



Monthly perspective | September 18, 2018

Will emerging market cycle affect Mexico?

SUMMARY

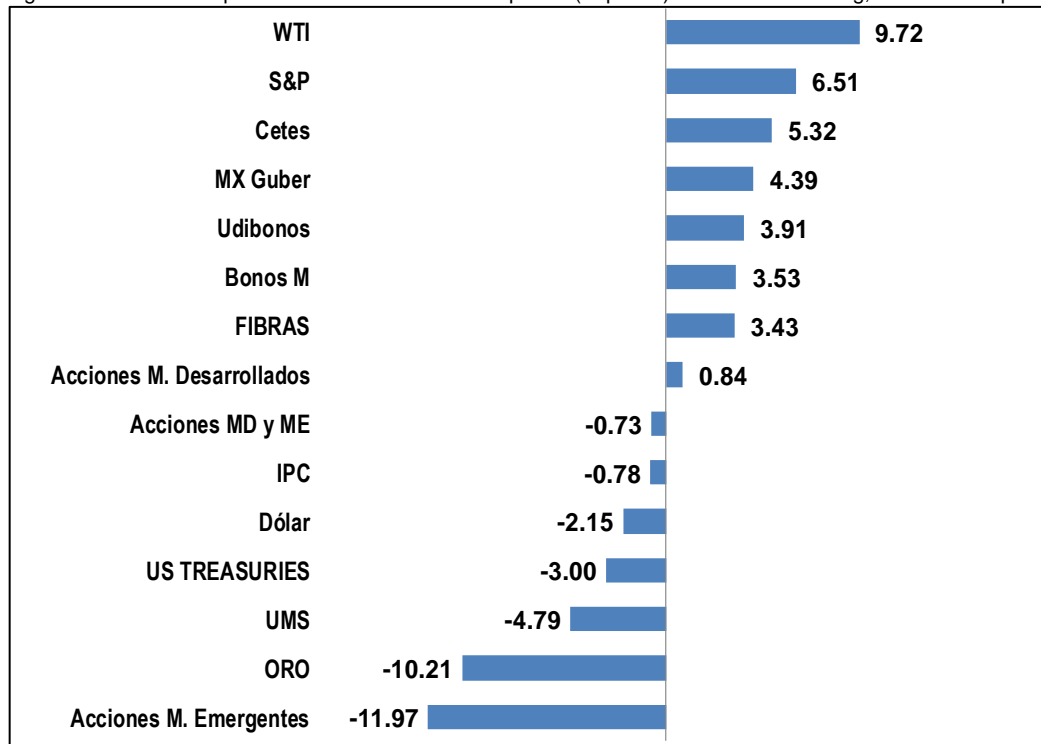
- Globally, investments affected by rate hikes, trade disputes, and emerging markets (EM) contagion.
- In Mexico, investments positively affected by US trade agreement, negatively by Canada exclusion and negotiations. Transition: still mixed signals.
- Global risks: US economic cycle, trade disputes, Europe, geopolitics, EM, monetary policy, cryptocurrencies.
- Local risks: negative NAFTA, negative transition
- Investment scenarios 2018, with probabilities: positive (30%), negative (30%), middle (40%).

“Having spent 10 years studying emerging markets, I know that you have patterns repeated over and over again” — Nouriel Roubini

Emerging markets: vulnerabilities exposed

Globally, rate hikes and trade disputes continue, generating uncertainty about growth. EM suffering owing to external and internal factors. In Mexico, optimism about a bilateral trade agreement with the US was clouded by uncertainty about whether Canada could be included in a renovated NAFTA. A new question was whether a new negative emerging markets cycle was beginning, possibly affecting Mexico.

Figure 1. Investments: performance 31Dec2017- 7Sep2018 (% pesos). Source: Bloomberg, Franklin Templeton



POLITICS

US

Bilateral deal or NAFTA with Canada?

On August 27, President Trump announced a bilateral trade agreement with Mexico, giving Canada a deadline until August 31 to join the agreement. On August 31, Trump notified Congress of a bilateral agreement and has 30 more days to deliver the final text (October 1 at the latest). The same date would apply if Canada joined the agreement. The goal of the US Congress is to review and approve the agreement before December 1, when President-elect Andres Manuel Lopez Obrador (AMLO) takes office.

The bilateral agreement establishes that in order to remain tariff free, 75% of vehicle content should be manufactured in the region (currently 62.5% vs. US initial proposal of 85%), and at least 40% with workers earning more than US\$16 per hour for cars and 45% for vans. After the partial watering-down of the original US proposals, it is estimated that 30% of Mexican vehicle exports would not comply with the new rules. Noncompliant companies would pay a 2.5% tariff under the most favored nation clause. The “sunset” clause which would have terminated the agreement automatically every 5 years was watered down to a 16 year term, to be reviewed every 6 years.

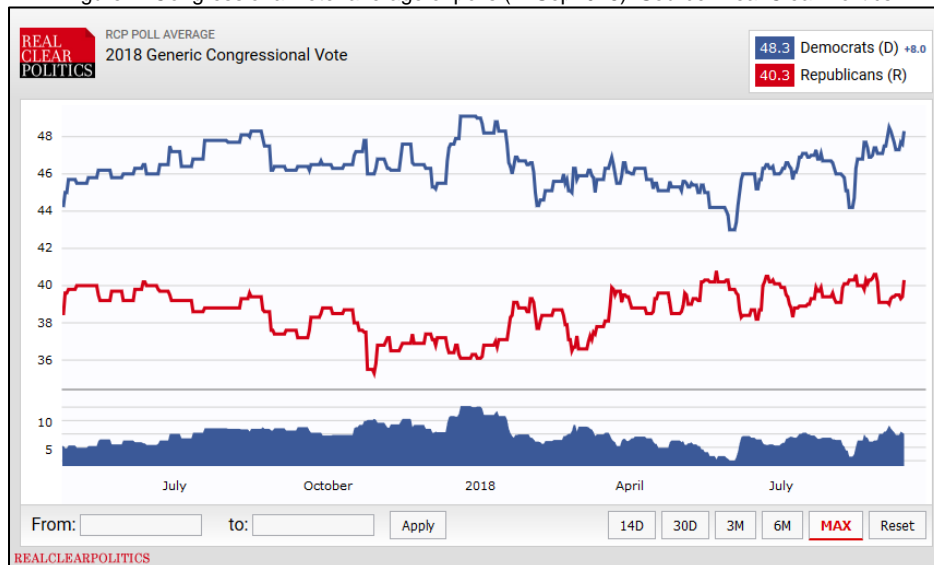
Mexican economy minister Ildefonso Guajardo said that he had signed a sideletter to the bilateral agreement, where all existing and future tariffs, like on steel and aluminum, would be eliminated. This letter would also protect the auto sector in the future, beyond rules of origin. If it is not agreed, auto companies would be subject to tariffs up to 25%, under section 232 of the US National Security Law.

After the bilateral agreement was announced, Chrystia Freeland, Canadian Foreign Minister, announced she would travel to Washington on September 4 to continue negotiations. Justin Trudeau, Canadian Prime Minister, said that, unlike Mexico, he would prefer not to join the agreement than sign a bad agreement. The biggest differences between Canada and the US are in the US pharmaceutical industry and chapter 19 of the current NAFTA covering dispute settlement, which Mexico agreed to eliminate in the bilateral agreement, but which Canada considers indispensable. Another problem is that Congress only approved that Trump negotiate a trilateral agreement, not a bilateral agreement, and it is not clear whether either the US Congress or the Mexican Congress will approve an agreement without Canada. In the case of no agreement, it is possible that NAFTA could continue in force, or that Trump, as President could unilaterally cancel US participation.

US: mid-term elections

On November 6, mid-term elections will renew 100% the House of Representatives (435 seats) and one third of the Senate (100 seats). According to current polls (Figure 2), it is probable that Republicans will lose control of both Houses. Ex-President Obama has announced he will campaign for some Democratic candidates.

Figure 2. Congressional vote: average of polls (12Sep2018). Source: Real Clear Politics



China: trade dispute heats up

On September 5, Trump met with Republican leaders in the White House to discuss a new tariff package for China, valued at US\$200bn. This would be the third package implemented in 2018 in addition to the US\$50bn. already implemented. While the first two packages targeted industrial goods, this package is targeted at consumer goods. Chinese Ministry spokesman Gao Feng announced that China has ready “quantitative and qualitative” reprisals, worth US\$60bn. On September 6, Trump threatened that he had US\$267bn. worth of tariffs that could be applied at any moment. Despite Trump’s efforts to reduce the bilateral trade deficit with China, YTD it has increased 7% in goods and services. While the US government has not yet applied the tariffs and invited China to continue the dialogue, Trump has said that “there is no hurry” in reaching a trade agreement with China.

North Korea: denuclearization timetable

Between September 18 and 20, Kim Jong Un, North Korean President, and, Moon Jae-in, South Korean President will meet to establish a timetable and define “practical measures” to denuclearize the peninsula.

MEXICO

Politics

Morena obtains absolute majority in Congress

Senator Manuel Velasco asked permission from Congress to finish his period as governor of the state of Chiapas, and was supported by Morena party members. In reply, 5 members of his Green Ecological Party (PVEM) switched to Morena. Following this switch, Morena has obtained an absolute majority in Congress (Figure 3).

Figure 3. Congress: composition by party and type of election. Source: Chamber of Deputies

G.P.	M.R.	%	1a.	2a.	3a.	4a.	5a.	R.P.	%	Total	%
MORENA	165	65.0	17	13	21	20	18	89	35.0	254	50.8
PAN	40	50.6	8	13	6	6	6	39	49.4	79	15.8
PRI	9	19.1	8	9	7	6	8	38	80.9	47	9.4
PES	30	100.0	0	0	0	0	0	0	0.0	30	6.0
PT	26	89.7	0	0	1	1	1	3	10.3	29	5.8
MC	17	60.7	5	1	1	2	2	11	39.3	28	5.6
PRD	9	45.0	1	2	2	3	3	11	55.0	20	4.0
PVEM	4	36.4	1	2	1	1	2	7	63.6	11	2.2
SP	0	0.0	0	0	1	1	0	2	100.0	2	0.4
TOTAL	300	60	40	40	40	40	40	200	40	500	100

Datos al: 05/09/2018

Hidalgo state: removal of powers

On September 3, the new legislature in the state of Hidalgo took office. PRI member María Luisa Pérez Perusquía was reelected as President of the governing body which controls the state’s Budget. This was made possible because the previous legislature, with a PRI majority, reformed at the last minute the Organic Law of Legislative Power, despite the majority win of Morena in the elections. Morena members objected and prevented the Hidalgo Congress from starting work. Morena members have asked Ricardo Monreal, coordinator of their national congressional group, to formally request the removal of executive, legislative and judicial powers at state level.

Morena fine from INE

On July 18, the National Electoral Institute (INE) announced a fine on Morena of \$197 mn. pesos due to irregularities in the operation of a trust for victims of the September 19, 2017 earthquakes, the heaviest fine in history. On September 1, the Electoral Tribunal of the Judicial Power of the Federation (TEPJF) revoked the fine on the basis that INE could not demonstrate that public funds were used, and that INE had violated the right to a hearing of the technical committee of the trust.

Last presidential report of sexenio

On September 3, President Enrique Peña Nieto presented the sixth and last report of his administration (*sexenio*). He featured among his economic achievements: 1) Remittances grew 35% during his administration, 2) Annual growth averaged 2.5%, 1% higher than Latin America, 3) In 2017 exports reached a historic high of US\$409bn., 4) 3.7 mn. formal jobs were created, and 5) annual inflation averaged 4%, lowest of any administration in 48 years.

Transition*Three basic documents*

In our previous Perspective we described the three documents which set the main objectives of the new government: 12 legislative priorities, 50 general guidelines to fight corruption and apply a policy of “republican austerity” and 25 priority economic projects. In this Perspective, we provide an update on advances in some projects.

New airport

One of the biggest promises of the AMLO campaign was the cancellation of the construction of the new Mexico City airport (Nuevo Aeropuerto de la Ciudad de México - NAICM). On August 17, AMLO announced that the final decision would be taken through a “citizens’ consultation” (referendum) which will be held on October 28. In preparation, AMLO asked for the opinion of three professional bodies (Unión Mexicana de Asociaciones de Ingenieros, Colegio de Ingenieros Civiles de México, Academia de Ingeniería de México). All recommended that construction should continue, as it has already progressed 32% (approximately \$100 bn. pesos), that risks of corruption should be corrected and that a major Investment in maintenance would be required due to possible subsidence in the runways. If construction continues, the NAICM would be financed 10% from government investment (\$28bn. pesos), 90% private investment (\$10.75bn. from airport taxes, \$32.25bn. through a FIBRA E issue and \$65bn. from the sale of the land of the current airport).

Maya railway

On December 1, a request for bids will be published for the Mayan railway (Tren Maya), the first with mixed public-private investment. Currently the government owns rights of way for a railway from Palenque to Valladolid, which will be extended from 900 to 1,500km, passing through the states of Yucatán and Campeche. The project is estimated to cost between \$120-150bn. pesos, partially through the tourism tax estimated at \$7bn. annual.

New refinery

AMLO announced that in the first 3 years of his administration a new refinery will be constructed in Dos Bocas, Tabasco (his home state), with a capacity of 400,000 bbl./day at a cost of approximately US\$8bn. 6 Pemex refineries will also be refurbished which operate at 40% capacity. The future Minister of Energy, Rocío Nahle, has stated that the investments will be included in the 2019 budget, without giving details. Moody’s said that the new refinery could affect Mexico’s sovereign rating, and Pemex, owing to higher debt.

2019 Budget

Doubts have been expressed on whether the 2019 budget can cover so many projects. The new federal government should present its final budget by December 15. At the state level, budgets should be presented to local Congresses by November 15, with no more details provided. Some projects, such as the Maya railway and the new refinery will be included in the budget. No further details have been revealed.

Transition: considerations

Previously, we have determined 5 key parameters to monitor the campaign and post-electoral promises of AMLO: leadership style and performance, Morena, macroeconomy, microeconomy and the so-called “Fourth Transformation” (Monthly Perspective August 2018). Uncertainty in relation to these parameters has not decreased, and is reflected in our above political (Morena, INE and Hidalgo) and economic (the 3 projects) commentary.

ECONOMY**GLOBAL****Growth**

Globally, growth is expected to slow in 2019 and 2020. For EM, higher growth is expected, but lower than before (Figure 4).

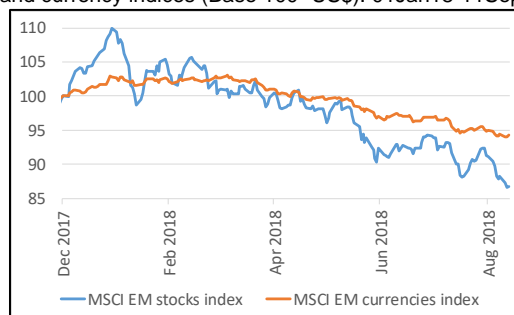
Figure 4. DM and EM: estimated growth 2018- 2020 (11Sep2018) Source: Bloomberg

Developed markets				Emerging markets			
Growth(%)	2020 E			Growth(%)	2020 E		
	2020 E	2019 E	2018 E		2020 E	2019 E	2018 E
World	3.25	3.60	3.70	World	3.25	3.60	3.70
Developed	1.81	2.12	2.40	Emerging	5.05	5.01	4.75
US	1.94	2.50	2.90	China	6.10	6.30	6.60
Euro Area	1.60	1.80	2.10	India	7.50	7.40	6.60
Japan	0.55	1.00	1.00	Rusia	1.65	1.60	1.80
Britain	1.65	1.50	1.30	Brasil	2.50	2.49	1.60
Australia	2.70	2.80	2.90	México	2.15	2.30	2.30
Canada	1.70	1.90	2.00	Corea del sur	2.55	2.70	2.80
Germany	1.60	1.80	2.00	Indonesia	5.40	5.30	5.20
France	1.60	1.73	1.80	Turquia	3.50	2.02	4.10

EM: has the cycle returned?

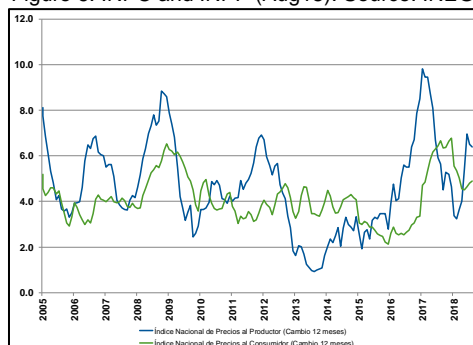
Since the Fed announced its intention to raise rates this year, and Trump introduced an aggressive trade policy, pressure has been felt in EM (Figure 5). The first affected have been those with poor economic fundamentals and political problems. Major examples so far are Argentina, with 30% inflation and GDP decline estimated for 2018 at -2.4%, Turkey, which after trade disagreements with the US has seen a lira depreciation of 75% YTD and a stock market fall of 20%, and South Africa, where the stock market has fallen 26% in US\$ and a recession has begun. There have been several successive months of negative flows to EM. This is normal for the cycle of rising interest rates in DM, and there is the issue of whether this could also affect Mexico, should its economic and political fundamentals deteriorate with the incoming government.

Figure 5. EM: stocks and currency indices (Base 100- US\$). 01Jan18-11Sep18 Source: Bloomberg

**MEXICO****Inflation**

In August, 12-month inflation reached 4.90% (4.81% July) and producer inflation fell from 6.51% to 6.38%. We expect that after the change of inflation calculation in August, inflation will be slightly more volatile (Figure 5).

Figure 6. INPC and INPP (Aug18). Source: INEGI



RISKS AND SCENARIOS 2018

We present 3 investment scenarios for 2018, where the objective is Mexican economic growth. In the positive scenario, all the risks turn favorable for Mexican growth in the negative, unfavorable, and in the middle, mixed (by nature, intensity, and/or duration).

RISKS

Global

- USA failure of progrowth initiatives, trade wars
- North America: NAFTA renegotiation.
- Geopolitics: Europe, Middle East, Russia, China, North Korea
- EM: crises and contagion
- Global slowdown, monetary policy
- Bitcoin

Mexico

- Transition 2018
- Security
- Corruption
- Oil price
- Debt increase: debt rating

SCENARIOS

Positive (30%)

- USA: tax reduction, deregulation, infrastructure Investment, no trade wars.
- NAFTA renegotiation in 2018: "win-win".
- Europe, China, Russia, Korea and Middle East: risks do not materialize.
- Synchronized global growth and successful monetary policy.
- EM: no crises or contagion.
- Bitcoin: crash does not affect economy.
- Mexico: positive transition.

Negative (30%)

- USA: pro-growth measures fail, trade wars.
- NAFTA renegotiation fails.
- UK and EU collapse, risks in China, Russia, Korea and Middle East materialize.
- Global slowdown owing to politics, economics, or monetary policy.
- EM: crises and contagion.
- Bitcoin: crash affects economy.
- Mexico: negative transition.

Middle (40%)

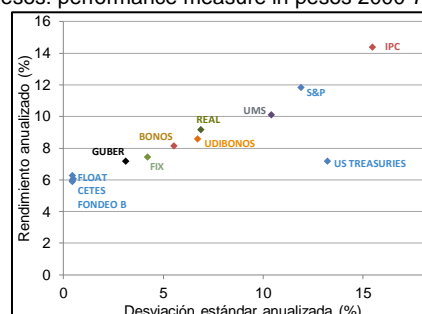
- USA: pro-growth measures work partially, some tariffs.
- NAFTA renegotiation with mixed results.
- Europe, China, Russia, Korea, Middle East; some risks materialize.
- Global growth continues, but less synchronized than 2017: monetary policy with varied success.
- EM: crises and contagion for some countries
- Bitcoin: crash affects economy partially.
- México: uncertain transition.

MARKETS

Investments in US\$ and pesos: comparative performance

Despite peso depreciation, long term (2000-2018) peso denominated investments have outperformed investments denominated in US\$, converted to pesos (Figure 7).

Figure 7. Investments in US\$ and pesos: performance measure in pesos 2000-7Sep2018. Source: Franklin Templeton



The US\$ and peso

The US\$ is stronger due the possibility of more hikes by the Fed, which has caused more outflows from EM. Peso volatility is increasing owing changing news on NAFTA negotiations and the transition process (Figures 8 and 9).

Figure 8. Index US\$ and peso 2005-7Sep2018. Source: Bloomberg

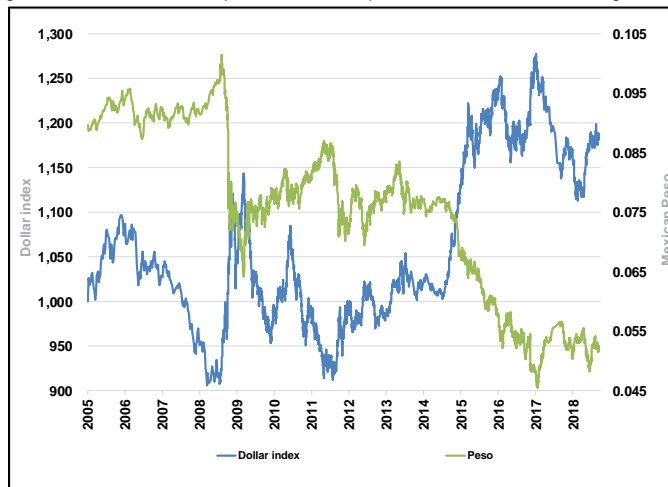
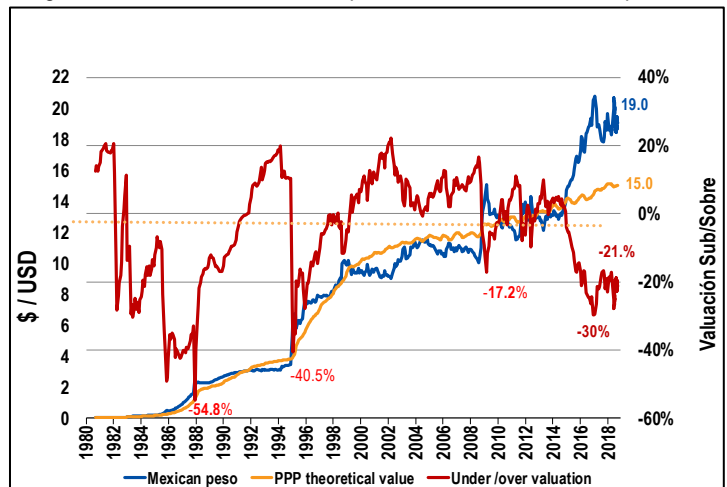


Figure 9. Peso vs. US\$: 1980-7Sep2018. Source: Franklin Templeton



Debt

Rates are expected to rise in DM, and to level or fall in EM (Figure 10).

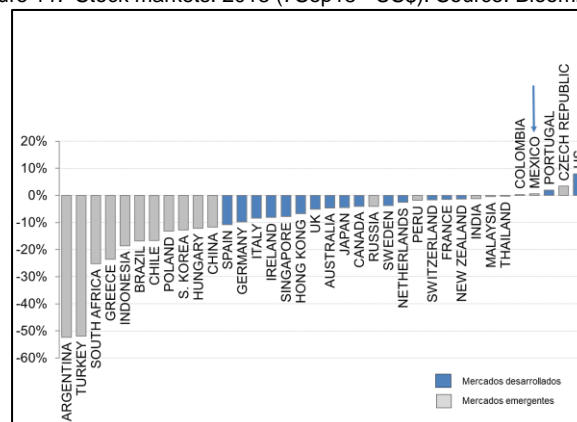
Figure 10. DM and EM: estimated nominal 10-year rates mid-2019 (7Sep2018). Source: Bloomberg, Franklin Templeton

Developed				Emerging			
local 10y yields (%)				local 10y yields (%)			
	2Q19e	Actual	(bps)		2Q19e	Actual	(bps)
US	3.04	2.88	16.14	China	3.78	3.60	18.3
Euro Area	0.94	0.31	62.9	India	7.50	7.82	-32.3
Japan	0.09	0.10	-0.5	Rusia	6.80	8.12	-132
Britain	1.88	1.25	62.8	Brasil	9.47	11.83	-236
Australia	3.08	2.59	48.8	México	7.50	7.80	-29.8
Canada	2.61	2.30	30.9	Corea del sur	2.77	2.50	27.3
Germany	0.94	0.31	62.9	Indonesia	6.65	7.94	-129
France	1.40	0.68	71.9	Turquia	11.77	22.69	-1092

Stocks

During 2018 after a strong 2017, market performance measure in US\$ has varied according to global (rates, trade disputes) and local factors (political and economic fundamentals). This dynamic has been particularly complicated for EM. The US market recovered due to strong 2Q reports and the Mexican market was stable owing to mixed NAFTA news, and a transition with mixed signals, but not negative (Figure 11).

Figure 11. Stock markets: 2018 (7Sep18 - US\$). Source: Bloomberg



In Mexico (Figure 12), and the US (Figure 13), in local currency, volatility has increased due to political uncertainty.

Figure 12. Mexico stocks (IRT and BIVAT pesos, 1Jan17- 7Sep18).

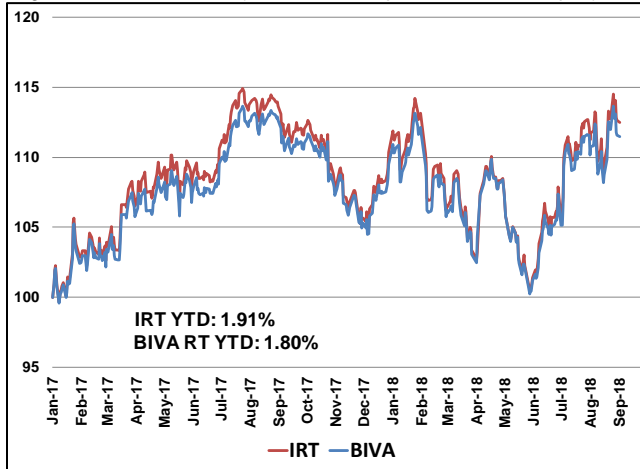
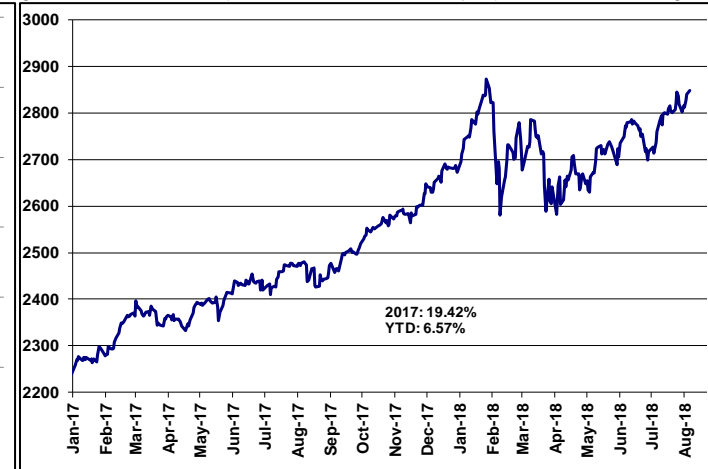


Figure 13. EEUU stocks (S&P500 US\$, 1Jan17-7Sep18). Source: Bloomberg



In Figure 11 comparative total return performance of BIVA and the IRT (Bolsa) is shown. Two issuers (Crédito Real y LIV Capital) decided to switch issues programmed for the Mexican Stock Exchange (BMV) to BIVA. Crédito Real will place stock certificates for \$700mns. Pesos and LIV Capital, an important shareholder in BIVA, requested permission to change the listing of its two CDKs. María Ariza, Director of BIVA, said that the target for 2018 was to achieve a level of volume at 20% that of the BMV.

Fibras

Due to novelty, high dividends, and inflation protection, Fibras have outperformed stocks since 2011. Since the Trump victory in November 2016, Fibras have been hit by NAFTA uncertainty, politics and inflationary fears. Recently, they have recovered with better NAFTA news (Figures 14 and 15).

Figure 14. Fibras vs. Mexican stocks (IRT) Mar2011-7Sep18 (base 100 MXN\$). Source: Bloomberg

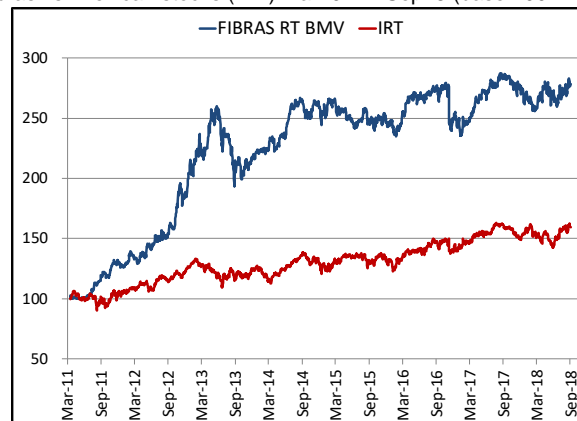


Figure 15. Fibras: valuation and dividends (7Sep18). Source: Franklin Templeton

	Mcap (M) (MXN)	Calendarized						
		2013	2014	2015	2016	2017	2018	2019
FUNO11 MM	119,692	6.0%	6.6%	6.5%	6.8%	6.8%	7.6%	8.1%
DANHOS13 MM	43,289	5.8%	6.5%	7.0%	5.8%	7.7%	8.2%	7.8%
TERRA13 MM	23,849	6.4%	6.5%	6.9%	8.1%	8.4%	8.6%	8.5%
FIBRAPL MM	22,629	3.3%	4.6%	5.8%	6.3%	6.1%	6.3%	6.1%
FIBRAMQ MM	16,365	8.2%	7.5%	8.8%	7.5%	7.6%	7.8%	8.1%
FIHO12	9,908	7.3%	7.2%	7.9%	7.4%	9.2%	11.0%	10.0%
FHIPO	8,085		11.6%	11.7%	12.0%	12.5%	13.0%	12.7%
FMTY14 MM	7,808			7.8%		8.7%	8.8%	
FINN13 MM	5,628	6.2%	5.7%	7.0%	7.8%	7.9%	8.0%	8.7%
FSHOP13 MM	5,594	8.4%	9.5%	10.2%	9.3%	9.2%	8.9%	8.0%

It is possible Fibra IPOs could occur in 2018, depending on political news, the possibility of a trilateral NAFTA, and historically attractive valuations.

Conclusion

The global outlook has become more complex owing to trade disputes, the rise in rates and possible return of an EM cycle. In Mexico the bilateral trade agreement with the US was clouded by a so far inconclusive negotiation with Canada. The political transition and the outlook for 2018-24 is still uncertain. Volatility is probable for global and Mexican investments. For peso denominated portfolios, overweight ILS for 1-3 year duration, and underweight stocks and fibras.

Nadia Montes de Oca
Ramsé Gutiérrez
Luis Gonzalí
Jorge Marmolejo
Octavio Martínez
Editor: Timothy Heyman
September 14, 2018

Main financial indicators: monthly at August 31, 2018

In August in Mexico, the IPC fell 0.30%. Nominal rates fell for short term and rose for medium and long terms. Real rates rose over all terms. The US\$ rose 2.86% against the peso. In the US, DJ, S&P500 and Nasdaq rose. Nominal rates rose for short term and fell for medium and long terms. In the Bank of Mexico business conditions survey optimism rose to 35% (34% previous), no change fell to 49% (50%), and pessimism remained at 16%.

Mexico					
Stock market and oil					
	31-Aug-18	31-Jul-18	Month	YTD	2017
IPC	49,547.68	49,698.01	-0.30%	0.39%	8.13%
Local currency (USD/MXN)	19.18	18.65	2.86%	-2.46%	-4.64%
Mexican oil mix (USD/bl)	66.29	65.09	1.84%	17.97%	21.36%
Nominal rates					
	31-Aug-18	31-Jul-18	Month	YTD	2017
CETES 28	7.97%	8.02%	-5 bps	65 bps	148 bps
CETES 360	7.90%	7.86%	4 bps	44 bps	103 bps
M5	7.85%	7.74%	11 bps	26 bps	38 bps
M10	7.91%	7.76%	15 bps	26 bps	15 bps
M30	8.02%	7.87%	15 bps	24 bps	-4 bps
Real rates					
	31-Aug-18	31-Jul-18	Month	YTD	2017
UDIBONO 10	3.59%	3.54%	5 bps	9 bps	45 bps
UDIBONO 30	3.76%	3.67%	9 bps	6 bps	-9 bps
Commodities					
	31-Aug-18	31-Jul-18	Month	YTD	2017
Gold	1,203.62	1,224.15	-1.68%	-7.61%	12.48%
WTI (USD/bl)	66.29	65.09	1.84%	17.97%	4.60%
UMS					
	31-Aug-18	31-Jul-18	Month	YTD	2017
UMS 10 years	4.21%	4.16%	5 bps	58 bps	-64 bps
UMS 20 years	5.39%	5.58%	-19 bps	86 bps	-74 bps
UMS 30 years	5.58%	5.64%	-6 bps	94 bps	-62 bps
Stock markets (US\$)					
	31-Aug-18	31-Jul-18	Month	YTD	2017
MSCI Developed	8,911.93	8,798.94	1.28%	5.26%	23.07%
MSCI Emerging	2,347.06	2,411.56	-2.67%	-6.93%	37.75%
MSCI Mexico	9,641.30	9,951.70	-3.12%	2.57%	16.27%
MSCI Brazil	5,204.97	5,867.13	-11.29%	-17.84%	24.48%

US					
Stock market					
	31-Aug-18	31-Jul-18	Month	YTD	2017
DJ	25,964.82	25,415.19	2.16%	5.04%	25.08%
S&P	2,901.52	2,816.29	3.03%	8.52%	19.42%
Nasdaq	8,109.54	7,671.79	5.71%	17.47%	28.24%
Nominal rates					
	31-Aug-18	31-Jul-18	Month	YTD	2017
Tbill 90	2.11%	2.03%	8 bps	84 bps	76 bps
Tnote 5	2.74%	2.85%	-11 bps	60 bps	21 bps
Tnote 10	2.86%	2.96%	-10 bps	44 bps	-3 bps
Tbond 30	3.02%	3.08%	-6 bps	19 bps	-23 bps
Real rates					
	31-Aug-18	31-Jul-18	Month	YTD	2017
Tip 5	0.76%	0.85%	-9 bps	50 bps	17 bps
Tip 10	0.78%	0.84%	-6 bps	31 bps	-3 bps
Tip 30	0.91%	0.94%	-3 bps	19 bps	-27 bps

Bank of Mexico survey		
Indicator	2018	2018 anterior
PIB	2.14%	2.25%
Inflation	4.41%	4.23%
Cetes 28	7.89%	7.85%
Local currency	18.92	19.11
Business conditions		
	31-Aug-18	31-Jul-18
Optimism	35%	34%
No change	49%	50%
Pessimism	16%	16%

Source: Bloomberg, Banco de Mexico

IMPORTANT LEGAL INFORMATION

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