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Mexico Trip Notes: AMLO[1] Unbound

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Deputy Portfolio Manager David Austerweil recently spent a week in Mexico, meeting government economic and political experts, as well as independent analysts and local market participants.

Summary

- AMLO's unchallenged control over government policy means Mexico is subject to his campaign promises: cancel the Mexico City airport, build a new refinery, increase social spending on youth and the elderly, and become, in his words, the "Fourth Revolution" in Mexico.
- Public finances will deteriorate as AMLO eventually chooses unfunded expenditures, to fulfill his campaign promises, over promised fiscal prudence. Petróleos Mexicanos[2] (Pemex) is where the most immediate fiscal risks are likely to materialize; a downgrade of Pemex to high yield (HY) would lead to significant forced selling of Pemex debt by dedicated investment grade (IG) investors.
- Investors in sovereign debt are not compensated for the high level of policy uncertainty and the deteriorating credit and institutional outlook.

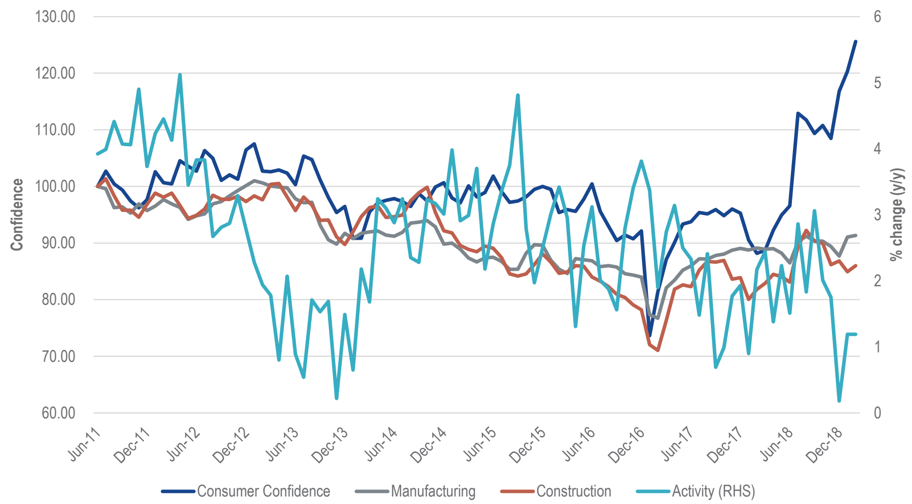
Political Dominance

AMLO is in complete control over government policy: his political party, the Movimiento Regeneración Nacional (Morena), controls both chambers of Congress, he reached an approval of 86%, and he speaks every morning directly to his followers by radio and social media. Moreover, there is no longer any opposition party with meaningful support: the Partido Acción Nacional (PAN) lacks a leader and lacks direction and many the Partido Revolucionario Institucional (PRI) officials have defected to Morena in order to stay in power.

AMLO's support is built on decades of failure of Mexican government policy to improve significantly the living standards and economic opportunity of the majority of Mexicans. Per capita gross domestic product (GDP) has not grown materially over the past three decades, investment in the economy has been sluggish, and crime remains endemic. Because of this failure, AMLO's direct appeals to the population are highly credible. Consumer confidence is surging to record highs as the average Mexican feels empowered by AMLO's success and believes he will deliver on his campaign promises. While there are high expectations for him to deliver, he will be able to blame neoliberalism and the "mafia de poder"[3], his two boogeymen, for both the failures of the past and his own future failures for some time to come. In the meantime, he is eroding institutional capacity and consolidating power in the presidency.

So far, elevated consumer confidence is not yet feeding into business confidence and businesses do not have plans to increase investment for a number of reasons: 1) AMLO has failed to articulate credibly how his fiscal target of a 1% of GDP primary surplus for 2019 is consistent with his spending promises; 2) AMLO has not articulated a business plan for Pemex that would allow it to meet its production goals and Pemex has not articulated a coherent message to markets about how Pemex itself will be funded, including upcoming debt maturities; and 3) AMLO has not earned the trust of the business community or provided a detailed plan of how he will address the major impediments to investment: lack of security and rule of law. Additionally, by cancelling the Mexico City airport project, AMLO has brought the sanctity of public sector contracts into question.

Mexico Consumer Confidence has not led to higher business confidence or economic activity so far



Source: INEGI

Self-Imposed Fiscal Straitjacket

AMLO made a number of financially costly promises during his campaign that, if achieved, would be positive for Mexico's growth and investment outlook: 1) increase the production of Pemex from 1.6 million barrels per day (bpd) to 2.4 million bpd; 2) build a new oil refinery in Dos Bocas, Tabasco and refurbish six existing refineries; 3) expand pensions for the elderly nationwide; 4) create an education program for youth to gain employment along with other social assistance programs; 5) develop new railroad infrastructure; and 6) substantially decrease crime and corruption. AMLO promised to do all of this without raising existing taxes and without creating new taxes, and while still maintaining a primary budget surplus of 1% of GDP. The main means of savings identified will come from major cuts to public sector wages (that have led career technocrats to flee the public sector), reprioritizing social spending away from old programs, cutting federal transfers to state governments, and curbing fuel theft at Pemex. The finance ministry has promised that the fiscal surplus will be the binding constraint and that expenditures that would break that surplus will be foregone.

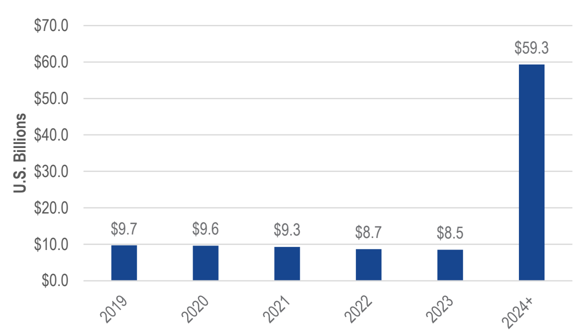
In order for the majority of these promises to be successful, substantially more would need to be invested, resulting in either a large primary deficit or much higher taxes. For example, AMLO has not budgeted any additional funds to fight crime; instead his strategy is to lead by example. However, the military and police are woefully underfunded and underpaid. AMLO chose to put his administration's ability to execute its promises in a straitjacket and it seems much more likely that he will choose to break out of this straitjacket rather than fail to deliver on all of his promises. The promises that AMLO is most likely to deliver on, based on his priorities, however, are the least productivity-enhancing. For example, third-party analysts all indicate that it would be much cheaper for Mexico to continue to import gasoline than to build a new refinery and that if self-sufficiency were truly the motive, Mexico should be building new storage capacity for fuels, as many regions have storage for just a handful of days. Blackouts have become more frequent as Mexico struggles with fuel shortages related to Pemex's fight against fuel theft.

Finally, the finance ministry includes a 6.1% increase in revenues in real terms for the 2019 budget law without any additional revenue measures. It is a useful budgetary strategy because if this revenue increase were to fail to materialize, the government would then be able to draw on its stabilization fund, worth about 1.5% of GDP, in order to fund the shortfall. The government may also use some of the stabilization fund to pay for Pemex, though it is not yet clear how this would be legal. If spent, the budgetary safety net of the stabilization fund would not be available for 2020.

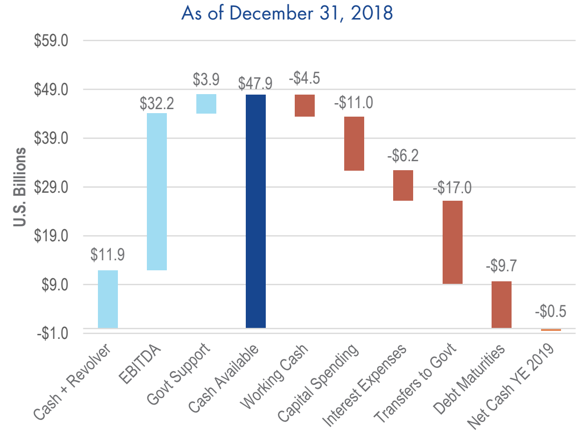
The Pemex Time Bomb

The biggest risk to a scenario of slow deterioration in institutional credibility and fiscal prudence comes from the state oil company Pemex. Neither the government nor the company has defined a coherent strategy of how it will increase oil production and build a new refinery under the capital constraints it faces. AMLO has promised to stabilize production in 2019 at around 1.7 million bpd and increase production to 2.6 million bpd by the end of 2024. Most analysts estimate it will cost around $15 billion to stabilize production in 2019 and, as Pemex has budgeted around $13 billion for upstream spending, it may fall a bit short of target. Recently, the finance ministry suggested that Pemex spend the $1.3 billion it gave the company in capital on financing debt instead of building the new refinery only to be rudely corrected by AMLO. As illustrated in the chart below, by the end of 2019, unless it is able to access capital markets to rollover debt, Pemex will have exhausted its existing cash and credit lines. Without these buffers, the nearly $10 billion in maturities to refinance in 2020 will become extremely problematic.

One quarter of PEMEX's debat matures during 2019-21
As of December 31, 2018



PEMEX's 2019 planned spending and financing needs consume its available cash and revolver
As of December 31, 2018



Notes: Support package from government includes $750 million in tax relief, $1.3 billion capital injection, release of $1.8 billion long-term government promissory note. EBITDA includes $10 billion in royalties/other government transfers and estimates for oil price of $55/bbl. Capex estimate based on IFRS. *Source: PEMEX; Moody's Investors Service*

In order to achieve AMLO's 2024 production goals, Pemex will need a complete transformation in terms of efficiency, a new tax regime where the government take is reduced so that Pemex is competitive with the private sector, and large annual infusions of capital. The more likely outcome is that Pemex stabilizes production in the near term, at the expense of future production and reserve replacement, and the government continues to improvise support measures until it is forced by the market to provide an explicit guarantee for Pemex's debt issuance. If Mexico were to fully combine the balance sheets of Pemex and the country (Pemex, essentially, becoming a ministry), it would add about 10% of GDP to Mexico's debt to GDP ratio and around 2% of GDP to the fiscal deficit on a recurring basis. Because AMLO has canceled the oil auctions and excluded future participation of the private sector, the growing capital needs of Pemex would eventually take the combined entity to below IG, leading to substantially higher borrowing costs as IG investors are forced to sell. Unfortunately, AMLO believes that Pemex is a great oil company and that energy matters are a national interest and so he cannot admit the need for foreign participation.

Banxico Watches and Worries

Last year, the Central Bank of Mexico (Banxico) was concerned about the renegotiation of the North Atlantic Free Trade Agreement (NAFTA) and the outcome of the presidential election. This year, it is concerned about the potential fiscal risks stemming from a deterioration in the credit quality of Pemex and the subsequent increase in financing costs for the government. The governor of Banxico is quick to remind investors that Mexico is not undergoing a typical business cycle; instead, it is buffeted by both external and domestic shocks. For this reason, Banxico has maintained an extremely tight monetary policy with a real policy rate of 4.25%. For 2019, growth is forecast to be between 1.5% and 2%, which is slightly below the potential growth rate of 2%. However, due to a continuing lack of private sector investment and government expenditures that may disappoint due to poor execution, growth may end up even lower than 1.5%. Inflation, on the other hand, is forecast to remain above Banxico's target over 2019 and only converge to target during 2020. Given the dismal growth outlook and the eventual expected convergence of inflation to target in 2020, the bond market has started to price in interest rate cuts of at least 50 bps for 2019.

However, it seems more likely that Banxico waits for a clear solution to Pemex's financing worries and for AMLO to present the 2020 budget in 4Q19 (to make sure the government's commitment to fiscal prudence remains) before reducing the policy rate. Local debt will suffer as the market prices out rate cuts and the curve should steepen on future fiscal slippage.

Mexico's De-Rating Story Is Not In The Price

Based on the emerging markets debt team's sovereign valuation model, Mexico's credit spreads are fairly valued for its current credit profile. On our sovereign radar chart for Mexico, levels of foreign direct investment (FDI), fiscal deficit, and government debt are all at average levels. Previous Mexican governments have worked hard to protect and improve these metrics. However, under AMLO's new administration, all of these metrics will steadily deteriorate. Additionally, AMLO is intentionally undermining key independent institutions like the electoral authority (INE) and the energy regulator (CRE) in order to remove checks to his power. AMLO's election represents a regime change. In his own words AMLO plans to carry out the "Fourth Revolution" in Mexico and investors should heed his words and invest with appropriate caution.

Note on radar charts: The red circle in the chart above is the mean for each radial (each radial measures an important variable such as PC/GDP, or private credit as a percent of GDP, etc.). The dark line is the result for Mexico, with results outside the circle being worse than the mean, and results inside the circle being better than the mean. Please see footnote located at the end for description of metrics.

IMPORTANT DISCLOSURES

[1] AMLO = Andrés Manuel López Obrador, President of Mexico.

[2] The Mexican state-owned petroleum company.

[3] Translation: mafia in power.

Radar Chart Key - PC/GDP - private credit to GDP, GGD/GDP - general government debt to GDP, TXD/GDP - total external debt to GDP, RES/M - international reserves to months of imports, RES/M2 - International reserves to % M2, M2/GDP - M2 to GDP, GR/GDP - Government revenue to % GDP, FB/GDP - Headline fiscal balance to % GDP, CAB/GDP - Current account balance to % GDP, FDI/GDP - Net FDI to % GDP, GDP/CPT - US$ GDP per capita to PPP, EDB - Ease of doing business, CE/A - Common equity to % assets, L/D - Loans to deposits ratio, XDS/CAX - External debt service (public and private) to % CA receipts.

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