EMERGING MARKETS DEBT

TEQUILA SUNRISE: GOOD NEWS FOR THE MEXICAN PESO

By Guillermo Ossés

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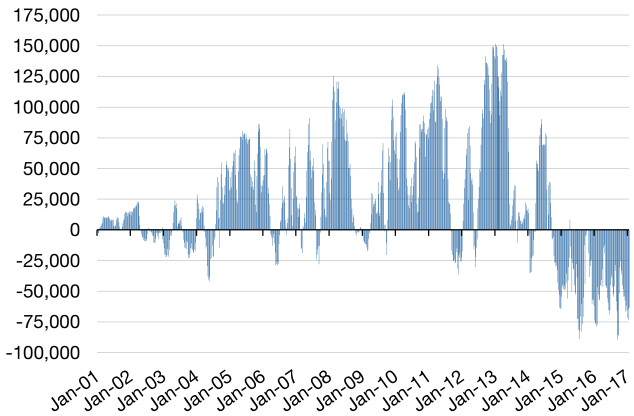
It is fair to say the Mexican peso (MXN) is somewhat unloved at present. Chart 1 shows the speculative positioning at the Chicago Mercantile Exchange (CME) for the week ending January 27th. As can be seen in the chart, the currency is currently 'enjoying' some of the biggest net speculative short positioning it has ever known.

The currency fell almost 12% in the immediate aftermath of Trump's victory and, from that point, proceeded to decline another 5% to an all-time nadir of just under USD22 on January 19th, before seeing a mild recovery. From our perspective, it is possible that this fall indicates the sale of positions held by other types of market participants, in addition to speculators. We suspect that these liquidations, coupled with continued pressure from speculators in a market with very thin liquidity, are what produced the downward move in MXN valuation.

Chart 1. MXN speculative positioning (ag USD) at the CME



We do not consider ourselves contrarian investors by identity, but in this instance we cannot justify going with the grain. Given the extent that flows have reached, we believe it is likely that positioning is now very clean. Moreover, with the trade balance – and consequently the current account – starting to improve and the Central Bank finally intervening, it has become much more difficult for the MXN to weaken any further in our view.

Some are understandably concerned about the rising animosity between Presidents Trump and Nieto. Although it was not a good sign that the latter cancelled his planned visit to the US, the fact that the two presidents held a relatively constructive call after the cancelation did something to help alleviate the situation. We therefore believe that the pattern of events so far cannot justify the belief that high tariffs (i.e. much more than 10%) will be imposed on Mexico in the near term.

There is also a more structural reason why the MXN could continue its recovery. Chart 2 shows the evolution of the different components of Mexico's balance of payments (BOP), as well as the country's accumulation of reserves. Between Q1 2011 and Q2 2014, portfolio flows moved noticeably higher, while the rest of the BOP's components did not experience drastic changes in aggregate (the increase in FDI being neutralized by a decrease in the current account balance).

Over this same period, it can be observed that foreign reserves increased steadily (from roughly USD95bn to USD195bn). This implied to us that, when portfolio capital was flowing into Mexico, the Central Bank responded by buying the USD to prevent the currency from appreciating.

Chart 3 provides further evidence for this theory. It can be observed that, over the same period as Chart 2, USMXN traded at an average of 12.92. In late 2014, the currency pair experienced a breakout, with the cross moving up meaningfully as portfolio inflows were collapsing.

We believe that the main reason for this move – which continued up to 18.36 by the end of Q2 2016 –was driven by the fact that, despite the portfolio inflows collapsing, the Central Bank did not meaningfully sell down the USD reserves that it had previously built up. We can see this in Chart 2 where, although portfolio inflows experienced a quarterly decrease from USD 17.2bn in Q2 2014 to USD4.1bn in Q2 2016, reserves barely fell. This means that, today, the Central Bank retains significant fire power to potentially halt the MXN's decline.

Chart 2. Mexico Reserves and Balance of Payments components

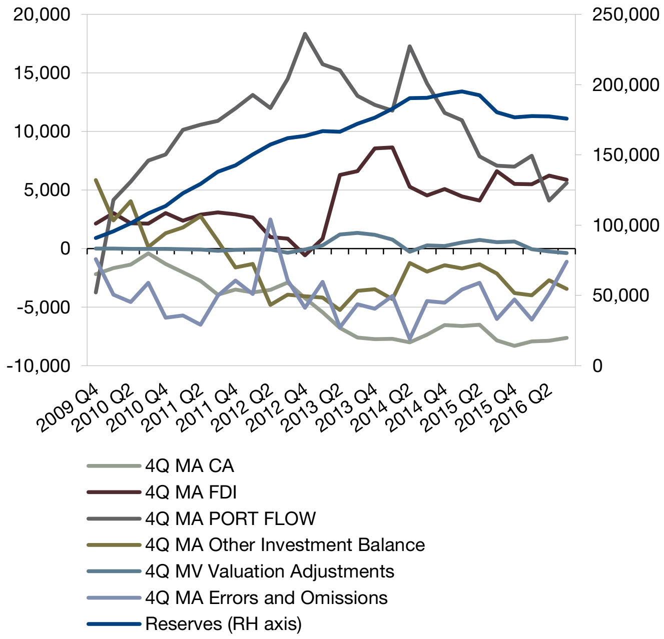
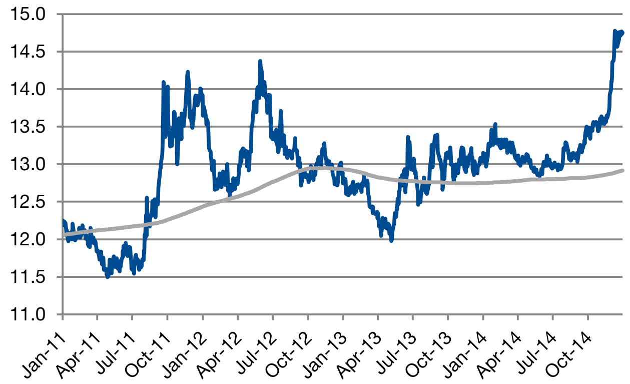


Chart 3. USDMXN and 4-yr moving average



In summary, when we look at Mexico today, we see a current account which has recently bottomed (Q2 2016), portfolio flows at levels we last saw in 2010 and a Central Bank which is beginning to intervene in the FX market by selling some of its USD reserves. In our view, it is difficult to see how this combination leads to further MXN depreciation, and instead indicates that it may cause appreciation.

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Guillermo Osses is the Head of Emerging Markets Debt Strategies for Man GLG ('GLG'). Prior to joining GLG Guillermo was a Managing Director and Head of Emerging Markets Debt Portfolios at HSBC Asset Management with responsibility for all global emerging markets debt portfolios. Prior to joining HSBC in January 2011, Guillermo was a senior emerging markets fixed income portfolio manager at PIMCO from 2006-2011. Prior to PIMCO Guillermo was responsible for proprietary trading and market making of emerging markets currencies at Barclays Capital (2000-2006). Guillermo also held a trading position in Latin American Local Markets at Deutsche Bank (1997-2000). He began working in the investment industry in 1995 and holds an MBA from the MIT Sloan School of Management. He received a B.A. from Universidad Catolica de Cordoba in Argentina.