

4. The probability of success of NAFTA 2.0 has diminished

Talks on NAFTA deteriorated in the fourth round, and the path towards “NAFTA 2.0” became much more challenging

Until September, the renegotiation of NAFTA had been moving ahead without major obstacles. The first three rounds took place without major differences, and although the most sensitive aspects of the negotiation had yet to be addressed, the expectation was that a successful renegotiation was not only the most likely but also a very likely scenario. It was thought that the talks would continue to make progress until an agreement was reached and that trade relations among the three countries would be maintained in the years to come with a NAFTA 2.0.

Talks on NAFTA deteriorated in the fourth round, and the path towards “NAFTA 2.0” became much more challenging. The US put forward proposals that were unacceptable to the other parties, as well as once again stressing its intention to reduce its trade deficit.

- i. It seeks to include a clause whereby the agreement will expire every five years unless all three countries agree on an extension (the "sunset clause")
 - 1. This proposal runs counter to the nature of the agreement in introducing an element of uncertainty in firms' investment decisions
- ii. The introduction of specific US content (50%) in automotive production and an increase in North American content to 85% from the current 62.5%
- iii. Limits to the scope for the other two countries to bid for US government contracts

Added to the above proposals is the proposal, already known, and reconfirmed in this fourth round, to eliminate chapter 19 on the resolution of disputes by an independent panel.

The question is what does the US really want . There are two possibilities:

- o Are the proposals a negotiation tactic aimed at obtaining major concessions from the other two countries, particularly Mexico?
- o Is it seeking to make agreement impossible by putting forward unacceptable proposals with a view to later seeking to justify a unilateral withdrawal?

The second possibility seems real, in other words a unilateral withdrawal by the US from NAFTA can no longer be ruled out. In fact, although we continue to assign a probability of more than 50% to a positive outcome of the talks (“NAFTA 2.0”), this is less than the 85% we had been ascribing to it until September. In other words, the probabilities of agreement and breakdown are now more evenly balanced in our opinion. That said, as we have shown in earlier editions of Mexico Economic Outlook, if the US acts in accordance with its economic interests it should keep the agreement in place. The fifth round starts on 17 November and the sixth round will take place in December. The very fact that the talks are continuing is in itself a positive sign within the context of deteriorating expectations following the conclusion of the fourth round. So is the fact that the business sector and certain members of Congress are exerting greater pressure for the preservation of NAFTA.

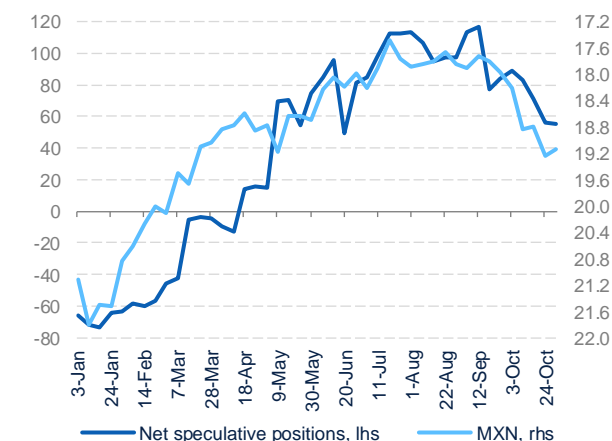
NAFTA and the exchange rate: the risks return

From what was likely to go badly to what could go well

During 2016 the risks associated with the US presidential election made the Mexican peso the poorest performer among emerging market currencies. The election result took the MXN to an all-time low of 22.0 pesos to the dollar in January. From then on and until August the outlook changed from excessively negative to positive. Basically the markets’ perception of the future of economic relations between Mexico and the US changed, and the exchange rate gradually reflected this change. The MXN was starting to move away from its low point (high point in terms of pesos per dollar) associated with the perception of what was likely to go badly (i.e. a possible break-up of NAFTA and the imposition of higher import duties than those of the WTO’s most favoured nation regime), and was gradually returning to levels more consistent with the fundamentals (around 17.0 – 17.5 pesos per dollar) in line with the increasingly widely held view that things might go well in the end and a NAFTA 2.0 could be reached. In fact this is clearly reflected in Figure 4.1, which shows how speculative positions went from betting heavily against the peso at the beginning of the year, to starting to take positions in its favour from April on after gradually winding down their positions against the peso during February and March. This change in the perception of the future of economic relations between Mexico and the US has been the main factor behind the strengthening of the peso during 2017. Indeed, since Trump became a candidate in April 2016 it has been by far the main variable explaining the movements in the peso, both in absolute terms (movement and level of the exchange rate) and in relative terms (comparing movements in the peso to those of other emerging market currencies).

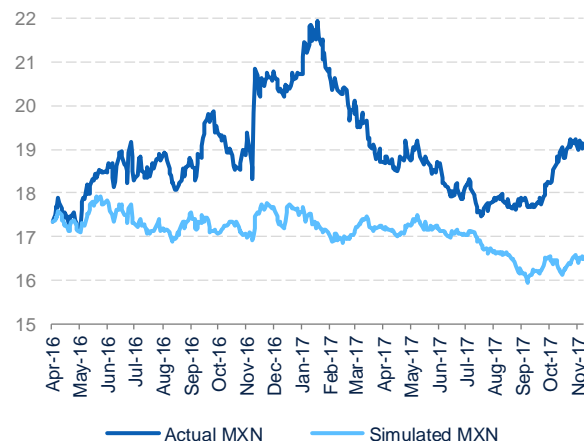
That said, the peso has also benefited from other factors: i) better improved economic prospects thanks to the notable improvement in the US manufacturing sector, ii) the improvement in Mexico’s fundamentals, with the current account deficit shrinking and the expectation that public debt, after rising for years (and at a faster rate in the past four years), will at last come down in 2017, and iii) the increase in Mexico’s interest rates resulting from monetary policy, which allowed the peso to go from being one of the emerging market currencies with the least risk-adjusted carry trade to being one of those with the most, and what is more in a context in which Mexico’s prospects were improving.

Figure 4.1 MXN and net speculative positions in the peso on the CME, 2017 (pesos per dollar, inverted scale and number of contracts in thousands)



Source: BBVA Research and Bloomberg

Figure 4.2 Observed exchange rate and simulated exchange rate* (pesos per dollar, replicating the average performance of other emerging market currencies* since 1 April 2016)



* Own calculations based on a new weighting of the JPMorgan Emerging Markets Currency Index after removing the MXN.
Source: BBVA Research and Bloomberg

Until August the peso was recovering the value lost due to its poor relative performance since April 2016

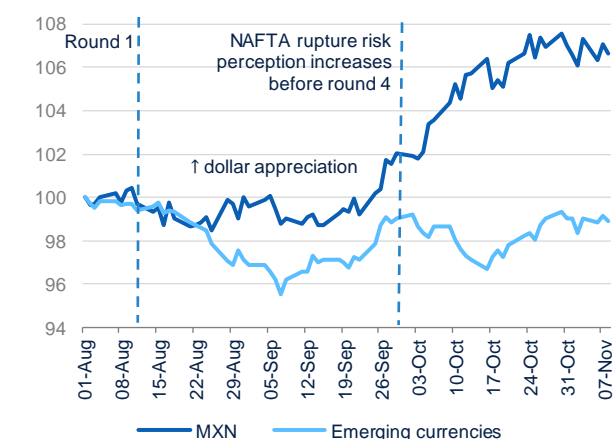
All this, but particularly the expectation that there would be a NAFTA 2.0, explains the strengthening of the peso from February to August 2017 which allowed it to recover its value not just in absolute terms but in relative terms too. Indeed, Figure 4.2 not only illustrates the recovery of the peso but also shows how the markets gradually eliminated the negative differentiation of the peso relative to other emerging market currencies. In order to compare the differentiation of the peso with that of other emerging market currencies, we simulated the trend that the peso would have had since April 2016 (MXN simulated in Figure 4.2). We see clearly how the peso started to deviate from the favourable trend of the emerging market currencies as soon as Trump became a candidate in April 2016. We also see how the peso started to recover the value lost due to this negative differentiation, with the exchange rate going on to reach 17.5 pesos per dollar at the beginning of August. This practically brought the peso back to the value that it would have had if there had been no risks associated with trade relations with the US.

The peso's negative differentiation returned in mid-August and was accentuated at the beginning of October

Although the first three rounds of NAFTA negotiations passed without major setbacks, the peso started to be negatively differentiated again from mid-August, precisely when the NAFTA renegotiation process started (see Figure 4.3). As can be seen, following the conclusion of the first round of NAFTA renegotiations which had started on 16 August, the peso started to evolve less favourably than the other major emerging market currencies. Although it was not depreciating, neither was it appreciating as the other emerging market currencies were on average. In the second half of September

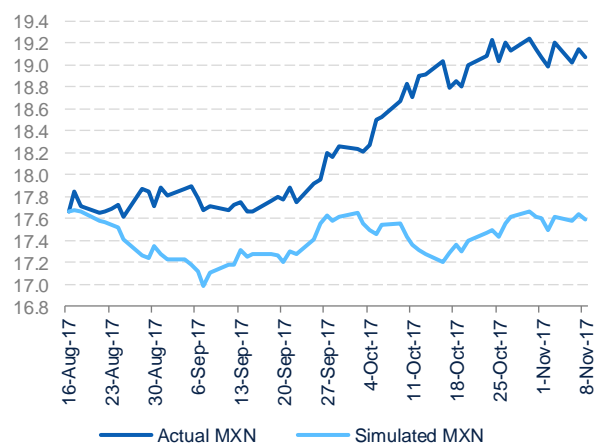
both the peso and the others weakened against the dollar due to the perception that the Federal Reserve would raise its key federal funds rate in December this year (an expectation which until then had not represented the consensus in the financial markets). Nonetheless, we should highlight the fact that during this period there was no such negative differentiation of the peso as had been observed in August. This differentiation can also be seen clearly in Figure 4.2: without the uncertainty associated with the start of the NAFTA renegotiation, the peso would have continued to strengthen, and would indeed very probably have returned to around 17.0 pesos to the dollar.

Figure 4.3 Exchange rate (MXN) compared with that of other emerging market currencies*, Aug-Oct (1 Aug 17= 100; +/- for depreciation / appreciation against the dollar)



* Own calculations based on a new weighting of the JPMorgan Emerging Markets Currency Index after removing the MXN.
Source: BBVA Research and Bloomberg

Figure 4.4 Observed exchange rate and simulated exchange rate* (pesos per dollar, replicating the average performance of other emerging market currencies* since 16 August 2016)



* Own calculations based on a new weighting of the JPMorgan Emerging Markets Currency Index after removing the MXN.
Source: BBVA Research and Bloomberg

At the beginning of October, before the start of the fourth round of the NAFTA renegotiation, the negative differentiation of August returned, but this time with a vengeance. The peso's weakness was accentuated as soon as news leaked of the proposals that the US was going to put forward in this round. The peso weakened from then on and returned to levels of around 19.0 to the dollar, ceding part of the ground it had regained over the course of the year following the change in prospects (see Figure 4.4).

In short, the weakening of the peso since mid-August has been entirely due to the risks associated with NAFTA. The peso's poor relative performance started with the first round of talks on NAFTA 2.0, was unaffected by more hawkish comments from the US Federal Reserve, and was accentuated in October with the increased risk of NAFTA breakdown.

Looking ahead, any change in trend will continue to be mainly in reaction to shifting prospects for the renegotiation of NAFTA. If subsequent rounds evolve more favourably and agreement is reached, the peso should strengthen, with the exchange rate returning to around 17.0 pesos to the dollar. Conversely, if the perceived risk of NAFTA break-up increases and if this risk materialises, the peso would depreciate by a further 5% approximately to around 20.0 pesos per dollar. For the moment, from now to the end of the year uncertainty will remain high and the exchange rate could continue to fluctuate around current levels of 19.0 pesos to the dollar. We are therefore maintaining our forecast of

MXN18.70 per USD at year-end. Added to the risk of the renegotiation process in the first half of 2018 will be the uncertainty typically associated with presidential elections in Mexico. The effects of this uncertainty will be seen mainly in the second quarter, in the months just before the election. Right now it is difficult to anticipate a level for the exchange rate, since we do not know what the starting point is. In other words it will be much lower (fewer pesos per dollar, stronger peso) than now if the prospects for NAFTA 2.0 improve, and even higher than now if the risk of break-up materialises. We could anticipate that, from the starting point at the end of the first quarter of 2018, the exchange rate could increase by about 5.0% and then decrease after the elections, irrespective of the result in our opinion, although at different speeds depending on it.

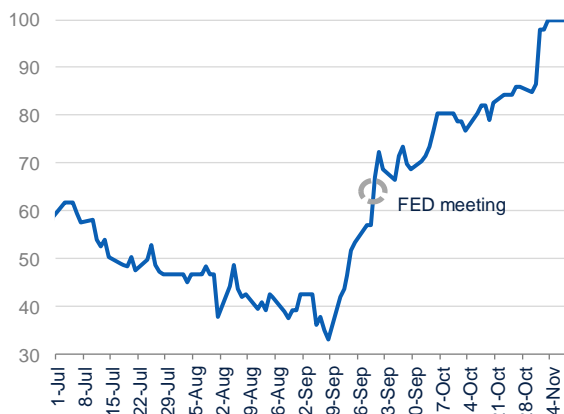
The incorporation of further US interest rate hikes into market expectations and the renegotiation of NAFTA influence the performance of domestic assets

The economic environment continues to be characterised by the reactivation of growth globally, low levels of risk aversion and expectations that monetary stimulus measures will be withdrawn very gradually. This last feature of the environment was adjusted slightly following the US Federal Reserve's September statement stressing that a further rate hike in December was a real possibility. This reflects the fact that, as in the past few years, investors' expectations regarding the pace of US monetary normalisation differ significantly from those of FOMC members, so much so that investors were assigning a probability of less than 35% to an additional rate hike in December before the meeting referred to.

This change in expectations gave rise to several movements in asset prices. The dollar, which had remained weak since the second quarter of the year, strengthened against all other currencies. Between 20 September when the Federal Reserve meeting took place and 7 November, the dollar gained 2.6% against developed market currencies and 3.7% against those of emerging markets. In the government debt market yield to maturity on ten-year US Treasuries rose by as much as 20 bps to 2.46% at its peak before settling at around 2.3%. On the short section of the yield curve yield to maturity of the one-year bond rose by 21 bps to 1.5%, its highest level since 2008. Thus the curve continues to flatten, influenced by the absence of inflationary pressures in spite of the recovery in the US labour market.

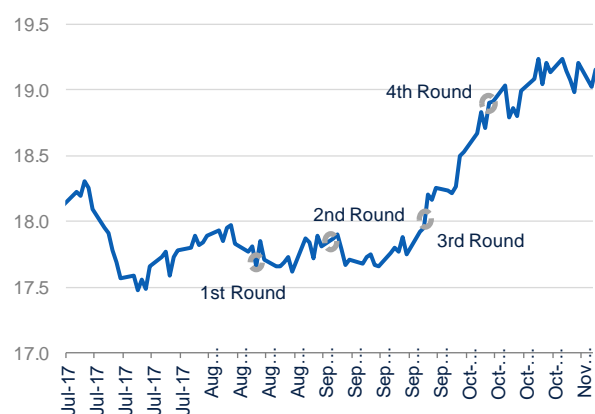
In the equity markets we continue to see significant gains underpinned by better-than-expected economic data globally and good corporate earnings reports. Both the worldwide benchmark for this asset class and the S&P500 are posting new all-time highs following gains of 2.4% and 3.3% respectively. We must mention that in the case of the S&P500 the expectation that November would see approval of the tax reform announced by the Trump administration also played a part. In the case of the emerging markets, growth was slightly less (2.2%), but at a level not seen since 2011.

Figure 4.5 Implied probability of an increase in the Federal Funds Rate in the Futures Market (%)



Source: BBVA Research based on Bloomberg data

Figure 4.6 Exchange rate and dates of conclusion of the NAFTA renegotiations (pesos to the dollar)



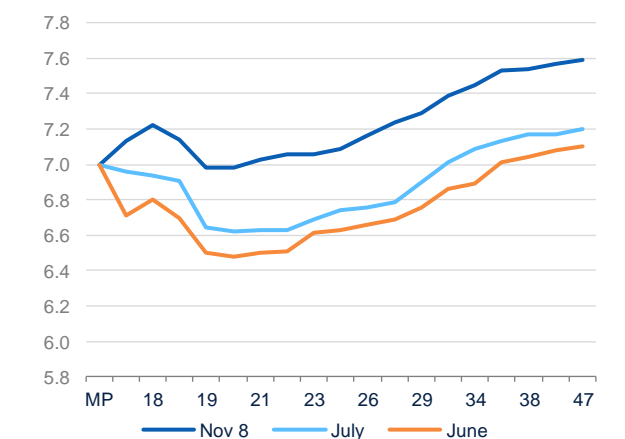
Source: BBVA Research based on Bloomberg data

In the case of Mexican assets, the increased uncertainty about a possible break-up of NAFTA led to negative differentiation. The most notable case is that of the exchange rate, as explained in the previous section. In fact, having been the currency that appreciated most during the first half of the year, the Mexican currency is now, after the Turkish lira, the second most depreciated since the start of the NAFTA renegotiation process on 16 August last. In spite of this significant depreciation, volatility and liquidity have not deteriorated much so far. It is worth highlighting that in response to this depreciation Banxico increased the amount of currency hedging auctions payable in pesos from one to four billion dollars.

Country risk, measured by the spread of the five-year CDS, increased by 15 bps after the US Federal Reserve meeting to 115 bps. This same level was reached again after the fourth round of NAFTA talks before falling slightly to 110 bps. Although this increase was significant, mention must be made of the fact that the level of this indicator is far removed from the long-term mean, which stands at around 130 bps, given the prevailing appetite for risk at the global level.

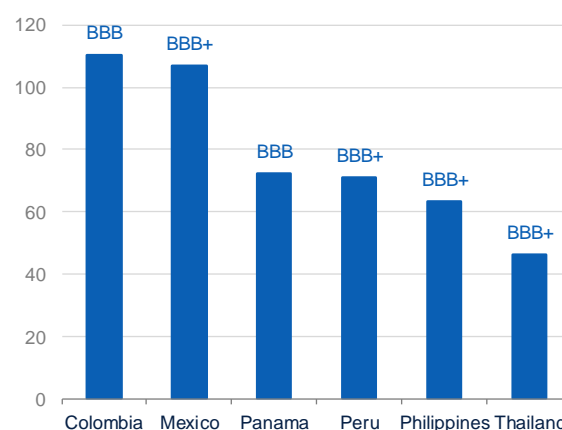
The increase in country risk, together with the Federal Reserve's starting to reduce its balance sheet, which brings the liquidity risk back down to levels more in line with those prior to the crisis, is behind the increase in long-term interest rates. It is worth recalling that since the last increase in the monetary rate, in June last, the curve had been showing a negative slope, so the movements described have reversed this situation. In effect, the yield to maturity of the ten-year government bond has risen by around 40 bps since 20 September to its present level of 7.25%. This situation was also influenced by the change in expectations regarding monetary policy, which have recently been factoring in a further rate hike of 25 bps next year. The higher interest rates have not been correlated with lower inflows of funds from abroad. In fact in the past three months holdings of medium- and long-term bonds have increased by around US\$2.7 billion, and the year-to-date increase has been approximately US\$6.3 billion. Lastly, negative differentiation was also observed in the Mexican stock market. The IPC stock index fell by 2.7% between 20 September and 7 November, while the emerging markets benchmark gained 2.0%. Nonetheless, so far this year the IPC stock index has gained 7.0%, reflecting the larger gains of higher-risk assets.

Figure 4.7 Government yield curve (%)



Source: BBVA Research using Valmer data

Figure 4.8 Sovereign risk. Five-year CDS spread by rating level (basis points)



Data as at 31 October 2017.

Source: BBVA Research based on Bloomberg data

In short, the renegotiation of NAFTA remains the main risk factor for the performance of Mexican assets, although the pace of monetary normalisation in the US continues to influence all emerging economies' assets, including Mexico's. The complex situation in which the NAFTA renegotiation is taking place leads us to think that going forward the conditions of volatility will persist and that market participants will be particularly attentive to any news on this subject. Long-term interest rates will remain at around their current levels providing there are no significant changes in expectations regarding monetary policy and in sovereign risk in the next few months. Specifically, we expect the yield to maturity of 10-year government bonds to end the year at around 7.3%.

Trade scenario in the event of break-up of NAFTA

If the US opts to withdraw unilaterally from NAFTA, trade relations between Mexico and the US would continue under the most favoured nation (MFN) tariffs set by the World Trade Organisation (WTO). In this case Mexico's exports to the US would face a weighted average tariff of 3.5%, while US exports to Mexico would pay a weighted average tariff of 4.9%. It is important to note that nearly 50% of Mexico's exports to the US currently pay the MFN tariff due to the fact that the verification of national content required for products to qualify for the benefits of NAFTA (0% tariff) in some cases involve high costs for producers.

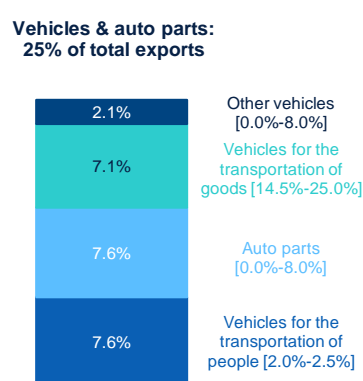
We estimate that the break-up of NAFTA would not have an across-the-board effect on trade flows, although it would have a negative effect on investment and on specific sectors such as production of vehicles for the transport of goods. This segment accounts for 6.1% of Mexico's total exports to the US and would face a tariff of 25% under the WTO's MFN regime.⁵ The other major segments of the automotive sector,⁶ auto parts (7.6% of total exports) and passenger vehicles (7.6% of total exports) would face weighted average tariffs of 1.3% and 2.5% respectively.

5: Except for compression-ignition piston-engine (diesel or semi-diesel) trucks with a total laden weight of more than five but not more than twenty metric tons.

6: Chapter 87 of the Harmonised Commodity Description and Coding System. This sector accounts for 24.3% of Mexico's total exports to the US.

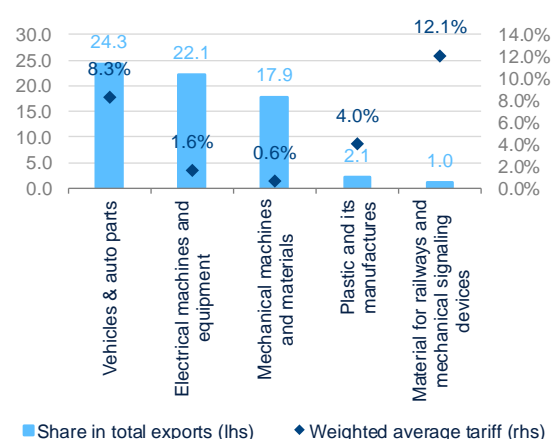
Other sectors with a large share of total exports, such as electrical and mechanical machinery and equipment (22.1% and 17.9% respectively) would face weighted average tariffs of 1.6% and 0.6% respectively. Plastic products (2.1% of total exports) and railway and mechanical signalling equipment (1.0% of total exports) would pay weighted average import duties of 4.0% and 12.2% respectively. These four sectors together, plus the automotive sector, are the five that contribute most (2.7 pp) to the weighted average tariff of 3.5% for total exports of goods.⁷

Figure 4.9 Exports of vehicles and auto parts.
Composition & WTO Tariff



Source: BBVA Research based on data from INEGI & WTO

Figure 4.10 Weighted average tariff of selected sectors and WTO tariff



Source: BBVA Research based on data from INEGI & WTO

We estimate that the elimination of NAFTA would affect economic growth mainly through investment (FDI and private domestic gross fixed investment). As regards FDI, the segment most affected would be manufacturing, especially the segment of the automotive sector specialising in trucks, which would be faced with import duties of 25% under the MFN regime. Although other sectors could feel the effects, we consider that the expected depreciation of the peso would more than proportionally offset the increase in tariffs on exports.

We consider that the reduced dynamism of export production in the automotive sector, especially the truck segment, would discourage investment in related domestic sectors (auto parts, accessories, etc.), so we would expect to see less growth in private sector domestic gross fixed investment. The biggest fall seen in private sector gross fixed investment in the recent past amounted to 15.5%, in 2009; we would not expect to see a fall of that magnitude in the event of the break-up of NAFTA. We estimate that the fall would be between 2% and 4%.

Assuming a fall of 7.4% in FDI and a decline in domestic gross fixed investment of between 2% and 4%, we estimate that the ending of NAFTA would have a negative effect on GDP growth in 2018 of between 0.5 and 0.8 pp.

7: The five sectors in question correspond to chapters 87, 85, 86, 84 and 39 of the Harmonised Commodity Description and Coding System.

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates' salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

This document is provided in the United Kingdom solely to those persons to whom it may be addressed according to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and it is not to be directly or indirectly delivered to or distributed among any other type of persons or entities. In particular, this document is only aimed at and can be delivered to the following persons or entities (i) those outside the United Kingdom, (ii) those with expertise regarding investments as mentioned under Section 19(5) of Order 2001, (iii) high net worth entities and any other person or entity under Section 49(1) of Order 2001 to whom the contents hereof can be legally revealed.

The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA Bancomer and the rest of BBVA Group who are not members of FINRA (Financial Industry Regulatory Authority), are not subject to the rules of disclosure for these members.

"BBVA Bancomer, BBVA and its subsidiaries, among which is BBVA Global Markets Research, are subject to the Corporate Policy Group in the field of BBVA Securities Markets. In each jurisdiction in which BBVA is active in the Securities Markets, the policy is complemented by an Internal Code of Conduct which complements the policy and guidelines in conjunction with other established guidelines to prevent and avoid conflicts of interest with respect to recommendations issued by analysts among which is the separation of areas. Corporate Policy is available at: www.bbva.com / Corporate Governance / Conduct in Securities Markets".

This report has been produced by the macroeconomic unit of Mexico:

Chief Economist

Carlos Serrano
carlos.serrano@bbva.com

Javier Amador
javier.amadord@bbva.com

Iván Martínez
ivan.martinez.2@bbva.com

Arnulfo Rodríguez
arnulfo.rodriguez@bbva.com

Saidé A. Salazar
saidearanzazu.salazar@bbva.com

BBVA Research

Group Chief Economist

Jorge Sicilia Serrano

Macroeconomic Analysis

Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios

Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets

Sonsoles Castillo
s.castillo@bbva.com

Long Term Global Modelling and Analysis

Julián Cubero
juan.cubero@bbva.com

Innovation and Processes

Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems and Regulation

Santiago Fernández de Lis
sfernandezdelis@bbva.com

Countries Coordination

Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation

Álvaro Martín
alvaro.martin@bbva.com

Regulation

María Abascal
maria.abascal@bbva.com

Financial Systems

Ana Rubio
arubiog@bbva.com

Financial Inclusion

David Tuesta
david.tuesta@bbva.com

Spain and Portugal

Miguel Cardoso
miguel.cardoso@bbva.com

United States

Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico

Carlos Serrano
carlos.serranoh@bbva.com

Middle East, Asia and Geopolitical

Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey

Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia

Le Xia
le.xia@bbva.com

South America

Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina

Gloria Sorensen
gsorensen@bbva.com

Chile

Jorge Selaive
jselaive@bbva.com

Colombia

Juana Téllez
juana.tellez@bbva.com

Peru

Hugo Perea
hperea@bbva.com

Venezuela

Julio Pineda
juliocesar.pineda@bbva.com

CONTACT DETAILS: BBVA Research – BBVA Bancomer: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 México D.F., México
e-mail: bbvaresearch_mexico@bbva.com - bbvaresearch@bbva.com www.bbvaresearch.com