J O Hambro Capital Management Group

Emerging Markets Spotlight

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"U.S. Strikes Gentler Tone on Nafta as Talks Countdown Begins"

Bloomberg headline, 18 May 2017

Mexico is an equity market that has in recent years generally been one of the less volatile emerging markets. Mexico is an OECD member with (relatively) stable politics, a highly regarded central bank and a limited presence in the stock market of the more cyclical commodity sectors, all of which tend to dampen swings in equity prices.

The last year has been very different, though. The election of Donald Trump after primary and presidential campaigns in which he repeatedly criticised NAFTA, Mexico and even the Mexican people had a dramatic impact on both the currency and the equity market, with MSCI Mexico down 13.1% in US dollar terms in November 2016. In 2016, Mexico exported a total of US$374bn of goods, US$303bn of which went to the US (with a further US$10bn to Canada, also under NAFTA). In addition, Mexico is a substantial beneficiary of tourist visitors, worker remittances and FDI flows from the US, and so a collapse in US-Mexican trade relations would be disastrous for the southern partner.

The fall in Mexican capital markets was intensified by rising US bond yields, being driven higher both by the US recovery and also by expectations that the Trump administration's reflationary policy agenda would push structural inflation higher in the US.

Finally, there was increasing concern that the 2018 presidential election might return a nationalist populist, Andrés Manuel López Obrador (AMLO), which would be a clear negative both for the Mexican economy and corporate Mexico, with further risks to the relationship with the US.

Six months on, these risks have largely (but not completely) passed. The Trump administration has not been able to move its legislative agenda forward with any real success. US Trade Representative Robert Lighthizer sent formal notification to the US Congress that he intended to renegotiate NAFTA, but the language used speaks more to modernisation and updating than to terminating it. To be clear, there are still risks that the talks could break down, or that the US administration could return to demonising Mexico.

Meanwhile, US bond yields have retraced about half of their post-election move, as US fiscal stimulus has been delayed and inflation remains stubbornly low, which eases the pressure on EM currencies. The domestic Mexican political situation remains fluid, but the victory for the ruling PRI party in the gubernatorial election in the key State of Mexico shows that opposition to AMLO will be robust.

Mexico is still working through the inflationary impact of the currency sell-off in 2016, with Banxico having hiked policy rates three times this year, following six hikes in 2016. The move in policy rates from 3.0% to 6.75% will drag on the economy, but growth should remain positive this year, and Mexican equities have historically been one of the most defensive in economic downturns. Mexican equities have significantly de-rated, with the premium Mexican assets attract over other emerging markets coming back to its long-term average.

Accordingly, we have moved our weighting in Mexico from zero towards a neutral position. Our preference is for high-quality, domestic demand-focused companies with strong growth prospects. We have added Walmart de Mexico, the largest retailer in the country, and Megacable, a cable-based media company benefiting from growth in TV and internet consumption in Mexico.