# MEXICO'S ECONOMIC OUTLOOK 2012

Gabriel Casillas, Ph.D.[AC]
Mexico Economic Research

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(52-55) 5540-9558
gabriel.casillas@jpmorgan.com
J.P. Morgan Casa de Bolsa, S.A. de C.V., J.P. Morgan Grupo Financiero



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# Agenda





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# Mexico continues to be in a 'sweet spot'

- We have three reason to believe Mexico will continue to grow at a healthy pace in 2012:

1. The recent two-month extension of the pay-roll tax cuts, which we anticipate to be extended throughout the year
2. A reinvigorated manufacturing sector
3. Stronger domestic demand and a positive outlook for banking credit

- We identify three risks to our optimistic growth call:

1. The possibility of more fiscal tightening in the US
2. Further negative news from European sovereign and debt crisis
3. Potential escalation of drug-related violence ahead of the presidential election

**Mexico SWOT analysis[1]**

| Strengths | Weaknesses |
|---|---|
| • Prudent fiscal stance<br>• Responsible monetary and FX policies<br>• A reivigorated manufacturing sector<br>• Relatively cheaper skilled labor<br>• Continued banking credit expansion<br>• Winning candidate could spur reform optimism | • Potential escalation of drug related violence<br>• Lack of meaningful structural reforms<br>• Potentially higher inflation |
| **Opportunities** | **Threats** |
| • US patrol tax cut extension<br>• Weaker peso<br>• Fiscal deficits abroad<br>• High energy prices<br>• Head of G-20<br>• Revaluation of Asian currencies<br>• Free trade agreement with Perú | • Euro area sovereign debt crisis<br>• US fiscal tightening |

Source: J.P.Morgan.
1. SWOT analysis is a strategic planning method used to evaluate the Strengths, Weaknesses, Opportunities, and Threats involved in a project or in a business venture is credited to Humphrey, Albert (1970).

# Agenda

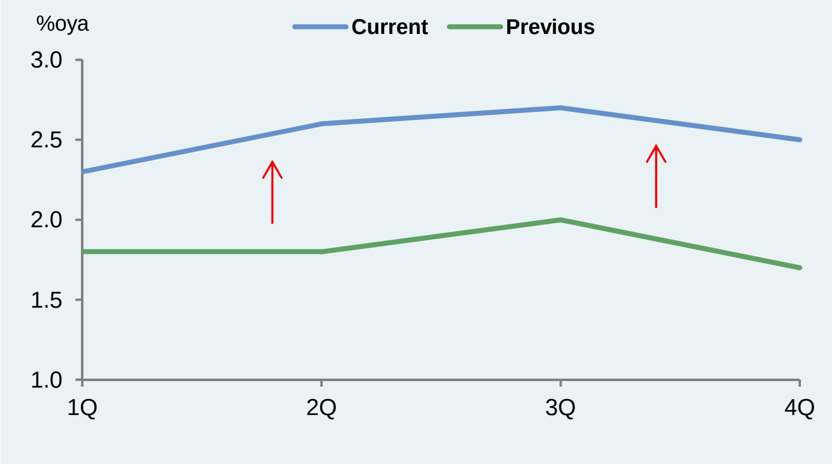
# A more promising scenario in the US has prompted us to rise our 2012 GDP growth forecast to 3.3%

- The recent approval of the 'Bush era' tax cuts prompted our US economist to revise its GDP growth forecast for year 2012 to 2.5%, from 1.9% earlier
- The adjustments included a considerable revision to US manufacturing production forecast to 2.8%, from 2.1% before
- Manufacturing is Mexico's major economic link with the US
- This adds to a stronger domestic demand, a reinvigorated auto sector, and a positive outlook for banking credit
- As a result, we now believe Mexico's GDP will grow 3.3% in 2012, instead of 2.5% that we had projected before

## Mexico and US manufacturing production

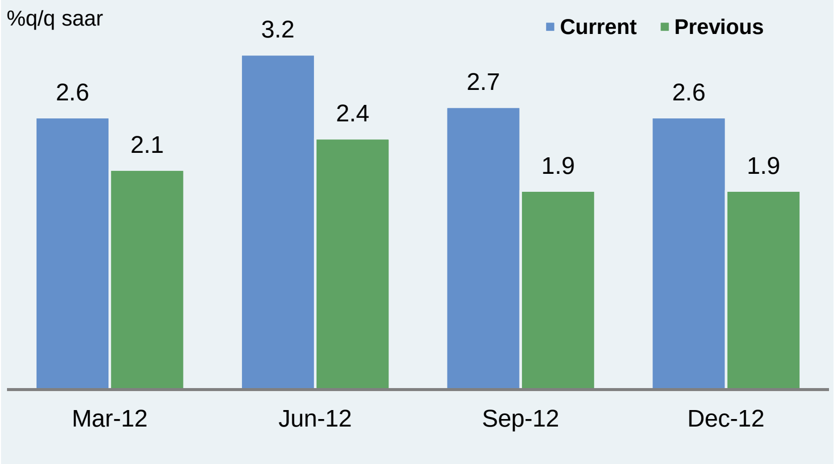

Source: INEGI and US Federal Reserve

## US GDP forecasts




Source: J.P. Morgan.

## US IP forecasts




Source: J.P. Morgan.



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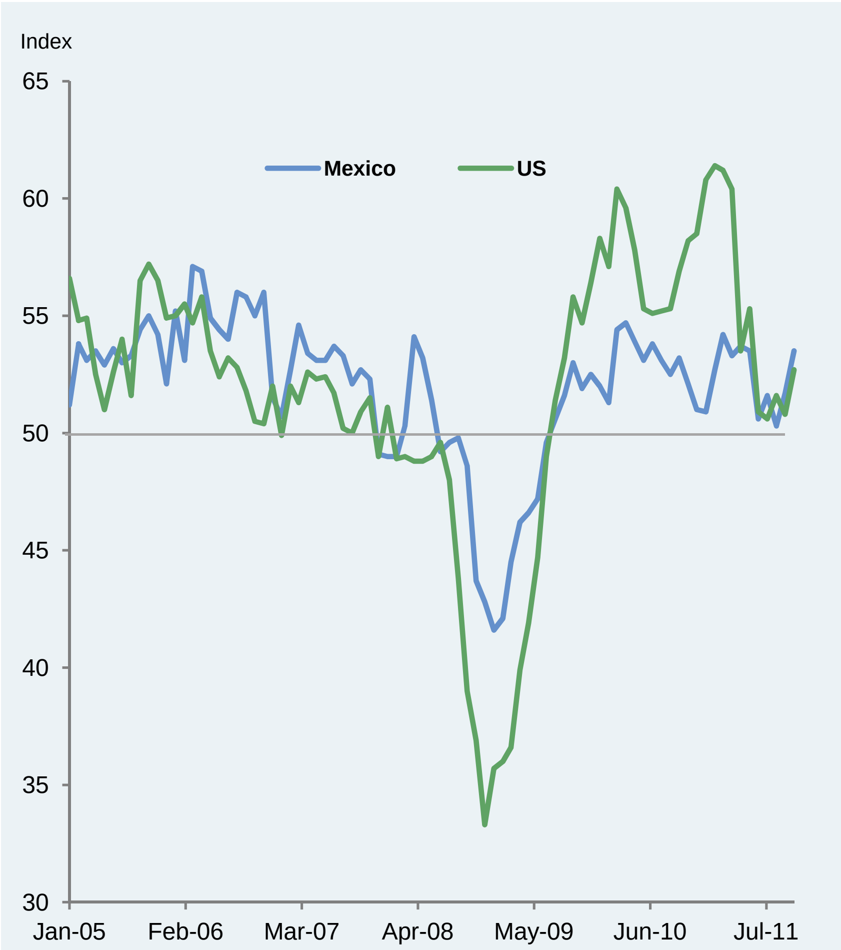
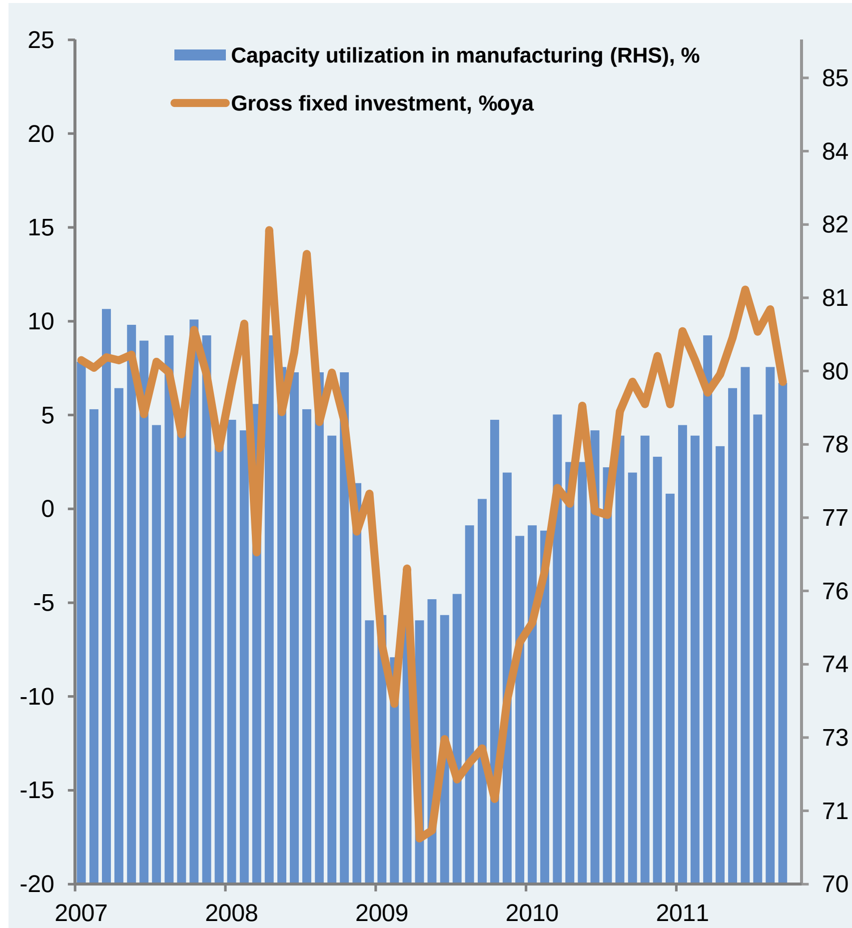
# Manufacturing outlook

## Mexico and US manufacturing PMI's




Source: J.P. Morgan with data from INEGI and ANTAD

## Investment and manufacturing capacity utilization




Source: Banco de México





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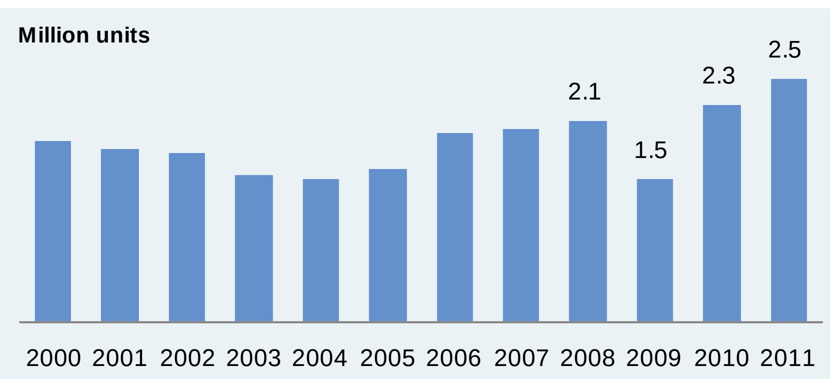
# A reinvigorated auto industry will continue to be the main driver of manufacturing activity

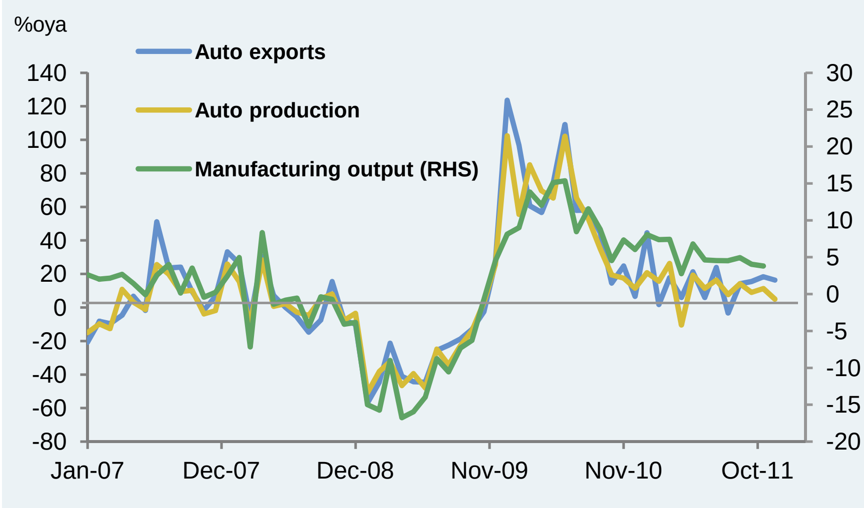
- Last year auto production reached a new historical high, expanding 12.2%oya to around 2.5 million units, after having boomed 50% in year 2010
- In this context, growth in the auto industry –which has been driving the up-tick in manufacturing activity–, is likely to stabilize at a healthy pace
- Auto exports expanded 14.3% in 2011, down from 52% in year 2010, and after falling 26.4% back in year 2009
- Auto sales increased 10.4% last year, up from 8.7% in year 2010, after falling 24% during the crisis in 2009. We expect growth in domestic sales to continue to expand at a healthy pace
- Several automakers across the world have reallocated part of their production to Mexico to benefit from a weaker peso, skilled Mexican labor, still-high transport costs, and the country's strategic geographic location

## Auto production



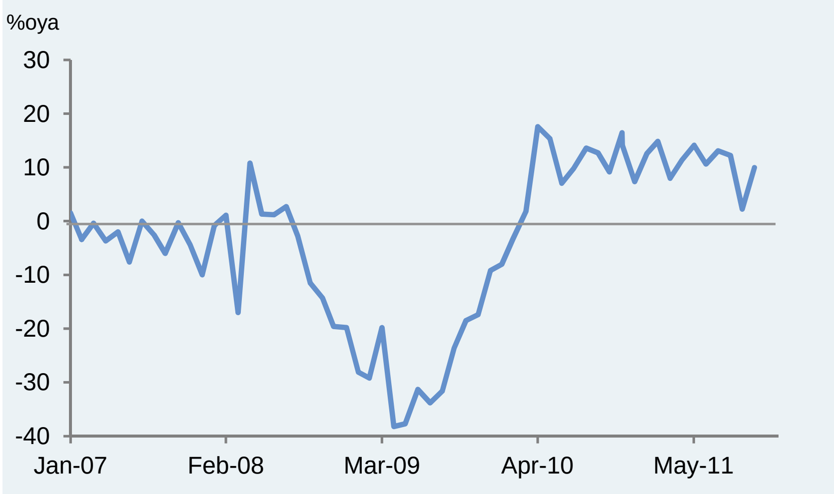

Source: AMIA

## Auto and manufacturing production, and auto exports




Source: INEGI and AMIA

## Auto sales




Source: AMIA

2. A REINVIGORATED MANUFACTURING SECTOR



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## We have observed a plethora of new investments in the automotive sector

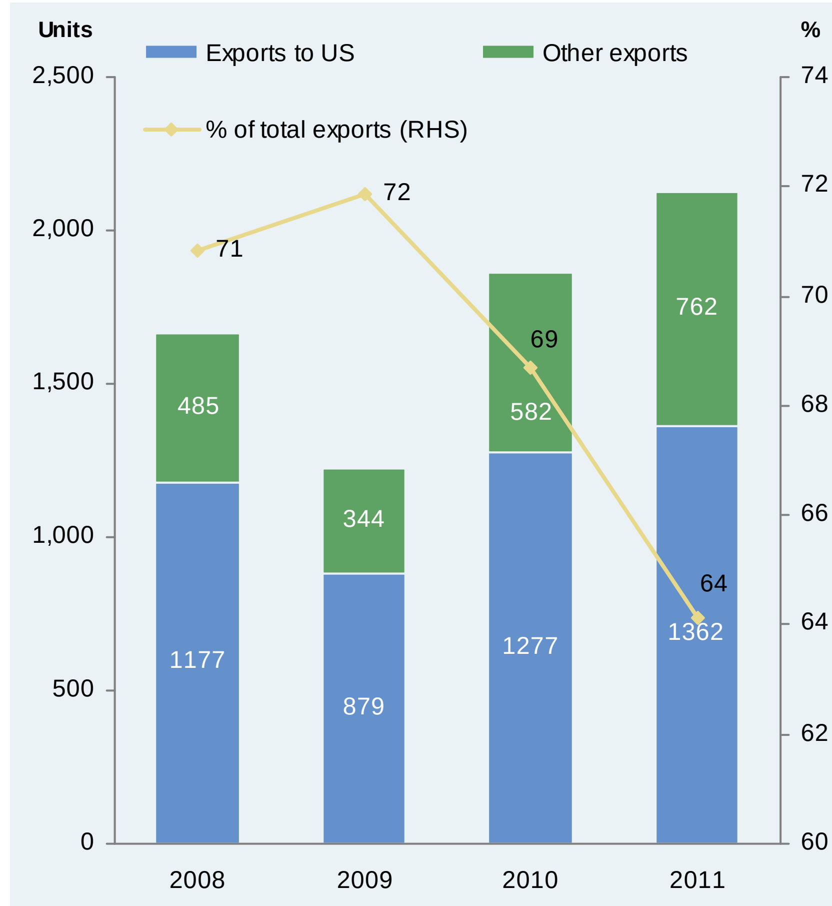
### FDI into the automotive sector

| | Announced date | US$, mn | State |
|---|---|---|---|
| Total | - - | 7,980 | - - |
| Chrysler | 1Q09 | 300 | Coahuila |
| GM | 3Q09 | 300 | San Luis Potosi |
| Ford | 4Q09 | 600 | Chihuahua |
| Ford | 4Q09 | 1,000 | Cuatitlán |
| Chrysler | 1Q10 | 550 | Toluca |
| Volkswagen | 1Q10 | 1,000 | Puebla |
| Nissan | 2Q10 | 600 | Toluca |
| Mazda | 4Q10 | 500 | Guanajuato |
| Volkswagen | 4Q10 | 550 | Guanajuato |
| Toyota | 4Q10 | 150 | Coahuila |
| GM | 1Q11 | 300 | San Luis Potosí |
| Honda | 2Q11 | 800 | Guanajuato |
| Nissan | 3Q11 | 330 | Aguascalientes |
| Daimler & Nissan | 4Q11 | 1,000 | - - |

Source. J.P.Morgan

## Mexico's automotive sector has gradually reduced its exposure to the US market

### Auto exports to the US



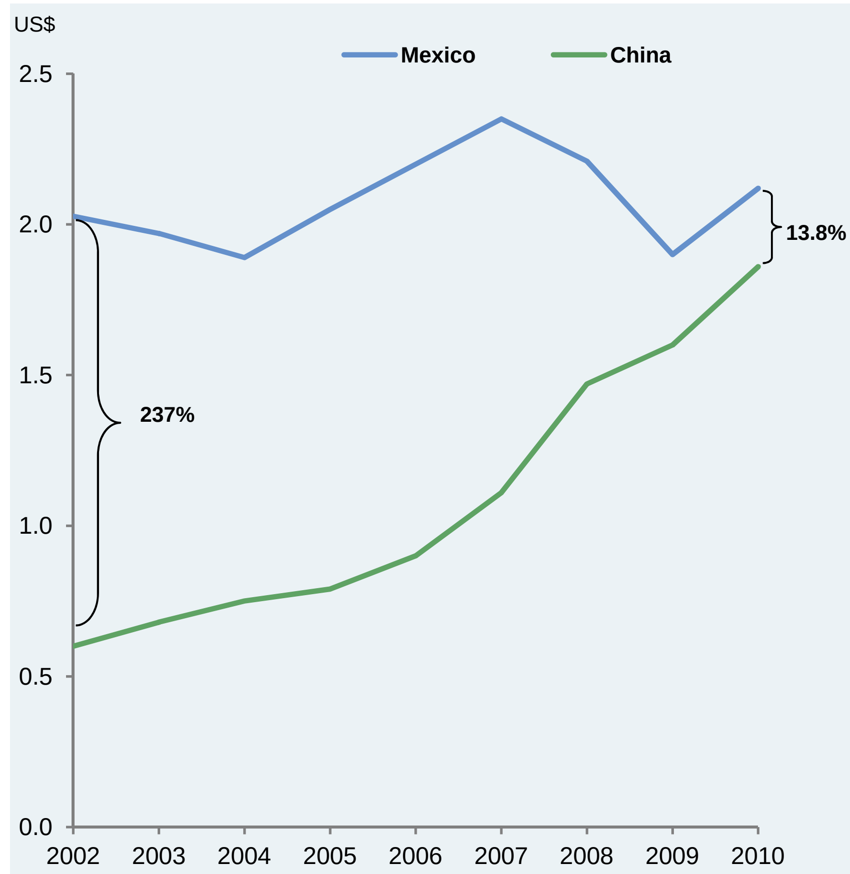

Source: AMIA and J.P.Morgan

# Moreover, gains in competitiveness suggest expansion in the auto sector could be sustained in 2012

## Mexican peso multilateral real exchange rate


Source: J.P. Morgan

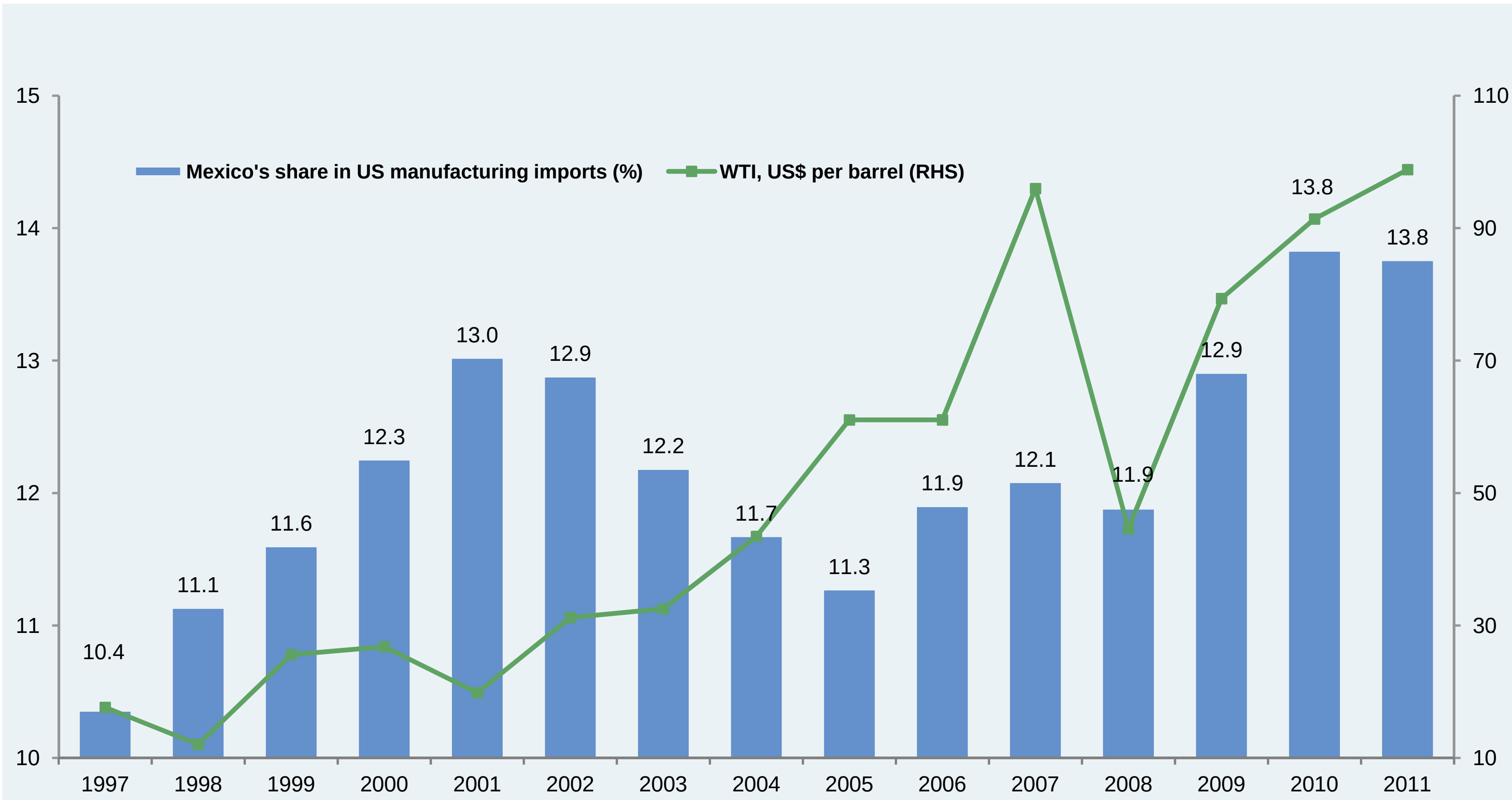
## Wages in the manufacturing sector




Source: Ministry of Finance

## In this context, transportation costs have increased significantly. All these has helped Mexico to gain market share in the US

**Participation of Mexican manufacturing exports in US imports vs. oil prices**




Source: US Census Bureau (up to October 2011), and Bloomberg





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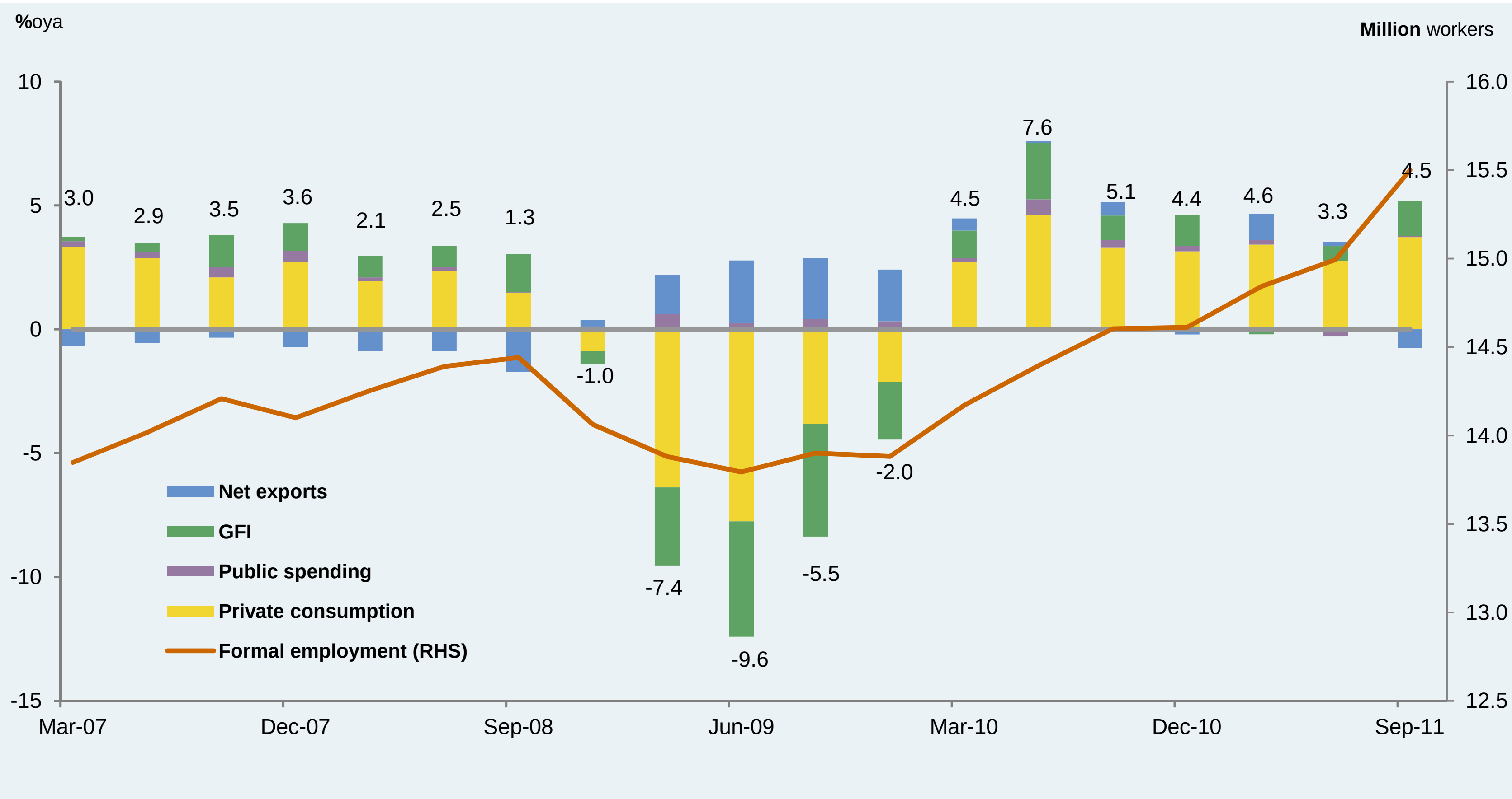
# Employment conditions and credit rebound have poised domestic demand back on track

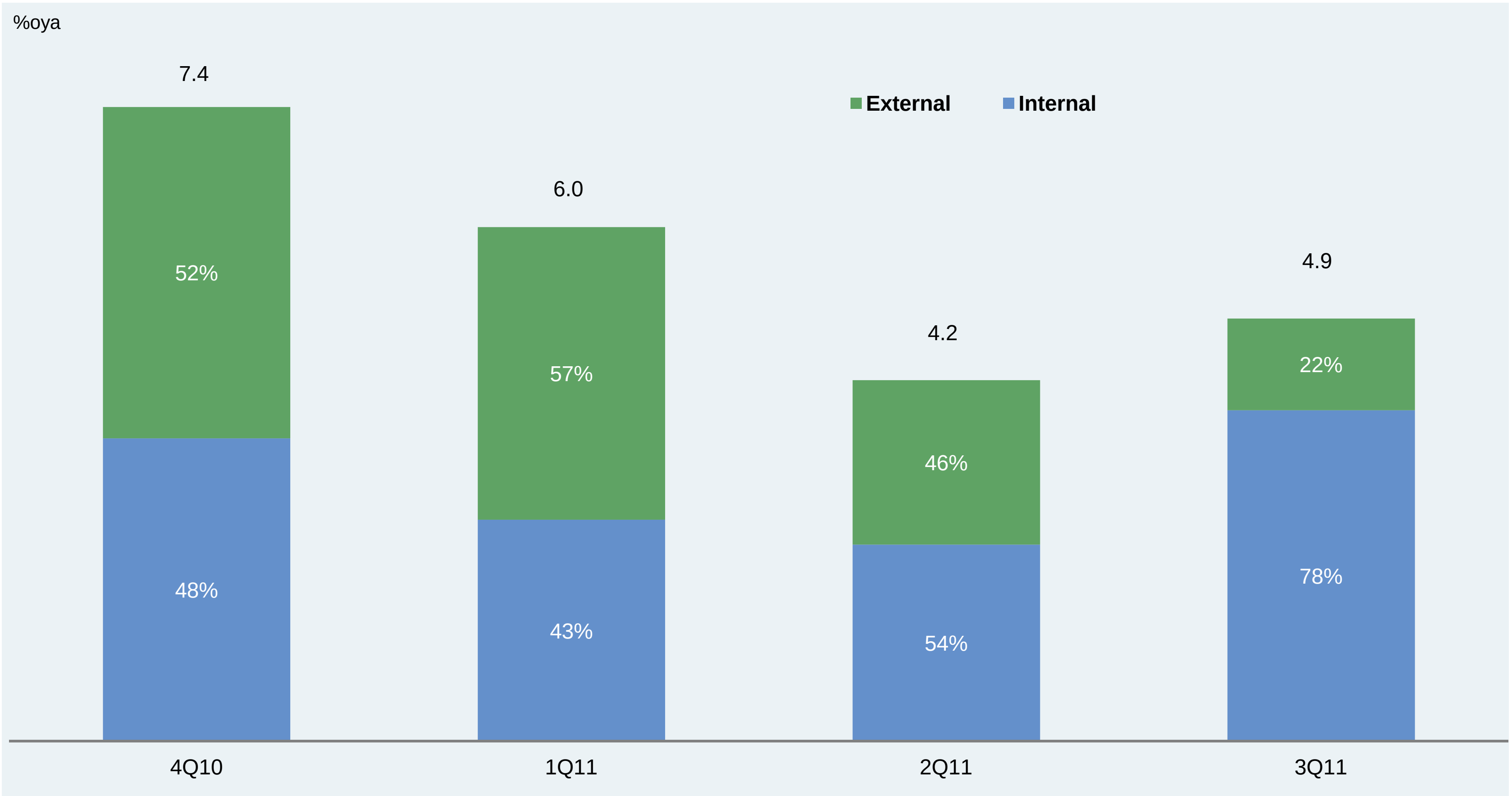
## GDP – Contribution by aggregate demand component[1]




Source: J.P. Morgan with data from INEGI
1. GFI includes the incidence of the change in inventories

# In this context, while Mexico's economic rebound was initially externally-driven, now domestic demand is clearly leading the recovery

**Contributions of internal and external demand to aggregate demand**




Source: J.P.Morgan with data from INEGI



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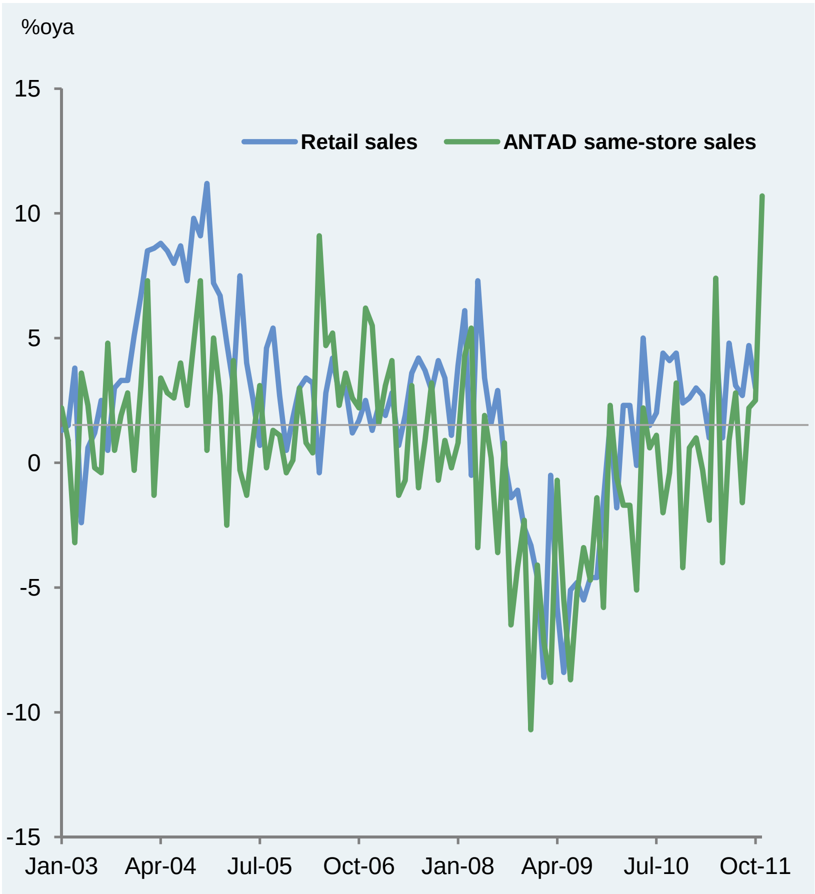
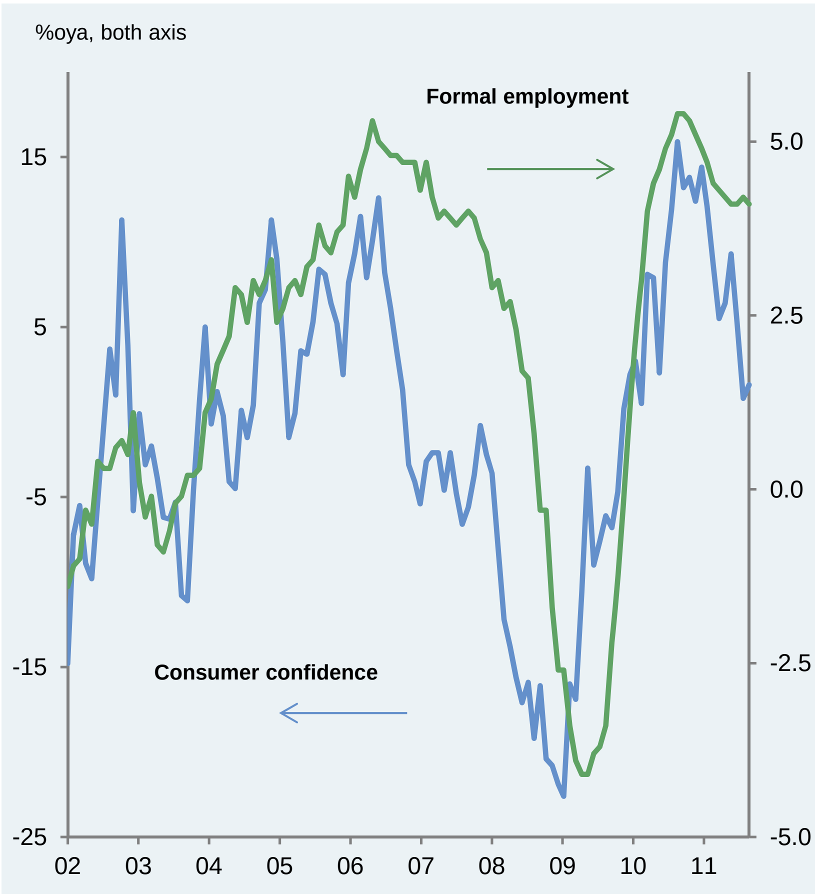
# Supermarket and retail sales also indicate that domestic recovery is taking place. Furthermore, formal employment and consumer confidence have also shown positive dynamics

**Mexico's retail sales**




Source: INEGI and ANTAD

**Consumer confidence and formal employment**




Source: INEGI and IMSS



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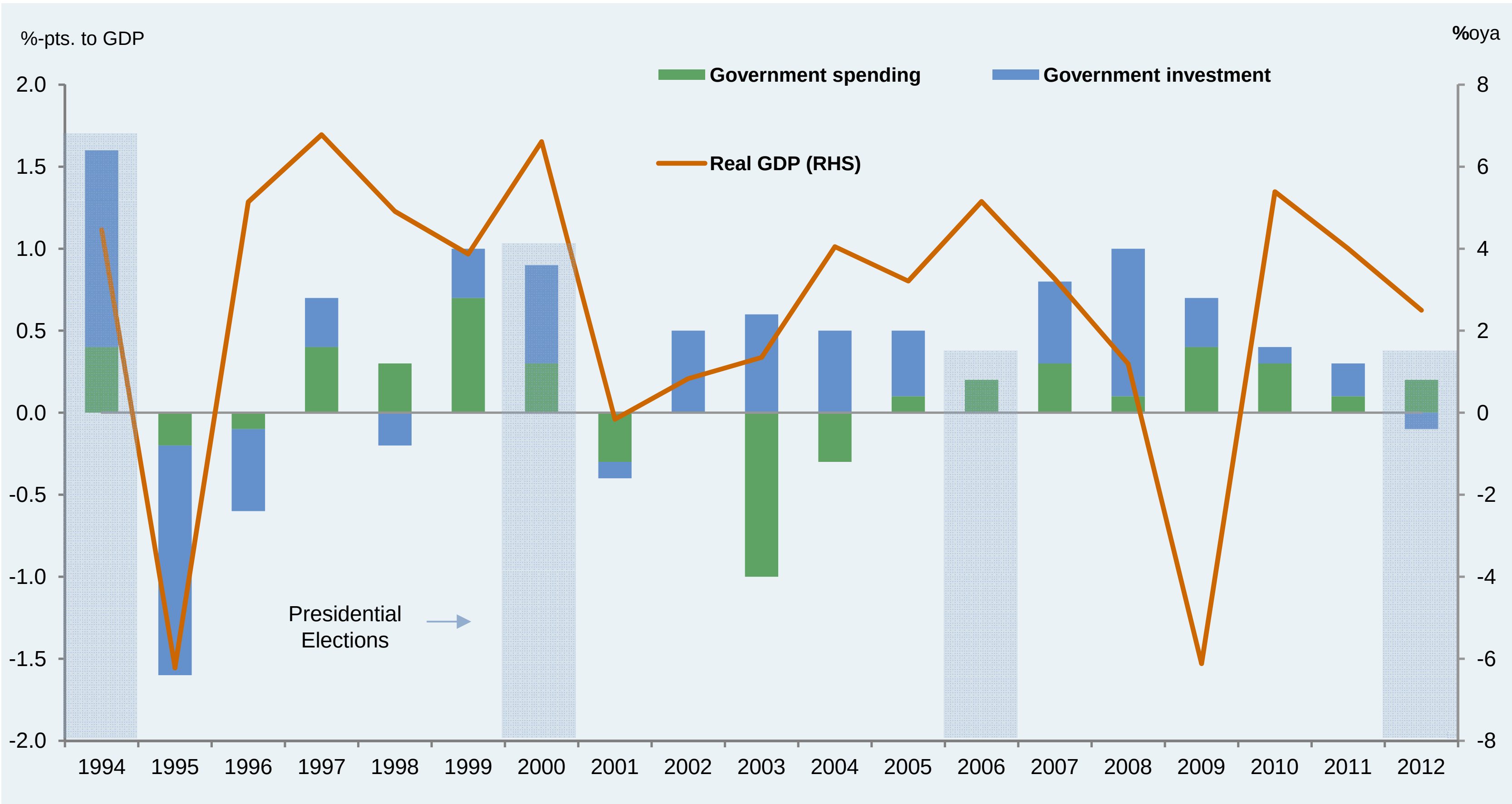
# We do not foresee the so-called ‘Año de Hidalgo’

**Government spending and investment contribution to GDP growth**




Source: INEGI.





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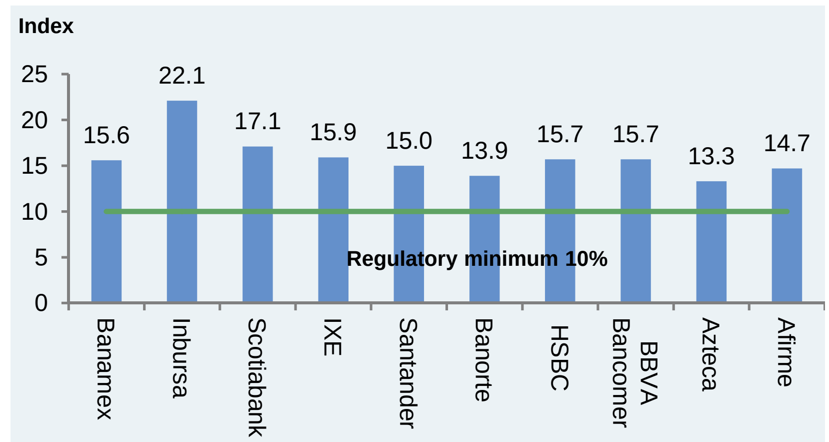
# Mexico's credit system is playing a major role boosting private consumption

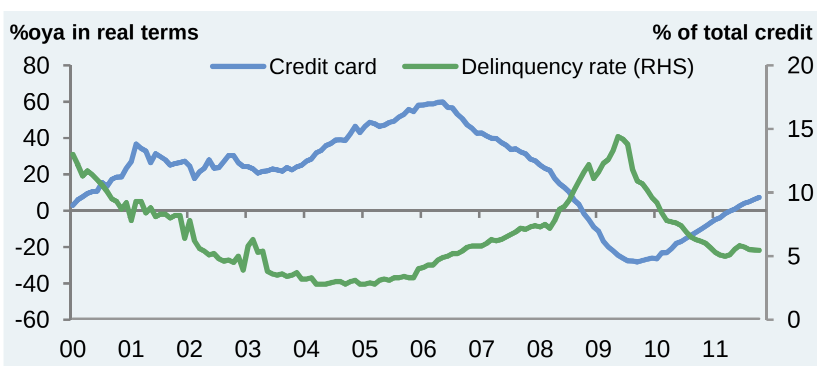
- We expect consumption to sustain its smooth ascending trend, encouraged by the improvements in both, banking credit and employment conditions
- Total commercial bank credit to the private sector represents less than 15% of GDP
- Mexico observed a credit card boom back in years 2003-06, in which non-performing loans increased significantly, making banks to rethink their credit-giving policies, and this was exacerbated during the global financial crisis
- Nevertheless, commercial banks have now "cleaned up" their credit balances, credit card interest rates have moderated, and employment conditions have improved significantly
- As a result, we believe that it is highly likely that all these will support the ascending trend in the country's credit cycle, and hence, domestic demand

## Capitalization indices of major commercial banks'



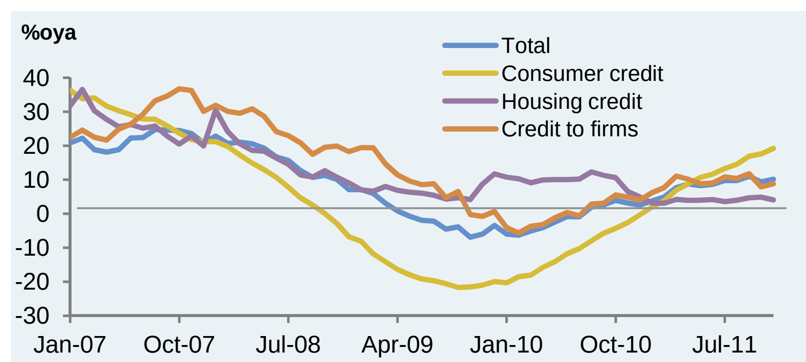

Source: National banking Commission (CNVB), Oct. 2011

## Credit card cycle




Source: J.P.Morgan with data from Banxico

## Banking credit to the private sector




Source: J.P.Morgan with data from Banxico

# Agenda

# We expect limited direct impact from the Euro area crisis

- Even though Mexico could be affected by indirect channels such as overall consumer and corporate confidence, as well as tighter credit conditions worldwide, we see limited direct effects. These could come from three sources:
- **(1) International trade:** Mexico exports less than 6% to the Euro zone. This contrasts to the previous recession where US downturn permeated directly into a Mexican economy that exports 80% to its northern neighbor
- **(2) FDI:** Netherlands and Spain have been responsible for about 25% of total FDI inflows in the past few years. However, the former is not facing the financial and fiscal stress of the latter. We highlight that about one fourth of the FDI from Spain is mainly directed towards construction projects that have need to win government auctions to continue building these projects, so we find hard to believe that these firms will leave these projects 'unattended'
- **(3) Mexican financial system:** Spanish banks are responsible for more than 40% of total consumer credit in Mexico. Nevertheless, foreign banks in Mexico do not operate as foreign banks' subsidiaries, but as Mexican banks in foreign hands. This makes a big difference, particularly as 95% of these banks' funding is local (*e.g.* depositors), and the money these banks are able to lend (or send) to their parent companies is quite limited
- In this context, however, we would still be concerned that these banks could decide to downsize their credit operations in Mexico, but these could be quite limited, particularly as the ratio of total banking credit to GDP is only 15%

**Euro area crisis channels of transmission**

| % of total | % |
|---|---|
| **Mexican exports by country** | |
| North America | 83.2 |
| Europe | 5.6 |
| South America | 4.9 |
| Asia | 3.3 |
| Other | 3.0 |
| **FDI by country** | |
| United States | 44.0 |
| Euro area | 35.1 |
| Spain | 14.7 |
| Netherlands | 13.8 |
| Other Euro countries | 6.6 |
| United Kingdom | 3.4 |
| Other | 17.5 |
| **Bank's consumer credit by country** | |
| Spain | 44.9 |
| United States | 33.9 |
| United Kingdom | 9.1 |
| Canada | 2.2 |
| Mexican and others | 9.8 |

Source: J.P.Morgan with data from Banxico, the Ministry of Economics, and Mexico's Securities and Exchange Commission (CNBV)
Note: Previous five-year average

# Agenda

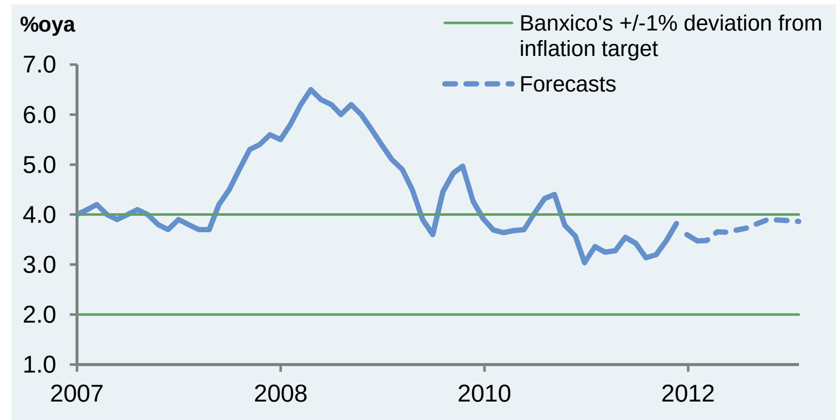


- US Fed’s long pause, well-anchored inflation expectations, and moderate wage negotiations should keep Banxico on hold throughout the year

# The US Fed's long pause, still tolerable inflation, and well-anchored inflation expectations will keep Banxico on hold throughout the year

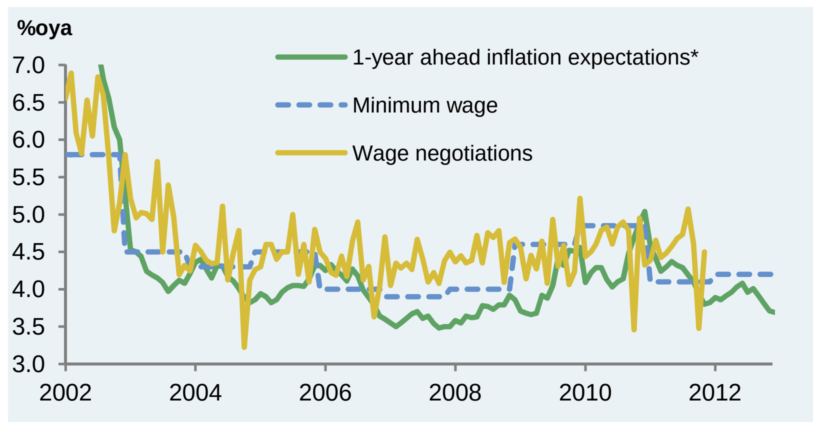
- Even though we expect inflation to surge a bit, relative to last year, we anticipate it to oscillate within Banxico 1% range around its 3% target
- Well-anchored medium-term inflation expectations (around 3.6%), and moderate wage increases clearly support our 'low-for-long' monetary policy call
- In this context, the minimum wage increase settled for 2012 was 4.1%, in line with the 4.2% agreed for last year. It is worth noting that minimum wage settlement is typically a good reference for wage negotiations throughout the year
- On the inflation front, we have observed an important structural change coming from three sources: The 'Viva Aerobus effect', the 'Wal-Mart effect', and lower inter-connection tariffs in the telecom sector
- On the other hand it is worth nothing that this year inflation will not benefit from the changes in CPI methodology, which helped to pull down inflation last year
- But more importantly, the balance of risk of inflation is tilted to the upside and will be mainly driven by potential passthrough effect coming from the relatively weak peso performance

## Headline inflation




Source: J.P.Morgan with data from Banxico

## Inflation expectations and wages in Mexico

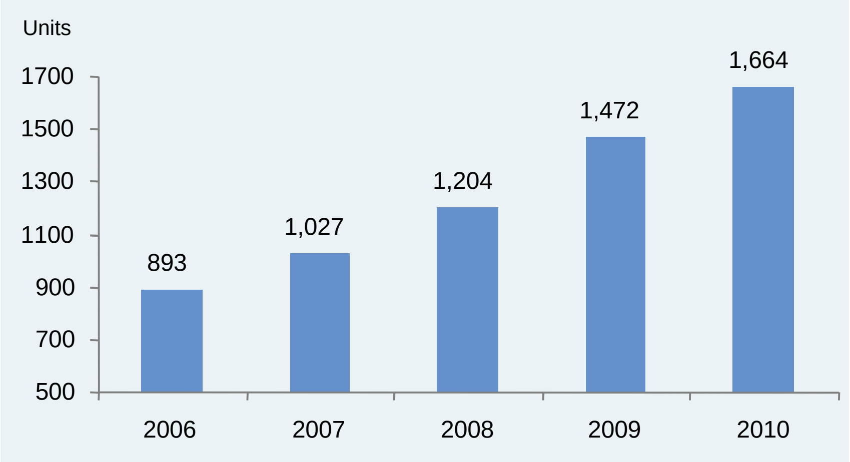



Source: Banxico, Ministry of Labor, CONASAMI, and J.P.Morgan.
*The series was moved 1-year forward

# Structural changes have triggered a higher degree of competition, which could help to offset any passthrough from the peso depreciation

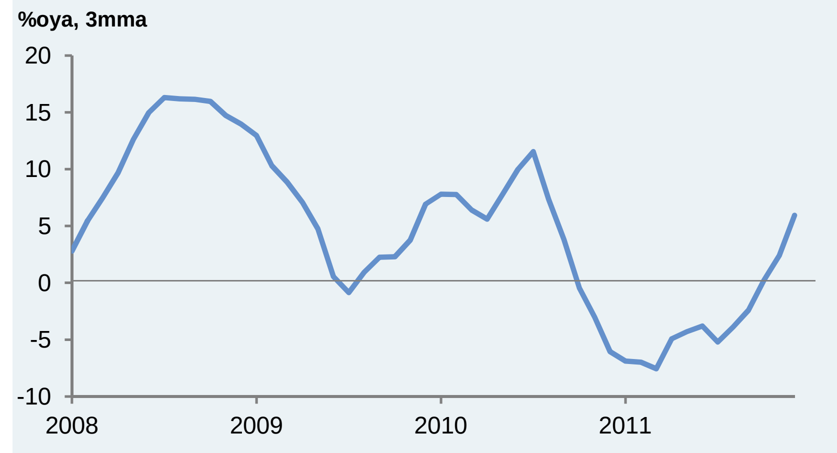
- **'Wal-Mart' Effect.** Wal-Mart has nearly doubled its stores during the last five years. We believe Wal-Mart's aggressive price-policy has fostered a higher degree of competition among supermarkets
- **'Viva Aerobus' Effect.** Despite Mexicana -once a leading airline in Mexico-, filed for bankruptcy and shut its doors about a year ago, air fares have not only not increased, but have actually declined. We attribute this 'new' dynamics to new 'low-cost' airlines that, in our view, have taken Mexicana's bankruptcy as a strategic opportunity to gain market share
- **COFETEL effect**. *COFETEL* (Mexico's telecom regulator) reduced local inter-connection tariffs by 60%. This, in sync with a higher degree of competition in the mobile phone and internet markets, has pushed telecom prices down

**Wal-Mart stores in Mexico**



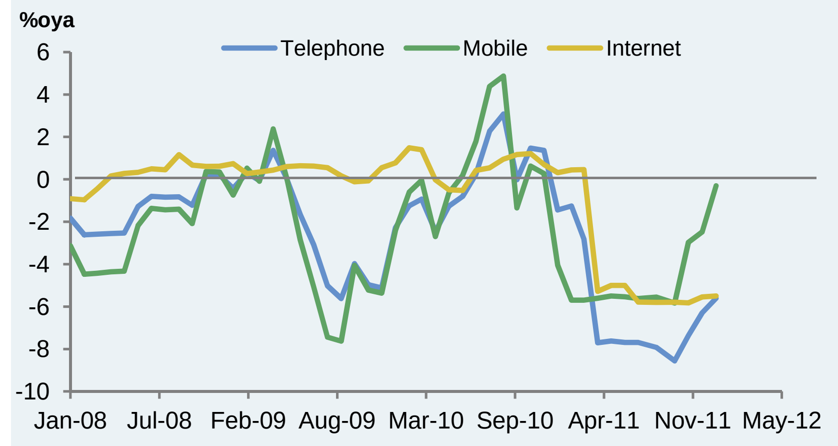

Source: Wal-Mart México

**Inflation in airfares - The 'Viva Aerobus' effect**




Source: Banco de México

**Inflation in telecom services**

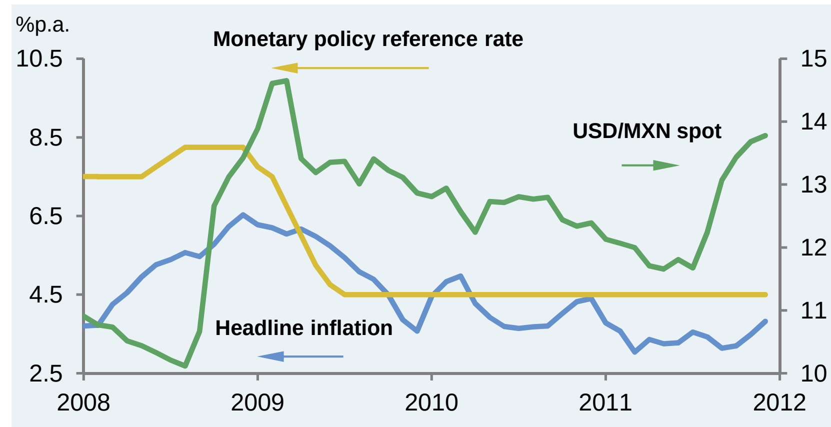



Source: Banco de México

## Banxico to stand pat in 2012

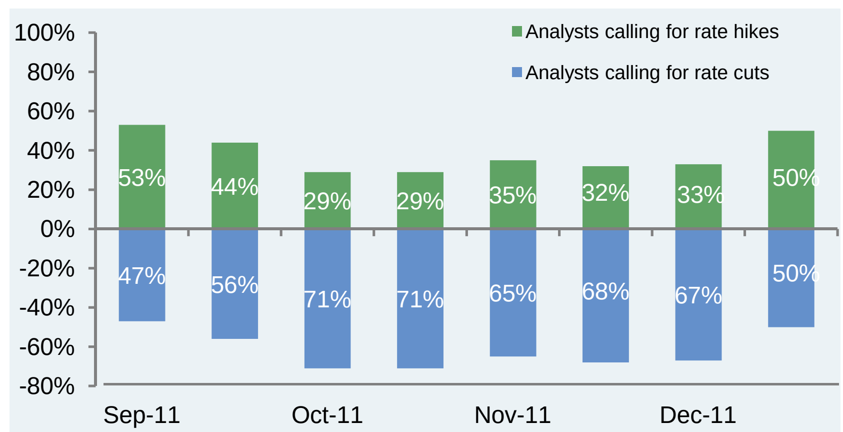
- We recently changed our monetary policy call from a rate cut early next year, to anticipate Banxico will hold rates ‘indefinitely’
- In our view, given Mexico's ‘healthy’ inflation outlook, the central bank board’s assessment will focus on the exchange rate inflation passthrough and future nominal exchange rate levels, as well as domestic demand dynamics
- In fact in the last Banxico minutes: ‘…all members of the board manifested that the exchange rate depreciation could be an upside risk for inflation…’
- In this context, analysts have shifted from expecting rate cuts in 2012, to anticipating hikes in 2013
- However, we believe it is still too early to talk about the need for tightening, as the output gap is just about to close, the balance of risks of global growth continues to be tilted to the downside, and even though inflation has recently surged, it remains within Banxico variability range of 1% around its permanent target of 3%
- As a result, given we still expect inflation to end next year around 4%, the abovementioned scenario provides support for our call that Banxico will keep the reference rate on hold for a long time

**Inflation, Banxico’s reference rate, and exchange rate**




Source: Banxico and Bloomberg.

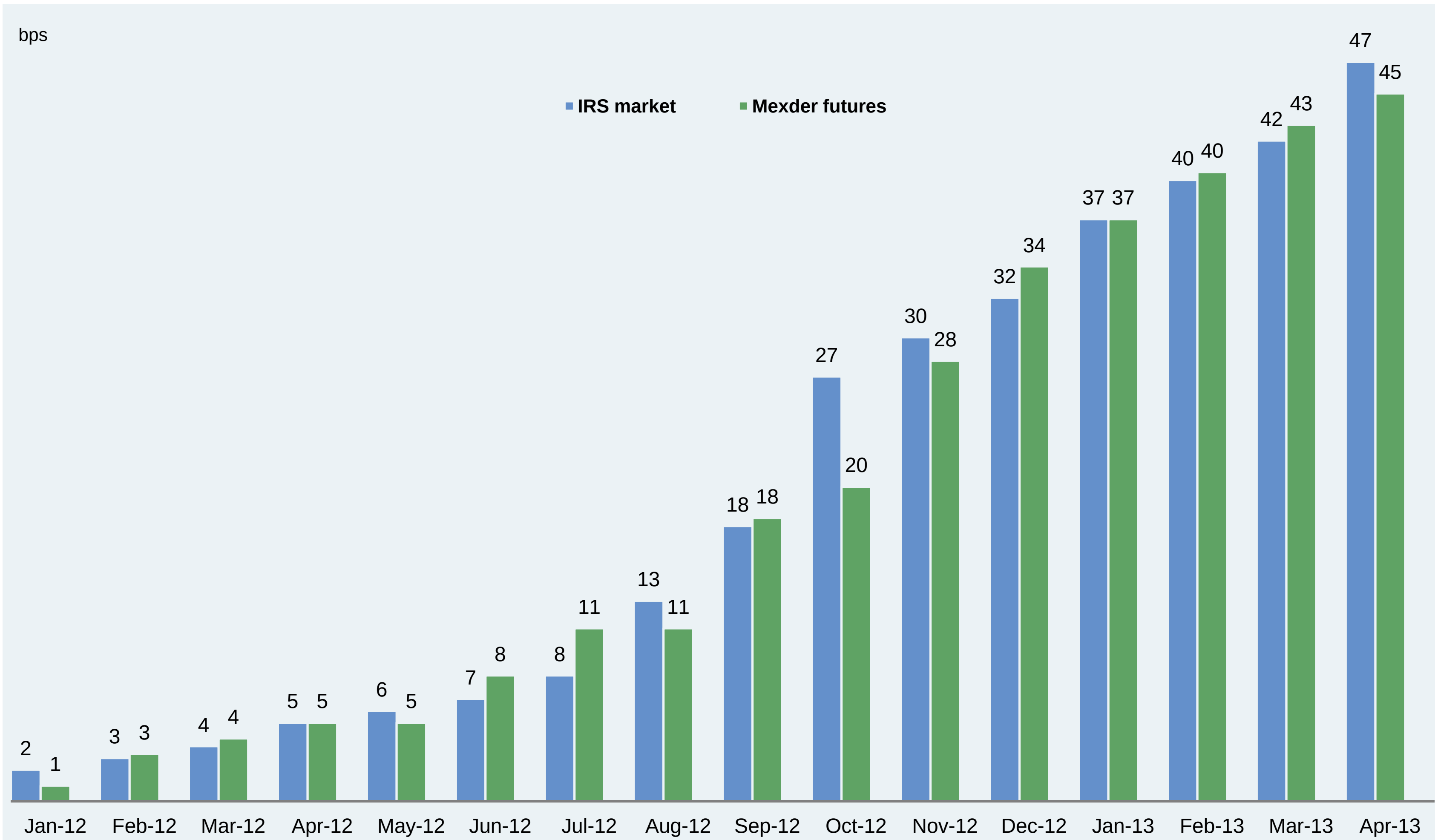
**Analysts’ monetary policy expectations**




Source: Banamex survey

# However, the market is already pricing a full 25bp rate hike in 4Q12…

**Analysts' and market's monetary policy expectations**




Source: J.P.Morgan with data from Mexder, Bloomberg and Banamex survey of economic expectations.
Note: Accumulated rate hikes.

# Agenda

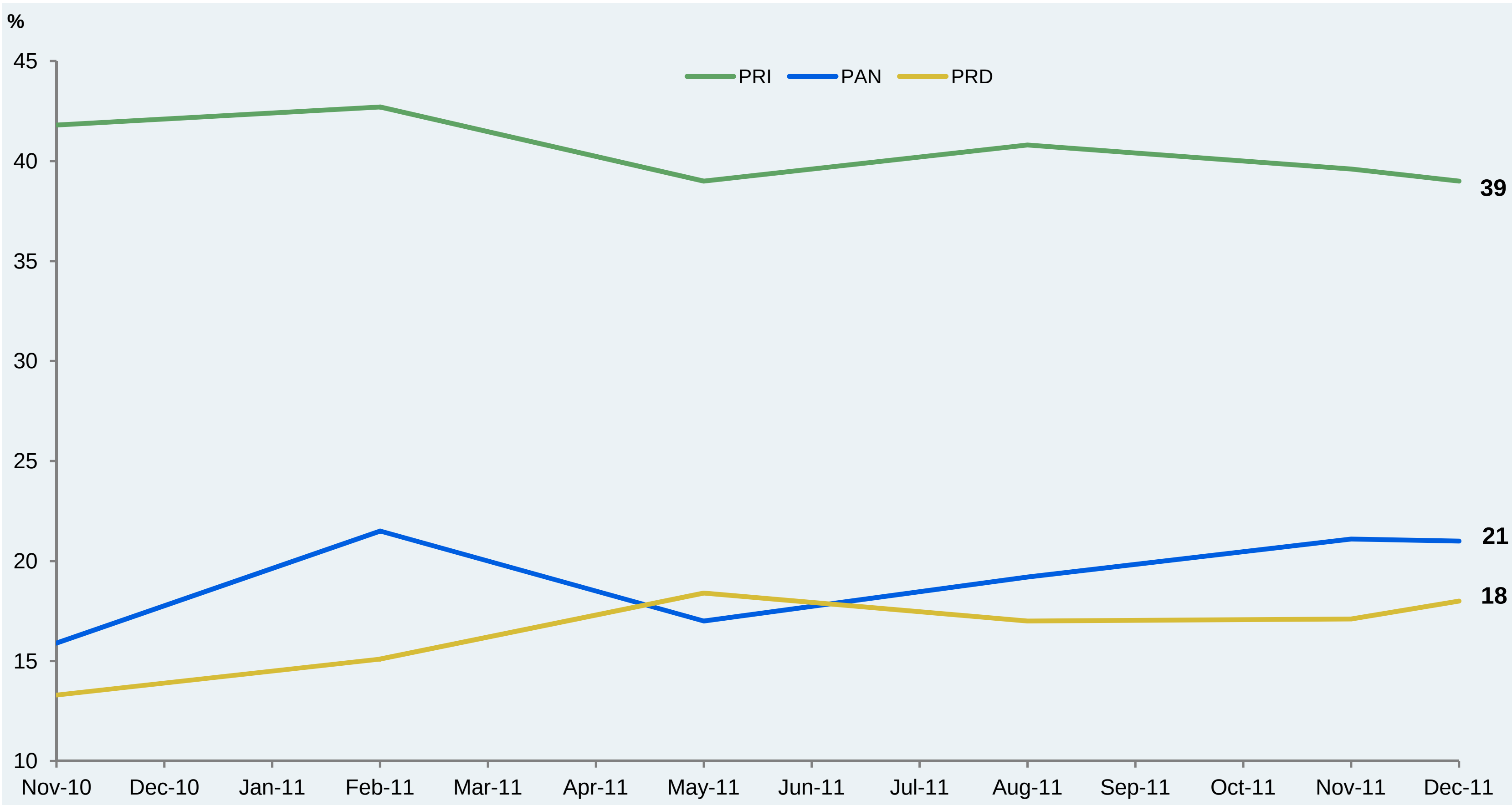


- The President and seven state Governors as well as the Congress will be fully renewed

PRESIDENTIAL ELECTION IN JULY

# Towards the Presidential election in July 1, 2012

**Presidential elections – voters' intention poll**




Source: Consulta Mitofsky (Decenber 2011).



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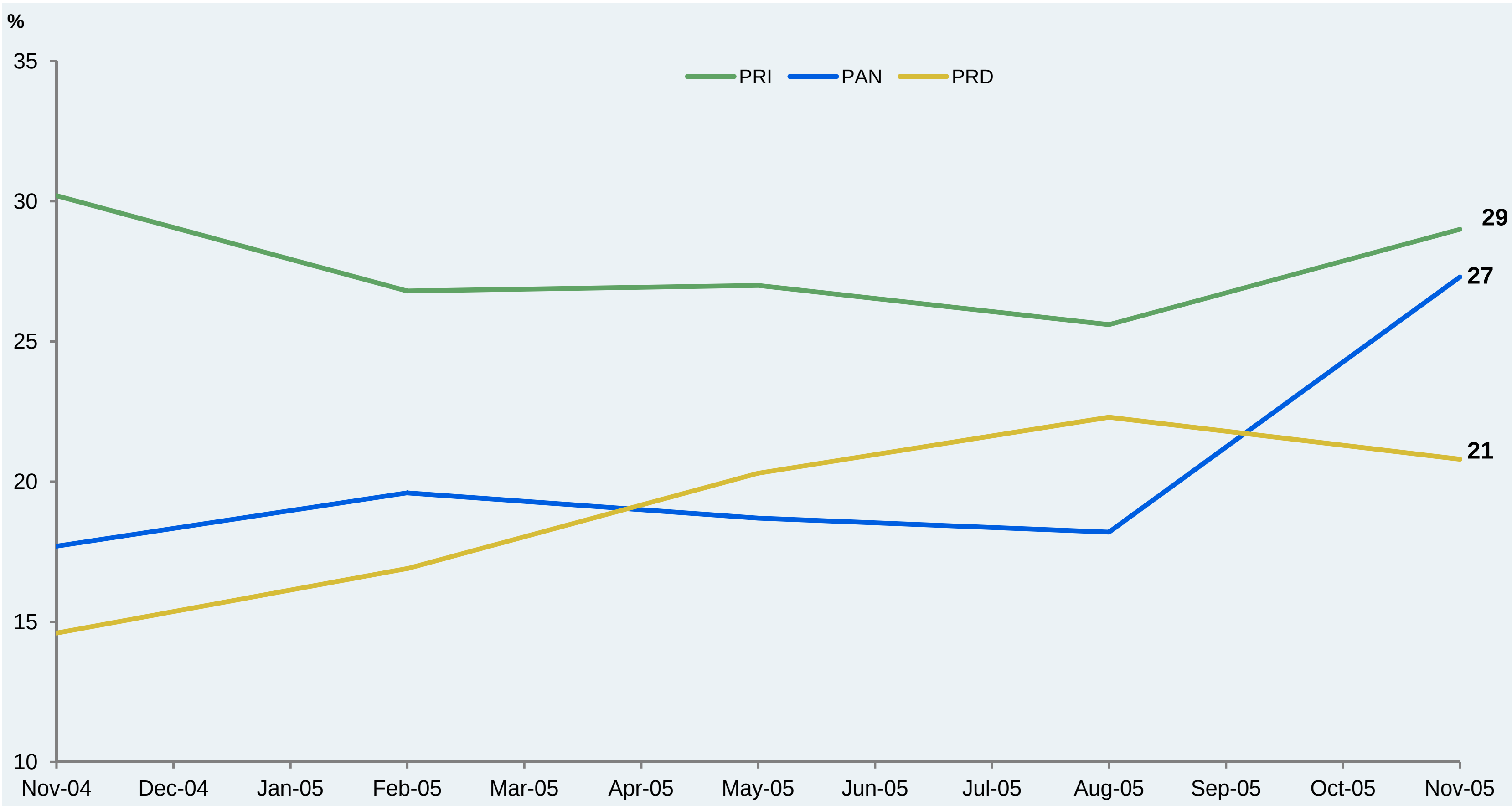
# This is how it looked 6 months ahead of 2006 presidential election

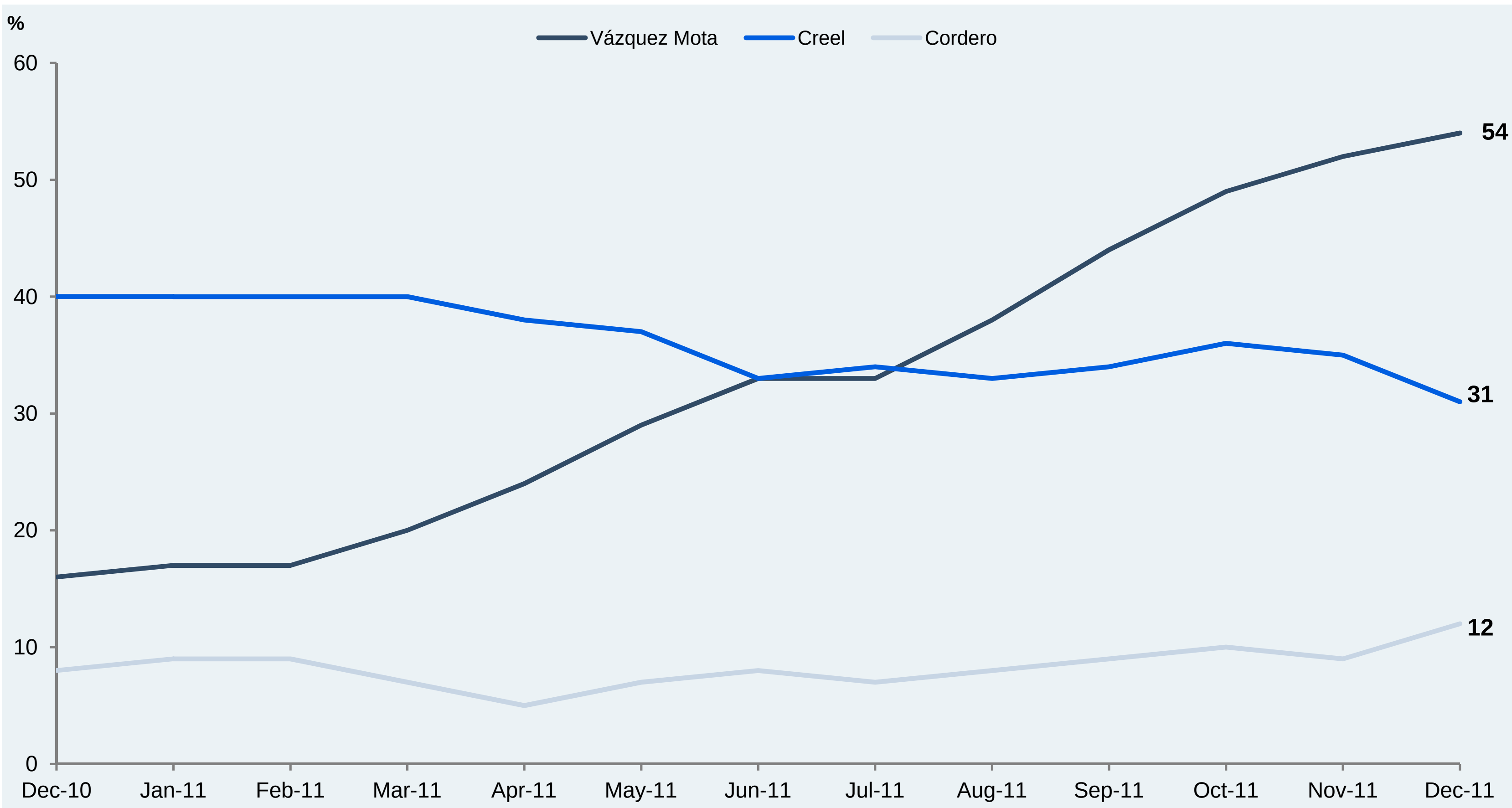
**Presidential elections – voters' intention poll**




Source: Consulta Mitofsky (November 2011).

# With Peña Nieto and AMLO officially leading the PRI and PRD candidacies, respectively, the focus is now on the PAN candidate which will likely be defined by mid-February

**Candidate preferences among PAN supporters**




Source: Consulta Mitofsky (December2011).

# Agenda



- We expect USD/MXN at 12.00 by year-end, fueled by a strong rally in 2H12

# Strong fundamentals do not support a depreciation trend

## USD/MXN forecasts

| | 1Q12 | 2Q12 | 3Q12 | 4Q12 |
|---|---|---|---|---|
| New | 13.50 | 13.50 | 12.80 | 12.00 |
| Previous | 12.80 | 13.20 | 12.20 | 11.80 |
| Difference | 0.70 | 0.30 | 0.60 | 0.20 |

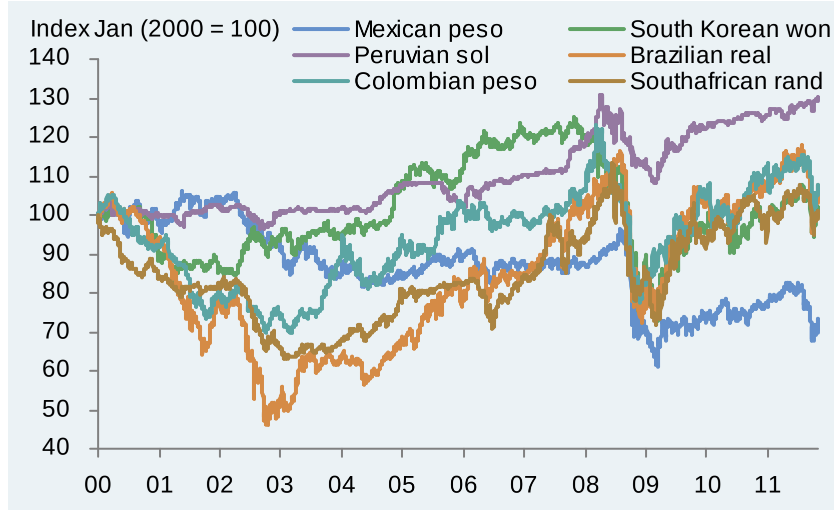
Source: J.P.Morgan and US Federal Reserve
* 1. Observed values in the "New" column vs. Forecast.

- Judging by recent market dynamics, current conditions look quite similar to 2008-2009. Nevertheless, we believe this time is quite different from 2008-09, we highlight four differences:

1. The US is not the epicenter of the crisis.
2. There are no Mexican corporates involved in toxic derivatives
3. Mexico's public finances are considerably healthier
4. Mexico's central bank holds significantly higher foreign reserve levels. FX reserves now stand at nearly US$ 200 billion, taking into account the IMF's Flexible Credit Line (FCL), which currently accounts for US$ 74 billion over a two-year horizon

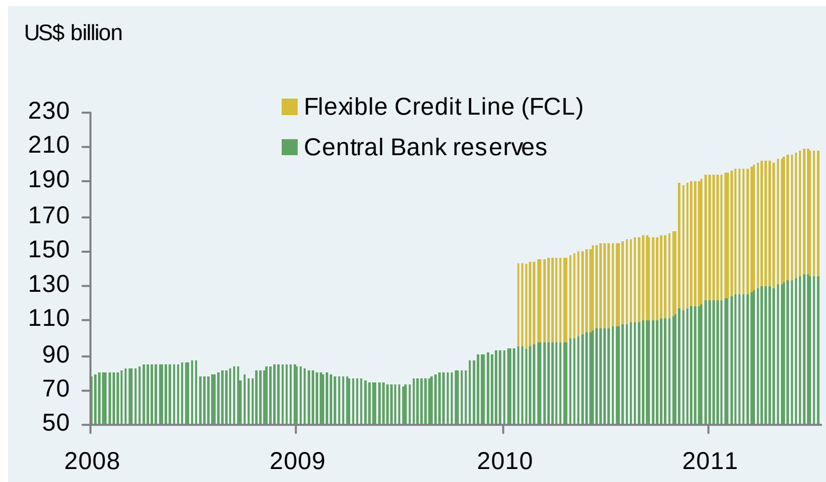
- In addition, the current account deficit is moderated and well financed

## Major emerging currencies index




Source: Bloomberg and J.P.Morgan

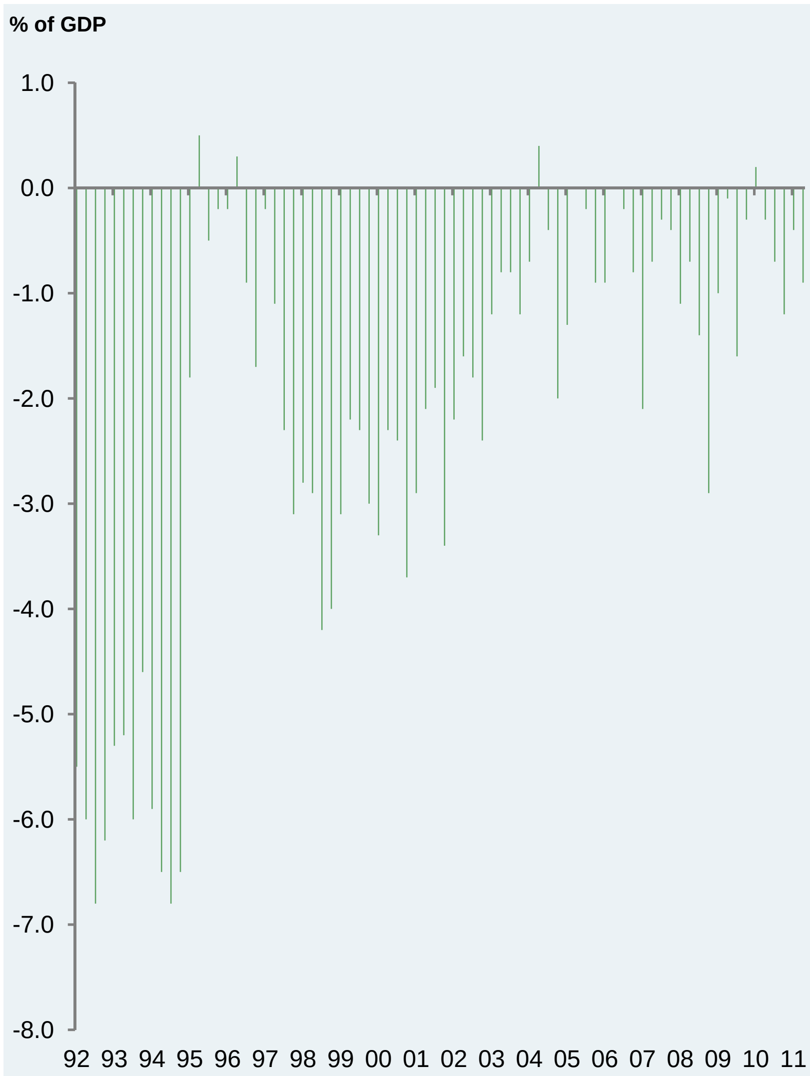
## Foreign reserves




Source: Banxico.

## The current account and fiscal deficits are moderated and well financed. This should become relevant in a global environment of fiscal laxitude

**Current account deficit**




Source: Banxico.

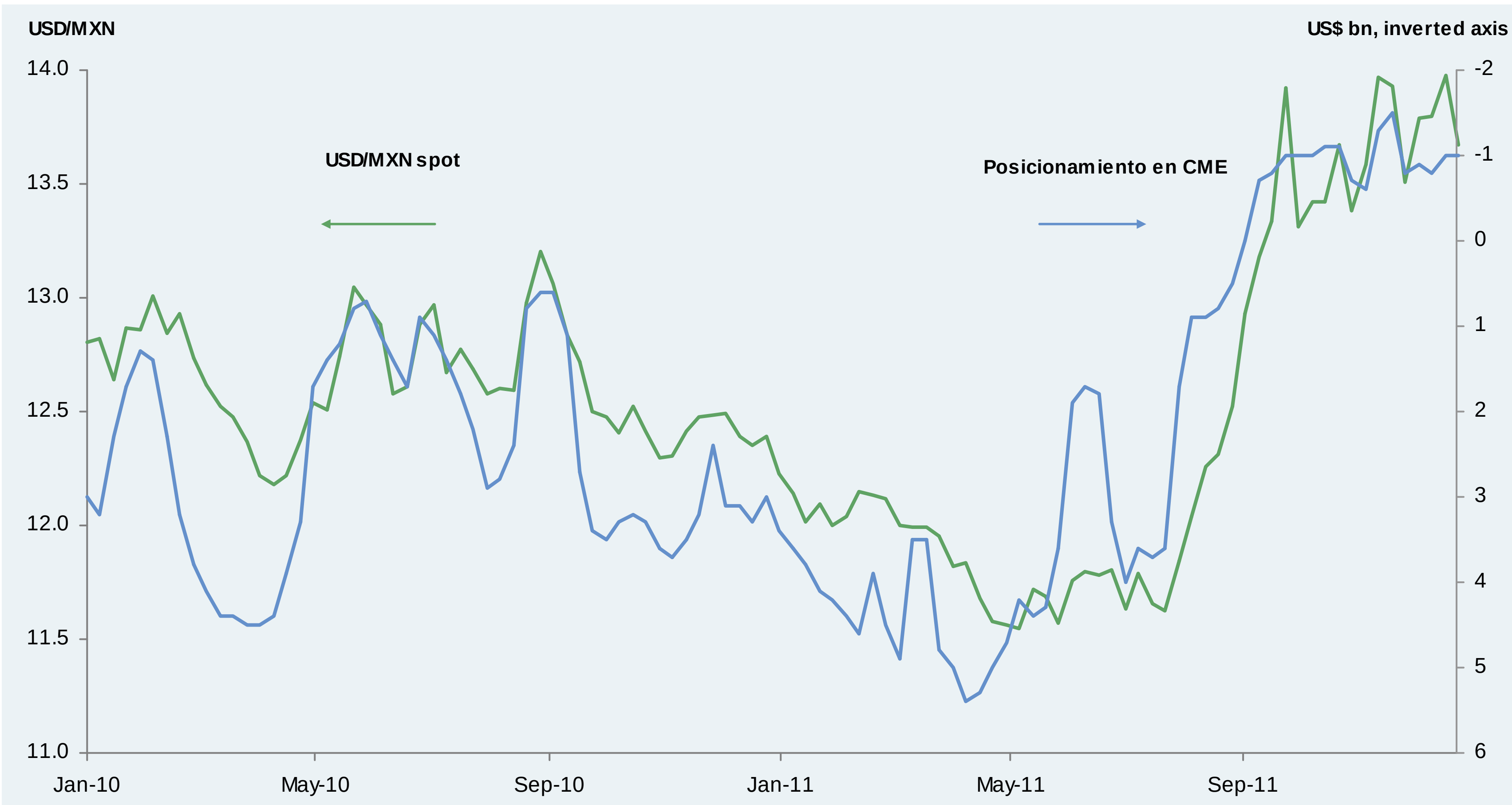
**Government deficit in 2011**


Source: Fitch (June 2010).
*Proposed for 2012

Market participants have reduced their long peso technical positions.

Going forward, however, we expect some degree of political uncertainty ahead

**IMM short USD/MXN positioning and USD/MXN spot**




Source: Bloomberg and J.P.Morgan.





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