Mexico:

A Country in Transition

We have been traveling regularly to and investing on and off in Mexico for over thirty years. We have seen the Peso strengthen and bust a couple of times; government-owned banks privatized and then bust; an ongoing roller-coaster ride in the Bolsa. Through it all, we have been big believers in the long-term prospects for the country, its economy, and financial markets. However, it is clear that a thoughtful process regarding entry and exit points is required.

High Valuations, Low on the List

In our country-ranking methodology we have seen the Mexican stock market move around our attractiveness list quite a bit. For several quarters, however, it has been lurking at the bottom of the pack as extremely high valuations (relative to its own history as well as to the other thirty countries in our model) have kept the market in an unattractive zone, which currently means the absolute bottom of our list. Consider some of the positives and negatives related to Mexico in the following tables.

Mexico: May 2014 Rankings (Out of 32 Countries)

Overall Rank	Last Month	Fundamentals	Momentum	Risk	Valuation
• 32nd	• 31st	• 9th	• 29th	• 9th	• 32nd

Mexico: The Good

Factor	Data Point	Rank	Value
• Fundamentals	• Leading Economic Indicator Growth	• 2nd	• 0.51%
• Risk	• Currency Valuation	• 2nd	• 4.90%
• Risk	• Change in Semi-Standard Deviation	• 5th	• -4.53%
• Risk	• Currency Competitiveness	• 5th	• 2.58%
• Fundamentals	• Current Internal Growth Rate	• 9th	• 8.60%

Mexico: The Bad

Factor	Data Point	Rank	Value
• Valuation	• 12 Month Forward P/E Ratio	• 32nd	• 17.56x
• Valuation	• 5 Year P/E Ratio	• 31st	• 21.06x
• Momentum	• 9 Month Momentum Score	• 30th	• 0.01
• Valuation	• Price to Book Value	• 30th	• 2.79x
• Risk	• Change in CDS Spread	• 29th	• 0.14%

For some of the reasons shown above, on a tactical basis, we have been without Mexico in our global and international portfolios and actually short in our long/short portfolio. There are some interesting headlines, however, that we are tracking closely. Energy reform has been talked about for decades, but is only recently, with the election of the new president Enrique Peña Nieto, actually becoming realtiy. Since 1917 with the creation of the current Mexican constitution, the government has controlled oil and its derivatives, basic petrochemical industries and the generation of electricity. In 1938, Presidente Lazaro Cardenas nationalized the entire Mexican oil sector. This has meant that, in practice, all profits that are generated from the state-run petroleum agency ("PEMEX") have flowed to the federal budget. Investments in new technologies, required capital expenditure, and deep water exploration have been woefully insufficient.

Recent Regulation & Reform

In December, historic constitutional amendments were passed, laying out the terms under which private companies will be able to bid on energy projects. In April, the government laid out new proposals implementing regulations to its congress that will dictate how it plans to open up its oil and gas resources for international private investment. There are more key dates in the timeline towards eventual implementation. The biggest is a special session of Congress planned for mid-June, at which time Congress will debate and vote on the regulations that have been put forth. A simple majority of 51% is required for passage. Regulations will lay out the specifics on bidding rounds, contracts, tax structures, etc. There will be additional detail on the different type of profit-sharing arrangements companies can use, including licenses and production-sharing agreements.

Mexico is showing itself to be very aware of how to compete internationally. A 25% minimum national content threshold will be enforced staring in 2025. Both of those variables are considerably friendlier than the Brazilian market, which was privatized in 2008. An overhaul to the fiscal regime has also been unveiled which is quite progressive and should make investment in Mexico's energy projects more appealing. The royalty will be as low as 10%, which will compete aggressively with other international markets.

The Bigger Picture

Check back occasionally as we update the progress on this topic. The momentum and outlook is strong. What will it mean for the country, its markets, and investors? There are no real direct ways to play this theme via Mexican companies in a pure sense. There will be positive knock-on effects that will be analyzed and assessed for petrochemical, cement, infrastructure, and financial companies. The bigger picture has to be seen as quite positive. It is hard to forecast precisely, but we are seeing research estimating 2.5 million new jobs by 2025. GDP could increase by 1% to 1.5% as a result of the reform. This kind of activity could translate into higher demand for goods and services. Emigration to the US could subside. In the US, the multiplier effect in the energy sector shows one new job created in the oil and gas industry supports four more indirect jobs; hopefully that kind of multiplier effect will be seen in Mexico. Government revenues certainly would increase, lower energy prices would reduce the need for electricity subsidies, and public financial pressures would ease. US companies that currently operate in the Eagle Ford should find it easy to extend their expertise across the border where the same formation flows into Mexico. The geographic regions of Tamaulipas, Nuevo Leon, Coahuila, Dallas, Houston, San Antonio and the actual border towns could see huge direct investment. If these various benefits begin to show themselves as realities, the Peso could strengthen as well. Mexico will be a strong candidate for rating agency upgrades.

Sources: Bloomberg, BBVA, Morgan Stanley, UBS, Credit Suisse

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