Take A Deep Breath For Mexico

"Poor Mexico! So far from God and so close to the United States!"
– Porfirio Díaz, President of Mexico, 1876-1890, 1884-1911

Now that Andrés Manuel López Obrador, the leftist candidate of Mexico's Party of the Democratic Revolution (PRD) has done the impossible and made Al Gore's challenge of Florida ballots in 2000 look downright gracious, everyone on both sides of the border had better take stock of Mexico's course.

Quite simply, the demographic future of the United States and the entire future of Mexico rests on how well incoming president Felipe Calderón and his National Action Party can address repair Mexico's divided polity and the loss of the most ambitious segments of their population to the U.S.

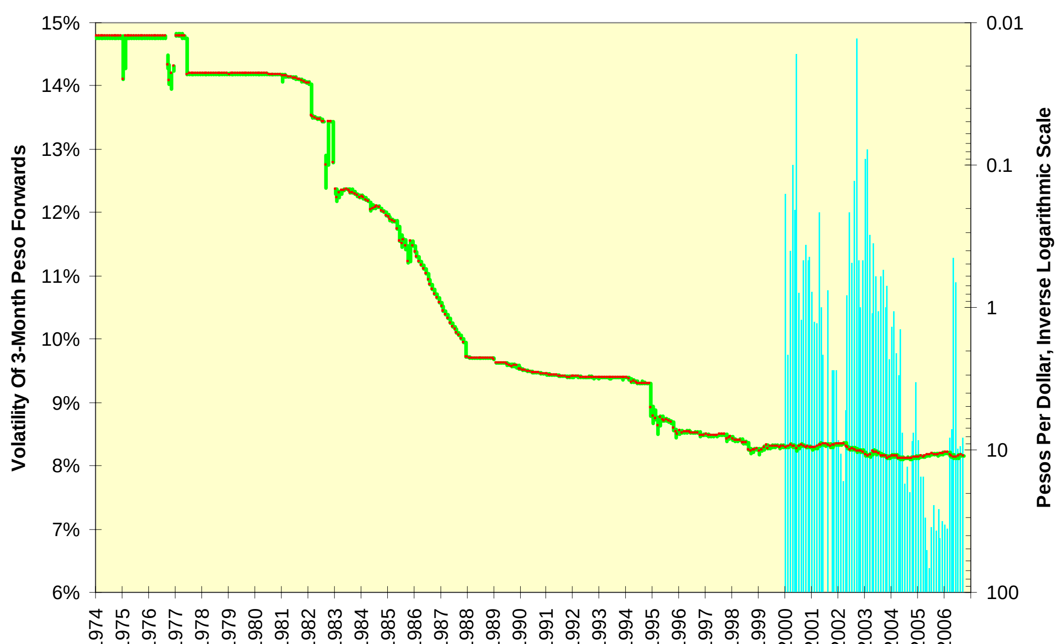
But we will have to leave saving the world to others, at least for now. Let's take the opportunity to update and expand upon the indicators from a correctly bullish November 2005 outlook for Mexico and see whether continued optimism is warranted. For the record, the total return on the Mexican Bolsa in dollar terms has been 22.8%, as compared to 4.1% for the Russell 3000 index.

Currency Risk

Just because we have not had any 1990s-style currency crises of late does not preclude their reappearance. If we have learned anything from history it is how trapped many countries and regions are by their own past. The ongoing strife in Lebanon, for example, is simply a reprise of their 1975-1990 civil war, which in turn was a duplicate of various 19th century Lebanese civil wars. How long did it take Russia to slide back into autocracy, etc?

Mexico's history in regards to its peso (MXN) is anything but encouraging. A proper depiction of its course since the mid-1970s must be made on a logarithmic scale traversing four cycles to capture the full magnitude of its period catastrophic devaluations. The last of these, one which set the stage for the various bailouts surrounding the 1997-1998 Asian crisis, was nowhere near the largest in percentage terms. Several of these, such as 1976, 1982, 1988 and 1994 were related to Mexico's sexennial presidential election cycle.

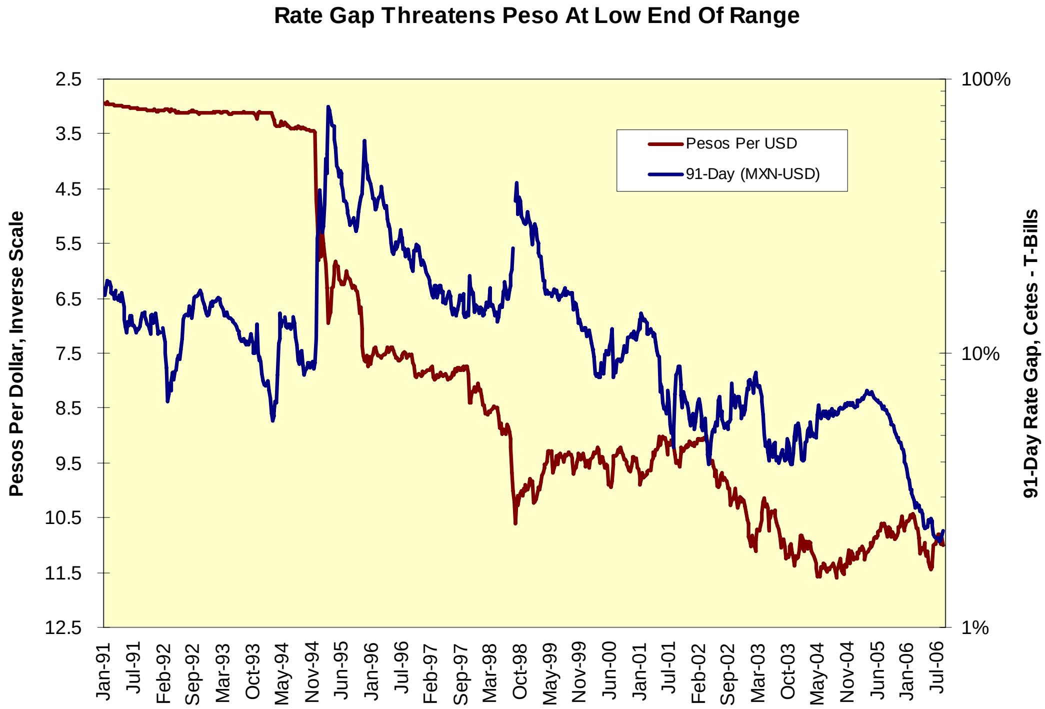
A Catastrophic History



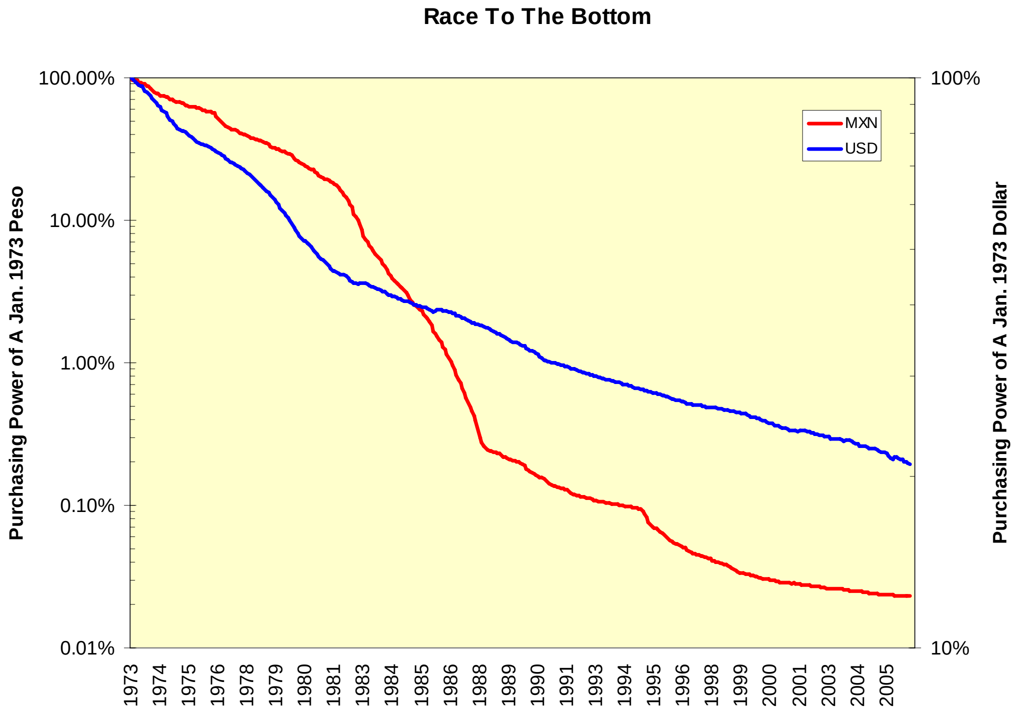
Mexico escaped this cycle with Vicente Fox' election in 2000, but the volatility of three-month MXN forwards jumped both in that year and during this year's cycle. For the sake of completeness, volatility remained high during the latter stages of the global bear market in equities; investors feared a repeat of the 1997 Asian experience wherein capital fled emerging markets and clobbered currencies and equities simultaneously.

The Rate Gap
Volatility remained high during 2002-2004 for another reason, and that was the emerging market carry trade. As U.S. rates plunged and Japanese rates remained microscopic, investors hunted for yield in markets such as Mexico. The more prudent of them purchased options as protection from a catastrophic devaluation. At present, the level of protection evident in the MXN market is low, which by contrarian sentiment is a bearish indicator for the MXN.

Where is this carry trade headed now? If we plot the MXN's course against the rate gap between 91-day Mexican bills (Cetes) and U.S. Treasury bills, (this graph also requires a logarithmic chart) we find the nominal rate premium "enjoyed" by Mexico is the lowest it has been since comparable data became available in 1991. Unless U.S. interest rates continue higher in the short-term, the MXN, now near the low end of its two and one-half year trading range, will come under pressure.

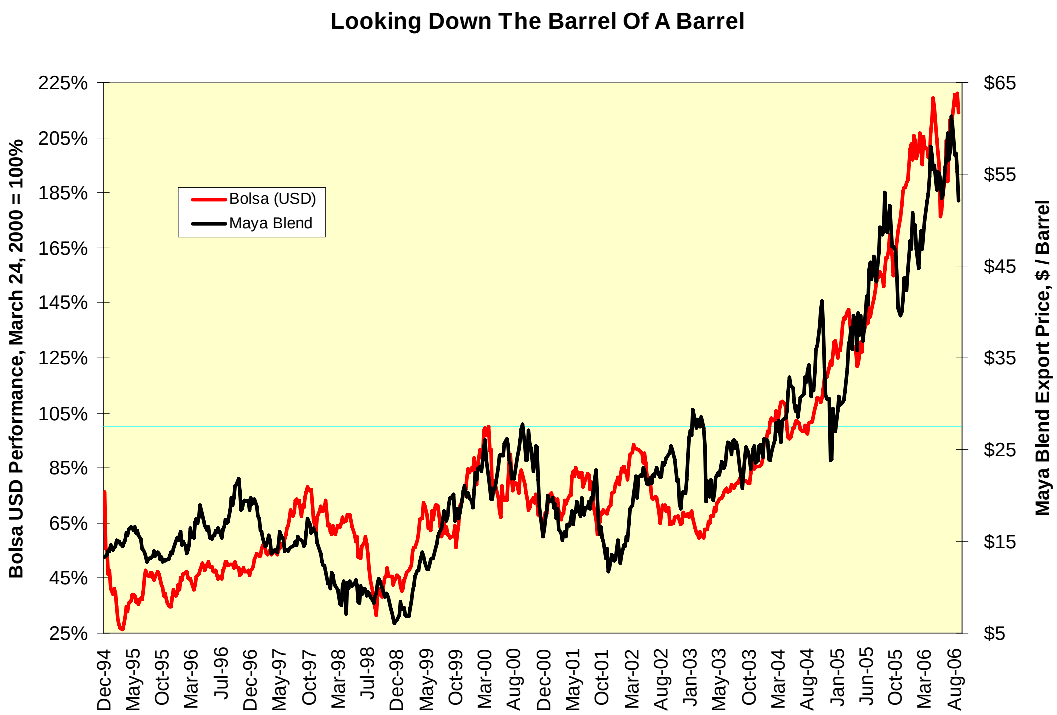


The tongue-in-cheek reference to Mexico "enjoying" a rate gap is born from personal experience. I was in Mexico in March 1995, when three-month Cetes were trading at more than 70%. I asked, "how do you do business at these rates?" The answer came back, "we don't." The cost of the various MXN collapses is high, and is best seen in the course of relative inflation between the U.S. and Mexico. The dollar has lost close to 80% of its January 1973 purchasing power – a figure shameful enough – but the MXN has lost 99.977% of its purchasing power over the same period.



The Crude Oil Connection

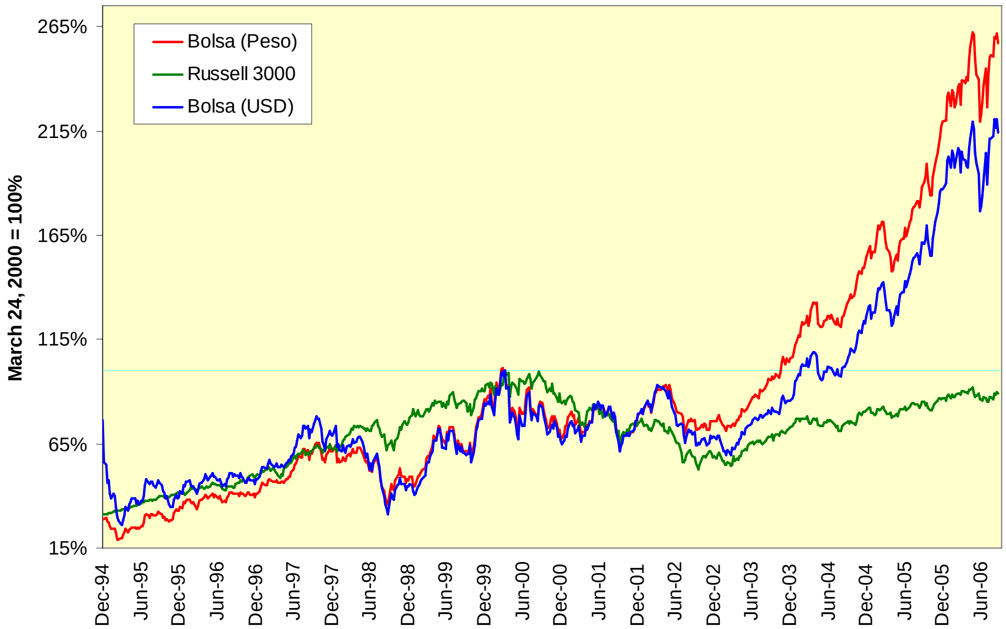
While Mexico is not as completely cursed by petroleum-dependence as are various Middle Eastern countries, Nigeria or Venezuela, its fortunes still are linked inextricably to *el oro negro*. Let's compare the path of the Mexican Bolsa index in U.S. dollar terms to the price of Maya Blend for export to the U.S. since the 1994 peso collapse. It should not take a great deal of statistical insight to see the strong correlation between the two markets.



Has crude oil reached a long-term top of significance? Not unless we enter a prolonged global recession that cuts demand growth significantly. But can we sustain the price increases seen over the past seven years without, finally, having crude oil prices push global growth lower? Methinks not.

That would suggest the long period of outperformance by Mexican equities is about to come to an end. Compare the indexed price paths of the Bolsa, both in MXN and dollar terms, to that of the Russell 3000 since the 1994 peso collapse. One would be hard-pressed to identify the late 1990s tech bubble in this chart.

Whose Market Has Remained South Of The Border?



The Mexican market has trumped those gains, and then some. Prudence, if nothing else, suggests reducing or even eliminating your exposure to this market until some evidence emerges that the incoming Calderón administration will be treated as legitimate by Mexico's disaffected political left.