Polina's Perspective

Mexico – the art of transformation

Polina Kurdyavko
Head of BlueBay Emerging Markets and Senior Portfolio Manager at RBC GAM

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Do you like art? I wouldn't consider myself an art connoisseur, but I enjoy exploring the art scene across the world during my travels. It gives a lot of information about a country's heritage, values and talent base.

Mexico City is ranked the best city in the world for culture by *Time Out* magazine, largely because of its incredible art and rich history. Last week I took a trip there to gain a better understanding of the pre-election dynamics and strength of the country's economic recovery, as well as to discuss possible solutions for the debt sustainability of Mexico's largest state-owned oil company.

I flew from Miami, surprised that all three direct flights to Mexico City, only thirty minutes apart, were overbooked. Driving through a busy and vibrant Mexico City, with fully-packed restaurants and heavy traffic, one could feel the sense of optimism that has spread on the back of strong growth in the neighbouring US economy. Feedback from the locals on the prospects for political transition, with the presidential elections a month away, also sounded quite constructive. Yet, the issue of debt sustainability of the country's largest oil company remains unresolved. This point is key to investors and explains the additional risk premium that they demand for Mexican risk assets. We believe there is a solution to the problem but the new government has to act, and act fast.

We maintain our overweight position in Mexico both through hard currency bonds and local rates, with the view that certain fundamental improvements have not yet been reflected in valuations. We are optimistic that Mexico's new government will take action to further boost the country's positive fundamental trajectory, starting with the energy sector, and this could open the door to more private capital and provide alpha opportunities for investors in the short to medium term.

What is the art of Mexico's transformation? The post-pandemic period has thrown a lot of challenges at Mexico, including the need to increase its policy rate almost threefold to 11.25% in order to battle inflation, whilst keeping fiscal deficits at bay, given the focus on the spending discipline of the current president. Yet, the country ended up being one of the key beneficiaries of the post-pandemic era, partly due to its proximity to the US and the benefits of nearshoring on the back of increased US/China tensions. The government's decision to increase minimum wages annually by 20% over the last three years, as well as 50% growth in remittances over the same period, provided further support to strong consumer demand.

This has left Mexico in a 'Goldilocks' scenario, with prudent and orthodox monetary and fiscal policies, coupled with strong economic recovery. The banking sector has been one of the key beneficiaries. Indeed, we hear anecdotally that select local banks have doubled their revenues over the last four years and target another 50% increase over the next 12 months. Moreover, given the relatively low banking penetration in Mexico and the fixed nature of select loan products like mortgages, the recent rate hikes have not translated into higher NPLs in banks' portfolios. Local pension funds, or so-called AFORES, continue to grow at a double-digit pace, reaching almost USD300 billion (or 20% of GDP), and making Mexico's pension system the largest in Latin America. This provides a stable funding base for the government, with over 50% of the assets invested in local sovereign debt, whilst also continuing to broaden and diversify the product range for local investors. Furthermore, the growth in the savings rate is also supporting the wealth management industry, allowing select players to double their assets under management over the last couple of years.

Can fiscal discipline be maintained after the elections? The Ministry of Finance expects the fiscal deficit to be 5.7% of GDP in this election year but is committed to bringing it down close to 3% next year. Whilst this target is ambitious, we would expect the fiscal deficit to decrease with the removal of pre-election campaign funding and some of President Andrés Manuel López Obrador's ("AMLO") investment projects, which would already translate into a 1.5-2% deficit reduction.

Presidential elections can often present tail events but, in the case of Mexico, we believe that victory for either candidate could be a positive event for the market. Claudia Sheinbaum, from the Morena party, is currently in the lead, with policies that are more aligned with AMLO but have more focus on sustainability and the hope of a softer diplomatic approach towards neighbours. The opposition candidate, Xóchitl Gálvez, is perceived to have a strong team with more focus on liberalisation and market friendly reforms.

Despite these positive dynamics, Mexican fixed income assets continue to trade at a wider spread than implied by its credit quality. Why are the valuations not reflecting the country's positive fundamental trend? One of the key unresolved issues lies in the debt sustainability of its state-owned oil company. With USD108 billion in debt versus USD20 billion EBITDA and negative free cashflow as of the end of 2023, investors have legitimate concerns about the company's debt sustainability, despite numerous reassurances of the government's implied support. As a result, the company current funding costs are amongst the highest in emerging markets, with limited access to borrowing.

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We believe that there is a solution that could address the underlying problem. Mexico's state-owned entity has two functions: profit generation and energy security. Currently the company's upstream operations are profitable, while downstream operations are loss making, partly due to the government's pricing policy. At present, all debt is assigned to the upstream operations, given their ability to generate cashflow. We would advocate separating the company's upstream division and downstream divisions into two separate entities. The upstream division (focused on profitability) could then take on a part of the debt that would be sustainable, allowing the company to invest and focus on its environmental targets whilst generating positive cashflow. This credit profile would be more comparable to state-owned energy companies in Brazil and Colombia that trade at a much tighter spread to their respective sovereigns.

At the same time, the downstream division, which fulfils the energy security role, can assume the rest of the debt that would require an explicit government guarantee. This would not deteriorate government credit metrics, as rating agencies already factor in this guarantee. Also, it is more likely for the government to get an approval from Congress on this solution, as opposed to asking it to guarantee the entirety of the quasi-sovereign debt burden. Maintaining the status quo is also not an option, given the company's large arrears with suppliers, negative cashflow and limited access to funding. This proposed structure would substantially lower the cost of debt for the company, potentially by 3-4% and also free banks' balance sheets to provide more support to the profit-generating E&P division.

We shared our suggestions with the government and company's officials during our trip and are encouraged by the positive feedback thus far. In fact, Claudia Sheinbaum went as far as referencing this plan as a solution in a Bloomberg interview over the weekend.

Can Mexico's new government deliver this new structure? Time is of the essence and the time is now. There are, of course, other issues that are worth monitoring in the country, including security challenges, continuous strength of the Mexican currency that at some stage becomes an impediment to growth and, perhaps most critically, the US elections, where a Trump victory could result in renegotiations of trade agreements. Yet, we believe that the debt sustainability issue is the one that the government can control and can address quickly, unlike the other risks mentioned above.

The boardroom of the Mexican state-owned company has beautiful artwork dedicated to the Mexican legends of Popoca and Mixtli – two of the tallest mountains in Mexico. The legend says that the Aztec princess, Mixtli, waited for her warrior Popoca to return from a battle. Upon hearing false news of her warrior's death, she died from a broken heart. When the warrior returned, he carried her body to the mountains and hoped that the cold snow would wake her up. The Gods felt the warrior's sorrow and turned both of them into mountains, so that they can always be together.

Artwork in a boardroom dedicated to the Mexican legend

The relationship between Mexico and its state-owned company is similarly interlinked, with both dependent on finding a sustainable solution going forward. The key is not to wait too long or to be content with a 'muddle through' narrative. The window of opportunity is still open to paint a new and brighter picture for the Mexican economy, and policymakers hold the necessary tools to shape the canvas that will captivate the imagination of the Mexican public and markets alike.

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