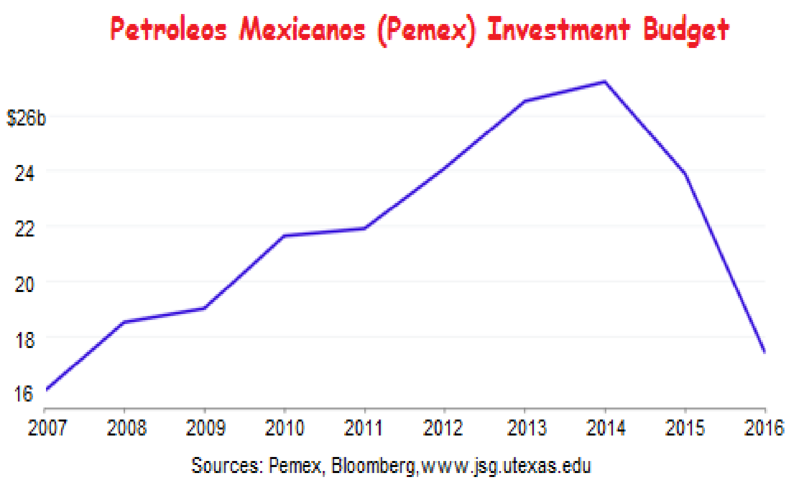
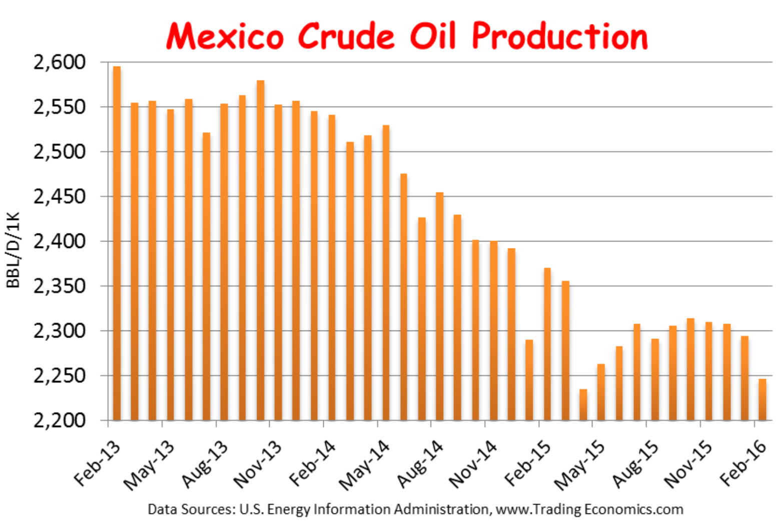
Mexico's Economic Outlook

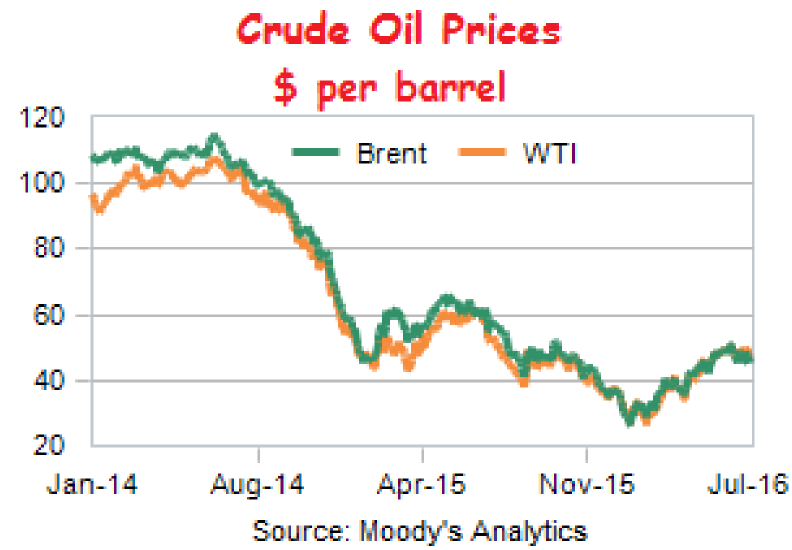


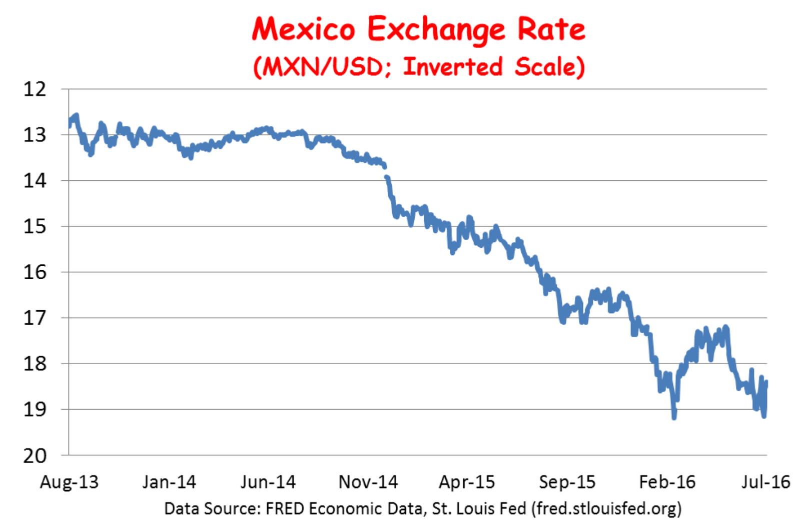


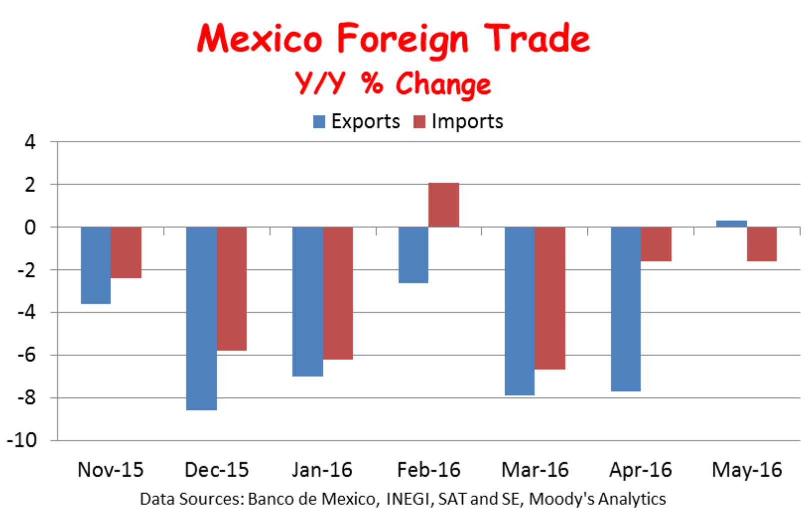
The Mexican economy is struggling to recover from a slowdown that began three and half years ago. Growth has fallen below 3% since 2013, the first year with Enrique Peña Nieto as president. Conditions are expected to remain lackluster in the near term, with growth reaching around 2.3% this year, half the rate of those experienced in the early 2010s.

The main culprit of Mexico's faltering economic recovery is weaker investment spending. Investment plummeted in 2013 due to the negative effects of transitioning to a new administration. New taxes on investment and the uncertain economic environment caused firms to continue to retrench in 2014. Meanwhile, lower oil prices over the last couple of years have significantly reduced oil-related fiscal revenue, the source of almost a third of the federal budget. As a result, public investment spending has weakened, along with investment by private sector firms that rely on the federal budget.

Reduced investment spending is crimping Mexico's production capacity, with oil production by the national oil company Petroleos Mexicanos (Pemex) dropping by almost a third compared to 2004 levels. The combination of falling production and lower oil prices has created major concern and prompted the government to re-open the industry to foreign investment after 77 years. The historic change is the core of President Nieto's energy reform efforts to raise production. The government sold around twenty-five shallow-water and onshore oil blocks to private firms during auctions last year and will hold another auction in December to sell ten deep-water oil blocks, where Mexico's oil production has yet to take place. Pemex has also agreed to join with private firms to develop the Trion light oil field, a massive deep-water oil block in the Gulf of Mexico.





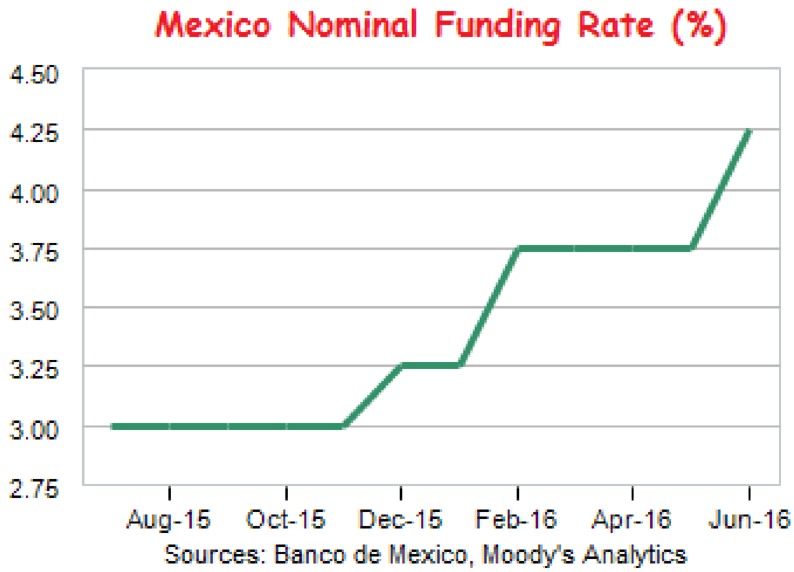


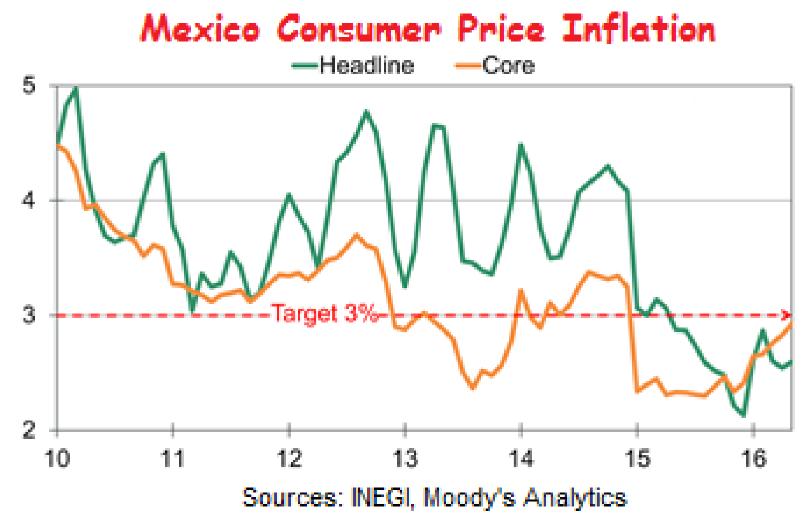
While the government's reform efforts have given hope for the nation's struggling energy sector, activity in the energy market will most likely remain restricted in the near term due to the downward trend in oil prices; fragile global economic conditions resulting from Britain's exit from the EU, along with improving oil supply from Canada and Nigeria, have resulted in a renewed decline in oil prices. Given that a strong recovery in oil prices is not expected any time soon, significant improvement resulting from the government's reform efforts will most likely not occur for a few years.

Lower oil prices, along with uncertain global economic conditions, have significantly increased risk aversion and caused the Mexican peso to depreciate sharply. Although the currency has recovered slightly, it recently dropped to a record low against the dollar and is now considered this year's worst-performing major currency. Unfortunately, the peso will likely experience further headwinds in the near term given the renewed decline in oil prices and financial volatility resulting from the Brexit.

Despite the weak peso, Mexico's nonoil exports are declining due to faltering external demand. In particular, cooling economic conditions in the U.S., Mexico's principal trading partner, have hurt Mexico's manufacturing exports. Although there is hope that Mexico's nonoil exports growth will strengthen as the peso faces additional downward pressure, the negative impact of lower oil prices on Mexico's energy sector will continue to outweigh any improvement in nonoil exports growth in the near term.

Meanwhile, the weaker peso and lackluster domestic demand have resulted in Mexico's imports growth to remain in negative territory for seven out of the last eight months. This trend is expected to continue in the near term as oil prices face additional downward pressure and the peso depreciates further, crimping domestic demand and confidence levels.





In an effort to reduce capital flight and stem the peso's downfall, the Bank of Mexico has tightened its monetary policy stance by raising the policy interest rate three times over the last six months. Mexico's nominal funding interest rate has now reached 4.25%, its highest rate in over three years, and additional rate hikes are expected through the rest of the year if global financial volatility worsens.

Meanwhile, the significant depreciation of the peso has caused inflation to rise through an increase in imported inflation. Although the inflation rate remains within the government's 2-4% target range, it is on an upward trend and is expected to increase further if the peso faces additional downward pressure. Thankfully, however, tighter monetary policy should help alleviate price pressures.

Overall, we see that Mexico's economy is struggling. The renewed decline in oil prices will continue to weigh on the nation's energy sector and prevent a strong recovery in investment and production in the near term. As a result, significant improvement from the government's energy reform efforts is not expected to occur for a few years. Although the falling peso will continue to boost the price-competiveness of Mexican exports in the global market, cooling economic conditions in the U.S. and lower oil prices will prevent a recovery in exports growth in the near term. Meanwhile, reduced government spending and higher interest rates will weigh on domestic demand. The economy will therefore remain restricted in the near term, with growth reaching around 2.3% this year, below potential.