CURRENT STATUS AND ECONOMIC PERSPECTIVE US-MEXICO

May 2024

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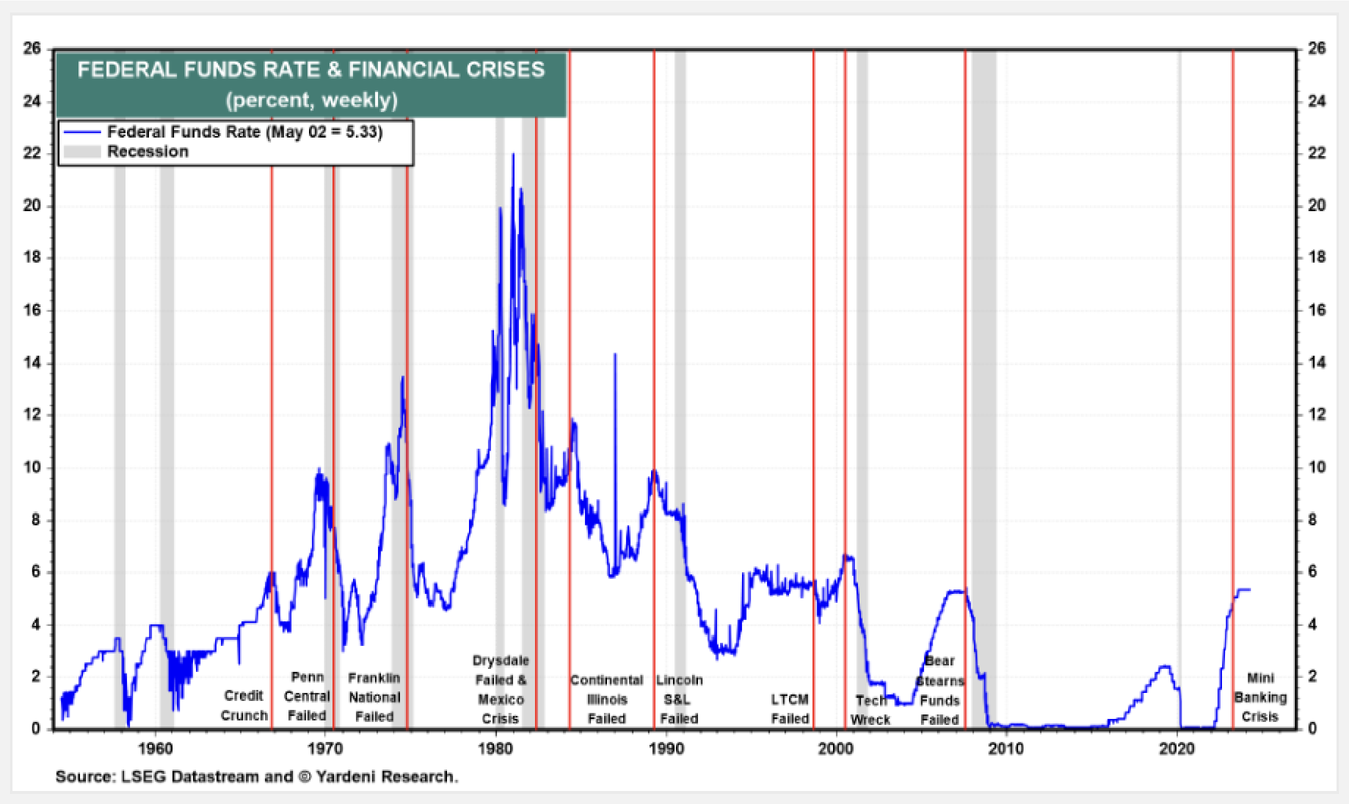
Recap of FED Decisions, Reference Interest Rate, and Asset Amounts.

We capitalize on the recent announcement made by the Federal Reserve on May 1st regarding the maintenance of the Fed policy rate. In light of this decision, we aim to offer a concise analysis of its implications. We interpret the Fed's action as an initial move towards a more accommodative monetary policy, evident in its moderation of Balance Sheet reduction.

To understand the effects of this monetary policy decision, we outline key contextual factors. These include the reference interest rate, the Balance Sheet, tapering, inflation, employment, inverted yield curves, and primary fiscal deficit.

Reference Interest Rate

The reference rate plays a crucial role in determining the opportunity cost of capital and significantly influences economic cycles and investment decisions. Presently, the reference rate stands at a notably restrictive level; in nominal terms, it mirrors the range observed during the 2007-2008 period, preceding the significant subprime crisis.



Source: Yardeni Research.

Recap of FED Decisions, Reference Interest Rate, and Asset Amounts.

Balance Sheet

The FED utilizes its Balance Sheet as another instrument to influence monetary policy. This tool reflects the assets held by various regional FED Banks and experienced substantial growth during the Covid-19 pandemic. This growth served as a means to finance both the Federal Government, through the purchase of Treasury bonds, and private entities, through loans backed by Mortgage-Backed Securities (MBSs).

In April 2022, the Balance Sheet peaked at $9 trillion, but as of early May 2024, it has been reduced to $7.4 trillion. For context, the U.S. economy boasted a GDP of approximately $27 trillion in 2023. The Balance Sheet expanded by approximately $5 trillion, equivalent to nearly 25 percent of the 2020 GDP, over the course of about a year and a half in response to the pandemic-induced crisis.

Expanding the Balance Sheet boosts capital availability in the markets by offering lower interest rates for private loans and lessening the government's need to offer higher rates to borrow. Conversely, reducing the Balance Sheet, primarily by refraining from repurchasing loans, exerts upward pressure on financing for both private entities and the Government. This, in turn, drives up interest rates and the returns that the government has to offer to borrow.

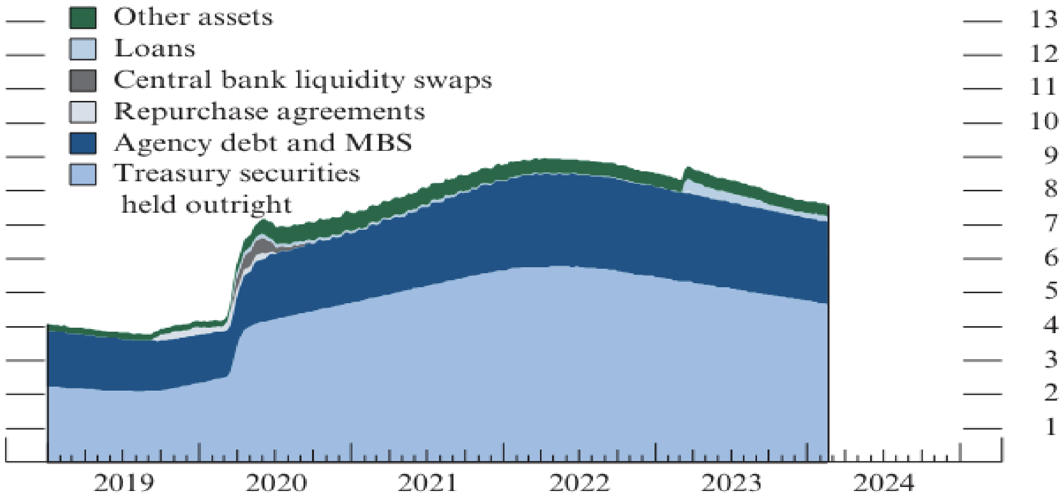
Source: Federal Reserve, Monetary Policy Report.

Recap of FED Decisions, Reference Interest Rate, and Asset Amounts.

Balance Sheet

B. Federal Reserve assets

Weekly | Trillions of dollars

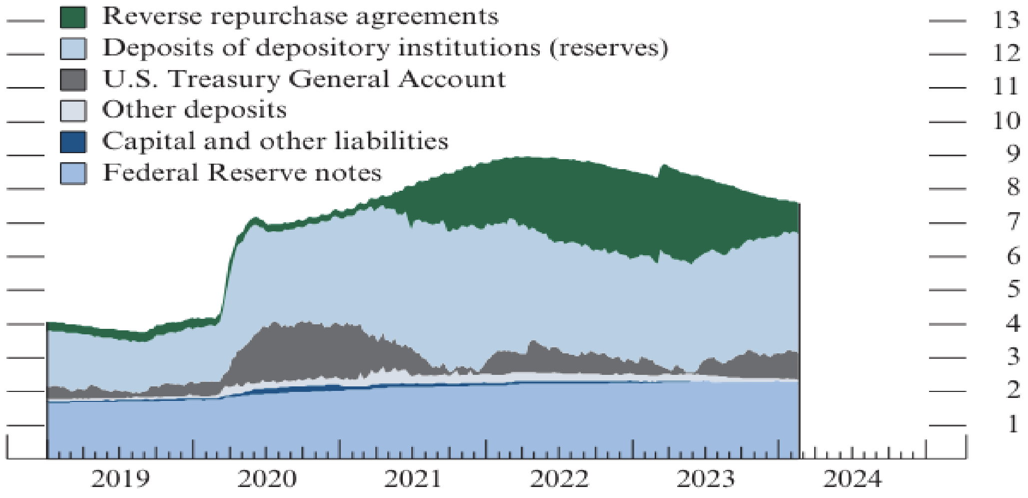


NOTE: MBS is mortgage-backed securities. The key identifies shaded areas in order from top to bottom. The data extend through February 21, 2024.

SOURCE: Federal Reserve Board, Statistical Release H.4.1, "Factors Affecting Reserve Balances."

C. Federal Reserve liabilities

Weekly | Trillions of dollars



NOTE: "Capital and other liabilities" includes Treasury contributions and is negative on February 21, 2024, because of the deferred asset that the Federal Reserve reports. The key identifies shaded areas in order from top to bottom. The data extend through February 21, 2024.

SOURCE: Federal Reserve Board, Statistical Release H.4.1, "Factors Affecting Reserve Balances."

Source: Federal Reserve, Monetary Policy Report.

Recap of FED Decisions, Reference Interest Rate, and Asset Amounts.

1. Factors Affecting Reserve Balances of Depository Institutions

Millions of dollars

Reserve Bank credit, related items, and reserve balances of depository institutions at Federal Reserve Banks	Averages of daily figures			Wednesday May 1, 2024
	Week ended May 1, 2024	Change from week ended Apr 24, 2024	Change from week ended May 3, 2023	
Reserve Bank credit	7,343,381	- 24,417	-1,160,208	7,326,278
Securities held outright[1]	6,908,206	- 20,427	- 917,342	6,892,302
U.S. Treasury securities	4,533,810	- 5,744	- 713,611	4,517,906
Bills[2]	195,143	0	- 85,823	195,143
Notes and bonds, nominal[2]	3,874,914	- 6,441	- 621,837	3,858,685
Notes and bonds, inflation-indexed[2]	350,058	+ 31	- 15,353	350,136
Inflation compensation[3]	113,696	+ 666	+ 9,404	113,942
Federal agency debt securities[2]	2,347	0	0	2,347
Mortgage-backed securities[4]	2,372,049	- 14,683	- 203,731	2,372,049
Unamortized premiums on securities held outright[5]	268,824	- 799	- 33,070	268,656
Unamortized discounts on securities held outright[5]	-24,849	+ 71	+ 2,557	-24,771
Repurchase agreements[6]	2	- 16	+ 2	0
Foreign official	1	0	+ 1	0
Others	1	- 16	+ 1	0
Loans	134,742	- 778	- 194,889	133,883
Primary credit	7,013	+ 169	- 43,686	6,791
Secondary credit	87	+ 10	+ 87	0
Seasonal credit	10	- 1	+ 7	13
Paycheck Protection Program Liquidity Facility	2,965	- 31	- 5,580	2,962
Bank Term Funding Program	124,667	- 925	+ 46,348	124,117
Other credit extensions[7]	0	0	- 192,066	0
Net portfolio holdings of MS Facilities LLC (Main Street Lending Program)[8]	14,124	- 383	- 8,098	14,114
Net portfolio holdings of Municipal Liquidity Facility LLC[8]	0	0	- 5,614	0
Net portfolio holdings of TALF II LLC[8]	0	0	- 1,902	0
Float	-454	- 211	+ 24	-615
Central bank liquidity swaps[9]	124	- 13	- 286	124
Other Federal Reserve assets[10]	42,663	- 1,860	- 1,590	42,586
Foreign currency denominated assets[11]	17,696	- 53	- 1,141	17,674
Gold stock	11,041	0	0	11,041
Special drawing rights certificate account	5,200	0	0	5,200
Treasury currency outstanding[12]	52,854	+ 14	+ 680	52,854
Total factors supplying reserve funds	7,430,172	- 24,456	-1,160,669	7,413,047

Note: Components may not sum to totals because of rounding. Footnotes appear at the end of the table.

Tapering (Asset Reduction).

The process of asset reduction started in March 2022, coinciding with the rise in key interest rates, thereby solidifying a notably restrictive monetary policy. According to the FED's records, the current balance of $7.4 trillion reflects a decrease of $1.16 trillion over the span of a year. Within this reduction, $713 billion can be attributed to U.S. Treasury Securities.

Source: Federal Reserve.

Recap of FED Decisions, Reference Interest Rate, and Asset Amounts.

Treasury Bonds and Cost of Debt

The combined impact of escalating rates alongside the reduction in available capital (Tapering) has elevated the Government's borrowing costs. The nominal return on Treasury bonds has approached 5%, a level not seen since the period of significant economic expansion preceding the subprime crisis.

Moreover, this implies that the real interest rate (nominal rate minus inflation) at which the Federal Government finances itself is the highest since 2009.

Source: Yardeni Research

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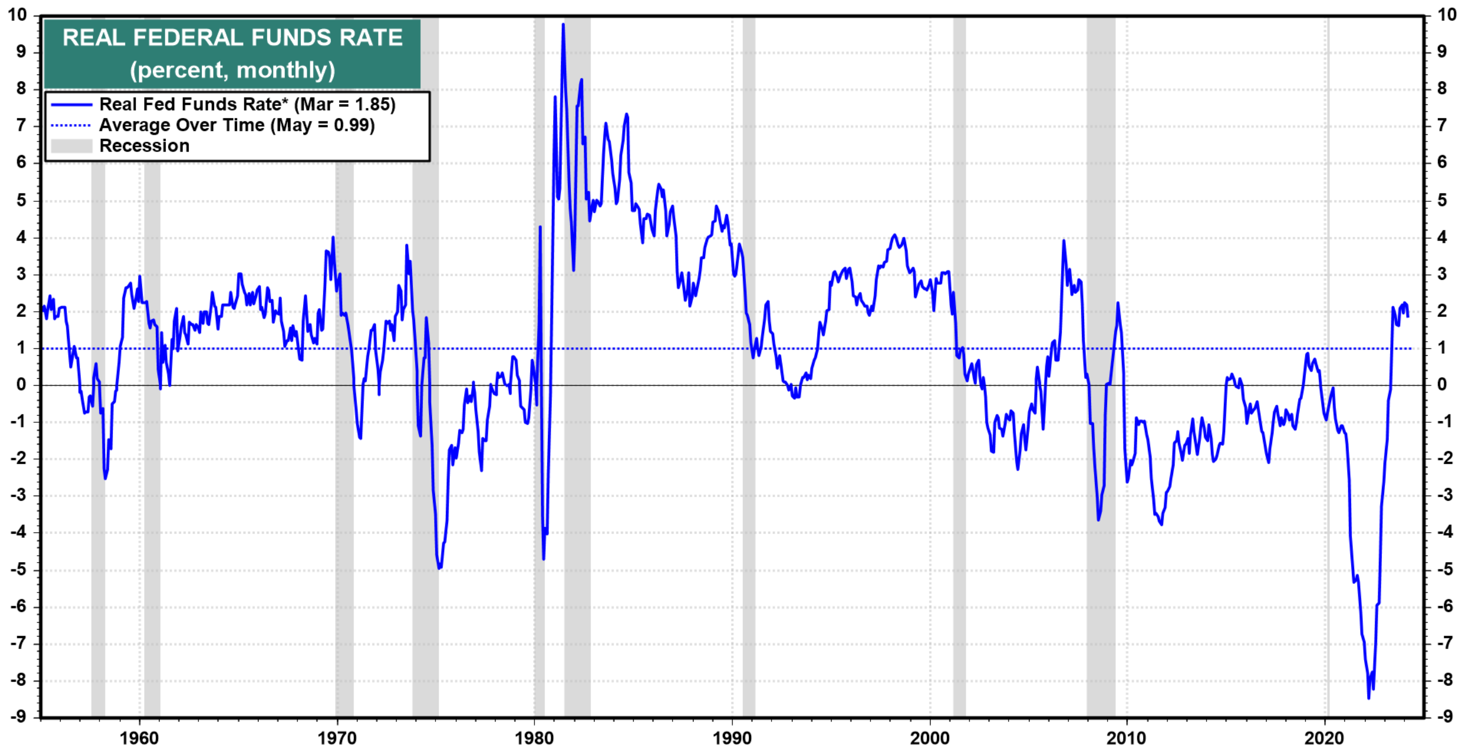
Treasury Bonds and Cost of Debt

The monetary policy announcement on May 1st outlined a deceleration in the pace at which the FED reduces the size of its Balance Sheet, decreasing from $60 billion to $25 billion monthly. Additionally, a portion of the principal payments received will be reinvested into Treasury bonds. This marks the first tangible signal from the FED indicating a shift towards a less restrictive monetary policy stance since its response to the Covid-19 pandemic.



Source: LSEG Datastream and © Yardeni Research.
* Federal funds effective rate minus CPI inflation rate.

Source: Yardeni Research

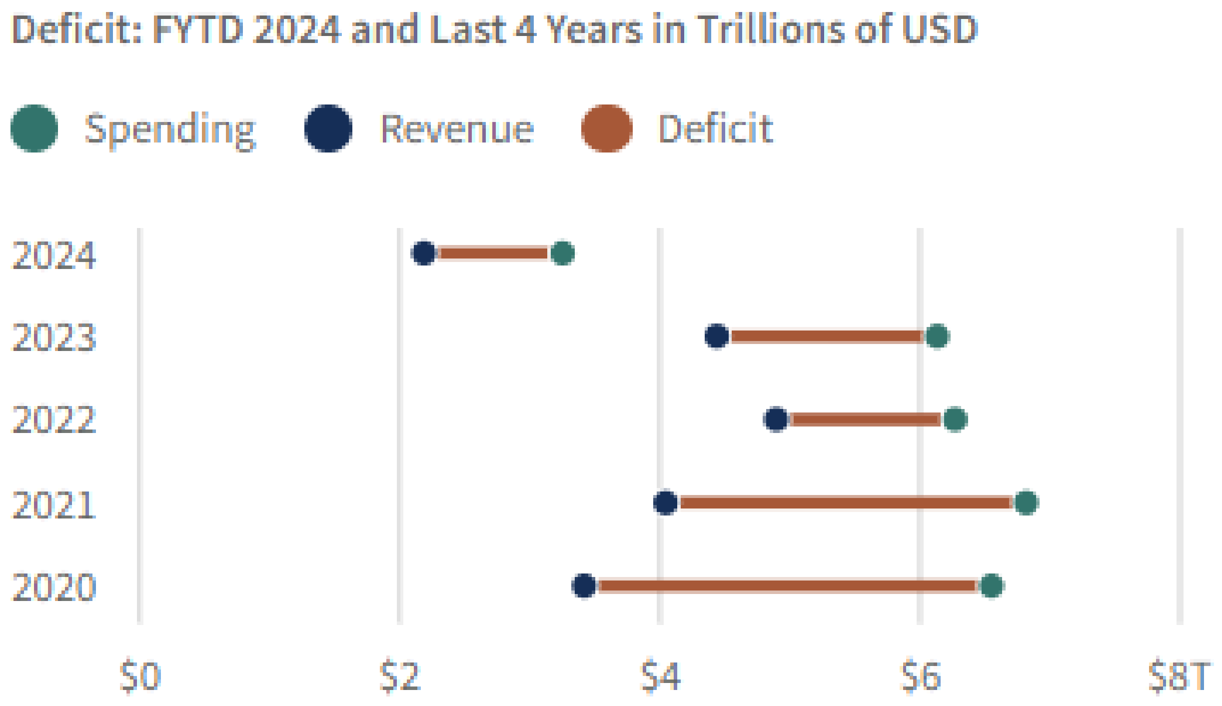
Recap of FED Decisions, Reference Interest Rate, and Asset Amounts.

CAPITAL PARTNERS

Fiscal Deficit, Contrast between Restrictive Monetary Policy and Expansive Fiscal Policy

Since March 2022, the FED has been actively implementing a restrictive monetary policy cycle, while concurrently, the Federal Government has pursued an expansive public spending cycle. These divergent policy approaches offer some insight into the limited impact of the FED's policies on inflation and the relatively minor negative effects on employment.

In 2023, the U.S. Government recorded revenue of $4.44 trillion and expenditures totaling $6.13 trillion, resulting in a significant increase in debt relative to GDP. Currently, the debt stands at $34.55 trillion, approximately 120% of the GDP. The contradiction between the FED and the Federal Government extends beyond the contrast in restrictive monetary policy versus expansive fiscal policy. It also influences interest rates and the long-term viability of the debt.



Source: Fiscal Data U.S. Government Treasury.

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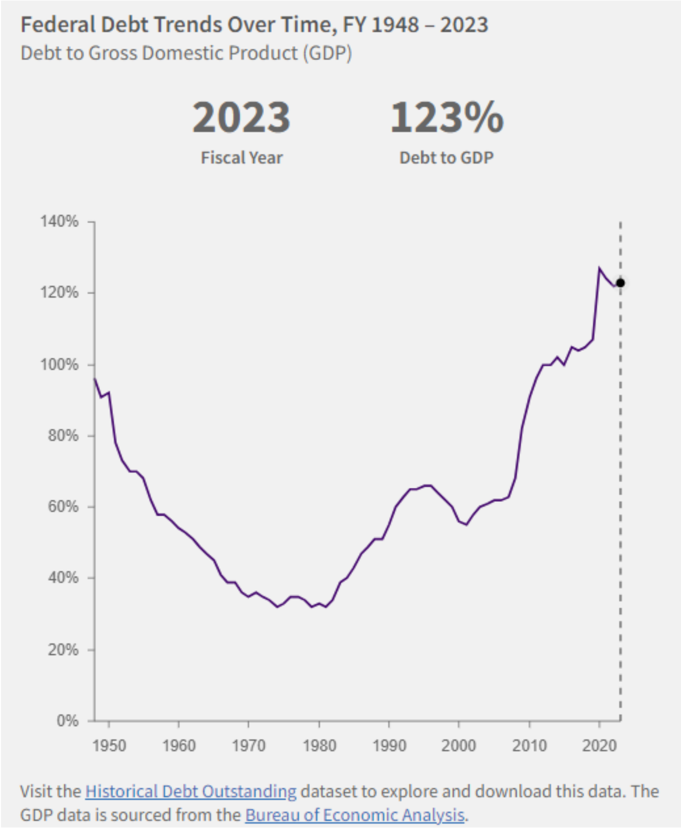
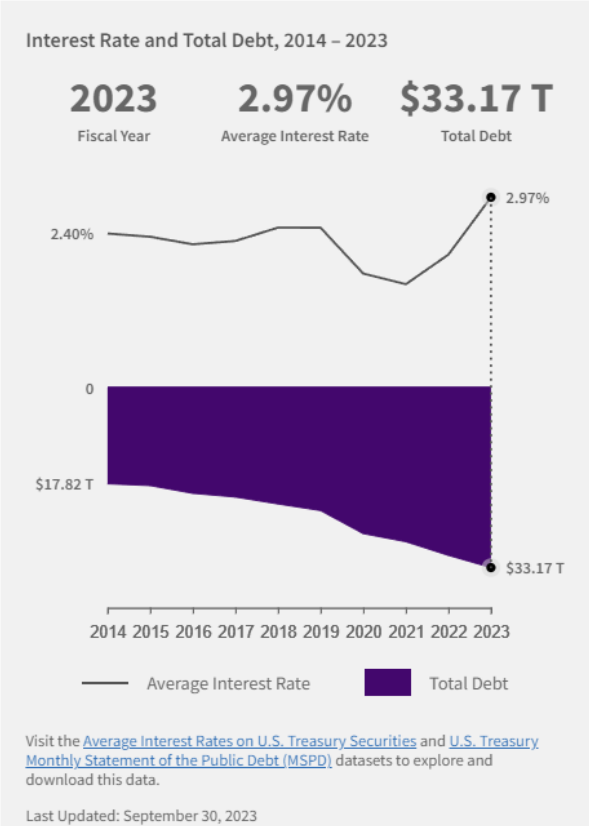
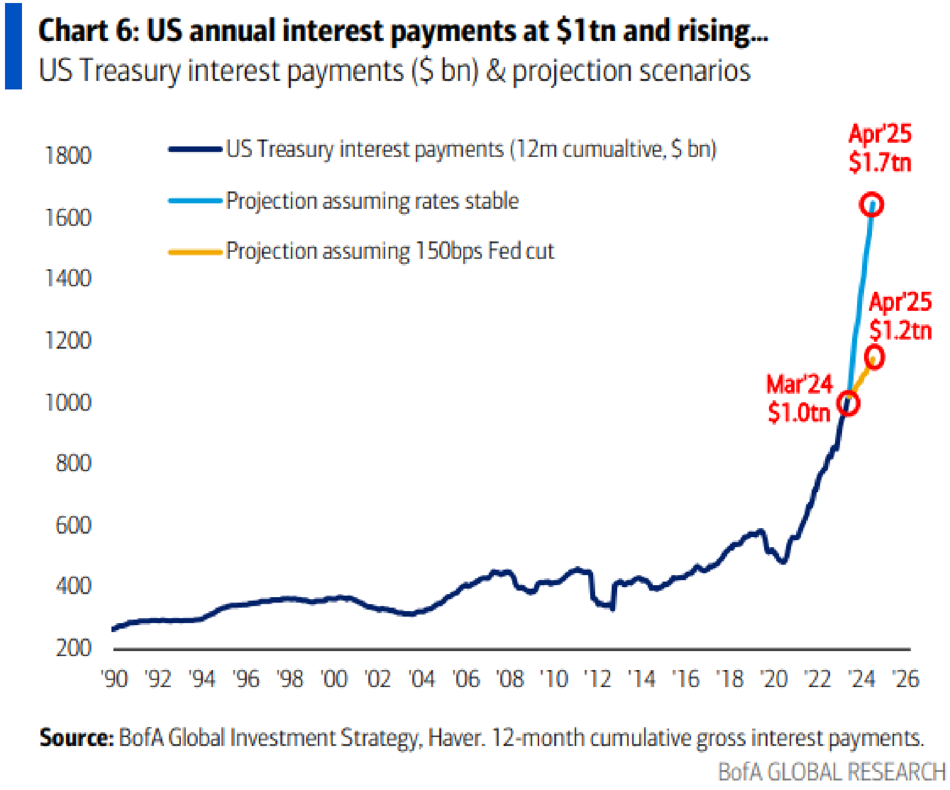
Fiscal Deficit, Contrast between Restrictive Monetary Policy and Expansive Fiscal Policy







Source: Fiscal Data U.S. Government Treasury , The Kobeissi Letter, quoting Bank of America.

Recap of FED Decisions, Reference Interest Rate, and Asset Amounts.

Recession or Soft Landing?

Presently, the inflation trend is downward, with a recent slight uptick, coupled with a robust labor market. However, the interplay between the FED and the Federal Government raises questions about the sustainability of the current policy approach. The downward trajectory in inflation, when observed, along with the modest weakness indicated in the April labor report—where only 170,000 new jobs were added versus the expected 250,000—suggests a potential decrease in interest rates.

This decline has deviated from the expectations set at the beginning of the cycle in the last months of 2021, when Jerome Powell asserted that inflation was a transitory effect resulting from conjunctural events that would swiftly alleviate. This viewpoint emerged from the perceived impact of the Suez Canal blockage in March 2021.

It seems that this narrative failed to materialize. The eventual and relative normalization of supply chains did not yield an anti-inflationary effect but rather seemed to prompt a deeper restructuring of production chains. This included a relative decrease in China's role as a trade partner of the U.S., with Mexico and Canada assuming a more prominent position.

It is relatively normal and expected, that the current level of economic restraint imposed by the FED would lead to some degree of recession or, at the very least, a significant economic slowdown. Perhaps the most critical factor for triggering this would be if the Federal Government, through fiscal spending, transitions towards a more restrictive policy, or even if there's just an expectation that it might do so.

Source: Federal Reserve, Monetary Policy Report.

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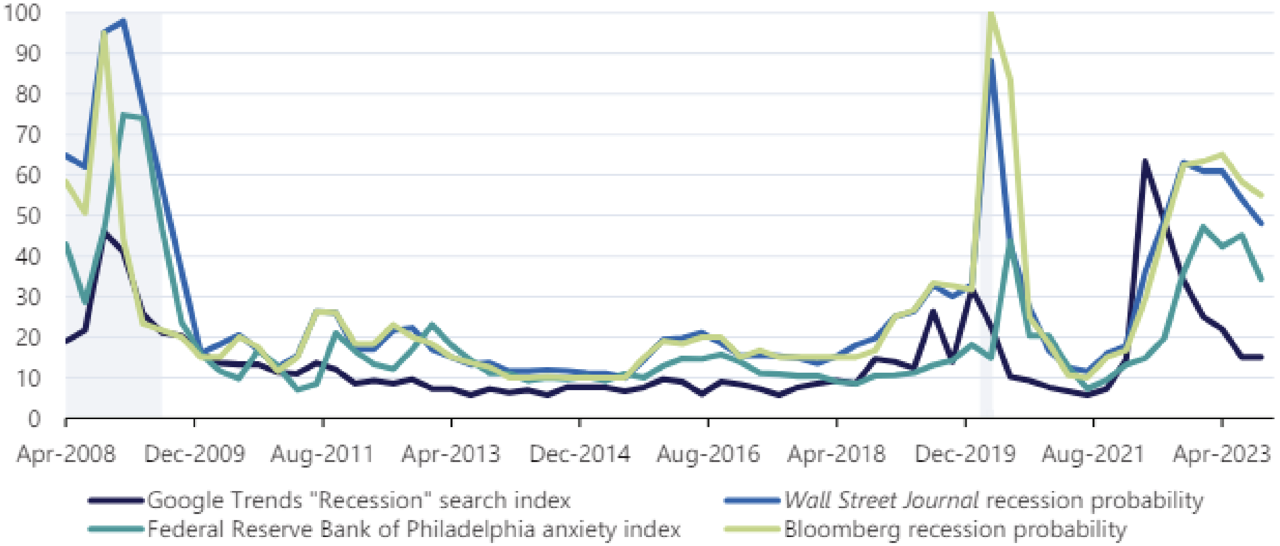
Recession or Soft Landing?

This juncture coincides with an electoral context, suggesting the possibility of a new approach to managing economic elements from the executive branch. In this backdrop, the ongoing debate revolves around whether it's feasible to lower interest rates to mitigate an economic slowdown sufficiently to prevent a severe recession and diminish the associated economic costs.

Certain indicators of recession probability remain elevated, notably the inverted rate-curve, where two-year Treasury bonds yield a higher annual rate than ten-year bonds. This suggests that the market views immediate uncertainty as more significant than the expected over a longer period.

Figure 2-1. Recession Probability Indicators, 2008–23

Percent probability or index: June 2022 = 100



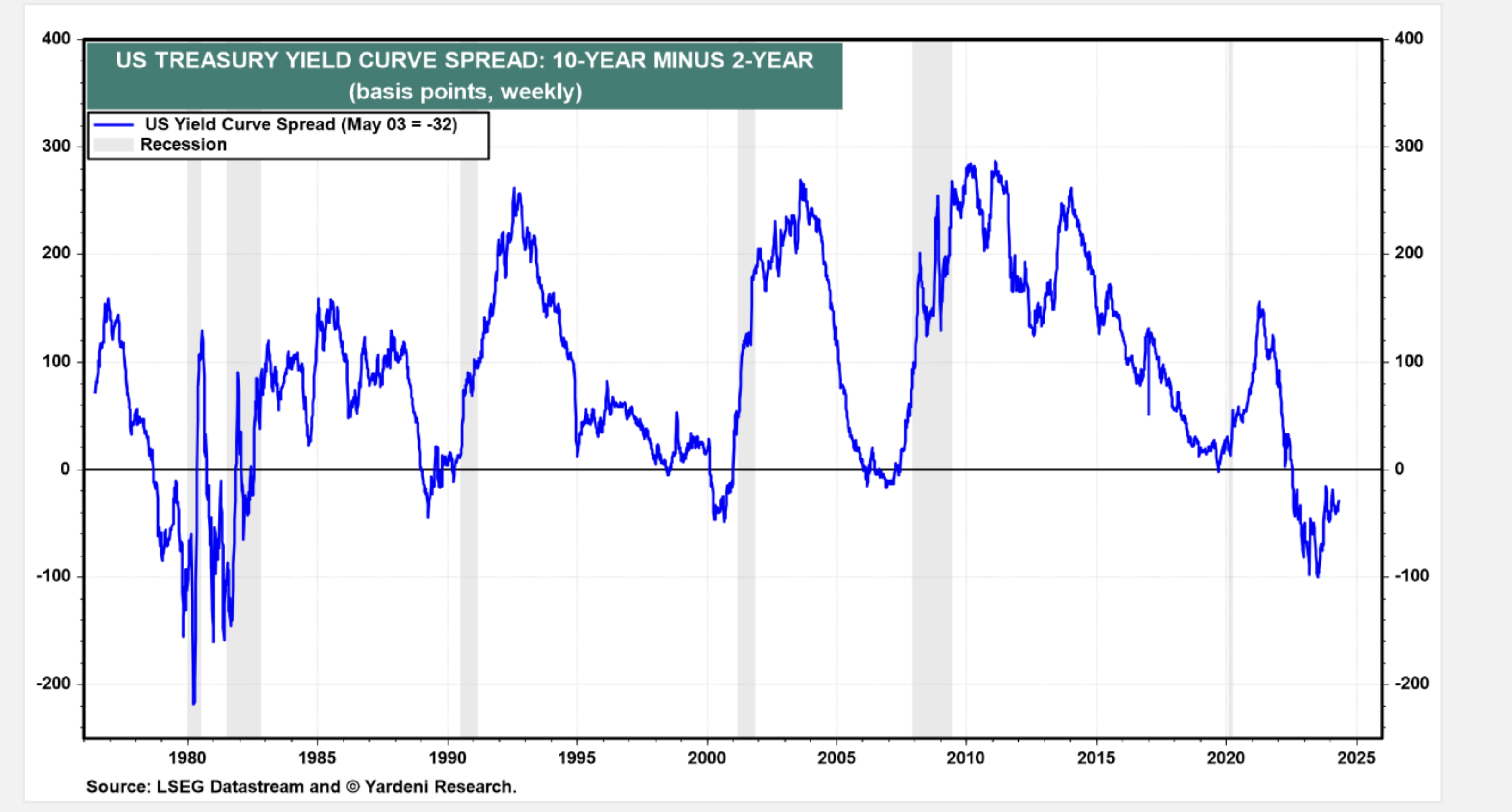
Council of Economic Advisers

Sources: Federal Reserve Bank of Philadelphia; *Wall Street Journal*; Google; Bloomberg; CEA calculations.
Note: Gray bars indicate recessions. Google Trends data are indexed relative to their peak month, June 2022, and are data from January 1, 2004, to December 31, 2023, downloaded on January 11, 2024. Data from the Federal Reserve Bank of Philadelphia indicate Q2 of the given year. Anxiety index represents the probability of a decline in real GDP for the subsequent quarter.
2024 Economic Report of the President

Source: Economic Report to the President.

Recap of FED Decisions, Reference Interest Rate, and Asset Amounts.

Recession or Soft Landing?



Source: Yardeni Research.

México

Mexico is experiencing its own version of this opposing-effects cycle. BANXICO maintains a highly restrictive target interest rate of 11.25%, coupled with an annual inflation rate of 4.42%, resulting in a real interest rate of nearly 7%—significantly higher than the real interest rate of less than 2% in the U.S. Despite this restrictive monetary policy, two factors are driving economic expansion: fiscal policy and the reconfiguration of value chains due to Mexico's increased role as a trade partner with the U.S.

In terms of fiscal spending, the Government has allocated substantial funds to infrastructure projects, particularly in the southern region, and has also earmarked historically high amounts for social programs. Spending on social protection, primarily cash transfers, is expected to rise by 64.4% in real terms between 2018 and 2024. By comparison, budgetary revenues in 2024 are projected to be around 21.3% of the GDP, with spending on social development, including social protection, health, and education, potentially reaching 12.8% of GDP—more than half of budgetary revenues.

The impetus from these spending components has accelerated, with the budget deficit as a percentage of GDP estimated to increase from 3.3% in 2023 to 5.9% in 2024.

Mexico is undergoing an electoral process nearly concurrent with that of the U.S., heightening uncertainty regarding the continuity of public policies. This uncertainty is compounded by several infrastructure programs expected to conclude soon without having similar replacement policies. However, social transfer programs are anticipated to persist.

In any case, a potential recession in the U.S. could have amplified effects in Mexico due to risks stemming from the strict restrictive policy, potential peso depreciation, and the inherent risks associated with political transition.

Source: SHCP

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