26 March 2020

Mexico: Economic and policy update

Brace for impact; we revise 2020 growth to -7%

- The rapid unfolding of negative shocks home and abroad obliges us to frequently revise forecasts
- We now see negative sequential growth in both 1Q (-4%saar) and 2Q (-35.5% saar) followed by a partial recovery in 2H20
- Social isolation, sudden stops in key economic sectors and a blow to health systems suggest downside risks are still in place
- We expect policy rates at 3% to ameliorate the imminent recession; MXN will continue to act as an automatic stabilizer
- With a 5% fiscal deficit for 2020, another rating downgrade cannot be ruled out soon after today's S&P cut to BBB (negative outlook)

As negative news continues to flow across the world economy and we continue to sail into uncharted territories, it seems increasingly likely that what was originally expected to be a mild recession, will turn into a deep recession, with several shocks occurring simultaneously amid little visibility ahead. Leaders continue to 'agree to disagree' on the right policies to face the COVID-19 crisis, even if monetary authorities are already deploying their big guns and fiscal packages are now being approved. Overlapping shocks will amplify in economies that are less prepared to face a pandemic (who was anyway?) and whose institutional frameworks and their rule of law are weaker. Informality and crime should act as negative feedback loops as unemployment rises, denting confidence for investment and consumption.

There are several factors that are leading us to downwardly revise growth again, and by lower we mean *way lower*. We now see GDP collapsing 7%y/y this year, as activity drops in 1H at a pace not seen in the 2008-09 GFC or the Tequila Crisis of 1994-95. Our colleagues now think the US economy will drop sharply in 1H, as tough social distancing measures (among other factors) hit the economy hard. This would mark the first layer of the strong revision—US weakness. What is troubling is that Mexico appears to be in the early stages of the COVID-19 contagion, and an eventual pickup in the number of cases would likely lead to strict social distancing measures, which as of now have not been enacted (Mexico is said to be in the second phase of the outbreak, as per the Ministry of Health). This marks the second layer. Just as the US might be rearing its head, Mexico might be fully entering the toughest phase of social distancing. So, following a partly externally-driven hit to activity, domestic conditions will likely take the wheel for most of 2Q.

Real GDP forecasts

%q/q saar (except full year)

	1Q20	2Q20	3Q20	4Q20	y/y
Previous	1.0	-15.5	9.0	3.0	-1.8
New	-4.0	-35.5	17.2	4.6	-7.0

Source: J.P. Morgan forecasts.

One of the most concerning issues in Mexico regarding compulsory social distancing is the very pervasive impact it should have on the informal sector, which in its broadest measure encompasses about 56% of the work force.

Lack of appropriate worker protection for this vulnerable share of the population should not only magnify the hit to the economy, and make it extremely painful, but is likely to have broader consequences. President AMLO's popularity is rapidly declining (e.g. this week's GEA-ISA and GCE surveys show approval ratings at their lowest levels since AMLO took office), and a collapse in activity of the expected magnitude, alongside the effect it would have on particularly vulnerable groups, would likely accelerate this decline. There have been remarks about supporting the informal sector of the economy, including SMEs, but few concrete actions have been enacted as of now. President AMLO has said there are about MXN400 billion (more than 3% of GDP) in available resources to help stem the crisis, but as said, few measures have been enacted. As such, we think the strongest hit to activity will materialize next quarter, leading to a massive 35.5% annualized drop in GDP (from -15.5% before).

Finally, we see a third layer, which is shaping up to be more lasting: the effect on potential growth in Mexico. Contrary to what we would have expected in a period of economic distress, the government's latest actions, conspicuously the public referendum to halt the construction (already underway) of a big foreign brewery in the north of the country, created a very negative response from the private sector, where confidence was already very low. This risks not only extending the initial shock to activity, as it seems increasingly clear that as capex pulls back, employment will eventually follow. Also, the persistence of capital weakness for several years (even before the current administration took office) points in the direction of a drop in Mexico's potential growth, which might be settling between 1% and 1.5%. This makes us wary about a strong recovery in 2021 despite the expected sharp contraction in 2020. For the moment we are forecasting a 2% increase, which factors partly this seemingly new equilibrium.

Inflation: Massive output gap to dominate potential further FX depreciation

As we have argued before, we think inflation is going to drop markedly in the very short term (couple of months), accelerate throughout the rest of the year, and fall markedly next year. This pattern would follow the impact of falling energy and tourism prices (shortest term), pass through pressures from a weaker FX (throughout the year), and reflect a massive widening of the output gap that eventually overcomes the fading impact of a weaker currency (next year). Given our new GDP profile, we now think the output gap will lurk at a staggering 9-10%, which implies a big disinflationary impulse to core inflation. Even if we entertain the idea that a sharp currency depreciation could ensue under a scenario like the one being depicted, it would have to be very large to offset the impact of weak activity. As a result, we now think next year's inflation is likely to stand slightly below 3.0%, with core probably at 2.5%, both by year end.

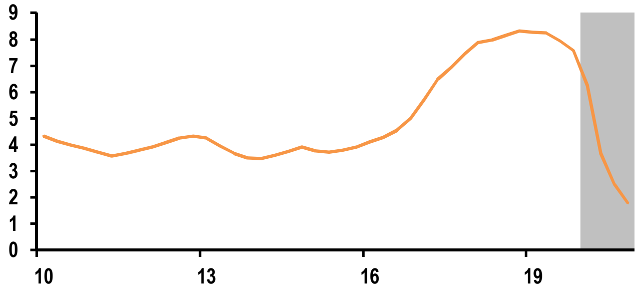
Banxico to do what it can

The fear of an overblown recession in Mexico is likely to be Banxico's driving force toward even lower rates than we entertained late last week, when we updated our year-end rate to 4.5%. If we are right, the drop in activity in 2Q will be massive and could show some early signs quite soon, in which case the central bank's response is likely to be rapid and aggressive (probably an extraordinary meeting in April with a 75 or 100bp cut). There are other considerations, to be sure. There might be the fear of accelerating capital outflows in a troubling scenario, but we think this would materialize regardless of whether the policy rate is at 5%, 4% or 3% if it were to happen.

Against this backdrop, Banxico's potentially best option is to provide as much support as possible to the economy and if bad comes to worse consider potential measures to mitigate the damage afterwards. We thus now think Banxico is likely to take the policy rate to 3%. To be sure, our Taylor Rule (TR) framework suggests the policy rate should in fact reach 1.8% by year-end, but we think that Banxico will refrain from dipping its toes below zero in real rates. Banxico cut to 4.5% during the GFC and eventually to 3% in the early years of the previous administration.

Mexico TR implied policy rate

% p.a.



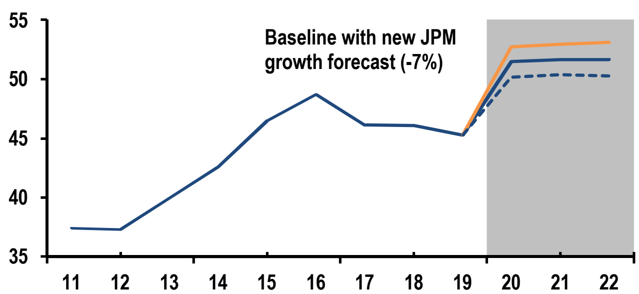
Source: J.P. Morgan. Sample 2009-19.

Fiscal deterioration likely to fast track credit rating downgrades

Amid a whopping 7% contraction, a sharp currency depreciation, and limited budget space to cushion the economic shocks in the short term, we expect debt-to-GDP to deteriorate significantly, from 45% to 51% at the end of this year, which will probably result in a downgrade by Moody's sooner rather than later. Earlier today, S&P cut Mexico to BBB, leaving a negative outlook, which suggests a second downgrade could happen in the next 12 to 24 months. Moody's rating is A3, still two notches above S&P, so we also believe they would be likely to maintain the negative outlook on after a downgrade. We expect a fiscal deficit of 5% this year as the government has now abandoned its binding primary surplus constraint, and revenues are compromised by the strong recession. At some point we thought that fiscal challenges and rating downgrades fears could have altered the pace of cuts of the central bank, but these are not normal times, so we expect sharp cuts to continue in the next few months.

Public debt projections with udpated 2020 GDP and lower potential

% of GDP



Source: J.P. Morgan with data from Banxico, Ministry of Finance, Bloomberg.

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