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ECONOMIC AND MARKET PERSPECTIVES

Mexico

MACROECONOMIC INDICATORS

	2011	2012	2013	2014	2015	2016F	2017F	Trend 2000-2016	Trend 2017-2021F
Real GDP (YOY%)	4.0	3.8	1.6	2.3	2.6	1.9	1.5	2.3	2.3
Per Capita GDP (LCU)	120,840	127,996	130,220	137,600	143,580	-	-	100,711	N/A
Per Capita GDP (USD)	9,754	9,740	10,206	10,350	9,072	8,052	7,763	8,445	8,702
Exchange Rate, LCU:USD (Average)	12.4	13.2	12.8	13.3	15.9	18.7	20.5	12.2	20.6
Current Account Balance (% of GDP)	-1.2	-1.4	-2.5	-2.0	-2.9	-3.0	-3.0	-1.7	-2.9
Fiscal Balance (% of GDP)	-2.5	-2.6	-2.3	-3.2	-3.4	-	-	-1.4	N/A
Real Private Consumption (YOY%)	4.8	4.6	2.5	1.8	2.2	-	-	2.9	N/A
Nominal Wage (YOY%)	3.1	4.2	4.4	3.1	4.2	4.5	4.6	6.1	4.7
Real Disposable Income (YOY%)	4.8	4.6	2.5	1.8	3.3	1.3	0.5	2.8	1.6
Total Industrial Production (YOY%)	3.5	2.8	-0.4	2.7	1.0	1.2	0.9	1.5	2.1
Unit Labor Cost (YOY%)	-0.2	-8.1	4.2	-5.1	-14.6	-12.2	-6.3	-1.4	2.2
CPI (YOY%)	3.4	4.1	3.8	4.0	2.7	2.8	3.8	4.5	3.6
PPI (YOY%)	6.0	4.7	1.1	1.9	0.4	5.4	-	4.8	N/A
Lending Rate (%)	4.9	4.7	4.2	3.6	3.4	4.7	6.0	7.3	5.3
10 Year Sovereign Yield	6.8	5.7	5.6	6.0	6.0	6.2	-	7.6	N/A
Central Bank Policy Rate (%)	4.5	4.5	3.5	3.0	3.3	5.8	-	4.6	N/A
Labor Force (YOY%)	2.1	3.0	1.1	0.3	1.9	1.6	1.5	1.8	1.4
Population (YOY%)	1.5	1.4	1.4	1.3	1.3	1.2	1.2	1.4	1.2
Unemployment (%)	5.2	4.9	4.9	4.8	4.4	4.2	4.3	4.1	4.4

TRADE AND EXTERNAL LINKAGE

Mexico Top 10 Trading Partners by Value – 2015

Imports		Exports	
United States	47%	United States	81%
China	18%	Canada	3%
Japan	4%	China	1%
Korea	4%	Brazil	1%
Germany	4%	Colombia	1%
Canada	3%	Germany	1%
Malaysia	2%	Spain	1%
Taiwan	2%	Japan	1%
Italy	1%	Korea	1%
Thailand	1%	France	1%

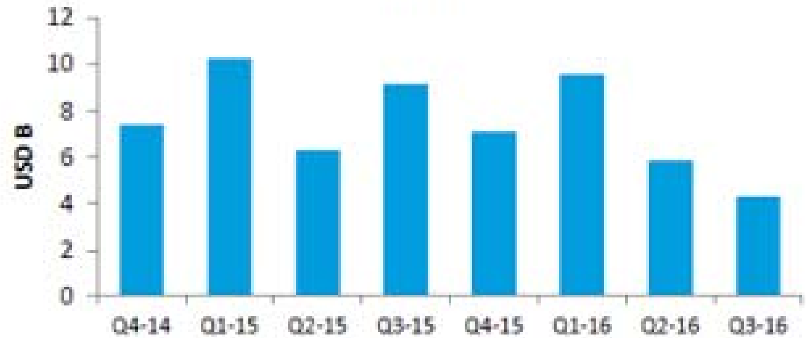
Source: IMF, Abbott Economics

Mexico Goods Trade Basket by Value – 2015

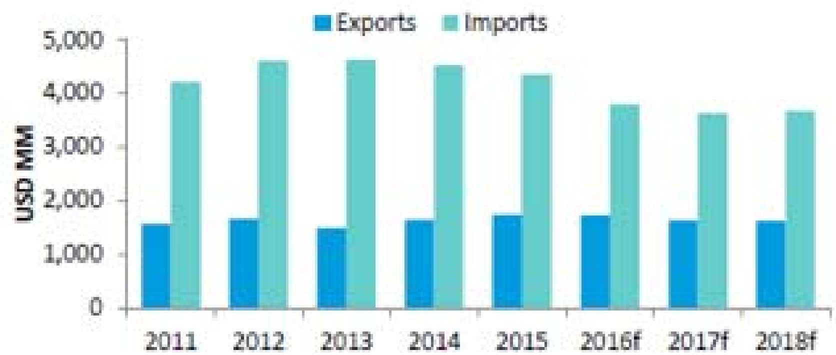
Imports		Exports	
Machinery	39%	Machinery	37%
Transportation Equip	10%	Transportation Equip	25%
Miscellaneous	9%	Miscellaneous	9%
Metals	8%	Food Products	6%
Rubbers & Plastics	7%	Fuel and Oils	6%
Chemicals	7%	Metals	4%
Fuel and Oils	7%	Rubbers & Plastics	3%
Food Products	5%	Stone and Glass	3%
Textiles	3%	Chemicals	3%
Wood & Wood Products	2%	Textiles	2%

Source: UNCOMTRADE, Abbott Economics

FDI Inflows



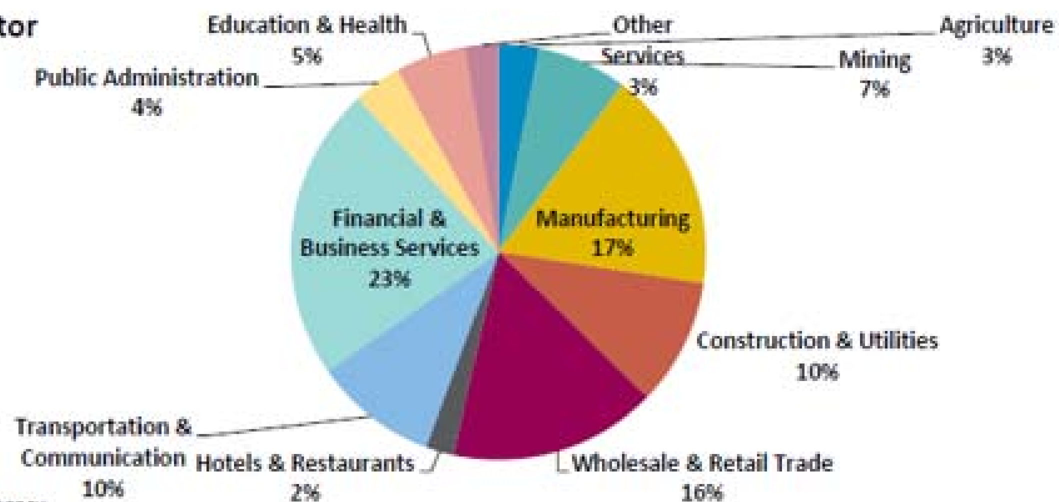
Pharmaceutical Trade



INTERNAL SECTOR

- Manufacturing averaged around 17% of GDP over the last decade, and has been one of the few sectors showing improvements in productivity. A weaker MXN has also helped Mexican exports increase their share in world exports (from 1.56% in 1995 to 2.40% in 3Q16).
- Oil and gas declined from about 10% in 1999 down to 5% in 3Q16 due to lower yields in petroleum fields and lack of investment. Although the energy reform presents opportunities for foreign investment, the recent decline in oil prices presents a more challenging outlook for the sector.
- Services sectors have continuously expanded from a low 57% in 1999 reaching an all time high of about 64% in 3Q16, a substantial increase driven by wholesale and retail trade, finance, and information in mass media.

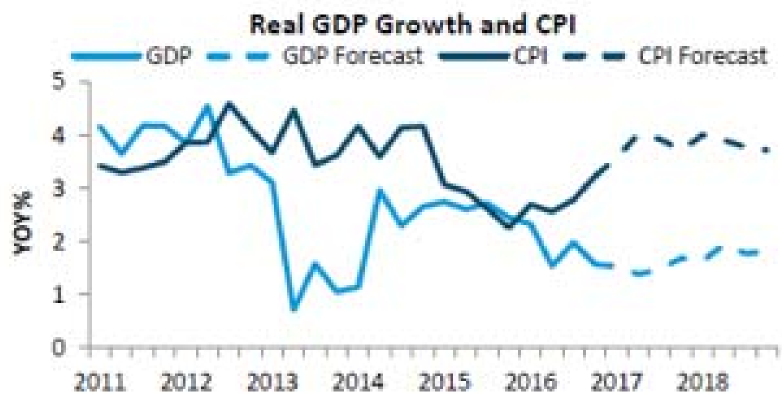
2016 Real GDP by Sector

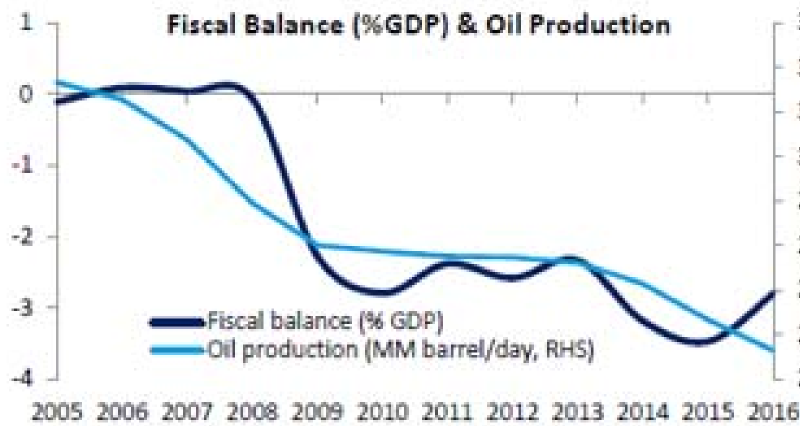


Source: Government Statistical Agency

LEARNING TO LIVE WITH LESS OIL & MORE UNCERTAINTY
MACROECONOMIC OUTLOOK

- Although government reduced its reliance on energy-related revenue with structural reforms to counter falling oil production and oil prices, government debt increased from 30% in 2006 to close to 50% in 2016.
- Despite responsible monetary and fiscal policy management, rating agencies decided to change Mexico's sovereign rating's outlook from neutral to negative in 2016, increasing the odds of a downgrade in 2017.
- 2016 GDP growth at 1.9% and 1.5% in 2017 as investment remains a drag (Trump policies are a high risk) and private consumption slows on higher inflation and tighter monetary conditions.
- Central bank is likely to continue tightening its policy rate to contain both the recent sharp move in the currency (MXN) and the liberalization in fuel prices from disorderly accelerating inflation.
- Uncertainty about trade ties with the US along with tightening credit conditions (given the fed and domestic central bank policy rate hikes) run the risk of decelerating investment further than expected.





HIGHER INFLATION; WEAKER EXTERNAL ACCOUNTS
MACROECONOMIC OUTLOOK

- Inflation has been inside the Central Bank's 2-4% inflation target since January 2015, but has been accelerating in 2016.
- The Central Bank increased its policy rate more aggressively than the Fed (and expectations) to contain depreciation in the MXN, which is accelerating current and expected inflation.
- Food and health inflation have a run rate above the ceiling of the Central Bank's 2-4% inflation target, while housing has been quite low, averaging about 0.6% YOY since January 2015.
- Among HC, prices of medications (7.6%) and medical equipment (5%) are rising due to weaker MXN, while medical consultations are decelerating (2.9%).
- FDI has hovered around 0.8% of GDP since 2015, while portfolio investment has slowed from 6% high in 2012 down to 2.3% in 2016 as investors are more worried about deterioration in fiscal position.
- The current account deficit widened from around zero in 2010 to 3.3% of GDP in 4Q16, a relatively manageable level, but somewhat worrisome given the decline in portfolio investment.
- Reserves are not high compared to other LatAm economies (equivalent to 5.5 months of imports), in part due to smaller importance of commodities.
- The contingent USD 88B FCL credit line with the IMF (without any conditions) and a weaker MXN provide some cushion to external accounts, but increased challenges with Trump pose a high risk.

Source: Haver

RISKS & OPPORTUNITIES

RISKS

- High poverty, informality, and inequality rates.
- Fragmented cartels may intensify violence and crime in certain regions (i.e. kidnapping and fuel theft).
- Impoverished rural population and poor hospital and clinical infrastructure hinders faster growth in HC.
- EPN mishandling of Trump's NAFTA renegotiation (and wall), rising crime and perceptions of institutionalized corruption could lead AMLO to gain 2018 elections, threatening EPN's reforms.
- Further declines in petroleum yields and/or oil prices may undermine tax revenue, forcing more aggressive government cost cutting, clouding the growth outlook.
- Dismantling of NAFTA or punitive US tariffs against Mexican exports could push the economy into a deep recession and weaken the MXN substantially.
- Low participation in secondary education (58% of the age cohort vs OECD average of 84%), although still one of the highest rates in Latin America.
- Reliance on short term capital (portfolio) flows to fund a widening current account deficit makes the currency highly sensitive to external shocks and prevents monetary policy from acting more freely based on weaker activity.

OPPORTUNITIES

- Large, young population (117MM, median age 27.6), with large middle class (48MM) and high literacy rate in LatAm.
- Low energy costs (4th largest shale gas reserves plus pipelines from US) along with energy sector reforms to support manufacturing and attract FDI.
- Uncertainty about NAFTA renegotiation and building of the wall, if resolved, may lead to a strong rebound in the currency and economic activity (via increased investment).
- If diplomatic and trade relations with US improve, weak currency (MXN) and execution of reforms may trigger M&A activity and strong investment inflows.
- Active in reducing trade barriers (44 agreements since 1994 is more than any other country), resulting in one of the most open (trade is high as % of GDP) large economies.
- Advanced intellectual property protection with LatAm peers has been lightly enforced so far (partly due to coordination), but has substantial room to improve.
- Low private debt levels and improving labor market may support confidence and HC spending.
- Growing pool of skilled labor, government incentives and demographics to make Mexico a hub for drug development.