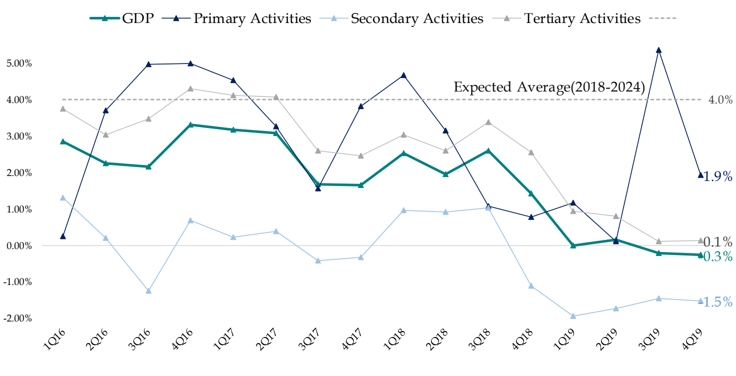
2019: a year of transition

The year 2019 marked the beginning of Andrés Manuel López Obrador's presidency, and it had positive and adverse events. Amongst the good results account stand: i) Fiscal discipline, ii) Exchange rate stability, iii) Robust external accounts, iv) Controlled inflation and, v) Drop of interest rates. Within the negative ones: i) A lack of economic growth, ii) Confrontational style of government, and iii) Uncertainty within the private sector.

Economic Stagnation: Path to Recovery

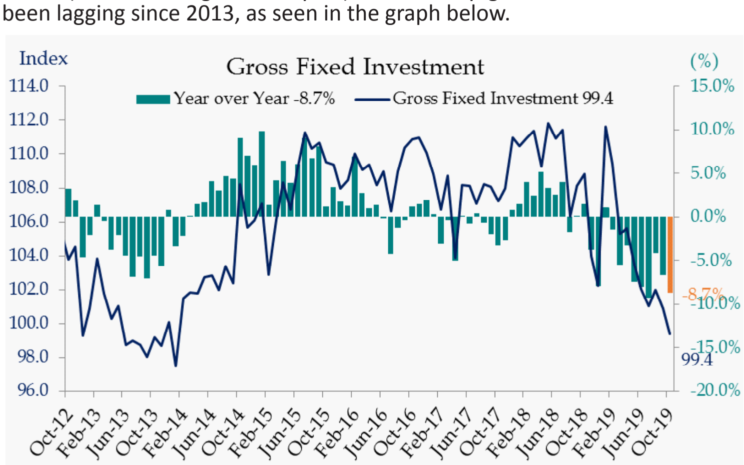
As warned in the beginning of year report, the fears of a deceleration in the economy materialized. The Gross Domestic Product (GDP) did not grow in 2019 due to the -1.5% contraction of the secondary sector and the deceleration of the tertiary sector which only grew 0.1%; the primary sector increased 1.9%.

Quarterly GDP by Component
Year over Year Growth



Source: INEGI

The above triggered a fall in Gross Fixed Investment, which in October (latest available data) had a negative annual growth rate of -8.7%. Besides, the industrial sector accumulates 14 consecutive months with annual decreases. Most of the fall is due to the unprecedented contraction of the construction sector (-5.78% throughout the year). Noteworthy, gross fixed investment has been lagging since 2013, as seen in the graph below.



Source: INEGI

To improve private sector's confidence, the government has announced the National Infrastructure Plan, which could amount for 3.6% of the GDP in the following three years. Nevertheless, it requires to be deployed to get the private sector's attention. Besides, the House of Representatives in the United States have already approved the United States, Mexico, Canada Commercial Agreement (USMCA) and it is expected that on January 2020 the Senate ratifies it. It is possible that the USMCA starts operating on April 2020.

The market consensus for 2020 GDP growth forecasts lies in 1.0%. This recovery seems realistic considering the reduction in systemic risk, the better perspectives of world economic growth, a better business environment, the certainty for foreign investment due to USMCA, and the possibility of relevant government announces that might boost local private investment.

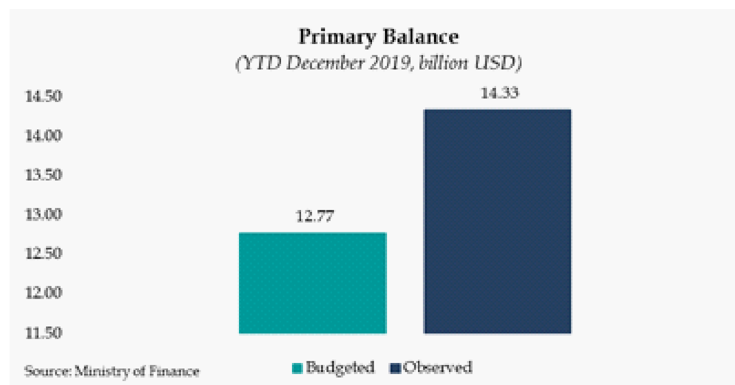
Economic Stagnation: Causes

The Gross Domestic Product (GDP) had a (-)0.3% year over year contraction in the 4Q19. The primary sector, which is mainly agriculture and only represents 3.3% of the GDP grew 1.9%. The secondary sector, which encompasses manufacturing, construction, mining and utilities, and represents 28.80% of the GDP decreased (-)1.5%. The tertiary sector, which is basically services, and amounts for 63.5% of the GDP only grew 0.1%. Noteworthy, the Mexican economy was in a technical recession during the 4Q18, 1Q19 and 2Q19.

The decline in the industrial sector is the main reason of the negative growth of secondary activities. The industrial sector accumulates 13 consecutive months with negative annual growth rate. The above is a consequence of the government's decision to cancel most of the building permits, therefore the construction subcomponent has had a year to date contraction of 7.45%. Even if the tertiary sector is still on positive figures, consumption has had a considerable deceleration, as it can be seen in Same Store Sales of both Walmart and ANTAD whose YtD averages are 4.7% and 3.3% respectively, considerably lower than the 2018 averages (7.0% and 5.1%).

Fiscal Discipline

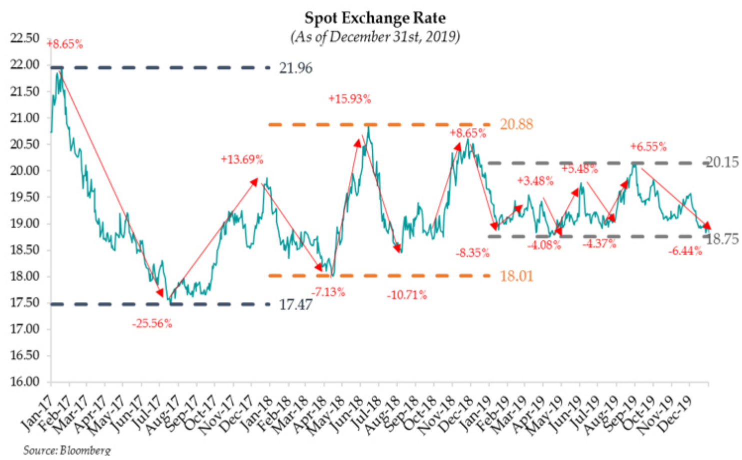
The government committed to a 1% of the GDP fiscal surplus, which by the end December, was almost US$30 billion larger than the budgeted one. Most of the macroeconomic forecasts are perceived as realistic by the markets except for the oil production platform, which still needs further details. Noteworthy, that even with lower tax income, the government managed to pursue the primary surplus due to under expenditure and the use of 45% of the stabilization fund. This good management of public finances allowed for a reduction of 75 bps thorough 2019 of the 5-year Credit Default Swaps (CDS).



Exchange Rate Stability and Robust External Accounts

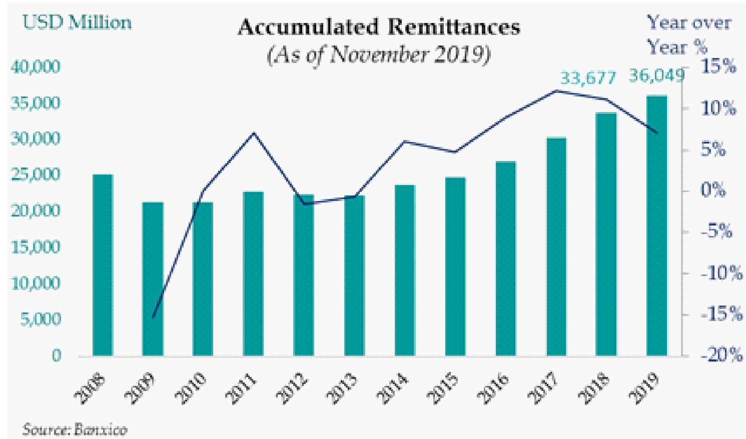
The Mexican Peso remains stable in the Forex markets; during 2019 the currency had a YoY appreciation of 3.9% against the US Dollar. These are the reasons that have allowed for the good behavior of the Mexican currency:

i. The consolidation of Mexico as the United States’ first trade partner throughout the year with more than US$614 billion of total joint trade. Mexico’s YTD until December US$101.75 billion surplus compares positively with the US$81.5 billion surplus for the whole 2018.
ii. The MXN-USD spot exchange rate continues exhibiting low levels of volatility. The distance between the maximum and minimum quote of 2019 (MX$1.40) is considerably smaller than the one observed in 2018 (MX$2.87) and in 2017 (MX$4.49).
iii. A US$2.19 billion deficit in the current account (0.18% of the GDP) in the 3Q19 that the US$12.16 billion surplus in the financial accounts handily compensates.
iv. The arrival of US$36.04 billion of remittances in the whole 2019. The highest figure since Banxico keeps track.
v. Year to date Foreign Direct Investment amounts US$26.1 billion, the second largest figure since Banxico keeps track.



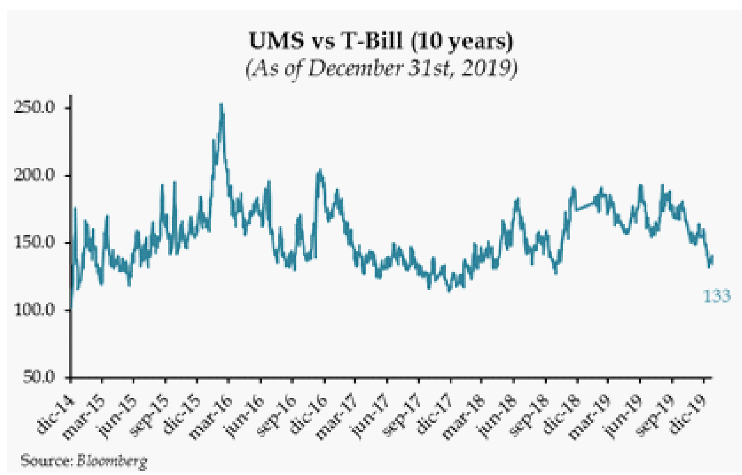
United States International Trade (As of December 2019)					
Country	Exports	Imports	Total Trade	Balance	
Mexico	256,374	358,126	614,500	-101,752	
% of Total	15.6%	14.3%	14.8%		
Canada	292,693	319,736	612,429	-27,043	
% of Total	17.8%	12.8%	14.8%		
China	106,627	452,243	558,870	-345,616	
% of Total	6.5%	18.1%	13.5%		
Japan	74,653	143,636	218,289	-68,983	
% of Total	4.5%	5.7%	5.3%		
Germany	60,296	127,462	187,758	-67,166	
% of Total	3.7%	5.1%	4.5%		
Korea, South	56,897	77,511	134,408	-20,614	
% of Total	3.5%	3.1%	3.2%		
United Kingdom	69,157	63,187	132,344	5,970	
% of Total	4.2%	2.5%	3.2%		
France	37,771	57,449	95,220	-19,678	
% of Total	2.3%	2.3%	2.3%		
India	34,410	57,665	92,075	-23,255	
% of Total	2.1%	2.3%	2.2%		
Taiwan	31,219	54,256	85,475	-23,037	
% of Total	1.9%	2.2%	2.1%		
Italy	23,790	57,160	80,950	-33,370	
% of Total	1.4%	2.3%	2.0%		
Brazil	43,083	30,853	73,936	12,230	
% of Total	2.6%	1.2%	1.8%		
Singapore	31,550	26,381	57,931	5,169	
% of Total	1.9%	1.1%	1.4%		
Hong Kong	30,800	4,713	35,513	26,087	
% of Total	1.9%	0.2%	0.9%		
Saudi Arabia	14,289	13,443	27,732	846	
% of Total	0.9%	0.5%	0.7%		
All other countries	481,877	654,579	1,136,456	-172,702	
% of Total	29.3%	26.2%	27.4%		
TOTAL 2019 YTD	1,645,486	2,498,400	4,143,886	-852,914	
TOTAL 2018	1,664,064	2,542,735	4,206,799	-878,671	
TOTAL 2017	1,546,654	2,342,905	3,889,559	-796,251	

Source: U.S. Census Bureau
Amounts in millions of dollars



Controlled Inflation and Drop in Interest Rates

Despite Banxico’s 100bp rate cut in 2019, inflation (2.63% in December) lies within the central bank’s objective (3.0% ± 1.0%); Market forecasts expect that this behavior prevails next year. Noteworthy, Mexico offers an attractive rate in relative and absolute terms. In December, the spread between Banxico’s and the Federal Reserve reference rate was 550 bps; at the beginning of 2019, it was 575, mainly because Banxico has been more restrictive in terms of monetary policy than the Federal Reserve has. Therefore, the spread throughout all the tranches of the yield curve is higher than 500 basis points. This spread is offered in a country with a stable exchange rate and where the risk of a downgrade in the sovereign’s debt has reduced due to proper management of public finances. Specifically, the spread between the 10-year UMS and the T-Bill dropped from almost 190 bps in December 2018, to 133 points in December 2019.



Pemex’s Current Situation

Fitch Ratings downgraded Pemex’s Issuer Default Ratings (IDR) from BB+ to BBB-, meaning it considers it a speculative investment. The above as a result of the lack of trust in the company’s business plan which continues to underinvest in its upstream business, which could lead to further production and reserves decline. Additionally, both Moody’s and Standard & Poor’s constantly expressed their concerns regarding Pemex’s business plan which made them adjust their perspectives on Pemex’s IDR from stable to negative.

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Definitions:

Banco de México (Banxico): *Is the central bank of Mexico. Its main function is to provide domestic currency to the Mexican economy and its main priority is to ensure the stability of the domestic currency's purchasing power.*
Basis points (bps): *Refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001.*
BBB-: *Rating that states that obligations are subject to moderate credit risk. They are considered medium grade and as such may possess certain speculative characteristics.*
BB+: *Rating that reflects speculative characteristics that may be compensated by significant uncertainties or significant exposures to adverse conditions.*
Credit Default Swap (CDS): *Is a financial derivative or contract that allows an investor to offset his or her credit risk with that of another investor.*
Economic Stagnation: *Is a prolonged period of slow economic growth, traditionally measured in terms of the GDP growth, usually accompanied by high unemployment.*
Exchange Rate: *Is the value of one nation's currency versus the currency of another nation or economic zone.*
External Accounts: *Summarize all interactions of the domestic economy with the rest of the world and can provide insights on the economic strength of a country and the risks that it faces.*
Federal Funds Rate: *Is the interest rate at which depository institutions such as banks and credit unions lend reserve balances to other depository institutions overnight on an uncollateralized basis.*
Fiscal Discipline: *Refers to a state of an ideal balance between revenues and expenditure of government, in an economy. If the fiscal discipline is not maintained, then the government expenditure exceeds government receipts.*
Foreign Direct Investment (FDI): *Is an investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.*
Foreign Exchange Market (Forex Market): *Is the market in which participants can buy, sell and exchange currencies. It is made up of banks, commercial companies, central banks, investment management firms, hedge funds, and retail forex brokers and investors.*
Gross Domestic Product (GDP): *Is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.*
Gross Fixed Investment (IFB): *Describes the net capital accumulation during an accounting period for a country. The term refers to additions of capital stock, such as equipment, tools, transportation assets and electricity.*
Inflation: *Is a quantitative measure of the rate at which the average price level of a basket of selected goods and services in an economy increases over a period of time.*
Mexican Consumer Price Index (INPC): *It is a global economic indicator whose purpose is to measure, over time, the variation in the prices of a basket of goods and services representative of the consumption of households in the country.*
National Infrastructure Investment Plan: *Mexican government's strategy to help boost the economy with an initial package of 147 projects.*
National Association of Self-Service and Departmental Stores (ANTAD): *Entity responsible of promoting the development of retail and its suppliers within the Mexican market.*
Primary Sector: *The portion of an economy that includes any industry involved in primary production, that is the extraction and collection of natural resources; such as farming, forestry, hunting, fishing and mining.*
Secondary Activities: *The portion of an economy that includes light and heavy industrial manufacturers of finished goods and products from raw materials.*
Spread: *Measure of the value added by the portfolio or investment manager in excess of a benchmark or index with similar level of risk.*
Tertiary Activities: *The portion of an economy that involves the provision of services to other businesses as well as final consumers.*
Treasury Bill: *It is a government debt instrument issued by the United States Department of the Treasury to finance government spending as an alternative to taxation.*
United States-Mexico-Canada Agreement (USMCA): *Is a signed but not ratified free trade agreement between Canada, Mexico, and the United States.*
Walmart: *Retail company. As of January 31, 2020 the security represents 1.42% of Portfolio Net Assets. For a list of full securities please visit: http://www.mxefund.com/portfolio_holdings.html.*