



FX MARKETS UPDATE

We expect the Mexican peso to reverse course before long

- **The Mexican peso’s outperformance since the start of 2022 has pushed up its valuation substantially, and we think that this leaves it vulnerable to sharp falls against the US dollar if, as we expect, the US economy falls into recession later this year.**
- **Despite the broad-based rebound in the greenback over the past couple of weeks, the Mexican peso remains near multi-year highs against the US dollar.** (See Chart 1.) Indeed, the peso has been the best performer among major currencies since the start of 2022 (see Chart 2), and it is one of only four currencies that is currently stronger against the dollar since the start of 2020.
- **The peso’s outperformance is somewhat surprising given the challenging backdrop that most currencies have faced since the Fed kicked off its rate hike cycle last year.** For example, the tightening of US financial conditions – which has tended to coincide with a weaker peso – appears to have had little effect on the peso. (See Chart 3.) What’s more, the peso also diverged from measures of country-specific risk premia – such as dollar bond spreads – for much of the past year or so. (See Chart 4.)
- **To some extent, we think this outperformance has been warranted. For one, Mexico’s central bank (Banxico) has been more hawkish than most other central banks over the past few years, sticking to its long-held approach of tracking the Fed’s policy stance closely.** Indeed, last week Banxico hiked by a **larger-than-expected 50bp** after an uptick in inflation, to 7.9%, in January.
- **In addition, Mexico’s close economic ties to the US mean that it has benefitted from the US economy’s strong rebound from the pandemic.** By contrast, many other emerging markets were more affected by the economic weakness in Europe and China last year. And many of Mexico’s peers in Latin America (and, in turn, their currencies) have faced domestic headwinds, such as fiscal sustainability concerns.

Chart 1: USD/MXN (Inv.)

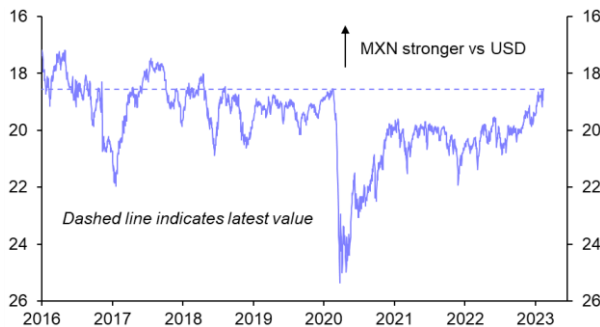


Chart 2: % Changes Vs USD Since 1st Jan. 2022

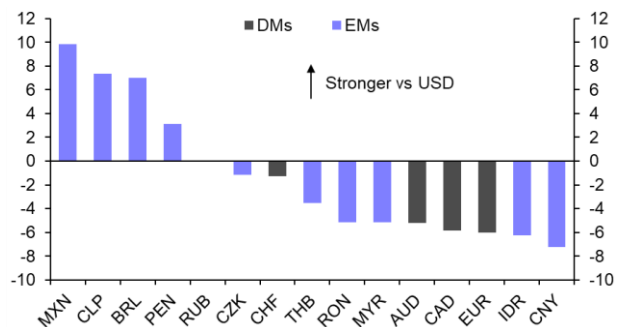


Chart 3: Changes In MXN Vs USD & Chicago Fed National Financial Conditions Index

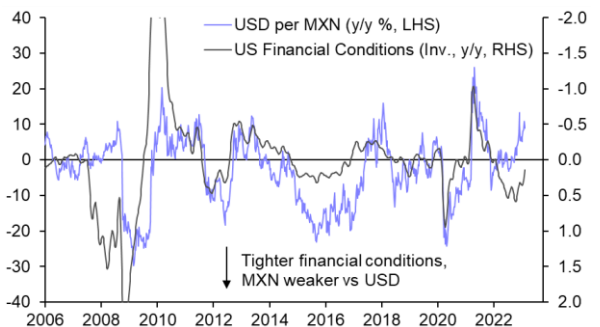


Chart 4: USD/MXN & Stripped Spread Of JP Morgan EMBI Mexico Index (Inv.)



Sources: Refinitiv, Capital Economics



- **But we think these tailwinds supporting the peso have largely run their course.**
- On the monetary policy front, while Banxico is likely to continue its hiking cycle (as indicated at their last meeting), we think that growing evidence of slowing economic growth and moderating inflation will prompt policymakers to **opt for a smaller (and final) 25bp hike** at their next meeting in March. (See Chart 5.)
- And although the latest US data have proved stronger than widely expected, we think this means that the economy will enter recession later rather than avoid one. After all, the Conference Board’s leading economic index (LEI) has never fallen to this extent **without being followed by a recession**. Not surprisingly, downturns in the LEI have tended to coincide with weakness in the peso, despite the recent divergence between the two. (See Chart 6.)
- Admittedly, the peso held up relatively well against the dollar during the “dot com” recession in the early 2000s, which was similar in magnitude to the recession we forecast this year. But back then, the peso had already weakened against the dollar for several years ahead of the recession amid crises in other emerging markets. (See Chart 6 again.) What’s more, the peso’s resilience during the 2001 recession (combined with broad-based weakness in most other currencies against the dollar) meant that its real effective exchange rate strengthened substantially. (See Chart 7.) We suspect this is one reason why the peso fell against the dollar *after* the recession ended.
- **While the timing of a potential US recession (and subsequent weakness in the peso) remains uncertain, we think the peso’s high valuation – relative to its own history and other major emerging market currencies (see Chart 8) – means that sharp falls over the next few quarters are likely.**
- **We are sticking with our forecast for the peso to weaken against the dollar – to 21 in the USD/MXN rate, from 18.6 currently – as risk appetite deteriorates amid a US recession later this year.**

Chart 5: Mexico Headline Inflation & Policy Rate

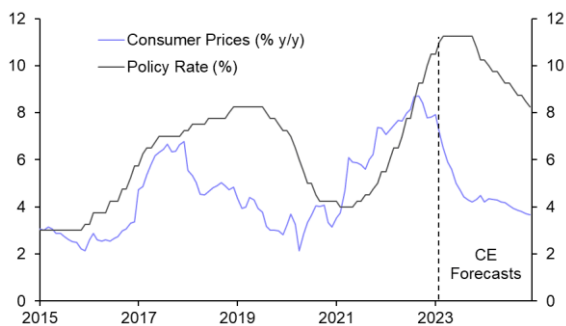


Chart 6: Changes In MXN Vs USD & US Leading Economic Index (LEI)

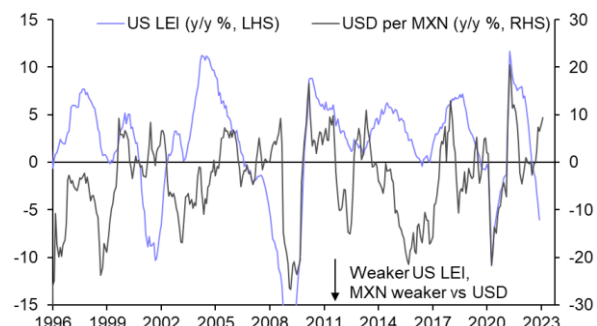


Chart 7: % Deviation From 7-Yr Average BIS Broad Mexican Peso Real Effective Exchange Rate

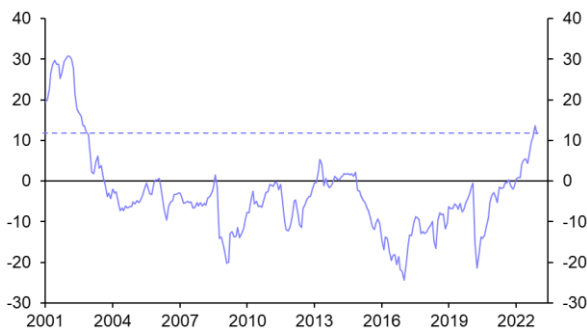
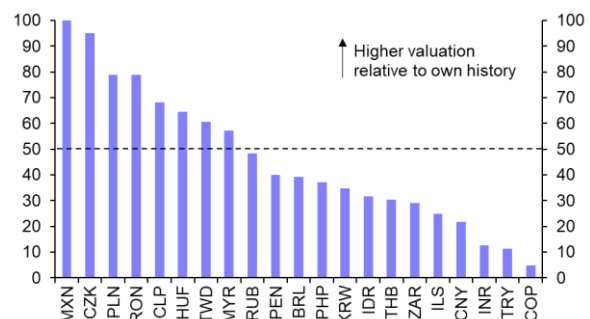


Chart 8: Valuation Percentile From CE Real Equilibrium Estimate (Based On Real Effective Exchange Rate)



Sources: Refinitiv, Capital Economics



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