COUNTRY NOTE: MEXICO

August 2024

GLOBAL EVOLUTION MEXICO

Mexico's June general election yielded a surprisingly large win for the Morena party. Its coalition is extremely close to securing a qualified majority in both chambers of Congress, likely enabling current President Obrador, known as AMLO, to pass constitutional reforms in September, his last month in office. AMLO's protégé and successor, Claudia Sheinbaum, inherits an economy with significant geopolitical opportunities, particularly in the realm of nearshoring, but also one in very poor shape with fiscal accounts at a 30-year high, sluggish growth, and eroding governmental checks and balances. We have concerns about AMLO's reforms further weakening government checks and balances and the ability - and willingness - of the new administration to adjust fiscal accounts

By Sofus Asboe, Senior Portfolio Manager

Politics & Constitutional Changes

During discussions with policy-makers, the main issue was the perceived likelihood of the Morena party-led coalition achieving a qualified majority and the potential for constitutional reforms in the final month of President Andrés Manuel López Obrador (AMLO). The party is proposing 18 constitutional reforms, the most critical affecting the judiciary and social spending related to minimum wage hikes and pensions. We think reforms - particularly the judicial ones - will pass in September, and the impact will be significant for Mexico's structural integrity.

The final scope of reform remains uncertain. AMLO aims to replace judges at all levels—Supreme, federal, and local courts. If this measure is not diluted – which is unlikely as Sheinbaum apparently supports it - it will significantly reduce the country's institutional checks and balances. The social reforms, directly sponsored by Sheinbaum, will add a recurrent and constitutional expenditure of around 0.15% to 0.2% of GDP. Locals are hopeful that Sheinbaum will be a more pragmatic version of AMLO, but she will need to balance the power of the radical movement within the Morena party as it pushes for higher social spending and limitations on private investment.

Growth and Nearshoring

Mexico is not typically a high-growth emerging economy, but it has recently benefited from the tailwinds of nearshoring supply chains. Historically growth has been weak, only matching population growth, implying zero productivity growth in the economy. Nearshoring presents an opportunity for momentum, but infrastructure and general investment have been lagging. Although foreign investment has increased in recent years, capacity constraints are starting to affect key industrial sectors. The deprioritization of infrastructure investment and a lack of promotion of private investment during AMLO's term seem to limit Mexico's ability to fully capitalize on nearshoring opportunities.

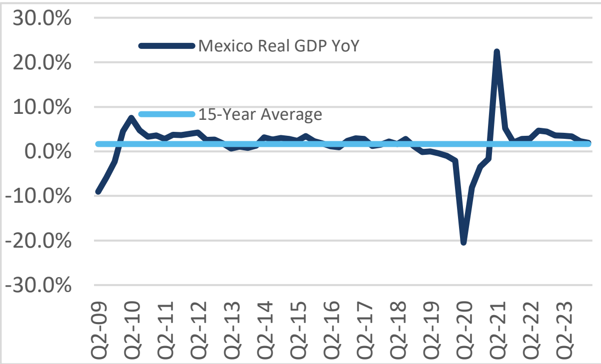

Chart: Last 15-years of Mexico real GDP growth YoY. Source: Haver.

The proposed judicial reform brings significant uncertainty to the thesis for private investments and could trigger pushback from the US concerning the USMCA (the 2020 trade agreement between US, Mexico and Canada), especially if a Republican president is elected in November. Recent growth in Mexico has been lackluster despite high public spending leading up to the election, which included both social programs and the finalization of key AMLO projects. The future growth outlook appears challenging given the need for fiscal adjustment, the completion of major public capital projects, and high uncertainty around constitutional changes and their implications for business activity and private investments.

Our view is that Mexico may be missing an historic growth opportunity by not promoting private investments and passing judicial reforms that significantly reduce institutional checks and balances. We would be more optimistic about growth if the judicial reform fails or is heavily diluted. We also believe Sheinbaum could be more favorable toward promoting private investment than AMLO, but if the judicial reform passes before her inauguration the structural changes could overshadow her more pragmatic nature.

Fiscal and Debt

Fiscal prudence was an unexpected narrative during AMLO's presidency, but in the latter part of his term he increased spending on pet projects and social programs. This means Sheinbaum will likely inherit one of the largest deficits in 30 years, around 5.5-6% of GDP. Debt is stable at around 50% of GDP excluding state-owned and operated petroleum company Pemex (and around 55% including it), which rating agencies already consider in their assessments of Mexico's sovereign rating.

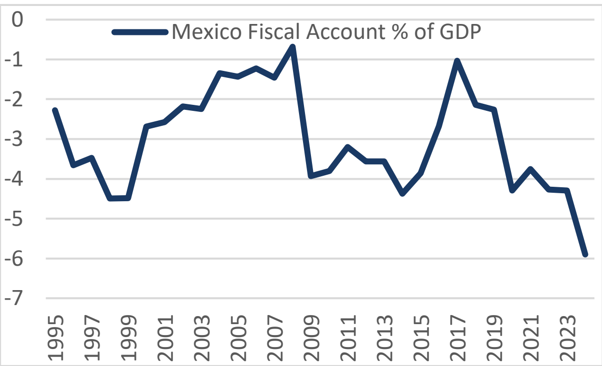

Chart: Last 30-years of fiscal performance in Mexico. Source: Haver & IMF.

The Sheinbaum administration knows it must consolidate fiscal accounts. The incoming administration projects a deficit of 3.5% in 2025[1], which seems very unrealistic given the growth outlook, Sheinbaum's unwillingness to cut social spending, and increasing interest costs. Capex could be cut in 2025 to adjust fiscal accounts, but Mexico needs critical infrastructure investments to capitalize on nearshoring momentum. Fiscal reform, likely in the form of tax reform, is also a must but Sheinbaum's team has not committed to this, instead floating the idea of taxing the banking sector to generate additional revenue.

We expect that fiscal adjustment under Sheinbaum will focus on revenue generation rather than spending cuts, as she needs to balance public approval, power struggles within the Morena party, and fiscal responsibility. In the coming years, either fiscal prudence will be abandoned or Sheinbaum will need to increase tax pressure on the economy, further challenging an already constrained growth outlook. Overall, fiscal accounts look vulnerable, with the deficit at a 30-year high while Mexico benefits from geopolitical nearshoring and a strong US economy. If these external tailwinds become neutral or negative, Mexico does not have the fiscal capacity to address the resulting issues.

External Balance and the Banxico

Mexico's external accounts have been strong post COVID, with a constant rolling basic balance surplus. This is unlikely to change in the medium term, especially with growth slowing and potential fiscal consolidation affecting imports. Foreign direct investment has picked up in the last two years, accounting for around 2.1% of GDP this year. However, this is still well below pre-COVID and pre-AMLO levels, even with the tailwinds of nearshoring.

This reflects AMLO's policy of skepticism toward private involvement and lack of promotion of Mexico as an investment opportunity. We believe there is a significant chance that Sheinbaum will differ from AMLO in this respect and start promoting Mexico more positively for private investments. Inflation is approaching the Bank of Mexico's (Banxico) target range, but uncertainty persists in the outlook due to fiscal stimulus, constitutional changes, and the pending US presidential election. We believe Banxico is closely monitoring the peso, as it is an AMLO priority to keep it strong in the last months of his term. Thus, it seems the spread between US and Mexican policy rates will persist, allowing Banxico to adopt a more dovish stance when the U.S. Fed moves, at least while AMLO is in power.

[1] Bloomberg

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