Emerging Markets: A Letter from Mexico

Our specialist Emerging Markets equities investment partner, Northcape Capital, recently returned from a trip to Mexico. In this paper the team delves into some of the economic and geopolitical factors underpinning the strength of the Mexican market. The team also discuss insights gained from meetings on the ground with various companies, economic and political experts.

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This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

A letter from Mexico

Following our recent research trip to Mexico, we delve into some of the economic and geopolitical factors underpinning the strength of the Mexican market. And we discuss some of our insights gained from engagement with various companies and economic and political experts on the ground.

Throughout our travels, three prevailing topics took centre stage in our conversations:

1. Nearshoring
2. The robust performance of the Peso ('Super Peso')
3. The forthcoming 2024 election.

In this series of discussions, we will first explore the dynamics surrounding the Peso's strength and the nearshoring trend. Later, we will shift our focus to the highly anticipated 2024 election.

Nearshoring – Mexico’s moment

In the 19th century, Mexican dictator Porfirio Díaz famously lamented, “Poor Mexico, So Far from God, So Close to the United States.” This enduring quote encapsulates the intricate and often convoluted history that binds Mexico and the United States.

The phenomenon of US companies strategically positioning segments of their supply chains in Mexico is hardly a recent development. Mexico has long presented an attractive, cost-effective alternative for American businesses compared to domestic production, with the 1994 North American Free Trade Agreement (NAFTA) and its 2018 successor, the United States-Mexico-Canada Agreement (USMCA), laying the foundation for this symbiotic economic relationship. This phenomenon holds a newfound significance, particularly in a world marked by ongoing China-US tensions.

Mexico's appeal as a cost-effective investment destination for American companies seeking to diversify away from China has surged, evident in the remarkable 40% increase in Foreign Direct Investment (FDI) from the US into Mexico this year. This influx of capital is a key element contributing to what is colloquially known as the 'super peso.'

Despite its geographic proximity to the United States, Mexico's GDP growth has historically hovered in the range of 2-3%. **However, the current year presents a notable departure from this trend, with growth anticipated to reach around 4%.**

While Mexico has always possessed geographic and demographic advantages, a certain element of serendipity has played a role in this recent surge. Escalating tensions between China and the United States have positioned Mexico as a desirable player in the global economic landscape, capturing the attention of American CEOs.

This focus on Mexico has created substantial demand for land, warehouses, and skilled labour. **The term 'friend-shoring' or 'nearshoring' has become ubiquitous in conversations among Mexican and global businesses**. **Vesta** – Mexico’s largest industrial property company and a holding in the portfolio has been a large beneficiary of this trend. Vesta is enjoying strong demand for its industrial properties thanks to the flock of US companies looking to establish a presence in Mexico. The northern city of Monterrey – a key market for Vesta, has seen industrial rental rates surge by over 35% over five years. Monterrey’s proximity to the border has made it a hub for industry giants such as Tesla and Foxconn. The entry of these companies to the area has bought with it significant foreign direct investment. **Tesla** plans to establish a US$15 billion assembly plant on land acquired in Monterrey, whilst **Foxconn's** US$1 billion investment in its site is already making waves.

Perhaps most impressive is the speed at which nearshoring is happening. Industry statistics show Mexico is rapidly displacing parts of supply chains once located in China. An example can be seen in the **automotive sector, where by 2025, an astonishing 40% of the production chain in Asia is expected to be relocated to Mexico.**

This surge in investment activity has seen Mexican companies achieve record profitability. It is no surprise that during our discussions management teams were focused on return on invested capital and returning excess funds to shareholders. This increased attention on returns is welcomed by Northcape given our affinity for businesses with superior returns and strong top line growth.

The rise of the "super" peso

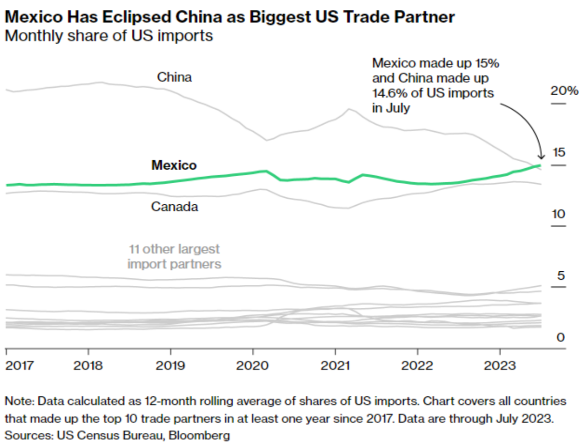
Whilst most EM currencies have seen their currency depreciate in 2023, the **Mexican peso has risen 14% against the dollar this year**, outperforming many of its international peers and leading to bragging rights for President Andrés Manuel López Obrador ("AMLO"). The peso's rise owes its momentum to a confluence of factors, including the assertive stance of the central bank (marked by the 6% rate differential in favour of Mexico over the US), an influx of manufacturing investments amidst the global rebalancing of supply chains, and an unexpectedly stringent fiscal policy.

In a stark contrast to many Western economies, the **Mexican Central Bank has been very proactive in addressing inflation.** The Central Bank's decision to hike sooner and faster has ultimately kept inflation in Mexico under control and propelled the peso to new levels. Added to this is the bilateral trade between the US and Mexico. The flurry of new investments and capital inflows into Mexico is driving superior profits as a result.

While a strong currency generally hurts exports, this hasn't been Mexico's experience recently **as the country overtook China as the top exporter to the United States this year (see Exhibit 1).** This positive trend further supports our overweight position in Mexico.

Whilst AMLO is celebrating the "super peso", for the many Mexicans who rely on remittances this is no cause for celebration. Mexico takes in nearly US$60bn a year in remittances (4.3% of Mexican GDP), mostly from the US, making them a pillar of household spending in a country that is now one of the biggest beneficiaries of cash transfers worldwide. Consequently, US dollars no longer stretch as far as they once did, creating challenges for many households. Despite the advantages that a stronger local currency brings to the economy, especially in terms of citizens' cost of living and the Producer Price Index, Mexico's high dependency on remittances places the nation in a somewhat precarious economic position.

Exhibit 1: Mexico monthly share of US exports



2024 Election (scheduled 2 June)

President AMLO assumed the role of the 65th President of Mexico on December 1, 2018, following a previous tenure as the Head of Government of Mexico City from 2000 to 2005.

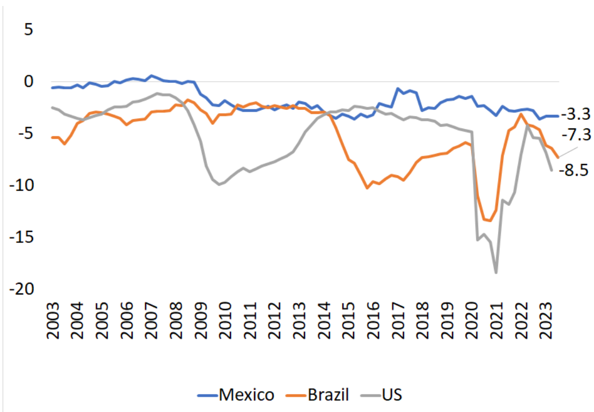
Before his successful 2018 presidential campaign, AMLO made two previous attempts to secure the presidency. Following his 2012 loss, AMLO distanced himself from the Democratic Revolution Party (DRP) and embarked on the task of founding a new political entity known as the Movement for National Regeneration (Movimiento de Regeneración Nacional), or MORENA. This effort led to MORENA's official recognition as a political party by the INE (National Electoral Institute) in 2014.

In his third bid for the presidency, AMLO represented the MORENA party and secured victory on July 1, 2018, with 53% of the popular vote. This win marked the first time a candidate had won an outright majority since 1988 and the first instance in which a candidate outside of the PRI (Institutional Revolutionary Party) or its predecessors had achieved such a feat since the Mexican Revolution.

When AMLO secured victory, he made a pledge to prioritise the welfare of the underprivileged. Despite expectations of unrestrained spending to fulfil this promise, his approach has been characterised by smaller budget deficits and a more conservative approach to accumulating debt compared to many Latin American leaders.

During the pandemic, a time when most leaders unleashed fiscal stimulus to support their economies, AMLO was tight-fisted spending less than 2.5% of GDP to protect against COVID. **This reluctancy to spend has led to a fairly healthy fiscal position for Mexico, a stark contrast to many of their peers in LATAM. Exhibit 2 below shows Mexico's fiscal deficit (-3.3 % of GDP),** vs the US (-8.5%) and Brazil (-7.3%).

Exhibit 2: Mexico Budget Balance (% GDP) vs US and Brazil



(Source: Bloomberg)

Only more recently has the government raised discretionary spending significantly. Going into the 2024 election the Mexican government plans to run up a larger budget deficit that will widen from 3.3% of GDP in 2023 to 4.9% in 2024. Much of the additional spending will cover social programs and funding flagship infrastructure projects.

The President of Mexico is elected for a single six-year term and is constitutionally prohibited from seeking re-election, making each presidential election in Mexico a non-incumbent contest.

While ineligible to run again, AMLO is resolute in his desire to pass on the torch to a successor from his own party, who will continue the political movement that propelled him to power in 2018. There is a risk that AMLO will become more adventurous with his industry policies in the final months of his term, as witnessed by the very recent move to negatively change regulation of Mexico's private airports.

Despite maintaining a relatively high approval rating of approximately 67%, it is uncertain whether this level of approval will be seamlessly transferred to his chosen successor.

AMLO has recently endorsed 61-year-old Claudia Sheinbaum as the candidate representing MORENA who will follow in his footsteps as his protégé. If she secures victory in the election, she will not only become Mexico's first female leader but also the country's first Jewish president.

Exhibit 3: Claudia Sheinbaum with AMLO

(Source: L.A. Times)

Claudia Sheinbaum was born into a relatively wealthy family in Mexico City with two science professors as parents. Sheinbaum pursued a career in academia herself, specialising in physics to eventually become an engineering professor. Her research primarily focused on energy usage within Mexico's buildings and transportation systems.

Whilst Sheinbaum holds progressive views on energy and climate she has vowed to consolidate AMLO's legacy thereby aligning herself with his political base. Thus, **Sheinbaum would provide the most continuity to the AMLO administration and caters to MORENA's left-leaning supporters.**

Whilst AMLO's hard-core voters follow him almost religiously, Sheinbaum lacks her mentor's charisma. It is unclear whether she will continue AMLO's agenda (as she has said) or modify it in important ways. Sheinbaum's strong left policy orientations in fiscal, social, cultural and environmental matters is evident when she speaks about climate change and the need for progressive fiscal policy. At other times however, she seems closer to AMLO's half-hearted conservatism in favouring militarisation.

The opponent: Xóchitl

In contrast to Claudia Sheinbaum, the leader of the opposition, Xóchitl (pronounced "so chill") Gálvez, is widely regarded as a very likeable and charismatic candidate. Xóchitl's communication style has drawn comparisons to AMLO's during his successful presidential campaign, which ultimately led to his election victory.

Xóchitl hails from a humble background, coming from the very small town of Tepatepec (pop. 11,000) in the state of Hidalgo. This is a clear factor that has contributed significantly to her appeal and could potentially help her make inroads into MORENA's large, low-income voter base. (Xóchitl claims that, as a child, she sold desserts at the local market to support her education and family).

Regarding her policy approach, Xóchitl has been actively engaging with the private sector, emphasising topics such as nearshoring, fostering investments, reforming the energy sector by allowing private investment in renewables and improving education.

Given Xóchitl's popularity, it comes as no surprise that AMLO has focused on discrediting her. The revelation of Xóchitl's home address by the MORENA government has raised concerns about her personal safety. Another more recent example from the incumbent government is the fishing expedition into her university thesis for Computer Engineering which found she did not cite the correct sources. The claims that this shows a “lack of integrity and academic honesty” is an example of the tactics MORENA is prepared to deploy to maintain leadership.

Exhibit 4: Xóchitl Gálvez (Source: Bloomberg)

The eventual winner of the presidential election, however, will inherit a complex scenario with less flexibility than AMLO enjoyed in 2018. The two key areas of complexity lie in the **fiscal landscape and the energy sector.** It is too early in the race to determine what policies each might look to enact however, at this stage both candidates appear to have similar views on the energy sector.

Conclusion

Northcape has maintained an overweight position in Mexico for many years, primarily driven by the country's favourable sovereign risk rating, benefits from nearshoring and attractive demographics and given the number of high-quality companies listed in Mexico. **Our investments span across various sectors in Mexico, including transport, telecom, financial, consumer, and property, and have proven to be exceptionally well positioned in light of these positive trends.**

However, the upcoming 2024 election may introduce some volatility in the capital markets, and it seems investors would probably prefer Xóchitl Gálvez over Claudia Sheinbaum. In our view even if Sheinbaum wins, the underlying positive structural trends in Mexico will remain, although GDP growth is likely to be lower than what would be possible under Xóchitl. Importantly, if the situation deteriorates materially, we have the processes in place to downgrade Mexico status and adjust our portfolio position.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au