

Economic Flash

The aftermath of the first US presidential debate: a tipping point for the MXN?

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- **Clinton's meaningful gains since the first presidential debate have shored up the MXN**
- **Relative to other EM currencies, the MXN has outperformed by about 4% since the first US presidential debate**
- **Looking ahead, if as current odds suggest Clinton ends up winning the election, a bet on the MXN would likely pay handsomely**

Clinton's meaningful gains since the first presidential debate have shored up the MXN

As we explained in a previous document (see "Our take on the MXN", September 19, 2016), three factors seem to have driven the MXN's underperformance since September 2014: i) reduced expectations of US growth; ii) weakening economic fundamentals, particularly related to the external and fiscal balances; and iii) the Trump factor. Since the release of that document, there have been new developments related to some of these drivers. As for the first driver, after unexpectedly softening in August, the US ISM manufacturing index edged back into expansionary territory in September. Other data also show greater strength with ISM non-manufacturing index surging in September to a strong 57.1 (previous: 51.4) and durable goods orders beating consensus estimates. Strong data this week has contributed to a decline in risk aversion. Solid US economic data should sooner or later give a boost to the MXN if US growth expectations end up being increased, but so far, the MXN seems to continue to lag behind the recovery path of the US economy (see Chart 1). Recall that usually there is a lag between these two series.

What else has changed since the release of our previous document on the MXN? Since 19 September, the peso has appreciated 2.2% and has recovered 3.1% of its value since the nominal exchange-rate (ER) versus the USD reached an all-time high (19.88 ppp) on September 26, the date of the first (of three scheduled) US presidential debates. The main factor behind the additional spike in pressures on the MXN seen since early August seems to be related to the US elections. The possibility of a Trump presidency has hit the peso. As the date of the first US presidential debate was approaching, Trump was closing in on Clinton in election polls. Indeed, Clinton's edge over Trump had narrowed to only about 2% on 26 September. More importantly the trend showed that Trump had strong momentum going into the first debate. That was a worrisome change of events for the MXN, and the ER was increasingly pricing in the risk (for the MXN and the Mexican economy) of a possible Trump presidency.

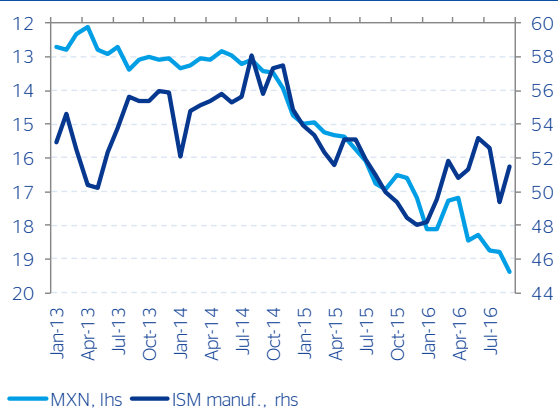
What has changed since September 26? Judging by the significant shifts in opinion polls seen since then, it seems that most think that Trump had a poor showing in the first presidential debate. Although polls still show that the race remains close (see Chart 2) and thus, the outcome of the election remains uncertain, the shift in the chance of winning has been much larger (compared to the shift in opinion polls) according to the models used by

FiveThirtyEight¹. How have the odds changed according to FiveThirtyEight? On September 26, Clinton's chance of winning had reached a recent low of 54.8% whereas today FiveThirtyEight forecasts¹ give Clinton a 78.3% chance of winning, which is still far from the 89.1% odds that she had on August 14 but no doubt she's made meaningful gains since the first presidential debate.

In addition, on September 29 Banxico increased the monetary policy rate by 50 bps (see our Banxico Watch). We think that this action took some pressure away from the MXN as it made the strategy of speculating against the peso a little less cheap.

A stronger US manufacturing sector should sooner or later boost up the MXN

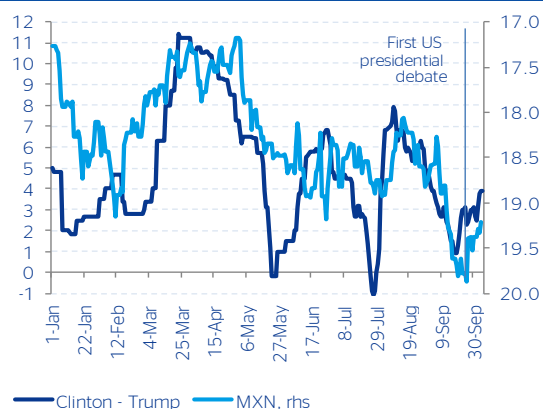
Chart 1
ISM Manufacturing & MXN
(Index* & pesos per dollar, inverted scale)



Source: BBVA Research / Bloomberg
* > / < 50 means expansion / contraction

Clinton's lead has somewhat widened since the first presidential debate

Chart 2
2016: US Election Survey Results & MXN
(Clinton minus Trump preferences* & pesos per dollar, inverted scale)



Source: BBVA Research / Real Clear Politics
* A positive number implies a Clinton lead while an increasing / decreasing trend implies a widening / narrowing Clinton lead

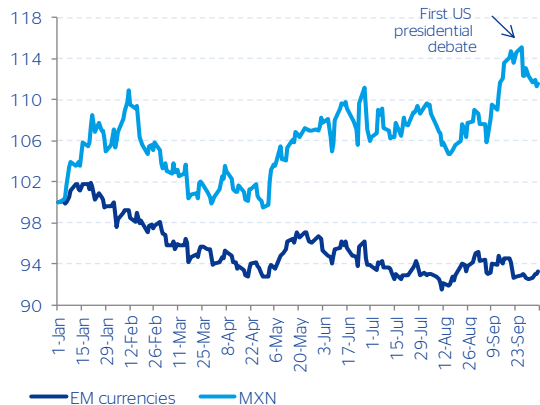
Relative to other EM currencies, the MXN has outperformed by about 4% since the first US presidential debate

Year-to-date, the MXN is down about 12% versus the USD, which compares poorly with the better performance of other EM currencies (see Chart 3). If we take the JP Morgan Emerging Market Currency Index, re-weight it after taking out the MXN (which has a relative weight of 11.11% in the original index) and rebase it to Jan 1, 2016 = 100, we can clearly and easily compare the performance of the MXN with that of other EM currencies to get a clear and quick picture of the two different tales so far this year: one of strengthening for most of EM currencies and other of significant weakening for the MXN (see chart 4). Indeed, as Chart 4 shows, relative to the better performance of other EM currencies, the MXN has underperformed by about 16%. However, it seems that 2016's sharp underperformance bottomed out on September 26, the date of the first US presidential debate. Indeed, the underperformance seems to have peaked at (-)20% just hours before the first face-to-face between Clinton and Trump (see Chart 4).

1: See: http://projects.fivethirtyeight.com/2016-election-forecast/?ex_cid=rrpromo

The MXN has somewhat recovered since the first US presidential debate in both absolute...

Chart 3
MXN & other EM currencies*
 (Jan 1, 2016 =100; + / - for depreciation / appreciation versus USD)



Source: BBVA Research / Bloomberg
 * Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN

... and relative terms. Indeed, the MXN has been outperforming other EM currencies since the date of the first US presidential debate

Chart 4
MXN relative to EM currencies*, 2016
 (Jan 1, 2016 = 1)



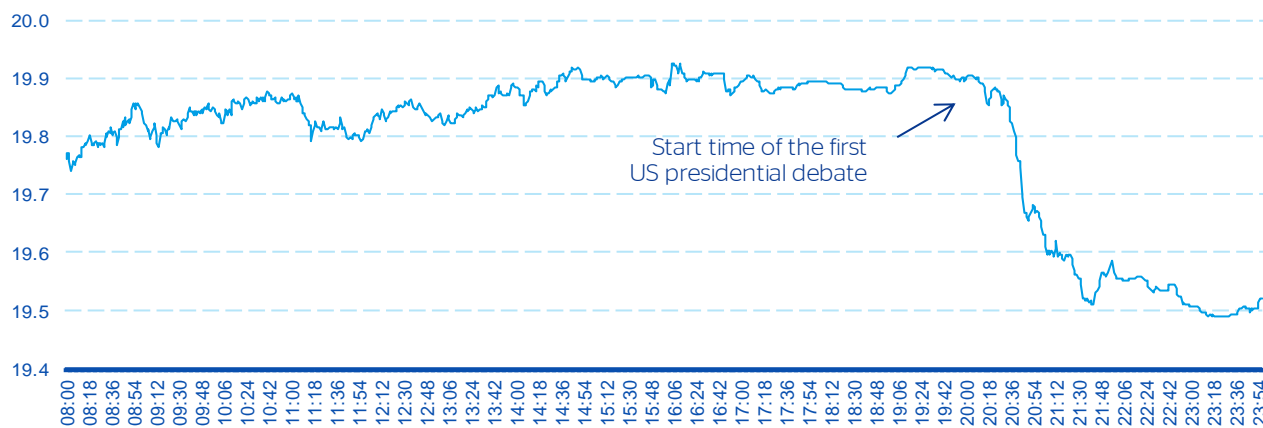
Source: BBVA Research / Bloomberg
 * Ratio > 1 / < 1 for MXN absolute outperformance / underperformance & increasing / declining trend for MXN relative outperformance / underperformance. Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.

Are markets tired of giving the piñata a whack?² For a change, since the first US presidential debate the MXN has not been whacked when an EM risk has gone up (e.g., increased odds of a Fed's hike this year). On the contrary, as showed by Charts 3 & 4, the peso has outperformed its peers over the past three weeks. The reason is straightforward as explained in the previous section: Clinton's odds of winning the presidency have improved markedly since the first US presidential debate. Indeed, as Chart 5 shows, as soon as the debate began to go downhill for Trump, markets began to price in the improved Clinton's odds that since then have been confirmed by the shift in opinion polls and chance of winning estimates. This is remarkable considering that the debate took place at a time when usually there is little movement in the MXN.

2: The simile between the MXN and a piñata is borrowed from Stephen Foley of the FT who brightly summed up the 2016 performance of the MXN in one sentence: "There always seems to be some other reason to give the piñata a whack" in "No end of reasons to whack Mexican peso", Financial Times, June 22, 2016.

Markets seem to have priced in better odds for Clinton during the first US presidential debate

Chart 5
MXN intraday movements, September 26 (ER versus USD)



Source: BBVA Research / Bloomberg

Looking ahead, what can we expect for the MXN until the outcome of the US presidential election is known?

By looking at recent polls, especially those from swing States, it seems reasonable to expect that Clinton might continue to hold a lead until Election Day. More so if as some think, the town hall format plays even more to Clinton's strengths, and thus, could do even better in the second debate³. In any case, although it is true that polling is clearly showing a shift in momentum toward Clinton, Trump is still likely to remain in striking distance. That, along with the Brexit feeling (ie, the outcome was neither expected by polls nor priced-in by markets on the date the referendum took place), probably explains why the MXN has recovered relatively little with such a big shift in momentum in the US presidential campaign. That said, we should expect the MXN to continue to slightly outperform other EM currencies as long as there is no other shift in momentum toward Trump from here to Election Day. Once we close in to the day of the election, the MXN will probably underperform, as the outcome is likely to remain uncertain. On November 8, a Clinton win (i.e., the better of the two possible outcomes for Mexico) would no doubt remove a big cloud from the horizon for the MXN. Indeed, if as current odds suggest Clinton ends up winning the election on November 8, a bet on the MXN might well be a pretty good trade that would likely pay handsomely. Indeed, as Chart 4 shows, there is still room for catch-up for the MXN related to the risks and possible outcome of the US election.

Having said this, once the dust settles after the US election, and the ER likely reaches a lower level, the MXN is likely to remain weak until the recent increase in vulnerabilities (mainly associated to the external and fiscal balances) begins to reverse, which is likely to take some time. The government should not relax if the outcome of the US election is favourable for Mexico, on the contrary, they should continue to remember that one should hope for the best but prepare for the worst. There will always be a new risk on the horizon. The best way for EMs to prepare for these times of heightened global financial volatility is to have strong macroeconomic fundamentals. Crucially, the government should focus on meeting its target of a primary surplus in 2017.

3: See for example: "The first debate was a defeat for Trump. Here's why the second could be an outright massacre." by Paul Waldman. Washington Post, September 29, 2016.

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