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How will Mexico's new president handle policy shifts and US uncertainty?

Mexico's new president Claudia Sheinbaum faces weak growth, a controversial reform agenda inherited from her predecessor and US election uncertainty. The government may slow the pace of constitutional changes, but much of the agenda will ultimately be pursued. Investor concerns regarding the country's institutions risk stymieing potential gains from "nearshoring".

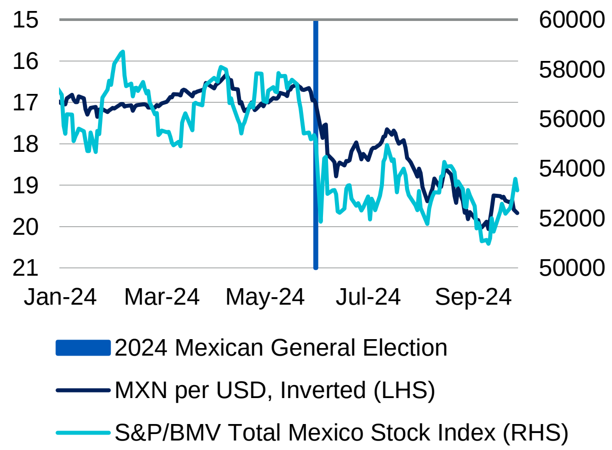
Key Takeaways

- Uncertainty has been rising sharply in Mexico since June, when new president, Claudia Sheinbaum, was elected and the Morena party won a landslide victory.
- This is due to increased investor scrutiny of the reform agenda she inherited from Andrés Manuel López Obrador and market concerns about the US.
- Following the approval in September of one of López Obrador's main proposals – the judicial reform – investors await details on what shape other proposals may take.
- Sheinbaum's administration may slow or limit the scope of changes to appease investors, particularly if the US election results spark renewed market pessimism.
- However, we ultimately expect the government to carry out the flagship components of López Obrador's agenda before Mexico's mid-term elections in 2027.
- Muted short-term growth will hamper fiscal consolidation over 2025, posing additional risks for investor sentiment.
- We expect Banxico to lower its policy rate by a further 50bps to 10% by year-end. The rate path over 2025 will depend on the US election outcome, with a Harris victory providing greater room for stimulus than a Trump win.
- Over the medium term, Mexico will likely benefit from "nearshoring" due to its connectedness with the US.
- That said, investor caution regarding the rule of law and USMCA compliance risks stymieing future FDI inflows.

Mexico is under pressure

Mexico's new president, Claudia Sheinbaum, who entered office on 1 October, faces a variety of challenges. These include the difficult macroeconomic backdrop she inherited from her predecessor, Andrés Manuel López Obrador, known as AMLO, as well as investor scrutiny regarding the implementation of the former president's reform agenda.

Figure 1: Concerns regarding the government's powers have weighed on Mexican assets



Source: Haver, abrdn, October 2024

Mexico's peso and equities have underperformed since June's general elections, when a landslide victory for the incumbent Morena party strengthened its legislative capabilities.

Scope for a meaningful recovery for these assets before the US election is limited, with prospects for 2025 dependent on both sentiment regarding domestic policies alongside the outcome of the US election.

AMLO's agenda will remain with President Sheinbaum

In September, Mexico's upper and lower houses approved López Obrador's constitutional amendment regarding the appointment of judges, and we expect that Sheinbaum will gradually push ahead with other contentious changes.

The reform will see judges at various levels, including the supreme court, elected by popular vote commencing in June 2025. This contrasts with the established qualifications-based system of selection.

Most judicial candidates and members of a new disciplinary tribunal for judges will be selected by the executive and Congress, both controlled by Morena.

These changes have triggered worries that judges' rulings may overly favour the government and state enterprises, potentially eroding the business environment. Markets are also cautious regarding other proposed reforms, most notably plans for the elimination of independent regulators in a range of sectors, including energy and telecommunications.

Removing objective regulators, alongside a potentially weakened judicial system, risks making Mexico less attractive to foreign investors. This would compound longstanding structural limitations on investment caused by infrastructural shortcomings and energy sector inefficiencies.

Unless foreign enterprises are able to also seek arbitration for disputes in international courts, this could threaten potential nearshoring gains over the coming years.

Moreover, the elimination of independent regulators would risk a breach of the United States Mexico Canada Agreement (USMCA), which is up for review in 2026.

Political room for manoeuvre will be limited

We expect Sheinbaum's presidency to prove challenging, as she faces party pressure to enact reforms and external pressure to avoid eroding democratic processes. Moreover, plans to consolidate Mexico's fiscal deficit while introducing more social welfare programmes will be difficult amid sluggish economic growth.

Markets could play a moderating role. Sheinbaum could (in theory) slow, temporarily pause, or temper the magnitude of the reforms to bolster sentiment. A potential adverse shock for Mexican assets following a Trump victory in particular could motivate greater caution for the government.

However, Sheinbaum has endorsed her predecessor's judicial reform, and has – although stating intentions to rein in total expenditure – outlined her own objectives of furthering social spending in certain areas after López Obrador's 2024 increases.

A combination of factors will motivate Sheinbaum to implement key parts of his broader proposals over the first half of her presidency (i.e. within the first three years of a single six-year term).

First, Morena's members will wish to capitalise on their post-election momentum and legislative dominance before mid-term elections in 2027.

Secondly, deviating from López Obrador's proposals would risk pushback from other senior members within the ranks of the Morena party and support base loyal to the former president.

Finally, even though López Obrador is officially stepping down, he is widely expected to remain influential over the party he founded.

Is nearshoring faltering?

Morena's reforms, alongside the risks that a second Trump presidency does more than 'review' the USMCA, have left many to question whether nearshoring will ever truly occur on a large scale. The Wall Street Journal recently reported that companies may be holding off on $35 billion worth of investment for these two reasons.

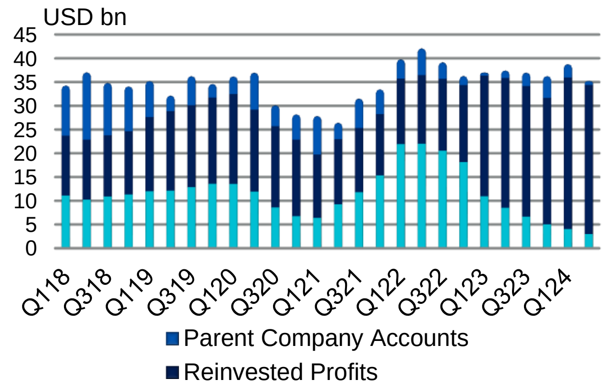
Mexico at least remains well placed to gain from a deterioration in relations between the US and China. US policymakers' increased focus on national security and supply-chain resilience provides incentives for businesses to move manufacturing. With

integration into US supply chains, favourable market access within the USMCA and lower labour costs, Mexico can still benefit regardless of who holds the Oval Office.

Some of the concerns may reflect a recalibration of excessive optimism about the immediacy of change. Judging nearshoring was always going to be hard to conclusively discern in real time.

Foreign direct investment (FDI) inflows remain somewhat uninspiring. Indeed, data from Banxico show that the level of "new" FDI inflows, which surged over 2022, has since fallen below its pre-pandemic levels (see Figure 2).

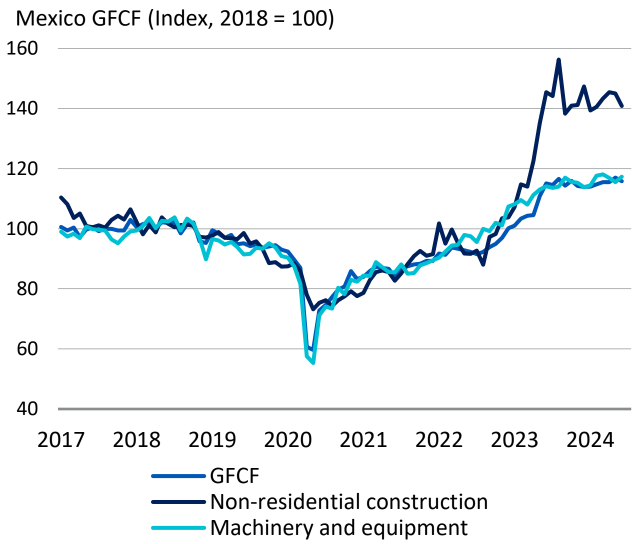
Figure 2: New FDI inflows have lost momentum



Source: Haver, abrdn, October 2024

That said, a marked rise in gross fixed capital formation (GFCF) – particularly non-residential construction – still points to an expansion of manufacturing capacity and ancillary infrastructure, even if a large proportion of this can be attributed to recent public projects (see Figure 3).

Figure 3: Construction remains very strong



Source: Haver, abrdn, October 2024

And, while the extent of the decline in new FDI has been surprising, it may not ultimately matter whether business expansion takes place via firms with existing operations or via new entrants.

USMCA: reviewed or ripped up?

Mexico's reforms will be a source of contention during the 2026 USMCA review.

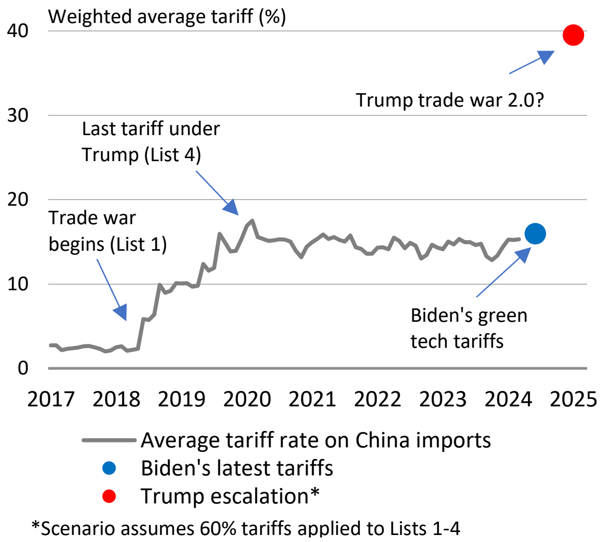
A Harris administration may focus on the provision within USMCA for independent judges to preside over labour disputes, but is unlikely to seek major changes to the USMCA overall.

A Trump administration may however use the review to extract other concessions, for example on migration and border security. Threats of *renegotiation* rather than *review*, combined with a stronger push to *onshore* rather than *nearshore* manufacturing, could hold back corporate investment and damage market sentiment.

That said, it is not clear that ripping up the USMCA – or changing it in a way that reverses the tailwinds to Mexican manufacturing – is plausible.

Renegotiation would require congressional approval in the US and parliamentary agreement in Canada. US corporations own substantial manufacturing operations in Mexico, which could be severely damaged. Finally, the US arguably needs Mexico more than ever if Trump is serious about launching a second trade war and decoupling from China (Figure 4).

Figure 4: Tariffs on China under Trump may boost US reliance on Mexico



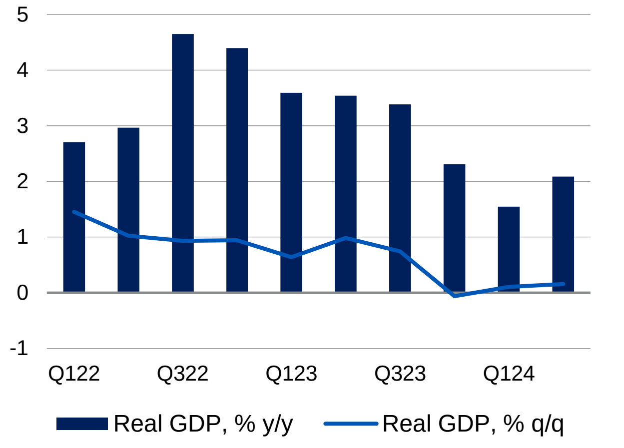
Source: US Census Bureau, USTR, WITS, abrdn, October 2024

Muted economic momentum is a challenge for fiscal consolidation

Alongside risks to nearshoring, the new government will face the challenge of subdued near-term economic growth.

After real GDP contracted by 0.1% quarter over quarter in Q4 2023, Mexico's economy grew by 0.1% in Q1 and 0.2% in Q2. Even the modest Q2 uptick was chiefly due to a 2.5% quarter-over-quarter decline in imports, symptomatic of weak domestic demand amid a 0.6% fall in private consumption.

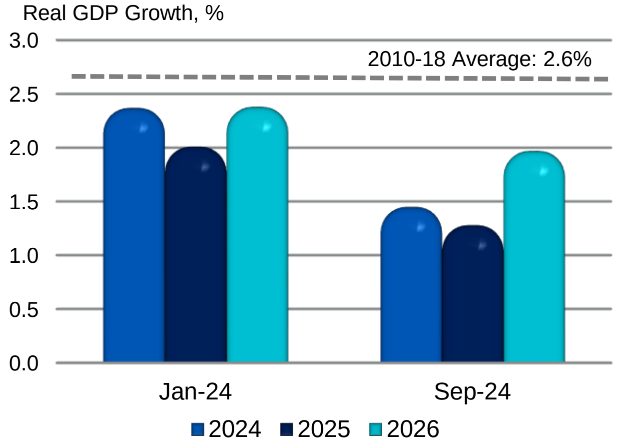
Figure 5: Mexico's growth has stalled over the past 3 quarters



Source: Haver, abrdn, October 2024

Domestic weakness and expectations for a slowdown in the US have led to respondents' projections for growth in Banxico's surveys deteriorating (Figure 6), with the private sector currently forecasting expansions of 1.3% in 2025 and 2% in 2026, down from 2% and 2.4% in January.

Figure 6: Private sector growth expectations fall further below trend



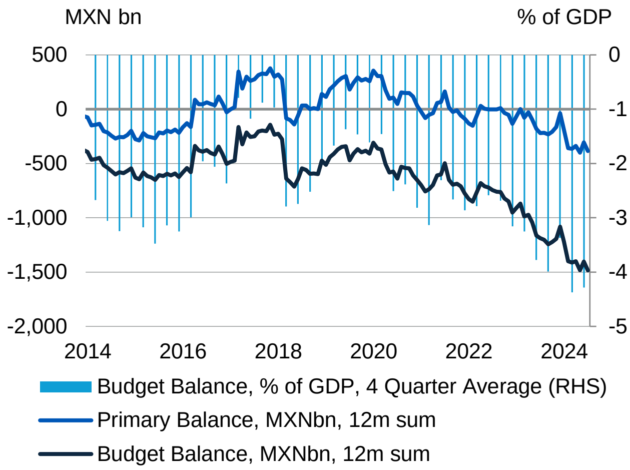
Source: Banxico survey of expectations, abrdn, October 2024

The average 2024 forecast of 1.5% in our view is overly optimistic, with current conditions likely to see growth much closer to the Bloomberg consensus of 1.1%.

Uncertainty regarding domestic activity and foreign investment will make formation of the government's 2025 budget – due in November – a tricky process.

This follows López Obrador's administration having pivoted away from relative fiscal prudence over the pandemic ahead of the elections. Indeed, increased social and infrastructure expenditures alongside higher interest costs have widened the overall deficit, which has averaged 4.3% of GDP over the past year.

Figure 7: Fiscal consolidation will be difficult in 2025



Source: Haver, abrdn, October 2024

It will be politically difficult to significantly lower spending at the risk of exacerbating economic headwinds, while muted activity hampers revenues. Expenditures related to the long-struggling state oil company Pemex also remain a fiscal constraint.

As such, the deficit is expected to narrow only modestly in 2025. That said, Mexico's debt load (41.9% of GDP in 2023) will likely remain small compared to other emerging markets (e.g Brazil: 74.4%) and developed economies (US: 130.2%).

Banxico will lower rates further, albeit cautiously

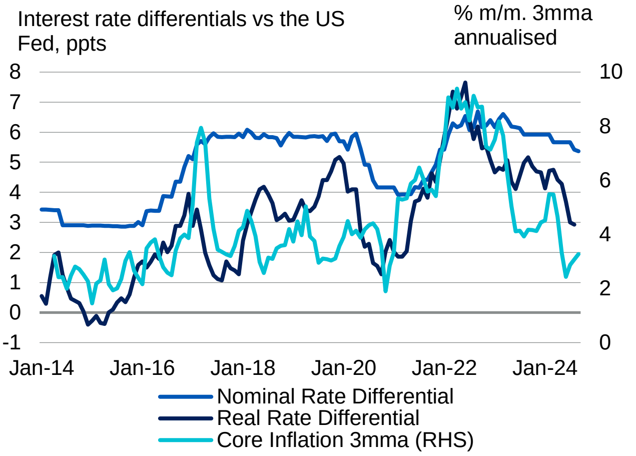
Banxico has to strike a delicate balance as it aims to support the economy while containing domestic and external price pressures.

It lowered its policy rate by 25bps to 10.5% in September, the third such move this year. Despite heightened peso volatility, the central bank cited confidence regarding ongoing disinflation and downside risks to growth as reasons to ease monetary policy.

This came after the second consecutive decline of mid-month inflation to 4.7% year over year in September, as well as the start of the Fed's own easing cycle.

We expect that weak growth, high frequency measures of core inflation now running at levels broadly consistent with Banxico's 3% target, and a declining fed funds rate will together lead the board to lower the policy rate by a further 50bps over its next two meetings to 10% by year end.

Figure 8: Banxico will cut rates further, but peso risks may limit extent of easing

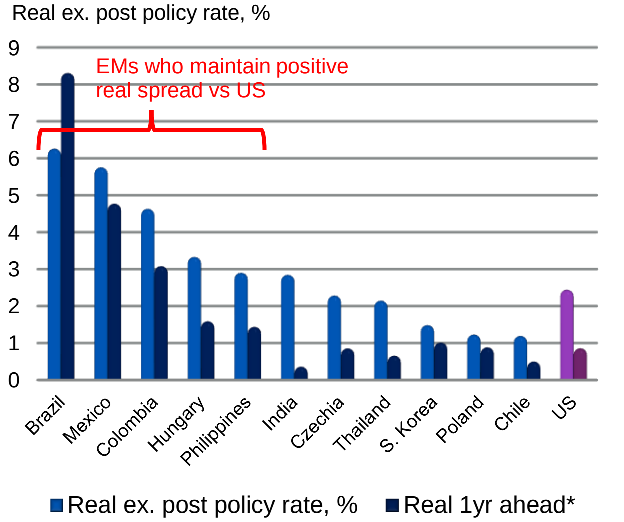


Source: Haver, abrdn, October 2024

The 2025 rate trajectory will be impacted by the outcome of the US election. The result is currently a coin toss.

In our view, a baseline of a Harris victory would see lower pressure on the peso and provide Banxico room to cut to a rate of around 8% by the end of 2025. This would mark only slightly more cutting than our forecasts for the Fed, but Banxico would have scope for further easing should inflation and domestic political developments be seen more favourably by markets.

Figure 9: Mexico's rate spread provides room for cuts, though trajectory is US-dependent



Source: abrdn, Haver, Bloomberg, October 2024. *Note: 1 year ahead real rates use Bloomberg MIPR and JPMorgan CPI inflation forecasts, which serve as a proxy for market expectations. Not all EMs have MIPR values.

Should Trump win, Banxico would most likely take a more cautious path. This outcome would exacerbate currency volatility risks, alongside scrutiny of the government's fiscal policy, reforms, and relationship with the US. This would likely see cuts curtailed to a rate of 8.75-9%by the end of 2025.

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