FX MARKETS UPDATE

The Mexican "super peso" looks poised for a sharp fall

- **The Mexican peso's relentless rise against the US dollar and most other major currencies is increasingly at odds with macroeconomic fundamentals. We think the peso is vulnerable to an abrupt fall over the coming months if, as we expect, risk sentiment deteriorates as a US recession hits.**
- In February, we highlighted the Mexican peso's outperformance of most major currencies (including the greenback) since 2020. Contrary to our expectations and those of most analysts, the peso's appreciation has continued through 17/$, its strongest level against the dollar since 2016. (See Chart 1.)
- **This is because both economic and market conditions have remained favourable for the peso. On the economic front, the US economy proved resilient over the first half of the year**. What's more, Mexico's terms of trade have improved relative to the US (largely driven by higher export prices in Mexico's automotive sector). (See Chart 2.) And amid the backdrop of strong risk appetite, the combination of falling volatility and Mexico's high short-term interest rates means that the peso's risk-adjusted "carry" remains high relative to its own history and other EM currencies. (See Charts 3 & 4.)

Chart 1: USD/MXN (Inv.)

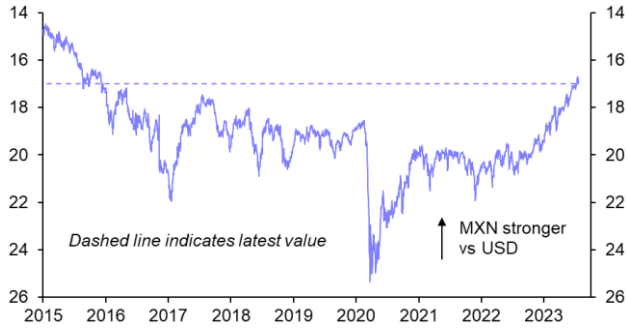


Chart 2: USD/MXN Deflated By CPIs Vs Ratio Of US To Mexico Terms Of Trade (2010 = 100)

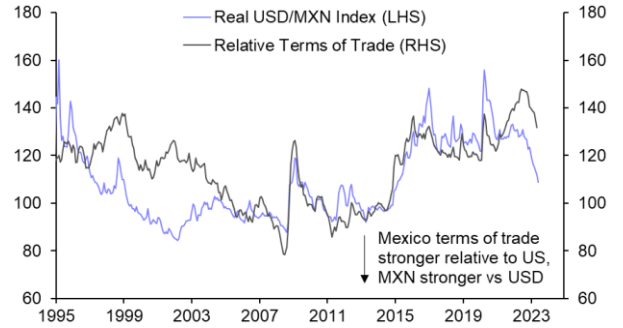
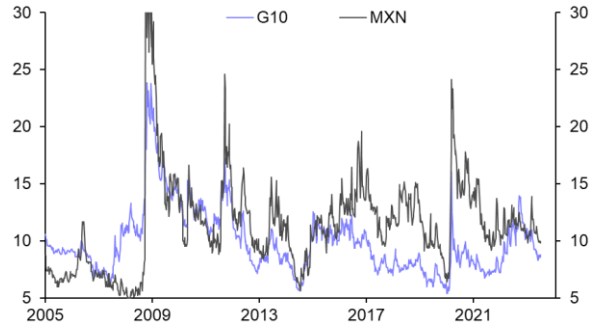
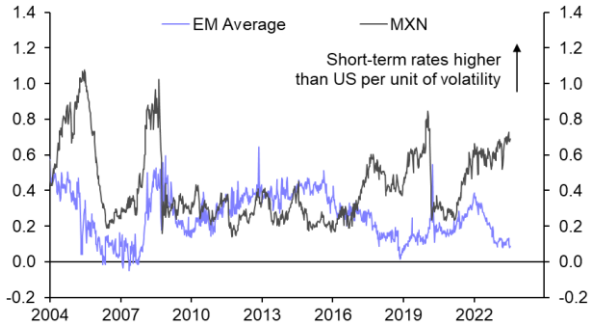


Chart 3: 3M Implied Volatility Of G10 Average & MXN (%, Annualised)



*Ratio of 3M forward-implied yield less USD to 3M implied volatility

Chart 4: EM Average & MXN Carry-To-Risk Ratio*



Sources: Refinitiv, Capital Economics

- **The peso might continue edge higher for as long as risk sentiment holds up. That said, if our expectation for risk sentiment to deteriorate as the US economy falls into recession proves correct, four factors suggest the peso's fall against the dollar will be substantial.**
- **First, the economic backdrop, while resilient, continues to worsen**. The peso's rally has diverged dramatically from the US economic cycle. (See Chart 5.) The first dotted box in Chart 5 highlights a similar divergence during the dotcom recession in the US, when the peso's resilience gave way to a fall of nearly 20% against the greenback.

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- **Second, the peso is significantly overvalued by all of the valuation measures we track**. Price-level based measures – such as the real effective exchange rate (REER) – suggest the peso is the most overvalued it has been in more than two decades. (See Chart 6.) Indeed, the latest current account data suggest the strength of the peso may already be weighing on Mexico's economy. And measures that track relative economic fundamentals also point to overvaluation. For example, the relative terms of trade (see Chart 2 again) are still near record levels in favour of the US, even after the recent improvement in Mexico's terms of trade.
- **Third, the factors supporting the "carry trade" have probably run their course**. Banxico is unlikely to restart its tightening cycle, so the currency's carry is unlikely to rise from here. More importantly, volatility is already low and risk appetite strong despite mounting evidence of slowing growth in the world's major economies.
- **And fourth, technical indicators suggest the peso's rally is nearing exhaustion**. For one, it has already strengthened against the dollar at the fastest rate in more than 20 years. (See Chart 7.) And net speculative positioning in the peso is nearing extreme levels that in the past coincided with a stable or falling peso. (See Chart 8.) While these indicators don't point to an imminent decline, they do suggest there is limited further upside for the peso.
- **Amid the broad-based weakness in EM currencies we anticipate later this year, these factors suggest to us that the peso is particularly vulnerable to a sharp depreciation. We continue to expect the peso to weaken against the dollar, to 20/$, towards the end of the year.**

Chart 5: Changes In US Leading Economic Indicator & USD Per MXN

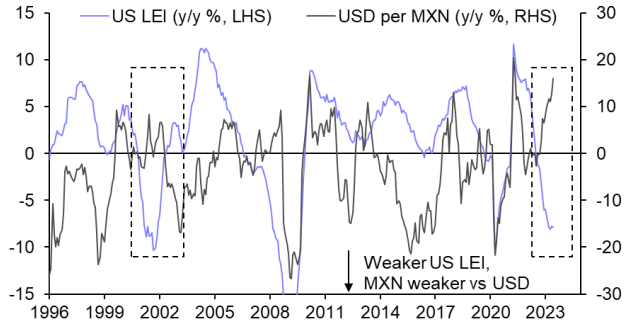

Chart 6: CE REER Valuation Score (Percentile Of Deviation From 7-Year Moving Average REER)

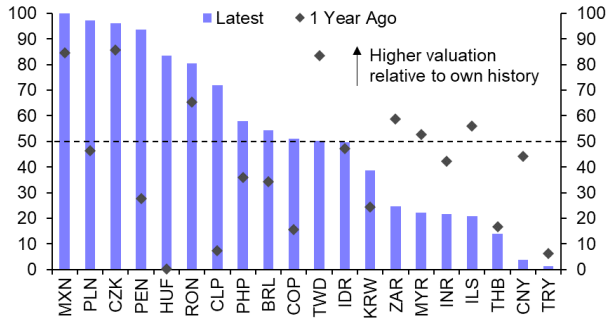

Chart 7: % Change (y/y) In USD Per MXN

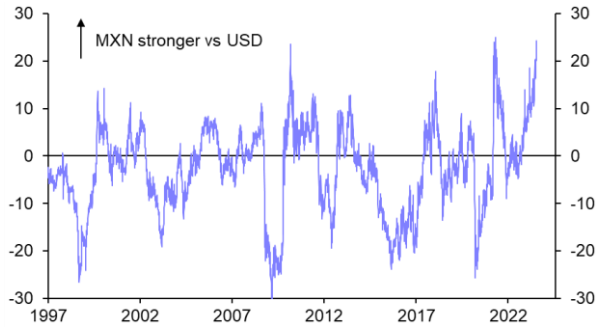

Chart 8: USD/MXN (Inv.) & Net Speculative Positioning (% Of Non-commercial Open Interest)

Sources: Refinitiv, Capital Economics

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