

MUFG LATIN AMERICA TOPICS



Mexico's Macroeconomic Performance: Q1 2017 and Current Economic Indicators

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7 JULY 2017

Overview

Mexico's GDP grew by 2.8% YoY in Q1 2017, the fastest pace since the third quarter of 2015.

Household consumption grew 3.3% YoY in Q1 2017, the highest growth rate since Q1 2013. This increase was supported by the strengthening of the labor market.

Mexico reported a contraction of 2.3% YoY in Gross Fixed Capital Formation (GFCF) in Q1 2017, the largest drop since Q4 2013. This result is explained by a contraction in both government investment (-11.6% YoY) and private investment (-0.5% YoY).

Inflation continued to increase in recent months and in May 2017 reached 6.2% YoY, the highest inflation registered since April 2009. The higher inflation is mainly the result of the fuel deregulation taking place this year that is expected to cause a YoY increase in fuel prices during 2017.

The Central Bank increased interest rates at its last meeting in June 2017 to 7.0% in an attempt to combat inflationary pressures. The Central Bank of Mexico will continue to try to raise the interest rate to address the high inflation in Mexico during 2017 but will likely halt these rate increases (or even cut rates) in 2018 as inflationary pressures likely subside.

In 2017, it is expected that Mexican GDP growth could decelerate slightly from its growth rate in 2016 (2.3%), even though Q1 performance showed the Mexican economy was more resilient than expected. Consumption could suffer due to inflationary pressures. In addition, the continued uncertainty regarding Mexico's relationship with the US and the government austerity measures could affect investment.



1. GDP, Economic activity

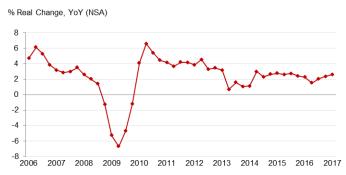
Mexico's GDP grew by 2.8% YoY in Q1 2017, the fastest pace since the third quarter of 2015 (Figure 1), and slightly better than forecast (2.7% YoY)¹.

GDP by Sector

On the production side, the service sector continues to be the main motor of economic growth in Mexico, growing 3.8% YoY in Q1 2017 (Figure 2). The subsectors of financial services, transportation and commerce (9.2%, 4.6% and 3.8% YoY, respectively) performed better than in Q4 2016 (7.4%, 3.1% and 2.4% YoY, respectively).

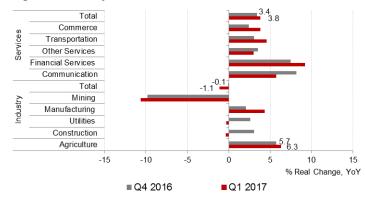
In contrast, the industry sector continued to struggle (-1.1% YoY) in Q1 2017. The mining sector fell 10.7% YoY, construction activity slipped 0.4% YoY, and utilities were

Figure 1: GDP growth



Source: INEGI, MUFG

Figure 2: GDP by Sectors



Source: INEGI, MUFG

off 0.3% YoY. The mining sector had seen its output decline in Q1, the fastest over the past three years. Oil and gas extraction continues to be the sector's main source of weakness. This weak performance is the result of the Government of Mexico cutting the budget of PEMEX² in 2017 by about 20% YoY in an attempt to rein in spending.

The agriculture sector grew 6.3% YoY in Q1 2017. This was acceleration from Q4 2016 (5.7% YoY).

¹ The median forecast of economists surveyed by Bloomberg.

² PEMEX (Petroleos Mexicanos) is the Mexican state owned petroleum company. In 2016, the government approved a permanent adjustment (cut) of PEMEX spending by 100 billion Mexican pesos (Economic Package, 2017). As a result of these cuts, PEMEX announced that it will not extract oil where costs are above 25 USD per barrel.

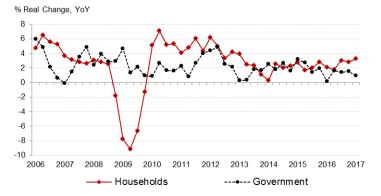


Consumption

Household consumption grew 3.3% YoY in Q1 2017, the highest growth rate since Q1 2013 (Figure 3). Households continue to demonstrate resilience even with the backdrop of soaring inflation and the uncertainties of trade relations with the United States.

The increase in household consumption in Q1 2017 was supported by the strengthening of the labor market with job creation of

Figure 3: Consumption



Source: INEGI, MUFG

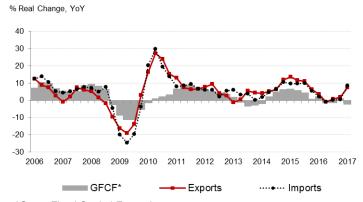
around 378 thousand jobs³ (about 40% more than job growth in Q1 2016) and a 3.4% unemployment rate in Q1 2017, the lowest level since Q2 2008.

Investment, Exports and Imports

Mexico reported a contraction of 2.3% YoY in Gross Fixed Capital Formation (GFCF) in Q1 2017, the largest drop since Q4 2013 (Figure 4). This result is explained by a contraction in both government investment (-11.6% YoY) and private investment (-0.5% YoY).

Exports increased 7.5% YoY in Q1 2017, in comparison to 1.8% YoY in Q4 2016. This is explained by the improvements in global demand that

Figure 4: Investment, Exports and Imports



*Gross Fixed Capital Formation Source: INEGI, MUFG

helped lead to a recovery in manufacturing exports. Imports registered a 8.4% YoY increase in Q1 2017, compared to 0.6% YoY in Q4 2016.

³ IMSS (Mexican Institute for Social Security) reported that the recent gains in job creation were partially due to Holy Week (the week leading up to Easter) occurring in March. If job creation in March 2017 is compared to March 2016, job creation increased 136% YoY. If Holy week is excluded from the analysis, there was still a 58% increase in job creation, making March 2017 the best month in terms of job creation in recorded history.



Foreign direct investment (FDI) contributes an important amount of total GFCF in Mexico⁴.

During the first quarter of 2017, FDI decreased to 8 Billion USD (Figure 5) from over 10 Billion USD in Q1 2016. Digging deeper into the sub-components of FDI reveals that most of the FDI during this period corresponded to reinvested earnings⁵ (63%), while only a small portion represented equity capital (25%), a figure that also decreased if compared to Q1 2016 (36%). The US contributed 50% of total FDI (Figure 6) during Q1 2017, and increased slightly during Q1 2017 in comparison to Q1 2016.

Both, equity capital and reinvested earnings are equally important to future FDI in Mexico. New investments in Mexico have declined YoY, possibly as the result of uncertainties coming from the US. Despite the fall in new

Figure 5: Foreign Direct Investment from the Rest of the World by Source of Investment



Figure 6: Foreign Direct Investment from the US by Source of Investment



investments, investors decided to reinvest earnings which could be a sign that investors have confidence in the Mexican economy and the potential profitability of the investment. It is still too soon to quantify the impacts of the Trump presidency on FDI in Mexico, and we will continue to monitor the evolution of FDI in Mexico closely throughout the year.

⁵ It is normal that reinvested earnings are higher in the first quarter of each year because companies usually reinvest their earnings from the previous year.



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⁴ In 2015, FDI represented 13% of GFCF in Mexico. This ratio is less than that in other countries in Latin America (Brazil, 23%; Chile, 37%; Colombia, 15%), but is above the average of all OECD members (12%). World Bank Data.

2. Fiscal Policy

Mexico's public finances during the Table 1: Mexico's Public Finance first four months of 2017 were aligned with the government's budget and appear on track to achieve a primary surplus for 2017. However, this improvement was supported largely by the Central Bank of Mexico's operation remnants that were the result of the international reserves gaining value due to the depreciation of the Mexican peso. Expenditures increased at a more moderate pace (2.8% YoY), thanks to the government's austerity efforts⁶. The challenge for the Mexican government will be maintain this positive trend once the

	January-April		
	2016	2017	% YoY
	(MXN Bn)	(MXN Bn)	
Revenues	1,686.6	1,919.8	13.8
Oil related	225.2	286.5	27.2
Federal government	101.1	161.4	59.6
Pemex	124.1	125.1	8.0
Non-oil related	1,461.3	1,633.3	11.8
Federal government	1,267.9	1,411.7	11.3
Tax	960.8	1,013.4	5.5
Non-tax*	307.1	398.4	29.7
Public entities under direct budgetary control	193.4	221.6	14.6
Expenditures	1,520.0	1,562.8	2.8
Programmable**	1,176.7	1,141.0	(3.0)
Current Expenditure	913.4	941.9	3.1
Capital Expenditure	263.3	199.1	(24.4)
Non Programmable***	343.3	421.9	22.9
Budgetary Balance	166.5	357.0	114.4

^{*}Includes Central Bank of Mexico's operation remnants

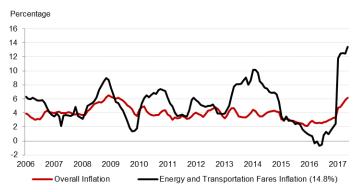
Source: Secretaria de Hacienda, MUFG

Central Bank of Mexico's support via operation remnants ceases due to an eventual appreciation of the currency.

3. Inflation and Monetary Policy

Inflation continued to increase in recent months and in May 2017 reached 6.2% YoY, the highest inflation registered since April 2009 (Figure 7). increase is principally due to the in energy increase prices and transportation fares⁷ as a result of the government decidina subsidizing fuel prices⁸. Inflation is expected to end 2017 above the upper band of the inflation target. The higher

Figure 7: Overall Inflation and Energy and Transportation Fares inflation



Note: The number in the bracket is the weight in overall inflation (2010).

Source: INEGI, MUFG

In December 2016, the government decided to begin a gradual deregulation of fuel prices as part of an energy reform process. This deregulation will have 5 phases during 2017 that will eventually include all states. During each phase, a group of states will see fuel prices deregulated. Meanwhile, the Economic Secretary is calculating the price of fuel on a daily basis. This price takes into account international oil prices, transportation and storage costs, distribution costs and a special tax on fuel.



^{**} Expenses that cover the activities of government institutions to provide services to people

Expenses that are allocated to fulfill government obligations by law, such as public debt

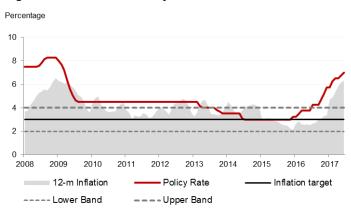
⁶ The government in its budget proposal for 2017 proposed a spending cuts of about 240 thousands millions of Mexican pesos respect to 2016 budget, which account for 1.2% of GDP.

Public transportation fares increased by 3.9% in Q1 2017. This was mainly due to a fare increase in Mexico City that was between 17% and 25%. This increase went into effect at the end of April.

inflation is mainly the result of the fuel deregulation taking place this year that is expected to cause a YoY increase in fuel prices, during 2017.

The Central Bank of Mexico increased the interest rate at its last meeting in June 2017 to 7.0% (Figure 8) in an attempt to combat inflationary pressures (between January 2016 and June 2017, the Central Bank increased the interest rate by 3.75 percentage points). The Central Bank of Mexico will continue to try to raise the interest rate to address the high inflation in Mexico during 2017 but will likely halt these rate increases (or even cut rates) in 2018 as inflationary pressures likely subside.

Figure 8: Inflation and Policy Rate

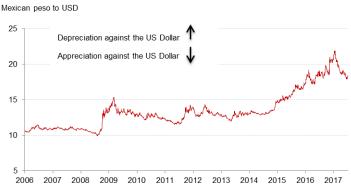


Source: INEGI, Central Bank of Mexico, MUFG

4. Exchange Rate

After reaching its lowest value in January, the Mexican peso started to appreciate (Figure 9). This was the result of the current view that the likelihood of significant changes to NAFTA as a result of any negotiations are low. However, the appreciation that has taken place during the beginning of 2017 should not be taken as a signal of any longer term trends, as continued volatility of the Mexican peso is expected throughout the year as a result of the still uncertain situation with the US.

Figure 9: Exchange rate (Mexican peso)



Source: Central Bank of Mexico, MUFG



5. Outlook

In 2017, it is expected that Mexican GDP growth could decelerate slightly from its growth rate in 2016 (2.3%), even though Q1 performance showed the Mexican economy was more resilient than expected. Consumption could suffer due to inflationary pressures. In addition, the continued uncertainty regarding Mexico's relationship with the US and the government austerity measures could affect investment.

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