

Factors and Fundamentals

Foreign Exchange Strategy

Mexican peso (USDMXN)

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NAFTA renegotiation talks and Mexico's 01-July election should continue to fuel volatility in USDMXN. The market expects those talks to fail but we think NAFTA will survive (at least via a commitment to avoid rash decisions and resume talks in December). We think AMLO will win the election and that will push USDMXN to 21.00 at the 6M horizon. However, we think his cabinet choices will be Lula-like and soothe markets, thereby allowing USDMXN to drift back down to 19.00.

FX Strategy team view	1m	3m	6m	9m	12m
USDMXN spot	19.50	19.00	21.00	20.00	19.00
Banxico base rate	7.25%	7.50%	8.00%	8.00%	7.50%
Fed base rate	1.25 – 1.50%	1.50 – 1.75%	1.75 – 2.00%	1.75 – 2.00%	2.00 – 2.25%

Bullish USDMXN Factors

- **NAFTA renegotiation talks are getting down to crunch time and all sides are negotiating through the media. We are likely to be fed a steady diet of volatility-inducing headlines. Uncertainty tends to trigger spikes in USDMXN—even if trading with the US under WTO rules might prove better for Mexico than retaining NAFTA.**
- **Leftist candidate Antonio Lopez (AMLO) is ahead of the presumptive PRI candidate Jose Meade and PAN-PRD consortium candidate Ricardo Anaya in opinion surveys. With independent candidates likely to peel voters away from PAN-PRI and the PRI beset by a scandal, AMLO may finally win the presidency. As the fiercest nationalist, AMLO would benefit from a NAFTA breakup in March.**
- The Fed is highly likely to hike at least 3 times in 2018.

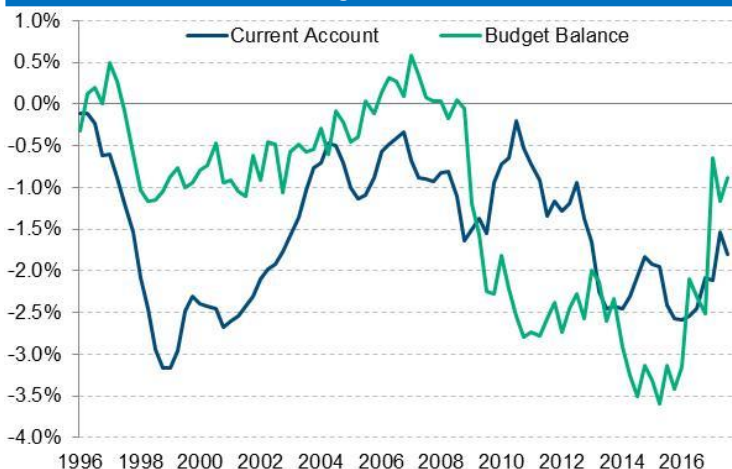
Bearish USDMXN Factors

- **We estimate USDMXN has a 7-8% NAFTA breakup risk premium. The market seems to have dismissed the possibility of a deal by the end of March, but we wouldn't.**
- Oil is only a minor export for Mexico, but the price of oil is a huge factor for federal finances. With oil in the \$60s, the government can loosen the purse strings.
- Given how far above target inflation is running, Banxico wants a stronger peso. Banxico hiked 150bps in 2017 and will likely continue hiking and otherwise pursuing MXN strength in 2018.
- MXN is extremely cheap on a PPP basis. *The Economist's* Jul-17 Big Mac Index had MXN undervalued by 48% raw or 16% income adjusted (at USDMXN 17.8).
- Mexico's twin deficits are better than average and improving.

Mexico FX Fundamentals Facts

- **Population and per capital GDP:** 124mn, USD8,562 per year nominal or 18,935 IMF PPP-adjusted for 2016 (avg USDMXN 18.70)
- **Government:** constitutional democracy with a president and bicameral legislature presently split fairly evenly among 3 main parties
- **President:** Enrique Peña Nieto (since Dec 2012)
- **Forthcoming elections:** next presidential election is 01-July-2018
- **Finance minister:** Jose Gonzalez Anaya (since 27-Nov-2017)
- **Central bank governor (Central Bank of Mexico or Banxico):** Alejandro Diaz de Leon Carillo (since 01-Dec-2017)
- **FX regime:** no capital controls combined with floating exchange rate very loosely managed by central bank auctions
- **Policy target rate:** official overnight rate
- **Central bank mechanism:** inflation targeting (since 1995) with a target of 3.0% and a +/- 1% band
- **Inflation:** 6.8% YoY total CPI and 4.9% core CPI inflation for December; 6.0% total CPI and 4.7% core inflation for calendar 2017
- **GDP growth rate:** 1.5% YoY for Q3 of 2017; 2.3% for calendar 2016
- **Current account balance:** -1.8% of GDP for Q3 of 2017; -1.6% YTD average for 2017; -2.1% of GDP for calendar 2016
- **Budget balance:** -0.9% of GDP for Q3 of 2017; -0.9% YTD average for 2017; -2.5% of GDP for calendar 2016

Mexico's fiscal and budget balances as a share of GDP



USDMXN price history and future view



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