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Mexico's New President-Elect and NAFTA

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Key takeaways

- *On July 1, Andrés Manuel López Obrador (AMLO) was elected as Mexico's next president. This historical election marked the first time (since 1929) that one of the country's two major political parties failed to win the presidency.*
- *Little is known about how the newly elected president's policies will differ from those of previous administrations. Moreover, the North American Free Trade Agreement (NAFTA) negotiations are ongoing and may be forced back to the starting line with the new Mexican administration.*
- *While president-elect Obrador has talked tough on NAFTA in the past, his tone has moderated recently. This suggests that he understands Mexico's meaningful dependence on its northern neighbors.*

What it may mean for investors

- *U.S. protectionism remains a risk to Mexico, as well as to Latin America and emerging markets in general, since they typically rely on trade to fuel economic growth. We expect NAFTA to be renegotiated and trade disputes to be resolved without escalating into a global trade war.*
- *We currently are neutral on both Latin American and Emerging Market equities, given strengthening fundamentals balanced against the potential for increased volatility this year.*

Meet Andrés Manuel López Obrador (who is commonly referred to as AMLO), Mexico's president-elect and the leader of Latin America's second-largest economy for the next six years (by law, Mexican presidents are permitted to serve only one six-year term). He won a landslide victory in the July 1 election and will be inaugurated as president on December 1. The third time proved to be the charm—as his previous two presidential campaigns ended in defeat.

While the president-elect's victory was expected (he had maintained a double-digit poll lead since March), it does bring a good deal of uncertainty—relative to ongoing NAFTA negotiations and possible economic and business policies. In today's report, we will assess these uncertainties and determine the likely impact to financial markets.

Who is AMLO?

AMLO's critics paint him as the next Hugo Chávez, a dictator whose socialist policies reshaped Venezuela and who many blame for its economic troubles today. Meanwhile, AMLO's supporters point to his more moderate policies while he was mayor of Mexico City. He has railed against the privatization of Mexico's Energy sector while also praising business investment. In the past, he was known as a firebrand, while more recently, he has campaigned on mutual respect and collaboration. The constituency and market watchers alike are asking: Is he a bully or collaborator, a socialist or a moderate?

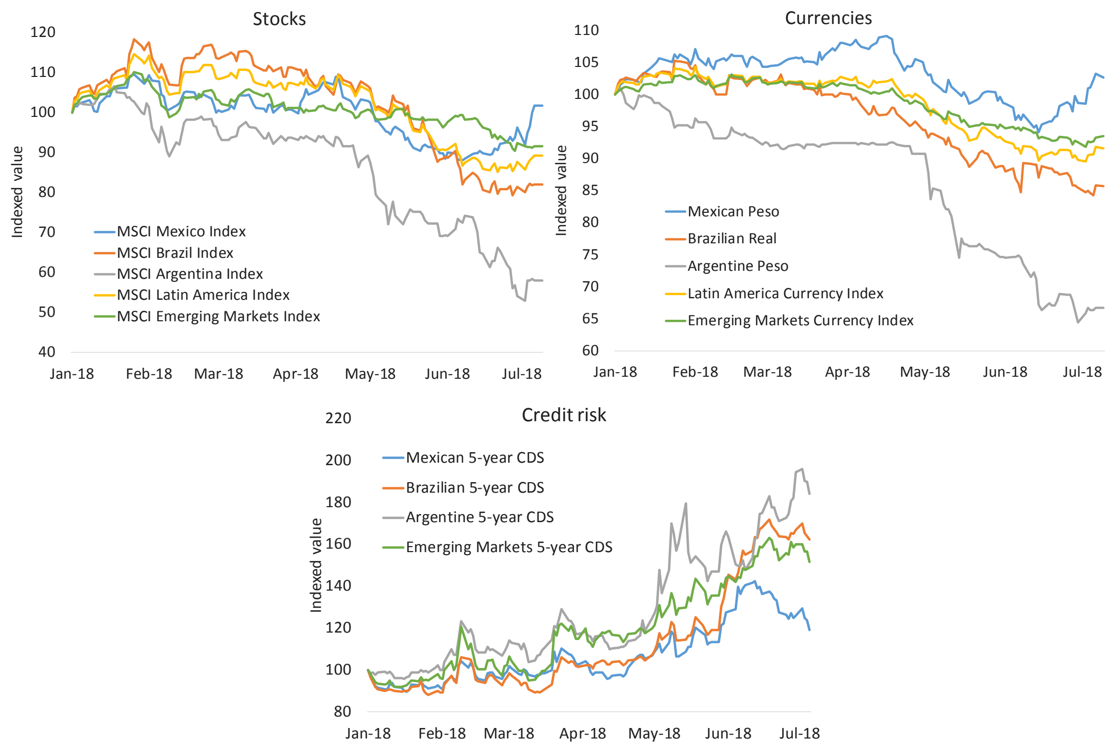
AMLO's track record as mayor of Mexico City should provide some useful hints for his possible future policies as president. As mayor, AMLO did increase social spending programs for senior citizens (among others), but he also cut government jobs, top officials' salaries, and debt growth. By most accounts, he led a fiscally responsible government and has pledged to do the same as president. Additionally, much of his popularity has been due to his image as a frugal "man of the people" who is bent on stamping out corruption. Thus, the fears of radical socialist spending may be overblown.

What do markets think?

Some investors have pointed to Mexico's recent financial-market trends as a negative reaction to an AMLO presidency. Year to date, Mexico's credit default swap spreads (or CDS, which measure perceived credit risk) have widened, the Mexican peso has depreciated against the U.S. dollar (and other developed-market currencies), and the Mexican stock market has lost 8% in value (as measured by the MSCI Mexico Index).

Yet, little insight can be gained by looking at Mexico in isolation. To determine if AMLO is truly "spooking the market," we must view Mexico in relation to other key countries in its region and emerging markets in general. When we compare Mexico to these peers, the story changes. Mexican equities and the peso actually are outperforming stocks and currencies of relevant Latin American and emerging-market peers, while its credit risk also has not risen to the same extent as credit risk measures of relevant peers (see charts below).

Chart 1. Mexican stocks, currency, and credit risk versus relevant peers



Sources: Bloomberg, JP Morgan, Wells Fargo Investment Institute. Daily data: January 1, 2018 – July 5, 2018. Indexed to 100 at January 1, 2018. Currencies are relative to the U.S. dollar. The Latin America Currency Index is represented by the Bloomberg JP Morgan Latin America Dollar Index. The Emerging Market Currency Index is represented by the JP Morgan Emerging Markets Currency Index.

Market action suggests a cautious optimism, or at least a "wait and see" approach, regarding AMLO.

The 800 pound gorilla—NAFTA renegotiation

In our view, the ongoing NAFTA renegotiation process remains the largest risk to Mexico. Many had hoped that an agreement could have been reached before a new Mexican administration came into power. In the past, AMLO had railed against NAFTA's impact on Mexico's agricultural sector and its inability to raise wages for Mexican workers (the Mexican poverty rate has dropped by only 9 percentage points since before NAFTA (while for Brazil, which is not party to the agreement, it dropped by 39 percentage points[1]). But AMLO recently has been in favor of maintaining some form of NAFTA, and he has pledged to renegotiate the agreement. This pivot may be a result of AMLO understanding just how dependent the Mexican economy is on NAFTA (and on its northern neighbors).

In fact, the U.S. buys about 75% of Mexico's exports, and those exports make up roughly 30% of Mexico's gross domestic product (GDP—see chart below). This economic exposure to the U.S. (and to possible U.S. tariffs) is significantly higher than it is for other countries.

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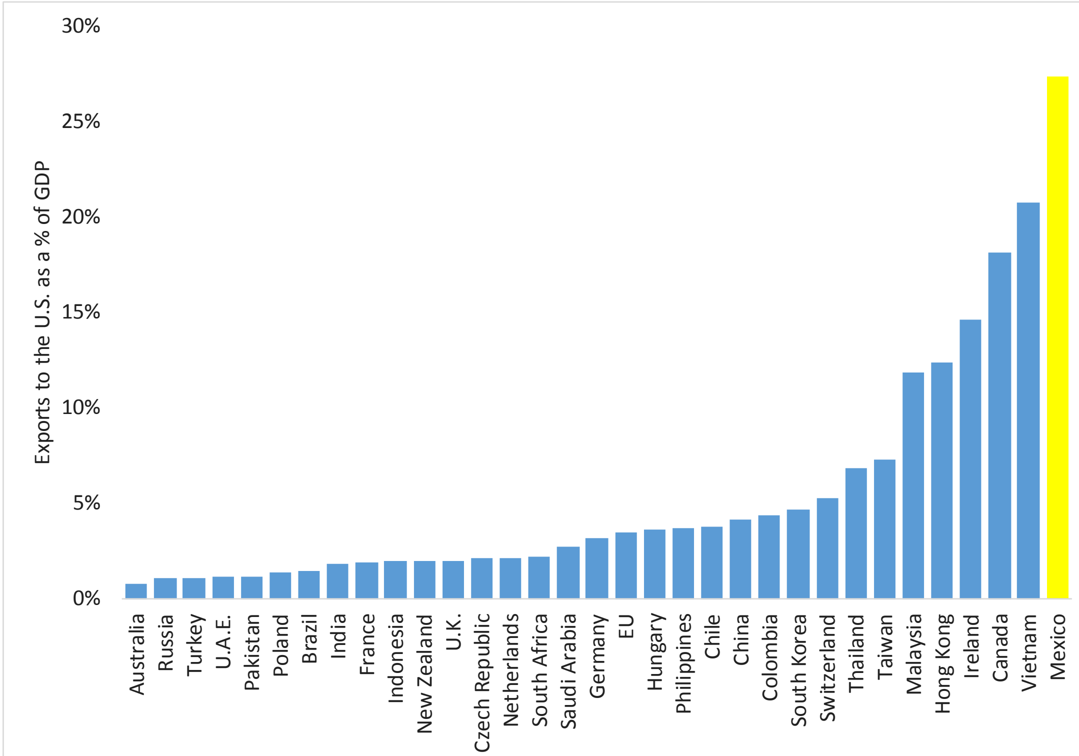
[1] World Bank data. Poverty headcount rate is calculated as the population of people that make $5.50 a day or less divided by the total population (2011 purchasing power parity). The Mexican poverty rate dropped from 43.7% to 34.8% between 1992 and 2016. The Brazilian poverty rate dropped from 58.2% to 19.4% between 1992 and 2015.

Chart 2. Exports to the U.S. as a share of GDP



Sources: Bloomberg, U.S. Census Bureau, World Bank, Census and Statistics Department of Hong Kong, Wells Fargo Investment Institute. Data shown is annual data, and it is for 2017.

Due to this relationship, most agree that Mexico is at a disadvantage in the NAFTA negotiations. However, Mexico still could inflict damage on the United States. If the agreement was scrapped with no alternate to take its place, default World Trade Organization (WTO) trading rules would apply. This would allow Mexico to levy much larger tariffs on U.S. goods than the U.S. could levy in response. For example, Mexico could impose a 37% tariff on U.S. transportation equipment, but the U.S. could only impose a 3% tariff in return.[2] The amount of goods that the U.S. exports to Mexico ($240 billion), coupled with Mexico's ability to levy such high tariffs on U.S. exported goods, has the potential to be very disruptive.

Mexican (and Canadian) tariffs also could target politically important regions within the United States. Of the 15 states with the largest exposure to NAFTA (as measured by exports to Mexico and Canada as a percent of state GDP), 13 states voted for President Trump.

In the end, "blowing up" NAFTA, with nothing to take its place, would be detrimental to all the economies involved, due to the past 24 years of cross-border supply chain integration, trade volume, and the number of jobs that are reliant on the trade agreement. Given these issues, we expect a trade agreement to eventually develop.

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[2] This is due to "bound tariff rates," which are the highest agreed upon tariff rates applicable to each WTO member. More developed countries tend to have lower bound rates than less developed countries. The rationale is that less developed countries need greater protection against foreign competition.

Yet, until there is some resolution to the NAFTA talks, market uncertainty will continue. This “800-pound gorilla” likely will delay any significant market bet on the outcome for an AMLO-run Mexico.

Investment implications

In our view, an AMLO presidency will most likely be better than critics fear. It is improbable that AMLO’s administration would enact policies that would discourage private business investment. This should help to appease financial markets. NAFTA renegotiation and U.S. protectionism remain more significant risks. Mexico is not alone in these trade-related risks; emerging markets, in general, have a large exposure to global trade, due to their heavy reliance on exports for growth. Thus, any escalation of trade disputes would weigh heavily on emerging markets as a group.

We do expect NAFTA to be renegotiated—and do not expect that the current trade rhetoric will escalate into a trade war. Yet, until there are concrete trade agreements in place, emerging markets (including Mexico) could be on edge. This may translate into increased volatility in these markets this year. We currently hold a neutral rating on Latin American and emerging-market equities, which reflects our anticipation of strengthening fundamentals amid the backdrop of higher trade risks and volatility.

Economic Calendar

Date	Report	Estimate	Previous
7/10/2018	NFIB Small Business Optimism	105.5	107.8
7/10/2018	JOLTS Job Openings	--	6698
7/11/2018	MBA Mortgage Applications	--	-0.50%
7/11/2018	PPI Final Demand MoM	0.20%	0.50%
7/11/2018	PPI Ex Food and Energy MoM	0.20%	0.30%
7/11/2018	PPI Ex Food, Energy, Trade MoM	--	0.10%
7/11/2018	PPI Final Demand YoY	3.10%	3.10%
7/11/2018	PPI Ex Food and Energy YoY	2.60%	2.40%
7/11/2018	PPI Ex Food, Energy, Trade YoY	--	2.60%
7/11/2018	Wholesale Trade Sales MoM	--	0.80%
7/11/2018	Wholesale Inventories MoM	--	0.50%
7/12/2018	Initial Jobless Claims	--	231k
7/12/2018	Continuing Claims	--	1739k
7/12/2018	CPI MoM	0.20%	0.20%
7/12/2018	CPI Ex Food and Energy MoM	0.20%	0.20%
7/12/2018	CPI YoY	2.90%	2.80%
7/12/2018	CPI Ex Food and Energy YoY	2.30%	2.20%
7/12/2018	CPI Index NSA	252.1	251.588
7/12/2018	CPI Core Index SA	--	256.889
7/12/2018	Real Avg Weekly Earnings YoY	--	0.30%
7/12/2018	Real Avg Hourly Earning YoY	--	0.00%
7/12/2018	Bloomberg July United States Economic Survey		
7/12/2018	Bloomberg Consumer Comfort	--	57.6
7/12/2018	Monthly Budget Statement	--	-$146.8b
7/13/2018	Import Price Index MoM	0.10%	0.60%
7/13/2018	Import Price Index ex Petroleum MoM	--	0.10%
7/13/2018	Import Price Index YoY	--	4.30%
7/13/2018	Export Price Index MoM	0.20%	0.60%
7/13/2018	Export Price Index YoY	--	4.90%
7/13/2018	U. of Mich. Sentiment	98.2	98.2
7/13/2018	U. of Mich. Current Conditions	--	116.5
7/13/2018	U. of Mich. Expectations	--	86.3
7/13/2018	U. of Mich. 1 Yr Inflation	--	3.00%
7/13/2018	U. of Mich. 5-10 Yr Inflation	--	2.60%
7/16/2018	Retail Sales Advance MoM	--	0.80%
7/16/2018	Empire Manufacturing	--	25
7/16/2018	Retail Sales Ex Auto MoM	--	0.90%
7/16/2018	Retail Sales Ex Auto and Gas	--	0.80%
7/16/2018	Retail Sales Control Group	--	0.50%
7/16/2018	Business Inventories	--	0.30%

Source: Bloomberg, as of July 5, 2018.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates.

Definitions

An index is unmanaged and not available for direct investment.

The J.P. Morgan Emerging Market Currency Index (EMCI) is a weighted index of 10 emerging market foreign-exchange rates. The weights are fixed at 11.1111% for the Brazilian real, the Mexican peso, the Chilean peso, the Chinese yuan, the Indian rupee and the Singapore dollar, and at 8.33335% for the Turkish lira, the Russian ruble, the Hungarian forint and the South African rand.

Bloomberg JP Morgan Latin America Currency Index is a trade and liquidity weighted index. Weightings for the currencies underlying the index are as follows: ARS (Argentine peso) 10%, BRL (Brazilian real) 33% CLP (Chilean peso) 12%, COP (Colombian peso) 7%, MXN (Mexican peso) 33%, PEN Peruvian sol) 5%.

MSCI Mexico Index is a free-float weighted index designed to measure the performance of large and mid cap segment of the Mexican market.

MSCI Argentina Index is a free-float weighted index designed to measure the performance of large and mid cap segment of the Argentine market.

MSCI Brazil Index is a free-float weighted index designed to measure the performance of large and mid cap segment of the Brazilian market.

MSCI Latin America Index is a free-float weighted index designed to measure the performance of large and mid cap segment of 5 Latin American countries.

MSCI Emerging Markets Index is a free-float weighted index designed to measure the performance of large and mid cap segment of 24 Emerging Market countries.

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