Mexico At Impending Risk

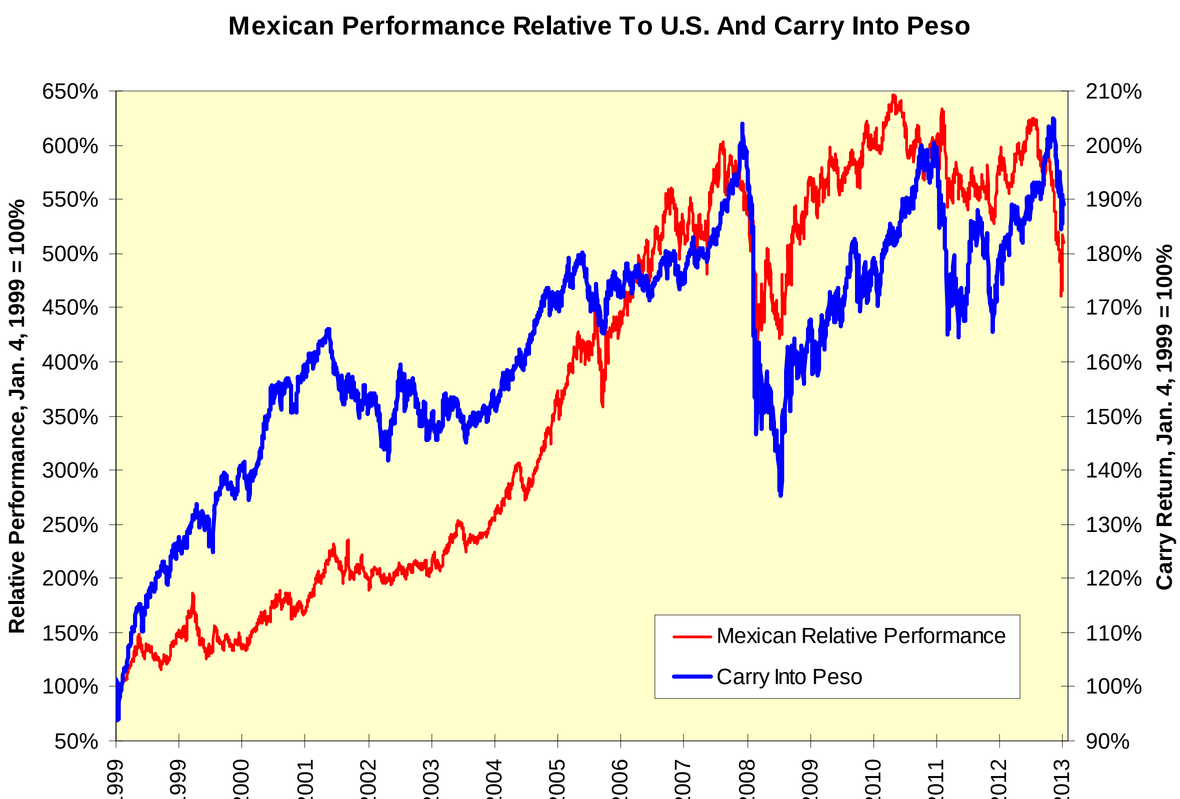
Most investors have seen references to the great 1982-2000 bull market and most investors know as well what eventually became known as the dotcom bubble of the late 1990s broke out in January 1995. What is surprising to many is both of these upside breakouts were associated with Mexican debt and peso devaluation crises, and both followed periods of higher short-term interest rates in the U.S.

The behavior of Mexican markets beginning with the yen's rise in early May and culminating with the FOMC's deployment of a circular firing squad to communicate its policies in June gives us an inkling of what might be coming down the road if and when the U.S. starts to raise short-term interest rates for real.

Preemptive Profit-Taking

We are so conditioned to treating our fellow investors as a herd of mindless dolts we overlook the possibility, noted recently in a discussion of Japanese selling of emerging Asian stocks, that markets get it right more often than not and that markets are made up of those very same cud-chewing, trend-following dolts we so despise in our self-image as wondrous contrarians.

In both the Japanese case and in the case of Americans investing in Mexico, people understood the emerging market carry trade was a bubble waiting to be popped; if the whole affair was to be a turbocharged case of easy-come/easy-go, then the rational thing to do would be to sell too soon. Mexican performance relative to the U.S. peaked on January 14, 2013 in dollar terms, but the carry trade of borrowing the dollar and lending the peso did not peak until May 8, 2013. Dollar-domiciled investors were selling into strength just as they had between December 2010 and May 2011.



First Out The Door

The recent selloff, as the philosopher Thomas Hobbes might have put it, was nasty, brutish and short. Between May 8 and the Federal Reserve's concert of apology crescendo ending on June 24, 2013, Mexican relative performance declined 16.59% and the carry return into the peso lost 9.56%. On an absolute basis, Mexican stocks lost 19.59%. As they say in Monterrey, "¡Oy!"

The critical part to remember is the Federal Reserve never took any action; everything noted above was an attempt by investors to be the first out the door. One day the Federal Reserve will take action, and if the panic noted above is any indication, it will lead to a stampede of funds out of Mexico.

The worst part about it is Mexico's two leading sources of foreign exchange, the remittances of workers in the U.S. and crude oil exports, both are diminishing. Remittances in May were 13.2% below year-ago levels and the dollar value of crude oil exports in March were 18.45% below year-ago levels. Selling by foreign investors into a pool of foreign exchange reserves less able to maintain the peso against an onslaught could lead to a 1982 or 1994-style peso collapse.

Those two episodes induced a more dovish stance by the Federal Reserve and helped propel our bull market. However, the capacity and willingness for the Federal Reserve to be more dovish is limited; yes, the Bank of Japan rescinded a small rate increase in the spring of 2006, but Japan was alone in the world at the time. I do not foresee American or others' policies reversing at an early point in the future first upward turn in interest rates to relieve Mexican distress.