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Proactive Investment Management & Financial Planning

Global Perspectives, November 2018: Why We're Not Investing in Mexico Right Now

Even though the U.S. stock market has been one of the best performers in the world over the last couple of decades, we still think there's a place for foreign stocks in portfolios geared toward capital growth. At the very least, diversifying a portfolio by including foreign stocks could reduce the overall volatility of the portfolio because those foreign holdings might appreciate when U.S. stocks are depreciating, and vice versa. In theory, searching for investments globally should also boost the chance of finding good returns. But does it make sense to invest in Mexico? Given my long experience helping run Mexican businesses for U.S. investors, and given the time I've spent in such "garden spots" as Culiacán and Durango (rather than the artificial tourist environments of Cabo San Lucas or Cancun), I think I have a good sense of how Mexico works and how you make money there. Sadly, as shown in this article, we see multiple long-term and short-term reasons to avoid investing in Mexican stocks or bonds right now, in spite of the country's close connection with the booming U.S. economy.

An Overview of Our Southern Neighbor

Mexico may be right on the U.S. doorstep, but many Americans only have a dim understanding of its investment environment, economy, and financial markets. Table 1 illustrates that while the United States is much bigger, Mexico's population is still very sizable. More important, it is also growing much faster than the U.S. population, and it is significantly younger. In Mexico, the share of the population at "retirement age" is less than half the share in the United States. The share of the population that has yet to enter the workforce, or has only recently done so, is almost 50% larger than north of the border. In theory, that might suggest Mexico is primed for strong economic growth. Not only is its population expanding enough to produce ever more workers and consumers, but more of Mexico's population is still in its high spending years, and more of its people are about to enter their period of highest productivity growth and best income gains.

In spite of Mexico's apparent advantages, Table 1 also shows how badly it has lagged its potential. Although Mexico's population amounts to almost 40% of the U.S. population, its total economic output (as measured by gross domestic product, or GDP) is only about 6% of U.S. production. That's because the average person in Mexico produces only about $19,900 worth of goods or services each year, compared with average output of $59,800 for a U.S. resident (to account for the different cost of living, the figures are adjusted using purchasing power parity, or PPP). Mexico's shortfall is especially surprising because the highly productive industrial sector (dominated by manufacturing) is a much bigger part of its economy. One thing holding Mexico back is that a very large part of its labor force is engaged in subsistence farming and basic services, with only limited productivity. As discussed below, another problem for Mexico's economy is that its financial system is too underdeveloped, constrained, and limited to effectively channel capital to profitable investment opportunities. A key reflection of that is in the fact that while the total value of publicly-traded stock is equal to 1.6 times GDP in the United States, it's only equal to about 0.4 times GDP in Mexico.

Table 1.
Comparison of USA and Mexico

	USA	Mexico
Demographics		
Population in Millions, 2015	319.9	125.9
Average Growth Rate, 2010-2015	0.7%	1.4%
Share of Population Aged 65+	14.6%	6.5%
Share of Population Aged 20-64	59.5%	56.7%
Share of Population Aged 0-19	25.9%	36.8%
Economy		
GDP, Trillions of $, 2017	$19.5	$1.2
Per-Capita GDP, $, 2017 (PPP)	$59,792	$19,938
GDP by Sector		
Agriculture	1.3%	3.3%
Industry	24.4%	31.0%
Services	74.3%	65.7%
Stock Market		
Market Cap, Trillions of $, EOY 2017	$32.1	$0.4
Market Cap / GDP	1.6	0.4

Sources: United Nations Population Division, International Monetary Fund, U.S. Bureau of Economic Analysis, INEGI, World Federation of Exchanges.

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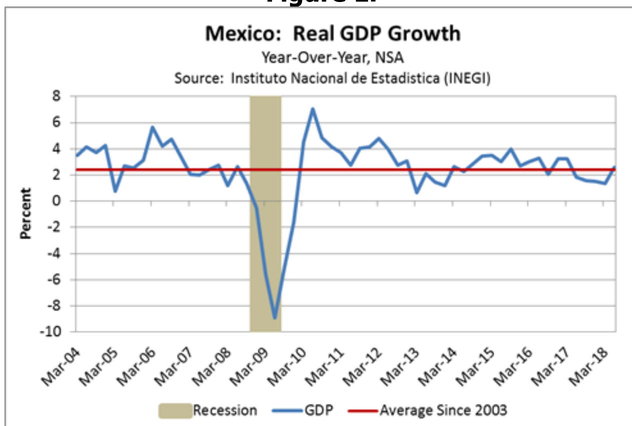
Long-Term Impediments to Growth

Economic growth was strong in both the United States and Mexico in the decades right after World War II, but growth has moderated in both countries in recent decades. For Mexico, growth has slowed even more dramatically than in the United States. From 1945 until its 1982 debt crisis, Mexico's GDP grew at an average annual rate of 6.3%, not far off the spectacular growth rates in today's developing Asian countries. It should be no surprise that growth then slowed in the decade after the debt crisis. After all, history shows that recovering from a debt-induced recession is typically long and drawn out, as governments, companies, and consumers work to cut their debt and adjust their finances. What is surprising is that the Mexican economy has continued to plod along at a rate of just 2.4% or so (see Figure 1), only modestly beating the average U.S. growth rate of about 2.2% over the same period. That's an enormous disappointment because, since 1982, Mexico has implemented a range of economic reforms geared at liberalizing its markets, increasing competition, and creating a stable operating environment for business. Opening the economy to foreign trade via the North American Free Trade Agreement (NAFTA) was probably the most dramatic reform, but Mexico has also implemented about a dozen other free-trade deals. It has privatized key companies, slashed its budget deficit, and cut its foreign debts.

Figure 1.



Economists generally ascribe Mexico's continued slow growth to structural problems that still have not been addressed. Like many observers, we think the biggest problem is political: Mexico has never been able to move beyond the political culture of the *cuadillos*, or strongmen, who have wielded power in Mexico ever since the time of the Spanish *conquista* in 1519. Even if Mexico is no longer subject to true one-party rule, the law operates only weakly on government officials, breeding chronic, self-serving cronyism, corruption, and impunity. For the economy, the lack of political accountability allows bad policies to remain in place. Key industries such as telecommunications and energy are highly monopolized, with the effect that supply is restricted, prices are high, and innovation is discouraged. Militant unions have a stranglehold on the country's schools, reducing quality and, along with heavy migration to the United States, restricting the supply of skilled workers. In the financial sector, lending is discouraged by the country's history of nationalizations, past financial crises, and a legal system that makes it difficult for lenders to seize collateral from delinquent clients. Finally, draconian tax and regulatory burdens for larger firms discourage start-ups from growing or innovating.

Figure 2.

Mexico did see a glimmer of hope over the last decade, as its relative international competitiveness improved. China, India, and other Asian competitors began to face higher wages and stronger currencies shortly after the turn of the century, making Mexico's costs more attractive in comparison (see Figure 2). In addition, many companies looking to sell into the large, lucrative U.S. market have realized that the distances involved in producing in Asia make them less responsive to their customers, so they have been attracted to the possibility of "near-sourcing" production in low-cost Mexico. Mexico's numerous free-trade deals have also given it the opportunity to diversify its exports. Finally, President Enrique Peña Nieto pushed through a reform program that aimed to eliminate many of the domestic economy's remaining problems in industries such as energy, telecommunications, and education. Unfortunately, vested interests watered down how the reforms were implemented, while external developments have helped short-circuit them. For example, a reform aimed at boosting oil production by allowing private firms into the energy market was implemented just when a surge in U.S. production sparked a massive, multi-year drop in global oil prices. While the government has successfully auctioned off multiple drilling concessions to oil private

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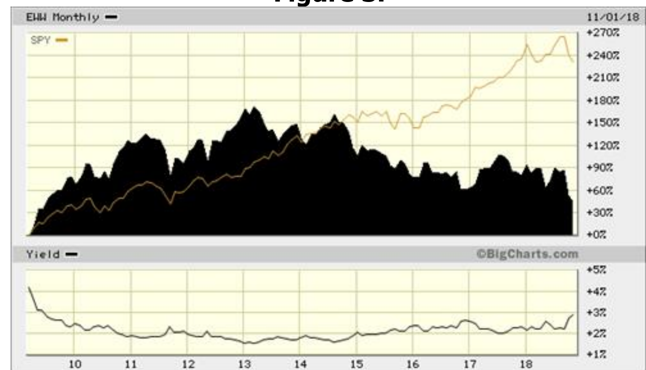
firms, actual successes are still off in the future, and the country's overall oil production continues to fall. In sum, we've seen no appreciable improvements in the structural and social impediments that have weighed on Mexico's economy and financial markets for so long.

Rising U.S. Interest Rates

Of course, even countries facing long-term challenges can enjoy short-term bursts of activity and good investment returns if conditions are right. For decades, those conditions have generally arisen in Mexico only when the United States was recovering from a recession. In those situations, Mexico often sees a strong rebound in exports to the United States, which allows Mexican stock prices to rise even faster than U.S. stock prices. In addition, Mexican financial conditions often improve following a U.S. recession, giving a further boost to its stocks. These positive dynamics are reflected below in Figure 3, which compares the price gains since March 2009 for an exchange-traded fund that tracks a broad index of Mexican stocks (the iShares MSCI Mexico ETF, symbol EWW, represented by the black area) versus a fund that tracks the S&P 500 index of large U.S. stocks (the SPDR S&P 500 ETF, symbol SPY, represented by the gold line). The figure shows that EWW substantially out-performed SPY all the way through mid-2014, but has seriously lagged it ever since. Moreover, conditions after a U.S. recession can also be good for the Mexican bond market. Since U.S. interest rates typically remain low for some time after a recession, the value of the U.S. dollar tends to weaken. In that environment, global bond investors seeking to gain an increased yield and potentially benefit from appreciating foreign currencies tend to channel more of their funds into less-developed "emerging markets" like Mexico.

Unfortunately, emerging markets like Mexico are now facing the opposite situation. Since the end of 2015, the U.S. Federal Reserve has been gradually hiking its benchmark short-term interest rate. After a modest delay, longer-term U.S. rates also started to rise, so investors can now get a decent yield in the U.S. bond market instead of taking on the risk of investing in the emerging markets. Increased demand for U.S. assets has also driven up the value of the dollar and driven down the value of assets denominated in foreign currencies. Investors buying assets denominated in pesos or other emerging-market currencies therefore face a loss from currency depreciation, while foreign entities that borrowed in dollars may find it harder to pay off their dollar debts. The result has been to put significant financial pressure on emerging markets around the world. Earlier in 2018, stock markets in Argentina and Turkey were especially weakened. Finally, the headwinds also hit Mexico. Importantly, we think the Fed will continue to hike U.S. interest rates, so we see little prospect for Mexico to get a breather anytime soon. Rather, we think continued rate hikes in the U.S. will remain a headwind for Mexican stocks and bonds.

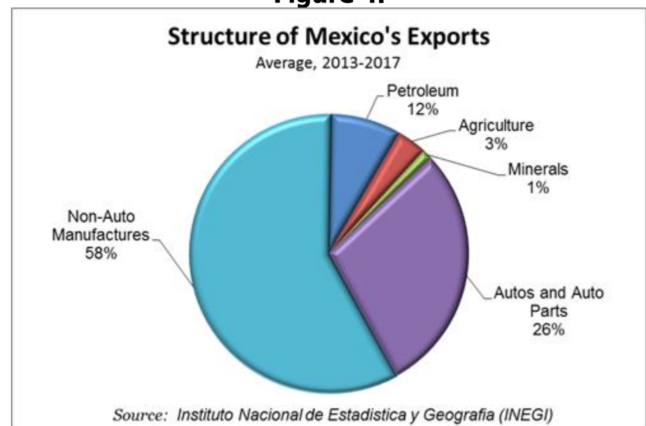
Figure 3.



Trade Tensions

As discussed immediately above, Mexico's stock market tends to perform best when the U.S. economy is rebounding from a steep recession. That makes sense, since the overall Mexican economy is highly leveraged to U.S. demand. Note, for example, that total exports amounted to some 37.4% of Mexico's GDP over the last three years, and that approximately 80.7% of total exports went to the United States. That means 30.1% of all Mexican GDP arises directly from sales north of the border. Finally, although many people still think Mexico's exports are mainly driven by petroleum, the reality is that value-added manufacturing is the country's main source of foreign sales (see Figure 4). When U.S. demand is rebounding or rising briskly, as it is now, much of Mexico benefits through increased factory activity.

Figure 4.



The problem is that the U.S.-Mexican trade relationship is now under pressure. President Donald Trump has fixated on the large U.S. trade deficit, putting much of the blame

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on imports from Mexico even though they are dwarfed by imports from China. Trump therefore pressed hard for an updating of NAFTA, and a preliminary agreement was reached this autumn. As we've written before, we think the overall changes in the document were relatively limited for the United States. All the same, the net impact will likely be to reduce Mexican exports and discourage investment in the country, all of which has the potential to weigh on the Mexican economy and financial markets.

AMLO

In our view, the final major concern for Mexico these days is the political and economic uncertainty unleashed by the country's presidential election last summer. The election was won by former Mexico City mayor and long-time leftist activist Andrés Manuel López Obrador, popularly known as "AMLO." Although AMLO's tenure as mayor of the sprawling capital is generally considered successful and pragmatic, investors are worried about the kinds of populist policies he might put into place once he is inaugurated on Saturday, December 1. On the one hand, AMLO has sent some signals that his economic policies could be as orthodox and practical as his policies in Mexico City. For example, he has selected several orthodox and well-respected individuals for key economic posts. On the other hand, several of his moves so far have sent alarm bells ringing. For instance, he has announced his intention to slash government salaries, producing an exodus of highly qualified policy experts from numerous government agencies. He has also proposed a law to drastically curtail the fees Mexican banks can charge their customers, ostensibly to make financial services more accessible to the public. Finally, and most dramatically, he launched a referendum on whether to continue construction of a major new airport for Mexico City. The referendum, which was run in a way that stacked the deck against supporters of the airport, resulted in the airport being canceled even though billions of dollars had already been spent on the early stages of construction.

The cancelation of the Mexico City airport has widely been seen as a sign that AMLO could make dramatic, unexpected swings in Mexican economic policies, especially in light of his past statements that suggest he may seek to concentrate even more power in the presidency. Among the biggest fears are that some of the reforms implemented by Peña Nieto will be reversed, including the privatization of the country's petroleum industry. We think that could put a new chill on foreign direct investment into Mexico, on top of the negative impact from today's low oil prices. We also suspect Peña Nieto's education reform is at risk, further prolonging Mexico's long-running shortfall in creating solid human capital. Ultimately, however, the big fear for investors is that AMLO's populism could eventually lead to broad, punitive measures against business, including tax hikes, tighter regulation, and even outright nationalizations.

Summary and Conclusion

While Mexico is a large, growing economy with plenty of resources and potential, we think its investment prospects are still limited by long-standing structural impediments and current headwinds from global financial conditions, trade disputes, and political change. We wouldn't necessarily avoid Mexico in all circumstances. As hinted at above, Mexican stocks can strongly outperform U.S. equities in the recovery phase after a recession. Unfortunately, we've already moved well beyond the recovery from the Great Recession, so this doesn't seem to be the time to invest in Mexico. In the current environment, we prefer to get international diversification from large, relatively stable developed countries such as Switzerland and Canada. As always, we continue to monitor global conditions and will adjust our strategy as things change.

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Chief Investment Officer

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