BofA SECURITIES

Mexico Viewpoint

Mexico: Top 5 (macro) questions for 2024

11 January 2024

GEM Economics
LatAm | Mexico

What are the economic implications of the election?

The main economic implication for 2024 is through fiscal policy: a big increase in the fiscal deficit in 2024 which increases government expenditure by 1.2pp of GDP in 2024. The election is on June 2, and most of the extra expenditure will be spent in the first half of the year in infrastructure projects and in social programs, which will support growth. But we expect a "fiscal cliff" towards the end of the year and in 2025 as the next administration will have to do a significant fiscal retrenchment to keep Mexico's credit rating. The election could also impact nearshoring and MXN, we discuss them below.

When and by how much will Banxico cut rates?

We expect Banxico to start a gradual cutting cycle in March (a change from June before) and then cut faster in 2H 2024 as the economy decelerates. We expect Banxico to cut 25bp in March and in June and then 50bp in September, November, and December to put the policy rate at 9.25% by end-2024 (8.75% before). We continue to expect Banxico to cut the rate to 7.50% by end-2025. We still believe Banxico should not cut rates ahead of the election as the economy remains hot, the labor market too tight, headline is still high and trending up, and inflation expectations are not at the target. But Banxico has been clear with its recent communications that it wants to cut as early as 1Q.

Is Mexico taking advantage of nearshoring?

Our answer is a qualified yes as investment is booming and Mexico continues to gain market share in US imports, but Foreign Direct Investment (FDI) remains muted. In addition, there has been no coordination between private investment in the north of the country (nearshoring) and public investment in the south (government's infrastructure projects), so Mexico is not yet taking full advantage of the opportunity. This year nearshoring investment could pause due to the elections in Mexico in June and in the US in November, to return by the end of the year and in 2025, if there is a weaker peso.

Will growth remain as resilient in 2024 as in 2021-2023?

We expect growth to decelerate in 2024 and in 2025 as the US slows down and as Mexico faces a "fiscal cliff" at the end of 2024 and in 2025. We expect growth to decelerate from 3.4% in 2023 to 2.0% in 2024 (1.8% before) and to 1.0% in 2025 (0.5% before). We increase our GDP growth forecasts as recent data in the US and in Mexico remain resilient, but our qualitative view is the same: Mexico is likely to decelerate sharply at the end of 2024 as government expenditure dries up and the US help fades.

Will the Super Peso finally weaken?

We believe so. After a long run of remarkable resilience, we have strong conviction that the Super Peso will weaken in 2024. Banxico's easing cycle, a decelerating domestic and US economy, a challenging fiscal outlook, and uncertainty amid presidential elections in Mexico and the US, will put pressure on what we see as a fundamentally overvalued MXN. We see MXN at 18.5 by end-2024.

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What are the economic implications of the federal election?

The spotlight in 2024 will be the federal election in June. Mexicans will elect a new president and both houses of congress at the federal level, as well as many local positions. The incumbent party is Morena (AMLO's party), which will go in a coalition with candidate Claudia Sheinbaum, who is well ahead in polls (Exhibit 1). We think she seems more to the left than AMLO, according to her speeches as former Mexico City mayor. On the opposition, the coalition "Fuerza y Corazon por Mexico" by PAN, PRD and PRI has Xóchitl Gálvez as its candidate. She seems more business friendly than AMLO according to her recent speeches, in our view. A third candidate, Jorge Álvarez, will also be on the ballot representing MC party. He will likely split the opposition's vote.

Investors are likely to concentrate on congress given Morena's lead in polls for the presidency. Morena and allies currently have a simple majority in congress, which allows them to control the budget but not to change the Constitution. After the election, a qualified majority for Morena may increase the risk of a more radical government as Morena would have the numbers to change the Constitution, while an opposition-controlled congress would increase check and balances. It seems that the question for the election will be if Morena is able to maintain its simple majority in congress or if the opposition could take it away.

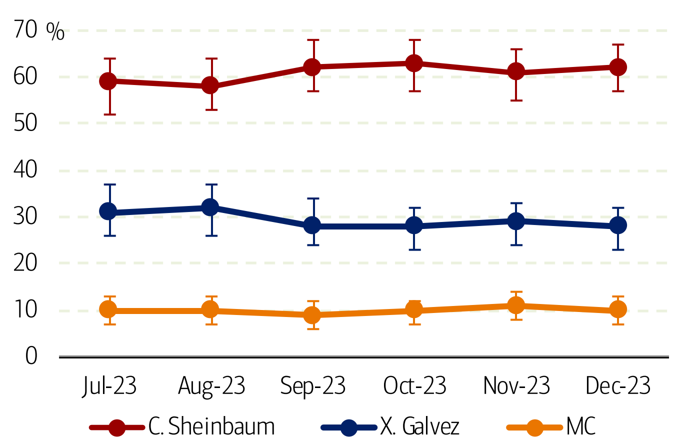
We believe that the main economic implication of the election for 2024 is through fiscal policy, as congress already approved a big increase in the fiscal deficit for the public sector in 2024 to 5.4% of GDP from 3.9% in 2023 (Exhibit 2). The increase in the deficit implies a large increase in government expenditure of 1.2pp of GDP in 2024 (Exhibit 3).

The election is on June 2, and most of the extra expenditure will be deployed in the first half of the year in infrastructure projects and in social programs, which will impact growth. In 2023, the public sector spent about 1pp of GDP in big infrastructure projects such as the Maya train, the interoceanic train, and the Mexico-Toluca train.

But we expect a "fiscal cliff" towards the end of the year and in 2025 as the next administration will have to do a significant fiscal retrenchment to maintain Mexico's credit rating. The Ministry of Finance forecasts include a large fiscal consolidation, with a reversal of the deficit to -2.6% of GDP and a reduction in government expenditure of 3pp of GDP.

Exhibit 1: Presidential election voter support (poll of polls, %)

2024 starts with a clear leader: incumbent's party candidate Sheinbaum



Source: Oraculus. Whiskers are 90% confidence intervals

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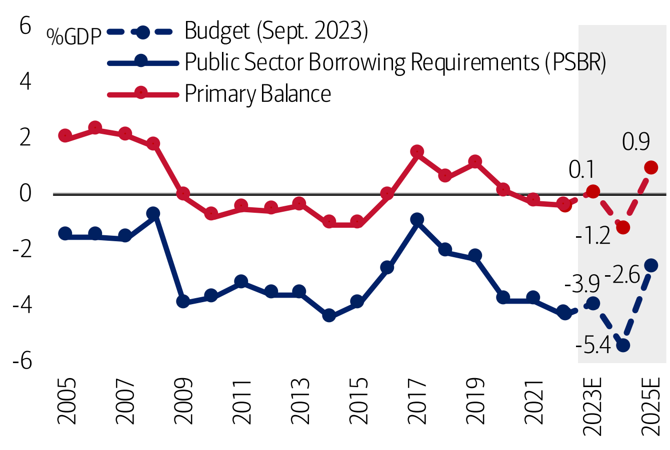
Exhibit 2: Measures of public sector balance

The '24 budget forecasts large fiscal stimulus for '24 and consolidation in '25



Source: Ministry of Finance

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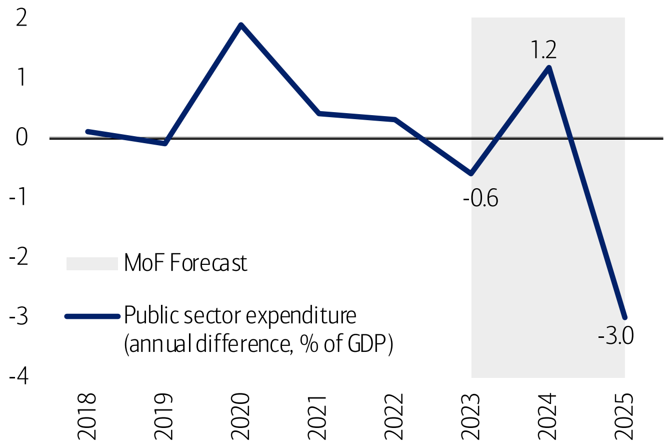
The extent to which a large fiscal retrenchment will happen in 2025 depends on the results of the election. For instance, an opposition-led congress could impose a large fiscal retrenchment. Mexico has some fiscal space as debt to GDP remains below 50% and compares well versus other EMs (Exhibit 4). But the government is already issuing significantly in external and domestic markets, which could impact interest rates to the upside and could also produce a vicious circle, pressuring expenditure.

Exhibit 3: Public expenditure to increase sharply in '24, by 1.2pp of GDP
This will lead to a fiscal consolidation in '25 of 3.0pp of GDP



Source: Ministry of Finance

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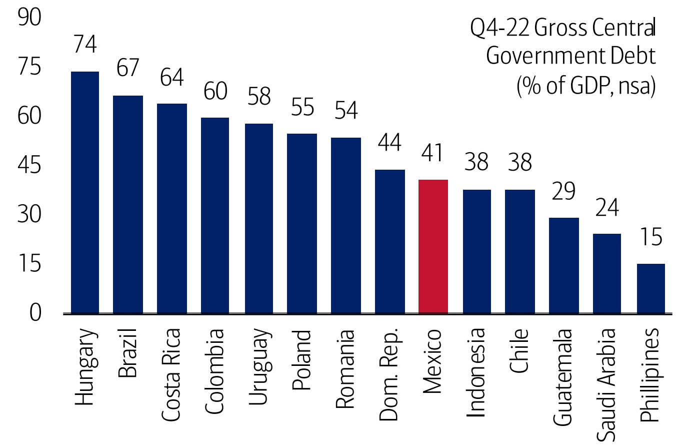
Exhibit 4: Central government indebtedness (% of GDP)
Mexico's low debt-to-GDP ratio, relative to peers, could foster more issuance



Source: World Bank, Haver.

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When and how much will Banxico cut?

We expect Banxico to start a gradual cutting cycle in March (a change from June before) and then cut faster in 2H 2024 as the economy decelerates.

Exhibit 5: Monetary policy path forecasts for Banxico and the Fed
We revise our forecast considering recent data and Banxico's comments

	New		Old		US Fed	
Meeting	Rate	Change (bp)	Rate	Change (bp)	Rate	Change (bp)
Jan-24	11.25		11.25		5.50	
Feb-24	11.25		11.25		5.50	
Mar-24	11.00	-25	11.25		5.25	-25
Apr-24	11.00		11.25		5.25	
May-24	11.00		11.25		5.25	
Jun-24	10.75	-25	10.75	-50	5.00	-25
Jul-24	10.75		10.75		5.00	
Aug-24	10.75		10.25	-50	5.00	
Sep-24	10.25	-50	9.75	-50	4.75	-25
Oct-24	10.25		9.75		4.75	
Nov-24	9.75	-50	9.25	-50	4.75	
Dec-24	9.25	-50	8.75	-50	4.50	-25
Jan-25	9.25		8.75		4.50	
Feb-25	8.75	-50	8.50	-25	4.50	
Mar-25	8.25	-50	8.25	-25	4.25	-25
Apr-25	8.25		8.25		4.25	
May-25	8.00	-25	8.00	-25	4.25	
Jun-25	7.75	-25	7.75	-25	4.00	-25
Jul-25	7.75		7.75		4.00	
Aug-25	7.50	-25	7.50	-25	4.00	
Sep-25	7.50		7.50		3.75	-25
Oct-25	7.50		7.50		3.75	
Nov-25	7.50		7.50		3.75	
Dec-25	7.50		7.50		3.50	-25

Source: BofA Global Research, Banco de Mexico, US Federal Reserve

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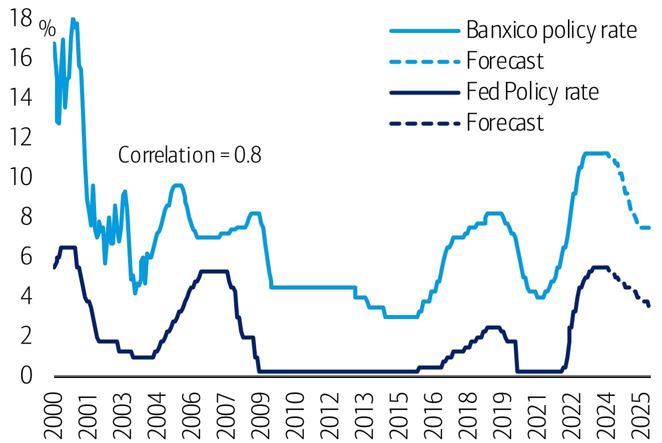
We expect Banxico to cut 25bp in March, June and then 50bp in September, November, and December to put the policy rate at 9.25% by end-2024 (8.75% before). We continue to expect Banxico to cut the rate to 7.50% by end-2025 (Exhibit 5).

One reason behind the change is that the Banxico rate is highly correlated with the US Fed's, and we expect the Fed to start a cutting cycle in March (Exhibit 6). Another reason behind the change is that core inflation continues to fall, driven by good's inflation (Exhibit 7). But the main reason behind the change is that Banxico's communication since November has been that it wants to cut as early as 1Q 2024 in a gradual and non-continuous way.

Exhibit 6: Banxico's and FED's policy rate and forecasts (%)
We expect a faster cutting cycle for Banxico, particularly in 2H24 and 1H25



Source: BofA Global Research estimates, Banco de Mexico, US Fed, Haver

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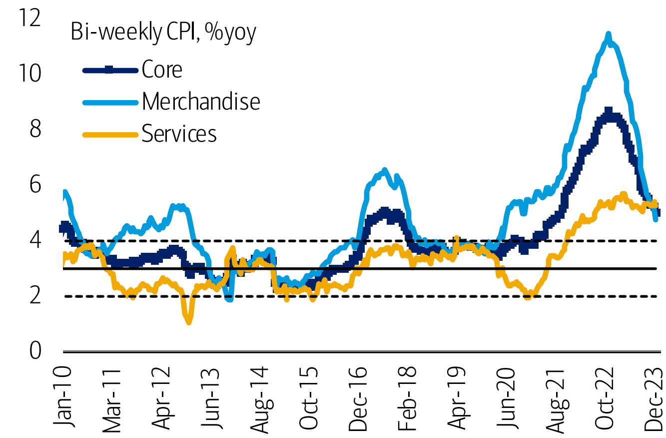
Exhibit 7: Biweekly core inflation (%yoy)
Core inflation is trending down, helped by goods; but services are sticky



Source: BofA Global Research, INEGI

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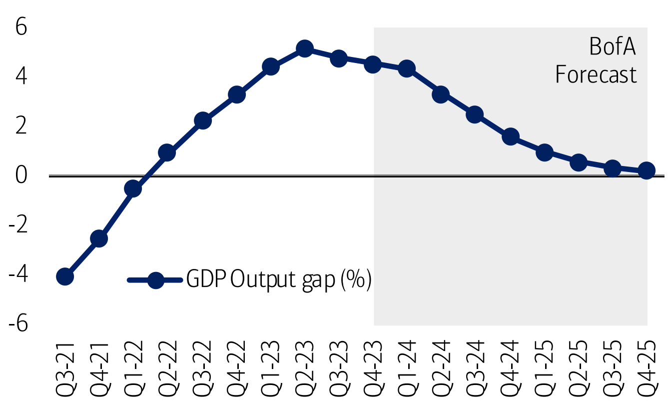
We still believe that Banxico should not cut rates ahead of the election as the economy remains hot (Exhibit 8), the labor market too tight (Exhibit 9, Exhibit 10), headline inflation is trending up, the level of inflation is still too high (Exhibit 11, Exhibit 12) and inflation expectations are not at the target (Exhibit 13, Exhibit 14). But Banxico has been clear with its recent communications that it wants to cut as early as 1Q, so we now pencil in a gradual start of the cycle in March (and have an inflation forecast that shows that inflation will not converge to the 3% target in 2024 or in 2025).

Exhibit 8: Output gap
The economy is overheated and will remain so in the short term



Source: BofA Global Research estimates

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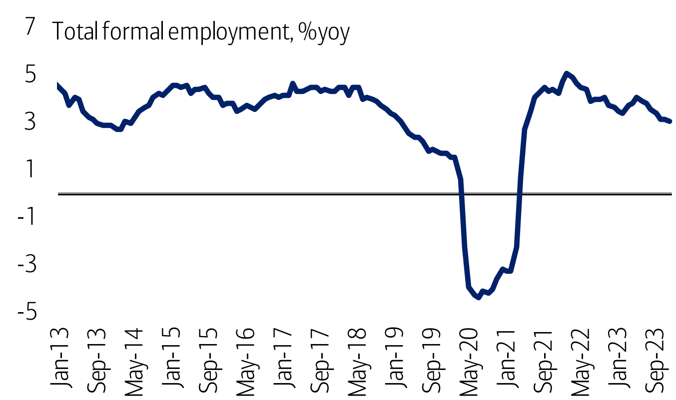
Exhibit 9: Formal employment growth
Total formal employment growth is still high, although decelerating



Source: IMSS, Haver

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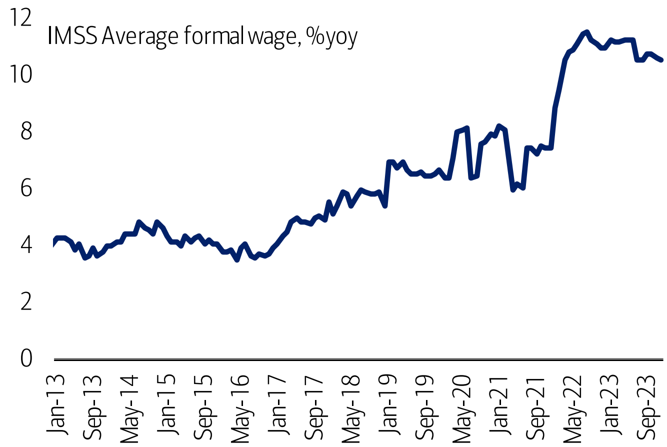
Exhibit 10: IMSS average formal wage growth
Wage growth, though decelerating at the margin, remains high



Source: IMSS, Haver

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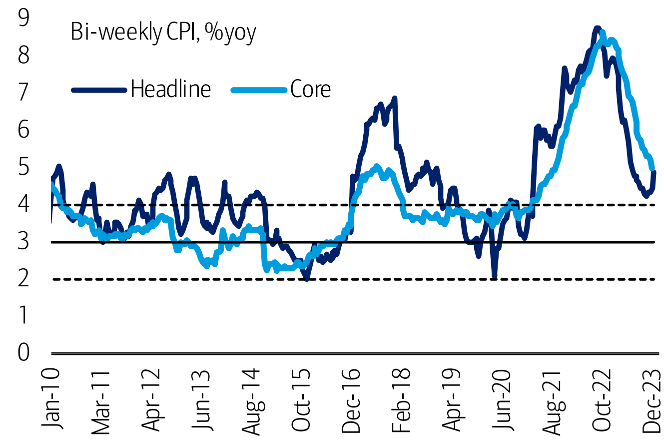
Exhibit 11: Headline and core inflation
While headline is currently trending up, core is steadily trending down



Source: INEGI

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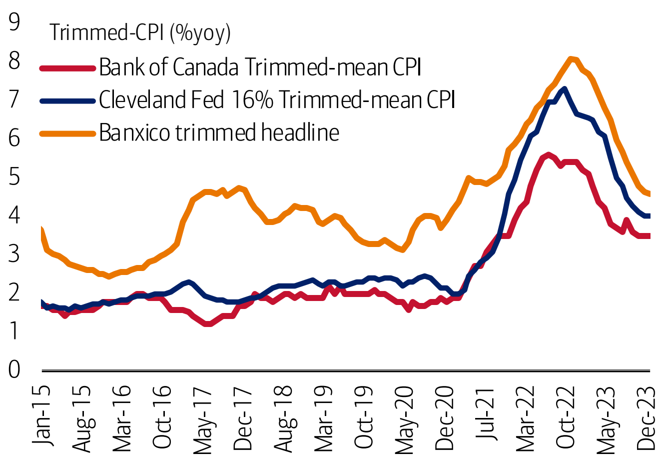
Exhibit 12: Trimmed inflation comparison
Trimmed measure in Mexico is decreasing, but inflation is still high



Source: Banco de Mexico, Bank of Canada, US Fed, Bloomberg

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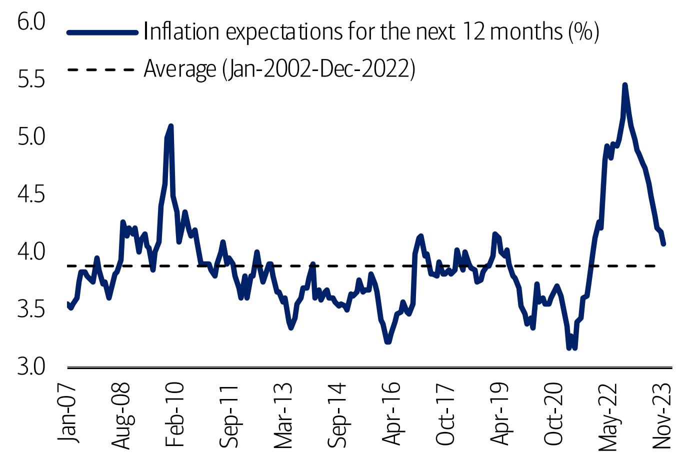
Exhibit 13: Inflation expectations for the next 12 months
12-month expectations remain above their average



Source: BofA Banco de Mexico

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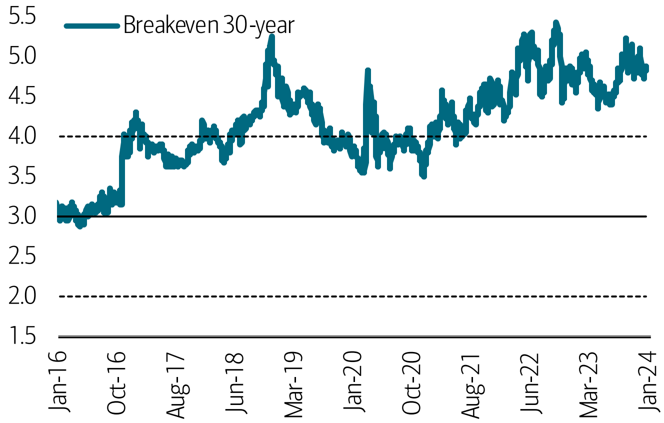
Banxico's change in communication and potential cut in rates while the economy is hot, fiscal policy is expanding and inflation remains high means that Banxico will probably not attain its inflation target this year or next (Exhibit 15).

We expect Banxico to accelerate the pace of cuts in 2H 2024 and in 2025 as the fiscal cliff hits the economy and the deceleration becomes clear. Banxico will likely lower the spread in real rates with the US Fed as in previous Mexico's cycles (Exhibit 16).

Exhibit 14: Breakeven inflation (%)
Implied long term inflation premium remains high



Source: Bloomberg

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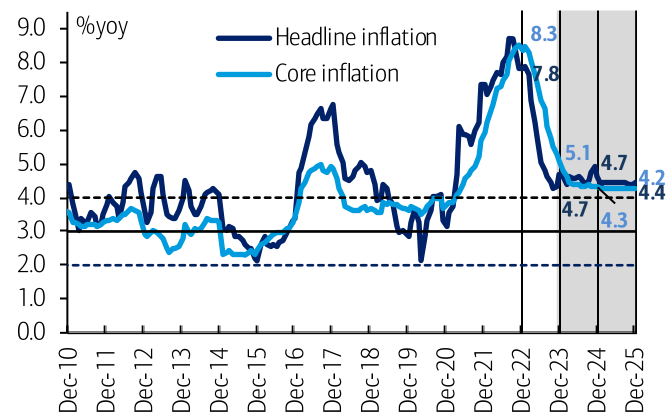
Exhibit 15: Inflation forecasts for 2024-25
We expect inflation above 4.0% throughout 2024 and 2025.



Source: BofA Global Research estimates, INEGI

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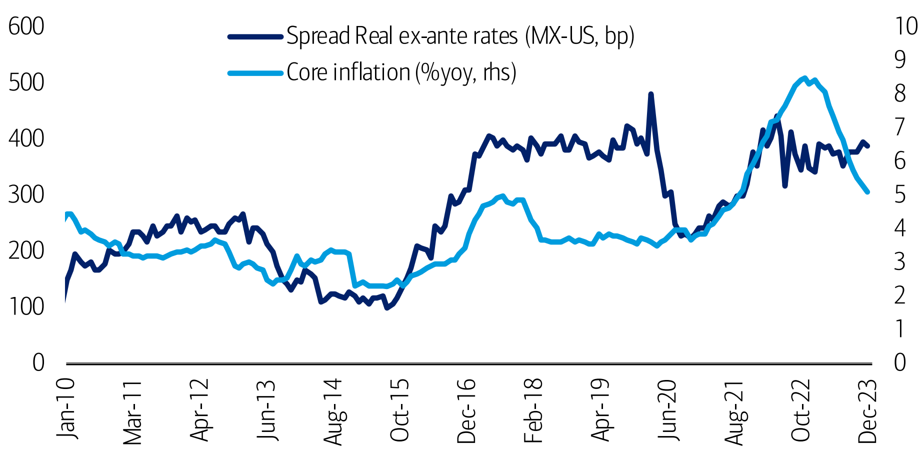
Exhibit 16: MX-US spread (ex-ante rates) and core inflation
As core inflation falls, the US-Mex spread is likely to fall, especially if the economy decelerates



Source: BofA Global Research estimates, Bloomberg

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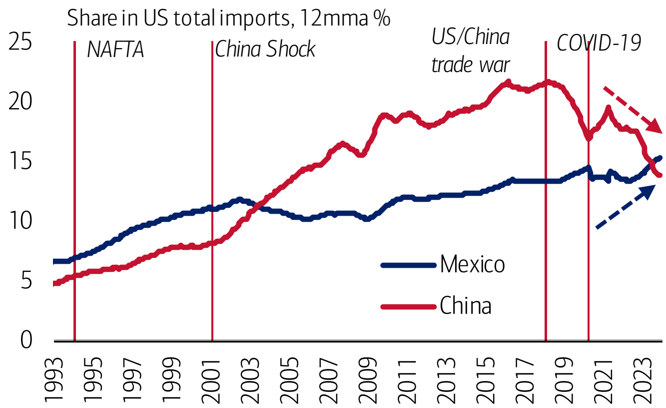
Is Mexico taking advantage of the nearshoring opportunity?

Our answer is a qualified yes. Mexico continues to gain market share in US imports (Exhibit 17) specially gaining market share from China (Exhibit 18). And investment is booming (Exhibit 19) driven by non-residential construction (Exhibit 20).

However, Foreign Direct Investment (FDI) remains muted (Exhibit 21) and despite many anecdotes Chinese investment in Mexico is not currently booming (Exhibit 22). In addition, there has been no coordination between private investment in the north of the country (nearshoring) and public investment in the south (government's infrastructure projects), so Mexico is not yet taking full advantage of the opportunity.

One narrative that has taken hold recently is that Mexico's gain in market share in the US market is just rerouting from China. But we looked at the data and do not find evidence of rerouting, as exports to the US have increased much more than imports from China (Exhibit 23).

Exhibit 17: Mexico's vs. China's share in US total imports
Mexico has outpaced China as top partner of the US



Source: US Census Bureau, Haver

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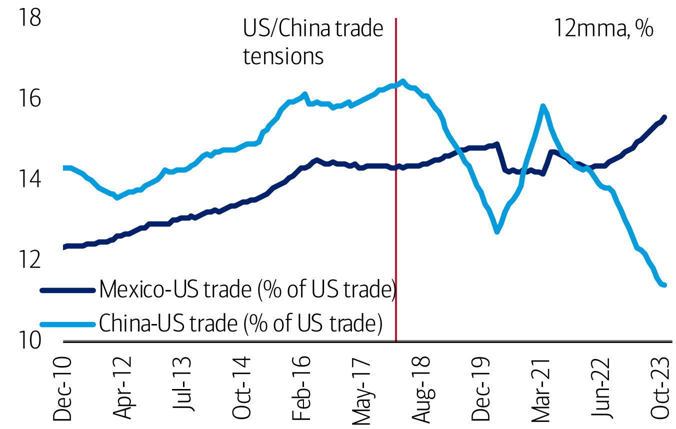
Exhibit 18: Trade between US, Mexico, and China
US-China trade war has posed an opportunity for Mexico



Source: US Census

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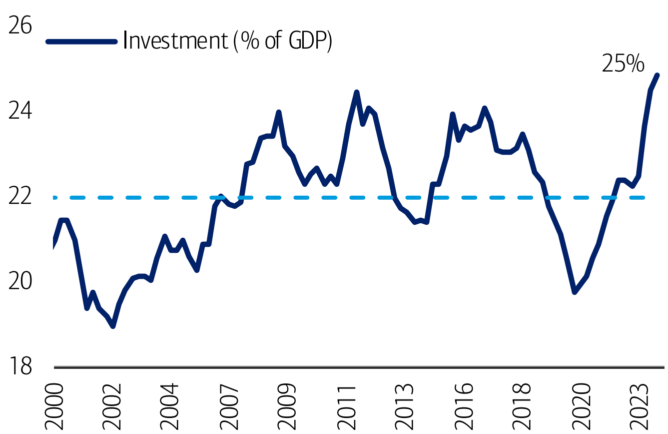
Exhibit 19: Investment as share of GDP
Investment in Mexico is booming; well above its +20-year average



Source: INEGI

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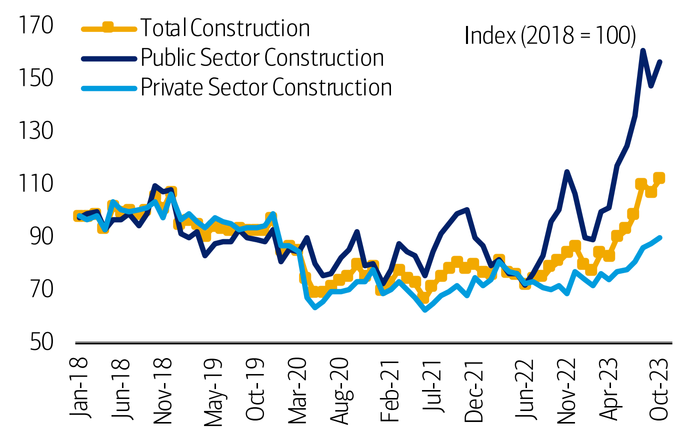
Exhibit 20: Investment in construction by sector
Milestone projects of the Government explain most of investment growth



Source: INEGI

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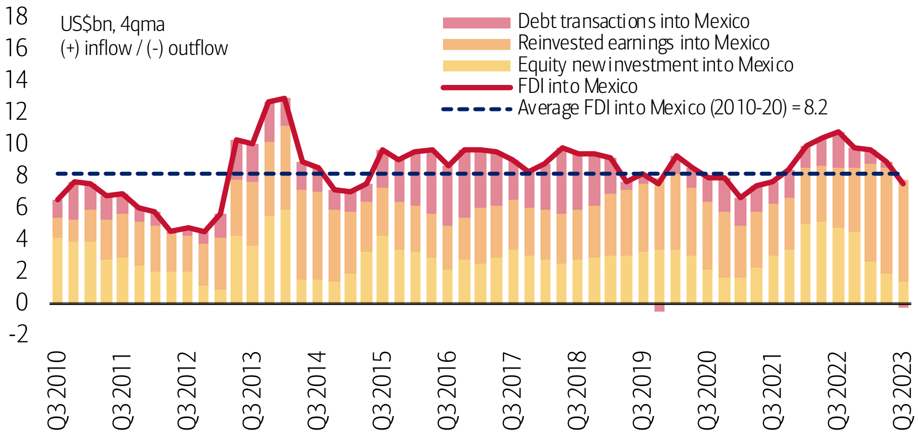
This year nearshoring investment could pause due to the elections in Mexico in June and in the US in November, to return by the end of the year and in 2025, if there is a weaker peso.

Exhibit 21: FDI into Mexico breakdown

FDI flows into Mexico have not followed the Nearshoring hype



Source: Banco de Mexico

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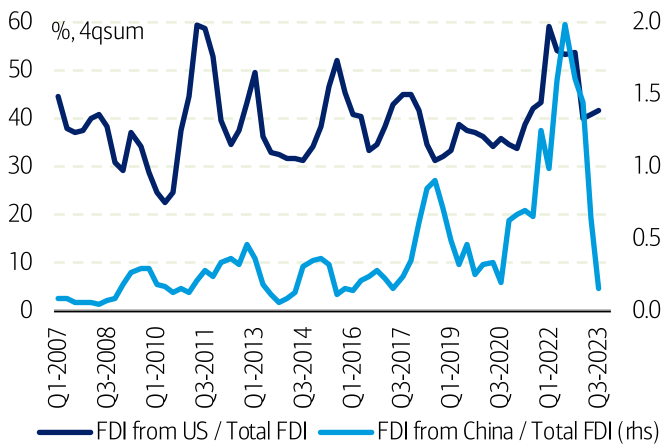
Exhibit 22: Chinese investments (FDI) in Mexico

Despite investment announcements, Chinese FDI nowhere to be seen



Source: BofA Ministry of Economy

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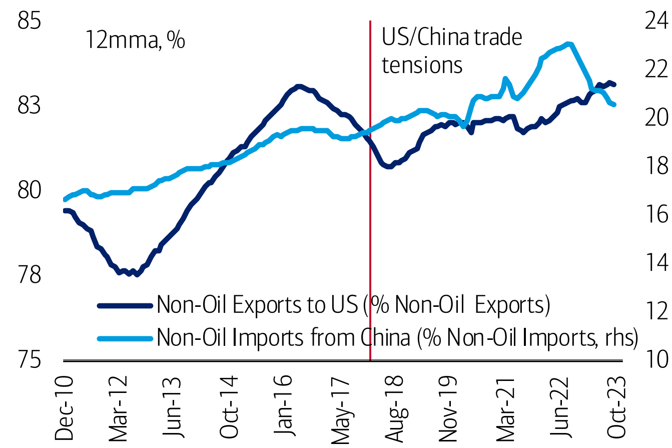
Exhibit 23: Mexican exports to the US, and imports from China

Exports to the US have kept its rhythm, while imports from China have fallen



Source: INEGI

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Will growth remain as resilient in 2024 as in 2021-2023?

We expect growth to decelerate in 2024 and in 2025 as the US slows down and as Mexico faces a “fiscal cliff” at the end of 2024. We expect growth to decelerate from 3.4% in 2023 to 2.0% in 2024 (1.8% before) and to 1.0% in 2025 (0.5% before) (Exhibit 24, Exhibit 25). The path is qualitatively the same as the path that we had before: a strong first half of the year in 2024 and a sharp deceleration in the second half of the year, returning to about trend growth by end 2025 (Exhibit 26).

Exhibit 24: Forecasts for economic growth in 2024-25
We now expect higher GDP growth in 2024 and in 2025

% qoq saar (unless stated)	New	Old
2023-Q1	2.3	3.2
2023-Q2	3.8	3.4
2023-Q3	4.3	3.4
2023-Q4	2.3	2.2
2023 (%yoy)	**3.4**	**3.4**
2024-Q1	2.0	4.3
2024-Q2	1.3	1.1
2024-Q3	0.3	-3.5
2024-Q4	-0.2	-0.7
2024 (%yoy)	**2.0**	**1.8**
2025-Q1	0.9	0.8
2025-Q2	1.6	1.7
2025-Q3	1.8	2.3
2025-Q4	1.9	2.2
2025 (%yoy)	**1.0**	**0.5**

Source: BofA Global Research estimates, INEGI

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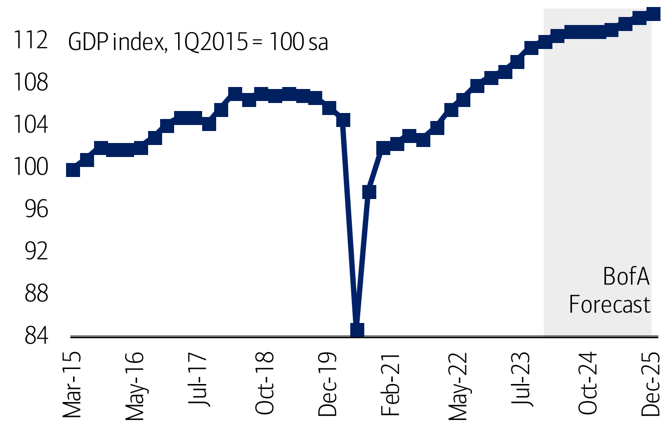
Exhibit 25: Forecast for economic growth in 2024-25
We now expect 2.0% yoy for 2024 and 1.0% yoy for 2025



Source: BofA Global Research estimates, INEGI

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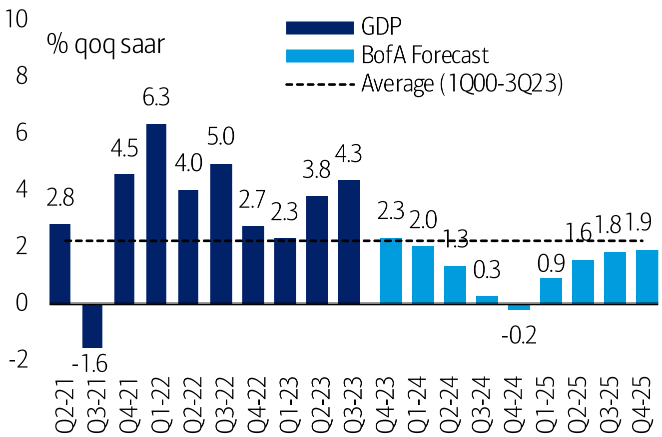
Exhibit 26: Mexico's GDP and forecast 2024-25 (% qoq saar)
We expect a strong 1H and soft 2H in 2024, with a gradual recovery in 2025



Source: BofA Global Research estimates, INEGI

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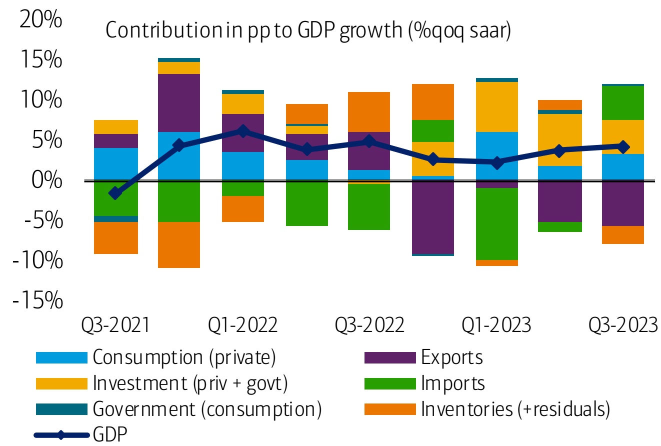
Exhibit 27: GDP contributions
Consumption and investment have supported the GDP throughout 2023



Source: INEGI

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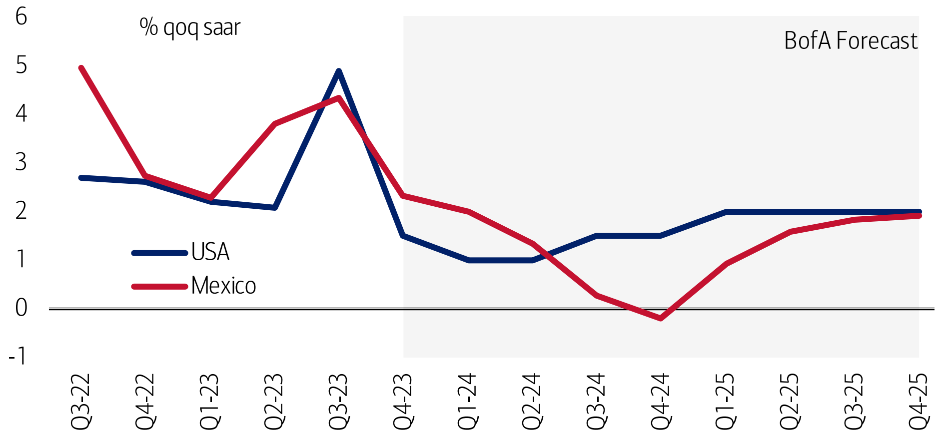
We increase our GDP growth forecasts as recent data in the US and in Mexico remain resilient. In Mexico growth continues to be supported by consumption and by investment (both private and public) (Exhibit 27). But the soft landing in the US is likely to decelerate Mexico with a lag (Exhibit 28) and the fiscal cliff that we expect (see question one) will likely dry public sector expenditure from end of 2024 onwards. The external demand for Mexico has already weaken, as exports have been contracting and the most recent print of remittances (November) shows and important deceleration.

Exhibit 28: USA and Mexico GDP and forecasts (% qoq saar)
The expected US soft landing will likely decelerate Mexico with a lag



Source: BofA Global research estimates, INEGI, BEA, Haver

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Will the Super Peso finally weaken?

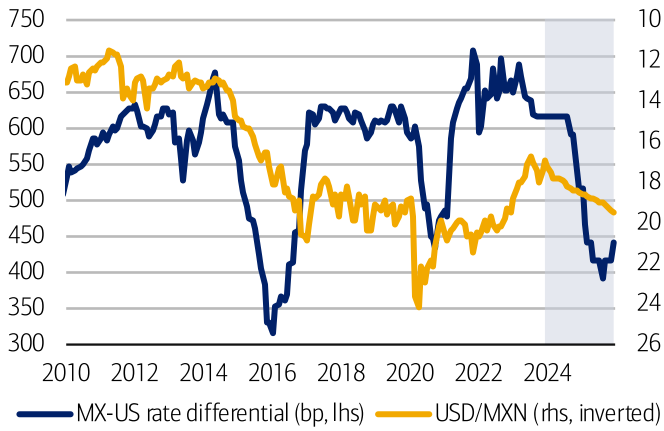
We believe so. The Mexican peso (MXN) remained remarkably resilient during 2023, appreciating by almost 15%. In fact, MXN was the second-best performing major currency globally, only topped by the Colombian peso. In our view, MXN outperformance in 2023 was driven by the protraction of the same factors that prompted MXN strength in 2022: a very tight monetary policy, a resilient US economy, restrictive fiscal policy, political stability, and optimism on the back of the nearshoring narrative. In 2024, we have strong conviction that the Super Peso will finally weaken, as we believe that there are significant downside risks to the factors that promoted MXN resilience.

On the monetary policy front, expect cuts to begin as early as March. While our baseline is that the early stage of the easing cycle will likely be slow, we believe Banxico has significant room to cut, likely reaching a terminal rate of 7.50% by 2025-end. We have argued that MXN strength has been largely driven by carry (see Keep calm, but don't carry on with MXN). Therefore, we believe that the compression in Mexico's interest rate differential against the US will put significant pressure on the peso in 2024 (Exhibit 29).

Our economic activity outlook is also unfavorable for the peso. A wider US-Mexico growth gap is associated with a weaker peso (see The Kryptonites to the Super Peso) and, even if our baseline is a soft-landing in the US, we expect a stronger deceleration in Mexico than in the US in 2024 (Exhibit 30). In fact, we forecast seasonally adjusted US GDP growth to decelerate to 0.6% yoy in 4Q24, from 2.7% in 4Q23, while Mexico's to slow to 0.9% yoy in 4Q24, from 3.2% in 4Q23. This should lead to a 0.3pp widening of the growth gap between the US and Mexico, putting pressure on the peso. We also believe a deceleration in US growth is enough to have an impact on remittances, which so far have provided significant support to MXN by keeping a narrow current account deficit.

We also believe that fiscal policy will no longer support the peso. Our expectation is that Mexico's consolidated public sector deficit will deteriorate by about 1.6pp in 2024, to 4.9% of GDP. This would represent the second-largest fiscal deficit deterioration in the EM space in 2024 (Exhibit 31). In our view, the market's baseline is that the significant deterioration in 2024 will be a one-off and that meaningful fiscal consolidation will take place in 2025. While we also expect some fiscal consolidation, we remain concerned that the market may gradually price higher risks that implementation of conservative fiscal policy could become challenging for the incoming government. This, in our view, means that a tight fiscal stance may not provide as much support to the peso as before.

Exhibit 29: Mexico vs. US interest rate differential and MXN
A compression in the interest rate differential may put pressure on MXN



Source: BofA Global Research, Bloomberg.
Note: We compute the interest rate differential using effective policy rates and the Wu-Xia Shadow rate to account for unconventional monetary policy.

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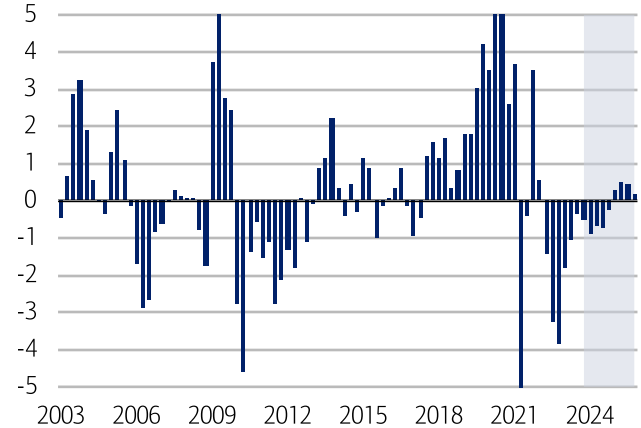
Exhibit 30: US-Mexico growth gap (pp)
We expect the GDP growth gap between Mexico and the US to widen



Source: BofA Global Research, Haver.

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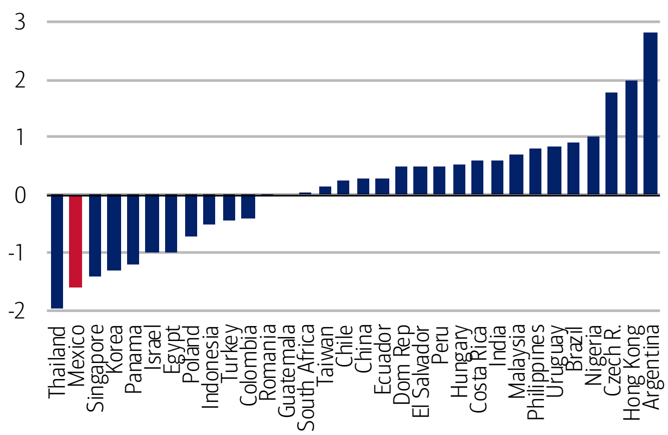
Exhibit 31: Expected fiscal deterioration in 2024 (% of GDP)
We expect Mexico to post the second-largest fiscal deterioration in 2024



Source: BofA Global Research.

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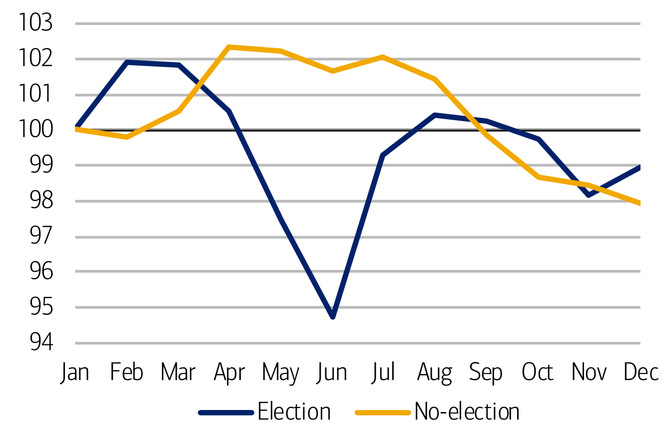
Exhibit 32: Cumulative MXN returns in election years (Index Jan=100)
MXN tends to weaken in the 3 months prior to the presidential election



Source: BofA Global Research, Bloomberg.
Note: We consider all election and no-election years since 2000.

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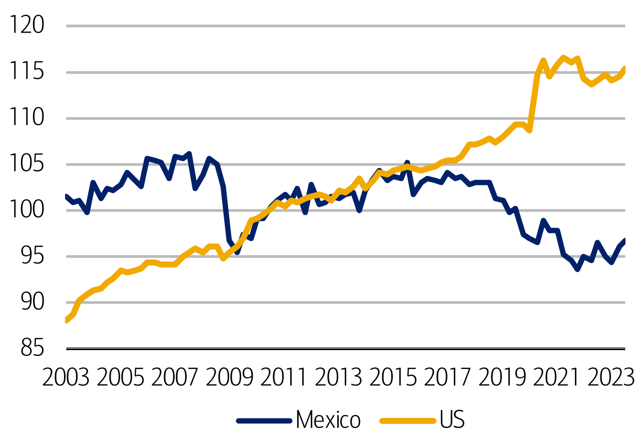
On the policy front, Mexico is set to enter a volatile environment. Domestically, Mexico will hold general elections in June, which should generate some policy uncertainty and increase the volatility of the peso. In fact, historically MXN weakens in the 3 months prior to the Mexican presidential election (Exhibit 32). In our view, this year there will be a larger focus on the congressional race, which could determine the extent to which deep policy changes could be enacted by the next government. On the external front, elections in the US may also introduce noise around topics such as trade and immigration, which could increase volatility as well. If the peso had been supported by a high carry-to-vol ratio, not only would carry decline on the back of Banxico's easing cycle, but also volatility may increase on the back of high policy uncertainty.

Moreover, we believe that valuation is also not supportive for the Mexican peso. We have strong conviction that the Mexican peso is overvalued and that the overvaluation cannot be explained by long-term macro fundamentals. Productivity in Mexico has declined considerably over the past 20 years, while productivity in the US has persistently increased (Exhibit 33), which should be conducive of a weaker real exchange rate and is inconsistent with a real effective exchange rate that is almost 20% stronger than its long-term average (Exhibit 34).

Exhibit 33: Productivity in Mexico and the US (Index 2010 = 100)
Mexico's productivity has declined, while US productivity has improved



Source: BofA Global Research, Haver.

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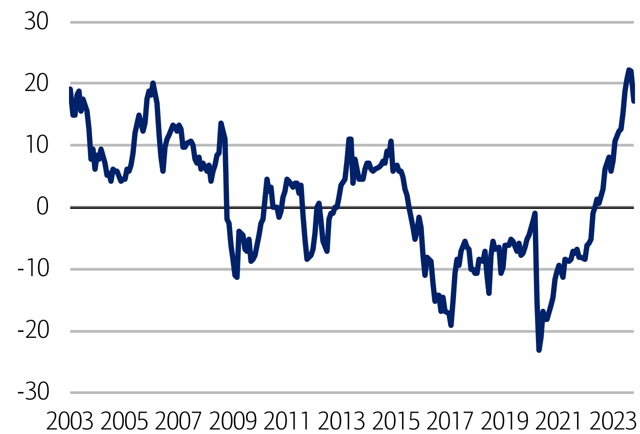
Exhibit 34: Mexico's REER (% deviation from long-term mean)
We have strong conviction that the Mexican peso is overvalued



Source: BofA Global Research, Bloomberg.

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Finally, we believe that the balance of risks also favors a weaker Mexican peso. In our view, the market may be underpricing the likelihood of a hard landing in the US and, as a result, MXN has remained particularly resilient. In a US hard landing, the Mexican peso could suffer as it would hit the currency via a risk-off shock, a strong negative impact on remittances, a sharp downturn in Mexico's growth, a potential pause in nearshoring dynamics and an aggressive compression in carry as central banks react to low-growth.

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