Mexico

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First Citizens
Research & Analytics

COUNTRY		CREDIT RATING			
Real GDP growth(%) Q3 2016 (BMI)	2.80%	S&P Foreign Currency	BBB+ (Stable)	Major Trade Partners	US 80.2%, EU 5.1%, Canada 2.7%, China 1.5%, Brazil 1.2%
Next General Election	1-Jul-18	Fitch Foreign Currency	BBB+ (Stable)	Major Exports	Crude petroleum, Cars, Vehicle Parts, Delivery trucks, Computers
Exchange Rate MXN/USD	0.054	Moody's Foreign Currency	A3 (Negative)	GDP Composition	Agriculture: 3.6%, industry: 36.6% and services: 59.8%

RECENT ECONOMIC DEVELOPMENTS

ECONOMIC OUTLOOK — **POSITIVE**

Mexico will benefit from stronger U.S. labor markets, bolstering manufacturing sector exports and remittance inflows. However, sharper monetary and fiscal tightening will weigh on Mexico's economy in the years ahead, tempering private consumption and real export growth. According to BMI forecast, real GDP growth will remain relatively flat between 2015 (2.4%) and 2016 (2.8%), accelerating only gradually in 2017(3.1%). Oil production is poised to be even weaker than anticipated on the back of cuts to state-owned oil company Pemex's budget. Moreover, rising inflation will eat into consumer purchasing power, tempering some of the benefit to private consumption from improving labour market dynamics. Fixed investment will remain a bright spot for the Mexican economy, with the country set to gain from increased foreign involvement in the recently reformed energy sector.

FISCAL PROFILE — **STABLE**

The authorities announced earlier this year additional expenditure cuts of 0.75% of GDP for both 2016 and 2017 to ensure that the targets for these years will also be met, despite the significant downward revisions in projected oil production and prices since the last budget. The cuts this year will fall mostly on PEMEX, and are part of a broader restructuring plan, aimed at making it an efficient and viable company in the context of persistently lower oil prices. Adherence to the fiscal consolidation plan is important to set the public debt-to-GDP ratio on a downward path, restore fiscal buffers, and maintain investors' confidence. Despite the sharp depreciation of the currency over the last two years, the yields on local-currency government bonds have increased only modestly, showing continued trust in the creditworthiness of Mexico's government.

EXTERNAL ACCOUNTS — **NEGATIVE**

Mexico's current account deficit will widen in 2016 as falling oil production and low prices weigh on export growth, while the Fed interest rate hikes increase the flow of income repatriated out of the country. BMI forecasted a shortfall of 2.9% of GDP, after a 2.8% current account deficit in 2015. While remittances will continue to tick higher, this will be insufficient to offset the impact of a rising primary income account deficit and a sizeable goods trade shortfall. Thereafter though, the country's external account position will improve, with rising oil prices and increased demand for manufactured goods narrowing the goods trade deficit, while remittances continue to tick higher. After 2016, it is projected that the current account deficit will begin to shrink, forecasting an average deficit of 2.1% between 2017 and 2020. Remittances will continue to climb higher on the back of strong US labour market dynamics. Moreover, the country's trade shortfall will narrow significantly.

CREDIT RATING — **STABLE**

On 27th January 2016, Mexico's S&P credit rating was kept at 'BBB+/A-2' Foreign Currency and 'A/A-1' Local currency sovereign credit ratings; Outlook remains Stable. The ratings on Mexico reflect its track record of fiscal and monetary policies, which has contributed to limited government deficits and low inflation, as well as moderate fiscal and external debt levels. According to S&P, Mexico possess a flexible economy which is able to adjust to changing global conditions, including a sharp drop in oil prices and local currency depreciation. The creation of more dynamic energy sector will lead to strengthening of the non-energy sector, such as manufacturing, over time, leading to an improved rating.

On 31st March 2016, Moody's Investors Service affirmed Mexico's A3 issuer and government bonds rating but change the outlook from stable to negative. The key reasons for the outlook change were:

1) Subdued economic performance and continued external headwinds, which challenge government fiscal consolidation efforts and increase the risk of debt ratios not stabilizing during the period of rating.

2) Contingent liabilities in the form of government support to PEMEX, given liquidity pressures that can undermine the fiscal consolidation process.

Upward pressure on Mexico's rating could result from higher than expected growth driven by continuing structural reform efforts, conversely downward pressure on Mexico's rating could result from stalled fiscal consolidation.

PEMEX IMPACT

A bailout of Mexico's state-owned oil company Pemex would likely prompt a modest deterioration in Mexico's fiscal or growth dynamics in the year ahead, though it will should not threaten the sovereign's ability to meet its obligation. It is assumed that the Mexican government will likely be forced to offer financial assistance to Pemex in 2016 as the state-owned oil company struggles in the face of elevated debt burden, sizeable arrears to oilfields service providers and limited liquidity. While a bailout would weigh on Mexico's sovereign credentials in the short term, damage to investor sentiment would be mitigated by government's history of prudent macroeconomic policies and Pemex's ongoing cost cutting measures.

OUTLOOK

First Citizens Research & Analytics maintains a *stable* outlook on Mexico because of its expected continuity in economic policies, along with ongoing fiscal adjustment that compensates for lower oil revenues and contains the government debt burden. However, a further prolonged decline in oil prices, or slower than expected growth in the U.S. economy, could lead to larger deficits and slower GDP growth. That, along with failure to effectively implement the recent reforms could contribute to weaker investor confidence, poor medium term growth prospects, and higher vulnerability to external shock, warranting a downgrade.