Mexican peso

Mexico's Peso remains the bellwether for Emerging Markets

Likely runaway election victory election for 'Amlo' could hit the currency hard

Jonathan Wheatley in London YESTERDAY

In the turmoil that has struck emerging market currencies over the past six weeks the headlines have been grabbed by the Turkish lira, the Argentine peso and, in the past week, the Brazilian real.

But what of the Mexican peso, traditionally seen as a bellwether of sentiment towards emerging markets as a whole? It crashed to an all-time low against the US dollar after the election of Donald Trump to the US presidency in November 2016. After staging a comeback, it is heading back in that direction, shedding 12 per cent of its dollar value since mid-April.

Worse may lie ahead. Analysts say the Trump administration's renewed abrasive attitude to trade and a likely runaway victory in Mexico's July 1 election for the leftist Andrés Manuel López Obrador, known to all as Amlo, could send the peso into uncharted territory.

"Markets are too complacent," said Win Thin, emerging market currency strategist at Brown Brothers Harriman. "There could be a big overshoot if Amlo wins that would test the levels of January 2017."

Peso threatens to test new lows

Mexican pesos per US dollar (inverted scale)

Source: Thomson Reuters Datastream

Even if that happens, however, the peso’s status as one of the big go-to assets for EM investors looks unlikely to be shaken badly.

For one thing, it is highly liquid. According to the Bank for International Settlements, it is consistently the second most traded EM currency after the Chinese renminbi, and is far more accessible to investors.

The peso can also be exchanged around the clock. Peso trading may be thin at some times of day but, unlike that of rivals such as the Brazilian real, it never shuts down.

Such ease of access may have contributed to the peso’s recent battering. Since May 1 it has fallen less than the Argentine peso, the real and the lira, but more than every other major EM currency, according to Bloomberg.

Bond yields have spiked

10-year government bond yield, %

Source: Bloomberg
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While fears over trade and Amlo have played their parts, the peso has also been caught up in the flight from EM assets prompted by a surge in the dollar’s value this year, especially since mid-April, and by rising US Treasury yields.

Those moves took many investors by surprise, prompting further asset flight.

“You think you are in the right trade but then markets get caught up in contagion,” said one EM credit strategist at an international bank.

The peso's fall since mid-April has been about twice that of EM currencies as a whole, measured by the benchmark JPMorgan index. The fall in Mexican stocks has been about half as much again as that in the MSCI EM index.

Yields on Mexican government domestic bonds are even higher now than they were immediately after the US election, suggesting added strain not only on investors' nerves but also on the public finances.

Foreigners piled in after US election

Foreign ownership of Mexican government bonds, %

Sources: Central bank, Bloomberg
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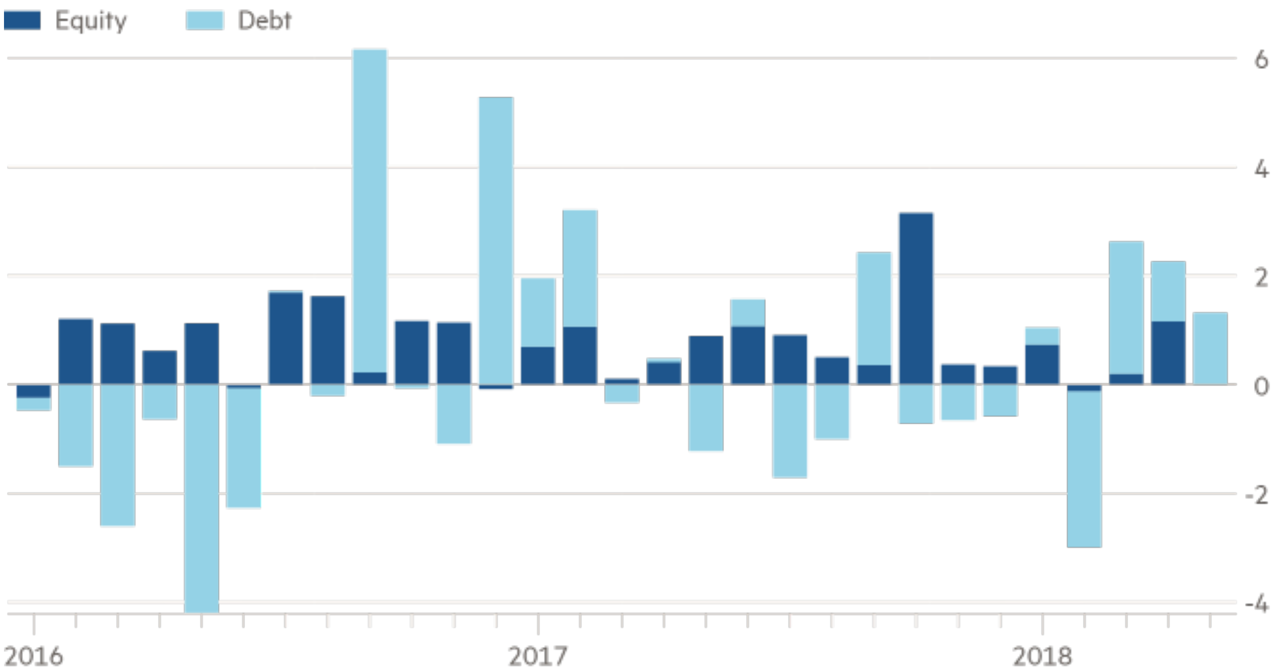
Yet investor positioning has remained strong in *mbonos*, the government's main peso bonds. Indeed, when yields spiked and the peso slumped after the US election, foreigners ramped up their share of total bond ownership to more than two-thirds, from a level of about 59 to 60 per cent over the previous two years. Even now, foreigners own about 61 per cent of Mexican government bonds, according to the central bank.

Indeed, much of the aversion to Mexican assets appears to have come from local investors rather than foreigners. According to the Institute of International Finance, a financial industry association and data gatherer, flows to Mexican stocks and bonds from non-resident investors have been positive in each of the past three months.

Foreign investors keep the faith

Non-resident portfolio flows to Mexico, $bn



Source: Institute of International Finance
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Even if the peso's status as an EM bellwether were to be dented, that might be no bad thing. As Carlos Capistrán, head of Mexican economics at Bank of America Merrill Lynch, pointed out, after recent policy tightening Mexico has the highest real interest rate of any investment-grade country.

"For the first time in history Brazil has lower nominal rates than Mexico, so that has helped," he said. "We have seen more violent moves in the real than in the peso," making the real a better indicator of EM investor sentiment.

Moves in the peso may turn violent again. Jorge Mariscal, EM chief investment officer at UBS wealth management, said he is "worried by [Amlo's] ideology, his backwardness, his stubbornness". He added that investors have not fully priced in an Amlo victory, especially if he also secures a majority in Congress.

Eswar Prasad, professor of trade policy and economics at Cornell University, said that if the peso keeps falling it will exacerbate the strain on Mexico's economy, balance of payments and financial system.

"A falling peso might not serve as a sufficient buffer against external shocks and could lead to a significant contraction in imports and economic activity," he said. "A depreciating currency and slowdown of capital inflows could feed off and worsen each other."

the currency's appeal to some foreign investors, who often go short the peso as a hedge against other long positions in EM assets. Indeed, net positioning in the peso on Chicago's International Money Market turned short last week for the first time in more than a year.

As Mexican interest rates rise, shorting the peso as a hedge becomes more expensive. But Mr Thin at BBH said he believes the peso will retain this role, even if the cost becomes too high for some.

He said he believes Amlo will not turn out as bad for business and markets as many fear and that Mexico's institutional strength will be sustained.

"Amlo won't want to preside over a freefall in the currency," he said. "The peso's role as a major bellwether is pretty safe."

Additional reporting by John Paul Rathbone in New York and Jude Webber in Mexico City

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