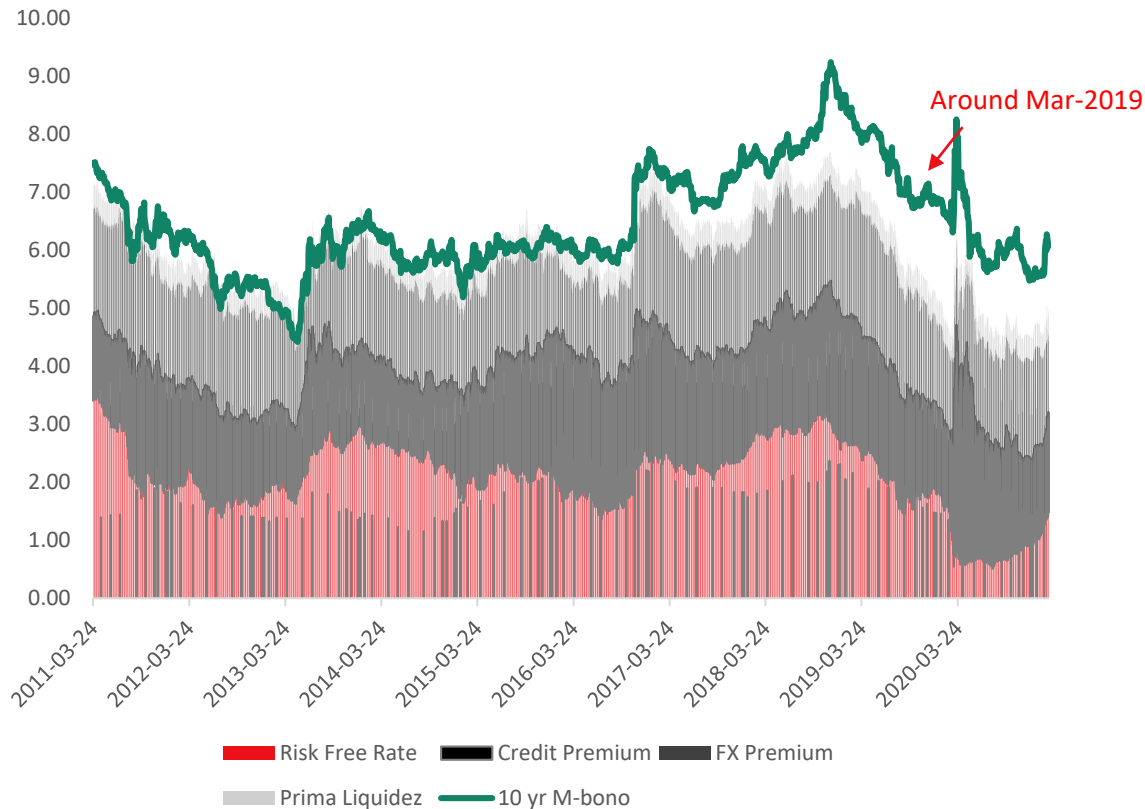
Sources: Scotiabank Economics, Moody's.



Sources: Scotiabank Economics, Moody's.

# 10yr M-bonos look “cheap to fair value”, but constant decline in foreign participation suggests downgrades being priced-in

M-bonos spread vs “Fair value” (% points)



Sources: Scotiabank Economics, Bloomberg.

Foreign holdings of m-bonos (% of total)



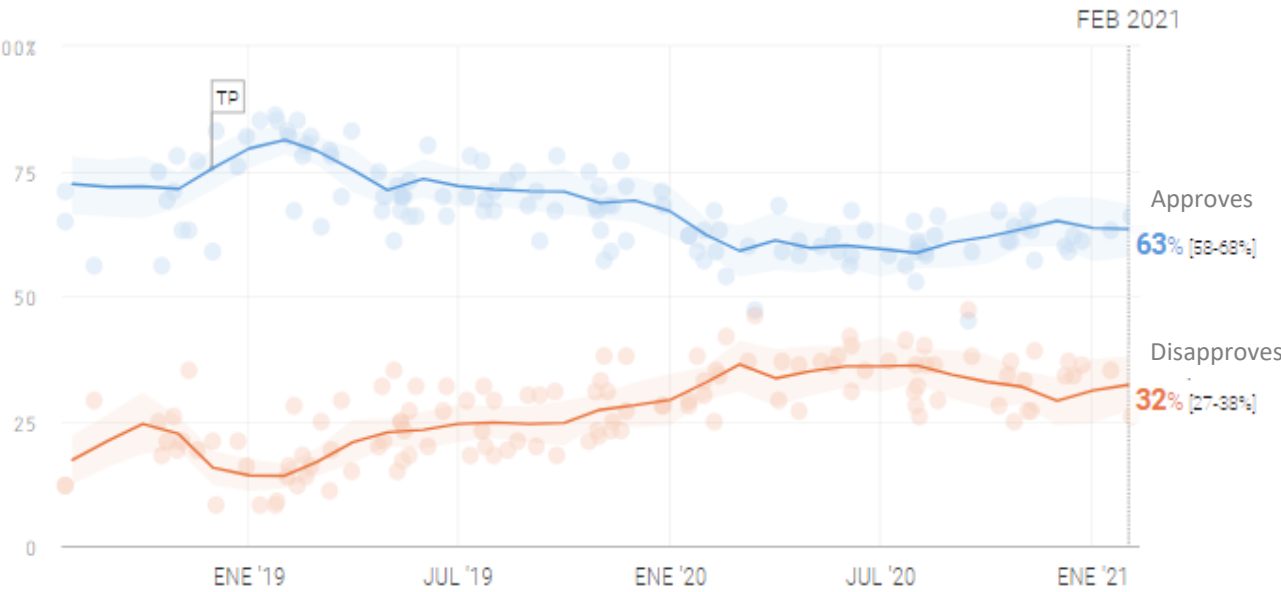
Sources: Scotiabank Economics, Banxico.



**Oraculus.mx:  
“The Oracle of Teotihuacan?”**

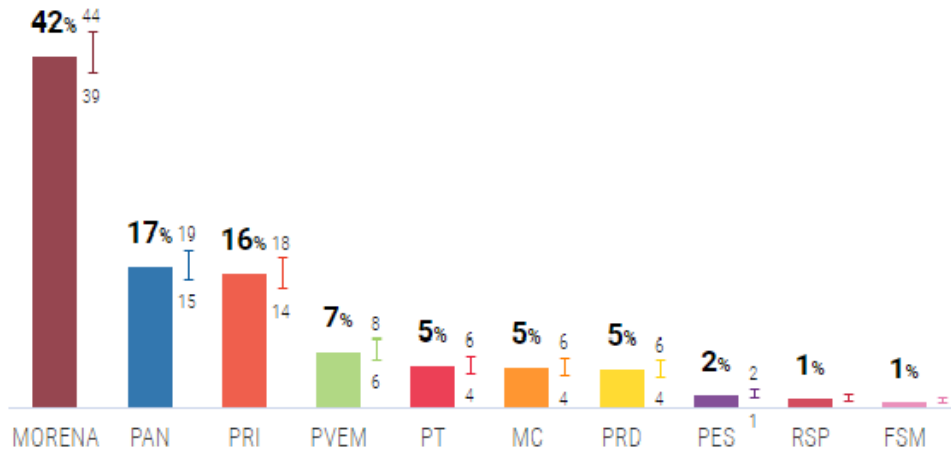
# AMLO approval rate rising, supporting mid-term prospects for Morena

**AMLO's Approval Rate (%)**  
Poll of polls from Oraculus.mx



**TP: AMLO Takes Possession.**  
Source: Oraculus.mx

**Projected votes for control of Congress by party (%)**  
Poll of polls of intended votes for mid-term Congressional Election.

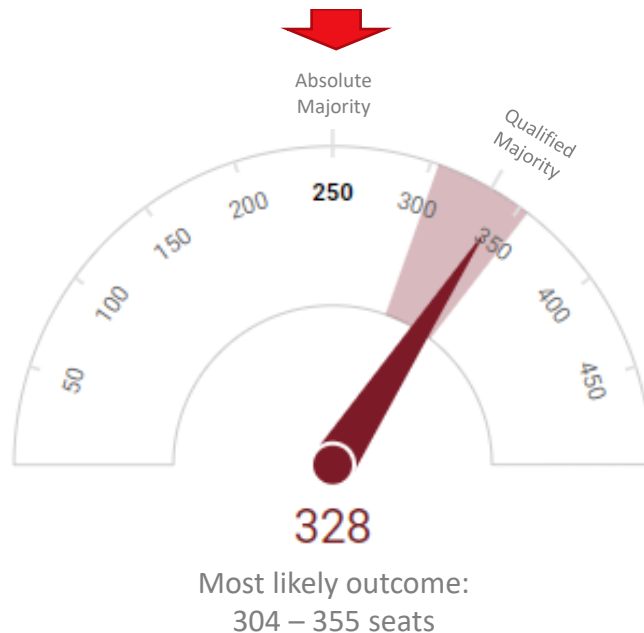


Estimates Include: void ballots, independent candidate votes, and non-registered voters.  
Source: Oraculus.mx

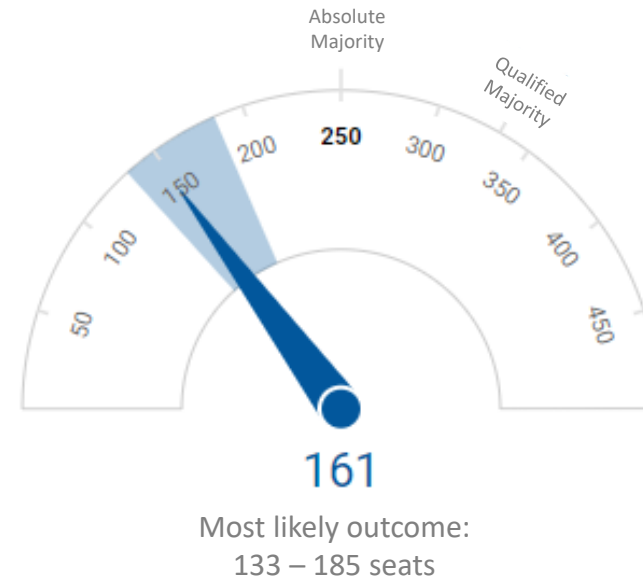
# Morena looks likely to retain at least an absolute majority, could get to a “Constitutional”/ Qualified one

Projected share of seats in the Lower House of Congress

**MORENA + PVEM + PT**



**PAN + PRI + PRD**



334 = magic number

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