Oh, No! There Goes Mexico!

History shows again and again how nature points out the folly of men. For this, American investors should be most grateful: The consensus start of the Great Bull Market™, August 1982, came on the heels of a financial crisis and devaluation in Mexico. Fed Chairman Paul Volcker, who broke the back of inflation at the cost of sky-high interest rates and a stiff recession, was persuaded to relax his grip to avoid a credit crunch spreading from Mexico to the U.S. banking system and beyond. The S&P 500 tripled in the following five years.

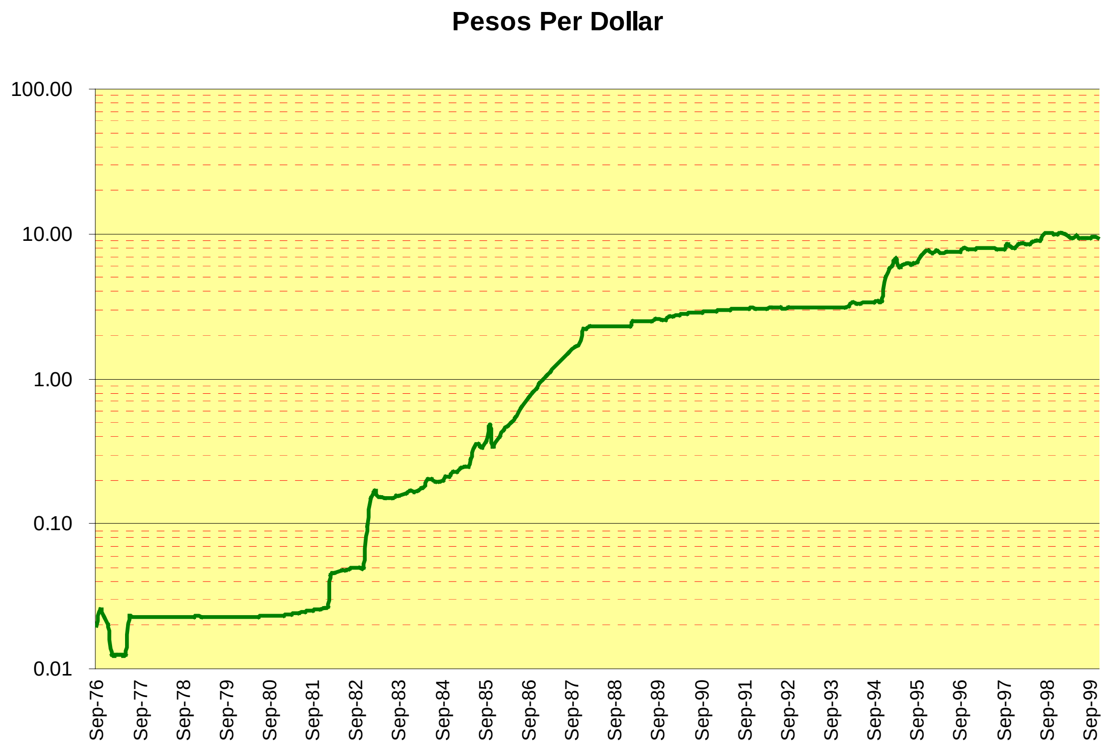
A similar financial crisis and massive devaluation emerged again in Mexico in 1994. This occurred on the in the wake of seven interest rate hikes in the U.S. beginning in February of that year. Fed Chairman Greenspan ended the tightening in the face of this emerging crisis and some derivative debacles such as the bankruptcy of Orange County. The S&P 500 has nearly tripled since the Mexican devaluation in December 1994.

Both 1982 and 1994 were presidential election years in Mexico; Mexican presidents are elected for a single six-year term. Our election cycle tends to see slow growth and/or a recession early in a new administration as the electorate recoils in horror at the attempts of the administration to follow through on its campaign promises. Mexican election cycles tend to produce calamities at the end of an outgoing administration as the fiscal and monetary excesses of the ruling PRI (Institutional Party of the Revolution, an oxymoron if ever there was one) during the campaign season cause an economic bursting. Sweeping unpleasantness under the rug and keeping it there are two very different things.

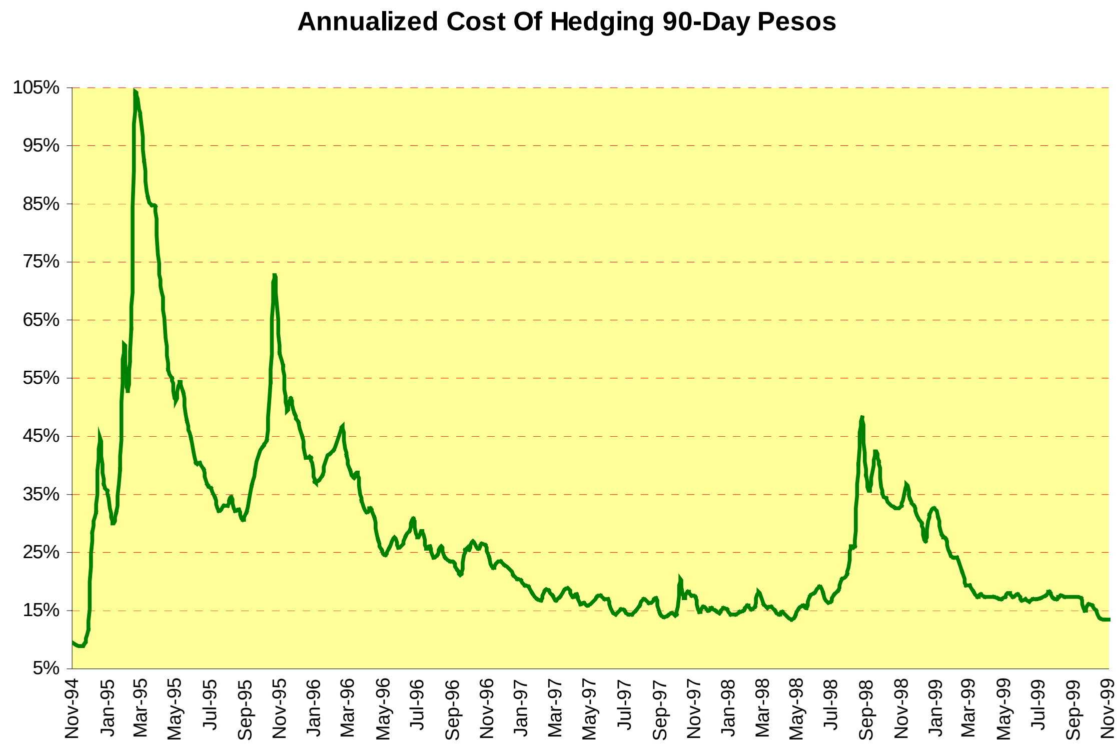
Outgoing president Ernesto Zedillo is trying to end this cycle by 1) actually allowing a primary within the ruling PRI instead of appointing a successor, 2) imploring the Bank of Mexico to hew to monetary discipline, and 3) allow actual political competition, after a fashion. If successful, this may deprive American investors of a monetary shot in the arm per 1982 and 1994, but, hey, we've been living off a pretty good buzz from the 1997-1998 Asian/Russian/Brazilian crises anyway. Will the opportunities arise in Mexico, and how can we play them through derivative instruments?

Dropping The Chalupa

Mexican assets are priced in pesos, a currency with a most unhappy history in our lifetimes; since the peso began to trade freely in September of 1976, it has lost an astonishing 99.788% of its value against the U.S. dollar, which in turn has weakened against other major currencies. While the Mexican elite rejects proposals for "dollarizing" the Mexican economy, Pedro Juan -- the Mexican counterpart of Joe Sixpack -- converts his pesos to dollars every chance he gets.

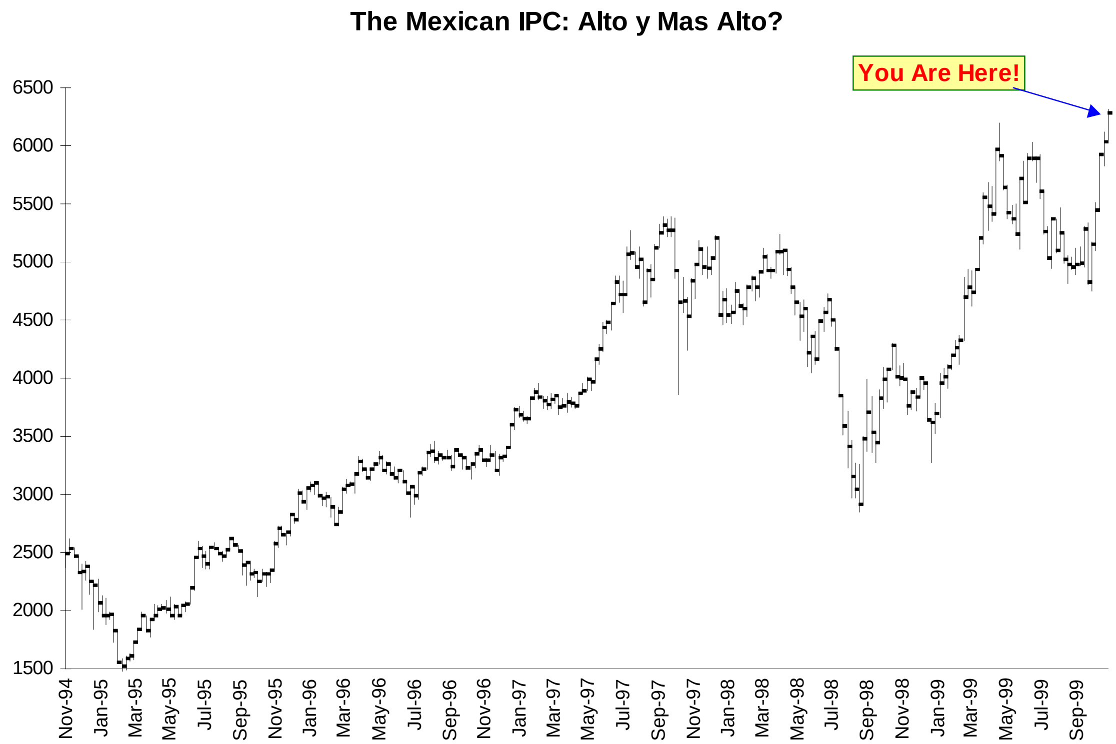


The pattern of the past quarter-century has been a series of catastrophic devaluations quite unlike the gradual devaluation engineered successfully in Brazil until January 1999. The fear of sudden currency calamity has made the currency risk in Mexican equities quite expensive to hedge as shown below; selling pesos forward is equivalent to borrowing at Mexican interest rates and lending at U.S. rates. In addition, the market for forward pesos is not particularly liquid to begin with, and liquidity tends to disappear when needed most: During the 1998 financial crisis, the government suspended weekly auction of 6-month and 1-year Cetes, the Mexican equivalent of T-bills.



The Giant Sucking Sound Wants You

Strong U.S. economic growth and the benefits of free trade have combined to create an export boom in Mexico; in addition, this year's doubling of oil prices has given the government a rather unexpected windfall. These factors will help keep a lid on Mexico's trade deficit and act like a tax cut, both of which should support the peso. They will also allow the Bank of Mexico to relax interest rates without fear of causing a peso collapse in an election year; this should support the IPC, the Mexican stock index. Finally, and perhaps most important, the lowering of Mexican interest rates will also reduce the cost of hedging peso exposure.



The IPC is in the midst of an upside breakout, one with the potential to extend to 7500 by early 2000. The investment climate is quite favorable, as noted above, and the cost of hedging the peso is near a five-year low. One peso future for every $50,000 of Mexican equities should do the trick.