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SEPTEMBER 2018

MEXICO—A CALMER NEAR-TERM OUTLOOK BELIES A SEA CHANGE IN POLITICS

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In the final week of August, we traveled to Mexico to get a feel for things on the ground following the country's elections, in which left-wing contender Andres Manuel Lopez Obrador, locally known as AMLO, was elected president. The trip was well-timed, as it gave us the opportunity to evaluate how the upcoming leadership change and more positive North American Free Trade Agreement (NAFTA) negotiations were affecting business sentiment. Members of our Latin America analyst team accompanied me, as did Malik Asif, the associate portfolio manager for our Emerging Markets Equity Strategy.

KEY TAKEAWAYS

- Andres Manuel Lopez Obrador won by a landslide. What does this mean for Mexico? Thus far, AMLO has exhibited a market-friendly approach. But after two decades of right-wing, multiparty rule, his left-wing politics and unprecedented majority in Congress could enable him and his government to make significant changes.
- The companies we visited expressed some relief over AMLO's more moderate, centrist tone, but they were skeptical and will be closely monitoring developments as he puts his administration together and formulates policies.
- We returned from the trip incrementally more positive about Mexico's near-term outlook. A revised NAFTA agreement with the U.S. would improve investment in the country. And AMLO's planned subsidies should boost consumption. Medium and longer term, however, we are concerned that his government could create fiscal imbalances if energy is nationalized and social programs are expanded.
- While valuations still look attractive in the real estate sector, we are finding few new opportunities as the market has largely priced in the better news.

A CLOSER LOOK

Mexico's near-term economic prospects look incrementally better. Gross domestic product growth should accelerate over the coming quarters, with support from strong exports and improved consumer spending. AMLO, who

takes office on December 1, has planned subsidies, which should increase disposable income during a time when the labor market is tight. As a result, we should see real wages grow. However, we are concerned about how AMLO's policies will play out longer term. AMLO inherits a growing country on sound fiscal footing. Yet it was clear from our trip that voters expect change. And he will have substantial power to modify and enact legislation. Historically, this combination has inspired populist politics.

Corporate management teams largely shared our views. While somewhat heartened by AMLO's more conciliatory postelection rhetoric, corporations and policymakers will be closely watching his December 2019 budget proposal and the appointment of a board member to the Central Bank of Mexico (Banxico).

We met with an energy expert who is a member of AMLO's team and likely to be appointed to a senior position at state-owned energy company Petroleos Mexicanos (Pemex). Changes in energy policy were a key part of AMLO's electoral platform. The expert, while knowledgeable and reasonable, had a left-wing mindset and emphasized that increasing domestic gasoline and natural gas production are matters of national security and take priority over economic considerations. On a more positive note, he seemed happy to maintain private sector participation in pipeline and other energy infrastructure projects.

We also had meetings with some of the larger banks. With the risk of the U.S. exiting NAFTA now gone, investment should continue, meaning higher demand for corporate loans. The sector expects loan growth to rise to 12% from 10% this year. One of our more positive meetings was with a smaller, high-quality franchise that has developed a strong operational niche in lending to small-to-medium enterprises. The senior management was optimistic that loan growth would accelerate and noted that the bank is reducing interest rate sensitivity before Banxico begins to loosen monetary policy. The bank has invested effectively in information technology. More than half of its transactions are now digital, and customers should soon be able to open checking accounts online in under five minutes!

While interest rates should begin to fall next year, they are still relatively high at 7.75%, which has hurt the real estate sector. We met with the management of a Mexican real estate investment trust, specializing in commercial real estate. We've held a decent-sized position in the stock for some time, and the meeting reinforced our premium view of both the portfolio's assets and company management. We believe that management knows how to develop high-quality malls, and we're encouraged that its investment in a new Mexico City mall is ramping up quickly.

Meetings with consumer companies confirmed the better outlook for consumption. Management teams were optimistic about profit growth, and, indeed, many Mexican consumer stocks have outperformed their Latin American peers. As such, valuations look full, and we hesitate to add to or buy at these levels. We also met with a multi-format retailer, which is well positioned to benefit from rising disposable incomes, given its leading competitive position and scarcity value. The management's proactive moves in the digital space should help defend against online-only competitors.

Looking forward, we will be laser-focused on AMLO's next moves. If the credible people he has appointed thus far execute well and stay in office, this could be further proof that his views have evolved. But given AMLO's background and the extent of his large majority in Congress, we remain cautious for now.

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