Disruption and uncertainty in international stock markets by the imposition of tariffs

On May 30th, through an official statement, President Donald Trump announced that, as of June 10th of 2019, the United States will impose tariffs of 5% on all Mexican goods. According to the president, the tariffs are a consequence of the invasion of hundreds of thousands of people who cross the border illegally, which in turn threatens national security. Noteworthy, according to official records from the US government, 79% of immigrants seized at the border were from Central American countries. This suggests the inability of the Mexican government to deal with immigration.

As it is a national security issue, tariffs do not violate the United States trade agreements with other countries. The tariff will be withdrawn if Mexico manages to diminish the crisis on illegal immigration effectively, otherwise it will rise to 10% on July 1st, then to 15% on August 1st, to 20% on September 1st and finally to 25% on October 1st.

The response of the Federal Government materialized with a letter, in Spanish, that the Mexican President sent to his US counterpart. This document explains that, to the extent possible, Mexico is fulfilling its responsibility to prevent the illegal transit of immigrants through the country. In addition, the letter proposes the following solutions: (i) an investment for the development of Central America and (ii) the beginning of negotiations between Mexican officials who, led by Marcelo Ebrard, Secretary of Foreign Affairs of Mexico, traveled, without prior appointment to Washington DC, with US officials.

Based on the amount of total trade between Mexico and the US in the first quarter of 2019, the tariff on all Mexican goods would apply to imports worth around $ 356 billion dollars. In its first stage the measure would collect approximately $ 17 billion dollars and, if taken to its last consequences, the amount would increase to more than $ 89 billion dollars.

As a result of the measures adopted by the United States regarding trade, on Friday, May 31st, the spot exchange rate closed at 19.62 pesos per dollar for a significant depreciation of (-) 2.43% in a single day. The above leaves the weekly depreciation at (-) 2.89% and eliminates year-to-date appreciation. Thus, the exchange rate surpasses the upper limit of the fluctuation band between 19.00 and 19.50 pesos per dollar observed this year.

The complex situation, the significant impact of tariffs and the possibility that these will gradually increase, lead to revise the expected exchange rate to a range between 19.50 to 20.00 pesos per dollar in the next weeks. This doesn´t rule out the possibility of reaching a parity of 20.62 pesos per dollar, which was the one observed on November 26th of 2018, —after the New International Airport of Mexico City was cancelled— in case the government can not disrupt this crisis.

Between April 30th and May 30th, the yield on the 10-year M bond fell from 8.10% to 7.94%. However, given the announcement of new protectionist measures in the United States, the rate of return of this instrument increased 10 basis points in one day, to settle at 8.04%. This leaves the spread against the 10-year treasury bill at 586 basis points; the highest since the end of January.

The imposition of protectionist measures to Mexico also had a strong impact on the Mexican Stock Exchange that brought its index to 42,749 points. This represents a decrease of (-) 1.38% in a single day. With this stock market adjustment, the decline in May was (-) 3.53%. This leaves the advance of the index in April without effect and places the accumulated yields in the year at 3.85%.

Given the possibility of an economic recession, there isn´t a positive outlook for the stock market. In this order of ideas, a significant destruction of value may occur, such as the one of November 2018 —after the cancellation of the airport— the index could reach a minimum of 39,427 points. This will depend on the management of the Mexican government.

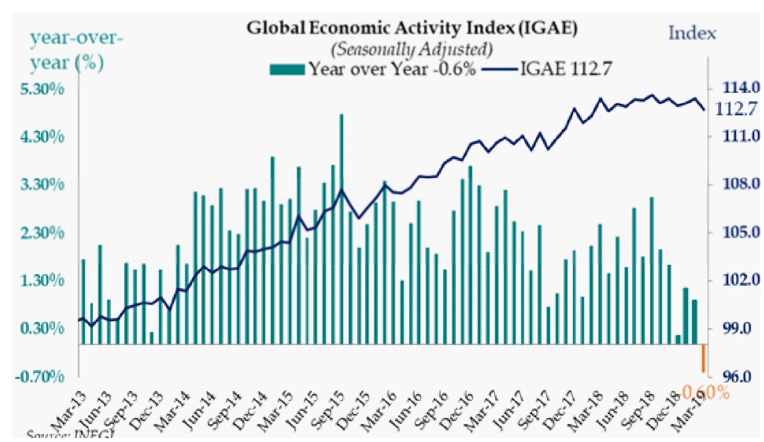
Economic Indicators

Gross Domestic Product

In May the fall of the Gross Domestic Product (GDP) in the first quarter of the year, which was (-) 0.17% quarter-over-quarter, was confirmed. Within its components, agriculture advanced 2.6% while the services and industrial sectors fell (-) 0.6% and (-) 0.2% respectively. A contraction of GDP in the second quarter of the year would, by definition, imply a recession.

Global Indicator of Economic Activity

In March, the Global Indicator of Economic Activity (IGAE) fell (-) 0.60% per year; this is the first contraction of the indicator since 2009. The primary —agriculture sector— showed a growth of 4.77% but the tertiary sector —services— showed a significant deceleration with a marginal advance of 0.27%. On the other hand, the industrial sector fell (-) 2.65% year-over-year, which represents its fifth consecutive fall since October of last year. In this context, the IGAE for April, which will be announced on Monday, June 24th, will be relevant for estimating GDP growth in the second quarter of the year.



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Definitions

Tariffs: A tax or duty to be paid on imports or exports.
Mexbol: The S&P/BMV IPC seeks to measure the performance of the largest and most liquid stocks listed on the Bolsa Mexicana de Valores. It is not possible to invest in an index.
BM-Bond: Mexico Federal Government fixed-rate development bonds that are issued and placed at terms of over one year, pay interest every six months and their interest rate is determined at issue date and remains fixed all along the life of the bond.
Treasury Bills: It is a government debt instrument issued by the United States Department of the Treasury to finance government spending as an alternative to taxation.
Spread: *The yield spread shows the difference between the quoted rates of return between two different investment vehicles. These vehicles usually differ regarding credit quality.*
Treasury Bills: *It is a government debt instrument issued by the United States Department of the Treasury to finance government spending as an alternative to taxation.*
M-Bond: *Mexico Federal Government fixed-rate development bonds that are issued and placed at terms of over one year, pay interest every six months and their interest rate is determined at issue date and remains fixed all along the life of the bond.*
Systemic risk: *Is the possibility that an event could trigger severe instability or collapse an entire industry or economy.*
Gross Domestic Product: *A monetary measure of the market value of all the final goods and services produced.*
(IGAE) *Global Indicator of Economic Activity: The Global Indicator of Economic Activity allows to know and monitor the monthly evolution of the real sector of the economy.*
Basis point (BPS): *One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001.*