

Mexico Economic Outlook

2Q20

Economic Effects of the Health Emergency

April 2020

Key messages

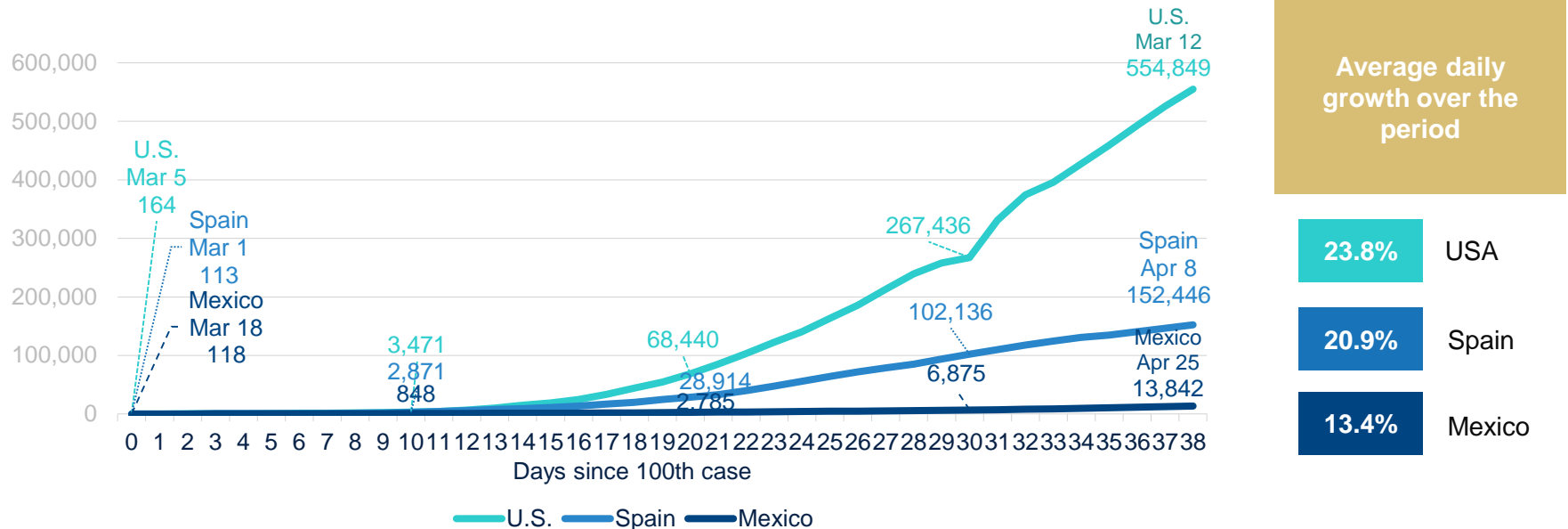
- Pandemic behavior forecasts according to statistical models
- Sharp decline in economic activity; currently no adequate countercyclical policies
- As we predicted, downward pressure on inflation is dominating; Banxico should accelerate rate cuts
- Long-term interest rates will continue to fall, though the slope will remain high due to higher risk premiums
- The negative differentiation in the peso will fall slightly; we anticipate lower exchange rates by year end

01

Pandemic Predictions According to Statistical Models

Confirmed Cases of COVID-19: Mexico vs. USA and Spain

CUMULATIVE CONFIRMED CASES OF COVID-19 IN MEXICO, USA AND SPAIN SINCE 100TH CASE (UPDATED APRIL 25, 2020)

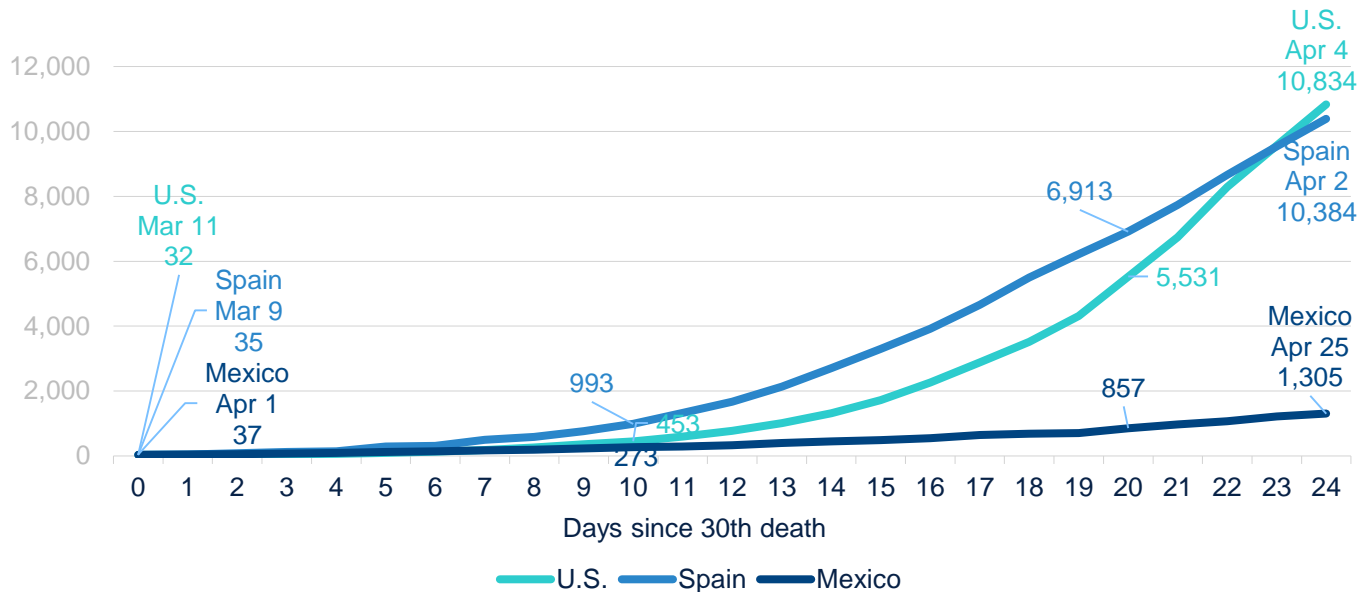


Notes: From the 100th case, the progression is shown after 10, 20, 30 and 38 days.

Source: BBVA Research based on data from the Mexican Department of Health, the CDC (Centers for Disease Control and Prevention), Johns Hopkins Coronavirus Resource Center and the ISCIII (*Instituto de Salud Carlos III* — Carlos III Health Institute).

Deaths Caused by COVID-19: Mexico vs. USA and Spain

CUMULATIVE DEATHS CAUSED BY COVID-19 IN MEXICO, USA AND SPAIN SINCE 30TH DEATH (UPDATED APRIL 25, 2020)



Average daily growth over the period

27.5% USA

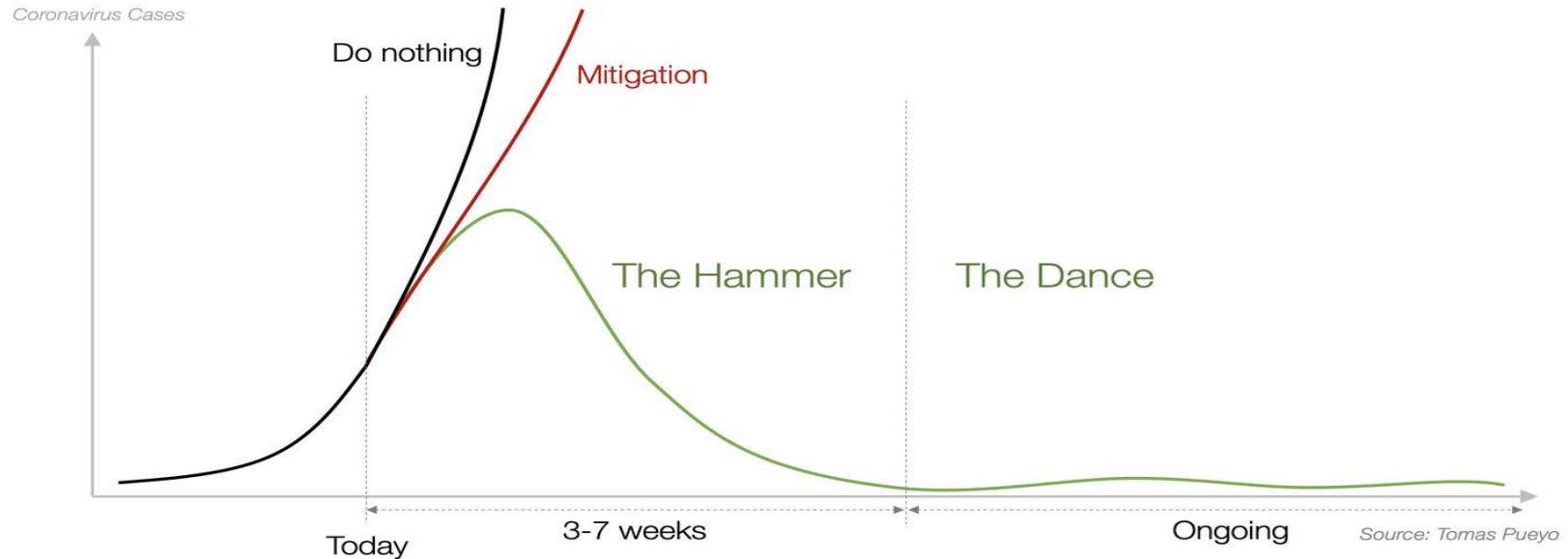
26.8% Spain

16.0% Mexico

Notes: From the 30th death, the progression is shown after 10, 20 and 24 days.

Source: BBVA Research based on data from the Mexican Department of Health, the CDC, Johns Hopkins Coronavirus Resource Center and the ISCIII.

Coronavirus: Social Effects Depending on the Implementation of Different Mitigation Measures



02

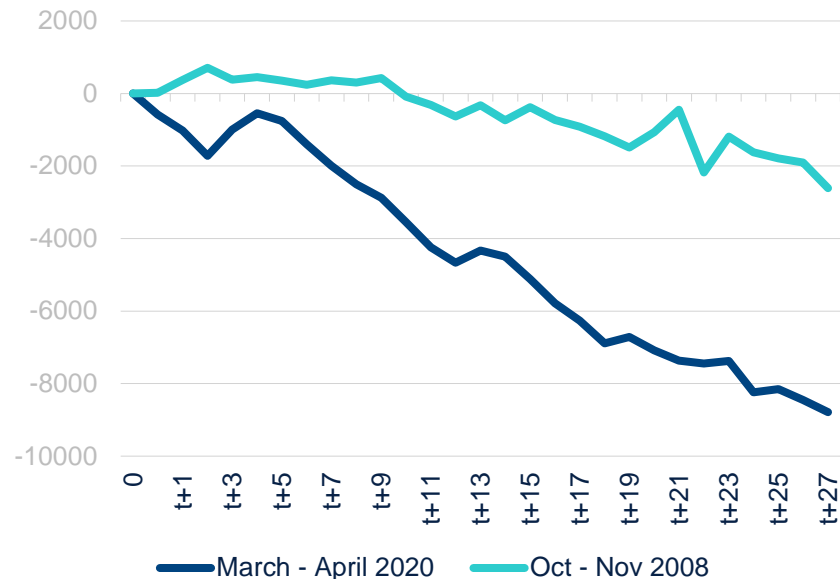
Sharp Fall in Economic Activity

Effect of Activity Shutdown in Mexico

1. Reduced demand and therefore lower economic activity
2. Supply constraints due to plant closures
 - Disruptions in global value chains and lower external demand
3. Falling oil prices weaken Pemex finances
4. Collapse in the tourism sector
5. Significant drop in remittances (at least 20%)
6. Outflow of capital

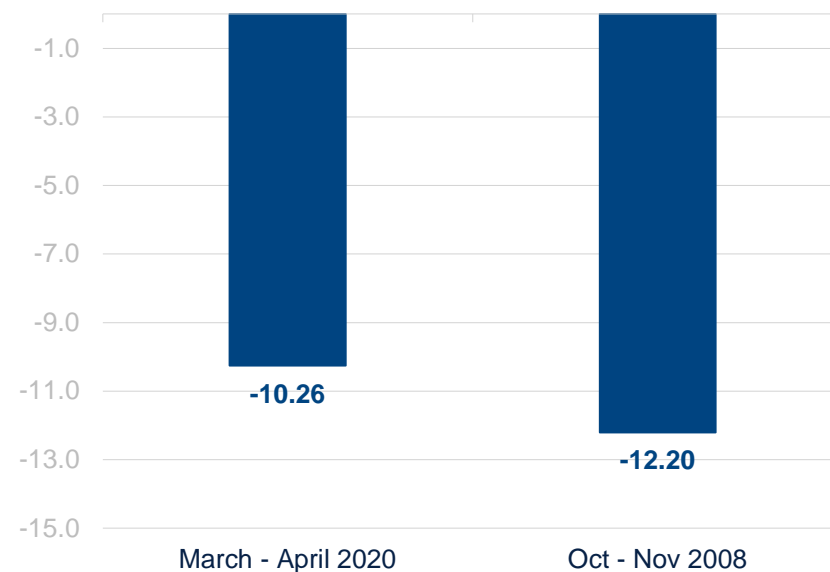
In Percentage Terms, Outflows During the Current Risk Episode Are Comparable to Those of the 2008 Financial Crisis

CUMULATIVE CHANGE IN FOREIGN-HELD M BONDS, OCT-NOV 2008 AND MAR-APR 2020* (IN MILLIONS OF DOLLARS, NOMINAL VALUE)



* Using data as of April 13, 2020
Source: BBVA Research/Banxico

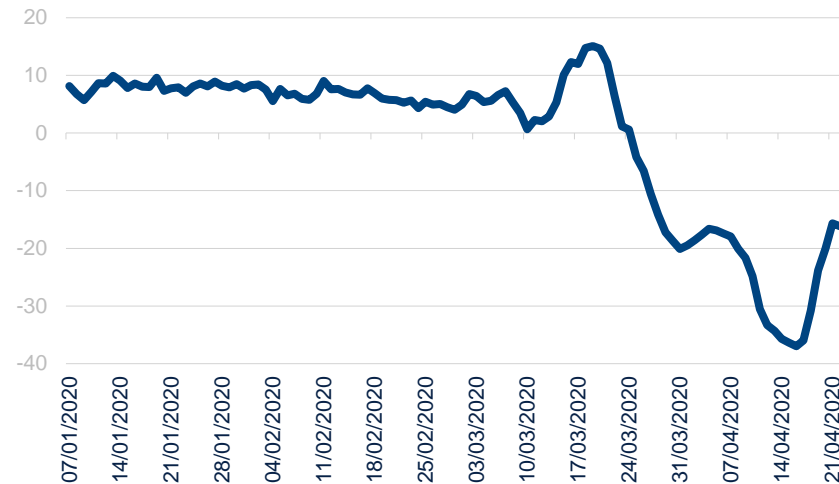
CUMULATIVE CHANGE IN FOREIGN-HELD M BONDS, OCT-NOV 2008 AND MAR-APR 2020 (% OF NOMINAL VALUE IN MXN)



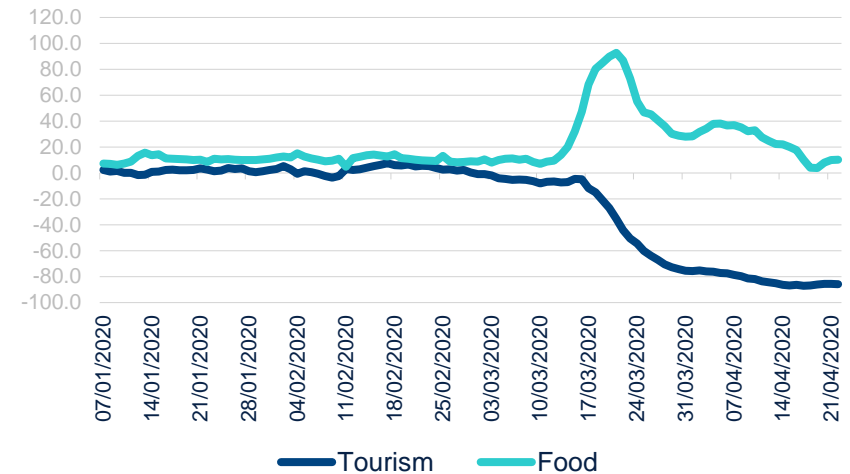
* Using data as of April 13, 2020
Source: BBVA Research/Banxico

Daily Data: The BBVA Consumption Indicator Shows a Drastic Fall Since the Last Week of March

BBVA CONSUMPTION INDICATOR*
(REAL YoY%, 7-DAY MOVING AVERAGE)



BBVA CONSUMPTION INDICATOR: TOURISM AND FOOD*
(REAL YoY%, 7-DAY MOVING AVERAGE)



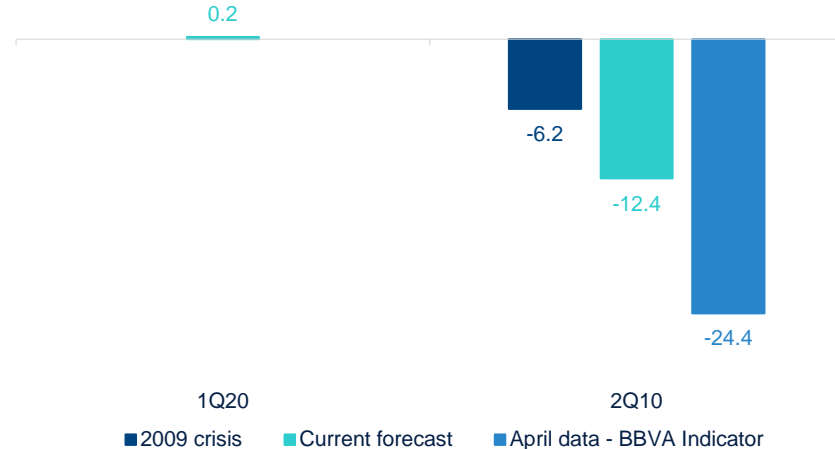
Source: Reuters, Cochilco and BBVA Research

In terms of YoY change, total expenditure in real terms in the first 22 days of April fell by 24.4%, pointing to a sharper-than-expected decline in 2Q20. The tourism sector is the most heavily affected.

Data From April Points to the Biggest Drop in Private Consumption in Recent History

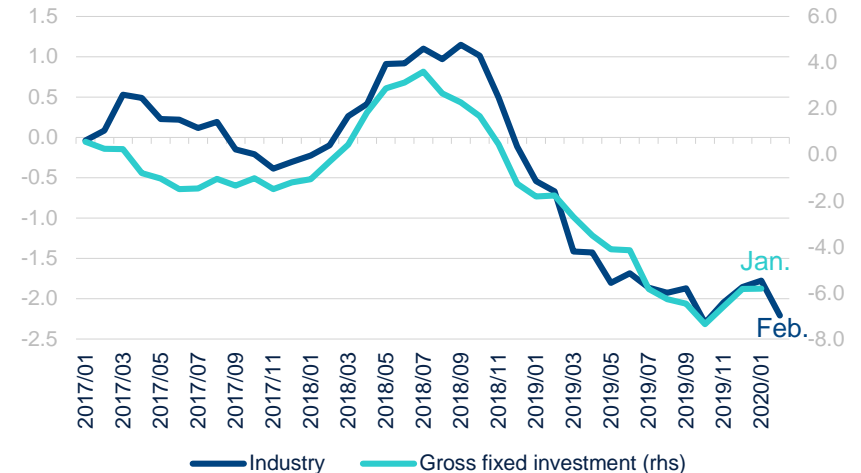
PRIVATE CONSUMPTION*

(YoY%, SA)



INDUSTRIAL PRODUCTION

(YoY%, 6-MONTH MOVING AVERAGE, SA)



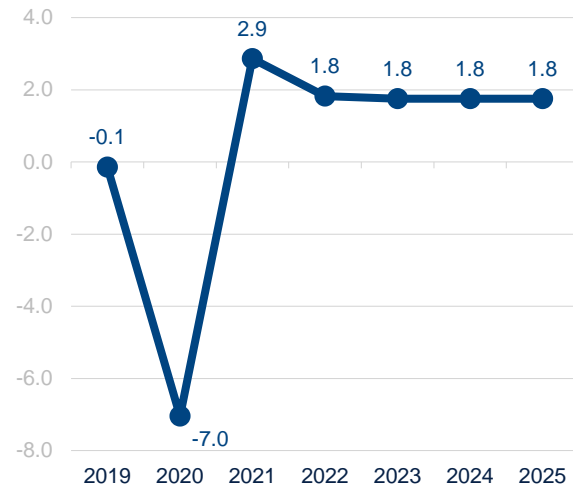
Source: BBVA Research/INEGI (*Instituto Nacional de Estadística y Geografía* — National Institute of Statistics and Geography of Mexico)

*Data for 2009 corresponds to 2Q09. The data for April corresponds to the YoY% change in real terms of the BBVA consumption indicator in the first 22 days of April.

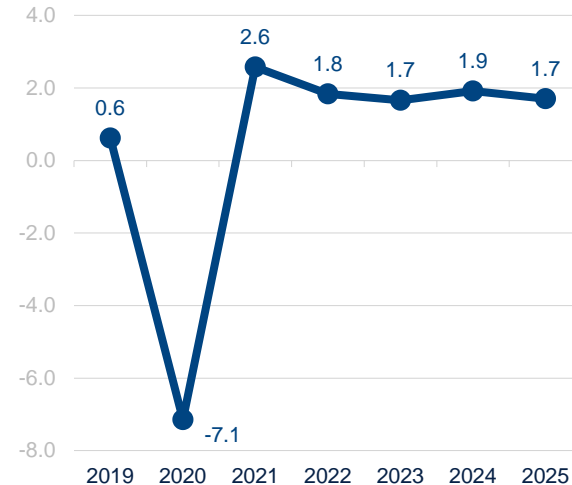
A moderate estimate would be a drop of at least two digits in 2Q20 (forecast -12.4%). Industrial production has deteriorated since April, suggesting early damage to value chains.

We Anticipate a Fall in GDP of Between 6.0% and 12.0% in 2020 (Point Estimate -7.0%)

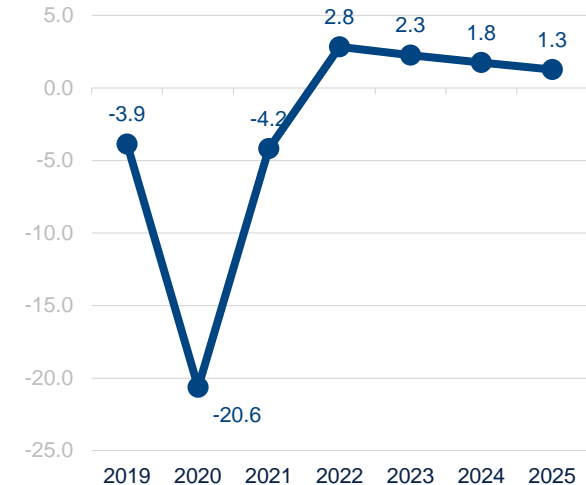
GDP
(YoY % CHANGE, SA)



PRIVATE CONSUMPTION
(YoY % CHANGE, SA)



PRIVATE INVESTMENT
(YoY % CHANGE, SA)



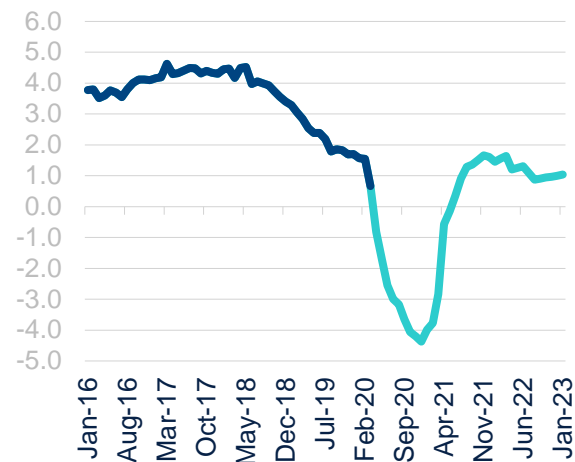
Source: BBVA Research/INEGI

Private consumption could fall by 7.1% due to social distancing measures and the negative impact on employment. Private investment could contract by 20.8% in the face of a global recession and increased domestic uncertainty surrounding questionable decisions made by the Mexican federal government. We anticipate that GDP will recover in 2021, with a growth of 2.9%.

Employment Heavily Impacted by the Contraction of Economic Activity and the Lack of Economic Policy Measures

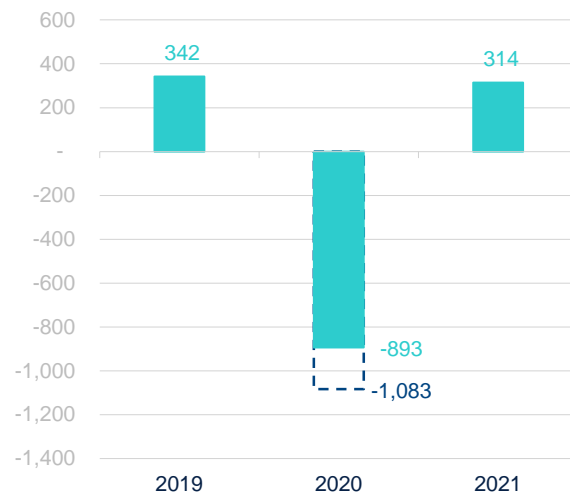
FORMAL EMPLOYMENT

(YoY % CHANGE)



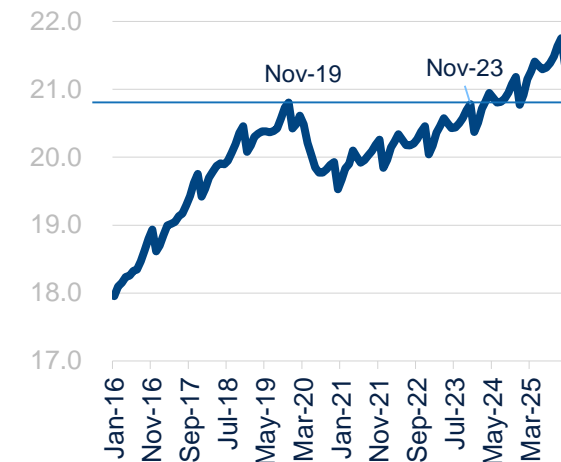
FORMAL EMPLOYMENT

(THOUSANDS OF JOBS, YoY % CHANGE TO DECEMBER)



FORMAL EMPLOYMENT

(MILLIONS OF JOBS)



Source: BBVA Research/IMSS (*Instituto Mexicano del Seguro Social* — Mexican Social Security Institute)

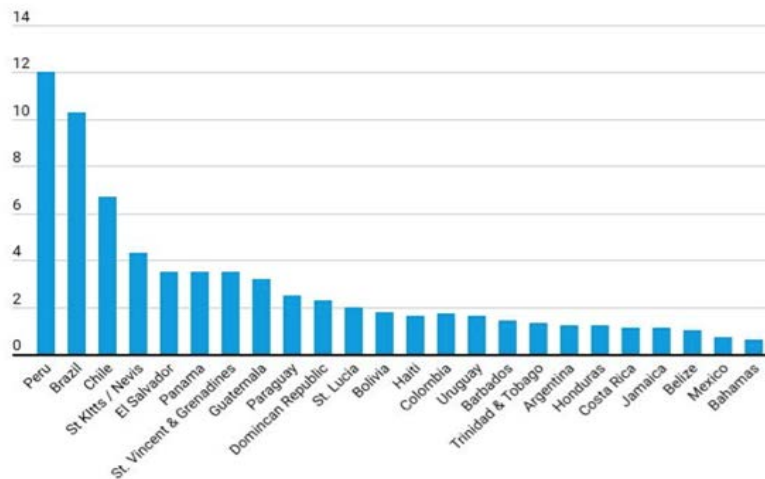
Based on GDP contracting 7.0%, we expect a net loss of between 893k and 1,083k formal jobs by the end of 2020, which would be a substantially higher job-loss figure than in 2009. If the drop in GDP is larger than this, then the job-loss figure could be above this range.

03

Decisive Fiscal Support is Needed...

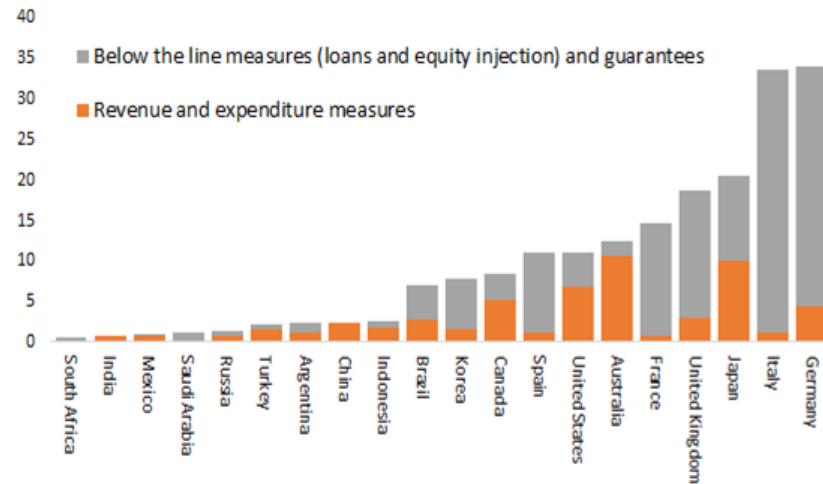
Mexico's Weak Fiscal Response to the COVID-19 Pandemic

PACKAGES ANNOUNCED IN RESPONSE TO COVID-19 (PACKAGES ANNOUNCED, % OF GDP)



Source: IMF

FISCAL MEASURES IN RESPONSE TO COVID-19 (% OF GDP)



Below the line measures generally involve the creation of assets, such as loans or equity injection.

What Can Be Done?

1. Recession is inevitable, but there are things we can do to speed up the recovery — if no action is taken, the recession will be deep and long-lasting
2. Economy or health: the false dichotomy
3. A robust fiscal reaction is needed, which will mean a faster recovery, and, paradoxically, lower fiscal deterioration in the medium term: IMF, fiscal reform
 - ❑ Health Sector
 - ❑ Companies
 - ❑ Most vulnerable groups in the population
4. Massive development banking program for SMEs
5. Relaxation of monetary policy and liquidity facilities
6. Mitigate the financial impact on Pemex

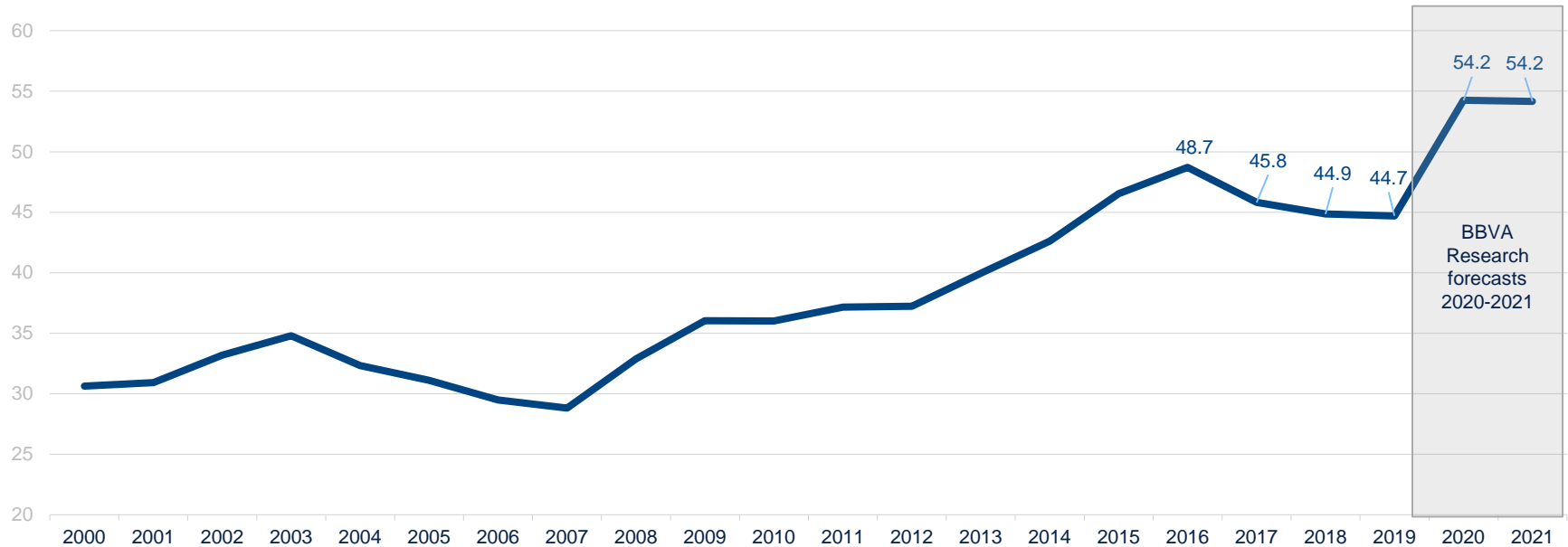
How Can Companies Be Supported?

1. The idea that profits are privatized and losses are socialized has held sway in the past
2. This can lead to moral hazard (ex ante or ex post)
3. However, companies can be supported without engaging in this practice, it would be a political mistake to allow viable companies to disappear: as it would lead to slower recovery and job losses
4. Aid must be subject to companies:
 - ❑ Maintaining their workforce
 - ❑ Not paying dividends or buying back shares
 - ❑ Giving the government equity participation options

The Historical Balance of the Public Sector's Financial Requirements Will Rise to 54.2% of GDP in 2020 and 2021

HISTORICAL BALANCE OF PUBLIC SECTOR FINANCIAL REQUIREMENTS

(% OF GDP)

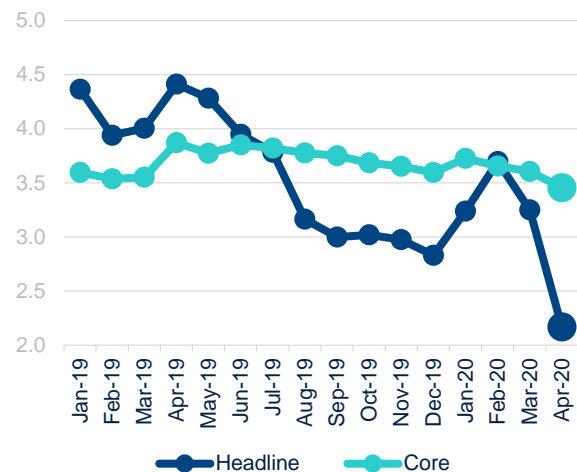


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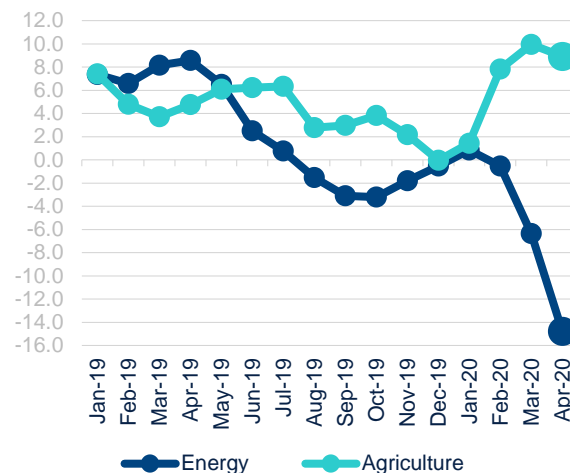
...as well as a loose stance of monetary policy: Banxico should pick up the pace of interest rate cuts

As We Predicted, In March and the First Half of April, There Was Strong Downward Pressure on Inflation

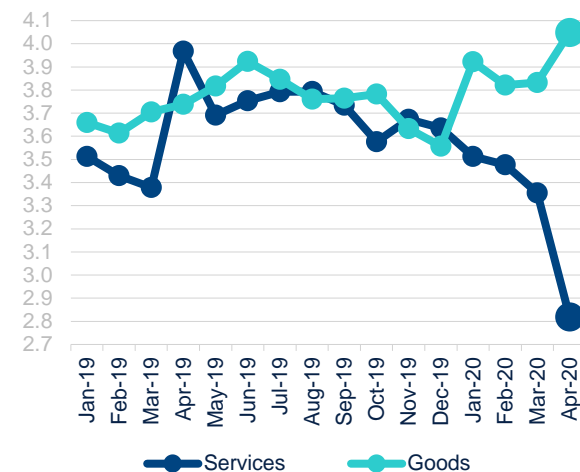
HEADLINE AND CORE INFLATION (% CHANGE YoY)



NON-CORE INFLATION AGRICULTURE AND ENERGY (% CHANGE YoY)



CORE INFLATION: GOODS AND SERVICES (% CHANGE YoY)

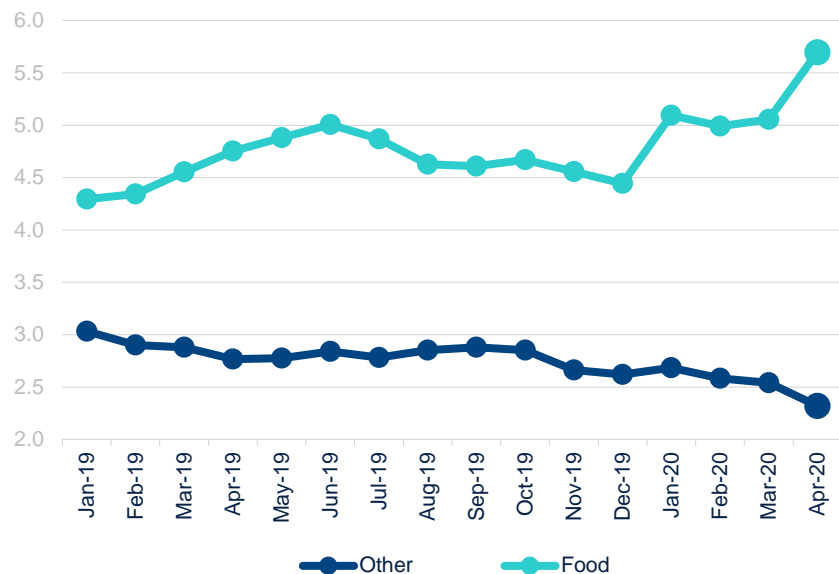


* April figures are a forecast, but incorporate data from the first half of the month
Source: BBVA Research/INEGI

The fall in energy prices more than offset the higher rate of increase in foods, and the downward trend of the services sub-index more than balanced the higher rate of increase in goods (due to processed foods).

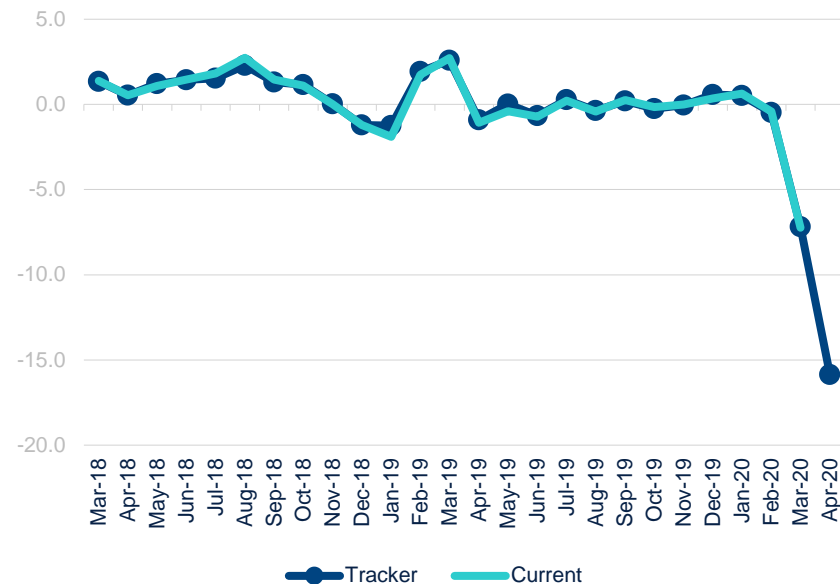
Downward Trends Increased in April As We Expected: Headline Inflation Will Decelerate to 2.2% and Core Will Decelerate to 3.5%

CORE INFLATION OF GOODS (% CHANGE YoY)



* April figures are a forecast, but incorporate data from the first half of the month
 Source: BBVA Research/INEGI

LOW-OCTANE GASOLINE PRICES: OBSERVED VS. TRACKER (% CHANGE MoM)

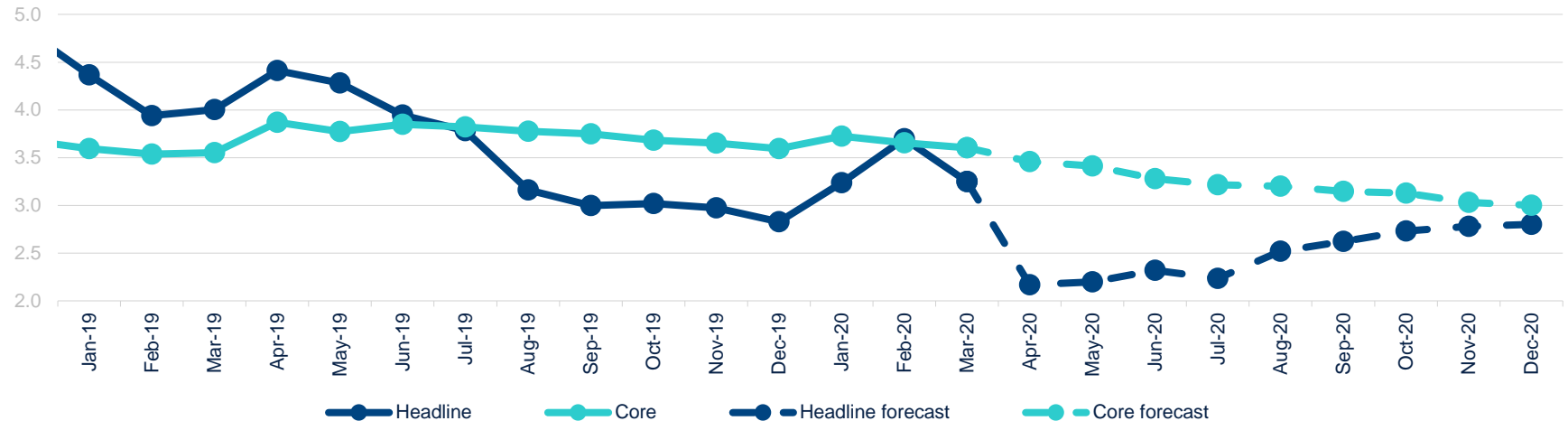


Source: BBVA Research/PETROintelligence

We Anticipate that Headline Inflation Will Remain Below 2.5% On Average During 2Q-3Q

BBVA RESEARCH HEADLINE AND CORE INFLATION OUTLOOK

(% CHANGE YoY)



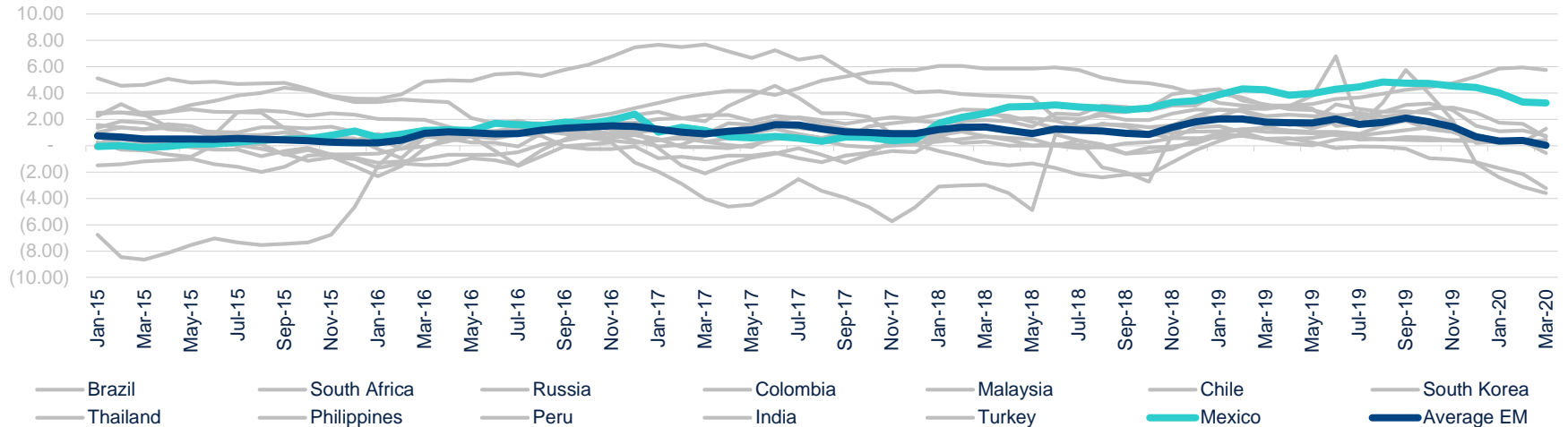
Source: BBVA Research/INEGI

Headline inflation will then rise moderately to close below 3.0% in December, while core inflation will slow to 3.0%.

Banxico Has Plenty of Margin to Continue Cutting Interest Rates and Increasing the Pace At Which It Does So

EX POST REAL INTEREST RATE IN EMERGING ECONOMIES

(%)



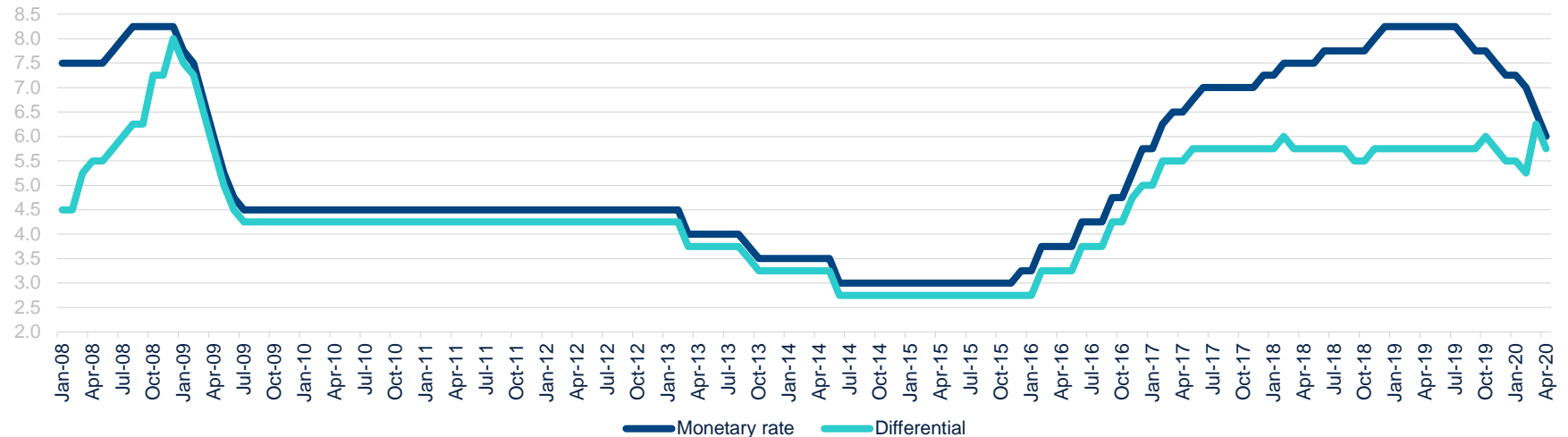
Source: BBVA Research/Bloomberg

Surprisingly, the real interest rate remains very high.

Banxico Has Plenty of Margin to Continue Cutting Interest Rates and Increasing the Pace At Which It Does So

NOMINAL AND DIFFERENTIAL INTEREST RATES COMPARED TO THE FEDERAL FUNDS RATE (%)

(%)



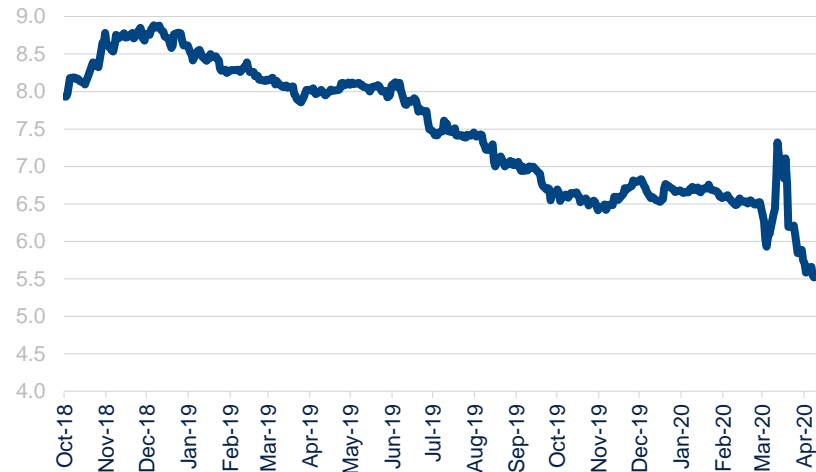
Source: BBVA Research/Bloomberg

The differential with the federal funds rate remains at 5.75 pp; i.e. it has yet to drop.

A More Aggressive Pace of Cuts and an Expansive Monetary Policy Stance Are Justified

26-MONTH TIE* SWAPS (%)

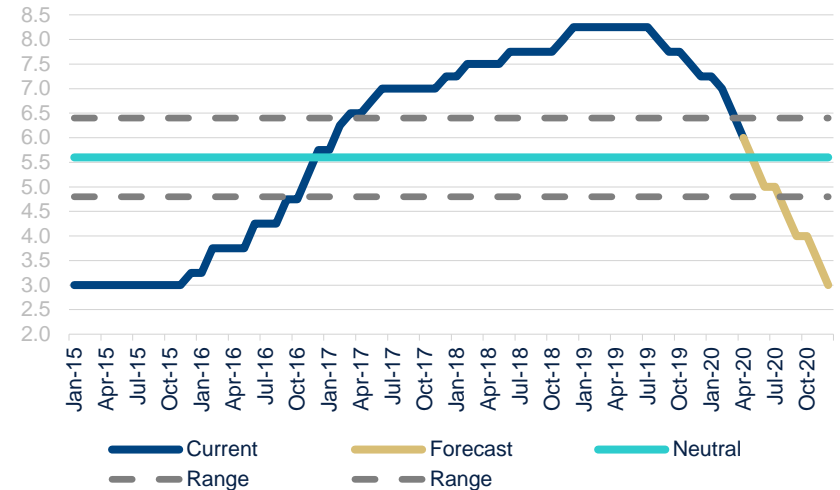
(%)



* Tasa de Interés Interbancaria de Equilibrio — Mexican Equilibrium Interbank Interest Rate
Source: BBVA Research/INEGI

BBVA RESEARCH INTEREST RATE OUTLOOK (%)

(%)

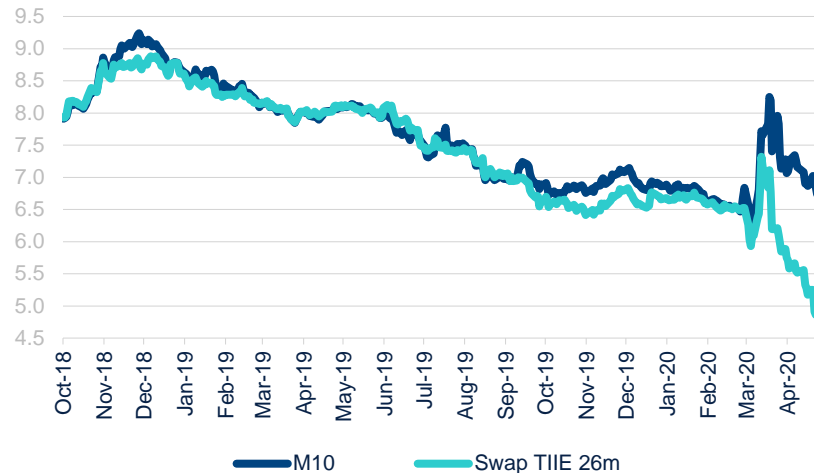


Market expectations have been gradually converging with our long-term expectation in the trend of cuts. We anticipate an expansive stance in 2H20, with the interest rate reaching 3.0% by the end of the year.

Long-Term Rates Have Fallen Very Little, With Further Cuts Anticipated, As We Expected, but There Is Room for Them to Continue Falling

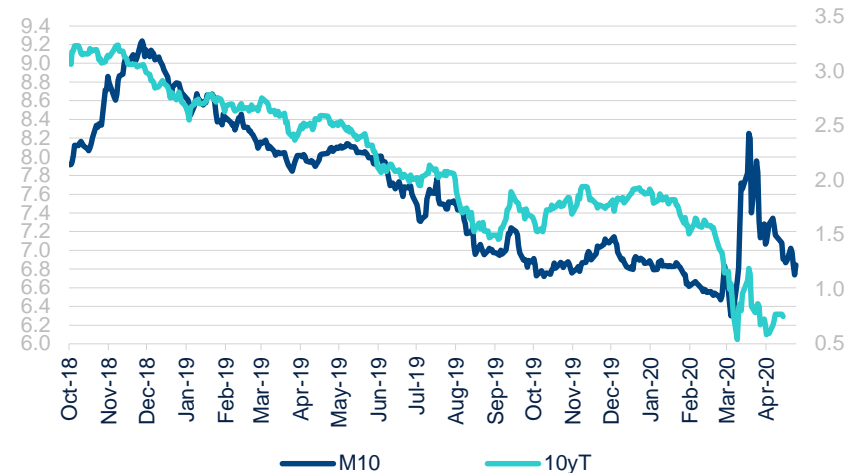
M10 AND 26-MONTH TIIE SWAPS (%)

(%)



M10 AND 10-YEAR TREASURY NOTES (%)

(%)

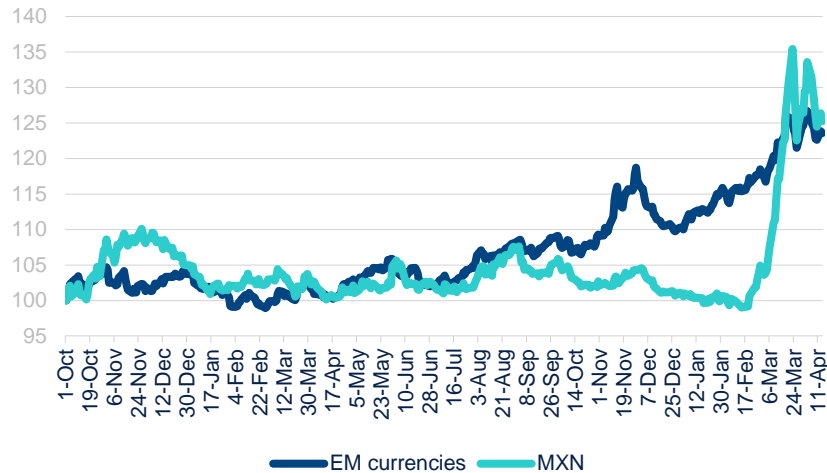


Source: BBVA Research/Bloomberg

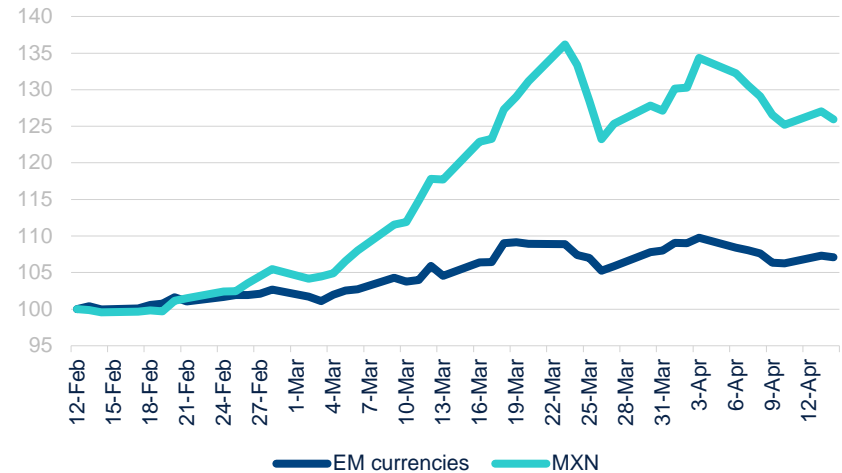
US interest rate spreads are very high at the moment. We expect the M10 rate to continue its downward trend and reach levels of about 6.0% by the end of the year.

Once Risk Aversion Decreases, We Anticipate That the Current Levels of 'Overreaction' Will Be Partially Reversed...

MXN VS. AVERAGE EM CURRENCY* SINCE THE BEGINNING OF 4Q (INDEX OCT 1, 2018=100)



MXN VS. AVERAGE EM CURRENCIES* SINCE THE BEGINNING OF THE GLOBAL RISK EPISODE (INDEX FEB 12, 2020=100)

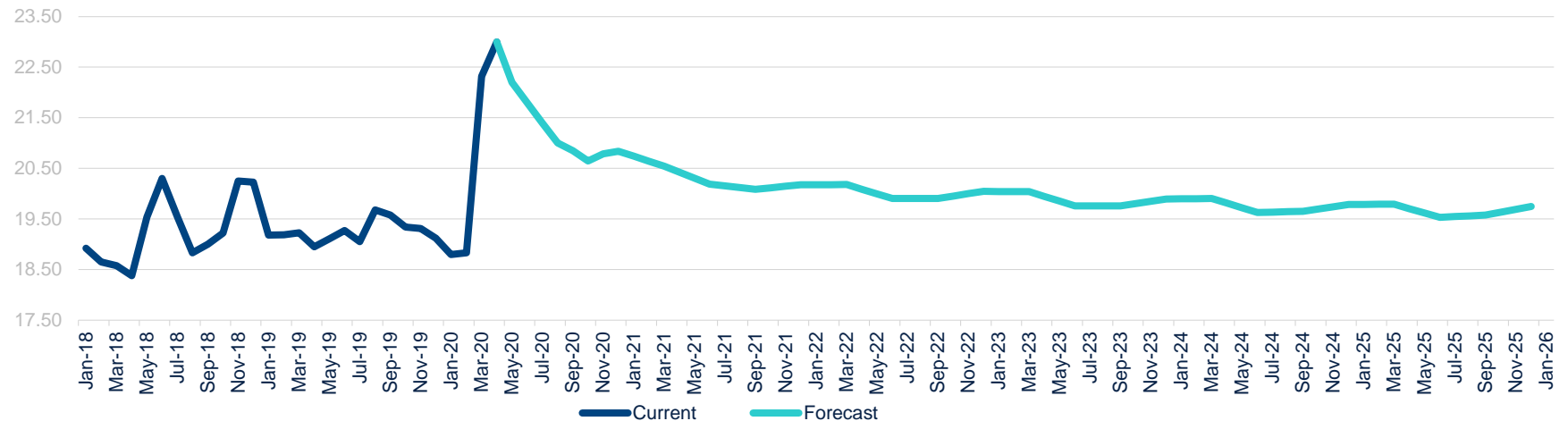


* Weighted average by liquidity and trade flow based on a reweighting of the JP Morgan Emerging Market Currencies index after removing the MXN; own calculations
Source: BBVA Research/Bloomberg

The negative differentiation in the peso during the current risk episode has been significant (around 20 pp); so far, it has shown no sign of reversal.

...and As the Aversion Declines, the Exchange Rate Rebound Will Fade Partially and Gradually

EXCHANGE RATE (MXN/USD)

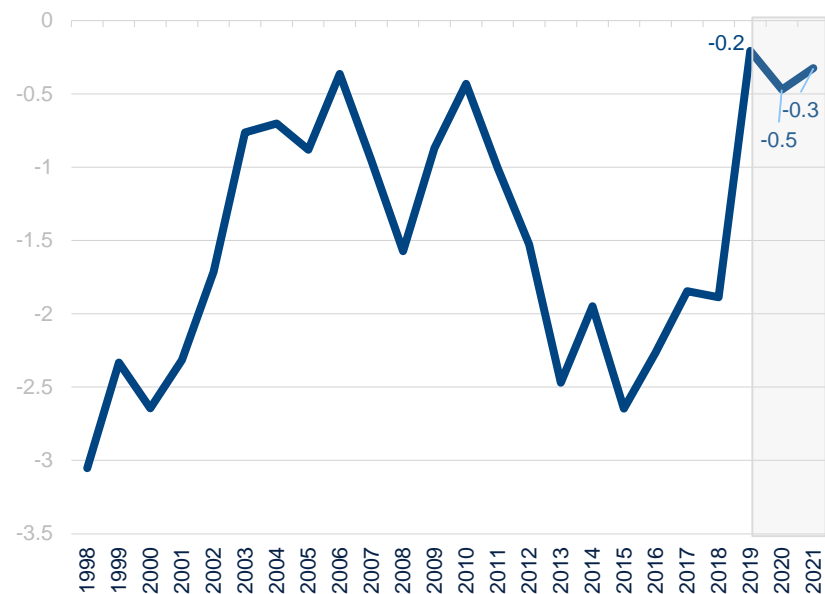


Source: BBVA Research/Bloomberg

We expect the peso to appreciate to 20.80 and 20.20 pesos against the dollar for December 2020 and 2021, respectively.

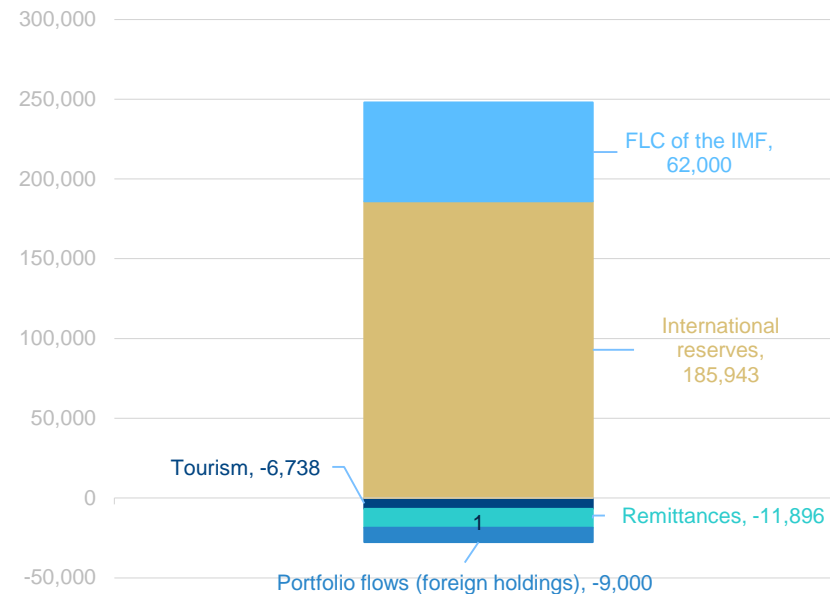
The Current Account Deficit Will Be Around 0.5% of GDP in 2020, With No Significant Risks for the Balance of Payments

CURRENT ACCOUNT (% OF GDP)



Source: BBVA Research/Banxico

INTERNATIONAL OUTFLOWS AND BUFFERS IN 2020 (USD MILLIONS)



Source: BBVA Research/Banxico & IMF

Macro Strengths in Relation to Other Economic Crises in Mexico

1. Traditional public deficit of 3.6% for 2020 vs. 17% of GDP in 1982
 - ❑ Access to markets to issue debt in local currency and with the longest average debt terms in history
2. No risk of balance-of-payment crisis
3. Autonomous central bank
 - ❑ There will be no inflation problems or interest rate increases
4. Floating exchange rate acting as shock absorber
5. Higher levels of solvency in the Mexican banking system

Key messages

- Pandemic behavior forecasts according to statistical models
- Sharp decline in economic activity; currently no adequate countercyclical policies
- As we predicted, downward pressure on inflation is dominating; Banxico should accelerate rate cuts
- Long-term interest rates will continue to fall, though the slope will remain high due to higher risk premiums
- The negative differentiation in the peso will fall slightly; we anticipate lower exchange rates by year end

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Economic Effects of the Health Emergency

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