Polar Capital Emerging Market Stars Strategy

Mexico: Momentum or moment?

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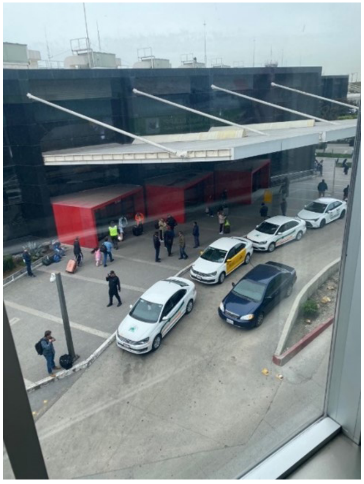
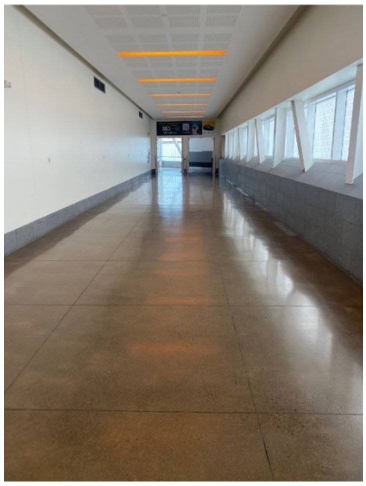
"Take an Uber to Mexico?" Earlier this year, I was in Southern California and planning to head south across the border to meet with companies. "You can just take an Uber" was the information I was given. While this is entirely possible (though not recommended), in reality my passage from the US into Latin America's second largest country was, reassuringly, a little more formal – though nonetheless very smooth. From downtown San Diego, it is a less than 30-minute drive to a passenger footbridge attached to the Tijuana airport that opened in 2015 which, as long as you have the correct documents, provides a startlingly safe, fast and convenient way to change countries in less than five minutes. My point is, something is happening in Mexico and more specifically around this border region. As with people, there is more activity and less friction in traded goods in both directions across this border, though principally northbound.

Taking this route was not accidental. As a team, we wanted to see and experience the much touted 'nearshoring' narrative that has set the Mexico market alight and understand its potential to persist as a new paradigm for Mexico's place in the world. We believe gains from nearshoring could be transformational for Mexico's economy.



Taxis lining up by the bridge



A quiet stretch of the foot-crossing

We have heard the phrase 'a Mexican Moment' plenty of times before. The Mexican market experienced a similar period of strength during 2013-15 as former President Enrique Peña Nieto swept in on a tide of optimism and enthusiasm. His administration was pro-business, pro-growth and based on an extensive agenda of constitutional reforms which many felt were vital for economic health. Chief among these was energy reform which offered a new vision for the sector, including the possibility of private sector investment to boost growth. FDI rose, as did the Mexbol Index, experiencing new listings in a way not seen since (it was during this period that the FIBRA, or Mexican REIT structure, was initiated) and the 'Mexico moment' seems to have been made.

However, all this ended in disappointment. Energy partnership investments and growth did not come and the consequences of high inflation from liberalised energy prices caused economic injury. Enter AMLO (President Andrés Manuel López Obrador) in 2018, winning the election in declamatory fashion on a platform of reversing many of these reforms and promising to renationalise the energy sector, a man who staunchly believes in big-state governance, even at the risk of deterring the private sector. Of all leaders, AMLO seems an unlikely figurehead for what perhaps is already another Mexican moment and there are signs he is not comfortable with the role. However, there are also increasingly signs that he understands this opportunity could be an even more significant golden age for Mexico and, at the very least, will not stand in the way. Anecdotally, when Tesla announced in March that they wanted to invest $5bn to open a plant in Monterrey (Northern Mexico), AMLO countered that they could open it in the south, home to all his pet projects. Then, likely realising Mexico would otherwise lose out entirely, he relented.

While we are always wary of anything akin to a 'this time it's different' thesis, the first Mexican moment was based on something that required a leap, higher complexity in creating and building a new industry structure. Now, growth is driven by compounding market share in key areas of existing competence and comparative advantages, or close adjacencies that can expand over time. It places more of the control with Mexico rather than on external factors. Since 2013, Mexico has improved its footing relative to key competitors such as China in a number of ways, including labour costs, exchange rates, commodity costs and tax rates which increase the country's comparative attractiveness for investment.

What is nearshoring and why will Mexico benefit?

The landmark 1994 NAFTA (North American Free Trade Agreement) helped Mexico deepen its trade relations with the US and make its manufacturing sector one of the most important. This flourished until China's accession to the World Trade Organisation in 2001 reduced the pace of Mexico's growth with the US market. More recently we have seen a reversal of that trend, with Mexico benefitting from caution regarding China, both in terms of a China Plus One strategy for companies' FDI (Foreign Direct Investment) and from capital market investment flows. We believe the new USMCA (United States/Mexico/Canada Agreement) which succeeded NAFTA in 2020, should continue to boost this vital trade partnership.

"Mexico has all the ingredients to be 'the factory of the Americas' in the same way China was once dubbed 'the factory of the world' and in so doing take some market share from China's current share of exports to the US"

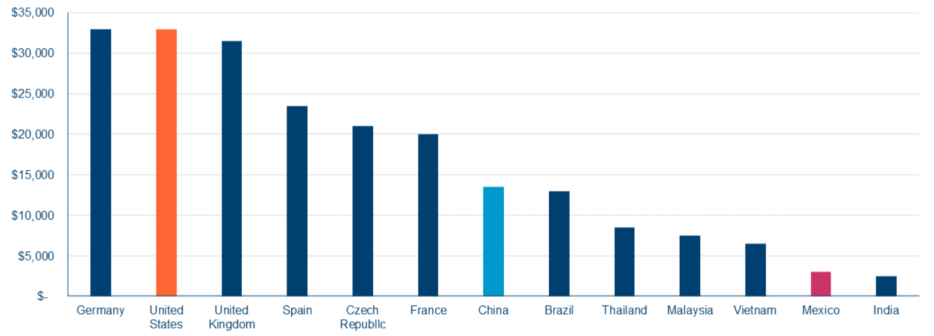
The world changed decisively in 2022. Vladimir Putin's invasion of Ukraine and with it the shattering of previously assured trading patterns, partnerships and the sense of global, democratic security, has cemented the paradigm shift in supply chains that was already underway. For decades, the phenomenon of globalisation, characterised by offshoring production to countries with lower labour costs and leading to specialisation in supply chains and certain trade routes, was a one-way trend. The creeping compounding of factors such as President Trump's tariffs, the pandemic and USMCA, together with other geopolitical tensions, particularly between the US and China, and the need for trust in trade relations, all of which began in 2018 to tilt the commonly established axes of global trade, were made irreversible by the consequences of the war. The market distortions and disruption caused by these layering trade barriers highlighted the level of dependence on certain strategic regions for supply-chain stability and threw into question the ongoing viability of current trade systems. The benefits of bringing production back closer to the point of consumption have started to add up again for the first time in decades. We see these structural changes propelling the reshaping that is underway in the emerging markets space.

Given all these incentives, companies are now preparing differently for the future and assessing options for relocation or expansion in alternate geographies. A CEO may consider reshoring back to the US, but after talking with his CFO see the advantages of Mexico. In fact, if you were going to build a country based on a checklist of requirements for a nearshoring nirvana, it might look just like Mexico. Mexico is second only to Chile in the number of free trade agreements it has globally (covering more than 40 countries and >70% of GDP, so it is very well positioned whatever blocks the world may split into); average manufacturing wages remain much lower than for its key export partners and competitors (see chart on page 3); it already has deep skill and infrastructure as a manufacturing economy and is very close to its largest export market, sharing a 2,000 mile border with the US which accounts for c80% of Mexico's exports. This ensures shorter, cheaper deliveries and greater trust in their security.

Mexico has all the ingredients to be 'the factory of the Americas' in the same way China was once dubbed 'the factory of the world' and in doing so take some market share from China's current share of exports to the US. While it is almost impossible to conceive of any location or hub replicating what China has built up, particularly in its Pearl River Delta ecosystem, if the US is to be able to re-engineer its supply chain to incrementally reduce exposure to China, the most viable solution is most likely via Mexico. Importantly, recent, major US policy including the CHIPS Act and the Inflation Reduction Act support nearshoring. This is, in part, why Mexico is experiencing strong investment interest and growth in new FDI inflows, which we believe are set to continue.

Labour costs

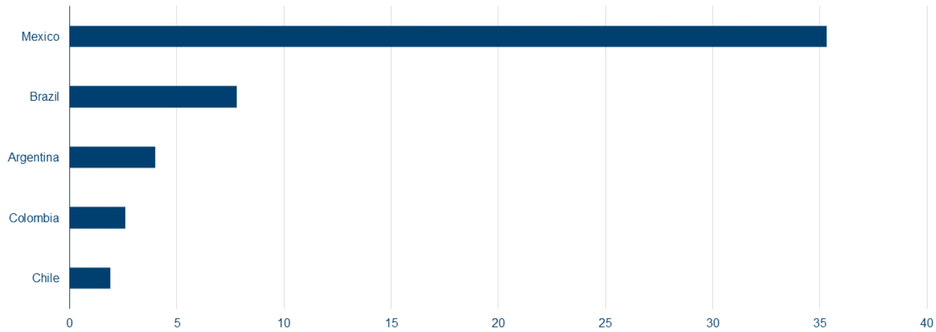
Average salaries of production workers/ machine operators (world)



Source: Indeed.com, 2022.

Estimates of the scale of the opportunity in monetary terms are currently somewhere along the legendary piece of string as per various bodies. Some sceptics, including economists at the Ministry of Finance who I spoke to during my visit, believe there is very little currently that can be attributed to nearshoring with certainty that might not have been invested in Mexico anyway were it possible to know the counterfactual. The most frequently cited figure is from the Inter-American Development Bank, which forecasts $35.5bn in additional goods exports over the medium term.

Additional exports of goods forecast by country ($bn)

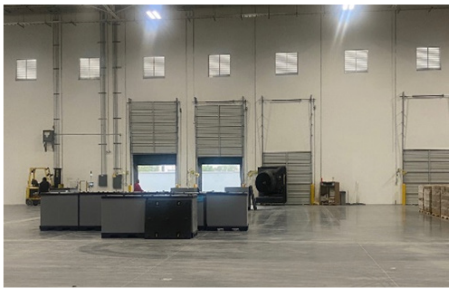


Source: IDB forecasts, 7 June 2022.

"There is very little currently that can be attributed to nearshoring with certainty that might not have been invested in Mexico anyway were it possible to know the counterfactual"

The opportunity appears vast, though to maximise chances of success there are a number of bottlenecks Mexico needs to address first (discussed below). It is most likely that the initial growth will come from familiar areas that Mexico has developed experience and sound markets in, such as autos and consumer electronics. Announcements of investments for auto facilities are currently leading the charge, accounting for c50% of FDI, including $870m from BMW, $764m from VW, $700m from Nissan and $200m from Stellantis in addition to the Tesla investment. It is expected that production of electric vehicles in Mexico could at least double this year.

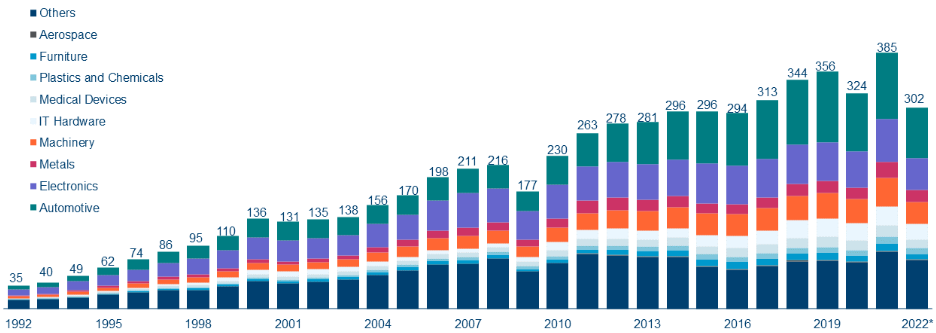
It is not all about autos – though this may come first – and it is not all US companies. What surprised and encouraged me as I toured around industrial mega-parks (the size of which defied belief), was the diversity of representation from Japanese industrial companies to Chinese medical parts companies to European furniture companies. Speaking to the industrial real estate companies that lease these vast, hangar-style plants, they cannot throw the buildings up fast enough to meet the demand they are seeing as they are fully leased before they break ground. They have been increasing rents well into the double digits for some time now and do not see elasticity kicking in. "We could almost charge what we want!" is the message. There is a 90% occupancy rate for these types of facilities across all northern states and the companies are raising more capital and bringing growth plans forward to try to take advantage of this market. CBRE have said the demand for leases of industrial space in key northern border states has quadrupled in the past two years and many more projects are in the pipeline.



Some of the sectors that Mexico is starting to see high export growth in, from a low base, such as healthcare or furniture, are areas in which it is less well established but to really make a dent in the c$575bn export trade China has with the US, the country needs to build its ability and ecosystems around these newer, often higher value sectors. It is likely that Mexico will not be able to replicate everything – certainly at first. I was given the example of a Chinese medical thermometer company that was considering nearshoring only part of its supply chain, as parts would not be achievable and establishing new ecosystems takes time.

"The demand for leases of industrial space in key northern border states has quadrupled in the past two years"

Mexican exports to the US by manufacturing ecosystem ($bn)



Source: Morgan Stanley / US Census Bureau, 2022. *Annualised by applying YTD growth as of October 2022.

This is where some are cautious as to whether nearshoring growth for Mexico will have equally wide-reaching effects for the real economy. The criticism is that when factories come to Mexico, it does not result in any form of trickle-down economics due to the nature of Mexico's exports, only 50% of which have any national component – this figure is 80% in China. There is a concern for the government that any wealth created remains concentrated in the north of the country, leading to greater imbalances and inequality in the country which is not socially desirable. This goes some way to explaining why the majority of AMLO's seemingly inexplicable infrastructure spending has been on projects in the south. However, the USMCA improves on NAFTA by requiring a higher proportion of local content which could mean a shift towards higher value manufacturing work rather than just final assembly.

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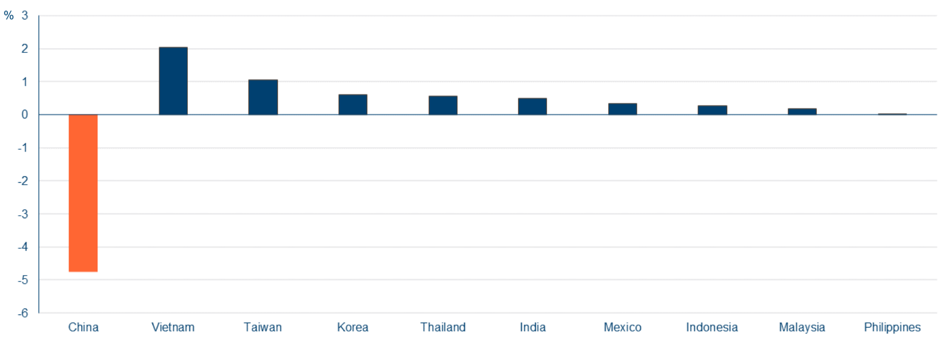
There are other criticisms that the pace of progress is being held back by the astonishing lack of drive from government to stop this opportunity and grease its wheels. There would be a myriad of policies the government could use to help growth from nearshoring, yet they have been reticent to do so. The political decisions not to go all in to maximise their moment is not something easily understood. AMLO conceptually seems to have the right intentions on social inclusion – not something to be messed around with in Latin America – but his implementation is not visionary and may extend the timeframe for some of the challenges to be alleviated and the bigger wins to come through. We need to see conclusions or progress on key issues to determine how far Mexico's momentum can continue, including the 2024 Presidential elections (see below), what happens next to the energy industry, potential for utility, power and labour shortages and ongoing negotiation on some points of the USMCA.

To monitor the progress of nearshoring we need to continue to track FDI flows – particularly now existing capacity utilisation is very high so we should expect additional capex investment coming through more strongly – and to watch global export market shares in key sectors.

The gap between China's exports to the US and Mexico's has already started to narrow, with Mexico holding its position as the second largest trade partner to the world's largest economy, just ahead of Canada, with respective figures for China and Mexico in 2022 standing at $575bn and $459bn, respectively. In relative terms, while Mexico's percentage share of US imports has remained stable at 16-17% since 2018, China's has fallen from 26.9% to 22.3%. It is therefore possible to see how Mexico can continue to benefit and drive additional points of GDP growth. Exports account for c40% of Mexico's $1.4trn GDP, with oil now less than 5% of this due to long-beleaguered production at Pemex. The vast majority of exports now are across the manufacturing spectrum. We see Mexico as the key China Plus One beneficiary in the West, however we also take a very positive view on some Asian markets, particularly Vietnam which could see a very significant impact from these shifts. With this in mind, please read our deeper insights into Indonesia and Vietnam.

Market share changes in US imports market (2022 compared to 2018)



Source: UBS, 2022.

For all that has been said about AMLO, his obstinance has in some instances served the country well. During Covid, his downright refusal to spend a bean on any sort of stimulus programme or impose lockdowns confounded onlookers, given his profound leftist credentials, yet it is this fiscal discipline that has seen lower debt levels and a faster recovery than the majority of the more hawkish peers. Demand for exports from the US was the first area to recover, followed by consumption, but then a surprisingly good tourism performance led to a record trade services balance in 2022 and overall GDP growth of 3.4%. The government's growth forecasts for this year are well ahead of consensus, at 3% in the budget (though with a range of 1.2-3%). They justify this under the scenario that there is no hard landing in the US, with no recession at all and monetary policy adjusts accordingly. It is also predicated on a normalisation of supply chains and commodity prices being back to pre-war levels.

The Central Bank, Banxico, has been second to only Brazil in action on tightening rates with the cycle starting from June 2021, to a current 11.25%, and now enjoying one of the highest real rates globally. They will likely be among the first to start rate cuts later this year as they are broadly expected to remain on hold for some time. Inflation has been decreasing from a peak of 8.5% in November 2022, though core inflation remains sticky and is decreasing more slowly than expected but will annualise out the base effects soon. The Mexican peso has also been markedly strong given these characteristics and is now looking more evenly balanced, especially with Banxico likely to begin cutting rates in the not too distant future, which would reduce the carry, and a new wave of inflows may be more mindful of US recession risk.

There is, however, need for fiscal reform as, while the government did not issue new debt or raid the coffers of pensions as with some regional economies, the pandemic meant all but exhausting the reserves of the Oil Revenue Stabilisation Fund with new inflows weak due to poor tax collection and low revenue from oil. Change is needed for longer-term stability and to avoid a credit ratings downgrade. The Fund is down to M$37bn and needs M$150bn for shock absorption (both figures show Mexican dollars). AMLO's aim is to build this back up by the end of his term.

Challenges and a change of the top

There has been a lot of concern as to whether Mexico, and specifically the northern states most exposed to nearshoring, will be able to be adequately supplied with quality labour and consistent, reliable electricity to meet the level of anticipated demand. Everyone I spoke to in Mexico, on all sides of the table, were confident that the Mexican labour force is up to the task, both in terms of numbers and in skill level, with 100,000 STEM (science, technology, engineering and maths) graduates each year. The country is also experiencing material internal economic migration from the south to the north, as well as immigration from other South American countries. The labour participation rate dropped slightly during Covid but it is coming back again, so while the market is tight and wages are increasing to support that (minimum wages have risen 100% under AMLO), there are no reports of labour shortages for the types of task that will be required.

"The central bank has been second to only Brazil in action on tightening rates with the cycle starting from June 2021…and will likely be among the first to start rate cuts later this year"

The shorter-term electricity bottleneck is on the transmission rather than the generation side, though in the medium term more generation capacity will need to be added if growth is as expected and, given lead times, this needs to be addressed sooner rather than later. It is a complicated area and an important issue for which the government have not yet provided clarity on the structure of future investment arrangements (most likely to be public/private partnerships), market pricing structures and a regulatory system which could support investment. The state electricity utility, CFE, are said to be working on this and the companies I met with are not concerned about electricity supply on a 1-2 year basis, but it would be good to have clarity.

Other risks to Mexico's fortunes and the nearshoring boom playing out are more well-rehearsed; its poor security has long been the case, yet has not held back the industry to any great extent. Mexico's concentrated links with the US are of course, a double-edged sword in the case of a US recession, and that is well understood. However, we do not currently foresee a long or deep recession and my visit did not suggest there is any sign of capex investment being delayed. Indeed, if these are investments for cost reduction rather than expansion in some cases, or to replace a critical factory deemed unviable in another geography, then this spending may not be as discretionary as other forms. Of course, Mexico and nearshoring would not be immune to a more severe US recession, but the country overall is in a healthy macro position.

In January, AMLO met with the two other North American leaders, Joe Biden and Justin Trudeau, for what has been called the 'Three Amigos' meeting, in Mexico City. A number of issues were discussed and initiatives mutually agreed but there remains a crucial sticking point under the USMCA that could present a problem for Mexico. The other leaders contend that Mexico's nationalist energy policy, which gives priority to the state oil, gas and electricity companies rather than "equal treatment of all actors" therefore contravenes the terms of the USMCA. A resolution to this is due to be reached later this year, otherwise Mexico could suffer sanctions under the agreement. Opening up this reform and their market to the North American energy industry would mean access to cheap US shale gas, which could be a benefit for Mexico in the medium term given they have long been a net energy importer as they transition to more renewable fuels.

AMLOnomics is all about restoring Mexico to the state-led, oil-fuelled years of the 1970s without recognising the world has moved on and his policies are instead a drag on growth as he refuses to implement the structural reforms needed to boost it. The nearshoring boom is happening in spite of AMLO, not because of him, though with his support it could be a great springboard. His relations with the private sector and international business have never recovered from his seemingly petulant act of scrapping the second airport in Mexico City, at great expense, because it had been the project of his predecessor.

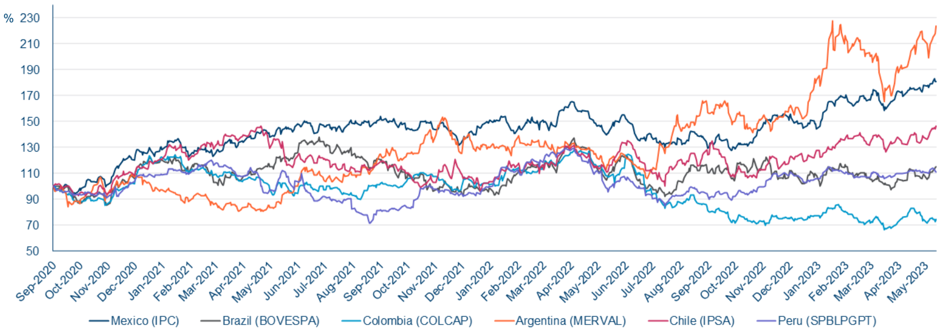
"Mexico and nearshoring would not be immune to a more severe US recession, but the country overall is in a healthy macro position"

There was an important moment in Congress (of the Union) in 2022 when AMLO tried to introduce a counter to the Energy Reform which would have ensured a larger state role in the electricity sector which was rejected. His approval ratings have always remained relatively high, so this was a surprise and perhaps marks a turning point, or a line on how far he will be allowed to go. AMLO leaves office in October 2024. There is currently no out-and-out successor, but three likely candidates from his Morena party from which a ballot will decide, heavily steered by AMLO's nod. The opposition is not currently strong enough to be likely to contest seriously, unless the three parties (PRI/PAN/PRD) run together in coalition, though we will get a good indication of how close things may go at upcoming state elections on 4 June. Whoever wins, a priority must be private sector re-engagement to support domestic investment which has been lacking, as well as FDI which could lead to dual-track growth expansion.

Momentum

Mexico's momentum since its rally began in September 2020 has seen the market race up more than 70%, in dollar terms, outstripping the performance of most other Latin American markets.

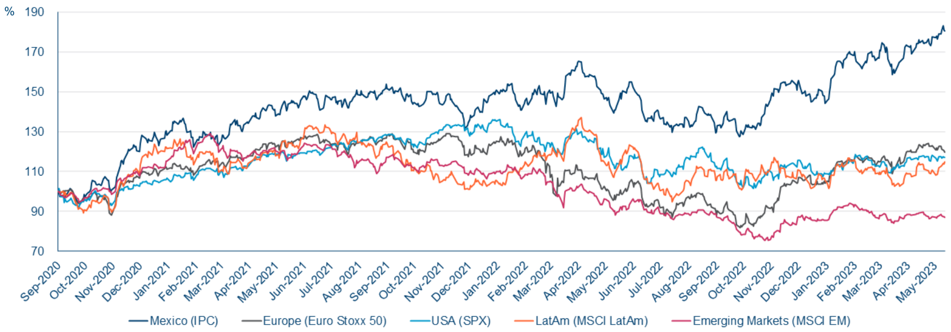
Relative performance of Latin American equity indices (%)



Source: Bloomberg, 12 May 2023.

This momentum looks even more positive when compared to other emerging and global equity markets.

Relative performance of global equity market indices (%)

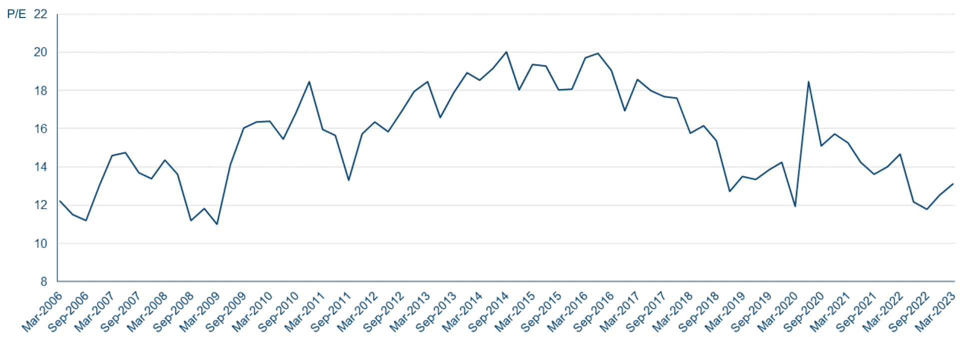


Source: Bloomberg, 12 May 2023.

The start of this ascent overlaps with the timing of sentiment turning the other way across a number of Asian emerging markets, principally China, due to the changes in the regulatory environment, its strict zero-Covid impact and higher sensitivity to long duration felt there due to the different sectoral make-up of some of those markets with high internet and technology exposure. In essence, Mexico in part became a new safe haven for emerging market investors. Closer to home, in September 2020 the market was also close to the US elections that were polling supportively, and the very positive vaccine news was just around the corner which also supported markets. Mexico gained a further, notable boost in flows following the Chinese Communist Party elections in 4Q22. There is of course internal credit to be given for the macro management which meant far lower imbalances both historically and compared to peer markets, reducing volatility and again creating an attractive investment destination. Latin America used to have a far higher weighting as part of the emerging markets index, from 30s% in the 1990s, falling to high teens prior to 2015 before dropping into mid-single digits more recently. However, change is constant in emerging markets and it could be that the elements are in place to see Latin America and Mexico rise again.

“Change is constant in emerging markets and it could be that the elements are in place to see Latin America and Mexico rise again”

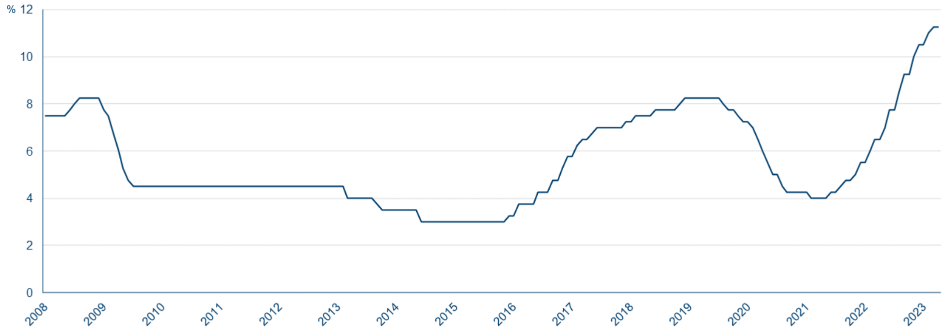
Mexican market P/E (Mexbol Index)



Source: Bloomberg, 31 March 2023.

After this period of significant strength, the Mexbol is now trading at 11.75x forward P/E compared with a long term-average of 13.8x. This period, shown above, includes the previous Mexico moment years (2013-15), when valuations reached heights of 18x forward earnings (23x current) at the index level. However, it is important to note that interest rates in Mexico were abnormally low during that same timespan, whereas today’s far higher prevailing rate will mean adjusted valuations are closer than they may first appear and the market might not be so undervalued.

Bank of Mexico official overnight rate (%)



Source: Bloomberg, 28 April 2023.

However, Mexico is still one of the few markets with a forecast for positive earnings growth which can create additional room for upside. As interest rates come down, and with them the cost of capital for Mexico equites, this should provide further valuation upside. For the market to move back to its long-term average current P/E multiple of 15.7x, regardless of interest rates, would imply a 22% further rerating.

If Mexico has been able to perform in the way it has and achieve this much against the odds of decades-high interest rates and a President that curbs rather than courts investment, there should be excitement at the prospect of both of those factors being removed relatively soon, just as the real nearshoring effects start to be more visible in data and how potentially powerful those improvements could be in unleashing the full growth effects of this new moment for Mexico.

Emerging Market Stars' strategy in Mexico

"As interest rates come down, and with them the cost of capital for Mexico equites, this should provide further valuation upside"

Given our very positive outlook for the Mexican market, we have been building our portfolio exposure to the country over the past year, though balancing that with the discipline of identifying attractively valued companies for the long term in a market that is not very deep and has become quite crowded. Our core exposure is to **Grupo Financiero Banorte**, one of its leading banks, which benefits from loan growth to both companies locating plants in Mexico and the developers constructing them, as well as from an overall uplift to consumer dynamics, all of which should mean nearshoring acts as a long-term tailwind to loan growth. The bank recently announced they are adding 800 staff specifically to help harness the growth from nearshoring. Banorte has a highly attractive profitability profile, solid balance sheet, proven corporate governance discipline and a promising digital transformation strategy. It is also notable that a number of our other portfolio companies have started opening operations or investing into assets in Mexico, which we are encouraged to hear when we meet with them as corroborating evidence of our analysis, giving us higher indirect exposure to Mexico which is a benefit.

This is a structural change that we expect to endure. We can be patient as we wait for the right opportunities to invest into additional key beneficiary companies that we have been following, with the potential to increase our portfolio weighting further over time. The industrial real estate companies may have had to put up 'sold out' signs with no vacancies no matter what the price. However, the equity market does not work like that. There are always vacancies to buy, but the price does matter and we want to maintain our disciplined process to promote the best outcomes.

The visit to Mexico convinced us more so than previously that the opportunity Mexico has before it could be game-changing and much more substantial than the 'moment' from 2013-15. A moment implies a flash in the pan, which in fact was all that transpired to be. If so, we believe this chance for Mexico is something much more permanent – not a moment, but a movement, both in the sense of a transitional pivot and of a groundswell of change, enthusiasm, support and activity. As the right moments allow, we may move more towards Mexico in our portfolio.

Naomi Waistell, Fund Manager
Polar Capital Emerging Market Stars Strategy
26 May 2023

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