Mexico: a golden opportunity for fixed income investors?

Image source: iStock/stockcam

Introduction

The recent presidential elections in Mexico, held on June 2, 2024, have created both uncertainty and opportunity in the bond market. Despite short-term volatility, there is a strong case for increasing exposure to Mexican sovereign bonds in local currency. Mexico benefits from a strong relationship with the United States and structural shifts like nearshoring, making it a promising landscape for fixed income investments.

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Key Highlights:

- Political changes: Claudia Sheinbaum's victory and Morena's majority in Congress raise concerns about potential constitutional changes. However, similar fears during Andrés Manuel López Obrador's (AMLO) administration did not materialise, suggesting resilience in Mexico's economic framework.
- Economic policies: Sheinbaum's commitment to foreign investment and U.S. relations, along with business-friendly initiatives, bode well for Mexico's corporate sector. The Finance Minister's focus on debt reduction and fiscal prudence further supports this positive outlook.
- Nearshoring boom: Significant foreign investments from companies like Tesla and Amazon highlight Mexico's strategic advantage in nearshoring, potentially boosting Foreign Direct Investment (FDI) and economic growth.
- Monetary policy: Banxico's effective inflation management and the potential for rate cuts enhance the attractiveness of Mexican bonds, despite current high rates.
- Market appeal: Mexico's investment-grade rating and attractive yield levels provide a solid foundation for fixed income investors. The current nominal yield of about 10% offers significant return potential.

Political landscape: fears vs. reality

Claudia Sheinbaum, the former mayor of Mexico City, is set to become Mexico's first female president. She has pledged to continue the policies of her predecessor, Andrés Manuel López Obrador (AMLO). However, her victory caused a negative market reaction: Mexico's sovereign and quasi-sovereign bond spreads widened, the Mexican Bolsa experienced a 5-10% decline, and the Mexican peso depreciated by 4% against the dollar. This reaction was driven by Sheinbaum's unexpectedly large victory margin and Morena's acquisition of a qualified majority in Congress, raising concerns about potential significant constitutional changes. These changes could negatively impact medium-term economic growth and lead to fiscal imbalances.

Chart 1: Mexican Peso Evolution vs. US Dollar

Source: Syz CIO Office, Bloomberg

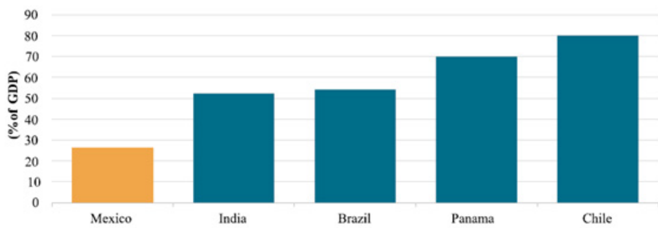
Historical context is important here. Similar concerns emerged during AMLO's administration but failed to materialise. Following the 2018 election, Mexican stocks initially declined due to uncertainties surrounding the new government's economic agenda, the role of public sector banks in social inclusion efforts, and proposed banking regulations. Despite these concerns, the anticipated challenges did not materialise, and the banking sector witnessed increased profitability over the past six years. The previous administration also established a business advisory council, featuring influential figures from the business community, which is likely to continue under Sheinbaum's leadership.

Positive economic policies and business environment

Despite initial market fears, Sheinbaum's policies are expected to positively impact the Mexican corporate sector. Her commitment to increasing foreign investment and maintaining strong U.S. relations is promising. Mexico is the second-largest recipient of Foreign Direct Investment (FDI) in Latin America, with FDI constituting nearly 50% of its GDP. Earlier this year, Sheinbaum outlined several business-friendly initiatives, including streamlining regulatory processes, upgrading customs infrastructure, enhancing security measures, promoting investment planning, and fostering foreign investment. These initiatives reflect a robust commitment to improving Mexico's business environment. Furthermore, Mexico's Finance Minister, who is expected to remain in place under the new administration, has committed to reducing the country's debt and maintaining a deficit-cutting agenda. The government aims to ensure macroeconomic stability and fiscal prudence, emphasising strong communication with investors and credit rating agencies to demonstrate the feasibility of their fiscal targets.

The Mexican macroeconomic picture is promising, as it is one of the countries benefiting the most from nearshoring, which should lead to a sharp increase in FDI. This trend is evidenced by numerous projects from major foreign companies, such as Tesla's $15 billion investment over the next two years and Amazon's $5 billion investment. Energy companies will also contribute significantly to future FDI, with Mexico Pacific (US), Copenhagen Infrastructure Partners (DEN), and Woodside Energy Group (AUS) investing more than $30 billion over the next four years. These sustained higher private sector investments should develop a large supply chain catering to the North American market and reduce reliance on China. Additionally, there is potential for increased access to credit for the private sector, as Mexico has one of the lowest domestic credit-to-private-sector ratios in Latin America.

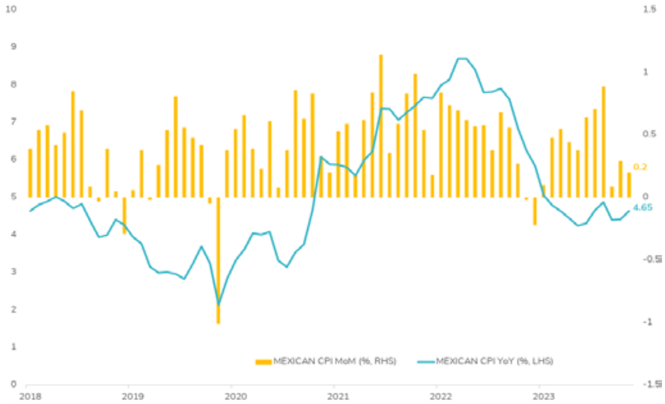
Chart 2: Domestic Credit to Private Sector as % of GDP: Mexico and Peers



Source: S&P Global Rating

While real GDP growth in Q1 2024 was modest at +1.6%, in line with market expectations, Mexico's growth outlook appears brighter in the long run, with an average growth rate above 2% over the next few years. On the inflation front, Banco de Mexico (Banxico) has managed inflation effectively, raising rates much faster and higher than developed markets. Inflation is back to pre-pandemic levels, although some recent upward pressure has been observed. Analysts predict year-end CPI at 4.27% for 2024 and 3.73% for 2025, while Banxico forecasts 4.40% for the end of 2024, 3.80% in 2025, and 3.50% in 2026.

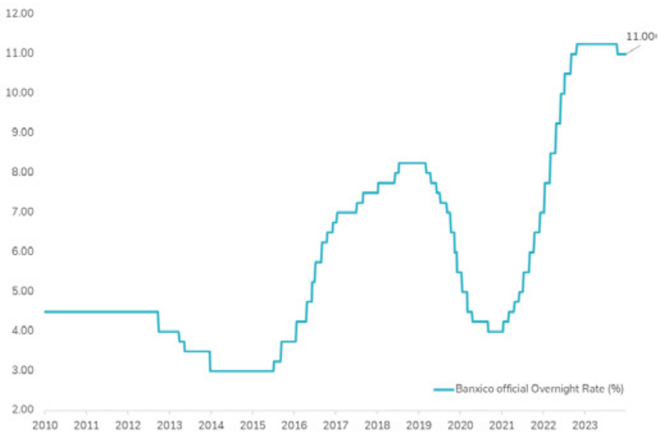
Chart 3: Evolution of Mexican Inflation in YoY and MoM



Source: Syz CIO Office, Bloomberg

Despite the deceleration in inflation, Banxico has not aggressively cut rates. With the current key rate at 11%, it remains significantly above the neutral rate. Banxico's inflation target is set at 3%, with a tolerance range of plus or minus 1%. The real short-term interest rate (R*), at which the economy is in balance, is set at 4%. Therefore, there is potential for rate cuts, especially if the Federal Reserve begins normalising its monetary policy later this year. With economic growth expected at 2.0% in 2024 and 1.8% in 2025, a real rate above 6%, and debt levels that could stimulate access to credit, Banxico is likely to continue normalising its monetary policy over the coming months.

Chart 4: Evolution of Banxico monetary policy in (%)

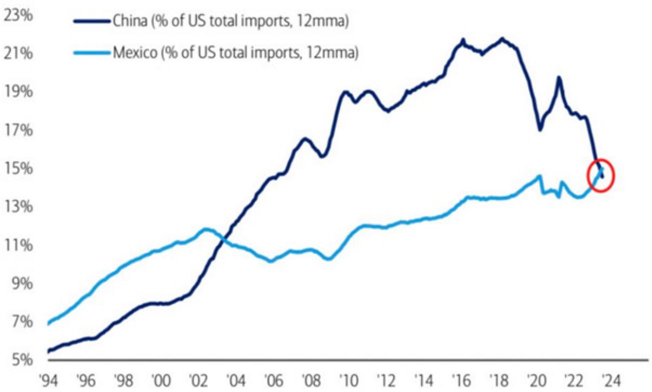


Source: Syz CIO Office, Bloomberg

Syz house view: Mexico's strategic position

At Syz, we remain constructive on Mexico as it should continue to benefit from its proximity to the US, making it a preferred partner. This explains the numerous investment plans from foreign companies. For the first time since 2003, the US is importing more from Mexico than China.

Chart 5: China and Mexico as % of US imports (12-month moving average)



Source: Bank of America

Mexico enjoys an investment-grade rating supported by its disciplined financial policy and stable access to external liquidity, while keeping its government debt-to-GDP around 48% this year, below the sovereign BBB median of 56% in 2023 according to Fitch.

While we think volatility will remain persistent in 2024/2025, we consider that the current yield is attractive enough to absorb this volatility. With a nominal yield of about 10%, the carry is a significant part of the potential return.

Chart 6: Evolution of the 10-year Mexican government yield in local currency (%)

Source: Bank of America

During AMLO's tenure, MBONO long-term bonds have delivered over 30% in total returns in local currency. Additionally, the Mexican peso has strengthened by more than 10% against the US dollar, further enhancing the attractiveness of these investments for foreign investors. In contrast, US Treasuries have remained almost flat over the same period, highlighting the superior performance of Mexican bonds.

Potential risks and challenges

Despite the positive outlook, there are several risks that investors should be aware of:

- Trade tensions with the US: aggressive tariff policies or trade disputes with the US could adversely affect Mexico's export-driven economy and its attractiveness to foreign investors.
- Pemex's financial stability: regarding Pemex, Sheinbaum is expected to adopt a pragmatic approach, initially addressing Pemex's substantial debt burden, which currently exceeds $100 billion, and its amortisation schedule. However, any mismanagement or failure to effectively tackle these issues could lead to financial instability for Pemex, impacting investor confidence.
- Constitutional changes and political risks: the potential advancement of significant constitutional changes could introduce political instability. Changes in the election of Supreme Court judges, the dissolution of autonomous bodies, and the enshrinement of social programmes in the constitution could impact the country's governance and fiscal flexibility, leading to investor uncertainty.
- Monetary policy shifts: while Banxico has managed inflation well, any unexpected shifts in monetary policy, either by Banxico or influenced by global economic conditions, could impact bond yields and investor returns.
- Global economic conditions: broader global economic trends, such as fluctuating commodity prices, global interest rates, and geopolitical tensions, could impact Mexico's economic stability and attractiveness to investors.

Conclusion: constructive on Mexico's fixed income potential

In conclusion, while short-term volatility is inevitable, the long-term outlook for Mexican fixed income remains promising. At Syz, we maintain a constructive view on Mexico, particularly its local currency sovereign bonds. Mexico's strong economic fundamentals, strategic positioning for nearshoring, and disciplined financial policies make it an attractive destination for fixed-income investors.

The current yield levels provide an appealing carry, and the potential for further monetary policy normalisation by Banxico could enhance returns. By closely monitoring the new administration's policies and economic indicators, investors can strategically position themselves to capitalise on potential gains while mitigating risks. Diversification and thorough analysis will be key strategies in navigating this evolving market landscape.

Mexico's bond market presents a unique opportunity to leverage its economic growth, structural advantages, and favourable investment climate, reinforcing our positive stance on its fixed income potential.

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