بنك أبوظبي التجاري ADCB

Tactical overweight on Mexican equities

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- **We see an opportunity in Mexican equities because they have significantly underperformed their emerging market peers as a result of a) a particularly restrictive monetary policy, b) fears of a Trump presidency.**
- **With the likelihood of a Trump presidency now fading, potential peso strengthening should stabilize the country's price- and macro dynamics, such that equity markets can recover.**

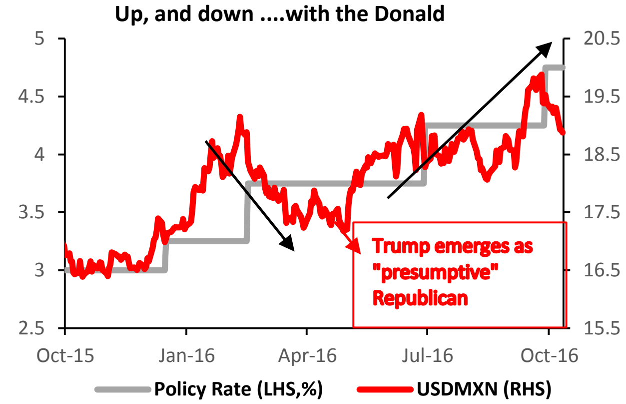
A note on our tactical equity calls

We have been underweight the global equity asset class since February 2015. This key call has proven prescient as the global MSCI index peaked in April 2015. At the beginning of this year we reinforced our bearish equity outlook by overweighting, within our equity holdings, the more defensive US equities, thereby reducing our clients' exposure towards the more vulnerable European and Japanese markets. Our bearish stance has, however, not refrained us from making tactical calls on specific equity markets, whenever we saw an opportunity. In fact, the moment we went underweight global equities, we made a currency-hedged tactical call on Swiss equities, as we anticipated that Swiss companies would massively cut costs following the revaluation of the Swiss franc. In June 2016 we took a tactical call on Emerging equities (which we have in the meanwhile also closed), as we expected global central banks – in particular the Federal Reserve – to ensure that global liquidity would remain abundant in the aftermath of the Brexit shock. We are currently currency-hedged tactically overweight UK equities, as further pound sterling devaluation is likely to benefit UK equities, in particular blue chips.

It is important to stress that we remain extremely cautious about the global equity asset class (we are underweight, after all). As such, it makes perfectly sense that the two currently open tactical calls (currency-hedged UK equities and Mexican equities) are defensive in nature. In other words, while we see for both calls a reasonable upside, we also think that - if things should turn globally sour faster than expected – the downside for these two calls is relatively limited. Within the advanced markets space, UK equities could still deliver positive returns even in a global market correction, making the reasonable assumption that the pound sterling devalues further. The Mexican call is admittedly trickier, but within the emerging markets space, Mexican equities are not very exposed to China and are already pricing in slower growth in North America. As such, they should hold up relatively better in case of a global market correction.

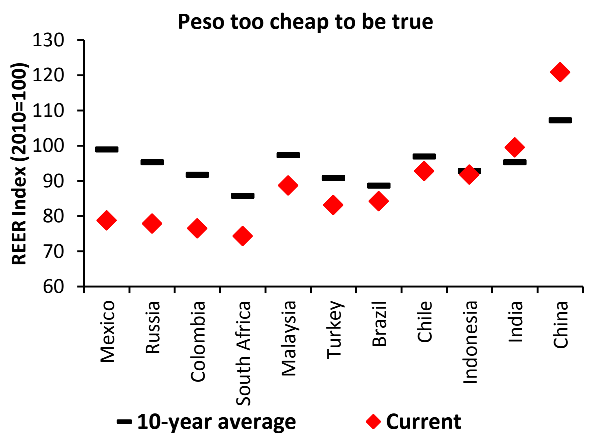
The macro-economics behind our Mexican equity call

The recent and massive devaluation of the Mexican peso (10% since May 2016) has occurred after the country's central bank had enacted a series of rate hikes, and after the currency had started to give signs of stabilization following that more restrictive policy stance. Given the importance of trade with the US and remittances from Mexicans working in the US, it seems therefore not that farfetched to assume that the renewed downward pressure on the peso had a lot to do with the emergence, last spring, of Donald Trump as a serious contender for the US presidency.



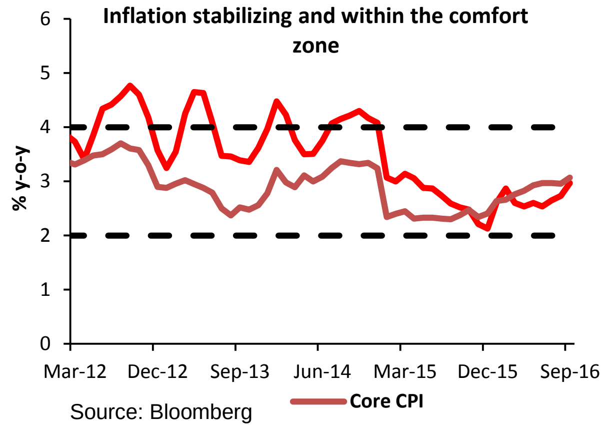
Source: Bloomberg

The resulting stark deviation from the country's average Real Effective Exchange Rate, the peso is now really cheap compared to its emerging market peers, confirms our suspicion that US elections fears might well have been behind what likely has been a typical case of currency undershooting.



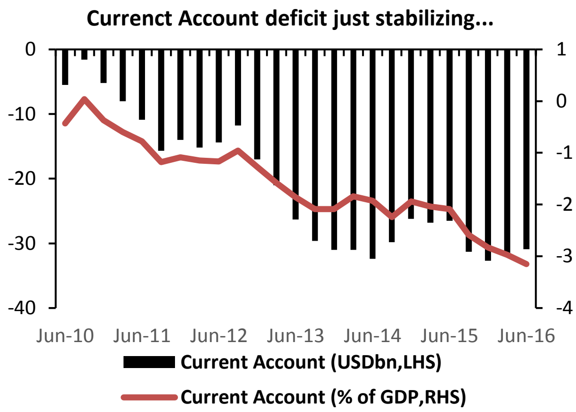
Source: Bloomberg

It is also worthwhile to point out that a stabilization, if not strengthening, of the peso, as a result of the prospect of the Trump presidency hypothesis fading away, should finally stabilize domestic prices and allow the central bank to halt rate hikes with a view of not precipitating an unwarranted slowdown. In this regard we observe that the central bank has reduced its 2016 growth forecasts four times this year, most recently to an estimate of 1.7-2.5%.



Source: Bloomberg

Over a longer period, Mexican macro concerns are here to stay as the country struggles to control its current account deficit and public debt dynamics. These issues are unlikely to disappear overnight as the lower oil price and slower growth in the United States have inevitably reduced the future stream of cash flows into the country.



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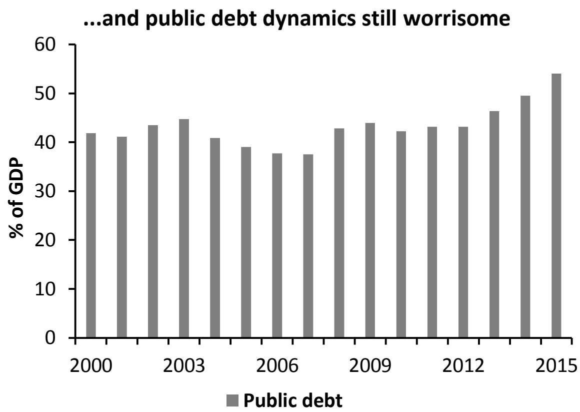
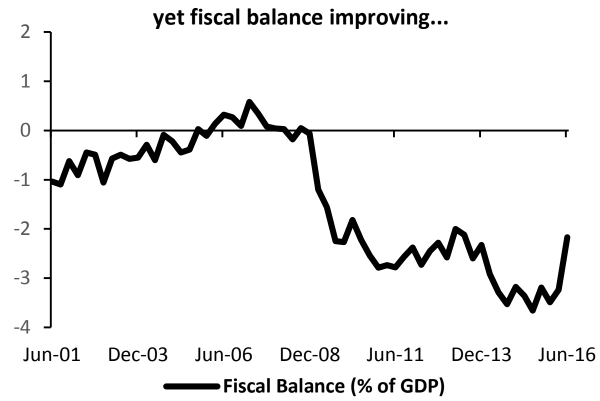


Source: IMF

Over a shorter horizon, however, the marginal stabilization in trade would also favor a stronger peso, as would the government' successful reduction in the fiscal deficit. Again, what matters now is that the likelihood of a Clinton presidency is adding to the positive currency momentum of timely restrictive monetary and fiscal policies. It is doing so by removing the threat of a further deterioration of (US) trade flows, as well as any concern that the US could somehow hamper the regular flow of remittances into the country.



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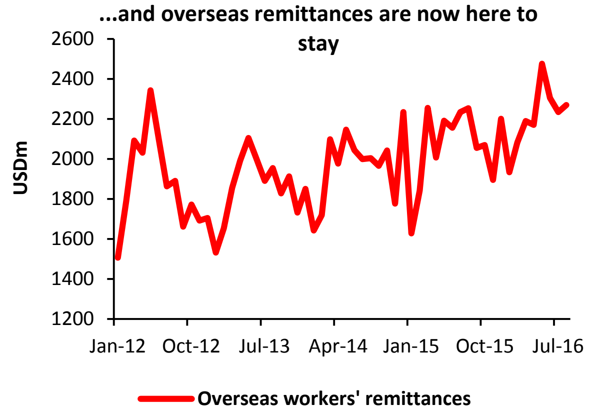


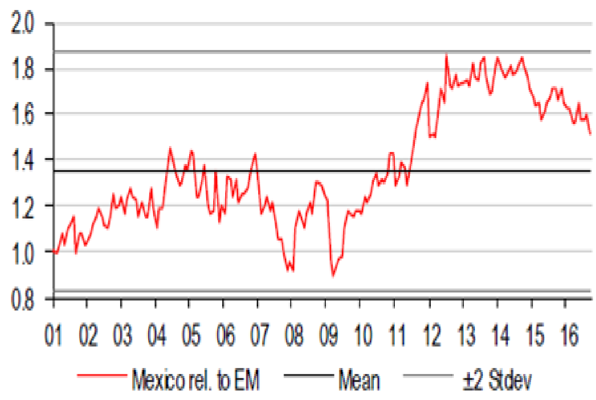
Source: Banxico

The case for Mexican equities

A stronger peso is likely to push Mexican real yields, currently amongst the highest in the emerging markets space, lower. This, in and by itself, should support Mexican equities which this year have massively underperformed the overall emerging markets space (+1% versus +10%). If, however, global equity markets would again move into a risk-off mood, say because of strong global dollar strength which would put downward pressure on oil and commodity prices and reignite capital outflows out of China, then it should be mentioned that Mexico is traditionally a defensive market. It is politically relatively stable and for sure less exposed to China (unlike markets such as, for example, Russia and Brazil).

The defensive nature of the Mexican market is reflected in the fact that it has historically enjoyed a significant risk premium over other emerging markets. In other words, it is a "less emerging" market, and as such it should correct less in case of global market jitters.

Mexico is traditionally a defensive play



12-month forward PE relative to EM; indexed to 1 at Jan 2001

Source: MSCI, IBES, Thomson Reuters, HSBC

Conclusion

The risk of a Trump presidency is very likely behind the reversal of the bottoming of the Mexican peso that had started at the beginning of this year. The ensuing interest rate hikes (to prevent the currency from further depreciating) have determined an unwarranted underperformance of Mexican equities, both vis-à-vis other emerging markets and advanced markets. Over the next coming weeks, increasing speculation that Mrs. Clinton will win the presidency, is therefore likely to lead to a strengthening of the peso, as well as Mexican bonds and equities. At the same time, the Mexican market is relatively defensive such that it should suffer less when global market jitters will resurge. Thus the risk-reward profile appears to justify this short-term opportunity.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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