May 17 2024
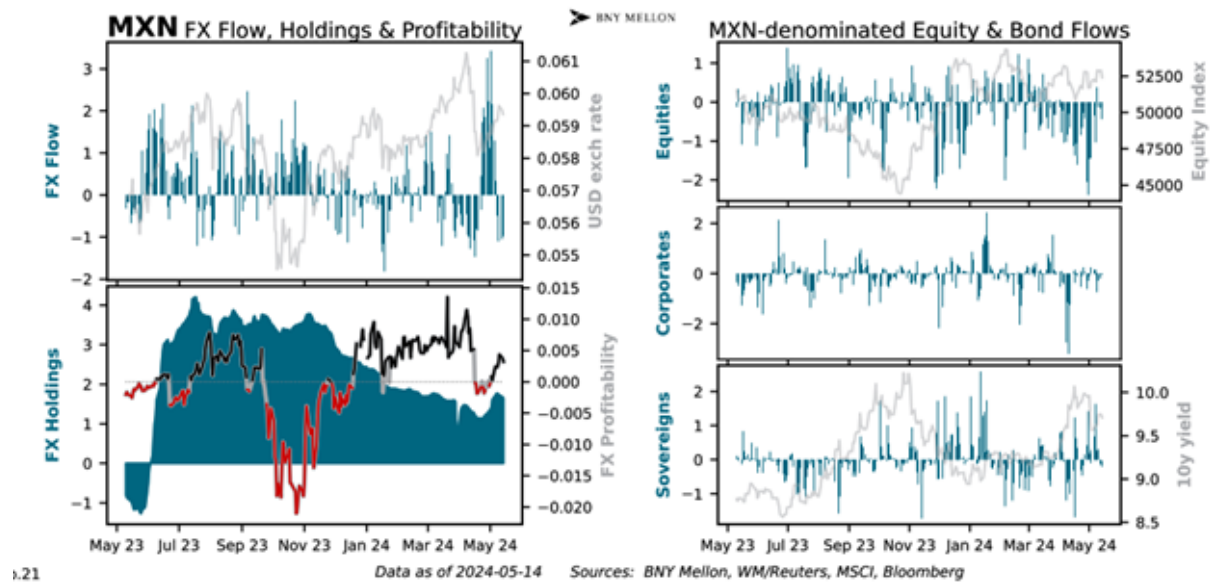
Mexico Election Risks & The Peso

Mexico has become the largest trading partner of the US, overtaking Canada last year, and the peso has enjoyed a significant rebound since the pandemic. Outgoing President Andres Manuel Lopez Obrador (AMLO) has presided over a significant rise in growth and inflation, as well as the budget deficit rising from 2% to 6% of GDP. The country's June 2 election will be important internationally as well, e.g., to markets with MXN having become the anchor leg of carry trades because of high real rates and stable growth. Mexico is also a favorite destination for onshoring investment flows and could be a hot-button issue in the November US election.
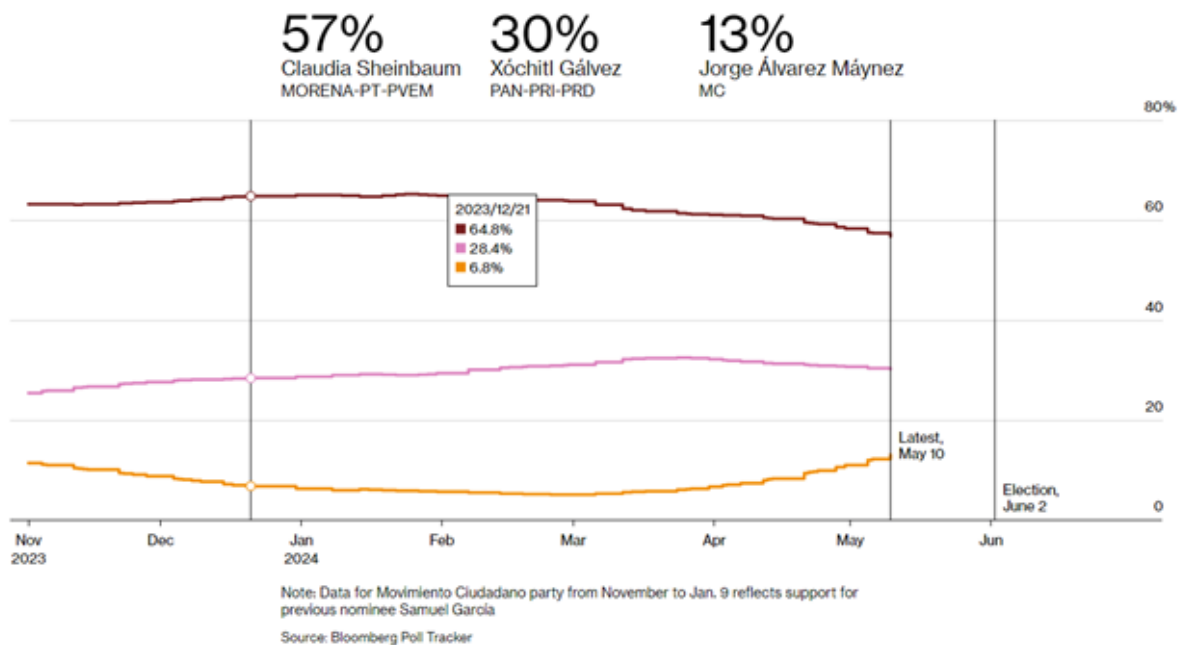
- Mexico election risk appears underappreciated by markets – as shown in FX options. The election campaign started March 1 with MXN 1m at-the-money option volatility at 9.82%. Now it's 12.08%, after a test over 16% during Iran-Israel geopolitical worries (18.20% traded in Asia). Prior to that jump, this option vol traded 16.20% in early April.
- Onshoring money flow has been significant, up 12% y/y to $36.1bn in 2023, while total exports rose to $493bn. US FDI alone last year was $13.6bn, plus $15.6bn in remittances. Of the $434bn in exports to the US, autos, auto parts, and data processing led the way. The risk of Mexico FDI dropping back in 2024 would seem linked to how the China-US relationship evolves.
- Mexico has not enjoyed the same flows or support in 2024 as it did in 2023 – making the election that much more important to asset positioning and investors. iFlow shows negative equity flows since March; corporate bond flows were also negative but sovereign bond flows mixed. Despite some unwinding this year, MXN holdings suggest longs remain.

Exhibit #1: MXN Holdings & Asset Flows

MXN FX Flow, Holdings & Profitability — MXN-denominated Equity & Bond Flows

Data as of 2024-05-14   Sources: BNY Mellon, WM/Reuters, MSCI, Bloomberg

Source: BNY Mellon

Most investors assume the June 2 election will be a non-event. Historical experience suggests otherwise. Polls still show Claudia Sheinbaum, the former Mexico City Mayor and ruling party candidate, leading with 49% of vote – according to a Mitofsky poll for El Economista. In second place is opposition coalition PAN candidate Xochitl Galvez with 28%, followed by center-left MC candidate Jorge Alvarez Maynez at 10.3%. Both opposition candidates are up from April by 1-2% and by 6-8% from March. Another 12.7% said in the May poll that they either would not vote or had not yet decided. Some pressure is reportedly being put on Alvarez Maynez to drop out to give Galvez a better chance to defeat the ruling MORENA party. The last debate ahead of the vote is May 19 and will focus on crime, foreign policy, and immigration. The Bloomberg aggregate poll tracker (exhibit #2) highlights the rise in Alvarez Maynez support and suggests he may be taking support from Galvez.

Exhibit #2: Bloomberg Aggregate Polling Shows Race Tightening

57%
Claudia Sheinbaum
MORENA-PT-PVEM

30%
Xóchitl Gálvez
PAN-PRI-PRD

13%
Jorge Álvarez Máynez
MC

2023/12/21
■ 64.8%
■ 28.4%
■ 6.8%

Latest,
May 10

Election,
June 2

Note: Data for Movimiento Ciudadano party from November to Jan. 9 reflects support for previous nominee Samuel García

Source: Bloomberg Poll Tracker

Source: Bloomberg, BNY Mellon

The 500-person Chamber of Deputies will also be changing in the election – 300 by winning the vote and 200 allocated using proportional representation. The 128-seat Senate similarly has 96 elected by winning the vote and 32 appointed by proportional representation. The risk for the election may reside in the regional vote and how the various parties split, with the risk of whomever is elected facing split control of the Chamber and/or the Senate. At present, MORENA lacks the two-thirds majority needed to fast-track change. After this election it seems likely to be worse off. Further, the role of drug cartels in interrupting the vote and the credibility of the election shows up in the notable campaign violence – 170 attacks including 30 murders, 77 threats to life, and 11 kidnapped candidates, according to El Pais.

Key issues for Mexico voters –

1. **Crime and violence.** Intentional homicides rose from 30,000 in 2018 to a high of 36,773 in 2020, before falling back to 29,675 in 2023. The Mexico Peace Index using GPI reported over a 3% drop in homicides and a 1%-plus improvement in all factors. Fear of ongoing violence has led Sheinbaum to pledge her Mexico City approach in coordinating police and National Guard efforts, along with speeding up judicial efforts. Galvez has pushed for increasing the National Guard budget and more powers to fight crime.
2. **Social Spending**. Neither Sheinbaum nor Galvez are urging fiscal cuts. Both support continuity of 'social safety net' programs. Retirement is a top spending issue, with Galvez seeking to lower the pension age to 60 from 65.
3. **Electoral Reform and AMLO future role**. President Lopez Obrador failed to pass electoral reform to reduce the number of counselors and require judges

to be elected. The reform had also sought to remove all proportional representation in the legislature. Sheinbaum supports another push for this reform, while Galvez supports the status quo and the protests movement against reform efforts. The legacy of AMLO and how he might play a role in the new administration is a big press topic in Mexico.

4. **PEMEX.** The government-owned oil company has $106bn in debt and it's not going well. Suppliers are owed another $40bn in unpaid bills. Capital injections and tax cuts have not fixed things. The nationalistic policies of the AMLO administration kept investors away from Mexico oil. Sheinbaum has not made her stance clear. Galvez seeks more private-sector solutions.

The last hot button topic for Mexico in the election is the currency. The "super peso" is over-valued and gained 20% in 2023. The central bank's (Banxico) role in keeping the MXN strong is one factor, with its board reluctant to cut rates further (after -25bp in March) pending any action from the Federal Reserve. Further, any Banxico action into the vote could be subject to accusations of being politically motivated.

The wide range of forecasts for USDMXN in 12 months is important to consider in the context of the election. Consensus forecasts see 17.60 in a year, with the range spanning from 16.30 to 19.00. Many see the US election as a higher risk event for MXN given the border issues and immigration focus. Right now, MXN plays a dual role of being the most liquid of emerging market currencies, thus providing a 24-hour hedging tool for other currencies, as well as a leader in the carry trade. Current positioning is long carry, but the factor is not stretched – suggesting we are in a "safe" zone for risk assets with moderate volatility expected ahead.

Exhibit #3: MXN Back Driving iFlow Carry

iFlow Carry

Sources: Bank of New York Mellon, WM/Refinitiv, Bloomberg, Bank of International Settlements
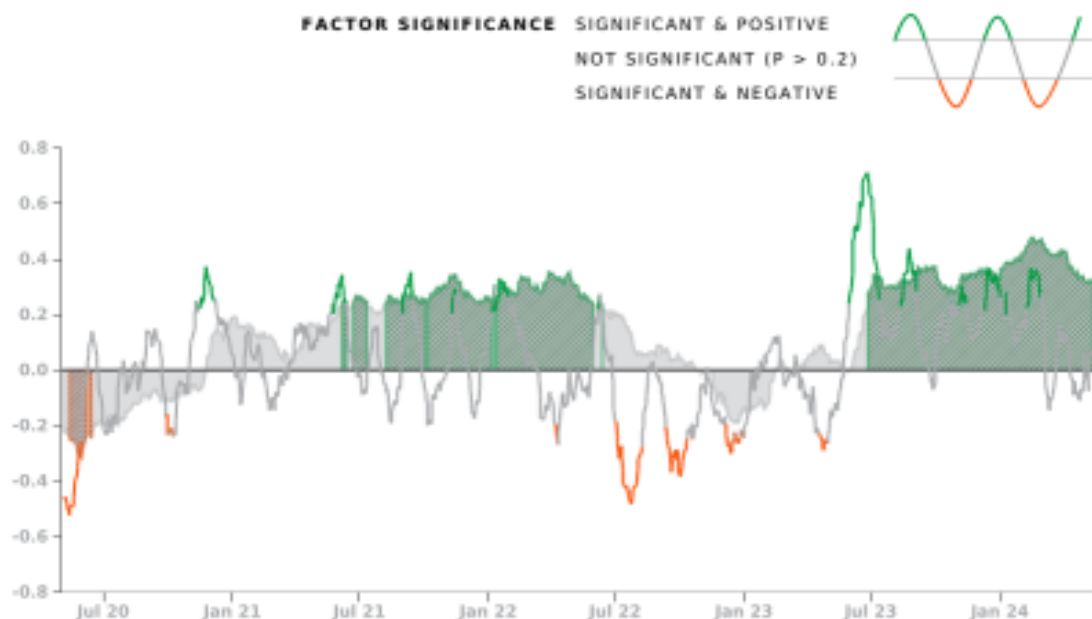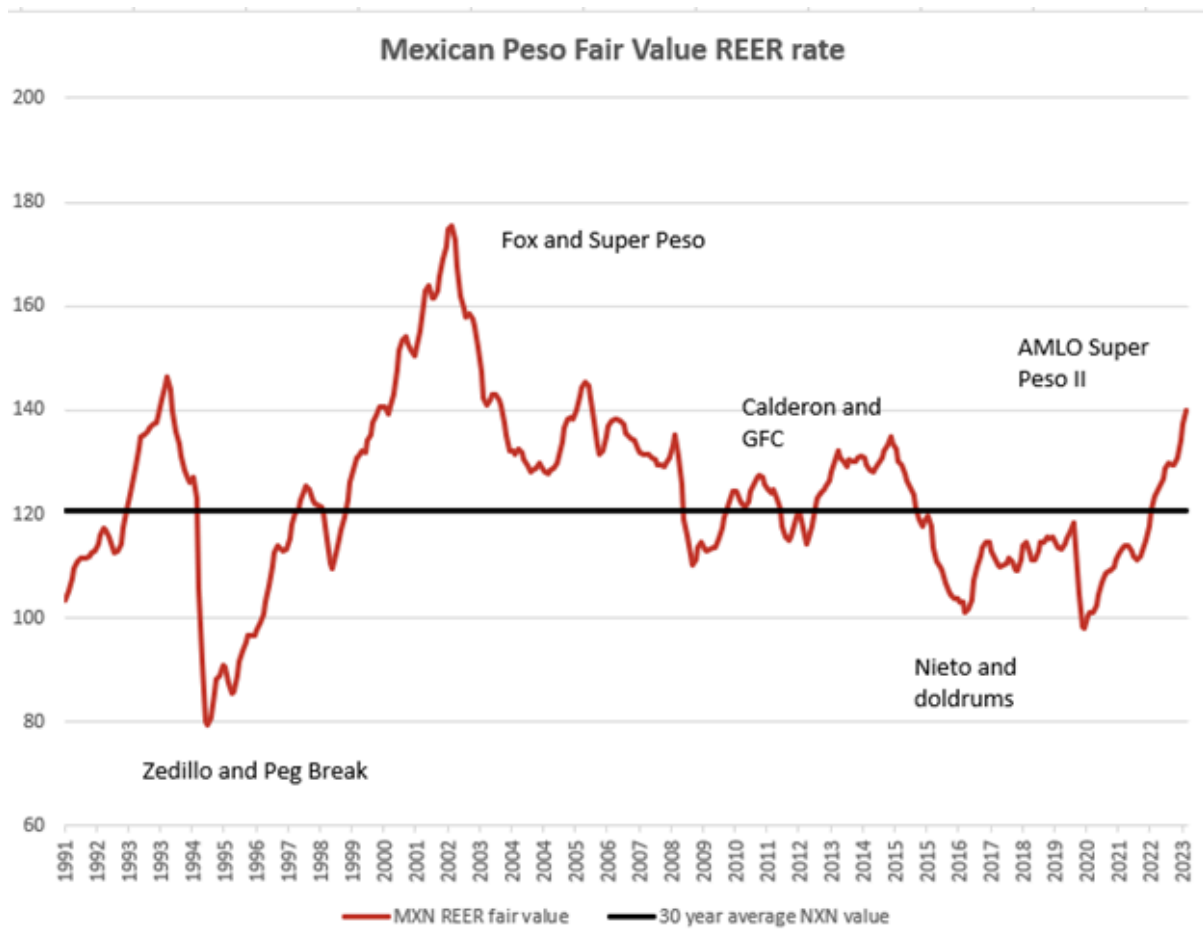
Source: iFlow, BNY Mellon

Bottom Line: The "super peso" risk for the election may be similar to other election narratives whereby investors 'buy the rumor' of a non-event vote and 'sell the result'. MXN has also acquired an international dynamic insofar as it has become viewed as a USD alternative. Both currencies are buoyed by high yields, and at the same time also burdened by domestic problems, e.g., fiscal spending spurring inflation, which are typically also taken into account when it comes to allocating capital. Onshoring China goods to sell to the US could be linked to the FDI-related growth but is also complicated by US politics (tariffs) and the USMCA trade pact review. Like we have noted in relation to other currencies, MXN can act as a shock absorber of sorts.

MXN overvaluation is notable: +40% during AMLO and 15% above the longer-term average. We think the stage could be set for a retrenchment, or at least a long dry summer, particularly if the historical precedent of other election cycles repeats.

Exhibit #4: MXN REER And Election Cycles

Mexican Peso Fair Value REER rate

Source: Dallas Fed, BNY Mellon

Please direct questions or comments to: iFlow@BNYMellon.com

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