FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Mexico at 'BBB-'; Outlook Stable

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Fitch Ratings - New York - 17 May 2021: Fitch Ratings has affirmed Mexico's long-term foreign- and local- currency Issuer Default Ratings (IDRs) at 'BBB-' with a Stable Outlook.

Mexico's rating is supported by a consistent macroeconomic policy framework, relatively stable and robust external finances, and government debt/GDP projected at levels slightly below the 'BBB' median. The rating is constrained by relatively weak governance, muted long-term growth performance and the implications for the federal government's own finances from its strategy of alleviating Pemex's tax burden. The Stable Outlook is supported by the relatively strong performance of public finances, notwithstanding medium-term challenges. This supports our assessment of macro policy credibility as a rating strength and backstop to private sector confidence despite some microeconomic policy and governance risks.

KEY RATING DRIVERS

Mexico's economy contracted by more in 2020 than the regional average of 7%, and the public health impact of the pandemic has been severe. Cases are currently declining, and the vaccination program is making progress. Nevertheless, Mexico's public finances have outperformed its peers, recording relatively smaller deficits and a more limited rise in the government debt/GDP ratio. The main reason for this relative resilience was the smaller direct fiscal response to the COVID-19 shock in 2020 at 0.7% of GDP above the line (with a further 1.2% of GDP below the line); this may have contributed to the fourth deepest contraction in private consumption among 20 large economies. Tax revenues also outperformed expectations by increasing in real terms, in contrast to previous recessions. Mexico is unusual in adhering to its fiscal rules through the pandemic.

The 2021 budget maintains a tight fiscal stance with overall spending growth of 4.3% in nominal terms compared with 2020 actual spending. The non-financial public sector (NFPS) balance target is -3.3% of GDP. The general government (GG) deficit approximation used by Fitch for comparison purposes and in its sovereign rating model was 2.4% of GDP in 2020, up from 1.8% of GDP in 2019. GG debt (which excludes Pemex but includes debts of the states) reached 49% of GDP, compared with the rating peer median of 54.4%. We expect a slight widening in the general government deficit to 2.8% of GDP in 2021 as some one-off sources of revenue including drawdowns from reserve funds, which are counted as non-tax revenue, will not recur (or be needed) in 2021. In 2022, tax changes are expected to deliver an increase in revenues; Fitch assumes that federal government revenues will rise by 0.5pp of GDP.

The debt of state oil company Pemex is equivalent to 9% of GDP, and Fitch views it as a contingent liability of the sovereign. Fitch assumes government support for Pemex of around 0.5% of GDP per year, on top of recent tax cuts that are likely to be made permanent. The government will support the company to the tune of MXN236bn (1% of GDP) in 2021, slightly higher than in previous years. Support comprises a tax credit that is equivalent to a cut to 40% from 58% in the rate of the DUC (profit-sharing tax) announced in February, a similar amount to help repay debt (allowing it to meet the bulk of its USD6 billion in external debt amortizations in 2021), and the remainder in capital injections to finance the Dos Bocas oil refinery. Direct tax revenue from Pemex is projected at 1.5% of GDP in 2021.

Fitch expects the economy to grow by 5% in 2021, with much of the year on year growth coming in Q2. Domestic reopening and strong US demand are the main drivers. The U.S. is the market for three quarters of exports and the main source of remittances. Real GDP grew 0.4% qoq in 1Q21, slightly better than expected given the impact of a spike in COVID-19 cases, and supply disruptions to energy and manufacturing. This comes after a contraction of 8.2% in 2020. We expect growth to fall to 2.7% in 2022, before moderating to around 2% p.a. over the medium term.

Fitch believes the monetary policy rate cutting cycle is over. Banxico's board held the policy rate at 4% at its meeting on May 13, 2021. Inflation reached 6.08% year on year in April, against a low base of comparison (prices fell by 1% month on month in April 2020), and driven by non-core items. Even without further exceptional price pressures, both average and end-year inflation will exceed 4% in 2021, and possibly reach 5%, but will trend down towards the target in 2Q22. Medium-term inflation expectations are within the target range of 3% +/- 1%.

Potential growth is relatively low and once economic slack narrows, prospects depend on how convincingly investment recovers from the COVID-19 shock and the typical contraction observed in the first year of the presidential administration. Greater certainty on trade with the U.S. following the signing of USMCA, a lower drag from the oil sector and the trend of near-shoring are growth-supportive factors.

However, in Fitch's view, a pattern of intervention by the government in markets and some regulatory bodies, coupled with controversial reform proposals could discourage investment, exerting a drag on growth potential. In many cases such proposals (such as changes to the Bank of Mexico law, or changes to the law regulating labor outsourcing) have been either modified after consultations with the private sector before becoming law or have been suspended by the courts. Regulatory quality, one of the six pillars of the World Bank Governance Indicators (WBGI), could be affected, potentially weakening the WBGI score in our Sovereign Rating Model.

The most recent changes affect the energy sector, where the state controls the former monopoly providers Pemex and CFE. Congress recently passed the Electricity Industry Law that changes the rules to prioritize the dispatch of power to the grid from thermal generators owned by the former state monopoly CFE. The law was suspended by the courts in March on a general basis as unconstitutional. A Hydrocarbons Law reform that would allow the government to suspend licenses given to private sector investors in oil and gas in certain circumstances was approved by the lower house but relevant articles of the law were similarly suspended.

Mid-term elections to Congress on June 6 could change the balance of power, causing the governing Morena party and allies to lose their two-thirds majority in the lower house, which would make it more difficult to approve constitutional changes. However, it might still be possible to approve changes in Congress (these also require ratification by a majority of state legislatures). An alternative referendum route exists for approving constitutional reforms, but reforms affecting government revenue and spending are not be eligible. A recall referendum on President Lopez Obrador's continuation in office may be held in 1H22.

Feedback

ESG - Governance: Mexico has an ESG Relevance Score (RS) of '5' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Mexico has a medium WBGI ranking in the 36th percentile, reflecting a recent track record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a moderate level of corruption.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Macro: Improvement in growth prospects to a level closer to the BBB median, underpinned by credible macroeconomic policies;

--Structural: Improvement in governance indicators to a level closer to the rating category median.

--Public Finances: Addressing weaknesses in public finances via revenue-enhancing reforms that would increase confidence in a stable or declining government debt path, and a reduction in contingent liability risks related to Pemex.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Macro: A weakening in the consistency and credibility of the macroeconomic policy framework, for example if unorthodox policy interventions become more widespread, negatively affecting growth prospects and/or leading to a reassessment of the upward notching in our rating adjustment for this factor;

--Public Finances: A trend increase in the government debt burden, evidenced by an upward trajectory in the gross general government debt/GDP ratio;

--Structural: Deterioration in governance indicators that widens the gap further to the scores of 'BBB' category peers and further undermines the business climate.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Mexico a score equivalent to a rating of 'BBB-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Macro: +1 notch, to reflect Mexico's track record under successive administrations of prudent, credible and consistent macroeconomic policies. The authorities continue to emphasize macroeconomic stability in both fiscal and monetary policy, which has contained macroeconomic imbalances. The long-term sustainability of this +1 notch adjustment could be threatened by a prolonged pattern of microeconomic interventions by the government, potentially weakening governance quality and impacting macroeconomic outturns.

- Public Finances: -1 notch, to reflect our expectation that ongoing sovereign support for Pemex will result in a lower tax take and/or higher general government debt burden, negatively impacting public finances.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

KEY ASSUMPTIONS

Fitch assumes that the global economy will perform in line with the forecast in its March 2021 Global Economic Outlook (GEO). Fitch has revised its forecasts for Mexico since publishing the GEO.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Mexico has an ESG Relevance Score of '5' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight.

Mexico has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight.

Mexico has an ESG Relevance Score of '4' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver.

Mexico has an ESG Relevance Score of '4' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Mexico, as for all sovereigns.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Mexico	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
•	ST IDR	F3	Affirmed	F3
•	LC LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
•	LC ST IDR	F3	Affirmed	F3
•	Country Ceiling	BBB+	Affirmed	BBB+
• senior	LT	BBB-	Affirmed	BBB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Sovereigns Latin America Mexico

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