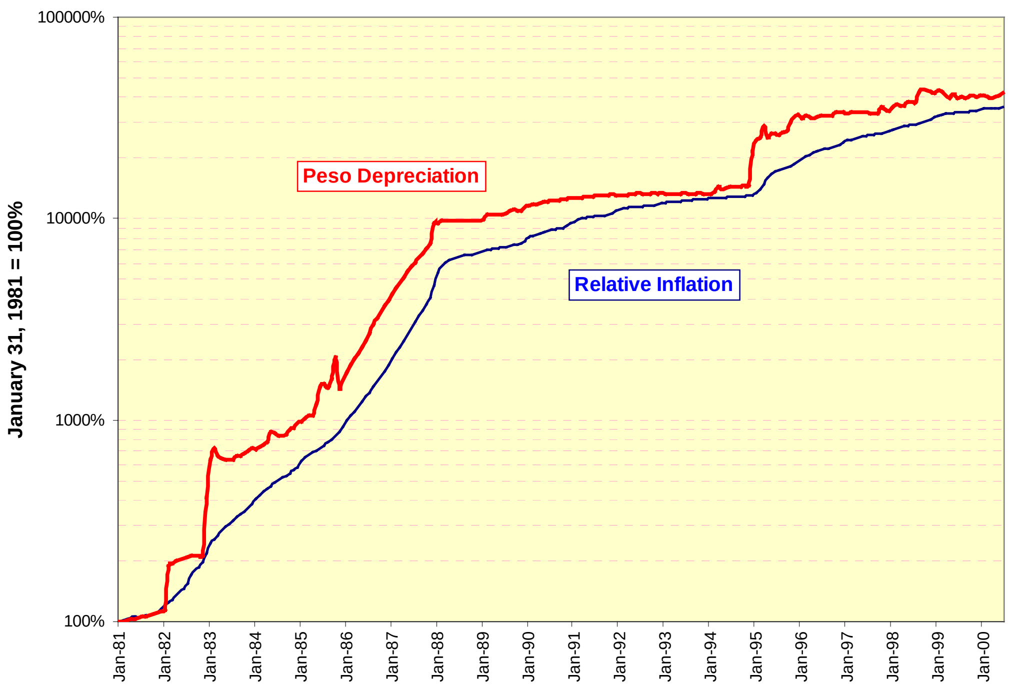
Mexican Stocks: Won't Get Fooled Again?

When in the course of human events a nation embraces life, liberty, and the pursuit of happiness, good things happen. This describes the present state of affairs in Mexico after three score and eleven years of Institutional Party of the Revolution (PRI) domination. We investors have an opportunity to assist Mexico in its new course and profit therefrom.

Stop The Presses

Incoming president Vicente Fox is making lower inflation a cornerstone of his economic policy, as well he should. No economic depredation by a ruling elite is worse than inflation, the cruelest and most regressive tax of all. The excessive creation of pesos since the currency was allowed to float in 1976 has caused each one to lose 99.798% of its initial value. The peso's weakness has been one of the principal reasons behind Mexico's comparatively high inflation rate: The country has a very high marginal propensity to import, and the weaker currency raises the price of foreign goods and services in peso terms.

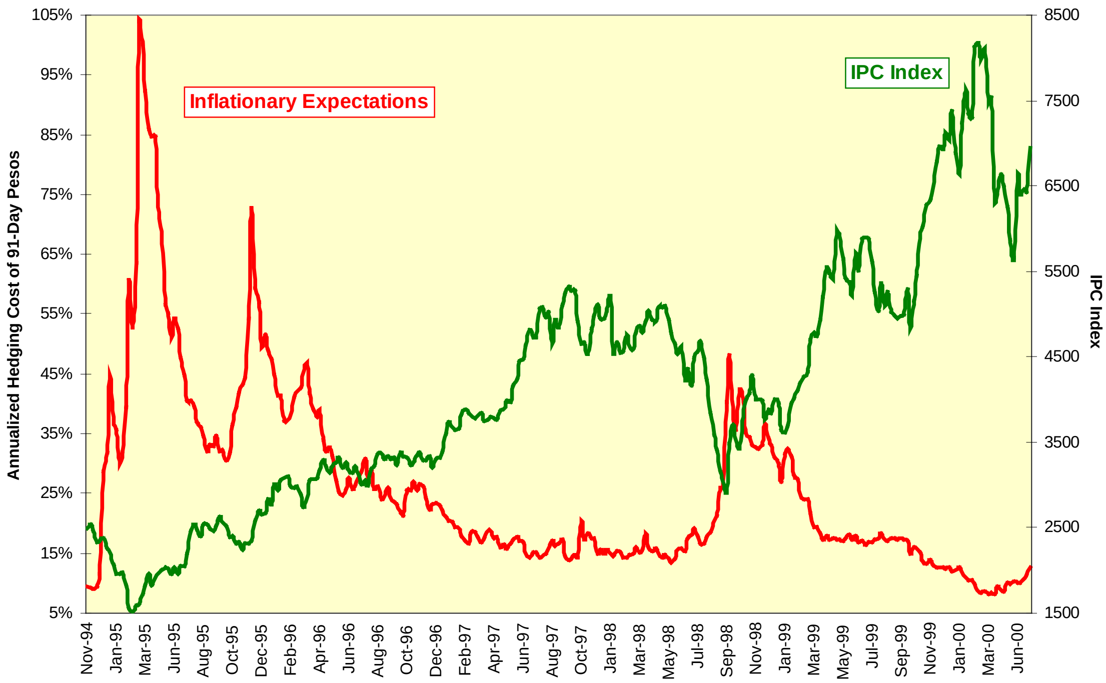
Peso Depreciation As A Function of Relative Inflation



Given the global experience of financial markets rewarding lower inflation -- the American bull market did not begin until Paul Volcker broke the back of inflation in the early 1980s -- we should expect a similar experience in Mexico if Fox is successful. Interest rates, which have been kept high in Mexico to compensate foreign investors for the risk of currency depreciation, will fall without penalty to the exchange level of the peso.

This will be unqualifiedly bullish for Mexican equities. First, the daily correlation of returns between 91-day rates and the Mexican Index of Prices and Quotes (IPC) index since the December 1994 peso collapse has been a very strong -.25. Second, the correlation between daily IPC returns and peso returns has been an even stronger -.32. As inflationary fears rise, foreign investors flee, the IPC sinks, and higher interest rates are required to forestall further capital outflows.

Plenty Of Room To Grow: IPC Index As Function of Inflationary Expectations



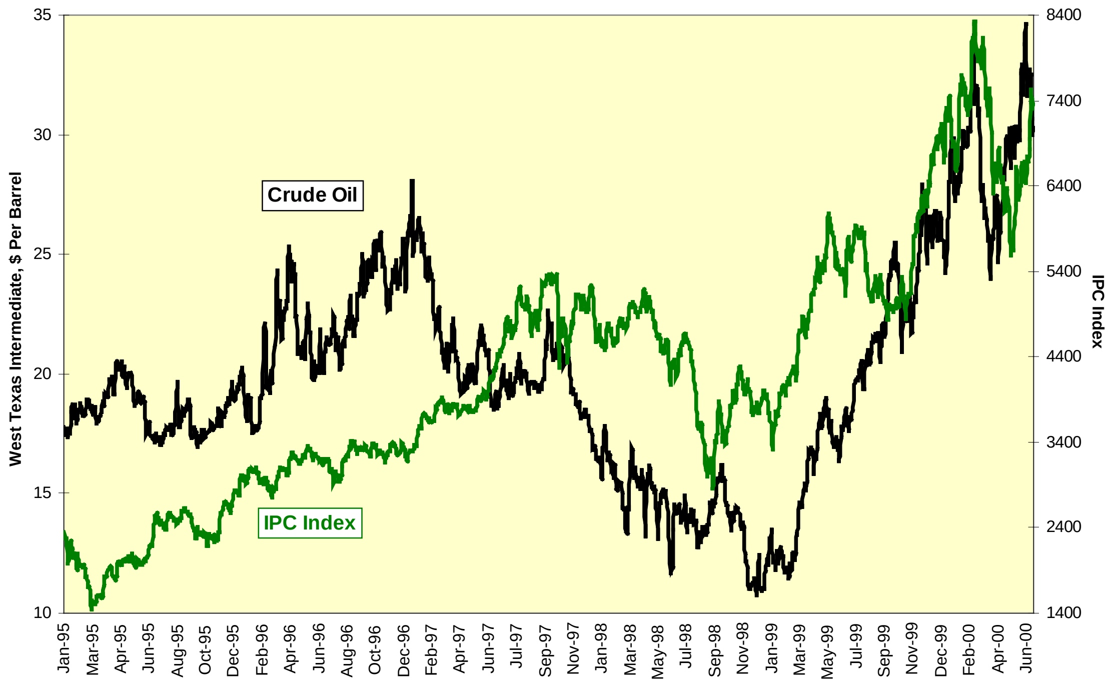
Second, the rewards in financial markets get exponentially stronger as interest rates decline even further. After all, a 5 basis point decline in Mexican interest rates in March 1995, when 91-day interest rates were 82% was only 0.061% of the base level, while an identical rate decline at today's 14.9% rates is 0.336% of the base level, 5.5 times as great. Should 91-day rates fall to 10.9%, a 5 basis point decline will be 0.459% of the base level. The returns on all financial assets will balloon accordingly.

The third and perhaps most important factor is psychological/political. Inflation encourages capital flight and purchases of non-productive tangible assets; this was true in the United States in the late 1970s, as Swiss bank accounts and Kruegerrands became fashionable. The owners of this flight capital are not the teeming masses yearning to be free, but rather the elite (read PRI). These potential investors and their capital have not benefited Mexico as much as they could have.

What About Oil?

Crude oil exports are a substantial source of foreign exchange and tax revenues for Mexico, and it should come as no surprise the IPC and oil prices are linked, with a .42 correlation since the most recent peso collapse. What is interesting here is the total absence of any oil company in the 35-member index; only TAMSA, which makes oil country tubular goods and has only a 0.794% weight in the IPC, is oil-related. The Mexican oil and petrochemical industry is a state monopoly, (PEMEX) and this should suggest some opportunities for further efficiencies.

Black Gold, Mexican Tea



Crude oil revenues are booked in U.S. dollars, while the government and PEMEX need to spend pesos. The higher price of crude oil creates a greater supply of dollars to sell for pesos, and this supports the exchange value of the peso, and lowers both inflationary expectations and interest rates.

Where Are The Flashing Red Lights?

Despite the bullish outlook -- and let's set a target on the IPC of 10,800 by next March -- we must remember markets do not move in straight lines, and neither do countries. President Fox will need the support of the vast PRI administrative apparatus to effect policy changes. Ronald Reagan faced the same problem, and the U.S. federal government today claims a greater share of GDP than it did in 1981.

Second, Mexico is in the position of catching a cold when others sneeze. The peso was rocked by the various Asian currency crises of 1997, and by the Brazilian real devaluation in January 1999. The peso has suffered one-day downturns related to problems with the Colombian peso. Should the U.S. economy slow, Mexican export growth will decline apace. Worse, if a financial downturn rocks U.S. markets, the IPC will get hit even harder. And, of course, if oil prices drop significantly, Mexico will be hurt.

Still, there's a lot to like about Mexico right now. There's never a wrong time to be on the right side of history.