Another sovereign debt rating downgrade, now to 'BBB-'

- **Today, *Fitch Ratings* cut Mexico's credit rating by one-notch to 'BBB-', from 'BBB', while maintaining the outlook 'stable'**
- **The agency's decision was driven by the expected impact to Mexico's GDP due to the COVID-19 pandemic, with the economy already in a weak spot and resulting in a much less favorable outlook for public finances going forward**
- ***Fitch Ratings*' action is consistent with our view of a risk premium that will remain elevated amid the complex global backdrop**
- **It should be noted that this comes after their recent revision of Pemex's rating further into 'High-yield' territory, to 'BB' from 'BB+', and should be followed by other relevant downward adjustments**
- **Despite today´s downgrade, as well as recent actions from other agencies, we still believe Mexico will remain an 'Investment Grade' country in coming years**

***Fitch 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', reaffirming the outlook at 'stable'. While the latter indicates the possibility of the rating remaining at its current level over the coming 12-24 months, this is not assured, as evidenced by today's action. Broadly speaking, the agency's revision was driven by the expected impact to Mexico's GDP due to the COVID-19 pandemic, with the economy already in a weak spot and resulting in a much less favorable outlook for public finances going forward. We should mention that this revision comes on top of the recent downgrade by *S&P Global*, which revised to 'BBB' from 'BBB+', with a 'negative' outlook. Meanwhile, *Moody's Investors Service* stands at 'A3' with a 'negative' outlook (see table below). Regarding the latter, we believe a downgrade will happen in the short-term, without ruling out the possibility of a two-notch cut considering that the agency's rating seems to be lagging. Despite of the latter, we maintain our view that Mexico will remain above the 'Investment Grade' threshold by at least two agencies during this administration, still supported by strong macroeconomic fundamentals, and despite unprecedented global and domestic headwinds.

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

Fitch Ratings	S&P Global Ratings	Moody's Investors Service
A-	A-	**A3 (Jun-5-2019)**
BBB+	BBB+	Baa1
BBB	**BBB (Mar-26-2020)**	Baa2
BBB- (Apr-15-2020)	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, Fitch Ratings and Moody's Investors Service

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COVID-19 to impact GDP, with Mexico already in a weak spot. The agency argued that, much as the rest of the world, the economic shock represented by the pandemic will lead to a severe recession in Mexico this year. Specifically, they expect the economy to contract *at least* 4% (Banorte: -3.5%), followed by a sequential recovery in the second half of 2020. Nevertheless, this is highly uncertain given the nature of the crisis, including its duration and ultimate impact. Thus, the balance of risks is firmly skewed to the downside.

In this backdrop, *Fitch Ratings* argued that the economy was already in a weak spot even before the crisis hit, stating that: "*...a recovery starting in 2H20 will likely be held back by the same factors that have hampered recent economic performance, which has lagged rating and income level peers...*". Specifically, *"...these include a previously noted deterioration in the business climate in certain sectors...*" along "*...a perceived erosion of institutional strength in the regulatory framework...*". Additionally, they said that "*...the factors that held back investment prior to the crisis, which in Fitch's view include relatively weak governance and ad hoc government policy interventions, are likely to persist...*".

Therefore, an eventual recovery would be dictated by prospects in the US, Mexico's main trading partner, with the USMCA agreement (to come into force at mid-year), relieving uncertainty that has prevailed since late 2016. It will also depend on the duration of the virus shock domestically. This also has downside risks, "*...as Mexico's official projections are based on a domestic lockdown lasting until early May, but this may be extended, or relaxed more gradually...".* On a more positive tone, the agency notes: (1) The credible monetary policy framework built around a flexible exchange rate, which will help absorb the external shock and minimize current account imbalances; and (2) long-standing strengths of public finances, including deep and developed capital markets.

Weaker growth, among other factors, will deteriorate fiscal accounts. Given their revised framework for GDP, the agency affirms that the outlook for public finances is much less favorable. They expect the general government deficit to widen by around 2.5pp of GDP, to 4.4% of GDP in 2020, higher than implied by the most recent budget review. This is projected even in without a debt-financed fiscal response to counteract the decline in activity due to the pandemic, with the government's response relatively limited when compared to other regions. As a result, *...general government debt/GDP is likely to jump by at least 6pp to almost 50%, the highest since the 1980s...*. Moreover, in the agency's opinion: "*...Consolidating public finances once the crisis is over and returning debt/GDP to a sustainable path will prove challenging...*".

Similar to growth, *Fitch Ratings* considers there are downside risks to fiscal accounts. Among them: (1) The possibility of higher expenditures than budgeted to combat the COVID-19 outbreak; and (2) a higher GDP contraction relative to the government's -2.9% forecast (mid-point), which could hurt revenues. Lastly, and despite Pemex's revision in June 2019 (see section below) had already accounted for the impact of the company's worsening financial position, they continue flagging this contingent liability as a key risk factor. Specifically, in light of more challenging conditions given "*...the sharp fall in oil prices and the widening discount of prices to global benchmarks...*", among other factors.

***Fitch Ratings*' action is consistent with our view of a risk premium that will remain elevated amid the complex global backdrop.** The 2Q20 has started with a breather from the sharp pressures experienced during March in mid- and long-term Mexican rates, with the Mbonos curve averaging a 29bps rally this month. As a result, the local risk premium approached by the spread between 10-year Mbonos and Treasuries trades at 630bps, from levels as high as 717bps in its most stressed phase the previous month, a mark not seen since 2008. However, *Fitch Ratings*' action is consistent with our view of a risk premium that will remain elevated amid the complex global backdrop, although with investors holding the expectation that the investment grade status will remain for Mexico going forward. In this sense, we expect short-term rates to depict a more defensive performance amid a steeper structure for the local yield curve. With respect to the FX market, the Mexican peso reacted to the announcement with a 1.3% depreciation to 24.30 per dollar in Asian trading hours. Also capturing our view of an elevated risk premium, we estimate a still volatile trajectory for USD/MXN in the coming weeks, with a short-term peak that will find support levels in the 25.00 area but could reach up to 26.50 during the quarter should a greater risk-off mode develops. We anticipate these dynamics to remain up until an inflection point in the global contagion rate occurs. Hence, we expect further actions from the Foreign Exchange Commission to support domestic liquidity conditions.

Standard Procedure – Downgrade to CFE and financial institutions. Based on *Fitch Ratings*' methodology and following standard procedure, we expect that, in coming days, the agency will announce several movements for the global scale rating of Comisión Federal de Electricidad and Mexican financial institutions. In this respect, we stand out Bancomext, Banobras, Nafin, Infonavit, IPAB and the main Mexican banks. However, for the first time Pemex's rating was downgraded before the sovereign on April 3rd, when they cut the Long-Term Issuer Default Ratings to 'BB' from 'BB+' and National Long-Term ratings to 'A(mex)' from 'AA(mex)', with 'negative' outlook. According to the agency, the action *"…reflects the continued deterioration of the company's stand-alone credit profile (SCP) to 'ccc-' amid the downturn in the global oil and gas industry, Fitch's lower oil price assumptions and the weakening credit linkage between Mexico and PEMEX…".*

We continue expecting Mexico to maintain its 'Investment Grade' status. While the outlook remains 'stable', it is not a sure thing that the rating agency will not revise it further down the road, as evidenced by today's action. However, it is still a better assurance than a 'negative' watch. This is especially relevant considering that the rating by this agency is now only one notch above the 'Investment Grade' status and is the second downgrade by *Fitch Ratings* in less than one year. As mentioned in the statement, some of the measures to bolster the rating include "*…improved investment and growth prospects underpinned by credible macroeconomic policies…*" and "*…declining government debt burden and reduction in contingent liability risks related to Pemex…*".

However, and also important, we highlight the call for an "*…improvement in governance indicators to a level closer to the rating category median…*", which is more related to corruption, insecurity and other ESG standards, and which in our view are longer-term structural issues. In this context, we believe that the Federal Government will undertake the necessary measures to prevent an additional downgrade from materializing. In particular, we see as positive that the administration remains firmly committed to maintaining healthy public finances, as well as making other relevant strides in corruption and security issues.

Analyst Certification

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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