Truth, Justice, And The Mexican Way

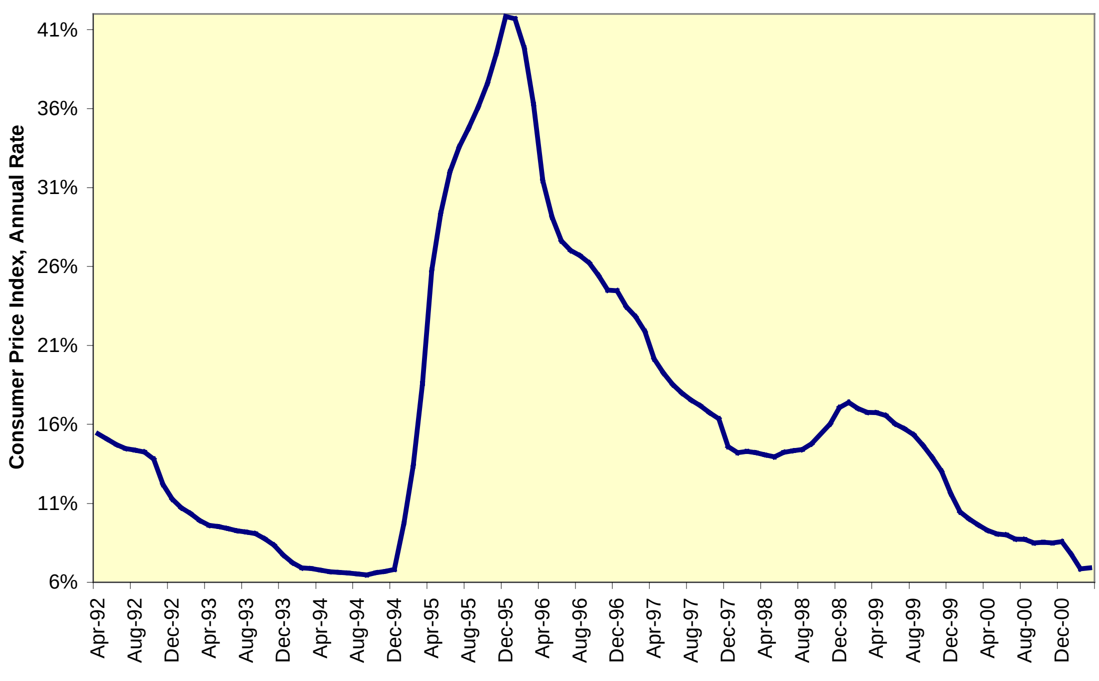
Is there an investor alive who hasn't gone through a period of frenetic trading and then realized they would have been better off doing nothing? Consistency of policy can be a virtue; recall Robert Rubin's "A strong dollar is in the interests of the United States" mantra. Once consistency is abandoned, as the Federal Reserve has discovered to our sorrow, markets devolve into a tangled mess of dashed hopes and sudden surprises.

The Fed and Alan Greenspan could learn consistency from a surprising source, the Bank of Mexico and its Governor, Guillermo Ortiz. Ortiz became Mexico's Secretary of Finance in December 1994, the time of a massive peso (MXN) devaluation, and had to spend the remainder of his tenure in that post fighting inflation and a weakening MXN with higher interest rates and fiscal austerity. Once he became Governor of the BOM in January 1998, he carried this policy through in open market operations, consistently leaving the banking system short of MXN to combat inflation.

The results speak for themselves so far in 2001. The MXN has appreciated 2.7% against the dollar; only the Polish zloty has been stronger. The Index of Prices & Quotes (IPC) on the Mexican Bolsa is up 8.1%. President Vicente Fox and Ortiz are arguing in public whether GDP growth in 2001 will hit the initial target of 4.5%, or fall to 3.0%, as Ortiz now predicts. Even inflation, long the bugaboo of the Mexican system, has fallen to a 7.2% annual rate. While this is high by U.S. standards, consider it has fallen from 40% levels in early 1996.

We know from our own disinflationary experience in the early 1980s that nothing is better for financial markets than the strong signal policymakers won't let inflation get out of control. Let's see what opportunities are presenting themselves in this environment.

Mexican Inflation: Coming Back To Earth



Mexican Equities: New Party, New Patterns

This column's last look at Mexico came in the immediate aftermath of July 2000 elections (see "Mexican Stocks: Won't Get Fooled Again," July 2000). The susceptibility of the Mexican economy to a slowdown in U.S. import demand was noted, and this has come to pass, with total exports falling from $14.1 billion in October 2000 to $10.2 billion in March 2001. But, the following observation was offered as well: "Worse, if a financial downturn rocks U.S. markets, the IPC will get hit even harder." In fact, since the downturn in U.S. markets began last September, total return on the IPC has been -11.2%, far better than the 16.9% loss for the S&P 500 and a 47.7% loss on the

Nasdaq Composite. This is a major and welcome departure from past patterns. The longer-term chart has formed a massive, multi-year bullish pennant.

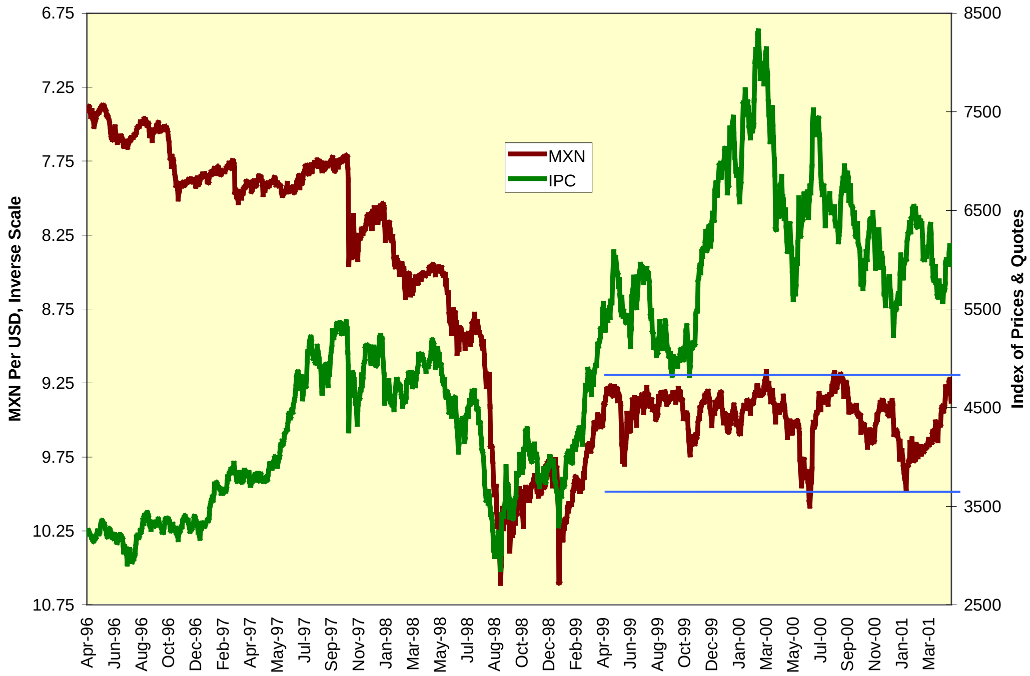
The usual supports for an IPC rally, an export boom, a surge in oil prices, and a drop in Mexican interest rates were all absent during this period. Mexico is a large exporter of crude oil, but is a large importer of natural gas. Oil prices peaked in the late summer of 2000, but natural gas prices continued to surge. These higher costs hurt oil country tubular steel giant Tamsa and steel manufacturers Hylsa and Grupo Industrial Saltillo fairly hard. The strong MXN is a never-ending source of complaint for the Monterrey industrialists and Maquiladora (duty-free assembly plants) exporters.

With these headwinds, how can we account for the strong relative performance in this period? The leading performers include some unlikely entrants, such as Penoles, a metal mining firm; metals prices have been under pressure globally. Construction and housing, represented by cement giant Cemex and real estate developer Geob, have been quite strong as well. The large banks, led by Banorte and Bancomer, have benefited from the end of the inverted yield curve that characterized Mexican money markets over much of 2000, and Walmart De Mexico has turned in a strong performance as the Mexican consumer continues to spend.

Stability Matters

We can recount winners and losers, and yet no clear picture emerges until we return the conversation to the BOM's singular and consistent goal of driving inflation lower and note another critical consequence of this policy: A tight exchange rate to the dollar. Mexico has eschewed the formal dollarization practiced by Argentina and Ecuador in favor of an exchange rate band between 9.25 and 10.00 MXN per dollar. This reduction of exchange rate risk along with a reduction in inflationary expectations has done and will continue to do much to eliminate planning uncertainties for Mexican businesses and foreign investors in Mexican securities.

A Fixed Exchange Rate?



Actions speak louder than words, and the credibility Ortiz quietly has established in the Mexican markets shows he places the welfare of his country over his ego and manufactured mystique. Who knows, he might even be better at simple, declarative English sentences than you-know-who. Let's just hope nobody writes a book about him entitled *El Maestro*.