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Respite granted by averted tariff threat for Mexican credit markets could be brief

by Alexander Engeln

The Mexican economy is experiencing a continued slump in 2019, affecting both its equity market, which is down over 7% since July 2018, and its bond market, with Mexican treasuries recently being downgraded to just above junk-level. Perhaps the most prominent current problem are the recent threats of US tariffs on Mexican goods by US president Donald Trump. Although the plans for an immediate implementation of an additional tax on Mexican exports to the US have been withdrawn for now, the growing isolationism of the US could see the weaponization of such economic tools against its trade allies come back. Trade deals like the already agreed-upon USMCA trade agreement between the US, Mexico and Canada could see the likelihood of a returned conflict drop to lower levels. However, as the ratification of this trade agreement by all three countries is still outstanding and considering the erratic behaviour of the current US administration, one cannot assume any such deal to hold indefinitely or to see it eliminate the risk completely. This article therefore details an evaluation of a stress testing scenario in case of a returned tariff threat using the Bottom-up Default Analysis (BuDA) toolkit and shows the negative consequences for the credit profile of the export-based Mexican economy using its result.

One potential reason for a return of a tariff threat could be an inefficiency of the current bilateral agreement aiming to curb the transition of illegal immigrants from southern countries crossing Mexico's territory on their way to the US-Mexico border. Another could be their repeated use by president Trump as a political tool during his campaign for re-election in the next presidential election. As this election is currently scheduled for November 3, 2020, a conflict over the effectiveness of the recent agreement after a few months seems the likelier option. For our stress scenario in this analysis, we therefore assume a new tariff threat to emerge in January 2020. This risk is especially significant for Mexico in particular, as recent events have shown that this strategy can be effectively used to achieve political goals of foreign interests against it. To give an insight into the potential consequences such an event, we use the BuDA toolkit to simulate the effects of a repeat of this event.[1]

The macro variable chosen to receive a negative shock for our scenario analysis is the value of the Mexican peso, represented by its nominal effective exchange rate (NEER). The reasoning for this is as follows: a steep drop in the currencies' value was already seen during the recent dispute (Figure 1), as is usual for cases of tariff threats. Such a drop in currency was for example also observed in the value of the Chinese Renminbi during the beginning of the current US-China trade war (Figure 1). After the announcement of the bilateral agreement on June 14, the peso has already regained the recent drop in value that occurred following the initial announcement of the US president's plans. Therefore, the positive trend of the NEER it had experienced before the tariff dispute emerged is assumed to resume until the end of the year. As a benchmark scenario, this positive trend is expected to continue beyond this point as well, as we assumed that the bilateral agreement will hold. As for the stress testing scenario, should tariffs come into effect in the future, the threat of US tariffs on Mexican goods would lead to a short-term increase in export volume. As the US is by far Mexico's largest destination of exports, accounting for 80% of all exports in 2018, companies would be trying to quickly offload their inventory before tariffs would come into effect. Following this event, the Mexican peso would devalue due to a loss of confidence by currency holders, the actions of short-sellers and potentially even devaluing actions by a Mexican government aiming at making the country's goods cheaper for foreign investors and thereby defending against a drop in export figures. For this reason, the stress test scenario is based on a negative shock in the Mexican

[1] Duan, J.-C., W. Miao, J.A. Chan-Lau, and The Credit Research Initiative Team of the National University of Singapore, 2019. BuDA: A Bottom-Up Default Analysis Framework, version 3.1.0. This document is accessible via https://www.rmicri.org/en/white_paper/. To analyze the dynamics of credit risk under macro-financial scenarios, BuDA provides a unique framework to evaluate the credit quality of each individual firm over given scenarios, which in turn forms a bottom-up portfolio of interest.

NEER, with the assumption of a continued monthly change rate in the NEER of -4% based on historical data. This represents the weakening of the peso compared to several prominent international currencies.

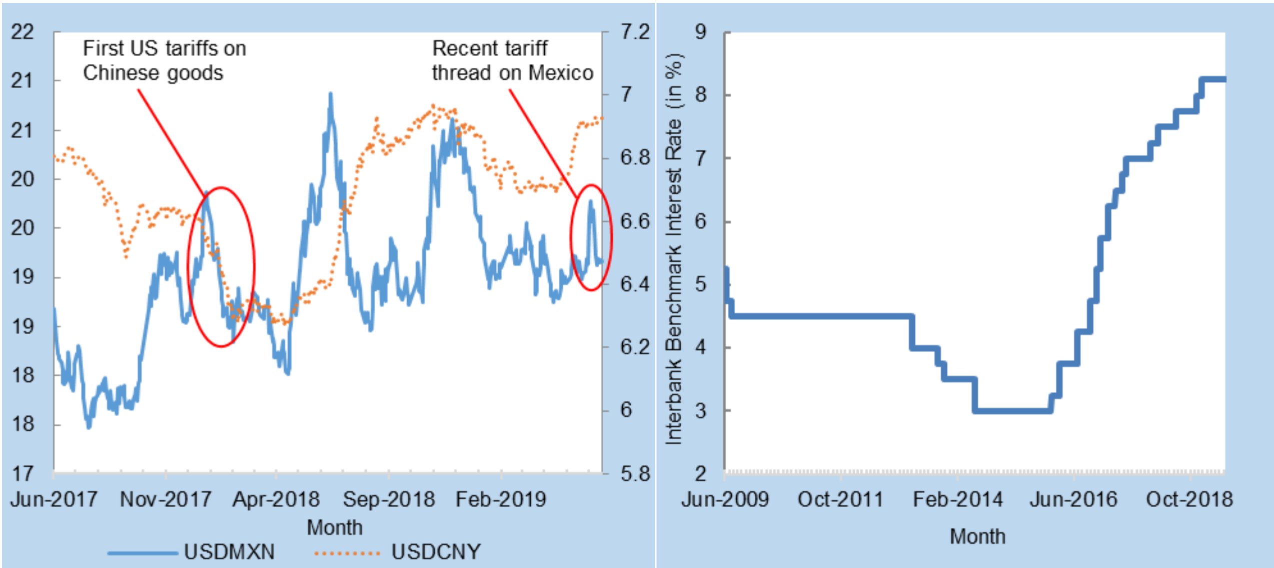

Figure 1 & 2: Development of the USDMXN and USDCNY exchange rates between June 2017 and today and the development of the Mexican Interbank Benchmark Interest Rate between June 2009 and today. *Source: Datastream*

Such a devaluation of the currency would have many negative effects on the risk profile of Mexican companies. The sources of these effects would be both domestic and international, affecting the companies' credit and business side: firstly, the Mexican central bank may raise the benchmark lending interest rate (already at its highest level in the past ten years at 8.25%, Figure 2) even further to prevent capital outflow. On the one hand, an increase in the benchmark lending rate would incentivize continued lending by capital owners despite this increase in risk profile. On the other hand, the resulting additional increase in funding costs for Mexican companies would further strain their economic competitiveness and increase their debt risk. It would therefore raise their individual probability of default (PD) as well.

Secondly, Mexican companies would be faced with an increased repayment cost, as any debt in a foreign currency would require a larger amount of pesos to repay, due to the currency's drop in value. This would increase the company's foreign debt risk profile, leading to a rise in the PD for the individual company.

Thirdly, the threat of US tariffs with a subsequent drop in the peso's value would have a negative impact on equity markets: confidence levels of domestic and international investors would drop at the heightened currency risk. Furthermore, a significant drop in export figures would be foreseeable, making export-dependent companies unattractive to investors. Industries like automotive manufacturing or the production of electronic goods would be expected to suffer the most, as they made up 25% and 20% of all Mexican exports respectively in 2017. In addition, many other export industries such as machinery production or crude oil would suffer as well as their competitiveness with American or other foreign businesses in US markets would be reduced. As a consequence, stock prices would plummet for many Mexican companies, resulting in an increase in their PDs.

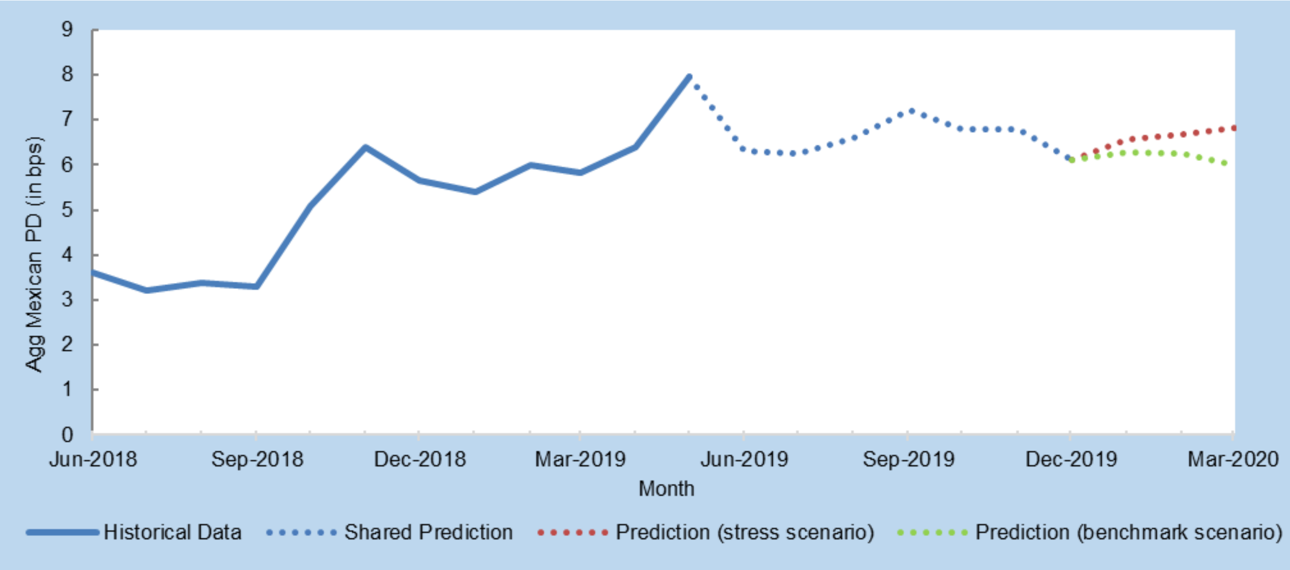

Figure 3: Historical and predicted development of the Mexico median PD (Agg PD) between June 2018 and March 2020 for a stress testing and a benchmark scenario. *Source: NUS-CRI*

While more effects of a new tariff threat would be sure to manifest themselves in other factors of the Mexican economy as well, this stress scenario shows that from January 2020 on the predicted rise in PD for many individual Mexican companies would together lead to an increase on the macro level for the country, represented here as the Agg PD of Mexico (Figure 3). In the benchmark scenario, it can be seen that the Agg PD level would be predicted to remain approximately constant, conditional on no tariffs being present. This shows that the negative effects of a tariff threat would not be limited to some individual firms, but have significant large-scale downsides for the overall economy too. Based on the economic effects laid out above, this prediction seems reasonable. Overall, the results of the BuDA showcase the threat of the fact that any respite for the Mexican economy can only be temporary while this use of economic trade tools as political leverage by the US remains possible (and at least not improbable) in the future.

Credit News

PBOC governor's boast of having 'tremendous room' to act to be tested soon

Jun 17. The claim by the People's Bank of China's governor of having enough policy space could soon be tested as the economy slows down following a worsening trade-war. The industrial output growth was recorded the lowest since 2002 highlighting headwinds from the trade war. However the one year lending rate has stayed at 4.35% since 2015 and also the Federal Reserve's dovish turn eases the depreciation pressures on the yuan. Some economists are of the view that whatever levers China pulls in response to a slowdown, the impact on the yuan must be calibrated to maintain economic stability. (Business Times)

Corporate bonds give reassuring signals amid market jitters

Jun 17. Solid demand for US corporate bonds is signaling a reasonable amount of optimisim from typically cautious investors, easing worries about looming economic slowdown. Although the spread between corporate bonds and Treasurys has generally increased throughout the year, it has levelled off recently. The narrowing spread is one factor giving confidence to stock investors as they push indexes closer to records despite worries about the economy and signals from the Treasurys market. Concerns have been raised about the recent yield curve inversion which generally occurs amid darkening growth prospect, but is also driven by various factors: inflation outlook, monetary policy and other countries' government-bond yield. However, amid the current low rate and potential rate cut, investors still express confidence and positive outlook on the investment environment. (WSJ)

Italian bankers look to insurance to offset balance-sheet risk

Jun 14. Banca Popolare di Bari SCpA is in negotiations with a credit fund to insure its loans in the case of a default. This helps ailing banks like Banca reduce risk on its balance sheet. The potential transaction is known as a synthetic securitization and it involves buying insurance from Christofferson Robb & Co, transferring the risk of the loans to the fund for a fee. Banca's transaction will be the first in Italy after European regulations allowed banks to use standardized risk models to factor in more relief from synthetic securitizations. These reforms will allow small and medium-sized Italian banks to use similar methods to allow them to reduce risk on their balance sheets at a cheaper cost and boost tier 1 capital ratio. Regulators are encouraging Italian banks to strengthen their risk capital but also lend out more money as the economy is flirting with recession. (Bloomberg)

Bankruptcies and slowdown hang over China's electric car market

Jun 13. The Chinese electric vehicles' start-ups are struggling to survive in the face of intensifying competition and subsidy cuts. The growth in the electric vehicles in china has been tenfold since 2014, which is highly dependent on the subsidiaries. The companies would be forced to increase the prices after subsidies would be cut this month for most of the vehicles. The start-ups are facing looming international competition and a tougher fundraising environment along with the changing infrastructure and people's mind-set being the major problems. (FT)

China's small banks run into more trouble

Jun 12. The yields on Negotiable Certificates of Deposits (NCDs) have risen sharply for lowly rated issuers and issuance has plummeted. The NCD market was spooked for two major reasons, one being the absence of collateral and the other being the delay in releasing the annual reports. There has been several instances of the central bank coming to rescue and backing the troubled small lenders time and again. The Chinese regulators need to analyse the situation and have long-term solutions and proper credit-risk mitigation measures. (WSJ)

Chinese regulators will restructure Baoshang Bank as soon as possible (Reuters)

Investors drawn to junk bonds on hopes of Fed rate cut (FT)

Euro zone banks are still piling up new bad loans, ECB warns (Reuters)

Regulatory Updates

EU plans easier restructuring of euro zone bonds from 2022: draft

Jun 14. Euro zone sovereign bond holders can expect their power to block bond restructuring greatly reduced, following plans of easing restructuring for all bonds issued on or after January 1, 2022 and with maturities above 1 year. The reform is designed to speed up the resolution of debt cirses, but critics are concerned that it could increase yields on bonds of governments with high debt, as they would be perceived by investors as at greater risk of being restructured. Although the issue has been discussed, the final adoption may only be realized in December to allow states to adapt their national rules to the new requirements. (Reuters)

China bank loans rebound, more policy easing may be needed

Jun 12. China gave out more bank loans in May to support the slowing economy in the midst of a trade war with the United States. Observers are also looking to see if policy easing can help to sustain credit growth.

Outstanding Total Social Financing (TSF) grew to 10.6% in May from 10.4% in April last year. The central bank is also ready to make policy adjustments in the event that the trade war worsens. Cuts to bank's reserve requirements are expected this year however the PBOC is reluctant to cut benchmark interest rates unless the economy takes a nose dive. The PBOC is also looking to reduce borrowing costs for companies and the government is also looking to up fiscal stimulus to support growth by fast-tracking infrastructure projects and cutting taxes for companies. China's economic growth in 2019 is on track to slow from a 28-year low of 6.6% last year. (Reuters)

Negative ECB rates so far neutral for bank profits (Reuters)

Leveraged loan risk not enough to warrant new rules for now: Basel official (Reuters)

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