GLOBAL
ECONOMY

12/18

Mexico is heading for volatile times

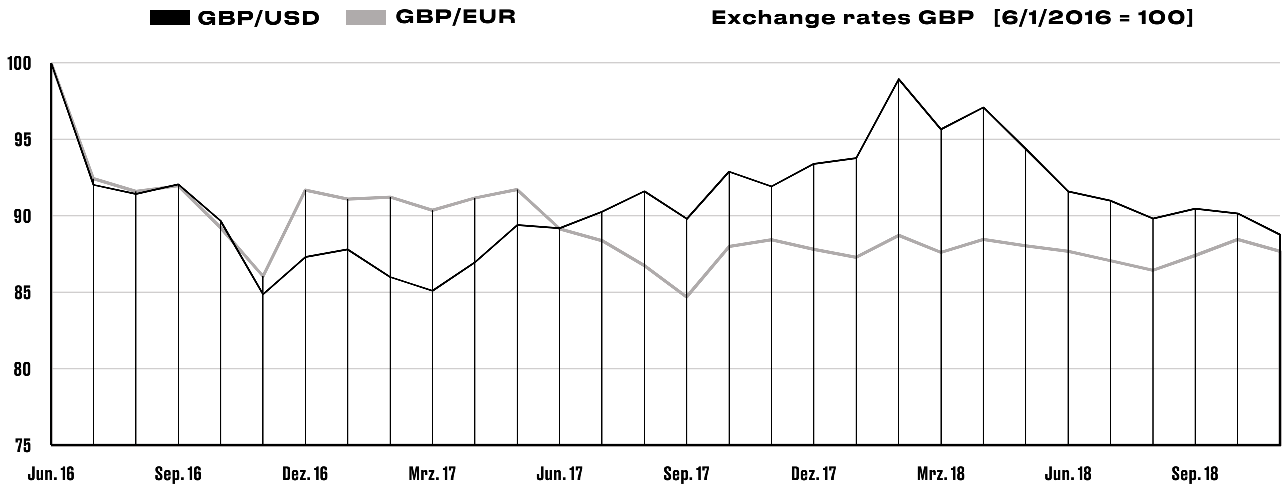
Corporate credit to be squeezed in 2019

J.S. Research

No-deal risk heightens with meaningful vote pulled by PM

It has become yet more volatile than anticipated by us, by contrast to so many other commentators even expecting Theresa May’s Brexit deal voted through by the House of Commons for lack of an alternative: Rather, the Prime Minister pulled the vote because her defeat was dead certain, and had to weather a leadership challenge. So what on earth happens next? And what will be the consequences? In the last, special issue of this report, we gave you a detailed analysis of the most likely path from here which outlined the still outsized risk of a no-deal scenario as well as the miniscule one of a second referendum or „People's Vote". Hold on, miniscule? Yes. For all the eventful sessions in the Commons between this and last Tuesday, we stick to our analysis that a People's Vote, although likelier than before, remains the outlier scenario in the weeks and months ahead. Granted, Labour inches ever closer to a second referendum, after the Shadow Chancellor called such a vote “inevitable" should it prove impossible to trigger a general election. That last point, however, is the first one why we doubt the prospect of another referendum: The last five days in the Commons have shown by just how much the Tories have alienated their Northern Irish ally, the DUP, propping up what is in effect a minority government. Its MPs were among those particularly furious at the Prime Minister for delaying Parliament’s vote on her Brexit deal, and the DUP's leader in the Commons, Nigel Dodds even said that his party would welcome a general election. In other words: It is increasingly likely that in a motion for no confidence in the government expected soon, the government might indeed lose (even though Mr Dodds hastened to add that the DUP had made its pact not with Theresa May or her government but with the Conservative Party) – making the way free for a snap election, because every other party but the Tories (yet not even all of them) will be voting for one. That is, even after surviving the leadership challenge, the Prime Minister is not yet safe. But for sheer lack of time, a potential new Prime Minister could not do anything other but table a motion to extend Art. 50. That, in turn, brings us back onto the path projected in November's special issue and the second reason for our scepticism about a People’s Vote: It is only after a general election and (!) a cross-party motion for the government (in reverse chronological order) to apply for an extension of Art. 50 in Brussels

Exchange rates GBP [6/1/2016 = 100]



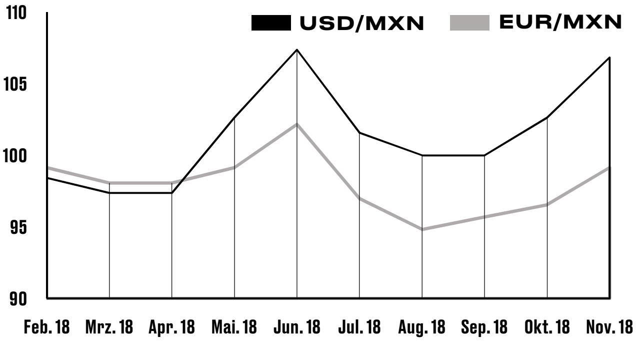
Data: comdirect

that a second referendum is conceivable. What, anyway, are the economic consequences to expect against this political turmoil? First and foremost, it is safe to say that uncertainty will prevail well into 2019, and possibly well into the late summer, too. Should Parliament vote for an application to extend Art. 50 which then is agreed by the EU, and should, after a general election, the new government indeed try to renegotiate the Brexit deal prior to holding a People's Vote, clarity is not going to show before the leaves will be falling again next year. The pivotal importance of an extension of Art. 50 as highlighted in the special issue thus comes to the fore again: Without it – or a temporary, unilateral revocation of Art. 50 by the UK as just confirmed by the European Court of Justice as another feasible route – all else is only of scholastic interest. Parliament cannot stop a no-deal Brexit on its own, because that is a legal certainty without anything other being agreed between the UK and the EU until 29 March 2019. And with the so-called meaningful vote by the Commons delayed to January, time becomes ever scarcer. Of course, the often mentioned "Plan B" of a Norway-style solution to the deadlock in Parliament would be the most business-friendly of options around. So what are its chances? Bad, we're afraid. That's because although a majority of MPs want to avoid a no-deal Brexit, all too many of them have been returned by constituencies heavily in favour of a Brexit nullifying freedom of movement, if anything. Any Norway-style option, however, would not only fly in the face of that mandate, but also stipulate that the UK continues to contribute into the EU's budget. The deadlock in Parliament is thus complete; and it's only by another general election that it might become disentangled.

A grounded airport tells the tale of growing uncertainty in Mexico

It was yet another of the political upsets of those past years: In his third attempt, the firebrand of the Mexican left, Andrés Manuel López Obrador was elected President by a landslide on July 1st this year. To be sure, "AMLO" is no second Hugo Chávez, nor is he implacably anti-American. As mayor of Mexico City (2000-5), one of Latin America's largest urban conglomerations, he got along well with business and investors, building roads and running a relatively efficient administration. And in his recent presidential campaign, he dropped his long-time opposition against the country's liberalisation of its energy sector in 2014. That said, the former mayor finally winning the office of President after twelve years of perpetual running is keen on implementing his leftist agenda. His proclivity to scorn separation of powers and the rule of

Exchange rate Mexican Peso (monthly av., Jan 18 = 100)



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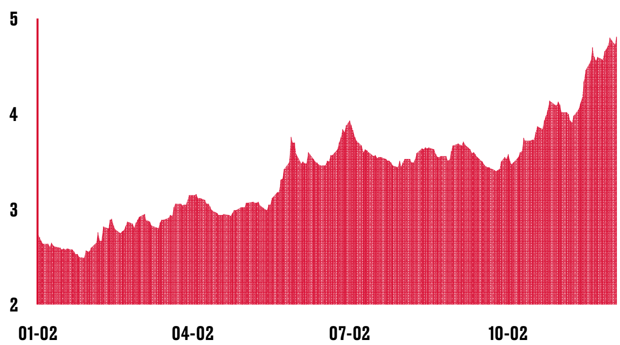
law remains a disconcerting trait, and his open contempt for institutions threatens to stymie his efforts to „eliminate" corruption: Mr Obrador has promised to govern largely by referendums, thus bypassing the constitutional order. It helps that his party Morena, a creature of his own making much like Emmanuel Macron's En Marche, has won a majority in both chambers of Congress. The first of those referendums has been held already, and promptly added to investors' concerns about this interventionist President: In a ballot attracting a mere one per cent of the electorate, the new airport for Mexico City already completed by a third was rejected, and AMLO promptly announced to terminate it. That spells difficulty for financing Mr Obrador's own ambitious infrastructure projects, with investors wary that history might well repeat itself, and the Peso thus tanking (see chart). Among those projects are, for example, two new refineries (whittled down to one) to boost the country's share in the value chain of crude oil. Both the refinery and most of the other infrastructure projects, though, will also be subject to approval by referendum. Even less promising are manipulative schemes such as that for "food self-sufficiency" aiming to provide for price guarantees for crops produced by farmers in the largely rural (and hence relatively poorer) South. Perhaps one of the most important aspects of Mr Obrador's tenure will be his maintaining (rather than obliterating) relations with President Trump and thus the

United States, Mexico's most important trade partner. As stated already, AMLO is not a confessed Yankee basher, but rather an introverted populist driven very much by his domestic agenda. That should take the dynamite from an alpha-male relationship which otherwise would certainly be heading to some major fireworks; indeed Mr. Obrador has already indicated his willingness to get along with the US President. And as much as it has been criticised strong-arming American trade partners into a lopsided revision of NAFTA, the USMCA accord has minted a new framework for trade between the US and Mexico already (provided it will be ratified by parliaments on both sides of the Rio Grande). Investors remain yet to be convinced – too big has been the shock over the haphazard termination of the airport project 'legitimated' by a bogus referendum, a feat that many expect to be repeated in the years ahead. Uncertainty for both Mexican as well as international businesses hence is rising, even if Mr Obrador presents a solid budget in a few days' time and stands by his announcement not to cancel licences of foreign oil companies. Watch this experiment of governing by referendum closely, for Mexico yet lacks the strong institutions needed to rein in if that should become necessary.

Corporate credit in Europe to become dearer in 2019 despite low interest rates

As markets in general have slid into turmoil since "Red October", a specific area of finance with widespread ramifications gets hit badly, too: The market for corporate debt, and in particular that in the eurozone. Even before the sell-offs in recent weeks, corporate bond spreads in investment grade paper, too, had been being on the rise, and have accelerated doing so. In other words: Even big corporations have to pay investors ever more to sell their debt, let alone smaller companies below the investment grade part of the market (see chart), though the ECB is as far away from raising rates as ever. One part of the explanation is the late stage in the credit cycle: With the Fed having begun to tighten monetary conditions and after a huge wave of corporate debt sold in times of ultra-low yields, credit markets have seen their apex. In the US, the Fed will, by all likelihood, continue to raise rates, if at somewhat decreased speed (cf. related post in section "Economic Ticker" on our website). In the Eurozone, it's not so much rising rates still in the distant future, but the looming end of the ECB's bond buying. Relevant to corporate credit in particular is the discontinuation of the ECB's related scheme, its so-called Corporate Sector Purchase Programme (CSPP). Under the CSPP, the central bank has bought some €175bn of investment grade corporate paper since 2016; in total, the ECB holds roughly a fifth of all outstanding corporate debt in the euro area. From the turn of the year, only maturing bonds will be replaced, with the policy eventually tapering out completely. Thus, at a critical time when demand for corporate debt has become subdued anyway, one of the most reliable buyers will be leaving the market: With the ECB often the least squeamish of bidders in new bond sales, financing cost for corporate issuers will go up markedly next year – and we're talking investment grade paper. The outlook for the rest of the market, hence, is even bleaker. That development inevitably will feed through to debt financing costs for companies big and small, when banks start to raise collateral and/or rates for business lending since their own refinancing via new bond sales will become dearer. Thus, even without the ECB actually starting to raise interest rates, debt financing is going to become dearer for European businesses – another warning sign that economic activity stands to slow in the months ahead. At the same time, equity financing will be difficult, too, with regard to market volatility having shot up and, in our view, more likely than not to persist that way. It's almost the classic description of the turning point in the Keynesian business cycle (yes, the man had many more impressive ideas than just deficit spending) when businesses' financing cost starts to rise while the expected returns from new investment deteriorate: Talk of an imminent recession, hence, is not so far off

Euro corporate high yield spread



Data: BofAML Euro High Yield Index (option adjusted), bloomberg the mark as many analysts and economists declare. And there's the potential even for yet another debt crisis: In the US, first trading firms, analysts and brokers have begun talking about a huge corporate credit bubble only waiting to burst, should fixed income markets unravel in a frenzy while the Fed keeps raising rates. If that were to happen, not only the financing of new projects would dry up, but existing debt would once again weigh heavily on corporate balance sheets. This time round, though, it wouldn't be so much banks but all the other industries affected most. Prepare for a rough ride in 2019.

Statistical Bulletin

Services PMI (Nov., pts.)

Sweden: 62.2 ↑ For all its current, unusual political uncertainty, the Swedish economy remains in boom mode - not least because, just as we'd been expecting her to do (see issue 12/17 of this report), the Riksbank has maintained its ultra-loose monetary policy as of yet.

Italy: 50.3 → Even though rising back over the neutral 50-points line, Italy's services sector just as its whole economy have got rattled by the populist government's deliberate stand-off with the EU. As long as that isn't resolved, it's hard to see economic sentiment improving any time soon.

Consumer spending (Q3, q/q, real, loc. currency)

Canada: +7.2% ↑ Canada's consumers keep spending like mad – and even with increasing speed by now. The shopping spree, however, rests on feet of clay as Canadian households have been binging on debt for quite a while (see issue 6/18 of this report).

Hong Kong: -3.1% ↓ Hong Kongers have been retrenching their outlays of late, not least due to the rising unease about the former colony's civil rights situation, with Chinese authorities increasingly interfering.

Composite PMI (pts.)

New Zealand: 54.50 ↑ New Zealand ranks at the top of Commonwealth economic growth leaders again. Though small and rather dependent on its agricultural exports, the economy's business confidence levels have recovered from their election-induced shock when the first Labour government in many years came to power last year.

Italy: 49.30 ↓ This is where the level of anxiety among Italian businesses still shows. Though the services sector might be in relatively decent shape, economic sentiment in general remains very subdued.

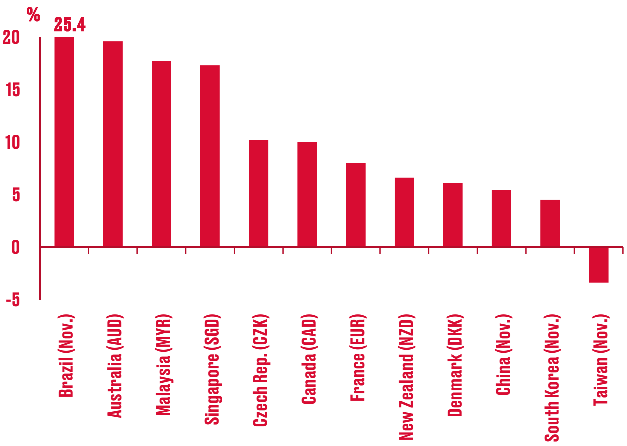
Capital flows

Brazil (Oct.): +USD453.3m → Capital flows into Brazil have been keeping their decent levels of late, not least due to the election victory of President Bolsonaro expected to be more business-friendly than his predecessors. As of now, however, inflows are relatively muted compared to the halcyon days of the BRICS frenzy.

China (Q3): -USD16bn ↓ Capital flows out of China are one of those warning indicators flashing amber right now. Even though the magnitude is still not disconcerting, the trend is clearly negative – and will remain so outside of an agreement in the Sino-American trade war.

Exports (Oct., y/y, nom., USD)

Brazil, too, is currently leading the pack in terms of exports growth. Expanding by a full 25+%, the country's selling to the world is recovering from its troughs. Australia and Malaysia also sport very healthy figures, demonstrating that the reverberations of the trade spat between China and the US have yet to show in most countries. Taiwan, though, appears to be a first victim, being the only industrialised exporter globally with a sizeable contraction of its products, which more often than not are inputs to Chinese manufacturers. China itself ranks among the tail of the list, though still positive.



Data: Trading Economics, bloomberg, comdirect, own calculations

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