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REMEMBERING THE FUTURE
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The Southern Frontier of North America: The Investment Case for Mexico

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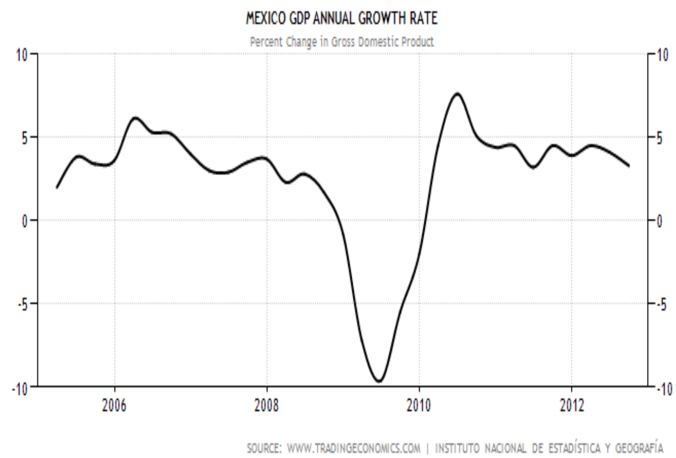
Introduction

About ten years ago a Chinese worker was earning about half of what a Mexican worker was making. Nowadays the Chinese worker makes about 10% less than the Mexican one. If China was the destination for manufacturing jobs in the late 20th century, that advantage has been eliminated relative to the other advantages Mexico enjoys as a destination for manufacturing, mining, and financial investments, among other sectors. This newsletter makes the case that Mexico not only has stabilized from an economic and political perspective, but actually promises to reward its investors with significant returns.

The Basic Business and Economic Fundamentals

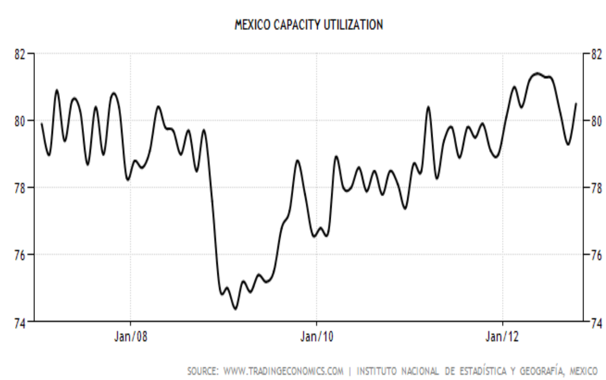
While the GDP growth rate may not accurately reflect the wealth creation trends in a country, at least as a proxy shows us the macro trends in terms of economic prospects. The following graph portrays a pretty healthy growth picture for Mexico. Since the financial crisis of 2007-'08 Mexico's growth rate has averaged more than 4%, putting it on par with its long-term potential, and hence eliminating any output gap.

Figure 1: Mexico's GDP Growth Rate



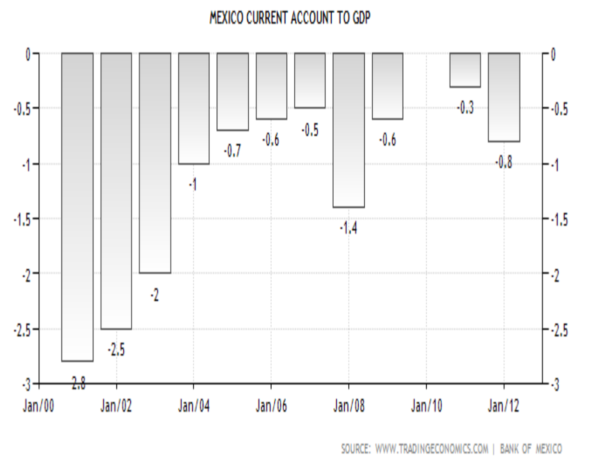
The stabilization in its growth rate has been accompanied by a healthy capacity utilization rate which enforces the concepts of strong employment, exports, as well as business confidence. The graph below shows that while capacity utilization dropped significantly following the financial crisis, it bounced back strongly and has remained above its historical average.

Figure 2: Capacity Utilization Rate



Of course, we cannot forget the historical fact that Mexico was almost driven to bankruptcy twice in the last thirty years (early 1980s and mid 1990s). In both cases, its current account deficit created economic earthquakes, and unless it had been for the US, the consequences would have been much worse. However, as the following figure shows, its current account deficit not only is it declining but also as a percentage of its GDP is very small and not worrisome, strengthening the underlying stable economic environment.

Figure 3: Current Account Deficit as a Percentage of GDP

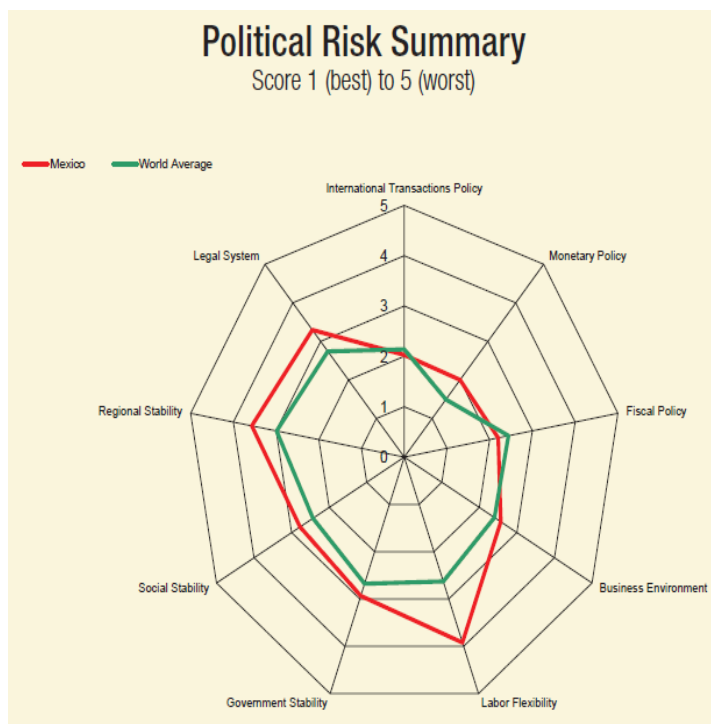


We cannot ignore of course major sources of potential social and political instability. As the following figure shows, the unemployment rate – relatively speaking - has stabilized and has been following a declining trend, reducing the chances – especially when combined with consumer confidence as will be shown later – of social instability.

Figure 4: Unemployment rate

Overall, Mexico is ranked as a country with moderate political and financial risk. Areas of concern include the legal, social, and labor stability ranking, as the following graph portrays, courtesy of the AMB organization. In terms of the business and economic environment the figure shows a stable and improving fiscal and monetary framework with relative good scores in international transactions policies and business practices.

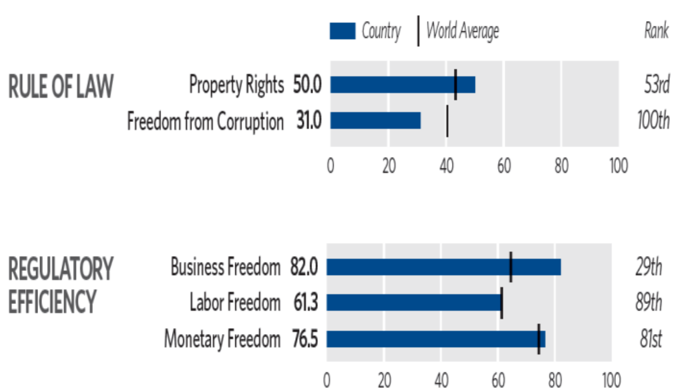
Figure 5: Political and Social Stability



Reviewing Mexico's Economic Dynamics

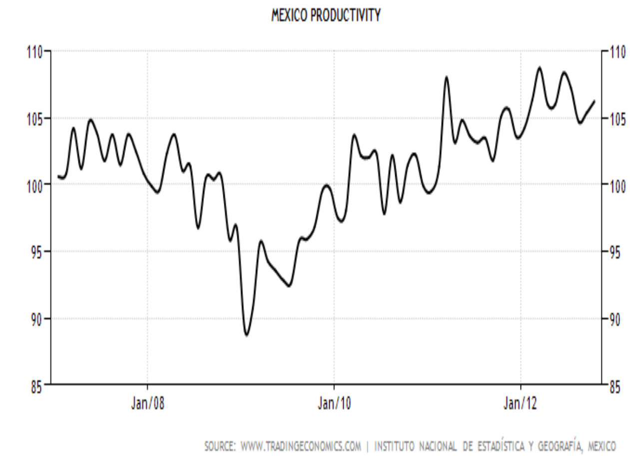
It is important to recall that Mexico has a free trade agreement with the US and Canada. That agreement along with its stable but competitive currency is one of the most important factors that attracts investments and creates growth prospects. While we do not deny the fact that the drug industry can create instability, we believe that in the last year it has come under control which in combination with demonstrated political will diminishes the chances of economic derailment.

Near-shoring is anticipated to become a trend for manufacturers. Most important auto makers are opening and expanding facilities in Mexico. The low transportation costs along with the economic fundamentals are attracting companies, and of course Mexican construction is a benefactor of all these investments. We cannot ignore of course that there are some problematic areas in Mexico, such as corruption, biased courts, stalled reform efforts, regulatory obstacles, all of which reduce business efficiency, as the following two graphs, courtesy of The Heritage Foundation, demonstrate.



Overall, however we are of the opinion that Mexico will keep enjoying foreign direct investments, significant growth in jobs and incomes, a stable political environment, and a financial sector (banks and insurances) that will be healthier and more dynamic. Our belief is based on what we consider one of the most important economic measures, that of productivity.

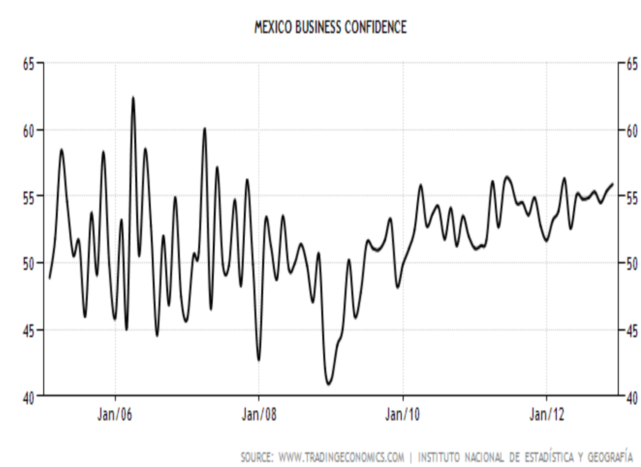
Figure 6: Mexico's Productivity



The figure below demonstrates an undisputable fact: Mexican economy is gaining ground due to its much improved productivity since the days of the financial crisis. Such productivity improvements have advanced Mexico's competitiveness relative to other Latin and S. American countries, as well as relative to some Asian countries.

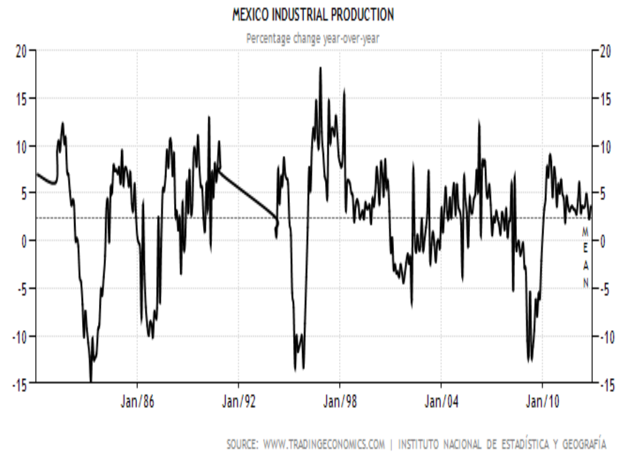
It is no wonder then that such significantly improved productivity will lead to improved business confidence, as the figure below shows.

Figure 7: The Evolution of Business Confidence Index



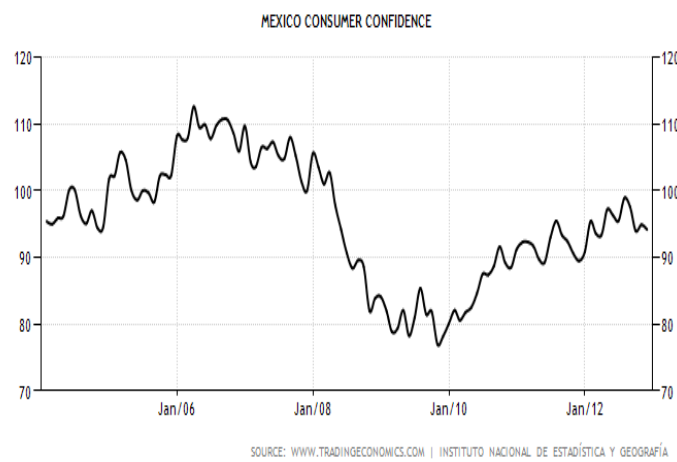
The higher and stable business confidence index feeds the investment feedback loop mechanism and is contributing in advancing the industrial production of the country.

Figure 8: Mexico's Historical Growth in Industrial Production



The graph above portrays a picture of a healthy industrial sector that is attached to good jobs, which in turn become the basis of a growing middle class that feels confident to spend and make plans for the future. Since 2009, industrial production has increased by close to 20%, and that increase has generated jobs and spending.

Figure 9: Consumer Confidence



The growth in industrial production has a mirror image in consumer confidence, which also has increased by almost 20%. Hence, potential capital investors they see a growing middle class that is confident and healthy, besides the production costs' advantages that Mexico enjoys.

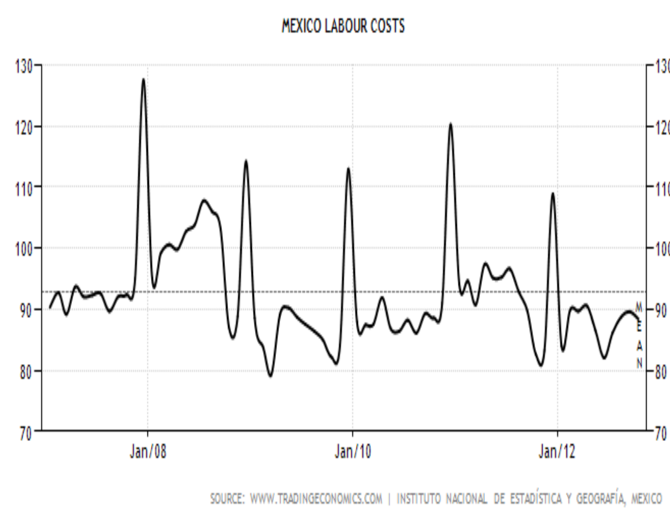
We also believe that an unstable currency is a recipe for disaster and instability. As the following figure shows, the Mexican Peso lost a lot of ground during the financial crisis, regained some when signs of financial stability showed up, and has currently stabilized at about 13 pesos per one US dollar.

Figure 10: Exchange Rate between USD and the Mexican Peso

That exchange rate is competitive enough to keep exports growing and its stability does not feed any significant inflationary fears.

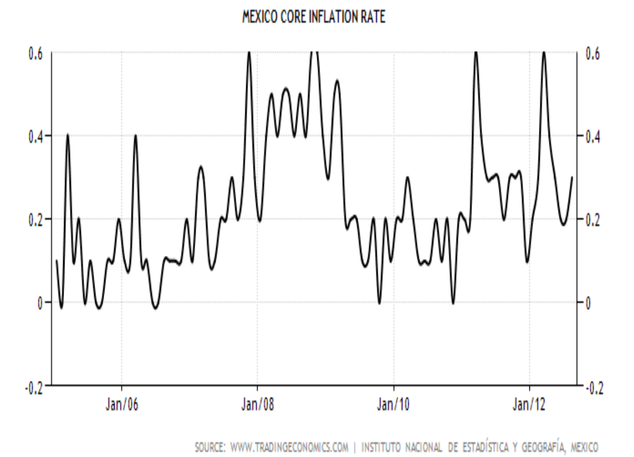
Speaking of inflationary pressures and fears, we should pay close attention to the following graph.

Figure11: Mexico's Labor Costs Relative to its Average



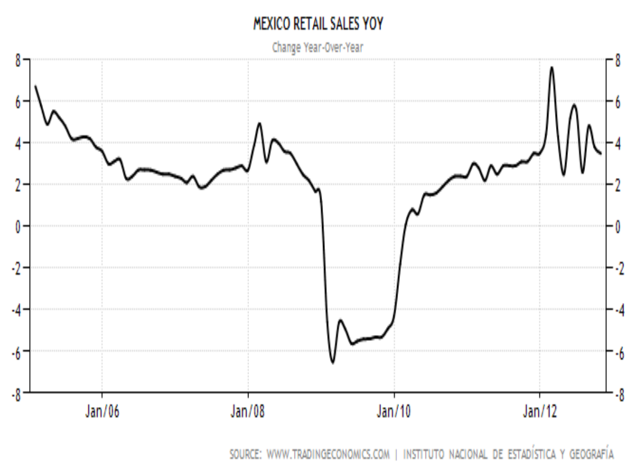
According to the figure shown above, Mexico's labor costs remain below its average, something that adds to the environment of economic stability and predictability, which are so important for investors, a healthy and growing economy, and a climate that accommodates a winning business spirit that enables wealth creation.

Figure 12: Core Inflation Rate



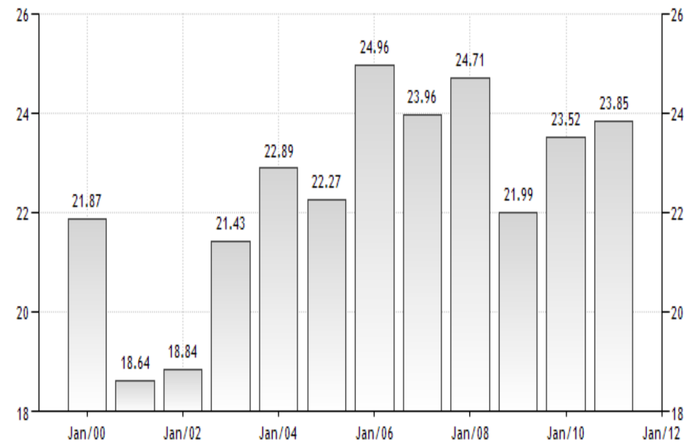
The stable currency along with the subdued labor costs, and the rising business confidence have kept the core inflation rate in Mexico at a low level with an overall inflation rate of about 3.4%. Knowing that their money is not losing significant purchasing power, allows Mexican consumers to enjoy a healthy rise in year-on-year purchases.

Figure 13: Annual Growth in Retail Sales



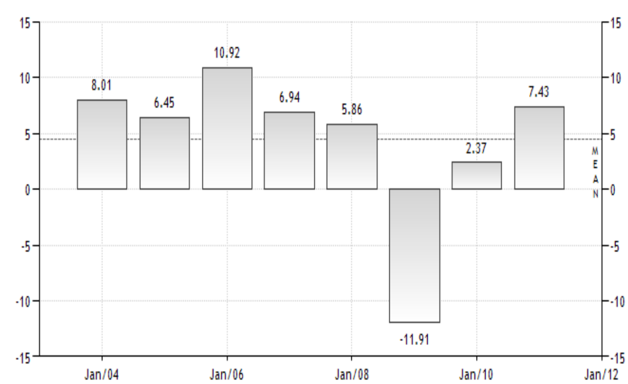
The almost 4% in annual retail sales signifies an economy whose consumers feel confident enough to spend the growth fraction of their earnings, and as they achieve a higher standard of living they allow the feedback mechanisms in the economy to expand and do their work multiplying the effects of that spending. Of course, if such growth in spending is done at the expense of savings and capital formation, then it will prove to be temporary and in the long term it will backfire.

Figure 14: Mexico's Savings Rate



However, as the graph above demonstrates, Mexico has preserved its historical average savings rate, and actually has increased it since the days of the financial crisis. That has contributed significantly to a healthy gross capital formation rate, as is shown below.

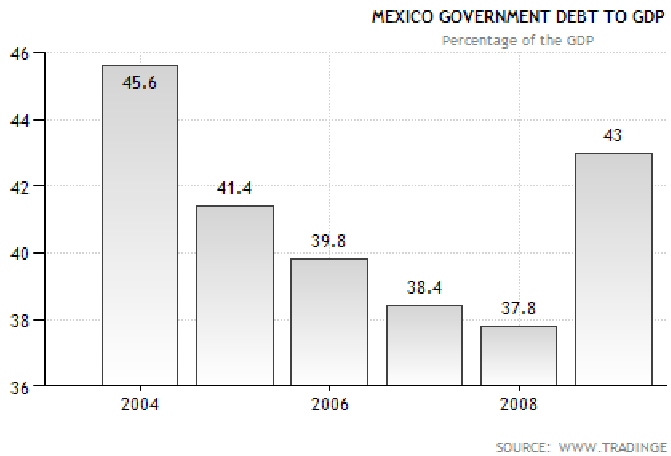
Figure 15: Annual Growth in Gross Capital Formation



The graph above provides us a clear picture of recovery for the Mexican economy since the days of the Great Recession. On average the gross capital formation was around 4.9% for Mexico (see dotted line above). The latest figures show that in 2012 the capital formation was almost 7.5%, a rate that resembles that of China during the 1998-2008 period.

Another encouraging sign that we identified in the Mexican economy has to do with its debt levels. While most developed economies are in an unsustainable debt level trajectory, the picture in Mexico is quite different.

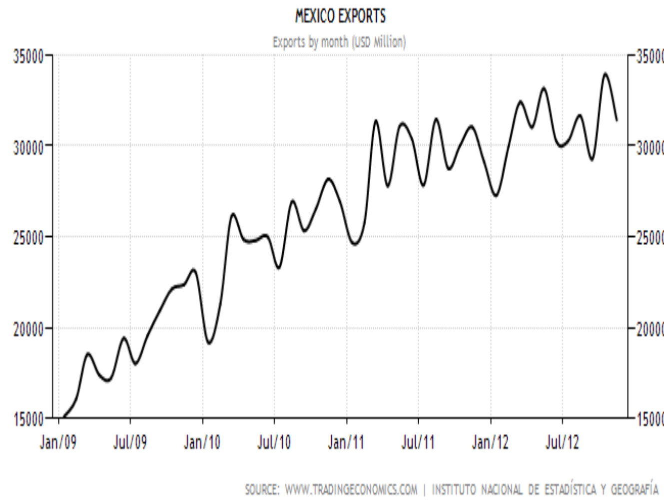
Figure 14: Government Debt as a Percentage of GDP



The government debt as a fraction of the GDP is lower nowadays than it was ten years ago. Granted that it increased significantly due to the financial crisis (as it did in almost every OECD country), however it shows a tendency to become stable given the fiscal stability in the country.

Before we conclude let's review three graphs that may tell us the future story of Mexico.

Figure 16: Exports Trend since the Financial Crisis



The picture above tells the story of a growing export sector that sustains good jobs and incomes in the country, and becomes the magnet of foreign investments. Specifically, as we see below US direct investments to Mexico have been picking up speed since the financial crisis (year 8 in the graph below). Spanish investments have also been rising at a significant pace, despite the fact that at home Spain is in a very challenging economic position.

Figure 17: US Investments in Mexico in the Last Ten Years

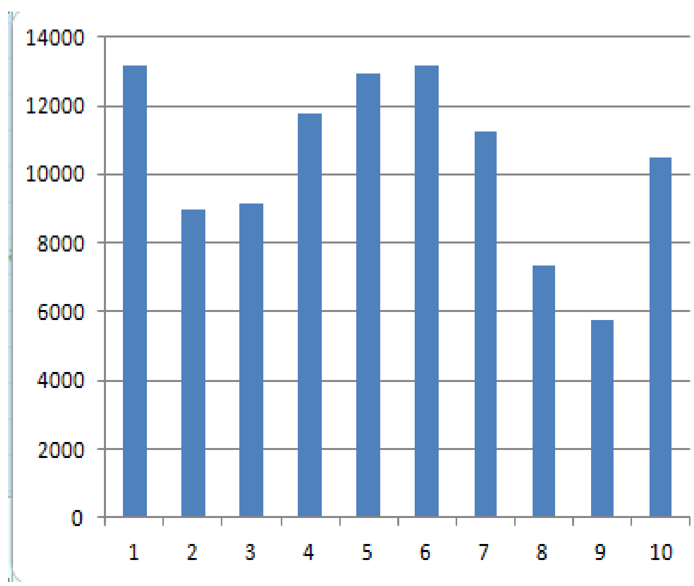
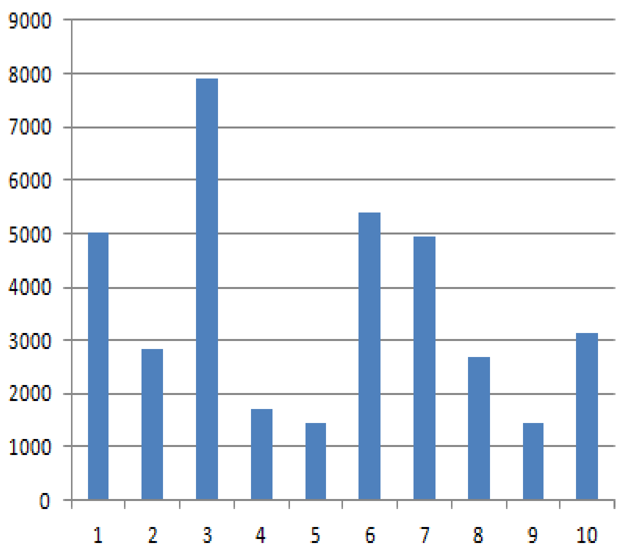


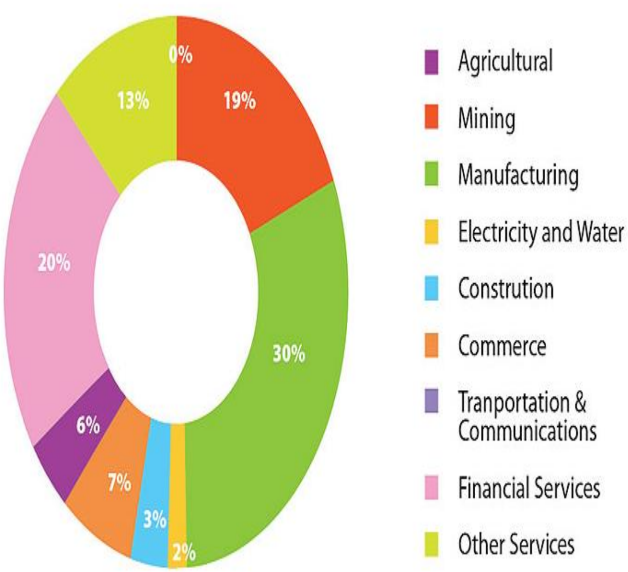
Figure 18: Spain's Investments in Mexico in the Last ten Years



Conclusion

As the analysis above showed we believe that investors who take a stake in Mexico have the potential of enjoying significant gains. The chart below shows the sectors that attract most of the funds that are destined for the Mexican economy.

Figure 19: Foreign Direct Investment Targets



However, if investors do not desire to invest directly in specific Mexican sectors and companies, there is always the possibility of a proxy ETF that invests in the Mexican market, which as it is shown below, has experienced significant returns in the last few years.

Figure 20: The Mexican Stock Market Since 2005

Happy investing!

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