S&P Global downgrades Mexico sovereign to 'BBB'. Keeps 'negative' outlook

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- **Today, S&P Global cut Mexico's credit rating by one-notch to 'BBB', from 'BBB+', maintaining a 'negative' outlook**
- **The agency expects a pronounced hit to Mexico's economy and that of the US –its main trading partner–, following the combined shocks of COVID-19 and lower global crude oil prices**
- **Furthermore, S&P Global downgraded Pemex to 'BBB', from 'BBB+' maintaining a 'negative' outlook, similar to the sovereign. Following standard procedure, we expect the agency to also downgrade CFE, along other financial institutions and Mexican corporates**
- **Despite today´s downgrade, the market discounts that Mexico will remain an 'Investment Grade' country for the next years, in line with our expectations**

S&P Global Ratings cuts Mexico's rating by one-notch, to 'BBB'. Today, the credit rating agency cut the long-term foreign currency rating to 'BBB' from 'BBB+', maintaining the outlook at 'Negative'. The latter indicates the possibility of a downgrade over the coming 12-24 months, *"…due to uneven or ineffective policy execution, potentially weakening public finances, or higher off-budget contingent liabilities…"*. Broadly speaking, the agency's revision was driven by the expected hit to the Mexican economy because of two global drivers: (1) The COVID-19 pandemic; and (2) the strong decline in crude-oil prices. Regarding other agencies, *Fitch Ratings* also has Mexico at 'BBB' with a 'Stable' outlook, while *Moody's Investors Service* stands at 'A3' with a 'Negative' outlook. Considering the latter, we reaffirm our view that Mexico will remain comfortably above the 'Investment Grade' (IG) threshold despite current global and domestic headwinds (chart below, left). Moreover, the agency adjusted their estimates for 2020-2023 (table below, right), highlighting their view that GDP will contract between 2.0%-2.5% this year (Banorte: -3.5%) and will rebound to 2.2% in 2021 (Banorte: 1.0%).

Mexico's sovereign credit rating
Bold rating indicates current level; date of last revision

S&P Global Ratings	Fitch Ratings	Moody's Investors Service
A-	A-	**A3 (Jun-5-2019)**
BBB+ ↓	BBB+	Baa1
BBB (Mar-26-2020)	**BBB (Jun-5-2019)**	Baa2
BBB-	BBB-	Baa3
	'Investment Grade' threshold	
BB+	BB+	Ba1

*Note: Dotted line indicates the difference between 'investment grade' and 'high yield.'
Source: Banorte with data from S&P Global Ratings, Fitch Ratings and Moody's Investors Service

Macroeconomic forecasts from S&P Global Ratings

Indicator	2019	2020f	2021f	2022f	2023f
GDP (% y/y)	-0.1	-2.0	2.2	1.8	1.8
Unemployment rate (%)	3.5	4.7	4.5	4.2	4.3
Public balance (% of GDP)	1.8	2.7	2.8	3.1	3.4
Public debt (% of GDP)	43.1	47.2	47.7	48.7	50.0

f = forecasts
Source: S&P Global Ratings

Global shocks triggered rating action. The credit rating agency stated they expect a pronounced hit to Mexico's economy and that of the US –its main trading partner– following the combined shocks of COVID-19, along the effects from lower global oil prices. According to S&P Global, the economic impact of COVID-19 will cause a contraction in domestic demand in Mexico and the United States, its main trading partner, during 2020. About the latter, they mentioned that they expect a contraction in growth this year (Banorte: -2.3%), with a 'U'-shaped recovery. This impacts our country since it is the destination of about 80% of exports, the main source of income from tourism and the inflow of remittances, among others. In addition, they mentioned that *"…this negative shock outweighs possible support for growth this year in México form the national infrastructure plan outlined in November 2019 or the passage of USMCA..."*. Moreover, S&P Global believes Mexico's poor economic performance *"…reflects, in part, the inability of the López Obrador Administration to improve private-sector confidence and investment dynamics..."*. On the other hand, the agency mentioned that *"… the combination of social, economic, and health challenges; only moderate fiscal flexibility; and recent external shocks could partially weigh on fiscal out-turns and debt levels over the next several years"*

Regarding the collapse of the Mexican oil mix, they commented *"… the financial profile of government-owned PEMEX has become more vulnerable amid the decline in oil prices…"* while the federal government can recover a large part of the potential lost oil revenues in 2020 thanks to the oil hedge in place and draw down of money in the Stabilization Fund ("*Fondo de Estabilización de Ingresos Presupuestarios"*, known as FEIP in Spanish). However, *"…the small cushion the fund provides is expected to erode by 2021"*. In reference to private-investment in the energy sector, the credit agency considers that *"….if the administration moves to enlarge the scope for private investment, current oil prices will make it more challenging to secure such investment in refineries and pipelines"*. In this context, they warn that the decline in international oil prices, *"…weighs on Mexico's fiscal position, affecting both the Mexican budget directly and the financial strength of PEMEX…"*.

On the positive side, it is worth noting that the agency assumes that the government will take the necessary measures to contain the widening of the fiscal deficit and a higher sovereign debt burden because of the economic slowdown. In this context, *"…President López Obrador has underscored a commitment to fiscal prudence…"*. Therefore, they assume that fiscal deterioration will be contained, in line with Mexico's record of adjusting its economic policies and the government's commitment to act with fiscal prudence. The analysis also considers a framework with a cautious monetary policy and a floating exchange rate regime that has supported investor confidence and overall economic stability.

S&P Global also downgraded Pemex debt ratings. In addition to its action on the sovereign rating, S&P Global revised the global scale rating of *Petroleos Mexicanos* (Pemex) to 'BBB' from 'BBB+', maintaining its 'negative' outlook. It is worth mentioning that S&P Global is the only credit rating agency between Moody's Investors Services and Fitch Ratings who captures the integral link between the oil company and the government. The stand-alone credit profile (SACP) was revised downwards, to 'ccc+' from 'b-'. In addition, the agency affirmed its national scale rating of 'mxAAA/mxA-1+'. The outlook on the national scale rating is stable. According to the agency, the action reflects their expectation of a strong likelihood of additional government support to Pemex in a scenario of financial distress. S&P Global acknowledges Pemex's critical role for the Mexican government in terms of revenues and also as a cornerstone for its energy policy.

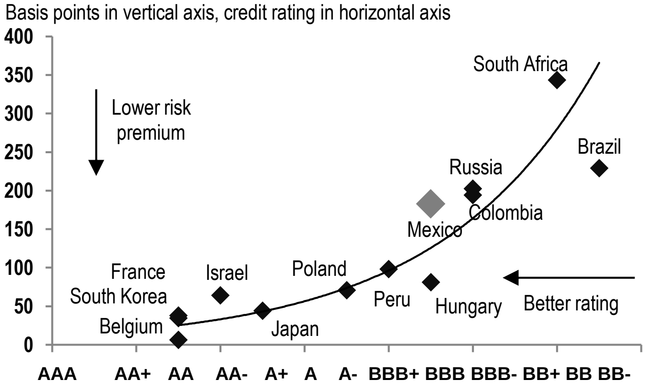
Standard procedure – Downgrade to CFE, financial institutions and corporates. After today's action and following standard procedure, we expect the agency to also downgrade CFE, along other financial institutions and Mexican corporates. We expect that, in coming days, the agency will announce several movements for the global scale rating of CFE, Mexican financial institutions and corporates. It is worth noting that, amid a sovereign rating action, the assessment of the most important companies in the country, including those considered as strategic, is standard procedure and does not necessarily reflect an issuers' financial downturn.

The first revision that we anticipate is to *Comisión Federal de Electricidad* (CFE). In this respect and similar to Pemex, the rating agency considers CFE ratings reflect the tight relation between the company and the government, so we expect a downgrade. Furthermore, the agency could assess the rating of financial institutions. In this respect and back in 2019, when the agency revised the sovereign outlook to 'negative' from 'stable', the number of institutions whose outlook was modified rose to 77, standing out *Nafin*, *Bancomext*, *Banobras*, *Infonavit*, *Fovissste*, *FEFA*, and the most important Mexican banks like *BBVA*, *Citibanamex*, *Banorte*, *Scotiabank* and *HSBC*. In the same way, we might be looking for a rating review for Mexican corporates rated on a global scale, including *América Móvil*, *Coca-Cola Femsa*, *El Puerto de Liverpool*, *Grupo México*, *Televisa* and *Kimberly Clark*.

Despite today´s downgrade, the market discounts that Mexico will remain an investment grade country for the next years, in line with our expectations. Local assets depicted a mild reaction following today's decision, as the downgrade was fully priced in by market participants. As observed below (left-hand side chart), Mexico's sovereign bonds are trading with a valuation similar to a 'BBB-' country. This phenomenon has occurred since the oil plunge of 2014-2016. The 5-year CDS is currently located 35bps above the fair value for a 'BBB' peer according to a simple regression considering several countries with different credit profiles and pricing of their sovereign bonds. Moreover, Mexico portrays a 102bps premium over Hungary despite having the same 'BBB' rating with S&P Global, but closer to Colombia and Russia which are labeled as 'BBB-'.

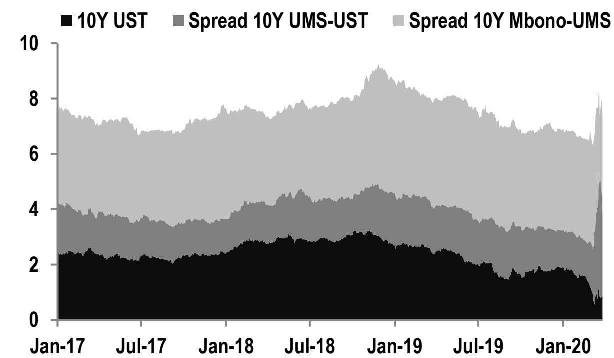
Global markets have suffered in recent weeks from a risk-off mood that has increased the premium embedded in almost every EM asset, as observed with the spread between peso-denominated and USD-denominated debt against the US Treasury (please see the RHS chart below). However, a relevant caveat from all this analysis is that Mexico's relative valuation remains unchanged at BBB-, in line with our thesis that the country will hold its investment grade status in the next years.

5-year CDS and S&P Global credit rating
Basis points in vertical axis, credit rating in horizontal axis



Source: Banorte with data from Bloomberg and S&P Global Ratings

Decomposition of Mexican risk premium (10-year)
Basis Points



Source: Banorte with data from Bloomberg

The Mexican government can avoid further downgrades. As it was aforementioned, today's downgrade came in accompanied by a 'negative' outlook. This is clearly a warning signal, that more downgrades could happen in the next 12 to 24 months. Nevertheless, in its communiqué, S&P Global mentioned a series of actions the Mexican government could undertake in order to avoid further rating downgrades. Such is the case of an "*...effective economic management that raises investor confidence, encourages private investment, and maintains moderate fiscal deficits…*", as well as measures to "*...contain the potential contingent liability posed by state-owned companies in the energy sector…*" and "*...broaden the non-oil tax base... (to) ...avoid an erosion of the sovereign's financial profile...*". Mexican president Lopez-Obrador has been fully committed with the country's healthy public finance. In this context, we do expect the Mexican government will pay attention to S&P Global's remarks and will keep the sovereign debt ratings well above the investment-grade threshold.

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We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Luis Leopoldo López Salinas, Jorge Antonio Izquierdo Lobato, Eridani Ruibal Ortega and Leslie Thalía Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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