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PANORAMA
MEXICO'S ECONOMY: MORE DIFFICULT TIMES AHEAD

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Mexico's economy has been increasing above the Latin American average since 2012. While the region contracted by 0.5 % in 2015, Mexico, its second largest economy, grew by 2.5 %. Looking ahead however, the outlook is less optimistic. Coface forecasts that the country's GDP will grow by 1.6 % in 2016 and 1.5 % in 2017.

A less supportive global environment is the key rationale behind this expected slowdown. The US presidential elections have created volatility in the Mexican market, due to its strong economic dependence on its northern neighbour. The less open approach to trade shown by the presidential candidates is also threatening the future of of trade relations. Beyond this political issue, Coface expects that the US economy will continue to slow in 2017 (to record +1.5%, following +1.6% in 2016). Against this backdrop, along with lackluster industrial activity in the US, the Mexican manufacturing sector is likely to disappoint again. Moreover, the slump in oil production, with low international prices, continues to represent a major concern on the fiscal front. Public debt rose to 42.3 % in 2015, up from 38.3 % in 2013, and is expected to reach 45 % by the end of this year.

This deteriorating macroeconomic outlook is clearly having repercussions at micro level. Momentum is therefore slowing in private consumption-related sectors. Coface is downgrading its risk assessment for the country's retail and automotive sectors, while commodity dependent sectors remain at risk.

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1 A CLOUDY ECONOMIC OUTLOOK

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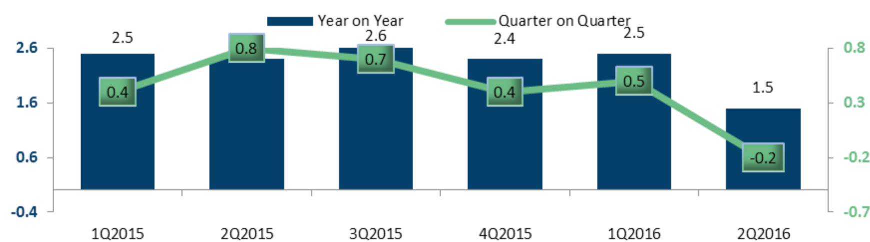
The economy lost steam in the second quarter of 2016.

According to national statistical institute Inegi, seasonally adjusted activity decelerated to 1.5 % in 2Q2016, down from 2.5 % y/y reported in the previous period (chart 1). On a quarter on quarter basis, GDP dropped by 0.2 %, marking the first contraction since 2013. Industry, which shrank by 1.5 q/q, was the main contributor to this weak result, due to the fall in oil production and challenges faced by manufacturing and construction industries. The services segment continued to lead growth, backed by consistent consumption indicators. Inflation remains low (at 2.97 % for the 12 months accumulated until September 2016), credit has observed rapid growth (recording 16.9 % YoY as at July 2016) and both the labour market and remittances are solid. Nevertheless, the services sector did slow during the period, to a growth rate of 2.4 % YoY, down from 3.4 % for 1Q2016.

Chart 1

GDP quarterly evolution (%)



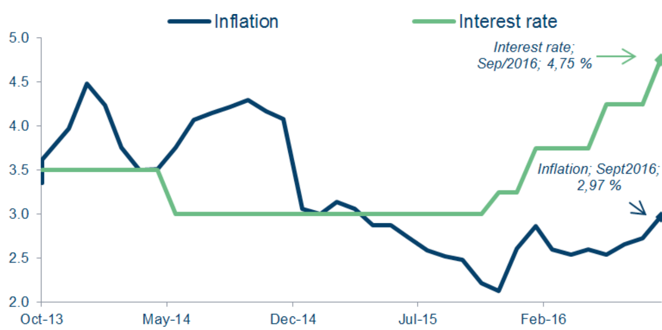
Source: INEGI

Income fundamentals are expected to gradually loose strength.

The sharp depreciation that the Mexican peso has experienced this year, leading to higher import prices and inflation, has reduced consumer purchasing power. According to the Bank for International Settlement (BIS), in a comparison of 61 currencies, the Mexican peso reported the third largest negative variation during the period from January to September 2016 (-12 % YoY). It stood only behind the British pound and the Argentinean peso (both with -14 %). This, combined with the recent recovery in oil prices, has put pressure on prices, driving them up from the historical low of 2.1 % recorded in December 2015, to 3.0 % in September 2016 (chart 2). The dissipation of base effects related to telecom reforms (which reduced tariffs) and the potential acceleration in the liberalisation of gasoline prices (proposed in the 2017 budget) could also drive up inflation. Furthermore, there is a growing probability that the United States will raise interest rates in December. Mexico's Central Bank (Banxico) is thus expected to continue monetary tightening. At the end of September, Banxico raised interest rates for the third time in 2016 - by 50 basis points up to 4.75 %. According to the Central Bank, these increases in interest rates have reduced the credit available for investment and consumption. The rising cost of credit has negatively affected credit demand, while credit supply has shrunk due to higher risks of portfolio recovery. Within this context, consumer confidence has been deteriorating for the last three months (falling from 93.4 in June, to 84.1 % in September).

Chart 2

Evolution of Consumer Price Inflation and Reference Interest Rates (a.y.)

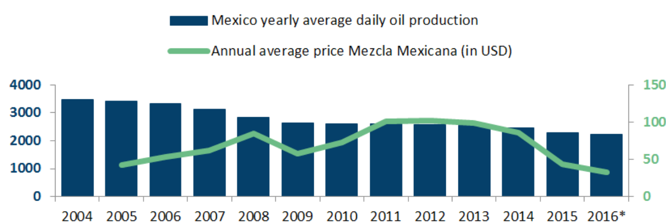


Source: Thomson reuters, forecast Coface

Government debt has been climbing rapidly since the 28 % recorded in 2005, up to 42.3 % in 2015. The government´s efforts to contain public deficit have not been sufficient to compensate for the combination of several years of disappointing GDP growth (annual average of 1.7 % in the period of 2011-2015) and the sharp slump in oil prices seen since mid-2014. Tax revenues emanating from commodities, which previously accounted for over one third of public-sector resources (35 % in 2013), now represent 15 %, or lower, of total fiscal revenues. Oil production has steadily decreased over the past 11 years, mainly due to underinvestment in the sector. A few days after Standard & Poor's decision to put Mexico's BBB+ rating under negative watch, José Antonio Meade, the country's newly appointed Finance Minister, presented a 2017 budget that signalled the government's intentions to step up austerity. The budget announced a 240bn MXN cut in expenditure (approximately 12.9 bn USD and 1.2 % of GDP). This is well above the cuts of 169 bn MXN for 2016 and 124 bn MXN in 2015. Most of the reductions will come from funding of the state owned oil company PEMEX (-5.3 bn USD). It would therefore seem that the government is shooting itself in the foot, as lower investments in the oil company will further reduce oil production, thus limiting future tax revenues. Despite the landmark energy liberalisation reforms of December 2013, private investment is also being undermined by low oil prices.

Chart 3

Mexican oil market



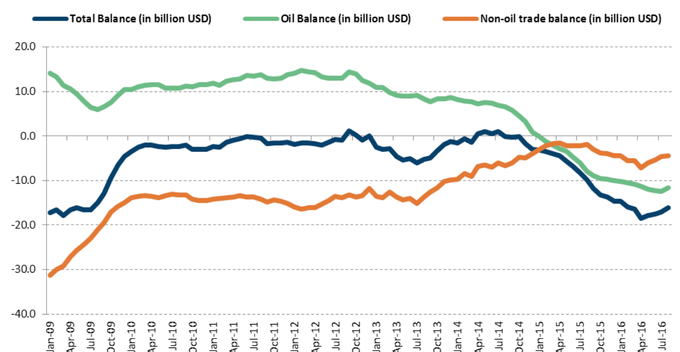
Sources: Mexico Geological Service and U.S. Energy Information Administration

Mexico's current account deficit widened during the second quarter of 2016.

It reached 2.9 % of GDP (31 billion USD) in the 12 months accumulated until the end of 2Q2016, up from 2.1 % observed one year earlier. Net oil exports have been the main contributor to this weak result, standing at -11.7 bn USD in the 12 months accumulated until August 2016 (-1.1 % of GDP), compared to -8 bn USD (- 0.7 % of GDP) in the same period of 2015. Manufacturing exports, which shrank by 2.8% over a year, have also been impacted by weaker demand. Exports to the country's premier destination, the United States (which represented approximately 84% of total manufacturing exports in 2015), fell by -1.8%. Demand from other countries during the period was also down by 7 %. No more than a minor improvement can be hoped for in the short term, as US activity is not expected to accelerate in the upcoming period and the recovery in oil prices is likely to be limited (Coface forecasts a Brent oil price average of 51 dollars per barrel in 2017).

Chart 4

Trade Balance accumulated in 12 months



Source: Mexico Central Bank

The combination of mounting fiscal vulnerability, deteriorating external accounts and rising uncertainties related to the US presidential elections, is pressurising the MXN.

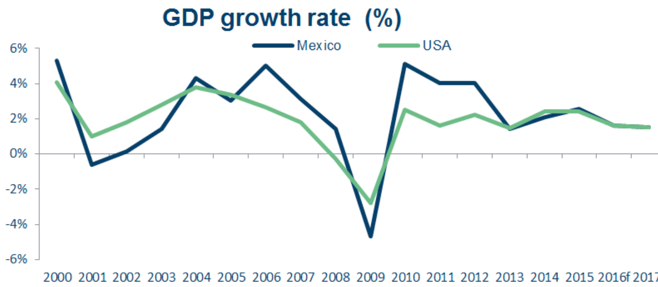
A recent study by Banxico[1], which analysed the exchange rate pass-through into consumer prices during the period from January 2011 to April 2016, suggested that there is a low relationship between the two variables. Considering a sample of goods and services that account for 58.6 % of the Consumer Price Index, the study calculated that a 1 % change in nominal exchange rates only translates to a 0.073 p.p. in consumer prices. While taking into account the share of the analysed CPI basket (and assuming that the remaining out-sample items have zero effect), the pass-through over aggregate inflation is down to 0.043 %. The Mexican peso stood at a rate of close to 19.3 MXN/USD in early October 2016, down from 17.4 MXN/USD at the end of 2015. The pressures being felt due to the US election campaign are expected to persist even after the outcome of voting is known. The potential victory of Republican candidate Donald Trump would be likely to generate greater turbulence for the Mexican foreign exchange market, than that of Democratic candidate Hillary Clinton. Donald

[1]Central Bank of Mexico: Price-Setting and Exchange Rate Pass-Through in the Mexican Economy: Evidence from CPI Micro Data, 2016

Trump has shown a somewhat radical stance on trade agreements and immigration – including his recent mention of forcing Mexico to pay for the construction of a border wall. His government could also halt remittances of US-based Mexicans to their birth country (which represent around 25 Bn USD a year). Even Hillary Clinton no longer seems convinced on the advantages of the Trans Pacific-Partnership[2]. Major changes in US economic strategy could have serious effects on Mexico (chart 5).

Chart 5

Correlation between GDP growth rates in Mexico and the USA



Source :IMF, forecast Coface

Table 1

Forecasts for main Economic Indexes

Mexico	2015	2016	2017
GDP — annual real growth	2.5 %	1.6 %	1.5 %
CPI Inflation — end of year	2.1 %	2.9 %	3 %
General government balance % of GDP	-3.5 %	-2.9 %	-2.6 %
Net Public debt % of GDP	42.3 %	45 %	46.3 %
Unemployment rate — year average	4.3 %	4 %	4 %
Current Account % of GDP	-2.9 %	-2.6 %	-2.6 %

Sources: Coface, IMF, Oxford Economics and Standard & Poor's

2 SECTOR BAROMETER

Coface's previous sector barometer[3] revision, saw the automotive and retail segments downgraded from low risk to medium risk. The outlook for each segment is detailed below.

SECTOR RISK ASSESSMENT

Sectors	Mexico	Latin America
Automotive	Medium risk	High risk
Agrofood	High risk	High risk
Chemical	High risk	High risk
Construction	High risk	High risk
Services	Low risk	Medium risk
Pharmaceuticals	Low risk	Medium risk
Retail	Medium risk	High risk
Steel	High risk	High risk

Source: Coface

Low risk · Medium risk · High risk · Very high risk
↗ The risk has improved
↘ The risk has deteriorated

Momentum of Automobile industry is slowing

Thanks to its proximity to the US and the Nafta agreement, Mexico remains a major hub for the automotive industry. Growing production in recent years saw the country become the world's 7th largest auto maker (surpassing Brazil). Production rose by 5.6 % in 2015, to reach 3.4 million units, following on from an impressive hike of 10.2 % in 2014. In contrast, the industry´s performance slowed to 0.9 % on a year on year basis between January and September 2016. This lackluster result is mainly due to lower exports, as the Mexican auto industry is highly export-orientated. In 2015, approximately 82.4 % of the country's auto production was sold to foreign markets, with the United States accounting for 80 %. Auto exports fell by 1.5 % during the first eight months of 2016, YoY, to stand at2.05 million units. This negative outcome is mainly due to weaker sales to the US.

Domestic sales have performed well, supported by the continued positive performance of income fundamentals. Auto sales have increased at a very fast pace during recent years, from 181 auto vehicle sales per thousand inhabitants in 2010, to 217 per thousand in 2015. 2016 has shown a similar trend, with auto sales growing by an impressive 18.4 % YoY during the first eight months of 2016. It is worth mentioning that sales have shown resilience, even in the context of the tightening monetary cycle which was triggered in late 2015. Currently, approximately 66 % of vehicle purchases are financed in up to 5 years and the delinquency rate stands at just 1.5 % of total credit for the segment.

The industry´s performance is expected to lose pace in the near future and the double digit growth in sales may not last for long - although a steep reduction is not anticipated.

[2]Trans-Pacific Partnership (TPP) announced in early October 2015, following five years of negotiations. The TPP aims to improve economic ties between member countries, by reducing tariffs and fostering trade. It involves three Latin American countries (Chile, Mexico and Peru) and another nine economies (US, Japan, Malaysia, Vietnam, Singapore, Brunei Australia, New Zealand and Canada) which together represent nearly 40 % of the world´s GDP.

[3]Sector barometer: Coface's assessments are based on the financial data published by listed companies in six major geographic regions: Emerging Asia, North America, Latin America, Western Europe, Central Europe and Middle East & Turkey. Our statistical credit risk indicator simultaneously summarises changes in four financial indicators: turnover, profitability, net indebtedness and cash flow - as well as claims recorded through our network.

Domestic sales are likely to gradually slow, as car penetration increases and income fundamentals become less supportive. As mentioned before, consumer confidence has been deteriorating over the last three months. Higher inflation and rising interest rates will negatively impact local sales.

The government is targeting an auto production rate of 5 million units by 2020. This seems unlikely, as it would require an annual average growth rate of approximately 8 %. In the last five years, 20 billion USD have been invested into new assemblies and into expanding the capacity of those already in operation. The country has also started to manufacture luxury autos. Questions remain, however, on whether there will be enough demand and on risks connected with overinvestment and overproduction.

Another issue is the outcome of the US general elections. The prosperous performance of Mexico's auto industry in recent years has been attacked during the presidential campaign as being responsible for job destruction in the US. Depending on the outcome of the elections, the Nafta agreement (which allows competitively-priced Mexican cars to be exported to the US) could be reviewed.

Agro/food: Risks mainly linked to agro activity

The agro segment only accounts for 3 % of Mexico´s GDP. The main crops are grains (such as corn and wheat), tropical fruits (such as avocados, watermelons, mangoes, papayas, grapes and Persian limes) and vegetables. The segment remains at high risk due to: 1) the continuation of low international prices; 2) currency depreciation impacting the costs of imported fertilisers; 3) the fact that the sector usually works with longer terms of payment; 4) the importance of good cash flow management in order to finance crops; 5) challenging weather conditions.

Chemical Industry: Not yet benefitting from the landmark oil reforms

Mexico's annual chemical output is estimated at 17 billion USD (1.4 % of GDP). Although the country has an abundance of natural resources, its underdeveloped structure (caused by years of underinvestment in the petrochemical industry), has made the sector highly depend on imported raw materials. Feedstock supply is dominated by the state owned oil giant, Petróleos Mexicanos (PEMEX). The historically high fiscal burden imposed on the company has reduced its investment capacity and thus contributed to the decline in oil production seen since 2004.

The positive effects of the landmark energy reforms approved in December 2013 have not yet been felt, as lower international oil prices have reduced the attractiveness of investing in the segment. The recently announced 2017 budget, with cuts of 5.3 billion USD in funding for the country's public oil company, will be a further factor in declining oil production. A change in the country's dependence on imported raw materials is therefore unlikely in the short term. Companies which rely on imports have been impacted by the strong depreciation of the Mexican peso observed since 2014.

Construction: Civil construction undermined by scarce public resources

Civil construction is being impacted by lower public resources. The construction industry plays a major role in the Mexican economy, accounting for around 7.3 % of GDP and the creation of 1 in 5 jobs. Industrial performance has, however, been lackluster, mainly due to government budget cuts in recent years. Some infrastructure projects have been delayed or cancelled, due to lower tax revenues from the oil industry. The Mexican Chamber of Construction Industry (CMIC) expects public investments in construction to be reduced by 30 % in 2017.

The Federation 2017 budget draft has cut resources allocated for the Secretariat of Communications and Transportation (SCT) by 27%. This will impact big projects, such as the works to extend subway lines in Mexico City. Additionally, of the 13 ongoing port projects in Mexico, only 2 have funds allocated for next year. Public Private Partnerships could be a way to mitigate these budget reductions and the government has proposed the creation of 4 new projects in this regard (focused on the maintenance and upkeep of roads). The environment is, however, marked by corruption scandals which are hindering the smooth operation of projects.

Homebuilding has performed relatively better. This segment has mainly been fuelled by favourable demographic trends and the wider availability of credit supply from commercial banks. There is a broad market to explore, due to the country's great shortage of housing, particularly amongst low income families looking for affordable homes. The National Statistical Institute (INEGI) estimates that, in 2014, there were 35.7 million people in need of housing – either currently without a home, or living in deteriorated or overcrowded buildings. The segment is, however, less attractive to foreign investors, as a major share of the demand is for budget homes, which usually bring lower yields for homebuilders. It is also worth noting that construction costs have been under pressure, due to the downward tendency of the Mexican Peso. Construction firms depend on imported materials and machinery, and have thus been forced to negotiate prices. Over the upcoming period, civil construction is likely to underperform homebuilding. The discouraging forecasts for oil prices are expected to continue dragging down investments in infrastructure.

Services: Growth expected to decelerate

The service segment represented 61 % of the country´s GDP in 2015. In the second quarter of the year, it reported a seasonally adjusted increase of 2.4 % YoY. This relatively good performance is backed by positive income fundamentals. In the near future, this rhythm of expansion is expected to slow, as the population begins to more intensely feel the counter effects of the tightening monetary and fiscal cycle. The segment does, however, have an important advantage over industry, as it is not exposed to competition from imports. This makes it easier to adjust prices and facilitates the maintenance of profit margins.

Pharmaceuticals: Activity supported by increasing life expectancy

Mexico's pharmaceutical market is Latin America's second-largest (behind that of Brazil) and the 11th largest in the global market. The sector accounts for around 1.5% of the country's GDP. On a per-head basis, Mexico's annual expenditure on pharmaceuticals and other medical non-durables are the lowest in the OECD, estimated at 279 USD per head in 2014 (compared to the OECD average of 532 USD).

The segment shows good long term perspectives, as the country has a population of around 120 million inhabitants and life expectancy is rising (currently at 76.5 years and expected to reach 77.5 years by 2020). Moreover the share of the population represented by those of over 65 years of age is expected to reach 8.2 % of the total by 2020 (compared to the current 7%).

In the short term the sector will be impacted by cuts in the federal budget. The public sector represents around 51% of the country's pharmaceutical industry. Reductions in healthcare services were implemented in 2015 and again this year, while a further cut of 7.8% has been proposed for 2017.

Retail: Income fundamentals expected to deteriorate in the near future

Retail sales play a major role in Mexico's economy, representing around 15.7 % of GDP. After being impacted by the 2008-2009 economic crisis, the segment has since reported solid growth. During the period from 2009 to 2015, the sector grew by a compound annual rate of 6 %. This positive outcome was supported by the country's growing population and the increasing representation of the middle classes.

Nevertheless, the Global Retail Development Index of consultancy A.T. Kearney highlighted the fact that the Mexican market is saturated and thus presents limited opportunities for newcomers. Moreover, while the country has one of the highest levels of per capita consumption in the region (at around USD 3,420 per year), this value is still well below those of developed countries (for example, the United States, with USD 11.500).

So far in 2016, retail sales have continued to outperform other segments. Sales increased by 7.9 % in July 2016, year on year, down from 9.4 % in June 2016 and 8.6 % in May 2016. Nevertheless, growth should start to decelerate, as consumers begin to feel the effects of rising inflation and interest rates.

Steel: Weak global and domestic scenario

The global steel market remains challenging, in a context marked by oversupply and low prices. China accounts for around 50 % of the market and its strong increase in production, combined with the deceleration of its economy, has impacted the world's steel market. Earlier this year, the Asian giant committed itself to closing 100-150 million tonnes of steel capacity by 2020. So far, however, there have been no signs of improvement. In the first eight months of 2016, steel production decreased by a meager 0.9 %, mainly driven by the marginal reduction of 0.1 % in China´s production. In the meantime, world capacity utilisation stood at 68.5 % in late August, only 0.5 p.p. above the level observed one year earlier.

Mexican steel production decreased by 0.3 % in the first eight months of this year, YoY, to 12 million tonnes. According to the Mexican Iron and Steel Industry Chamber (Canacero), the country is the world´s 13th largest steel producer and the industry represents approximately 1.9 % of Mexico´s GDP. Idle capacity in the country is high, reaching 37 % in 2015. The country's steel makers need to deal with the scenario of lower profitability worldwide, as well as with competition from imported steel and the negative outlook of one its biggest consumers (civil construction). At the end of October, the Ministry of Economy decided to renew the 15 % tariff on steel imports from countries with which Mexico has no commercial agreements (such as China). The aim of this is to protect Mexico's domestic industry from dumping initiatives (products that sells for less than their cost of production - a practice of which China is accused by many countries).

The environment will remain sensitive in the near future. From a global perspective, it would appear that China´s pledges to reduce its total capacity will take some time to materialize. Meanwhile, Mexico's domestic market will continue to be partially undermined by the lackluster activity in construction.

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