Grupo Financiero BASE

Economic Forecasts

September 11, 2024

Indicator	Year	Pessimistic	Central	Optimistic
Mexico GDP growth	2024	0.9%	1.3%	1.6%
	2025	-0.4%	0.8%	1.2%
U.S. GDP growth	2024	2.3%	2.5%	2.8%
	2025	0.6%	1.8%	2.5%
Inflation YoY, end of year	2024	3.7%	4.6%	5.2%
	2025	3.2%	4.1%	4.8%
Interest rate, end of year	2024	10.00%	10.25%	10.50%
	2025	8.00%	8.50%	9.50%
Exchange rate, end of year	2024	21.00	19.50	18.50
	2025	21.50	18.50	17.00

The optimistic, central and pessimistic scenarios are in relation to Mexico's economic growth.

Source: Grupo Financiero BASE

In the early morning hours of Wednesday, September 11, the Mexican Senate approved the Judiciary reform, with 86 votes in favor and 41 votes against, in the absence of one senator. The core of this reform is the popular election of judges, magistrates and ministers, without requiring work experience in the field. On one hand, this will put an end to the judicial career and on the other hand, it allows the political parties in power to choose the candidates for these positions, politicizing the justice system. Therefore, the Judiciary reform weakens the separation of powers.

The Judiciary reform is a risk for Mexico's economic growth, as it generates uncertainty. The reform puts at risk the arrival of new foreign investment and, subsequently, the reinvestment of profits. It also endangers the trade relationship with the U.S., Mexico's main trading partner, since the dismantling of the legal structure generates doubts that the country will be able to fully comply with the commitments established in the USMCA. The approval of the reform to the Judiciary also makes it likely that other pending reforms will be approved, mainly the elimination of autonomous agencies, including the regulators of economic competition, which are necessary within the framework of the USMCA. In view of this, the U.S. government could initiate new disputes against Mexico and impose trade sanctions.

Finally, the approval of the reform to the Judiciary, weakens Mexico's institutional framework, increasing the risk of sovereign debt rating cuts.

In this context, the probability of the Mexican economy falling into recession in the coming months increases, which would be followed by a long economic stagnation, in a scenario similar to what happened after the cancellation of the new Mexico City airport, when due to risk aversion, the Mexican economy fell into recession in 2019, showing a GDP contraction of 0.4%. The impact on the economy will depend a lot on how cautious foreign business and investors are about Mexico and how much they slow down investment projects and hiring of personnel.

This deterioration in economic expectations will pose a challenge for Claudia Sheinbaum's administration.

The risk of upward pressure on the exchange rate and downward revisions to economic growth have increased given the following factors:

1. **The approval in the Senate of the Judiciary reform.** The reform jeopardizes Mexico's trade relationship with its main partners and raises the probability of credit rating downgrades. Furthermore, since Morena (the ruling party) and coalition parties have obtained a qualified majority in the Senate, nothing prevents them from approving other reforms such as the disappearance of autonomous agencies, where the disappearance of the Federal Telecommunications Institute, the Federal Economic Competition Commission, the Energy Regulatory Commission and the National Hydrocarbons Commission are of specific concern. Nor can it be ruled out that, during Claudia Sheinbaum's administration, a reform to the National Electoral Institute will be promoted, as it would be a serious risk for the continuity of democracy in Mexico.

   The fact that the ruling party has obtained a qualified majority in the Senate also deprives the opposition of the number of senators necessary (1/3) to challenge reforms before the Supreme Court. Therefore, the approved reforms will not be challenged.

2. **The slowdown in economic growth has continued.** In July, the Advance Economic Activity Indicator showed a monthly contraction of 0.13%. Meanwhile, the Advance Indicator of Private Consumption contracted 0.08% in July. Finally, gross fixed investment up to June (at the end of the first half of the year) grew 0.66% y/y, slowing for eight consecutive months and being the lowest annual growth rate since March 2021.

   Since there is still little information for the third quarter, the expectation of GDP growth in 2024 of 1.3% is maintained, but considering the risks to investment presented by the reforms and the continued economic weakness, the probability of cuts to the growth expectation and an economic recession has increased. Grupo Financiero BASE estimates that the impact of the approval of the reforms could be at least 1.9% of GDP, an impact that could begin as soon as the second half of 2024.

3. **Economic weakness makes it more likely for Banco de Mexico (the Mexican central bank) to cut interest rates.** Two additional rate cuts of 25 basis points each are expected to close the year at 10.25%. However, there could be three rate cuts in the event that economic weakness materializes more than expected, along with a decrease in non-core inflation. As a result, the risk that the peso depreciates towards the end of the year has increased due to the lower interest rate differential with the U.S. and other economies such as Japan.

4. **The risk of credit rating downgrades has increased.** The institutional dismantling associated with the reforms of the Judiciary and the disappearance of autonomous agencies may cause downward adjustments in Mexico's institutional grade. Likewise, on November 15, amid the presentation of the 2024 Economic Package, it will be necessary for the next government to provide clarity on the strategy of spending cuts or revenue increases, that would allow the reduction of the budget deficit from 5% of GDP in 2024. If neither the macroeconomic framework nor the strategy to reduce the deficit is credible, rating agencies could adjust Mexico's credit rating outlook to negative and in 2025 begin to cut the rating. Moody's currently maintains Mexico's sovereign debt at Baa2, two notches above speculative grade, while Standard & Poor's maintains a rating of BBB, also two notches above speculative grade. Fitch Ratings maintains a rating of BBB-, so it would only need a one-step cut to lose investment grade with this rating agency.

5. **Deterioration of the trade relationship with the U.S. and the possibility of trade sanctions.** In August, the U.S. Embassy in Mexico officially expressed concerns about the approval of the Judiciary reform, after which President López Obrador announced a pause in his relationship with the Embassy. In addition, several industry associations in the U.S. have expressed their concern to the State Department about the

probable approval of the reform, arguing that it would affect the review of the USMCA and would jeopardize the administration of justice in Mexico. Considering the above, it's likely that the Mexican reform will be part of the discussion by the U.S. Congress in 2025, prior to the review of the USMCA in 2026.

Likewise, it is likely that the energy trade dispute will be revived and that new consultations will be opened on other issues, rising the probability of trade sanctions against Mexico.

In addition to domestic factors, the exchange rate faces risks from abroad, including:

1. **The destruction of carry trade positions.** The Bank of Japan will probably raise its interest rate again, reducing bets in favor of the peso.

   In fact, in the Chicago futures market, net bets in favor of an appreciation of the Mexican peso stood on September 3 at 30,479 contracts, each worth 500 thousand pesos, accumulating a 78.18% drop since the 2024 high reached on April 9.

2. **Election campaigns in the U.S. are ongoing and Mexico is likely to continue to be criticized by the Republican Party candidate, Donald Trump.** In August and the first half of September, market attention turned to domestic factors in Mexico, specifically the approval of the Judiciary reform, and it is likely that during September domestic factors will continue to be the key determinant of the exchange rate. However, market attention could return to the U.S. electoral process in October, prior to the November 5 elections. It's likely that in the scenario that Donald Trump wins the election, the exchange rate will face upward pressure after the preliminary results are released.

Considering the aforementioned points of risk aversion about Mexico and lower carry trade incentives, it's likely that the exchange rate will again reach levels above 20 pesos per dollar and that episodes of high volatility might be observed that could push it towards 21 pesos per dollar before the end of the year. According to the central scenario, the exchange rate could stabilize in December, heading towards 19.50 pesos per dollar if risk aversion about Mexico moderates and capital stops flowing out of the country. The narrative with which Claudia Sheinbaum starts her six-year term will be important for this. In the 2025 Economic Package, the boost to public spending on infrastructure will also be relevant, without neglecting the necessary cuts in other areas in order to reduce the fiscal deficit.

However, the probability of the pessimistic scenario materializing has increased.

It was previously mentioned that the pessimistic scenario could materialize if: 1) the Bank of Japan signals that it will continue to raise the interest rate, 2) the Bank of Mexico signals that it will cut the interest rate at a faster pace than the Federal Reserve, 3) the trade relationship with the U.S. deteriorates, 4) the probability of credit rating cuts increases, and 5) global risk aversion rises due to various factors. These points, with the exception of 5), have been met.

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