BTMU Focus Latin America

Mexico: macroeconomic performance

(2Q GDP and Current Monthly Indicators)

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I) Mexico: Growth Momentum (1)

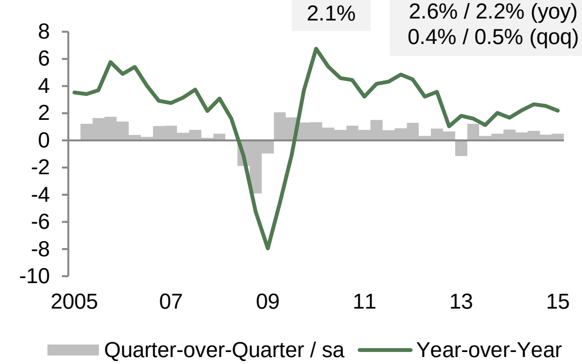
▪ Mexico's second-quarter economic data send two different messages.

- Recent data about the Mexican economy seem to paint two very different pictures. On one hand, the economy apparently stepped up a gear in 2Q 2015 according to demand-side data. For instance, private consumption soared by 3.0% yoy in 2Q, following a rise of 3.2% in 1Q, which means that households are spending at the fastest pace since 2012. That might be surprising given the recent currency depreciation (i.e., higher import costs), but the fact is that only 11% of consumer goods are imported. Also, fixed investment continued to show a fairly solid pace of growth in 2Q despite a pullback in public investment due to lower oil-related revenues. Better yet, export volumes, partly fueled by a weaker peso and partly shored up by the growth momentum of the auto industry (e.g., car exports hit 1.4 million units in the first half of the year, an all-time record-high level), increased by 8.9% yoy in 2Q despite the heavy drag from falling oil exports. But on the other hand, and according to supply-side data, the economy actually lost some momentum due to weak industrial production in 2Q.

Figure 1: GDP Growth

% real change

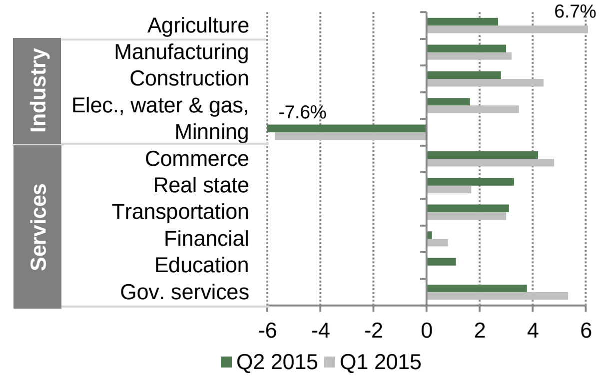
2014	1Q / 2Q 2015
2.1%	2.6% / 2.2% (yoy) 0.4% / 0.5% (qoq)



Source: Instituto Nacional de Estadística y Geografía (INEGI); BTMU

Figure 2: GDP by Sector

% real change yoy

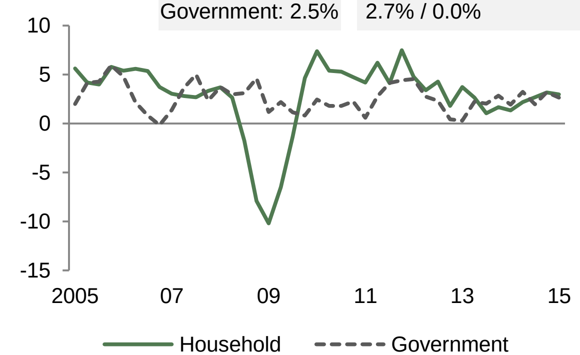


Source: INEGI; BTMU

Figure 3: Consumption

% real change

2014	2Q 2015
Household: 2.0% Government: 2.5%	3.0% / 0.5% (yoy / qoq) 2.7% / 0.0%

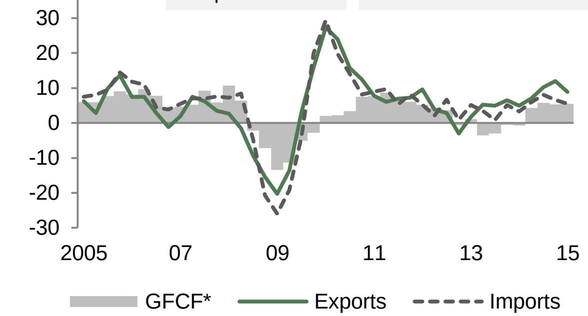


Source: INEGI; BTMU

Figure 4: Investment, Exports and Imports

% real change

2014	2Q 2015
Investment: 2.3% Exports: 7.3% Imports: 5.7%	5.5% / 0.9% (yoy / qoq) 8.9% / 1.0% 5.5% / 0.6%



* Gross Fixed Capital Formation

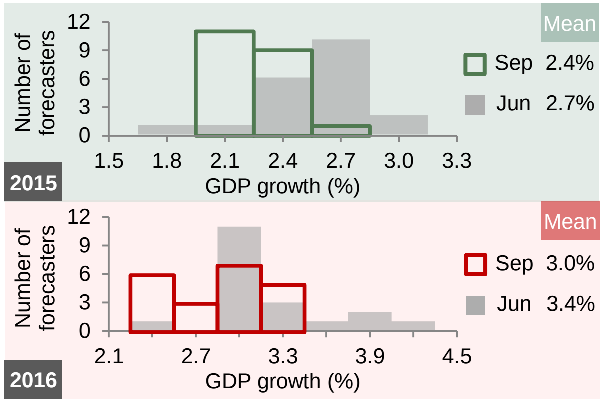
Source: INEGI; BTMU

I) Mexico: Growth Momentum (2)

- **Weak industrial production will probably drag economic growth down to below 2.5% this year.**

- It seems the Mexican economy is indeed losing speed, according to the most recent data. The IGAE index, a proxy for GDP, for instance, rose by only 2.07% yoy in July, which is the slowest pace in more than 10 months. More disquieting, perhaps, is the fact that industrial production (about one-third of GDP) only grew 1% yoy in the first 7 month of the year. Worse yet, it has been growing below 1% since April, with no signs of recovery. A closer look at its components underlines how widespread the slowdown is: construction is losing steam as the government cuts investment; mining activity continues to dip due to falling oil production; and manufacturing production, closely linked to the US, has been cooling down since February. There are underlying weaknesses in the demand side as well: consumer and business confidence remain weak. All this, of course, does not bode well for 2H 2015. In fact, we do not see GDP growing more than 2.5% this year. The prospects for 2016 are better, but the downside risks are greater as well (e.g., tighter financial conditions than expected).

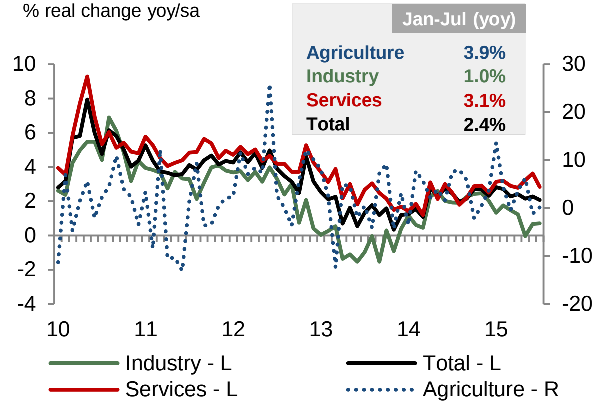
Figure 5: GDP Growth (private forecasts)



Source: Consensus Economics; BTMU

Figure 6: Index of Economic Activity (IGAE)

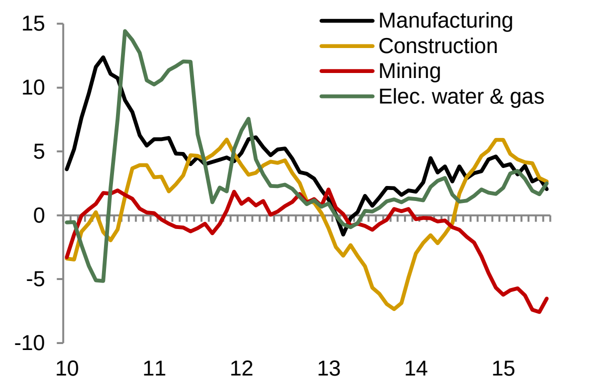
% real change yoy/sa



Source: INEGI; BTMU

Figure 7: Industry Production by Sector

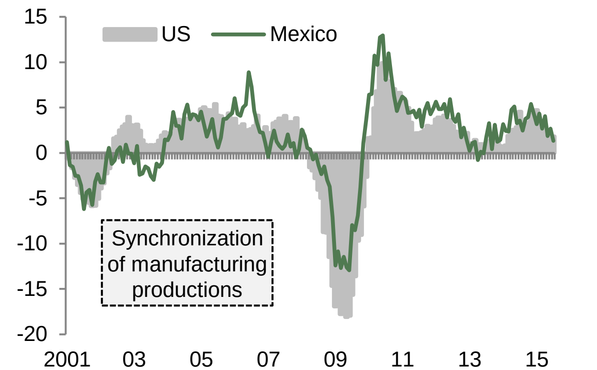
% real change yoy, 3-month moving average



Source: INEGI; BTMU

Figure 8: Manufacturing Production

% volume change yoy

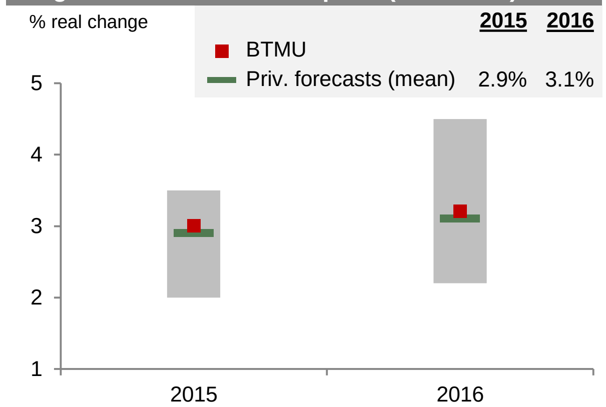


Source: INEGI; Federal Reserve; BTMU

▪ Household consumption will pick up this year despite low consumer confidence.

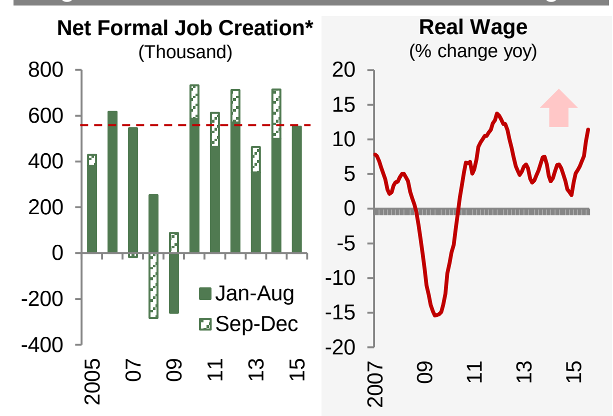
- Household spending continues to build momentum as reflected in retail sales, which have been rising at an average monthly yoy rate of 5% in real terms so far this year, and nearly twice as fast as it was in 2014. Other indicators too tell the same story: car sales rose by 20% in the first 9 months of this year compared to the same period in 2014; and consumption of imported goods increased by 6% yoy in 2Q 2015 despite the depreciation of the peso. More importantly perhaps, this growing momentum in private consumption is underpinned by improvement in job creation, real wages and remittances, suggesting that private consumption should pick up this year. However, the expected recovery is likely be hampered by some underlying weaknesses. For instance, consumer-credit growth remains low and consumer confidence has been falling for months, which possibly reflects softer economic growth prospects and pessimism over the benefits of the structural reforms. Should those driving factors stay weak, further improvement in consumption growth in 2016 would be hard.

Figure 9: Private Consumption (Forecasts)



Source: Consensus Economics; BTMU

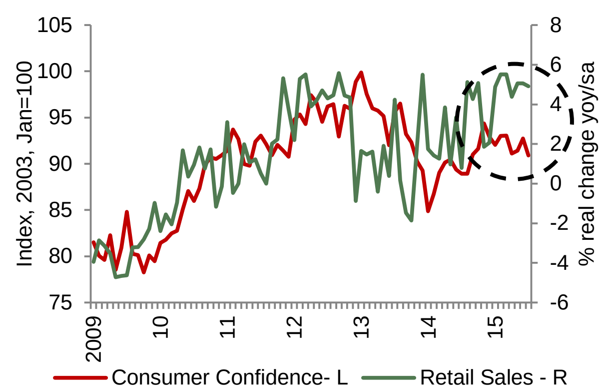
Figure 10: Net Formal Jobs Creation and Wages



*Mexican Social Security (IMSS)-insured workers

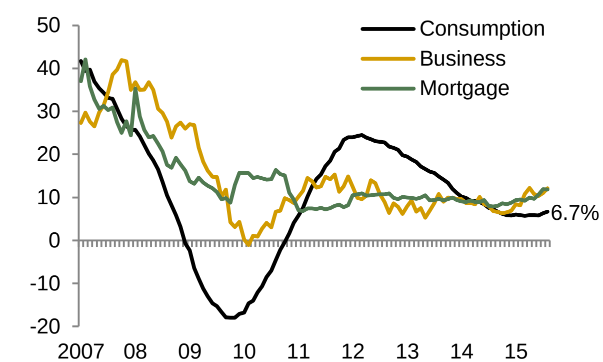
Source: Secretariat of Labor and Social Welfare; BTMU

Figure 11: Consumer Confidence and Retail Sales



Source: INEGI; BTMU

Figure 12: Credit to the Private Sector



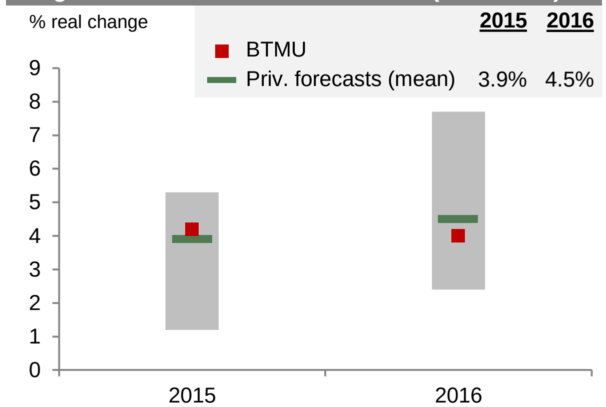
Source: Banco de Mexico; BTMU

I) Mexico: Growth Momentum (4)

- **Investment will pick up this year too; but recovery will be restrained by low business confidence.**

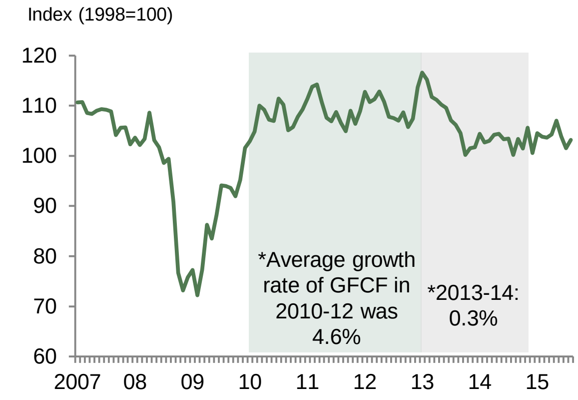
- Investment is set to pick up this year after a meager 2.3% increase in 2014. Gross fixed capital formation (GFCF), a measure of investment in property and equipment, grew by more than 5% yoy in 1H 2015, mainly on the back of strong growth in private-investment spending. Yet in our previous report we highlighted several downside risks to the recovery and, sadly, some of those have materialized. First, construction output, which makes up about 60% of GFCF, has been slowing since April. Second, public investment continued to be a drag in 2Q 2015 and will very likely remain so well into 2016 in the light of more fiscal-austerity measures for 2016 budget (*see next slide*). Third, the structural reforms have so far failed to deliver the benefits in terms of higher foreign investment: FDI returned to historical level after a brief spike in 2013 (the reforms were announced in late 2012). No wonder business confidence still remains weak, although the recent oil auction (i.e., second phase of round one) was successful and could end up being a confidence boost down the road.

Figure 13: Gross Fixed Investment (Forecasts)



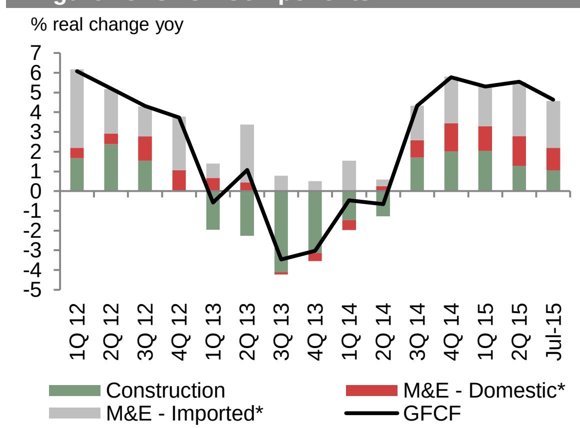
Source: Consensus Economics; BTMU

Figure 14: Business Confidence



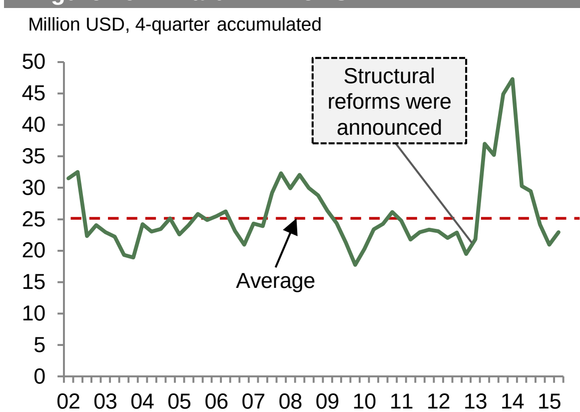
Source: Banco de Mexico; BTMU

Figure 15: GFCF Components



* Machinery and Equipment
Source: INEGI; BTMU

Figure 16: Inward FDI Flows



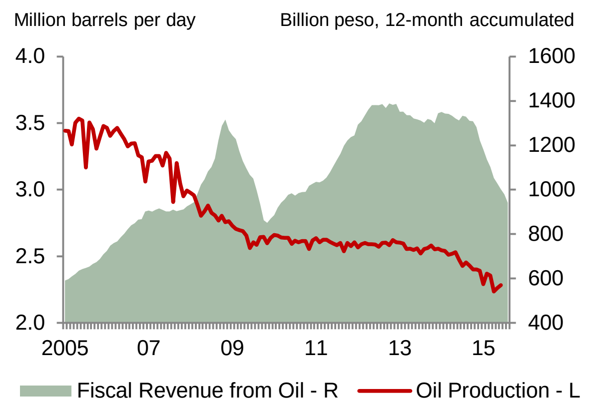
Source: Banco de Mexico; BTMU

II) Mexico: Public Finances

▪ Plummeting oil-related revenue forces the government to curtail spending next year.

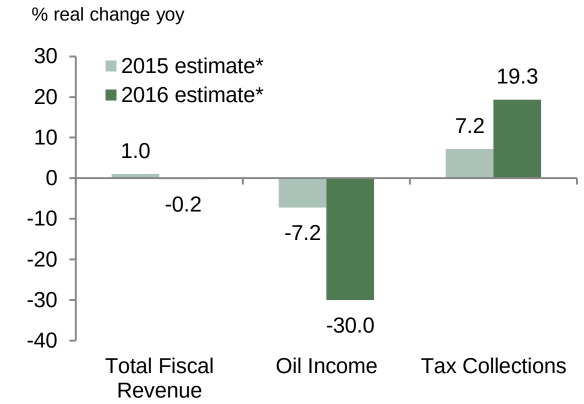
- Last month the government submitted its 2016 budget proposal to the Congress, which laid out the steps the Peña Nieto administration will take to cope with the plummet in oil prices. With oil-related revenue already sinking by about 35% yoy in the first 8 months of this year, and the government's apparent reluctance to run up more debt; officials opted to slash spending next year by 5.8% in real terms. The axe will largely fall on capital spending and in the energy and transportation sectors, which could hinder growth in the short-to-medium term. True, in the face of a tougher external backdrop and mild economic growth, that was probably the right policy choice. Still, the proposed budget might not be austere enough: should GDP growth fails to pick up in 2016 and match the official forecast (i.e., 2.6%-3.6%), or oil production falls faster than expected, then fiscal revenue could dip more than projected, forcing the government to raise more debt. If that happens, it would not be the first time as the estimate of the path of public debt has been revised up over the recent years.

Figure 17: Oil Production and Fiscal Rev. from oil



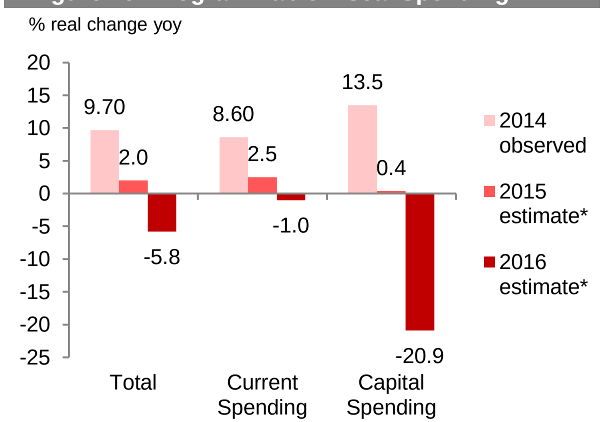
Source: EIA; Ministry of Finance and Public Credit (SHCP); BTMU

Figure 18: Fiscal Revenues



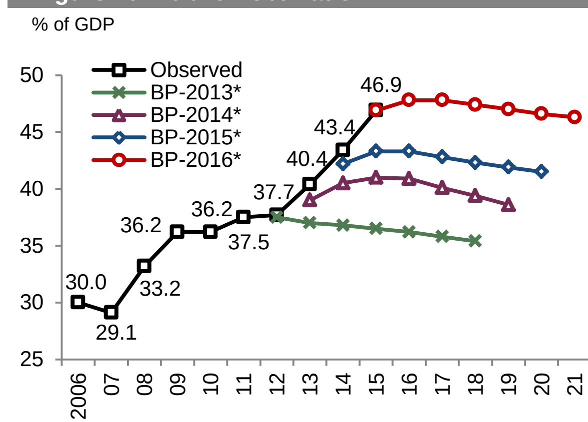
*Projected by SHCP in budget proposal (BP) 2016
Source: SHCP; BTMU

Figure 19: Programmable Fiscal Spending



*Projected by SHCP in budget proposal (BP) 2016
Source: SHCP; BTMU

Figure 20: Public Debt Ratio



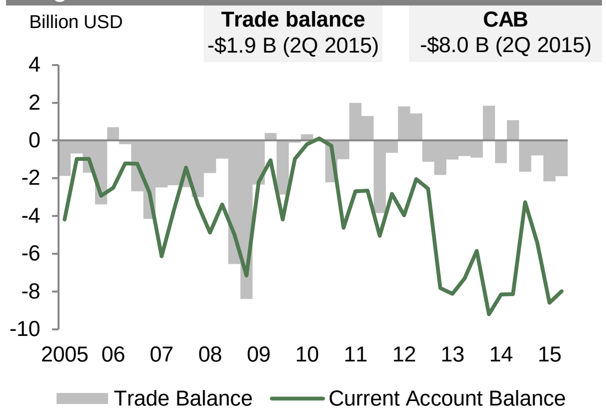
*Projected by SHCP in budget proposal (BP)
Source: GlobalSource Partners; BTMU

III) Mexico: External Sector

- **Low oil prices and falling domestic production of oil are putting a big dent in Mexico's exports.**

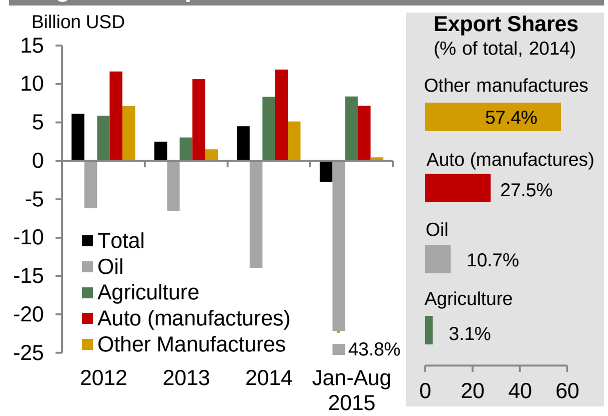
- Mexico's current account deficit narrowed slightly to $8 billion (0.7% of estimated GDP) in 2Q 2015 from $8.6 billion in the prior quarter, largely on the back of higher remittances from Mexican overseas (98% of the total remittances come from the US). However, trade deficit remained fairly large at $1.9 billion as the steep fall in oil prices took a heavy toll in Mexico's exports. In fact, oil exports, which make up about 11% of Mexico's total exports, slumped by 43.8% yoy in nominal terms in the first 8 months of 2015. To be fair, the blame cannot fall exclusively on low oil prices: domestic oil production has been in continuous decline since its peak in 2004 (3.5 million barrels per day back then vs. 2.3 today). Still, the hope is that the recent steep depreciation of the peso (more than 20% since August 2014), by making the country's manufacturing industry more competitive (e.g., lower unit labor cost), will wind up being a big boost for exports and pushing trade balance into positive territory. So far this year, manufacturing exports have been growing at a slow rate, but that may be due to weak external demand.

Figure 21: Current Account Balance



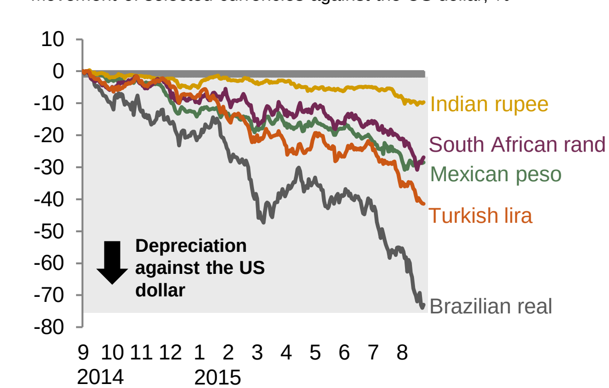
Source: Banco de Mexico; BTMU

Figure 22: Exports of Goods



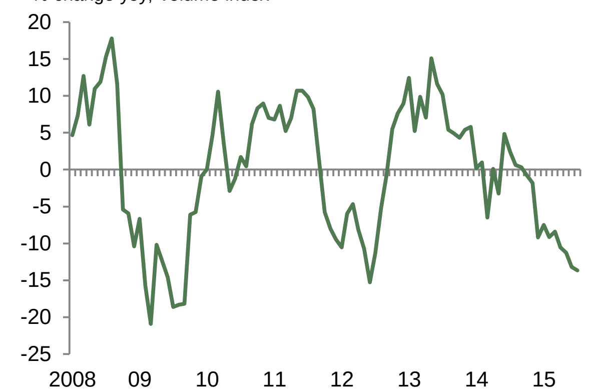
Source: Banco de Mexico; BTMU

Figure 23: Exchange rates



Source: Thomson Reuters; BTMU

Figure 24: Labor Cost in Manufacturing Sector



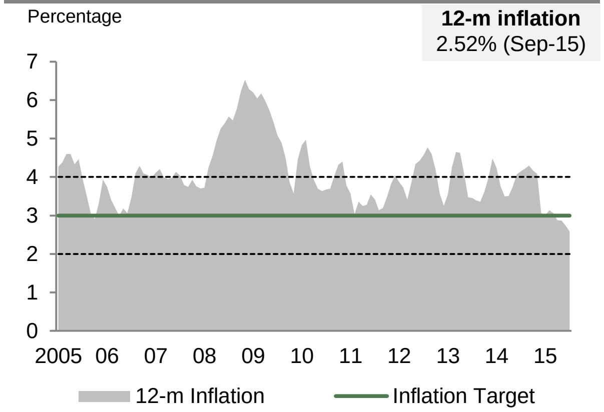
Source: INEGI; BTMU

IV) Mexico: Prices and Monetary Policy

- **CPI inflation hit another record low in September at 2.52%, within Banxico's target range.**

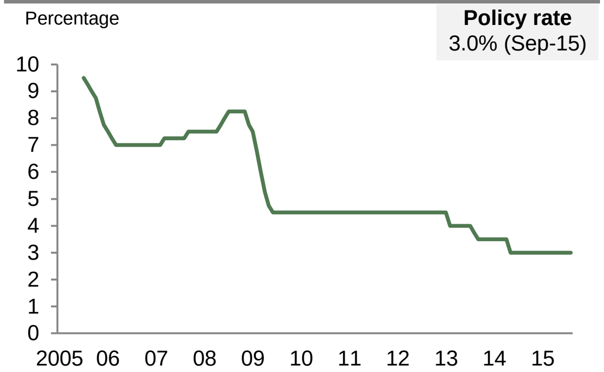
- Mexico's 12-month CPI inflation hit another record low in September at 2.52%. After struggling with stubbornly high inflation throughout the second half of 2014, upward pressures on prices started to cool off early this year as a result of (i) a widespread fall in input and service prices (e.g., telecom and energy prices); (ii) weak pass-through from a depreciating currency to consumer prices; and (iii) limited inflationary pressures from the demand side (the output gap is still in negative territory according to Banxico's estimates). In this context, it is very likely that inflation will stay below the target of 3% this year, which would allow Banxico to stick with its loose monetary policy in a bid to pump up GDP growth, at least until the Fed decides to lift interest rates. Nevertheless, we think there are good reasons to believe inflation will move higher next year. First, the effects of lower energy prices are likely to trail off next year. Second, producer prices and real wage growth have been picking up steadily since 1Q 2015, which could potentially translate into higher consumer prices soon.

Figure 25: CPI Inflation and Inflation Target



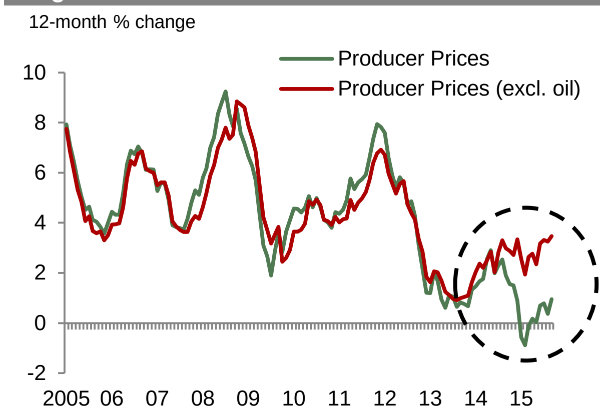
Source: INEGI; BTMU

Figure 26: Policy Rate



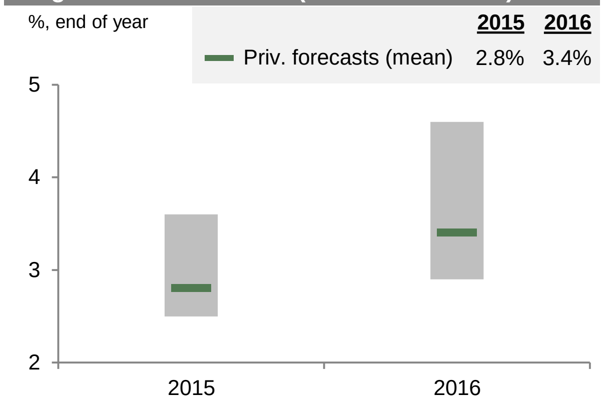
Source: Banco de Mexico; BTMU

Figure 27: Producer Prices



Source: INEGI; BTMU

Figure 28: CPI Inflation (Private Forecasts)



Source: Consensus Economics; BTMU

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