MEXICO — "Outlook Revised to Stable, Strong Fundamentals / Conservative Policy Dynamics"

PLEASE SEE IMPORTANT DISCLOSURES & COPYRIGHT INFRINGEMENT IN THE APPENDIX

SYNOPSIS

Despite the scourge of crime and subpar growth relative to its peers, **Mexico's traditions of democracy and strong institutional frameworks over the last two decades have underpinned political stability, sovereign creditworthiness, investor confidence and ongoing access to capital markets** even during periods of global adversity. Mexico has a US$2.4 trillion economy, the 11th largest in the world and the second largest in Latin America. The population is approximately 130 million and the economy has been heavily weighted towards manufacturing since the North American Free Trade Agreement (NAFTA) in 1994 and its successor, the United States-Mexico-Canada (USMCA) Agreement which fully came into effect on July 1, 2020. Mexico is the US' second largest export market and its third largest source of imports with two-way trade in goods and services exceeding US$623 billion in 2017.

Besides the US, Mexico has free trade agreements with 46 sovereigns including Peru, Chile and Colombia with whom it signed the Pacific Alliance in 2012.

Central Bank independence, inflation targeting and a commitment to timely monetary policy decisions is also key to the strength of Mexico's investment grade rating (BBB/Stable). The sovereign is also endowed with natural resources such as oil, natural gas, timber, gold, zinc, copper and lead. Its natural resources have also led to the creation of large and important state owned and operated entities, namely Petroleos Mexicanos (PEMEX), the state run oil company, and Comision Federal de Electricidad (CFE), the state run dominant electric company.

Politics is polarized; there are traditional political parties and anti-establishment coalitions and / or movements. The divide is primarily along economic and domestic policy lines where cautious macroeconomic management has meant a limit on gasoline subsidies which has hurt business confidence. Policy makers highlight the fiscal and long term debt impact of the subsidies but the anti-establishment coalitions highlight the struggles of the poor and the effect of energy price inflation on the population.

Mexico, while being a wealthy country, has highly unequal income distribution with per capita GDP coming in at (US$9,926) approximately one-third of the US. Organized crime, public insecurity, corruption and subdued private investor confidence limits the upside to GDP growth. Mexico has average GDP growth of just about 2% and as at 2022, the economy has yet to return to pre-pandemic levels.

Long standing cautious policy making and prudent macroeconomic management has kept fiscal deficits and the debt in check compared to rating peers while the floating exchange rate and actively traded peso allows the economy to absorb shocks on the monetary side. External debt comes in at a manageable 25% of CAR (Current Account Receipts) which supports a solid external position. **External liquidity is also bolstered by access to a two-year IMF flexible contingent line of credit for up to US$50 billion** (approx. 4% of GDP).

THE POLITICS

Mexico's Chief of State and Head of Government is President Andres Manuel Lopez Obrador who came to power in December 2018. The President sits for a single 6-year term and elections are due in July-2024. The MORENA party is by far the strongest in Congress with 58 seats, this is more than double the seats of its closest rivals PAN and PRE with 22 and 14 seats respectively. Other political parties such as the MC, PRI, PRD and PT among others, make up the minority numbers.

In recent years the current administration has been criticized for moves to centralize political decision making and reduce political independence. However, there remain important checks and balances including the need for a two-thirds majority in Congress to pass constitutional amendments. Other controversial proposals, such as constitutional electricity reform and energy policy proposals, put forward by MORENA have been rejected by Congress and put aside by the Supreme Court.

The general view is that given the need for consensus to pass important legislation, no major policy initiatives will be passed before the next election due 2024.

ECONOMICS

Years of moderate to low private sector investment due to high crime, poor energy policies and weak consumer confidence combined with low public sector investment, poor quality education and judicial uncertainty have combined to constrain Mexico's growth prospects. Economic growth has averaged a weak approx. 1.7% over the last two decades. Investment/GDP and exports/GDP (**Table 1**) however remain robust compared to its rating peers because of Mexico's free trade agreements with the US & Canada (USMCA). **Record remittance inflows (US$50 billion) support low level consumption by the poor** as Mexicans continue to make the dangerous land border crossing to the US. It is also projected that **demand for exports will wane as higher US interest rates slow US GDP growth however, it is believed that recovery in tourism and domestic support services will at least partially offset any potential economic contraction for Mexico**.

Mexico's external vulnerability remains manageable as gross external financing needs compared to Current Account Receipts (CAR) plus usable reserves remains within the 84% category. Short term external debt / current account receipts is also well contained, coming in at below 10%. International reserves are also robust, coming in above US$200 million and representing approximately 4 weeks of goods and services cover.

ECONOMIC INDICATORS

Table 1

	Mexico- Selected Economic Indicators						
	2018	**2019**	**2020**	**2021**	**2022E**	**2023f**	**2024f**
Economic indicators (%)							
GDP per capita (000s $)	9.7	9.9	8.4	9.9	10.8	11	11.3
Real GDP growth	**2.2**	**-0.2**	**-8.3**	**5**	**1.7**	**1.9**	**2.1**
Investment/GDP	22.7	21.2	19.1	20.2	20.3	20.6	20.8
Exports/GDP	39.3	38.8	39.5	40.3	39.3	39.6	40.5
Real exports growth	5.9	1.5	-7.2	6.8	6.1	1.7	2.5
Unemployment rate	3.3	3.5	4.6	4.1	3.6	3.7	3.6
External indicators (%)							
Current account balance/GDP	-2	-0.2	2.5	-0.4	-0.6	-1.1	-0.8
CARs/GDP	43.1	42.8	44.6	45.1	43.6	43.5	44.4
Net FDI/GDP	2.1	1.9	2.3	2.5	2	1.9	1.9
Net portfolio equity inflow/GDP	0.6	0.8	0.5	0.5	0	0	0
Gross external financing needs/CARs plus usable reserves	86.5	84.6	77.9	83.8	83.4	83.6	84.5
Narrow net external debt/CARs	36.9	37.2	37.4	25.4	23.8	24.6	24.5
Net external liabilities/CARs	101.3	105.2	98.6	84.6	83.6	87.2	88.2
Short-term external debt by remaining maturity/CARs	10.5	11.4	12.9	11.5	9.9	8.9	9.8
Usable reserves/CAPs (months)	3.8	3.9	4.8	4.1	4	3.9	3.8
Usable reserves (mil. $)	176,394	183,034	199,097	207,835	211,709	214,939	218,168
Fiscal indicators (general government; %)							
Balance/GDP	-1.8	-1.8	-2.3	-3	-3.2	-3	-2.7
Primary balance/GDP	0.2	0.3	0.1	-1	-1.2	-0.9	-0.6
Revenue/GDP	18.2	18.1	19.4	18.2	-----	18	18.3
Expenditures/GDP	20	19.9	21.7	21.2	20.9	21	21
Interest/revenues	10.9	11.9	12.5	11	11.4	11.6	11.4
Debt/GDP	42.2	42.7	48.3	47.2	47.2	48.2	49
Monetary indicators (%)							
CPI growth	4.9	3.6	3.4	5.7	7.4	4.1	3.2
Exchange rate, year-end (LC/$)	19.65	18.93	19.95	20.5	20.5	21	21.5
Foreign currency share of residents' bank deposits	15.9	14.4	15.4	16.2	16.2	16.2	16.2

Sources: Mexico's Ministry of Finance, Central Bank of Mexico, National Statistical Institute (INEGI), IMF and S&P Global Ratings.

On the fiscal side Mexico continues to pursue prudent and cautious fiscal policies. We acknowledge that the deficit has widened from approximately 2+% to approx. 3% however, compared to its peers the deficit remains well contained. The primary (non-interest) balance has also seen some slippage, moving from a marginal surplus to a marginal deficit. However, the primary balance is expected to revert to surplus over the medium term. **Cautious fiscal policy has also meant that despite covid-19 and the Russia / Ukraine conflict, Mexico's debt/GDP remains firmly anchored below 50%.**

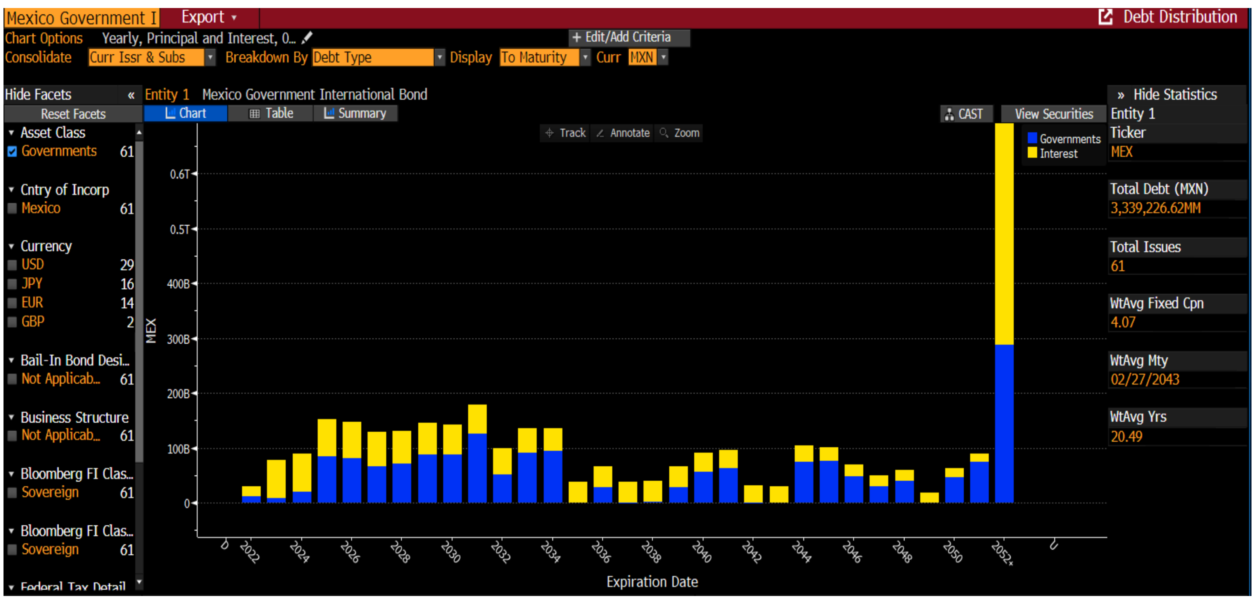
DEBT & FISCAL

The relatively low debt means that the debt service burden is also manageable as measured by interest expense as a percentage of government revenues; this ratio is firmly anchored at approximately 11%. **In terms of upcoming external liabilities (Table 2),** Mexico has consistent maturities and interest expense payments over the medium term (6-7 years). However, **the debt dynamics indicate that these payments are manageable** as measured by narrow net external debt / CAR (Current A/C receipts) coming in at 25% over the next couple of years.

Mexico also has various stabilization funds (from consolidated trusts and autonomous bodies) which form a small cushion against economic volatility. The Federal Revenue Stabilization Fund (FEIP), as at March 2022, comes in at 24.6 billion Mexican pesos (MXN) or just 0.1% of GDP

External investor holdings of Mexico's locally issued central government debt has declined to about US$80 billion in 2022. The industry view is that the decline reflects global market volatility (covid & Russia/Ukraine war), a rebalancing of EM debt towards China (who entered the World Government Bond Index in 2021) and issues regarding government policies which has also led to negative sentiments by locals (excise tax & gas subsidy).

Table 2



LOW RISK OF DEFAULT

Mexico's debt structure avoids the asset/liability mismatch faced by many LATAM and EM sovereigns. Approximately 80% of Mexico's central government debt is issued in Mexican pesos (MXN) and about 55% of the debt is fixed rate debt. The maturity profile of the debt also eases any potential near-term fiscal burden (& rollover risk) with the average life of external debt coming in at 21 years and approximately 7 years for the local debt. There is strong participation from locals in the Mexican debt market with residents holding about 70% of total commercial sovereign debt. That said, Mexico is still active in the global capital markets. **The aforesaid highlights the limited risk investors face from exposure to Mexican Sovereign debt.**

Despite the prudent management of its sovereign debt, Mexico's Achilles heel is its relatively poor management of PEMEX and CFE. PEMEX is fully owned by the Mexican government, the oil and gas conglomerate shapes Mexico's energy policy and is embedded in the economy. It is the largest company in Mexico and the largest tax payer. However, various issues of low production, under investment in capital expenditure, questionable contract awards, theft and corruption have led to several downgrades of Pemex by the rating agencies. In 2019, oil production fell below 1.6 million barrels per day, while proven reserves fell to 7 billion barrels of oil equivalent (bnboe).

In response to the historically poor management, the government has cancelled future bidding rounds until further notice. There is also limited private firm involvement, with the government restricting private firms to service contracts and only limited bidding for specific contracts. **While the government does not guarantee the debt of PEMEX and CFE, it is highly likely they will intervene to provide extraordinary support during times of distress.** Hence the weak financial profile of these quasi-sovereign entities is a risk to Mexico's fiscal performance.

Other potential risk factors emanating from areas such as banking and central bank policy making are deemed low at this time. Mexico's financial system is deemed well capitalized and highly liquid and has weathered the global pandemic and on-going Russia/Ukraine crisis well…so far. The central bank's independence is well protected and there is strong public support for the institution. Inflation has been kept in single digits since 1999 and the central bank has moved to contain inflation via a combined 375 bsp increase in interest rates to 7.75% from its pandemic low. Monetary policy is conducted within the context that a sharp rise in the exchange could undermine the confidence of foreign investors in Mexico's locally issued sovereign debt.

FUNDAMENTALS SUMMARY

Mexico is a relatively stable, low risk sovereign based on its fundamentals and a country we would recommend taking exposure to at this time. Low debt, a conservative fiscal policy stance, no bunching up of maturities in the medium term and a manageable debt servicing cost all bode well for Latin America's second largest economy. The major challenge for the sovereign are its two government owned and controlled utility companies, PEMEX and CFE. Corruption, questionable awarding of contracts and theft have dogged the management of both entities. That said, the government has made small strides in controlling the rot in both entities, restricting bidding by private firms until further notice and making key managerial changes.

THE TECHNICALS

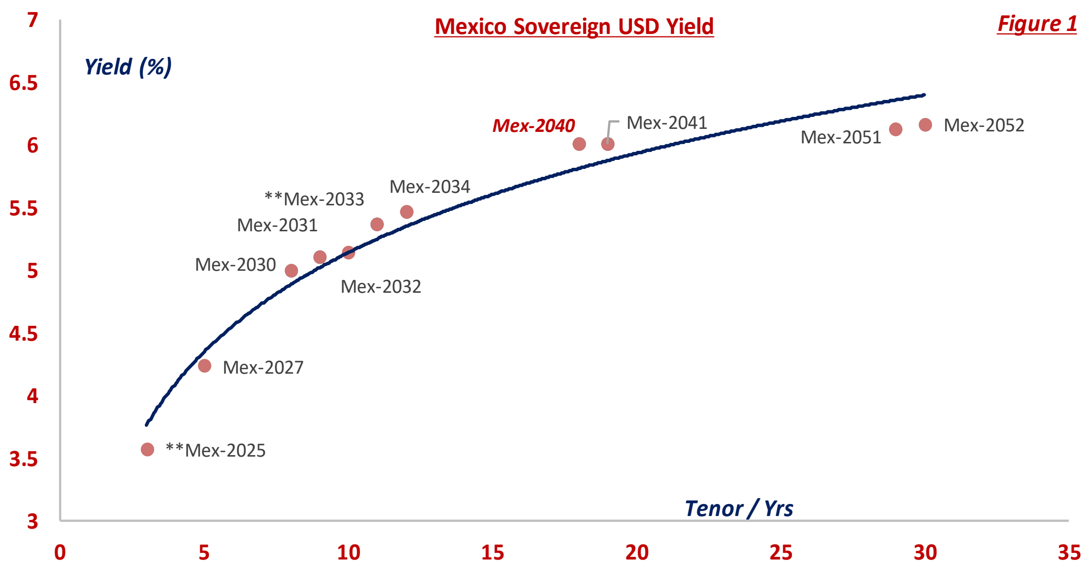
A look at Mexico's USD-denominated sovereign debt across the curve (***Figure 1***) indicates that the yields range between 3.6% and 6.2%. The bonds in the middle of the curve, raging between the 2030's and the 2041's, seem to offer the greatest value given how wide they trade from our extrapolated yield curve. The 2033's and the 2025's are the most actively traded by volume, according to Bloomberg, of the USD denominated notes.

Mexico USD-Denominated Global Bonds (Table 3)						
Bond	**Ask Yield**	**Ask Price**	**Coupon**	**Maturity Type**	**Yrs To Maturity**	**Issue Size**
**Mex-2025	3.573	100.059	3.60%	Bullet	3	3,000
Mex-2027	4.236	99.648	4.15%	Bullet	5	3,150
Mex-2030	4.998	89.072	3.25%	Callable	8	3,069
Mex-2031	5.105	82.996	2.66%	Callable	9	3,396
Mex-2032	5.142	97.05	4.75%	Callable	10	2,500
**Mex-2033	5.371	96.015	4.88%	Callable	11	2,204
Mex-2034	5.47	83.914	3.50%	Callable	12	2,868
Mex-2040	**6.008**	**100.435**	**6.05%**	**Bullet**	**18**	**4,250**
Mex-2041	6.013	80.568	4.28%	Callable	19	3,257
Mex-2051	6.129	84.841	5.00%	Callable	29	2,500
Mex-2052	6.166	76.708	4.40%	Callable	30	2,931

Source: Bloomberg; Opco

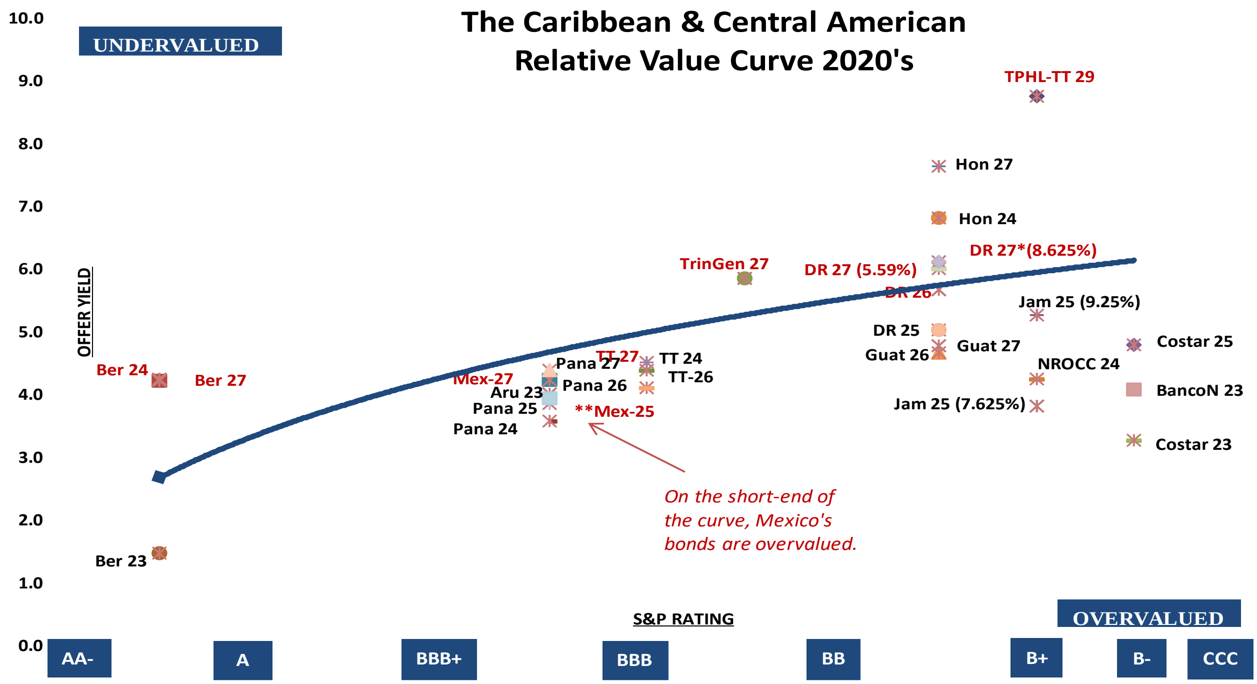
***- Most Actively Traded-Bloomberg*

However, we like the 2040's because of their relatively high coupon rate (cash flow), relatively higher yield and larger issue size (liquidity).

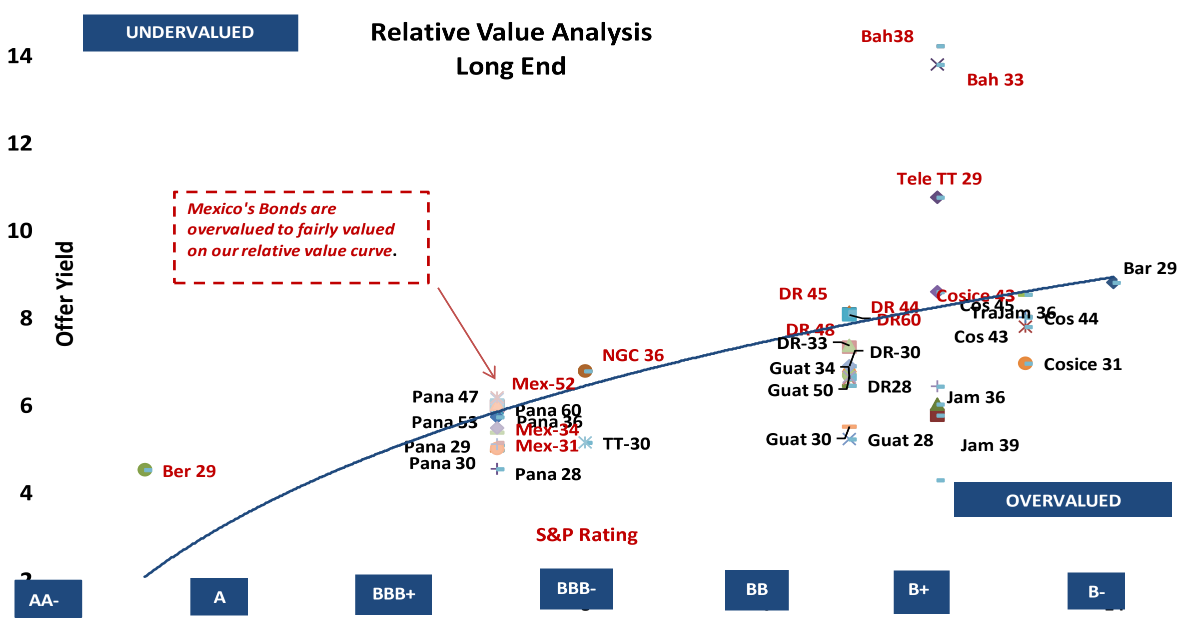


A look at our yield curve also indicates that the 2040's trade wide to the curve.

From a **relative value perspective**, on the **short end of the curve below**, Mexico's bonds are considered overvalued. The Mexico 27's and the 25's trade inside our relative value curve along with Panama, Aruba & Trinidad. The quasi-sovereigns (TPHL-TT & the Tringen's), the **Dominican Republic**, Bermuda and Honduras are the more attractive and undervalued assets based on our relative value curve.



On the long end of the curve (below), most of **Mexico's USD** denominated global bonds trade between **relatively expensive and fairly valued**; Mexico trades in line with Panama. Our relative value curve indicates that the NGC-36's, Dom Rep, Cosice, Telecoms-TT, Bermuda and the Bahamas are the most attractive and trade widest to our exponential curve.



RECOMMENDATION

Based on our analysis of the technicals, Mexico's USD sovereign bonds are either fairly or overvalued. If we had to choose one, we would go with the 2040's based on liquidity, yield and cash flow/coupon. That said, Mexico is rated investment grade, the sovereign benefits from prudent economic policy making, has low debt, low debt servicing cost, has no bunching-up of maturities and offers diversity. The country is endowed with hydrocarbons (oil & natural gas), has a vibrant tourism industry and benefits from many free trade agreements including the USMCA (the follow-up to NAFTA) which provides preferential trade access to the US and Canada.

We are recommending Mexico as a diversity play and assign an **UNDERWEIGHT RECOMMENDATION**; we acknowledge that for Jamaica the funding cost may be too high however for TT and the DR it could represent an opportunity.

Source: Standard & Poor's / www.capitaliq.com, FITCH Solutions / www.businessmonitor.com, www.imf.org, US department of State, Moody's Investor Services, CIA Factbook.

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

PLEASE NOTE THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY, THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

STRONGLY UNDERPERFORM—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 2.5% FOR THIS PARTICULAR ASSET

UNDERPERFORM—REDUCE EXPOSURE IN YOUR PORTFOLIO TO 2.5% - 4.9% FOR THIS PARTICULAR ASSET

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

HOLD/MARKETPERFORM—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

OUTPERFORM/BUY—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

The investments referred to in this report may not be suitable for you should consult your licensed investment advisor. Nothing in this report constitutes investment, legal, accounting or tax advice or a representation that any investment or strategy is suitable to your individual circumstances or otherwise constitutes a personal recommendation to you.

Disclosure Under The Securities Act

This disclosure is being provided pursuant to section 39 of the Securities Act. This research report is prepared by Jamaica Money Market Brokers Limited (JMMB) and the information and views expressed are those of JMMB. JMMB is a subsidiary of the JMMB Group Limited (JMMBGL). Associated persons of JMMB include JMMBGL and its subsidiaries and affiliated companies, including JMMB Fund Managers Limited, a licensed securities dealer and manager of collective investment schemes.

As at the date of this report, JMMB and its affiliates, directors, officers, employees and other associated persons may from time to time buy or sell, or act as principal or agent in, the securities mentioned in this research report. JMMB or its affiliates, directors, officers and employees have no interest in or interest in the acquisition or disposal of the securities other than expressed above. No part of their compensation is or will be related to the recommendations or opinions in this report.