BTMU Focus Latin America

Mexico: macroeconomic performance

(2015 GDP and Current Monthly Indicators)

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April 8, 2016

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I) Mexico: Growth Momentum (1)

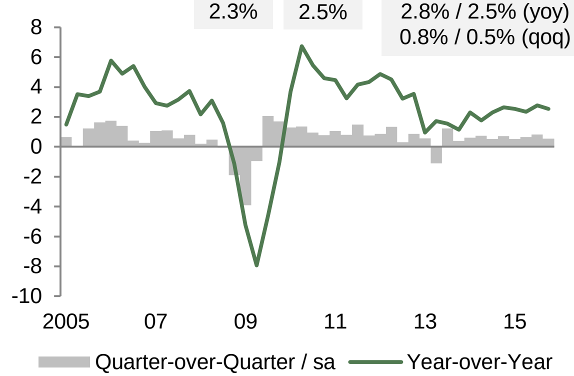
▪ The Mexican economy grew a bit faster in 2015, but still fell short of initial expectations.

- The second-largest economy of Latin America grew by 2.5% last year, a pace that was a tad faster than in 2014, but fell short of initial expectations for three consecutive years. Yet it is not easy to paint a clear picture of Mexico's economic momentum in 2015, especially in the presence of substantial statistical discrepancy between demand-side and supply-side data. On one hand, the economy, weighed down by a poor performance in the industry sector, did not show signs of speeding up. But on the other hand, consumption, gross fixed capital formation (GFCF), and net exports grew by more than 3% and at a much faster pace than a year earlier. Though it is hard to discern a clear path of the overall economy, we believe the data suggests two new trends. First, consumer spending gained momentum in 2015 after 2 years of disappointment, mainly on the back of low inflation and good labor-market conditions. And this upturn is consistent with retail-sales data. Second, GFCF lost steam in the first half of 2015 and has been slowing down since then, which is also consistent with a weak industry activity.

Figure 1: GDP Growth

% real change

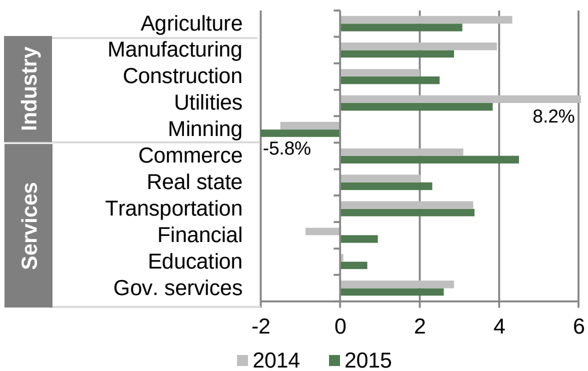
2014	2015	3Q / 4Q 2015
2.3%	2.5%	2.8% / 2.5% (yoy) 0.8% / 0.5% (qoq)



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

Figure 2: GDP by Sector

% real change yoy

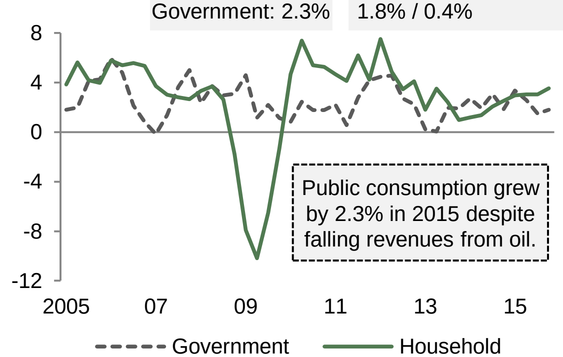


Source: INEGI; BTMU

Figure 3: Consumption

% real change yoy

2015	4Q 2015
Household: 3.2% Government: 2.3%	3.6% / 1.0% (yoy / qoq) 1.8% / 0.4%

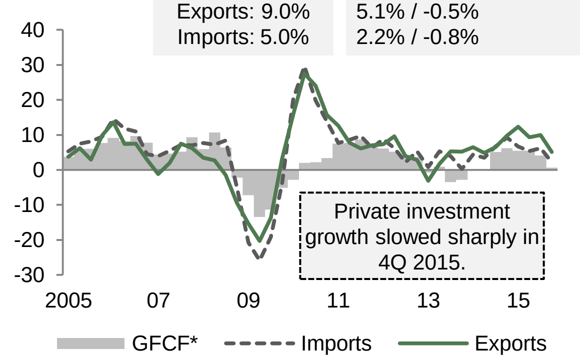


Source: INEGI; BTMU

Figure 4: Investment, Exports and Imports

% real change yoy

2015	4Q 2015
Investment: 3.8% Exports: 9.0% Imports: 5.0%	0.6% / -1.1% (yoy / qoq) 5.1% / -0.5% 2.2% / -0.8%



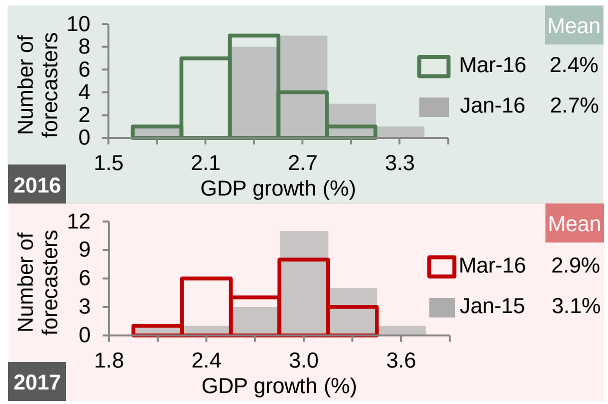
* Gross Fixed Capital Formation
Source: INEGI; BTMU

I) Mexico: Growth Momentum (2)

▪ Headwinds from the external front could restrain Mexico's GDP growth this year.

- The Mexican economy had a rough start this year. The peso tumbled in the first 2 months, buffeted by a hostile external environment: increased volatility in global financial markets, and lower oil prices (their impact on government's finances and Pemex, the state-owned oil company). In fact, the peso lost as much as 11% of its value against the US dollar in early 2016, and was one of the worst-performing emerging-market currencies, raising fears that the steep depreciation would reignite inflation. Against that backdrop, the central bank, known as Banxico, and the Ministry of Finance took some measures: (i) discretionary dollar sales; (ii) raised the policy rate by 0.5 pp to 3.75%; and (iii) announced more budget cuts for 2016 of about 0.7% of GDP that will mostly fall on Pemex. Now, judging by how the peso has performed since then, probably the storm has passed. Yet some headwinds are still around, and could limit or even put a break on this year's GDP growth. One worry is Pemex, which is facing cash-flow shortages and has become a burden for the government (continued next slide).

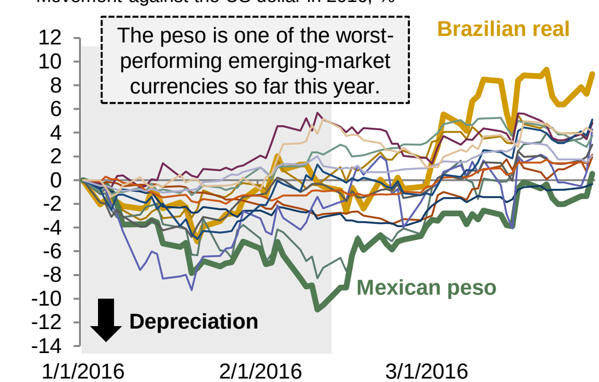
Figure 5: GDP Growth (private Forecasts)



Source: Consensus Economics; BTMU

Figure 6: Emerging-Market Exchange Rates*

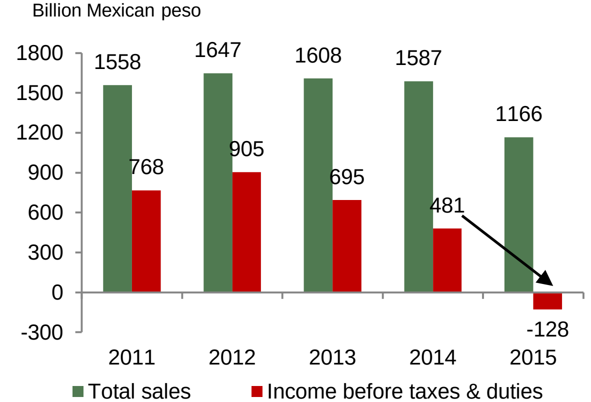
Movement against the US dollar in 2016, %



*Selected emerging-market currencies.
Source: Thomson Reuters Datastream; BTMU

Figure 7: Pemex's Sales and Income*

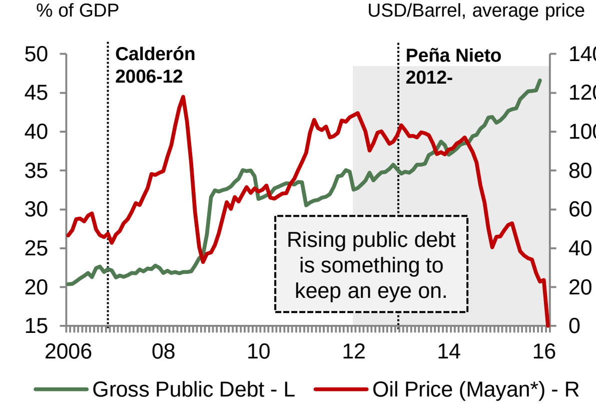
Billion Mexican peso



*The state-owned oil company
Source: Petróleos Mexicanos (Pemex); BTMU

Figure 8: Gross Public Debt and Oil Price

% of GDP USD/Barrel, average price



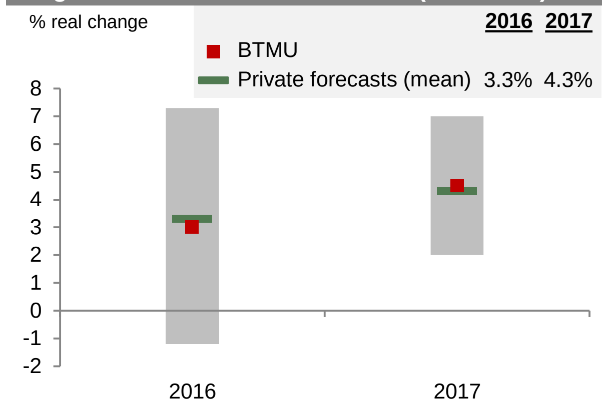
* Mexican Mayan crude oil
Source: Ministry of Finance and Public Credit (SHCP); Pemex; BTMU

I) Mexico: Growth Momentum (3)

▪ Investment growth could lose speed in 2016; but consumer spending will probably remain robust.

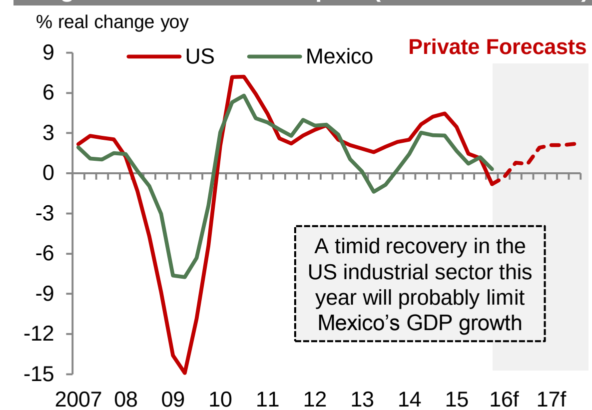
- Granted, the budget cuts are probably a necessary step in the right direction, but it is still early to tell whether its new CEO, Mr. González Anaya, will be able to put the state-owned oil company on a better footing in such a weak price environment. Should Pemex's situation gets worse, the government has vowed to step in. Though an eventual bailout might not put the health of public finances into jeopardy, as Finance Minister Luis Videgaray assured; it will probably raise questions about the country's rising public debt. The other concern is, of course, the US industrial sector as it will likely experience a timid recovery in 2016. That means investment in Mexico (particularly from the private sector), which has the tendency to move in a similar direction as US industrial production, could grew at a slower pace than last year. Still, not all is bleak. Consumer spending will likely remain robust and fairly growth-supportive throughout 2016, shored up by positive wage growth, strong job creation, and the ongoing expansion of mortgage and personal loans. Recent data on retail sales seems to corroborate this trend.

Figure 9: Gross Fixed Investment (Forecasts)



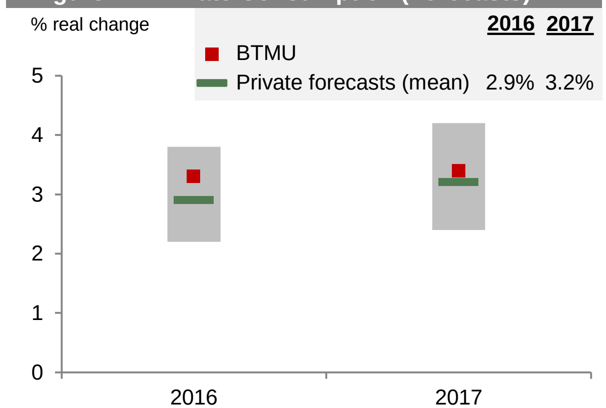
Source: Consensus Economics; BTMU

Figure 10: Industrial Outputs (Private Forecasts)



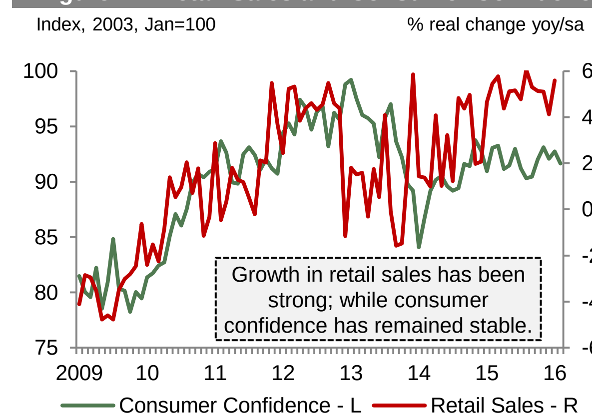
Source: INEGI; Federal Reserve; Bloomberg; BTMU

Figure 11: Private Consumption (Forecasts)



Source: Consensus Economics; BTMU

Figure 12: Retail Sales and Consumer Confidence



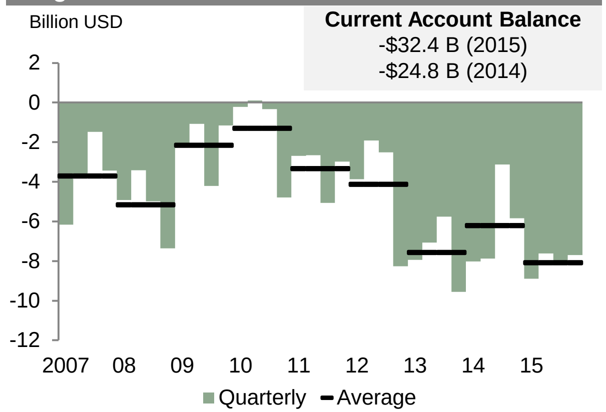
Source: INEGI; BTMU

II) Mexico: External Sector

▪ Low oil prices and weak demand for manufactured products put a big dent in Mexico's exports.

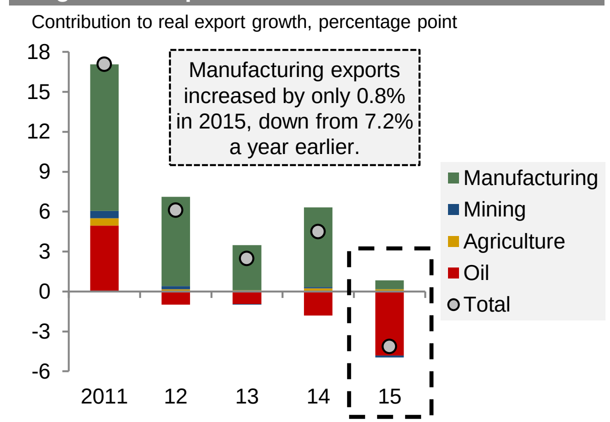
- Mexico's current-account deficit reached $32.4bn in 2015 (about 3% of GDP), up from $24.8bn a year earlier. The increase stemmed from the country's widening trade deficit, which jumped by more than four times to $14.4bn, the highest level since 2008. In part, those bleak results reflect the dire situation facing Pemex, the state-owned company that used to control the oil sector before the sweeping energy reform. Production and reserves of crude oil, for instance, have been falling steadily for more than a decade; and last year's export volume of oil rose by just 2.6%, which was nowhere near enough to offset the effects of low oil prices. No surprisingly, export earnings from oil, a major source of revenue for Pemex, plummeted by 45% in 2015. Now the company plans to cut around one-fifth of its annual budget this year to ease its cash-flow problems. True, oil only makes up a small fraction of Mexico's exports (10% over the last three years), thus much of the blame also lies with the weakening demand for manufactured products from its main trading partners (*see Mexico: Export Profile report*).

Figure 13: Current Account Balance



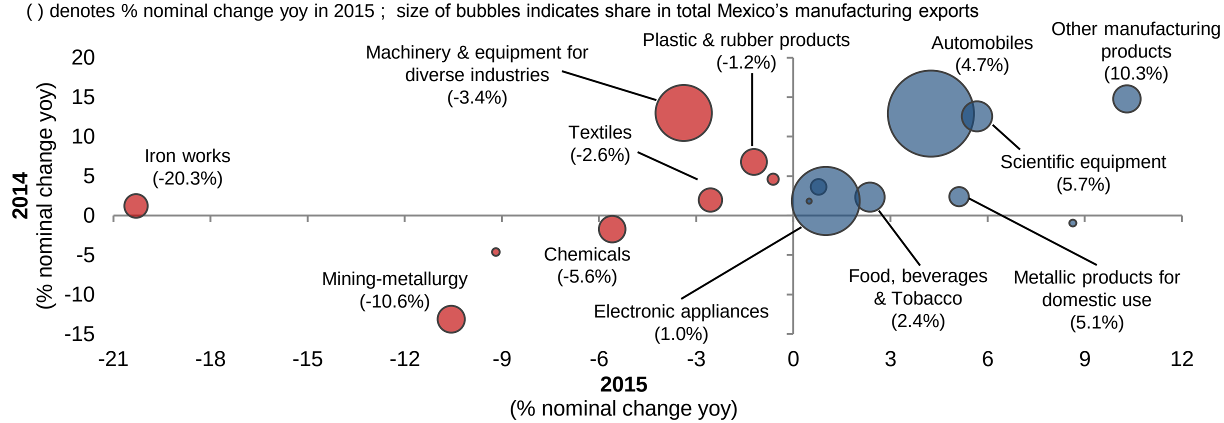
Source: Banco de Mexico; BTMU

Figure 14: Exports of Goods



Source: Banco de Mexico; BTMU

Figure 15: Mexico's Manufacturing Exports



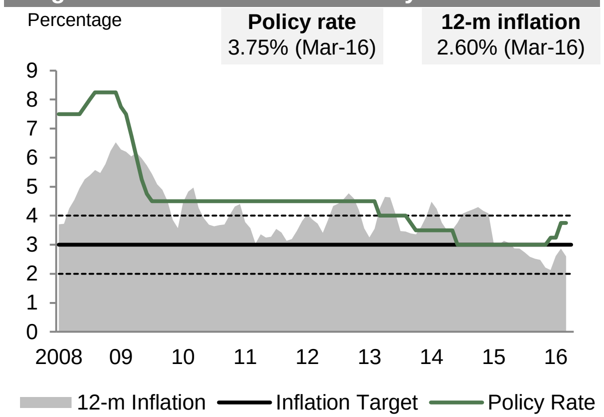
Source: INEGI; BTMU

III) Mexico: Prices and Monetary Policy

▪ **Inflation picked up as expected, but a weak peso may begin to add pressures on prices in the coming months.**

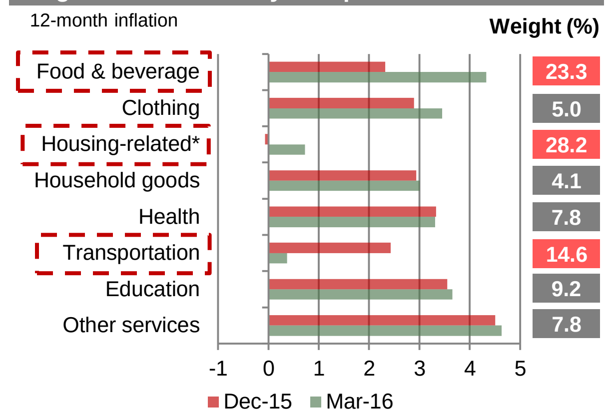
- It was expected, but still came as a blow: 12-month inflation surged to 2.6% in March from just 2.1% three months earlier. And as anticipated in our prior reports, part of the rise was driven by food inflation, which spiked in the first two months of 2016 due to the unwinding of favorable base effects, and some factors that have impaired the supply of foodstuffs. Also, housing-related costs increased by 0.7% yoy in March as the fall in electricity tariffs and telecom prices moderated. In fairness, inflation is still below Banxico's target rate of 3%, and low energy prices continue to nudge in the opposite direction. Yet the worry is not so much about the rise of inflation, but rather its acceleration as it could have been fueled by the pass-through effect of a weaker peso. True, that inflationary force has so far remained subdued, allowing inflation to reach a historic low last year. But recent evidence seems to suggest a new trend: prices of tradable goods have been climbing at a faster pace; and ever-higher producer prices, partly caused by a weaker peso, might force companies to pass along their higher costs to consumers soon.

Figure 16: CPI Inflation and Policy Rate



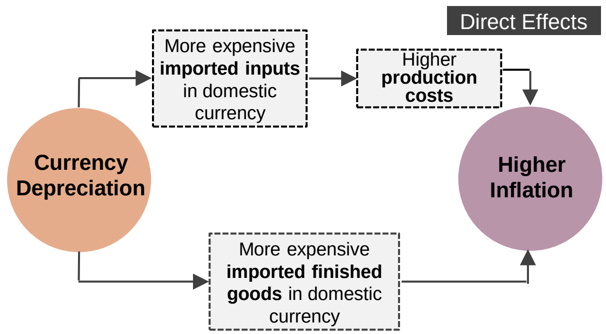
Source: INEGI; Banco de Mexico; BTMU

Figure 17: Inflation by Components



*Includes housing costs, electricity fares and telecom services
Source: INEGI; BTMU

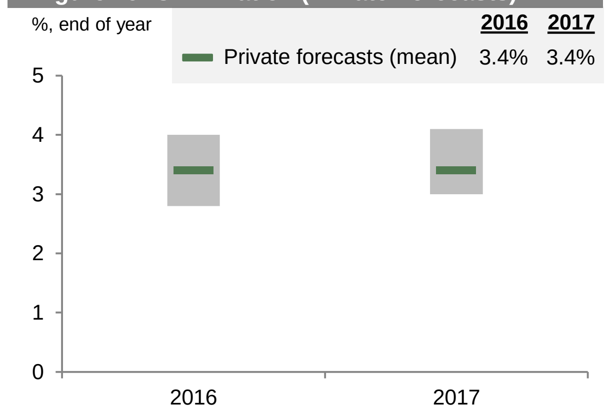
Figure 18: Exchange Rate Pass-through to Prices



Using data from Jan 2000- Jun 2015, Banxico found that a depreciation of the peso of 10% adds 0.38% to inflation*.

*See Quarterly Report July-September 2015 by Banxico, pages 18-20.
Source: BTMU

Figure 19: CPI Inflation (Private Forecasts)



Source: Consensus Economics; BTMU

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