MEXICO UPDATE

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TRADE UNCERTAINTY AND HIGHER RETAIL ENERGY PRICES PUSH MEXICO TOWARD RECESSION IN EARLY 2017

Policy uncertainty is already restraining cross-border trade

2017 will be a difficult year for the Mexican economy. The specifics of the Trump administration's proposed renegotiation of the North American Free Trade Agreement are still to be determined, and their ultimate effect could even be relatively limited; a 20 percent tariff on Mexican imports imposed in early 2017 would leave the U.S. dollar cost of Mexican imports little changed from early 2016, since the peso depreciated by 20 percent against the dollar over the intervening 12 months (See Chart 1). But until those specifics become clear, businesses engaged in cross-border trade are likely delaying capital spending plans in Mexico and limiting inventories to avoid being caught off-sides by a sudden change in trade policy. This overhang of uncertainty will at least temporarily advance the Trump administration's "buy American and hire American" economic goals, and by extension, discourage US imports, sourcing, and manufacturing in Mexico. Since Mexico's capital spending on machinery and equipment comprise about 5 percent of its economy and manufactured exports sold to US customers comprise another 15 percent, the headwind to Mexican economic activity in early 2017 is substantial.

Government-administered energy price hikes are eroding consumer spending power

This drag from trade coincides with headwinds to domestic consumer spending which originate in Mexico's state-owned oil company Pemex. Even though global oil prices are higher in early 2017 than a year earlier, they are not high enough for Pemex to grow production or capital spending; construction spending in Mexico's oil and gas sector actually plunged over 50 percent from a year earlier in the latest data for November 2016. Since Mexico's government still relies on royalties and taxes from Pemex for over a quarter of public revenue, low oil prices also are pressuring Mexican public finances. The country's fiscal responsibility law mandates public spending cuts whenever the government experiences revenue shortfalls, and in 2017, the government

CHART 1: POLITICAL UNCERTAINTY DROVE THE PESO TO RECORD WEAK LEVELS AFTER THE US ELECTION

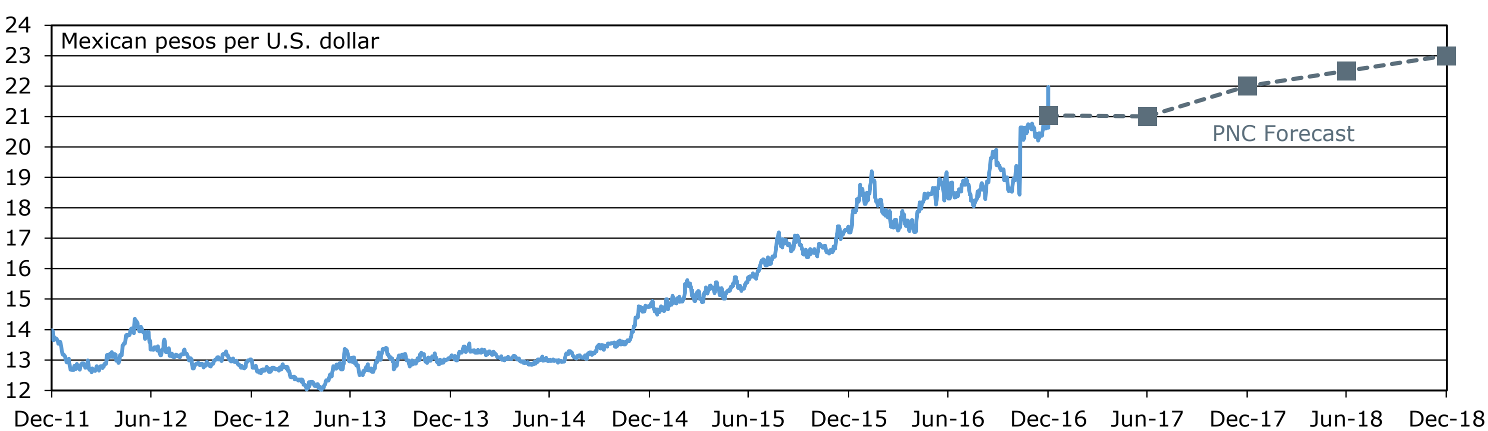

Chart sources: Bank of Canada, CEIC, The PNC Financial Services Group

Higher interest rates restrain business capital spending and consumer spending

responded to revenue shortfalls by raising prices of retail gasoline and natural gas products produced by Pemex (a.k.a. a "gasolinazo"), reducing Pemex's losses and conserving public sector cash flow for other uses. For Mexican consumers, higher energy prices are a tax hike by another name. Consumers will respond by reining in consumer spending on non-energy goods and services, diminishing a source of domestic demand that had been resilient in 2015 and 2016.

We forecast additional depreciation of the peso in 2017 and 2018

A sharp increase in benchmark interest rates is a further headwind to the Mexican outlook. Conservative fiscal policy and credible monetary policy helped Mexico keep inflation expectations low in recent years, and translated into low real interest rates that fueled fast growth of consumer and business credit. But since December 2015, the Bank of Mexico has been forced to raise interest rates, first to maintain a stable premium on Mexican rates relative to US benchmarks as the Fed normalized US monetary policy, and then to defend the value of the peso as trade became an US electoral issue. The Bank of Mexico nearly doubled its target interbank rate between December 2015 and December 2016, from 3.0 percent to 5.75 percent, and 10-year government bond yields have also risen (See Chart 2). Despite Mexico's deteriorating growth outlook, the Bank of Mexico is likely to continue to tighten monetary policy in the first half of 2017 to defend the value of the peso. While the Bank of Mexico does not target an explicit value for the exchange rate, it believes exchange rate stability is an important anchor for Mexican inflation expectations. The Bank of Mexico is likely to raise its target interbank rate another 1.25 percentage points to 7.0 percent in the first half of 2017; the Bank of Mexico seems likely to halt or at least slow rate hikes in the second half of 2017 after Mexico's statistical agency releases data showing a weak first half of the year. PNC Economics forecasts further depreciation of the peso in 2017 and 2018 as capital markets adjust to a new, and presumably less close, relationship between Mexico and the United States (See Chart 1).

A recession seems likely beginning in early 2017

After real GDP growth of about 2.3 percent in 2016, Mexico's economy seems likely to experience a recession (two or more consecutive quarters of falling real GDP) beginning in the first half of 2017 as consumers rein in spending, manufacturers delay capital expenditures, and as businesses add to inventories more cautiously. Full-year output will likely increase only 0.25 percent from 2016. In 2018, the July general election, which will elect a new Mexican President, will create additional uncertainties. Mexico was a de facto single party state during most of the 20th century, dominated by the establishment Institutional Revolutionary Party (PRI). The centrist opposition party PAN held the presidency between 2000 and 2012, before polls returned the PRI to office. Current opinion polls suggest that the presidency could in 2018 go to the leftist Party of the Democratic Revolution, who have never (yet) held power – and who might subject the Mexican economy to another round of sudden policy change.

CHART 2: MEXICAN INTEREST RATES NEARLY DOUBLED SINCE LATE 2015, A LARGE NEGATIVE FOR GROWTH PROSPECTS

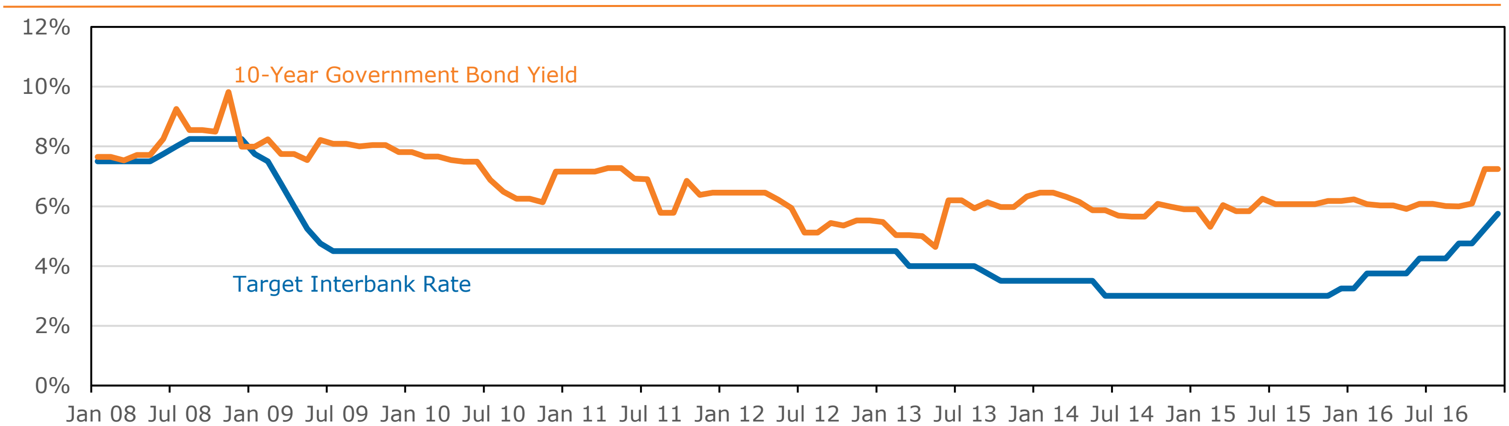

Chart sources: Bank of Mexico, CEIC, The PNC Financial Services Group

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