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Weekly Economic Update

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Volume 84, Number 1   October 6, 2017

We traveled to Mexico City this week with The Global Interdependence Center to learn more about our southern neighbor's views on trade, currencies, oil, immigration, their upcoming elections and a host of other topics. We enjoyed detailed discussions at the Bank of Mexico, the Bolsa (stock exchange), the Ministry of Finance, and at a private dinner with the US Ambassador to Mexico. Though most events were held under Chatham House rules to foster a more open discussion, we would like to share our views on what we learned – primarily by illuminating the Mexican view, which strangely enough is not the same as the accepted wisdom in the US (especially among investors).

The timing of our event could not have been better as many participants were preparing for the fourth round talks on the renegotiation of NAFTA. Three rounds of preparatory discussions have been held in the US, Mexico and Canada – but this round starts to address the thorniest issues. In anticipation of these talks, Mexican senators representing the current PRI government talked tougher last week about the possibility of walking away from NAFTA altogether. This represents a growing conviction in Mexico that life after NAFTA – which would mean a return to WTO rules – though undesirable, would see slightly higher tariffs largely absorbed through a one-time currency adjustment. This analysis in quite similar to the expectations concerning a border adjustment tax (BAT). Mexico hopes that the same US coalition of Republican politicians (representing states with significant retailers, auto producers and agriculture) that deep-sixed BAT will prevail on preserving NAFTA. Still, having just survived a substantial slide in the peso following President Trump's unexpected victory – and a subsequent recovery – Mexico is adjusting to living with more currency volatility.

The Mexicans realize that an end to NAFTA is a real possibility. Canada is not a natural ally as they enjoy an opt-out clause that would simply return them to an earlier bilateral agreement with the US. The greatest threat is that the US Administration would walk away from WTO altogether – in which case Mexico and the rest of the world would have to renegotiate. No one places much credence in that option, though watching Trump's dismissal of the Paris Accord, his abandonment of the TPP, and the threatened decision to void the multi-country Iran pact leaves many their nervous about US policy and trustworthiness. One solution is a scramble to strengthen options via other trade partners, where agreements with some may provide back door access to the US for the 80% of Mexican exports that head north of the border. Bottom line, whether NAFTA falls or not, Mexico is seeing a need to diversify that will turn their attention to Europe and Asia for trade and investment.

It was clear that the looming July 2018 Presidential election in Mexico was pushing their agenda to have a NAFTA settlement before the end of the year. It is unclear whether there is any room in the crowded US Congressional calendar to even consider a significant change to NAFTA -- not only before the end of the year, but before our own mid-term election next November. In particular, because the US may not be negotiating with the current leadership after July. This Mexican election is particularly fractious as it will replace the unpopular Nieto, but the PRI – the perennial party of power in Mexico -- has not yet selected their new candidate. The current leader in the polls (narrowly) is the leftist firebrand (think Sanders) and former Mexico City mayor Obrador, leading a new party called Morena or AMLO (think Macron). Analysts expect the polls will narrow once the PRI announces a candidate. Several other parties, including PAN and PRD, have formed a broad front to defeat PRI. However, former first lady Zavala, wife of Mexico's only non-PRI President Calderon, just left PRD to run on her own. She joins an unprecedented 11 other independent candidates. Regardless of who wins, they will continue to face a Congress dominated by the PRI and so policies are not expected to move away from recently enacted reforms in telecom and energy.

Immigration, and most recently DACA, are closely interwoven with the trade debate. Eligibility to renew status under DACA ended October 5th while we were in Mexico. Of the 800,000 children in the DACA program, 600,000 are from Mexico. While Congress is considering new rules to deal with DACA's future, Mexico is actually ready to accept these former children home – just not all at once. They note that a requirement of DACA is that the applicant be in school or have a GED or equivalent. US high school educated workers would be valuable in Mexico even if they don't speak Spanish as many Mexican firms have English speaking divisions. Mexico expects they would fill job openings or create their own jobs much as they believe earlier waves of immigrants headed north to the US have previously. Immigration as a boost to growth is not an academic topic today, as Syrian immigration to Germany over the past few years has caused social strife – but added to economic growth. The US will face a significant wave of legal immigration from Puerto Rico in the coming year, and like the Mariel boat wave from Cuba, we expect that this will lead to faster growth overall US growth and entirely new communities, rather than competition for a fixed pool of existing jobs. Perhaps we should consider sending DACA applicants (and other working illegals) to Puerto Rico for community service, rather than back to Mexico before they reapply for legal immigration.

At the Bank of Mexico, much of the conversation centered on Mexico's current very high rate of inflation – which is largely due to surging energy costs after deregulation of the electricity sector a year ago. As with Japanese VAT tax increases, these reforms caused a pig in the python effect as they work their way through reported annual CPI increases. Mexico's CPI should plunge lower toward 4% early next year as the energy hikes pass out of the data. This is still high compared to the 3% target, but should drift within the 1% acceptable band around the target. The Bank sees more recent data as confirming that new inflationary pressures (which were mostly from the pass through effect of higher energy cost) are small. As a result, recent hikes in the central banks reference rate are expected to end – though they will not be quickly reversed. The combination of sticky rates and plunging inflation suggest a threat to Mexican growth from sharply higher real interest rates. However, real economic growth has surprised to the upside recently, while high inflation has reduced the burden of earlier debt accumulation. Long term interest rate appear already to have peaked as Bank rate hikes are ending.

One perennial problem for Mexico is a low domestic savings rate and underdeveloped financial markets. Combined with the earlier commitment to the view that all Mexican oil is a resource for the people and so no foreign ownership should be allowed, this meant that Mexican oil resources were underutilized and inefficiently operated. However, as the deregulation of the telecom industry has shown, competition increases consumer options and lowers prices. Private firms (from Italy and Houston) have recently found 3.4 million barrels of oil – out of an estimated 9 billion in Mexican reserves. Perhaps those figures will have to be revised higher. However, issues concerning cross-ownership and the upcoming election – where Obrador is campaigning for a roll back of energy reforms -- are clouding the speed with which these huge finds will be developed.

As with many economies around the world, Mexico is currently outperforming – but is faced with a range of uncertainty based on upcoming elections at home and trade negotiations abroad. What we found most informative and reassuring was the degree of professionalism being directed at solving these challenges, rather than the political gridlock seen in Brazil and Venezuela. The collapse of Venezuela is seen as a cautionary tale for all Latin American countries. Meanwhile, the chaos from corruption charges in Brazil – which permeates its politics – reflects a similar problem in Mexico, which underpins the fragmentation of political parties there. The recent spike in the peso from 18 to 22 – and back – concentrated Mexico's attention on the exposure it has to US policy and leadership. The timeliness of their elections as they seek to resolve these problems will reveal much about the country's future – just as it has in the UK, France and with elections currently underway in Japan.

An associated factor that will be watched closely by all in Latin America is the US's treatment of Puerto Rico, an American territory with a Latin population. Whether the topic is NAFTA, DACA, leaving TPP or the rollback of opening relations with Cuba, Latins are increasingly worried about the long term commitment of the US to its southern neighbors. The elites who control that part of the world understand that Trump alone cannot be responsible for the recent reset, it reflects a deeper shift in US policy. At the same time, China has come courting, looking for access to natural resources and end markets for its consumer goods and infrastructure development projects. Prudence encourages diversification, and though Mexico would appear a natural competitor to China, the importance of international supply chains – especially in automobiles -- means there is integration already. China has the money and desire to diversify its own access to the US through indirect channels. For all investors, the courtship between China and all our Southern neighbors requires monitoring.