Mexican Stocks Should Get More Respect

Rodney Dangerfield, he of the recent heart-valve surgery, made getting no respect respectable and thus blazed a trail for markets such as Mexico's Bolsa. China grabs all of the attention as the world's low-cost exporter of manufactured goods. France continues to present a litmus test for some as to whether our foreign policies are on course. Venezuela's obstreperous Hugo Chavez is going for the hemisphere's PITA award (Pain In The you-figure-it-out).

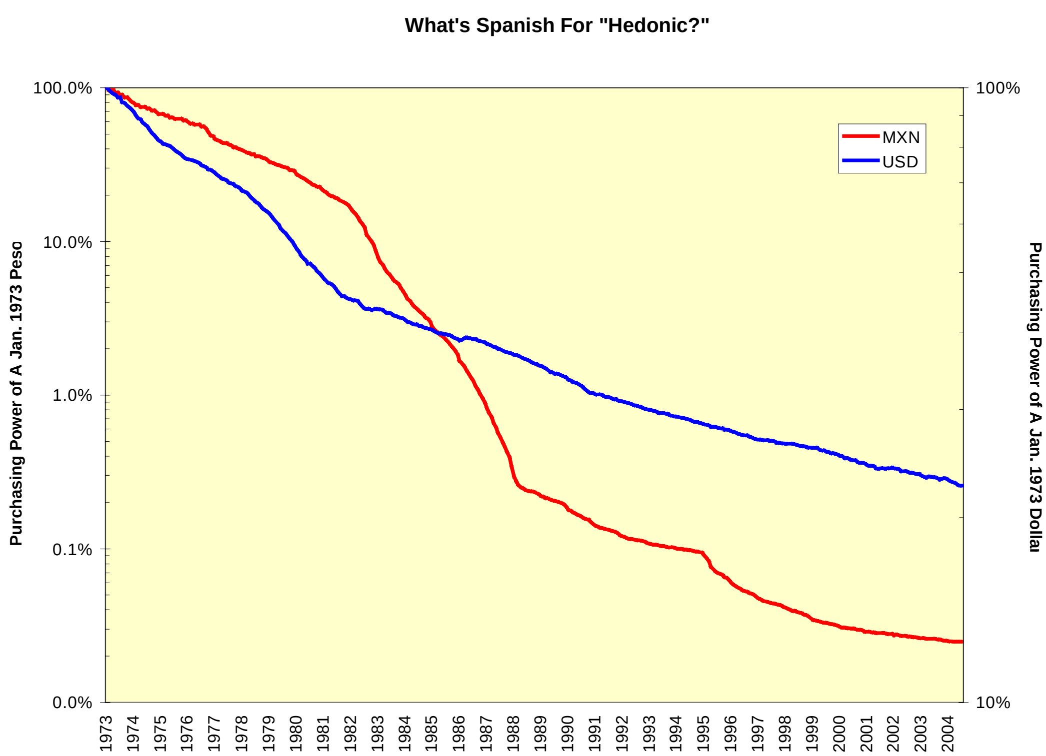
Mexico, our NAFTA partner and economic symbiont, simply goes about its business quietly, effectively and without a whole lot of respect. Its benchmark Bolsa index is up close to 16.3% in 2004 in peso terms. Unlike many previous rallies dependent on a weak peso to boost exports, this one has occurred within an environment of relative currency stability; the peso is down only 1.4% against the dollar on a year-to-date basis.

A common lament in Mexico is they are so far from God and so close to the United States. As we will see below, this should be amended to recognize that God gave them oil to export to El Norte.

The Peso

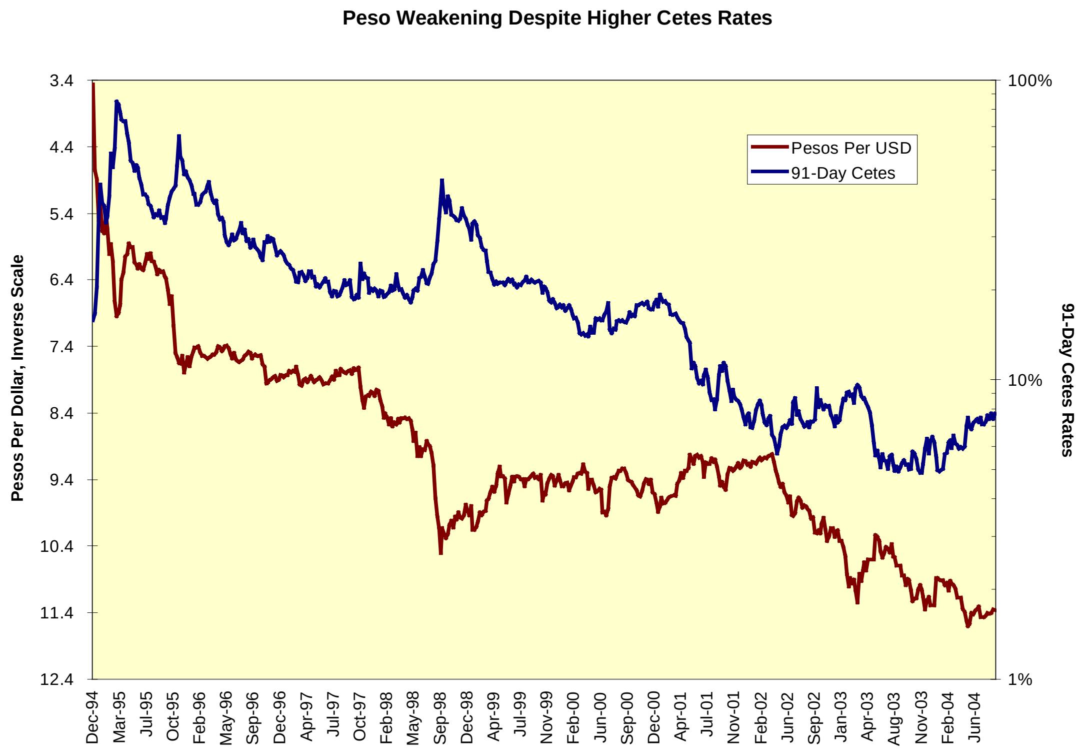
No discussion of the Mexican markets is complete without a discussion of the Mexican peso (MXN) and its travails over time. Whether the Mexican economy is growing or shrinking, whether its interest rates are rising or falling, whether its politics are stable or in turmoil, whether oil prices are rising or falling, the peso just gets weaker over time. The principal reason behind this seemingly permanent trend is an inflation-importation mechanism that takes over even if the Bank of Mexico is squeezing the money supply by leaving banking system reserves short (the "corto"). Mexico's close integration to the U.S. allows for capital inflows that circumvent the Bank of Mexico's best intentions.

The result is a historic trend toward higher inflation almost difficult to comprehend. Since January 1973, the purchasing power of the dollar as measured by the Consumer Price Index has declined to 22.55¢. The purchasing power of a peso has declined to .025 *centavos*. Their inflation has been 1,000 times worse than ours.



The constant loss of purchasing power requires the Finance Ministry and the Bank of Mexico to keep interest rates high in order to compensate investors. Even today, the yields on 91-day Cetes, their equivalent of Treasury bills, is

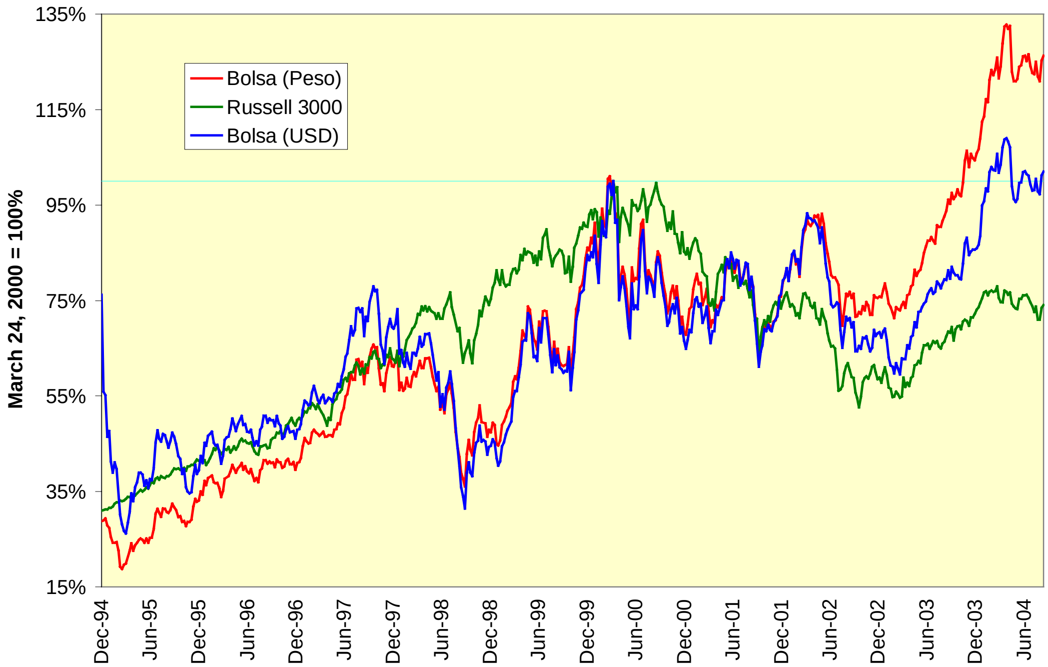
7.7%. That may sound high, but it is certainly an improvement from levels nearly ten times higher prevailing in the aftermath of the December 1994 peso devaluation. Over time, every drop in the exchange value of the peso is met by higher Cetes rates, and these obviously impose a substantial drag on the Mexican economy.



Mexican Equities

But even with the endemic problems of high inflation and nominal interest rates and an ever-declining currency, Mexico has not been a bad place for American investors. The comparison depends on the time frame used: If we compare the currency-adjusted returns on the Bolsa since December 1994, we see how we would have been better off keeping our money at home. But if we move the point of comparison to the March 2000, which marks a global peak more than the single-country event of December 1994, the picture changes dramatically. The Bolsa has gained nicely in inflated peso terms and has held its own in dollar terms while the U.S. market as represented by the Russell 3000 has continued to languish.

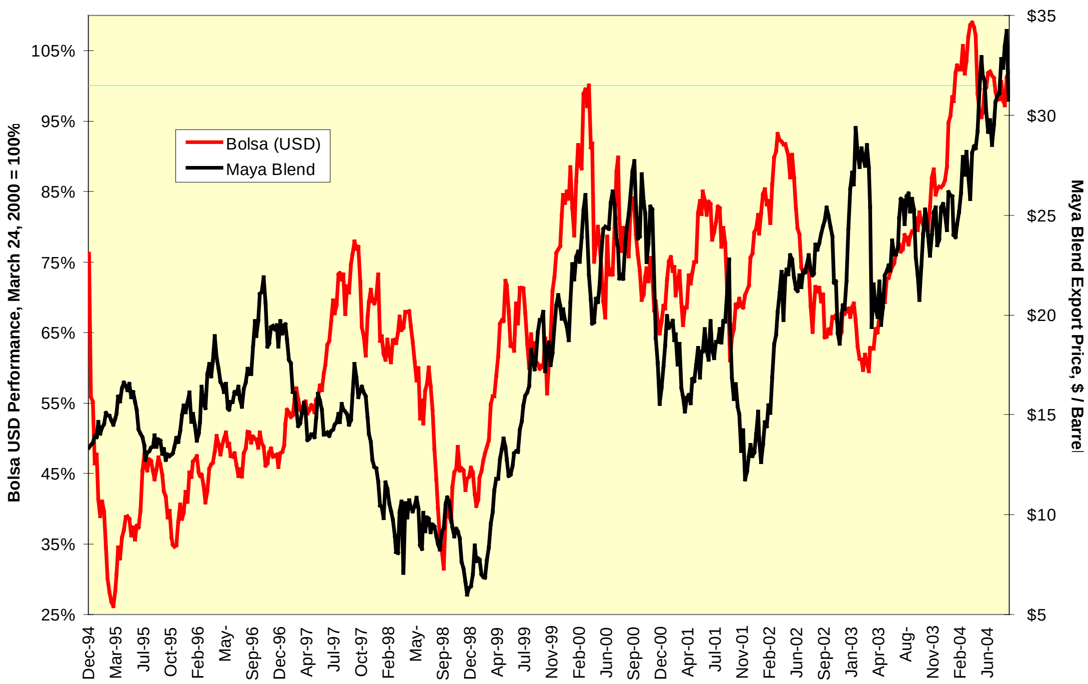
Outperforming On A Currency-Adjusted Basis



What About Oil?

The question inevitably rises whether Mexico is catching a bit of a free ride on higher oil prices, and this is certainly a fair question given the significance of oil to Mexico's export picture. If we compare the currency-adjusted Bolsa series above to the export price of Mexico's benchmark Maya Blend to the U.S., we can see an obvious correlation. Interestingly enough, while oil prices appeared to lead the Bolsa returns prior to the 1999 low in oil prices, the opposite has occurred since that point: Mexican stocks appear to rise and fall in anticipation of changes in oil prices.

An Obvious Link



Winners And Losers

Given this expected and confirmed link to oil prices, there is no equivalent to buying the oil sector in Mexico as we can in the U.S. Pemex, the Mexican state oil company, is off-limits to foreign investors. One of the best proxies for the oil industry is Hylsamex, a steel company that makes oil country tubular goods such as pipes and well casings. It is up a modest 175% this year. Grupo Mexico, a mining company, is up close to 40%. Other winners include Savia, an agricultural exporter and a big beneficiary of NAFTA. For those of you looking for a more diversified approach, the iShares MSCI Mexico index ETF, which trades under the ticker EWW, offers a reasonable alternative and is denominated in dollars. It is up 30.8% so far in 2004.

But please remember that oil prices rise and oil prices fall. Nothing in the rise of oil prices has ended Mexico's homegrown problems of inflation and an ever-weakening currency. Should oil prices break, an outcome not predicted here, the outperformance of the Bolsa in dollar terms, the only ones that matter to you, will end. You have to respect that.