Market Update

Mexico in Transition

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Contributors

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- Mexico, like many other economies, is navigating a shifting landscape of short-term global economic and financial fundamentals, while also developing longer-term opportunities.
- In the short term, the Mexican economy must deal with rampant inflation and a central bank that is committed to fighting that inflation by raising policy rates aggressively.
- Latin American equities benefited from the run up in commodity prices, but like other emerging markets have been hit hard by the volatility and uncertainty in emerging market equities this year.
- We have upgraded our view of Mexican equities to a mild overweight as the combination of attractive valuations and solid but unspectacular growth prospects should be of interest to global investors.
- Given the volatility in European and Asian emerging markets, we believe the attractive valuations provided in Latin America, and in particular in Mexico, are compelling.
- The relative resilience of the neighbouring US economy, and strong trade links are another plus for Mexico, compared to other EM markets that are more linked to China. The nearshoring movement, which has gained momentum, should provide further upside to the Mexican economy and equity markets across multiple sectors such as autos, industrials and logistics in the not too distant future. Additionally, the country's food and energy sectors are well positioned in the current environment.
- Within global and Mexican equities, we maintain a balance between growth and value and look to deploy total return strategies. This should boost returns through dividend yield and buyback strategies.

Mexico, like many other economies, is navigating a shifting landscape of short-term global economic and financial fundamentals, while also developing longer-term opportunities. In the short term, the Mexican economy must deal with rampant inflation and a central bank that is committed to fighting that inflation by raising policy rates aggressively. Longer term, opportunities exist in numerous areas ranging from energy, food production, and manufacturing. Moreover, Mexico does not suffer from the high levels of political uncertainty that other countries in the region are likely to struggle with over the coming months.

At HSBC Global Private Banking, we have decided to overweight Mexican equities for several reasons. First, equities in Latin America are trading at historic discounts relative to their emerging market peers. Second, the central bank, Banxico, has tightened policy more aggressively than the US Federal Reserve in order to help combat rising inflationary pressures. The trajectory of policy rates has helped to keep the Mexican Peso steadier than most other EM currencies, which should aid in its fight against inflation. The central bank's actions to fight inflation may prove beneficial as we head towards 2023. Third, the Mexican economy has historically been more directly linked to US economic performance. This should prove beneficial for Mexico as it seems the US economic slowdown should not be as pervasive as in other global regions, providing Mexico with an advantage, especially relative to its peers in the region that are more tied to China. Finally, the nearshoring movement, which has gained momentum with the Biden administration, should provide further upside to the Mexican economy and equity markets across multiple sectors in the not too distant future.

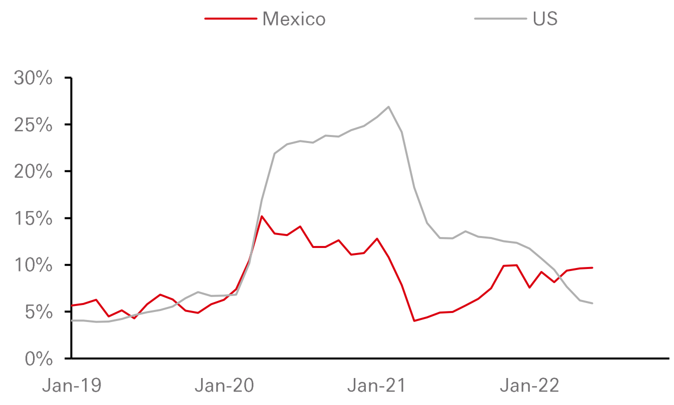
Mexican equities: a relative game

Mexican equities have suffered from volatility like other global markets. In Latin America, equity markets continue to trade at more than 25% discounts relative to their historic averages. While that is true in Mexico, other markets like Brazil and Chile are trading at much greater discounts relative to their historical averages. Moreover, economists forecast that other countries in the region could see a peak in inflation and policy rates faster than Mexico.

On the other hand, Mexican equities have drivers that could provide more consistent returns relative to regional peers. First, some of the other equity markets in the region have tied their fortunes more directly to China. Forecasts for growth in China for the next 18 months are modest at best and well below the targets set forth by the government. Second, the Mexican economy and central bank are more linked to the US economy and markets. While economic growth in the US was officially negative in the first half of the year, forecasts for the balance of this year and 2023 look relatively benign. Significantly, underlying demand and strength of the labor market remain visible. Most economists suggest growth in the US will remain around trend but the economy should avoid outright recession. Solid wage gains and a historically low unemployment rate should enable consumers to maintain steady consumption, albeit at a slower pace and discounted prices. Third, the Mexican central bank has raised rates aggressively and along a similar trajectory as the US Federal Reserve. This has maintained stability for the currency. While the US Fed is not done raising rates, it seems that much of the heavy lifting is behind it and future Fed tightening policy could be less hawkish. This could provide solace to markets and maintain somewhat of a cap on longer-term interest rates, which could be positive for equities. Finally, other countries in the region are in the midst of political turmoil, elections, and constitutional reform. While Mexico is not a political oasis of stability, on a relative basis, localized risks seem more manageable and familiar.

Monetary growth has been more stable in Mexico

M2: Y-o-Y % change



Source: Bloomberg, HSBC Global Private Banking as at 25 August 2022.

Opportunities & proximity

Mexico is a participant in several sectors where supply remains constrained, demand is fairly inelastic, and pricing power and margins can be maintained. Two of those sectors are food and energy. In addition, Mexico is a major manufacturing partner to the US, and bilateral trade agreements such as USMCA, will continue to provide Mexico with advantages. In the financial sector, the normalization of interest rates should enable companies in the sector maintain margins and potentially expand profitability.

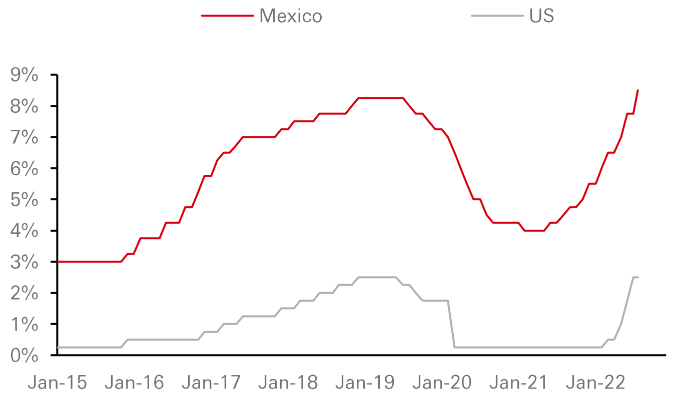
In the agricultural sector, Mexico's Ministry of Agriculture & Rural Development noted that in the first half of 2022, Mexican agricultural trade with the US increased by 16% compared to the same period last year. Exports to the US rose 18% while imports from the US increased 13% during the period. Mexican food trade with the US resulted in a $10.1 billion surplus balance which jumped 24% from the first half of the year in 2021. The agricultural sector remains well positioned and with global supply constraints remaining, should remain quite profitable as well.

The Covid pandemic and recession resulted in tremendous pent-up demand and supply chain disruptions. As a result, many American corporations have decided to begin the process of nearshoring. Moving production closer to end-users could make sense for some sectors and companies, as it eliminates long shipping routes that may be sensitive to global disruptions. Other considerations are actually proving more structural, such as geopolitical risk, higher shipping costs, and the issues surrounding immigration and local job creation. This would move supply chain logistics to the domestic market or to partners who are closer in proximity. Mexico would clearly stand to benefit greatly from this trend, especially given its advantages in terms of lower labor and transportation costs, and its proximity to the US market. In the short term, industrial conglomerates and auto parts producers would likely benefit most directly. In addition, industrial warehouses and logistical distribution companies with a presence in border states could feel a more immediate impact. In the medium to longer term, we expect this effort to expand meaningfully, with Mexico as a key potential beneficiary.

Over time we would expect companies in sectors as varied as technology, vehicle production & parts, basic manufacturing, medical equipment, and household appliances to expand efforts to relocate manufacturing facilities to a more productive, profitable, and proximate base like Mexico. Globally, manufacturing exports remain quite strong, especially to large end user markets like the US, Europe, and China. The US remains the largest importer of manufactured goods, as it alone was responsible for 15% of total global manufacturing imports from 2018-2020, with around 25% of this sourced from China and around 15% from Mexico.

Both central banks have been tightening aggressively

Central Bank Policy Rates



Source: Bloomberg, HSBC Global Private Banking as at 25 August 2022.

Banxico, inflation & the currency

The central bank of Mexico, Banxico, has kept to its policy of tightening monetary policy in a synchronized manner with the US Fed. Banxico remains committed to fighting inflation. It has raised policy rates consistently from a trough of 4.0% in February 2021. In August, it hiked its policy rate by 75 basis points to 8.50% in a unanimous decision. This was in line with market consensus forecasts and the US Fed. Significantly, with its latest hike, the Mexican central bank has raised its policy rates 450 basis points from the most recent trough, which is more aggressive than the US Fed's tightening policy of 225 basis points. This tightening policy signals a serious desire to fight inflation and defend the currency. The Mexican Peso has been the best performing currency in the region, especially against the US dollar. This has not been easy as the US dollar typically rises and has risen during turbulent economic times.

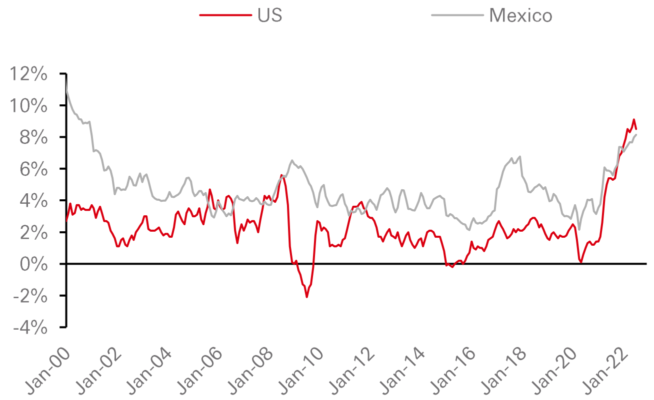
Looking ahead to 2023, HSBC believes there is room for the currency to strengthen. Some of the issues surrounding higher inflation, slower growth, a slower moving US Fed, and a solid balance of payments picture suggest the MXN could be a standout currency in emerging markets and the region.

As in many other countries, inflation has been on the rise in Mexico in the post-Covid economic recovery. Mexican inflation has risen rapidly, troughing at 2.2% in the spring of 2020, but posting an 8.0% year-on-year growth rate in June 2022. This is the fastest rise in inflation since 2001. Given domestic and global forces, headline and core inflation expectations continue to show that the convergence to the 3% target will most probably be delayed until 2024.

In the US, the NY Fed posted a study "How much did supply constraints boost US inflation?". The Fed's analysis was that 60% of the jump in US inflation during the 2019-2021 period was due to pent-up demand and the overall stronger demand for goods. The remaining 40% was due to supply-side issues and logistical constraints, that ended up magnifying the impact of the higher demand. The Fed report concluded that US inflation would have peaked at 6% instead of 9% without the supply bottlenecks. Clearly, that type of analysis can be applied in other countries. Therefore, slowing global demand should reduce supply constraints and tighter monetary policy in the form of higher policy rates and slower growth in monetary aggregates, should help tame demand. That confluence should help contain inflation in the next few years.

Inflation has accelerated in both the US & Mexico. Slower growth may help slow demand and supply disruptions

CPI: Y-o-Y % change



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Investment Summary

Globally, the asynchronous business cycle continues. In countries like the US and Mexico where the central bank is fighting inflation by aggressively raising policy rates, equity markets have remained particularly volatile. Given the hawkish policies already enacted, future tightening will likely be less aggressive. Moreover, in both countries inflation may be peaking, and interest rates in those markets may provide some solace to equity investors.

Regionally, Latin American equities benefited from the run up in commodity prices, but like other emerging markets have been hit hard by the volatility and uncertainty in emerging market equities this year. We have upgraded our view of Mexican equities as the combination of attractive valuations and solid but unspectacular growth prospects should be of interest to global investors. This is especially true given prospects for growth and profitability in other global markets.

We continue to recommend that equity investors maintain a balance between growth and value and that they look to deploy total return strategies. This should boost returns through dividend yield and buyback strategies. Given the weakness in Asian emerging markets, we believe the attractive valuations provided in Latin America, and in particular in Mexico, are compelling. While Mexico's discounted valuations are not as deep as some of its regional peers we feel the stability of growth and earnings, given its relationship with US economy and markets, is a positive. In addition, relative political stability and the potential for expanding its manufacturing base through an expansion of nearshoring and manufacturing exports to the US provides Mexican exports and equity markets with further upside potential.

Risk Disclosures

Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk
Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments
High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:
• Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
• Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
• Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures
• Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
• Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or cancelled. Investors may face uncertainties over when and how much they can receive such payments.
• Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal.

Changes in legislation and/or regulation
Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalization risk
The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

Reinvestment risk
A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate.
Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to-market valuation.

Alternative Investments
Investors in Hedge Funds and Private Equity should bear in mind that these products can be highly speculative and may not be suitable for all clients. Investors should ensure they understand the features of the products and fund strategies and the risks involved before deciding whether or not to invest in such products. Such investments are generally intended for experienced and financially sophisticated investors who are willing to bear the risks associated with such investments, which can include: loss of all or a substantial portion of the investment, increased risk of loss due to leveraging, short-selling, or other speculative investment practices; lack of liquidity in that there may be no secondary market for the fund and none expected to develop; volatility of returns; prohibitions and/or material restrictions on transferring interests in the fund; absence of information regarding valuations and pricing; delays in tax reporting; - key man and adviser risk; limited or no transparency to underlying investments; limited or no regulatory oversight and less regulation and higher fees than mutual funds.

Risk disclosure on Dim Sum Bonds
Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.
Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond. There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.
Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

Risk disclosure on Emerging Markets
Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin
The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments

and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

Currency risk – where product relates to other currencies
When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan ("CNY") risks
There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.
There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products
In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

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