







Trump: when it rains, it pours

Portfolio Management team

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Franklin Templeton Servicios de Asesoría Mexico (FTSAM)

- Established 2013.
- Subsidiary of Franklin Templeton Investments.
- Investment solutions for our clients taking into account their needs and the global and local environment.
- Portfolio management team with more than 20 years' experience.
- Pioneers in Mexican investments*.

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- Put clients first.
- Build relationships.
- Achieve quality results.
- Work with integrity.

SUMMARY

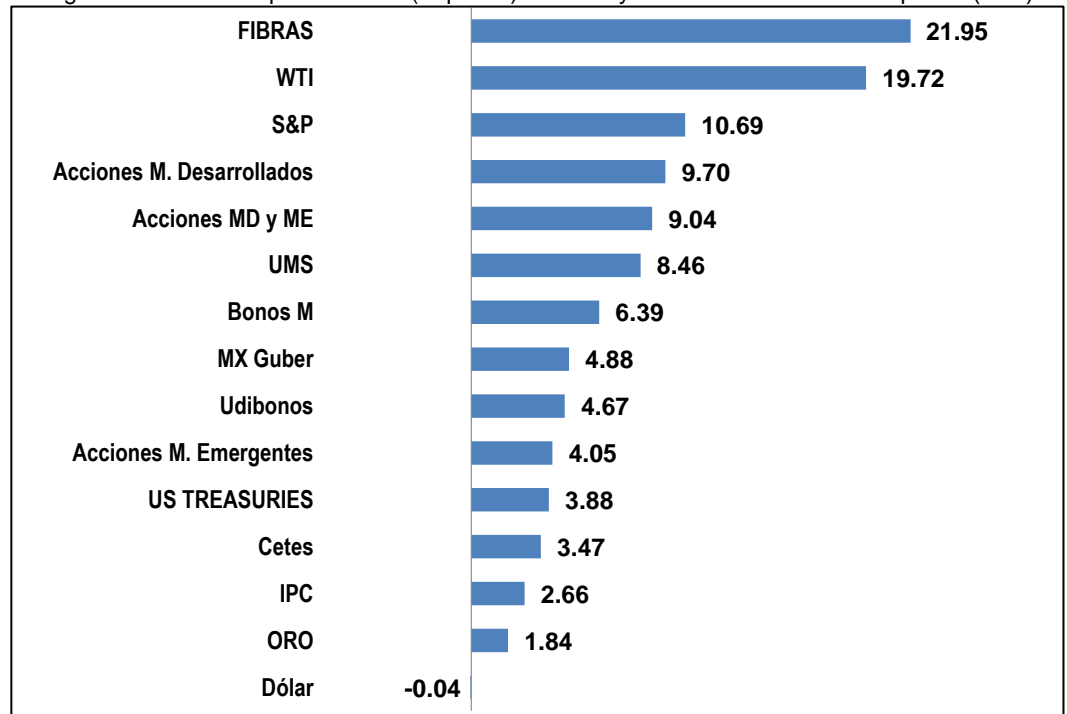
- Global. Risk assets fall sharply owing to the intensification of the US-China trade war.
- Mexico. Lower estimated growth, lower than programmed public spending, negative economic data, and Trump tariff threats, affect risk assets. Fitch lowered rating to BBB, Pemex to BB+, and CFE to BBB and Moody's changed outlook from stable to negative.
- Global risks 2019: sudden slowdown, trade wars, geopolitics, Brexit/Europe, monetary policy, emerging markets (EM).
- Local risks: trade war with US, dysfunctional government, non-ratification USMCA in US, credit downgrade.
- Investment scenarios 2019 with probabilities: positive (10%, from 20% previous), negative (50% from 40% previous), middle (40%).
- For peso portfolios, overweight liquidity and ILS 1 to 3 year duration, underweight stocks and fibras.

“Never ask for a lighter rain. Just pray for a better umbrella.” Anonymous.

Economies and markets threatened by trade wars

While returns on risk assets YTD have been positive (Figure 1), they fell sharply in May (see Monthly Indicators on page 11). Main reason was an intensification of the US-China trade war and, at the end of May, an unexpected threat by Trump that, if Mexico did not reduce the flow of illegal migrants to the US, he would introduce tariffs from 5% up to 25%, effective June 10. In June, Fitch lowered Mexico's rating to BBB, Pemex to BB+, and CFE to BBB, and Moody's changed the Mexico outlook from stable to negative.

Figure 1. Investment performance (% pesos): to 31May19. Source: Franklin Templeton (“FT”)



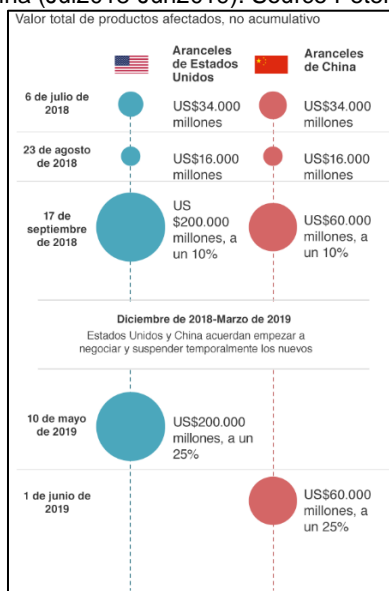
POLITICS

US

China: trade war intensifies

After an 8 month pause, in May the US government approved an additional increase in tariffs from 10 to 25% on Chinese products worth US\$200bn., effective June 1 (Figure 2). China replied with 25% tariffs on US goods worth US\$60bn., almost half China’s imports from the US. Trump threatened to approve a new tariff of 25% on remaining Chinese exports to US worth US\$325bn. According to the IMF, trade war escalation could reduce global growth by 0.5% in 2020. With a clear view to the presidential elections on November 3, 2020, Trump has announced that he will reach a favorable trade agreement with China.

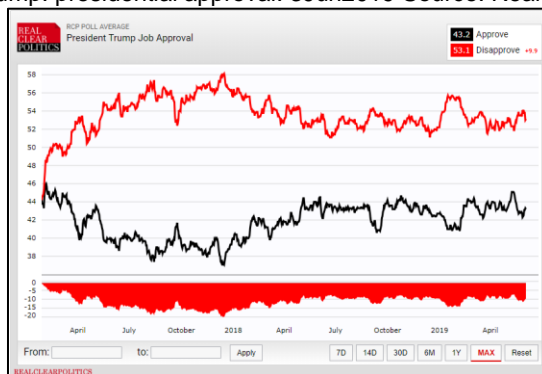
Figure 2. Tariffs applied US-China (Jul2018-Jun2019). Source Peterson Institute, BBC (13May2019).



Trump: approval rating improves

According to the Harvard-Harris poll Trump’s approval rating is at 48%, its highest level in two years. 42% of respondents plan to vote Democrat in 2020 (compared to 37% Trump). 71% think the US economy is strong. Real Clear Politics in its poll of polls measures presidential approval at 43.2%. Though it is not at its highest, it has improved in recent weeks (Figure 3).

Figure 3. Trump: presidential approval. 3Jun2019 Source: Real Clear Politics



EUROPE

Brexit: May resigns

After her Brexit agreement with the EU was rejected by parliament for the third time, Theresa May announced her resignation effective June 7 as leader of the Conservative Party and Prime Minister. Former Foreign Secretary and Brexiteer, Boris Johnson, announced his candidacy to succeed her, reiterating his proposal to leave the EU by October 31, with or without an agreement.

MEXICO

US-Mexico: new tariffs

After an increase in illegal migration of 32% over April (a total of 144,000) to South West US, on May 30, using the argument of “national emergency”, Trump announced that if Mexico did not take measures to combat the migration crisis, effective June 10, the US would introduce a tariff of 5% on all imports from Mexico. If the crisis continues, tariffs will rise on a staggered basis to 25% (Figure 4). The (clearly electoral) goal is that US companies return to the US to manufacture their products.

Figure 4. Proposed tariff levels by US vs. Mexico. Source: Trump announcement

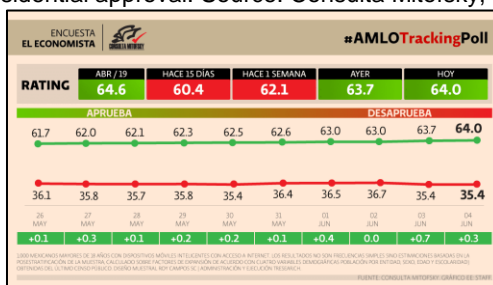
Due date	Tariff level
10 June	5%
1 July	10%
1 August	15%
1 September	20%
1 October	25%

AMLO responded to the threat with a letter to Trump where he asserts that since the beginning of his administration, Mexico proposed to the US investments in Central American countries for their own economic development and job creation, which would reduce emigration. From May 31, Mexico sent a team headed by Foreign Minister Marcelo Ebrard to start negotiations, which are still unresolved. Some Republican legislators are against the linkage of the migration problem with trade, and the use of tariffs as a weapon. They will vote with Democrats against Trump’s national emergency, but, if that occurs, Trump will likely be able impose his will through a series of legislative maneuvers to overcome NAFTA and WTO rules.

AMLO’s ratings improved by reaction to Trump

After falling due to the increase in insecurity, AMLO’s letter to Trump improved his ratings (Figure 5). On Thursday June 6, AMLO invited all sectors of Mexico to a summit “for the defense of Mexico’s dignity and friendship with the US” to be staged in Tijuana on Saturday June 8.

Figure 5. Presidential approval. Source: Consulta Mitofsky, El Economista



Public spending shortfall

Public spending YTD 2019 has been 6% less in real terms than 2018 (\$110bn. nominal pesos). This shortfall was due to the austerity policy, and lack of spending experience and efficiency of the new government above all in relation to the new social programs. The only sector which spent more than programmed was CFE (Figure 6).

Figure 6. Public sector Budget: total spending 2018-2019 (mn. pesos), Source: SHCP

Concepto	Enero-abril			Diferencia nominal (3-2)	Variación % real (3/1)
	2018 P./ (1)	Programa (2)	Observado P./ (3)		
Total	1,808,698.3	1,881,141.9	1,771,046.7	-110,095.2	-6.0
Gasto primario	1,641,409.6	1,682,442.9	1,588,363.3	-94,079.7	-7.1
Programable	1,295,966.3	1,349,066.3	1,267,668.7	-81,397.6	-6.1
Gobierno Federal	959,344.3	989,401.9	924,509.1	-64,892.8	-7.5
Ramos autónomos	31,810.2	38,709.1	28,374.6	-10,334.5	-14.4
Ramos administrativos	371,654.1	351,272.0	318,452.0	-32,820.0	-17.8
Ramos generales	555,880.0	599,420.7	577,682.5	-21,738.2	-0.2
Organismos de control presupuestario					
directo	298,304.3	358,161.8	326,843.2	-31,318.6	5.2
IMSS	184,004.1	223,459.3	199,666.3	-23,793.0	4.2
ISSSTE	114,300.2	134,702.5	127,176.8	-7,525.7	6.8
Empresas Productivas del Estado	289,894.0	292,942.9	300,449.3	7,506.5	-0.5
Pemex	124,704.4	155,246.2	132,443.2	-22,803.0	1.9
CFE	165,189.6	137,696.7	168,006.1	30,309.4	-2.4
(-) Operaciones compensadas	251,576.3	291,440.2	284,132.9	-7,307.4	8.4
No programable	345,443.4	333,376.6	320,694.5	-12,682.1	-10.9
Participaciones	281,679.2	311,631.6	311,546.3	-85.2	6.2
Adefas y otros	63,764.2	21,745.1	9,148.2	-12,596.9	-86.2

Dos Bocas refinery construction begins

On June 3, AMLO announced the beginning of construction of the Dos Bocas refinery, which will take just 3 years and cost \$150bn. pesos. Construction has begun despite the fact that there is only one technical study preapproving the change of land use and the fact that there is no environmental and regional risk assessment. Rocío Nahle, Energy Minister, announced that these studies would be available shortly.

State elections

On June 2, elections were held in 6 states, 3 favorable to Morena and 3 to the PAN, which consolidated its position as second party, with the PRI in third. In general, turnout was lower than in the 2018 elections (52%) (Figure 7).

Figure 7. State elections 2019: results. Source: INE

State	Elections	Results	Turnout
Puebla	Governor	Wins Morena with 44.67%	33.42%
	5 mayors	Wins PRI 4 of 5 mayors	
Baja California	Governor	Wins Morena with 50.38%	29.95%
	17 deputies	Wins 17 Morena	
Aguascalientes	11 city councils	Wins 5 PAN, 2 PVEM, 1 PRI, 1 PRD, 1 PT, 1 Morena.	38.98%
Durango	39 city councils	Wins 16 coalition PAN-PRD, 16 PRI, 2 PAN, 2 Morena, 1 PT, 1 Movimiento ciudadano, 1 Partido Duranguense	45.35%
Quintana Roo	15 deputies	Wins 11 Morena, 3 coalition PAN-PRD y 1 PRI	22.15%
Tamaulipas	22 deputies	Wins 21 PAN, 1 Morena	33.15%

ECONOMICS

GLOBAL

Growth

Global growth is expected to slow in 2019, according to the consensus, with a possible recovery in 2020. However, it is estimated to be lower than 2018. Lower growth is expected in both US and China (Figure 8).

Figure 8. Expected global growth. Source: Bloomberg

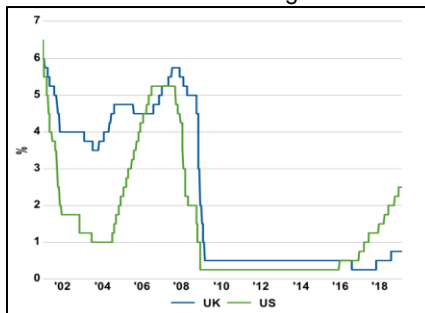
Developed markets				Emerging markets			
Growth(%)	Growth(%)			Growth(%)	Growth(%)		
	2020 E	2019 E	2018 E		2020 E	2019 E	2018 E
World	3.30	3.30	3.70	World	3.30	3.30	3.70
Developed	1.69	1.86	2.29	Emerging	4.89	4.84	4.97
US	1.90	2.60	2.90	China	6.00	6.30	6.60
Euro Area	1.40	1.20	1.80	India	7.18	7.00	7.40
Japan	0.50	0.60	0.70	Rusia	1.70	1.40	1.80
Britain	1.40	1.30	1.40	Brasil	2.45	1.80	1.22
Australia	2.60	2.20	3.00	México	1.80	1.50	2.10
Canada	1.80	1.50	2.10	Corea del sur	2.40	2.30	2.70
Germany	1.40	0.90	1.50	Indonesia	5.10	5.10	5.20
France	1.35	1.30	1.50	Turquia	2.50	(1.40)	3.00

US

Fed: possible rate reduction

The Fed announced that it might lower its reference rate if the economic outlook deteriorates owing to trade wars, changing its earlier position that the economy was healthy. The futures market implies a 60% probability of a rate cut this year (Figure 9).

Figure 9. Reference rates: Fed and Bank of England. Source: Franklin Templeton



MEXICO

Lower growth estimates

Expected growth has declined since the new government took over. On average, analysts expect 1.35% in 2019 (Figure 10). Consumer confidence fell for the third consecutive month, even though it is 22.5% above its level over the same period in 2018 (Figure 11).

Figure 10. Mexico: estimated growth 2019. Source: Banxico

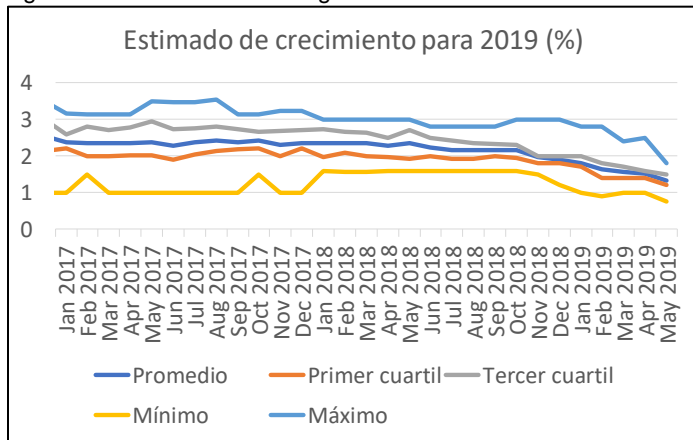
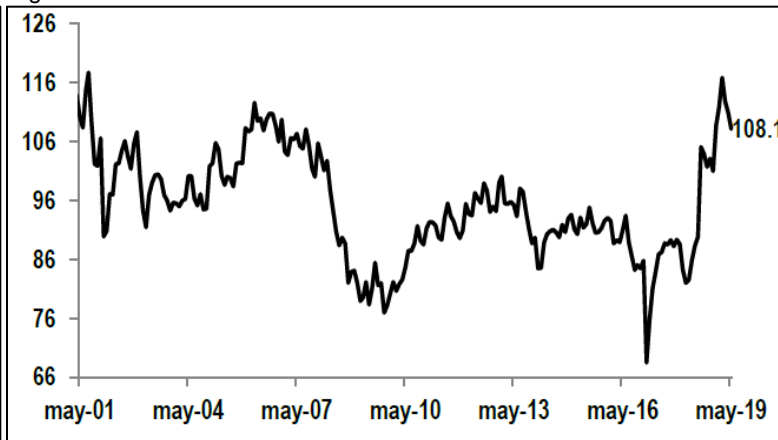
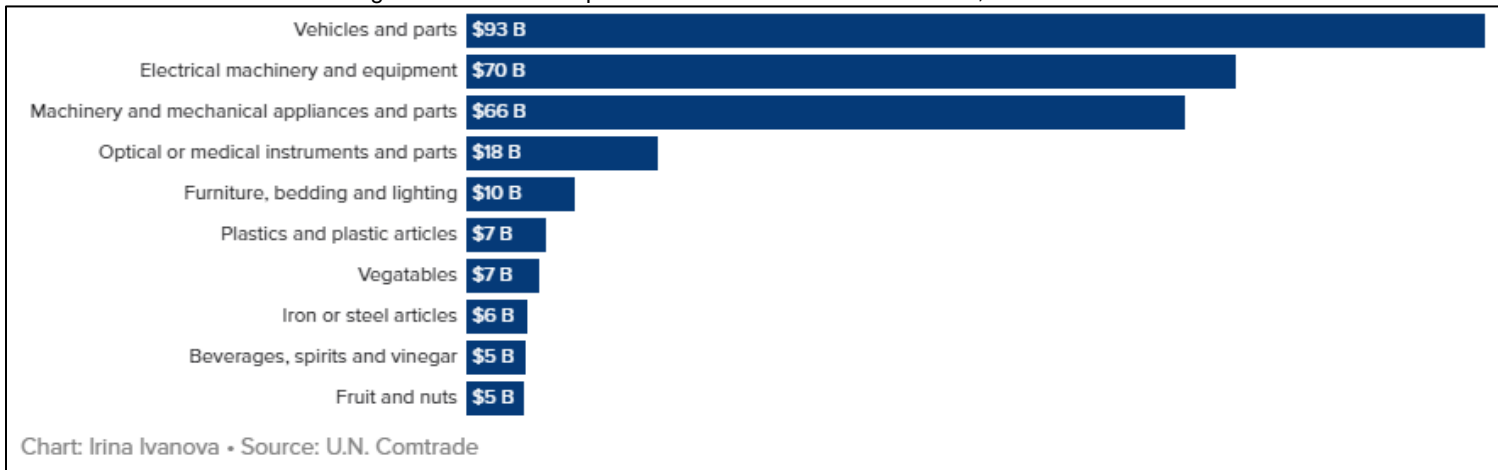


Figure 11. Consumer confidence. Source: INEGI



Mexico is one of the main trading partners of the US, with exports of US\$372bn. in 2018. Biggest exports were vehicles and autoparts (Figure 12). 40% (approx.) of exports to the US and 75% of imports are intermediate goods. If and when the threatened tariffs enter into force at maximum level, it is estimated that US growth will fall to 1.4% in 2020, and in Mexico to 0%.

Figure 12. Mexican exports to the US in 2018. Source CBS, UN. Comtrade



First full quarter of presidency: worst since 1995

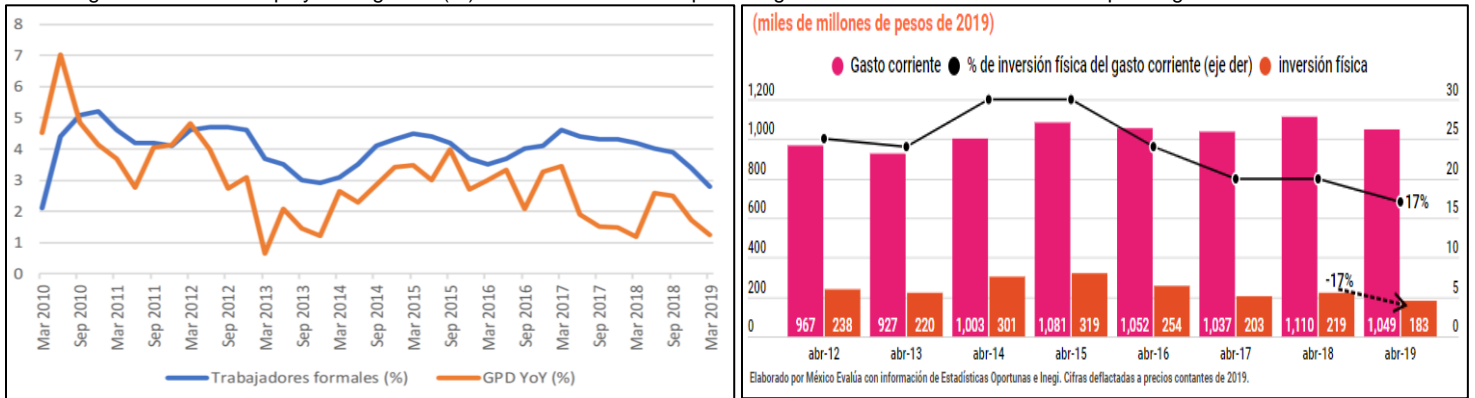
Compared with other presidencies growth (real GDP) has been at its lowest level since 1995 (Figure 13). With 1Q2019 growth at -0.2%, negative growth is also expected in 2Q2019, which would technically be a recession.

Figure 13. Real GDP: first quarter presidency. Source: Franklin Templeton

Presidente	Crec 1T de su admon
AMLO	-0.17
EPN	0.34
FCH	0.71
FOX	0.15
Zedillo	-5.75

Owing to government cutbacks, formal employment has decreased (Figure 14). Fixed investment has also fallen (Figure 15).

Figure 14. Formal employment: growth (%). Source: Franklin Templeton Figure 15. Fixed investment/current spending. Source: México Evalúa



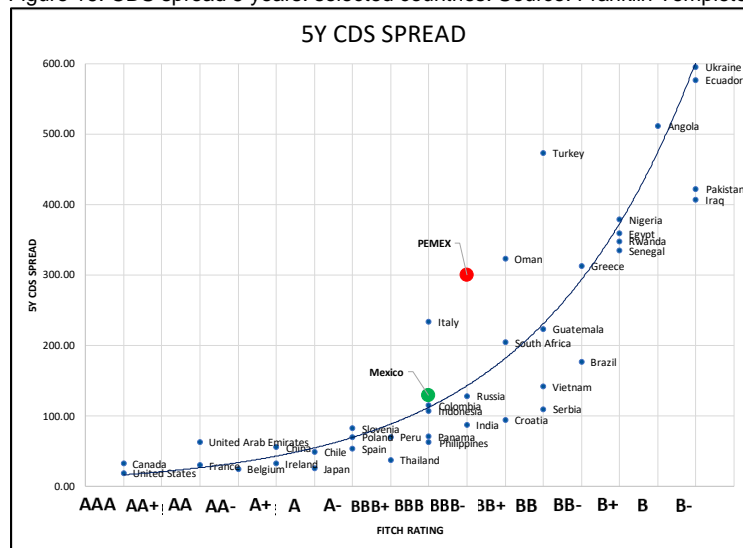
Mexico: ratings modification

On June 5, Fitch lowered Mexico’s sovereign rating from BBB+ to BBB and changed the outlook from negative to stable. This is based on Pemex’s credit profile, the weak macroeconomic outlook, and trade tensions owing to tariff threats. Moody’s maintained Mexico’s rating at A3, but changed the outlook from stable to negative.

Pemex refinancing

In May, AMLO announced that Pemex debt will be refinanced to a total of US\$8bn. With a revolving loan from HSBC, JPMorgan and Mizuho Banks: US\$2.5bn. with a syndicated credit, and two lines of credit renewed with a revolving credit of US\$5.5bn, at a rate of Libor+235bps. After the downgrade for Mexico, Fitch lowered Pemex rating from BBB- to BB+, below investment grade. For several months Pemex has been trading at a level corresponding to a lower rating (Figure 16). Fitch also decreased CFE rating from BBB+ to BBB.

Figure 16. CDS spread 5 years: selected countries. Source: Franklin Templeton



RISKS AND SCENARIOS FOR 2019

The objective is Mexican economic growth. In the positive scenario, all risks turn out favorable for growth, in the negative, unfavorable, and in the middle, mixed. Estimates for each scenario are given in Figure 17.

RISKS

Global

- US: monetary policy, recession, dispute between executive and legislative branch
- Global: trade wars
- Geopolitics: Europe, Middle East, Russia, China, North Korea, Venezuela
- EM: crisis and contagion

Mexican

- New government
- Security
- Corruption
- Oil
- Debt rating

SCENARIOS

Positive (10%)

- US: expansion continues, trade disputes but no major consequences
- Monetary policy does not derail cycle.
- Rapid ratification USMCA.
- Geopolitical risks do not materialize.
- Global growth.
- EM: no crisis or contagion.
- Mexico: new government functions, spending drives infrastructure/consumption, measures anticorruption and antiviolence work, ratings upgrade.

Negative (50%)

- US: expansion stops, trade wars affect global commerce.
- Monetary policy derails cycle.
- USMCA not ratified, elimination threatened.
- Geopolitical risks materialize.
- Global recession.
- EM: crisis and contagion.
- Mexico: new government dysfunctional, spending out of control, anticorruption and violence measures backfire, ratings downgrade.

Middle (40%)

- US: slow expansion continues, rhetorical trade disputes.
- Adequate monetary policy, but uncertain.
- USMCA approved late, with changes.
- Geopolitical: risks materialize partially.
- Global slowdown, unsynchronized.
- EM: crisis and some contagion from vulnerable countries.
- Mexico: government partially functional, continued mixed signals, ratings stable.

Figure 17. Scenarios for 2019. Source: FT

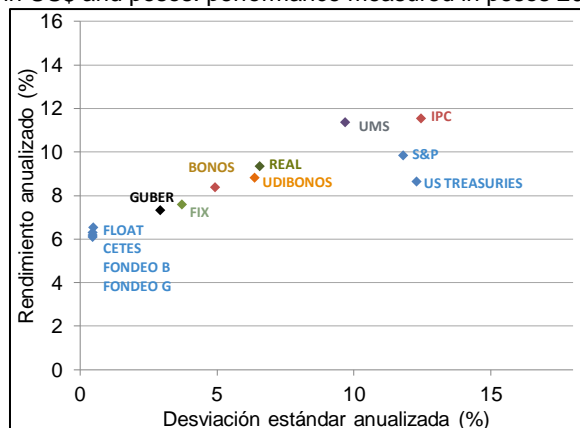
	Scenarios for 2019			2018
	High	Low	Base	Observed
Probability	10%	50%	40%	
<u>US</u>				
Economy	> 2.50%	< 2.50%	2.50%	2.90%
Inflation	> 1.90%	< 1.90%	1.90%	2.50%
Budget deficit	< 4.50%	> 4.50%	4.50%	4.20%
Current account deficit	< 2.60%	> 2.60%	2.60%	2.50%
Fed Funds rate	> 2.50%	< 2.50%	2.50%	2.50%
TNote 10 US	> 2.65%	< 2.65%	2.65%	2.69%
Oil (WTI)	> \$52.93	< \$52.93	52.93	45.41
<u>Mexico</u>				
Economy	> 1.32%	< 1.32%	1.32%	2.00%
Inflation	> 3.75%	< 3.75%	3.75%	4.87%
Budget deficit	< 2.50%	> 2.50%	2.50%	2.10%
Current account deficit	< 1.60%	> 1.60%	1.60%	1.60%
Cetes28 (year end)	> 7.96%	< 7.96%	7.96%	8.42%
Peso/US\$ (year end)	< \$19.92	> \$19.92	19.92	19.65

MARKETS

Investments in US\$ and pesos: comparative performance

Following the peso depreciation since Trump, long term (2000-2019) the gap between returns on peso and US\$ denominated investments, converted to pesos, has decreased. Peso investments have still outperformed (Figure 18).

Figure 18. Investments in US\$ and pesos: performance measured in pesos 2000-may2019. Source: FT



US\$ and peso

After Trump's tariff threat against Mexico, the peso weakened to \$19.60/US\$ (Figure 19). Business sentiment measure by Banxico deteriorated in May, with 5% thinking the climate will improved (vs. 35%, following the July 2018 elections) (Figure 20).

Figure 19. Peso vs. US\$: 1980-May2019. Source: FT

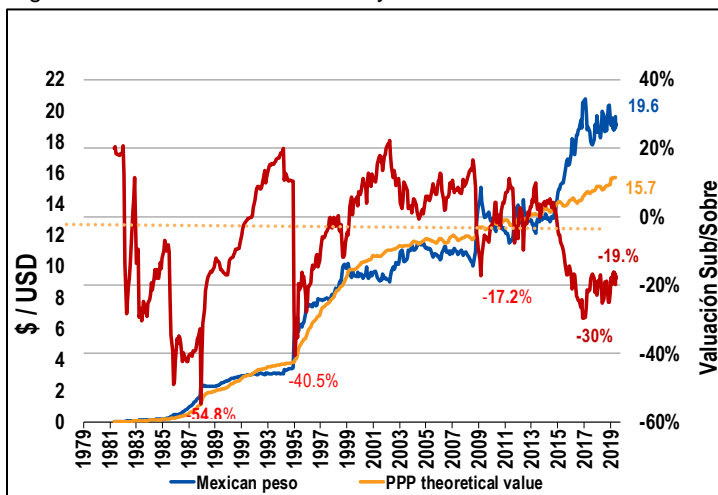
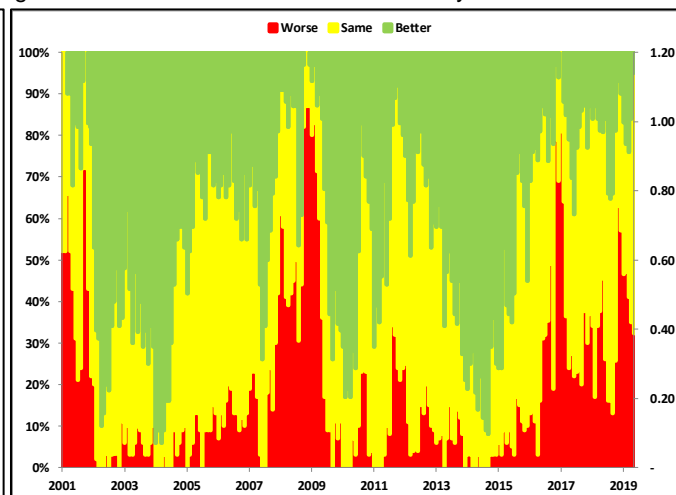


Figure 20. Banxico sentiment: Dec2001-May2019. Source: Banxico



Debt

Rates are expected to rise in DM and all EM, except China, Indonesia and Turkey (Figure 21).

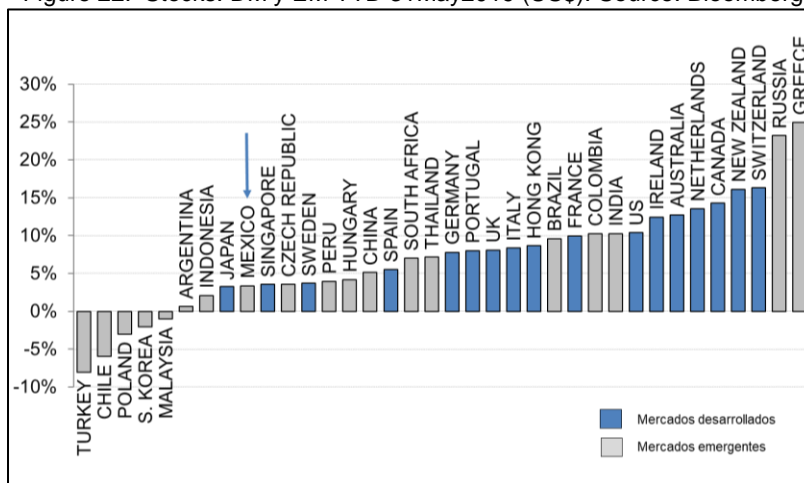
Figure 21. Developed and Emerging Markets: 10 yr nominal rates estimated at end-2019 (May2019). Source: Bloomberg, FT

Developed				Emerging			
local 10y yields (%)				local 10y yields (%)			
	4Q19e	Actual	(bps)		4Q19e	Actual	(bps)
US	2.73	2.21	51.67	China	3.13	3.30	-16.5
Euro Area	0.28	(0.18)	45.5	India	7.27	7.14	13.5
Japan	0.02	(0.09)	10.5	Rusia	8.11	7.71	39.9
Britain	1.49	0.90	59.3	Brasil	8.67	8.43	24.3
Australia	1.92	1.50	42	México	8.07	7.94	12.6
Canada	1.98	1.55	42.7	Corea del sur	2.11	1.74	36.9
Germany	0.28	(0.18)	45.5	Indonesia	7.63	8.05	-41.9
France	0.57	0.24	33.4	Turquia	18.76	19.09	-33

Stocks

YTD 2019, despite May, US\$ performance has been positive for most markets, compared to 2018. (Figure 22).

Figure 22. Stocks: DM y EM YTD 31May2019 (US\$). Source: Bloomberg



Fibras

Since inception, Fibras have outperformed stocks (Figure 23). In 2019 they have recovered strongly after 2018, when they were affected by USMCA uncertainty. If rates fall, Fibras could benefit. (Figure 24).

Figure 23. Fibras vs. IRT Mar11 (=100)-31May19.

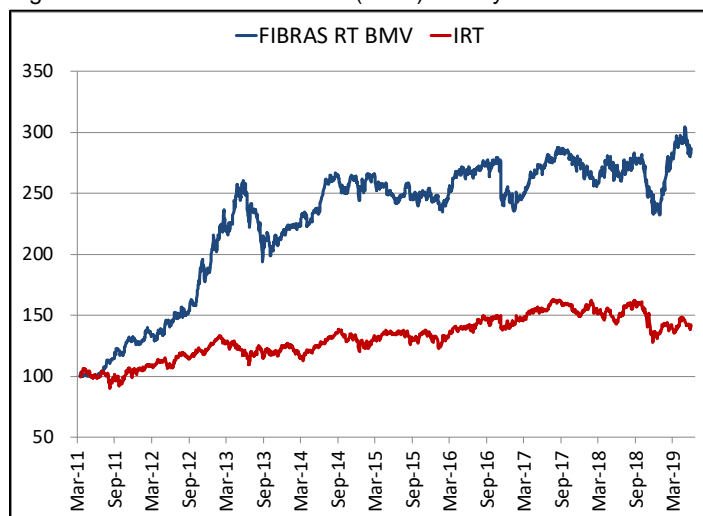


Figure 24. Fibras vs. IRT. Jan18-31May19. Source: Bloomberg

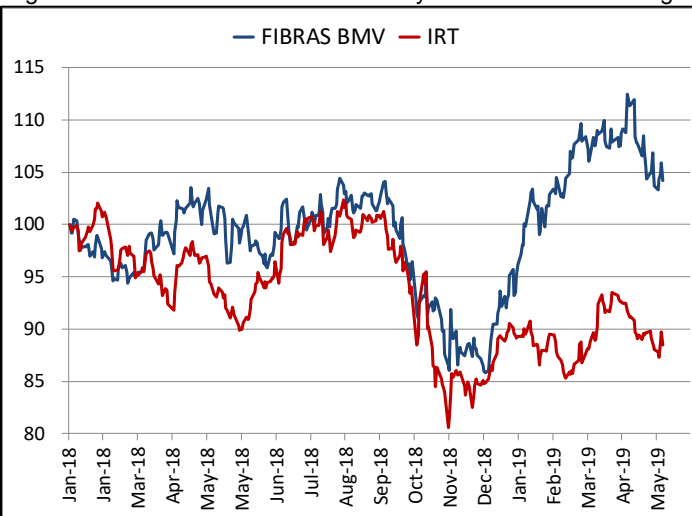


Figure 25 Fibras: valuation and dividends (may2019). Source: Bloomberg

	Mcap (M)	Calendarized						
	(MXN)	2015	2016	2017	2018	2019	2020	2021
FUNO11 MM	95,062	4.8%	6.3%	6.8%	9.4%	8.1%	8.7%	9.2%
DANHOS13 MM	35,179	5.0%	6.3%	7.0%	9.8%	8.7%	9.0%	9.2%
FIBRAPL MM	21,626		6.8%	6.5%	8.8%	7.3%	7.7%	8.9%
TERRA13 MM	19,696	6.5%	7.5%	7.8%	10.6%	10.0%	10.3%	10.2%
FIBRAMQ MM	14,898	7.6%	7.1%	8.6%	8.7%	7.4%	7.8%	8.3%
FIHO12	8,064	7.6%	7.8%	8.1%	9.7%	8.3%	8.2%	9.2%
FMTY14 MM	7,539			7.6%	8.7%	9.0%	9.4%	9.7%
FHIPO	6,747	7.6%	7.8%	8.1%	9.7%	8.3%	8.2%	9.2%
FINN13 MM	5,204	5.7%	6.4%	7.9%	10.0%	9.9%	8.5%	8.9%
FSHOP13 MM	4,102	5.4%	8.2%	10.8%	12.7%	12.6%	12.5%	12.8%

Conclusion

In Mexico, plans announced and actions taken by the government have affected the business climate, the economy and growth estimates. The intensification of Trump's trade disputes not only against China but also against Mexico offer an additional threat, which could increase as US presidential elections approach. We continue to advise caution in peso denominated portfolios, overweight liquidity, and ILS debt 1 to 3 years duration and underweight stocks and fibras.

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Editor: Timothy Heyman
June 7, 2019

Investment indicators to May 31, 2019

During May, in Mexico, the IPC fell 4.14%. Short term nominal rates rose, but medium and long term rates fell. 10 year real rates fell. The US\$ rose 3.33% against the peso. US: DJ, S&P500 and Nasdaq fell. Nominal and real rates fell over all terms. WTI fell 16.29%. According to Bank of Mexico business climate index, optimism fell to 5% (16% previous), no change rose to 62% (49%), and pessimism fell to 32% (35%).

Mexico					
Stock market and oil					
	31-May-19	30-Apr-19	Month	YTD	2018
IPC	42,749.16	44,597.32	-4.14%	2.66%	-15.63%
Local currency (USD/MXN)	19.64	19.01	3.33%	-0.04%	-0.06%
Mexican oil mix (USD/bl)	56.57	63.62	-11.08%	26.58%	-20.47%
Nominal rates					
	31-May-19	30-Apr-19	Month	YTD	2018
CETES 28	8.47%	8.45%	2 bps	5 bps	110 bps
CETES 360	8.05%	7.97%	7 bps	-44 bps	103 bps
M5	7.86%	7.94%	-8 bps	-66 bps	93 bps
M10	8.07%	8.14%	-8 bps	-59 bps	101 bps
M30	8.45%	8.50%	-5 bps	-44 bps	111 bps
Real rates					
	31-May-19	30-Apr-19	Month	YTD	2018
UDIBONO 10	3.76%	3.81%	-5 bps	-35 bps	61 bps
UDIBONO 30	3.96%	3.96%	0 bps	-16 bps	42 bps
Commodities					
	31-May-19	30-Apr-19	Month	YTD	2018
Gold	1,305.80	1,284.02	1.70%	1.96%	-1.70%
WTI (USD/bl)	53.5	63.91	-16.29%	19.71%	-20.47%
UMS					
	31-May-19	30-Apr-19	Month	YTD	2018
UMS 10 years	4.26%	4.40%	-13 bps	-66 bps	129 bps
UMS 20 years	5.14%	5.09%	5 bps	-64 bps	125 bps
UMS 30 years	5.00%	5.23%	-23 bps	-83 bps	120 bps
Stock markets (US\$)					
	31-May-19	30-Apr-19	Month	YTD	2018
MSCI Developed	8,554.77	9,069.95	-5.68%	10.08%	-8.20%
MSCI Emerging	2,253.09	2,428.54	-7.22%	4.19%	-14.25%
MSCI Mexico	8,222.01	8,844.77	-7.04%	3.26%	-15.29%
MSCI Brazil	6,911.82	6,794.58	1.73%	9.27%	-0.15%

US					
Stock market					
	31-May-19	30-Apr-19	Month	YTD	2018
DJ	24,815.04	26,592.91	-6.69%	6.38%	18.04%
S&P	2,752.06	2,945.83	-6.58%	9.78%	11.97%
Nasdaq	7,453.15	8,095.39	-7.93%	12.33%	23.26%
Nominal rates					
	31-May-19	30-Apr-19	Month	YTD	2018
Tbill 90	2.35%	2.43%	-8 bps	-10 bps	194 bps
Tnote 5	1.93%	2.28%	-35 bps	-58 bps	58 bps
Tnote 10	2.14%	2.51%	-37 bps	-55 bps	24 bps
Tbond 30	2.58%	2.93%	-35 bps	-40 bps	-8 bps
Real rates					
	31-May-19	30-Apr-19	Month	YTD	2018
Tip 5	0.35%	0.43%	-8 bps	-65 bps	91 bps
Tip 10	0.40%	0.56%	-16 bps	-58 bps	48 bps
Tip 30	0.74%	0.94%	-20 bps	-47 bps	22 bps

Bank of Mexico survey		
Indicator	2019	2019 anterior
PIB	1.32%	1.52%
Inflation	3.75%	3.66%
Cetes 28	7.96%	7.89%
Local currency	19.92	19.90
Business conditions		
	31-May-19	30-Apr-19
Optimism	5%	16%
No change	62%	49%
Pessimism	32%	35%

Source: Bloomberg, Banco de Mexico

IMPORTANT LEGAL INFORMATION

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*Timothy Heyman, President of FTSAM, founded Heyman y Asociados in 1985. In 2013, Franklin Templeton established FTSAM and merged it with Heyman y Asociados.

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