Long 11/16/23 Udibonos

Thesis: Heading into Q2, Mexican inflation seems set to accelerate on global commodity moves, meanwhile an economic slowdown and monetary room-to-maneuver could indicate a slowing hiking cycle.

Inflation outlook

- A recent report by the Mexican Finance Ministry projected year-end 2022 inflation at 5.5%. The report indicated that inflation will remain elevated and only recede back near Banxico's 3% target by the end of 2023. Inflation was at 7.3% in February, up from 7% the previous month.
- In February, approximately 0.25pp of CPI was attributable to Ukraine conflict spillover. Mexican CPI figures are particularly vulnerable to elevated prices of refined petroleum products, the majority of which imports are from the US (where demand/supply dynamics support elevated prices). I expect that the spillover into higher oil, food, and other commodity prices on the global market will increase this contribution to CPI for Q1 and Q2.
- Higher CPI will increase the value of Udibonos via greater coupon and principal adjustments.

Growth outlook and future hikes

- Banxico started the Mexican hiking cycle last year in June, much earlier than many of its CB counterparts. As a result of tightening monetary conditions, paired with AMLO's fiscal austerity policies, the Mexican economy has suffered. In particular, the significant manufacturing industry has contracted (PMI<50) for 25 straight months. Nevertheless, inflation remains elevated and can be expected to worsen in the coming month/s. On the back of this, growth outlooks have dampened leading to downward revisions and weaker confidence.
- Mexico's early start to the hiking cycle gives the central bank some breathing-room to slow down the pace of rate increases. Weakening economic activity could provide the impetus to translate that into policy. Additionally, Mexican rates weren't brought down to near-zero during the pandemic, but to 4%. An already-elevated base level means that monetary authorities have more room to maneuver, according to a dovish member of the Banxico board. (Also, the Finance Ministry's projections seem to resign to the supply-side nature of inflationary pressures, which wouldn't call for excessive monetary moves.)
- These impediments to growth, paired with monetary maneuvering space, could support a slower hiking cycle in the future. Slower hikes will provide less of a drag to bond prices and thus support Udibonos.

FX, hiking cycle risks

- Udibonos are denominated in 'investment units' that are payable in Mexican pesos. This means that our returns in dollars are subject to FX risk if the Mexican peso depreciates. In my view (last week's pitch on short MXN), this is a significant risk, so we might consider hedging it out.
- From a historical perspective (Appendix B), the Mexican key rate is not that high. In late 2018/early 2019, the rate was over 8% (vs 6.5% now), which gives Banxico space to hike in the future. It would not be surprising to see future hikes bring the key rate to that level and beyond over the next 1-2 years as authorities continue to attempt to anchor inflation expectations.
- Relating to this, it seems like AMLO is intent on hiking further and, after his early hike announcement recently, the CB's independence in slowing the hiking cycle may be a risk.

Appendix

A. 11/16/23 Udibonos price

B. Mexican key rate, 2012-2022