EMI and Franklin Templeton Investments
Joint Collaboration

Mexico as an Emerging Market

SUMMARY

- From 1994 to 2015, emerging markets (EM) have grown from 22% to 44% of global GDP, and 13% to 26% of global market capitalization.
- From 2000, EM have grown 50% more than developed economies, and EM 200% vs. 100% developed stock markets.
- Since 2008, EM stock markets and currencies have performed worse than developed markets.
- Main causes have been the slowdown in China, fall in commodity prices, probable interest rate hikes in the US, and crises in Greece and China.
- This "perfect storm" is not necessarily over. But for 2016 higher growth is projected for EM, with, possibly, a positive effect on stocks and currencies
- Mexico has been affected by the same processes, and for 2016, higher growth is forecast. It is different from other EM because of its links to the US, its solid public and private finances, and structural reforms.
- There are still external risks (e.g. Middle East, Ukraine, implementation of Greek bailout and Chinese market support), and Mexican risks (security, corruption, politics).

"Strength lies in differences, not similarities" - Stephen Covey

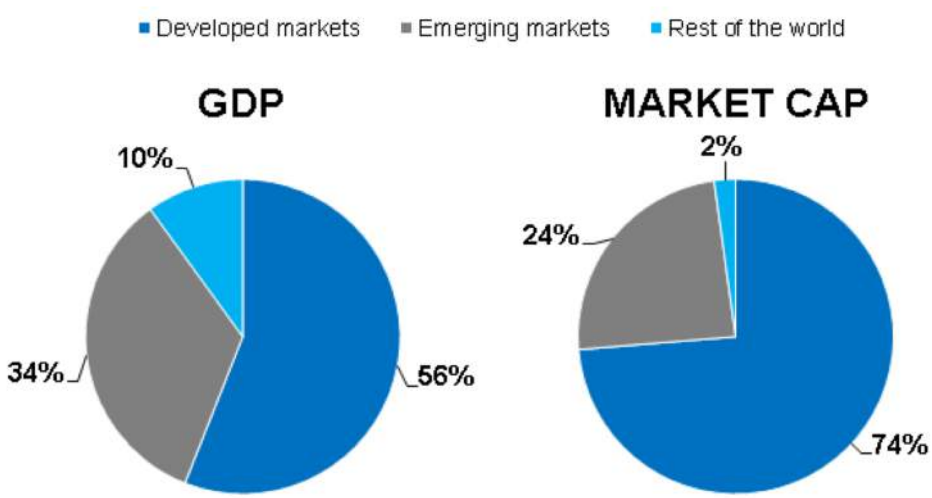
Emerging Markets

Among the many definitions of "emerging markets" (EM), we prefer:

"A country where the process of basic institution building is not complete"

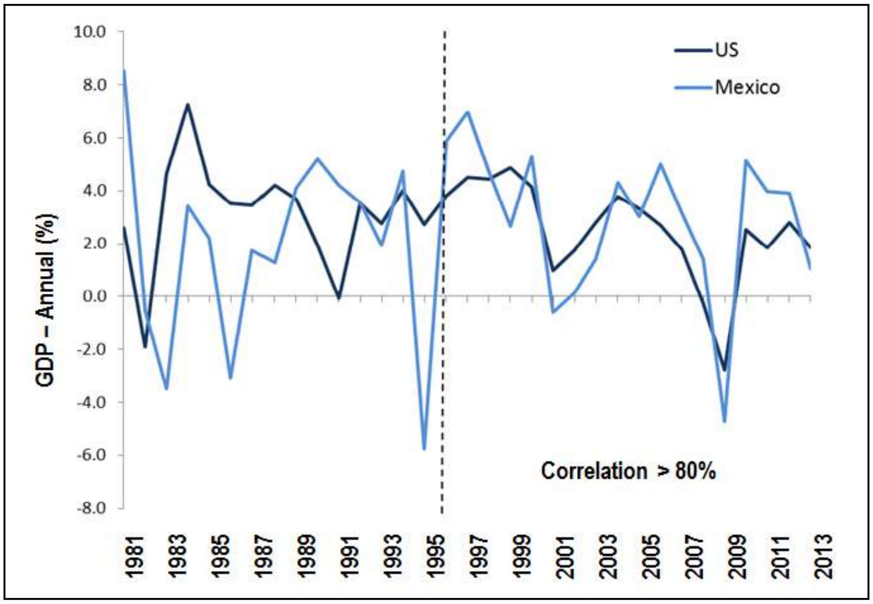
EM development began in earnest at the end of the 1980s with the decline of ideological barriers, as communism collapsed with the Berlin Wall, and of geographical barriers with the explosion of information technology. Since 1994, with 86% of global population and 76% of land area, EM (and other countries) grew from 22% of global GDP, and 13% of global market cap to 44% and 26% respectively in 2015 (Figure 1).

Figure 1. Global GDP vs. market capitalization June 2015. Source: Franklin Templeton, Bloomberg, IMF, Factset.



* Timothy Heyman, President of FTSAM, founded Heyman y Asociados in 1985. In 2013, Franklin Templeton established FTSAM and joined forces with Heyman y Asociados.

Figure 2. Mexico and US: GDP increase (%) 1981-2013. Source: BTGPactual



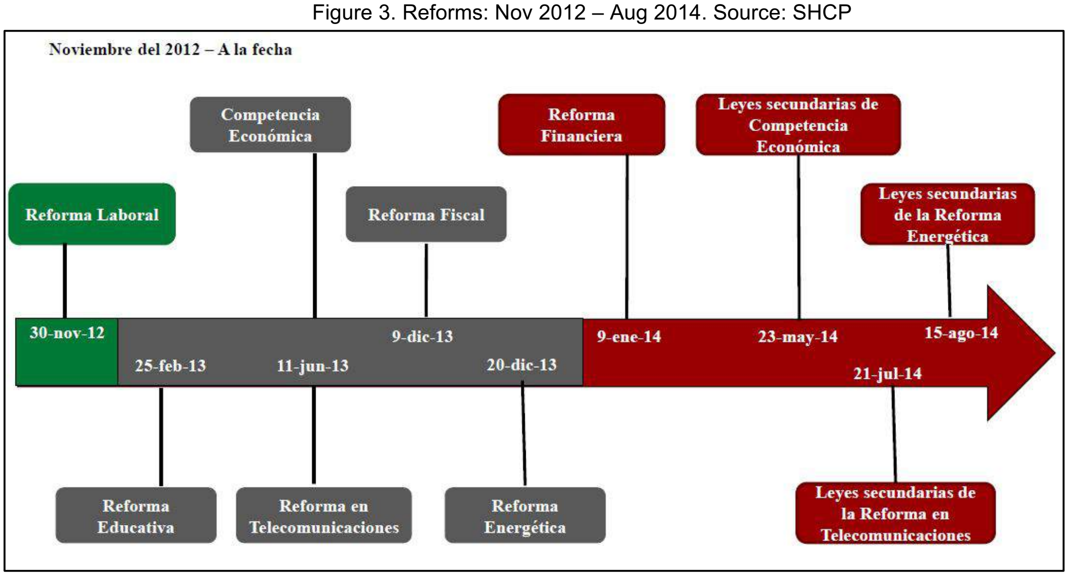
Second stage reforms

To consolidate the success of the first stage reforms it was necessary to introduce second stage, or "structural" reforms. But in spite of political change in 2000, when Vicente Fox was elected as the first non-PRI President since 1929, the reform process stalled. Furthermore, in spite of the increase in FDI and the greater linkage with the US economy, the rate of economic growth did not increase.

"Without the development of new regulatory agencies, tax reform initiatives, adjustments to trade policies, and enhancements in education, labor, and telecommunications, the prospects for economic growth engendered during the first-stage reforms might not be realized[1]."

It was 20 years before second stage reforms were passed, ironically, with the return of the PRI to Los Pinos in 2012. After the Pact for Mexico was signed in December 2012, President Enrique Peña Nieto achieved the passage of 9 important legislative changes (Figure 3).

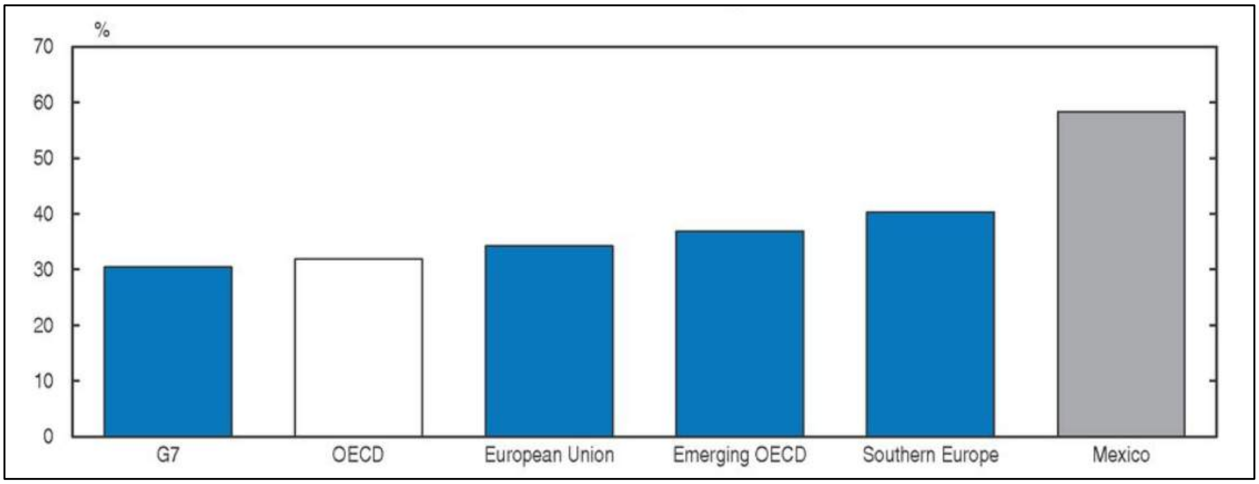
Figure 3. Reforms: Nov 2012 – Aug 2014. Source: SHCP



[1] *Economic Policy Reform: the Second Stage. Ed. Anne Krueger (University of Chicago Press, 2000).*

According to the Organization for Economic Cooperation and Development (OECD), Mexico was the member country which implemented the highest percentage of its recommendations between 2013 and 2014 (Figure 4).

Figure 4. Proportion of reform recommendations by OECD substantially adopted 2013-2014. Source: OECD[2]



Medium term effects

The OECD estimates the effect of reforms after 5 years (Figure 5).

Figure 5. Reforms: economic effect after 5 years, assuming immediate implementation. Source: OECD

	via productivity growth (%)	via capital deepening (%)	via employment growth (%)	GDP growth (%)
A. Pacto por Mexico Reforms:	**0.41**	**0.51**	**0.03**	**1.0**
1. Product market regulation				
a) Telecoms	0.06			0.06
b) Electricity & gas	0.32			0.32
c) Petroleum		0.45		0.45
2. Labour market reform				
Employment protection			0.03	0.03
3. Tax structure		0.07		0.07
4. Legal reform	0.03			0.03
B. Additional Reforms:	**0.91**	**0.00**	**0.10**	**1.0**
5. Judicial reform	0.50			0.50
6. Labour market reform				
a) Pro-formality reforms	0.42			0.42
b) Female participation			0.10	0.10
Total	**1.82**	**0.51**	**0.13**	**2.0**

These were the main conclusions in relation to Telecommunications, Electricity and Gas, and Petroleum:

- Fully implemented, the Pact for Mexico reforms will increase annual GDP growth 1% after 5 years.
- Over the medium term, the effect on GDP will be threefold: growth in productivity, increased investment, and employment growth.
- The study estimates minimal effects of labor, fiscal, and legal reform after the 5 year period, but that, long term, judicial and labor reforms could increase GDP growth by an additional 1%.

[2] *OECD Economic Surveys: Mexico (January, 2015)*

- It is probable that financial and educational reform (not included in the table) will also have significant effects on long term growth[3].

Reforms: progress by March, 2015

In this Commentary, we analyze progress that had been announced (to March, 2015) on reforms (Energy, Finance and Telecommunications). Subsequently, we consider possible effects on the economy and markets.

Energy

The reform has three objectives: a) make the energy industry more efficient and productive, by opening it up to the private sector, b) give more financial and operational independence to Petróleos Mexicanos (Pemex) and Comisión Federal de Electricidad (CFE), openly subjecting them to regulation by independent commissions, and c) assign the surplus generated by the energy industry to a long term fund.

Constitutional change was approved in December 2013 and the secondary laws in August 2014. In March 2015, progress was announced in various areas. Pemex and CFE have been converted to "productive state companies", through changing 26 regulations and the strengthening of two regulatory Commissions, the Energy Regulation Commission (CRE), and the National Hydrocarbons Commission (CNH). In addition four new agencies were created: the National Agency for Industrial Security and Conservancy for the Hydrocarbons Sector (ASEA), the National Center for Energy Control (CENACE), the National Center for Natural Gas Control (CENAGAS), and the Mexican Oil Fund for Stability and Development. Between 2014 and 2015, bidding rounds Zero and One have been held for hydrocarbon exploration and exploitation.

Figure 6. Estimated investment in hydrocarbons and electricity cogeneration (US$bn.) 2014-2020. Source: Marcos y Asociados

	2014	2015	2016	2017	2018	2019	2020	Total	AGR
Pemex CAPEX	**25**	**28**	**31**	**31**	**31**	**31**	**31**	**208**	**3.7**
Inversión privada									
Campos maduros (20-25)	1	2	2	2	3	5	6	21	
Aguas profundas (4 bloques)	0	1	2	5	6	8	9	31	
Gas de lutitas (1000 pozos)	0	1	2	3	6	9	12	33	
Modernización de refinerias	0	0	0	2	3	5	6	15	
Procesamiento de gas y fracc.liquidos	0	0	0	1	1	2	2	6	
Ductos gas natural (10,000km)	1	2	2	3	4	5	5	22	
Proyectos cogeneración	0	1	1	1	1	1	1	6	
Proyectos petroquimicos	1	1	1	1	2	3	4	12	
Otros proyectos alm. y dist.	0	1	2	2	3	4	5	16	
Total inversión privada	**3**	**8**	**12**	**20**	**29**	**40**	**50**	**161**	
Pemex + inversión privada	**28**	**36**	**43**	**51**	**60**	**71**	**81**	**369**	**19.2**
PIB a precios corrientes (MMM USD)	**1,280**	**1,331**	**1,391**	**1,454**	**1,519**	**1,587**	**1,659**	**12,966**	**4.4**
Pemex CAPEX/PIB	**1.95**	**2.10**	**2.23**	**2.13**	**2.04**	**1.95**	**1.87**	**1.60**	
Pemex+IP/PIB	**2.20**	**2.68**	**3.08**	**3.51**	**3.95**	**4.46**	**4.87**	**2.85**	

As a result, there will be an estimated investment of approximately US$62.5 bn. in gas pipelines, Round One investment, and electricity generation and transmission; it is estimated that 212,000 total jobs (direct and indirect) will be created. This estimate is substantially reflected in estimates (Figure 6) from the independent energy consulting firm Marcos y Asociados, which were made after the two Rounds, and the 40% fall in the oil price between June 2014 and May 2015.

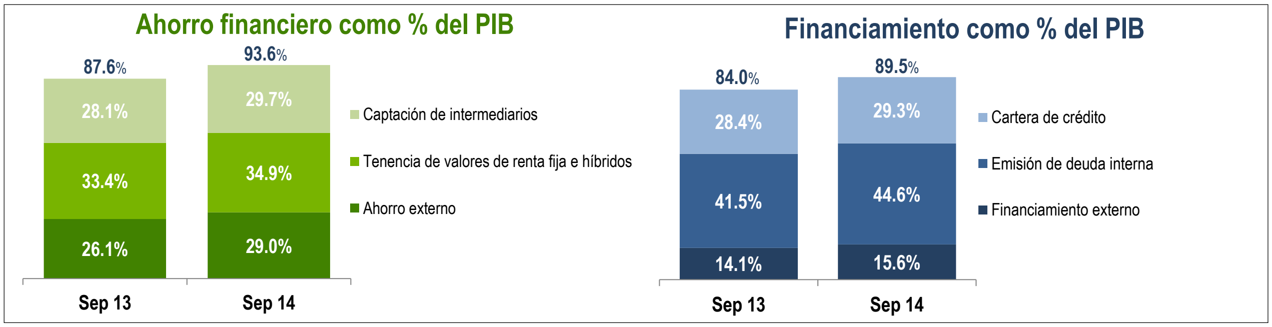
In addition, partly as consequence of the fall in energy prices, electricity prices have been reduced by 18-26% for industrial use, 16% for business use, 7.5% for high consumption and 2.5% for domestic consumption. Gas costs have fallen by 4%.

[3] The IMF differs, as it estimates that, owing to financial reform, GDP grows an additional average annual 0.07-0.16% in the period 2016-2019. *IMF Country Report No. 14/319 (November, 2014).*

Financial

Financial reform has four objectives: a) increase competition, b) increase financing through the development banking system, c) improve conditions so that private financial institutions can lend more, and d) strengthen the financial system.

Figure 7. Savings and Finance Sep2013-Sep2014. Source: Comisión Nacional Bancaria y de Valores (CNBV)



Since the reform, which was approved in January 2014, savings and finance have increased (Figure 7 – complete data available in September 2014).

- Internal savings increased from 61.5% of GDP in 2013 to 64.6% in 2014.
- Internal financing increased from 69.9% of GDP in 2013 to 73.9% in 2014.

Telecommunications

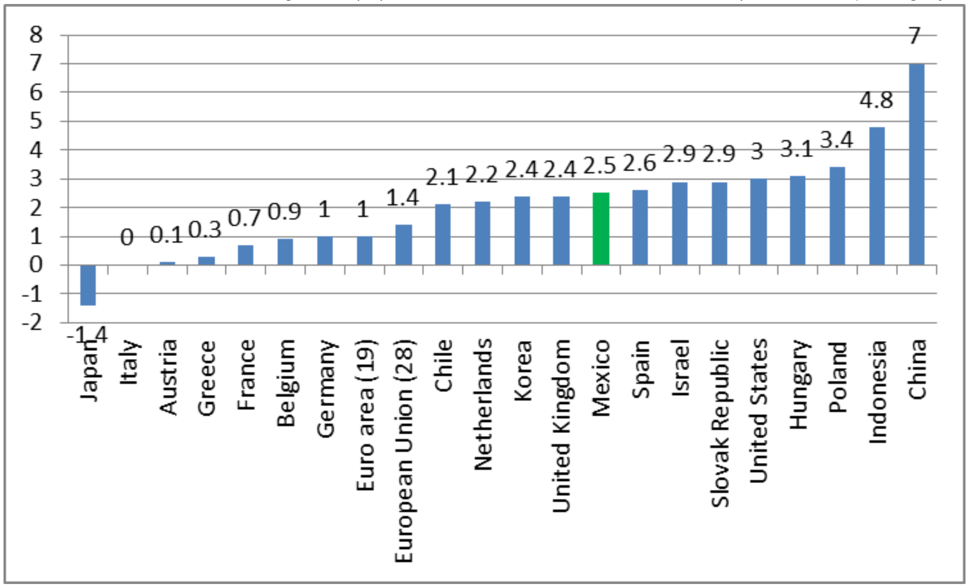
The objectives of the reform are that telecommunications and broadcasting services be provided in conditions of competition, quality, plurality, universal coverage, interconnection, convergence, free access and continuity.

Constitutional reform was approved in June 2013, and secondary legislation in July 2014. There has been progress on several fronts:

- Three regulators (Ministry of Communications and Transport - SCT, Federal Competition Commission – CFC, and Federal Telecommunications Commission - Cofetel), have been reduced to one entity with stronger powers, the Federal Telecommunications Institute - IFT.
- América Móvil has been obliged to reduce its telecoms market share to 50%, a process that has begun with the entry of ATT to Mexico, with an investment of US$4,375 mn. through the purchase of Iusacell and Nextel.
- New national TV chains were opened for bidding.
- New investment of US$10 bn. is planned for the project “Red Compartida”.
- National long distance costs were reduced to zero and international long distance costs reduced by 40.7%. Cellphone costs were also reduced.

Possible effect on economy and markets

Figure 8. OECD countries: GDP growth (%) 1Q2015 vs.1Q2014. Source: OECD (countries reporting by May 27, 2015)



It is difficult to attribute to the reforms any immediate effect on the economy. However, the 2.5% growth figure for Mexican GDP in 1Q2015 (vs. 1Q2014), although less than originally estimated at the beginning of 2015, was higher than several other countries in the OECD (Figure 8). The fall in Mexican oil prices and production, the rise of US interest rates, and low global growth, should also be taken into account.

It is possible that the reforms also influenced the markets' view of Mexican country risk, reflected in Mexico's credit rating, the spread on its local 10 year bonds, and the price of 5 year Credit Default Swaps, all of which appear to be correlated with a lower currency depreciation since 2012 than in other countries (Figure 9).

Figure 9. Emerging markets: peso depreciation vs. country risk data Dec2012-April2015. Source: SHCP

	Cambio desde el 31 de diciembre de 2012 a la fecha		
País	Tipo de Cambio (%)	Bono Local a 10 años (pb)	CDS 5 años (pb)
México (A3/BBB+/BBB+)	20.1	44	21
Indonesia (Baa3/BBB-/BB+)	32.3	233	34
Turquía (Baa3/BBB-/BB+)	50.6	216	103
Sudáfrica (Baa2/BBB/BBB-)	43.1	118	71
Brasil (Baa2/BBB/BBB-)	47.8	342	125
Rusia (Ba1/BBB-/BB+)	75.9	239	248
Colombia (Baa3/BBB/BBB)	39.8	126	47

Conclusion

The reforms of this administration are significant. Almost halfway through the *sexenio*, information that has been released on energy, finance and telecommunications reform is positive, and it is possible that this is reflected in GDP growth figures for the first quarter of 2015, as well as country risk indicators comparing Mexico with other emerging markets. As the OECD analysis recognizes, legal/judicial, labor, educational, and fiscal reforms are less measurable in the short term, but of even greater importance over the long term. There is still a way to go for the reforms to be generally accepted and implemented, and evidently this is the major challenge for the administration in the second half of the *sexenio*. It is possible that the mid-term elections scheduled for June 7 will give some indication of the probability of successful implementation during this period.

Recommendation

Using the framework provided in this Commentary, we will be monitoring progress on the reforms in each sector. Meanwhile, we see reasons for cautious optimism. We therefore maintain our recommendations on asset allocation, depending on the risk profile of each investor: we are positive on shares and fibras, and cautious on duration for long term debt instruments, owing to a probable rise in interest rates, both in the US and Mexico.

June 2, 2015
Timothy Heyman
President and Chief Investment Officer
Franklin Templeton Investments

Main financial indicators: monthly performance (May 31, 2015)

In May, in Mexico the IPC rose 0.27%. Nominal rates rose over all terms, while real rates fell. The US$ rose by 0.07% against the peso. In the US, S&P500, DJ and Nasdaq rose. Nominal and real rates rose over all terms. The price of the Mexican oil export mix rose 0.33% and WTI 1.12%. According to the Bank of Mexico, optimism increased to 63% (61% previous), no change fell to 28% (33%), and pessimism increased to 9% (6%).

Mexico

Stock market and oil

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
IPC	44,703.62	44,582.39	43,145.66	0.27%	3.61%
Local currency (USD/MXN)	15.38	15.37	14.74	0.07%	4.34%
Mexican oil mix (USD/bl)	57.2	57.01	45.45	0.33%	25.85%

Nominal rates

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
CETES 28	2.99%	2.77%	2.64%	22 bps	35 bps
CETES 360	3.46%	3.39%	3.28%	7 bps	17 bps
M5	5.34%	5.28%	5.21%	6 bps	13 bps
M10	6.01%	5.93%	5.81%	8 bps	19 bps

Real rates

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
UDIBONO 10	2.79%	2.97%	2.46%	-18 bps	33 bps
UDIBONO 30	3.45%	3.51%	3.21%	-6 bps	24 bps

Commodities

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
Gold	1,190.58	1,184.37	1,188.06	0.52%	0.21%
WTI (USD/bl)	60.3	59.63	53.27	1.12%	13.20%

UMS

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
UMS 10 years	3.60%	3.43%	3.58%	17 bps	2 bps
UMS 20 years	4.38%	4.26%	4.39%	12 bps	-1 bps
UMS 30 years	4.63%	4.46%	4.58%	17 bps	5 bps

Stock markets (US$)

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
MSCI Developed	6,723.06	6,694.31	6,381.05	0.43%	5.36%
MSCI Emerging	2,031.75	2,116.09	1,920.69	-3.99%	5.78%
MSCI Mexico	10,290.09	10,249.82	10,356.89	0.39%	-0.64%
MSCI Brazil	4,571.43	5,179.28	5,188.98	-11.74%	-11.90%

US

Stock market

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
DJ	18,010.68	17,840.52	17,823.07	0.95%	1.05%
S&P	2,107.39	2,085.51	2,058.90	1.05%	2.36%
Nasdaq	5,070.03	4,941.42	4,736.05	2.60%	7.05%

Nominal rates

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
Tbill 90	0.01%	0.01%	0.04%	0 bps	-3 bps
Tnote 5	1.49%	1.43%	1.65%	6 bps	-16 bps
Tnote 10	2.12%	2.05%	2.17%	7 bps	-5 bps
Tbond 30	2.88%	2.75%	2.75%	13 bps	13 bps

Real rates

	29-May-15	30-Apr-15	31-Dec-14	Month	YTD
Tip 5	-0.08%	-0.29%	0.38%	21 bps	-46 bps
Tip 10	0.32%	0.11%	0.49%	21 bps	-17 bps
Tip 30	0.95%	0.72%	0.83%	23 bps	12 bps

Bank of Mexico survey

Indicator	2015	2015 anterior
PIB	2.66%	2.88%
Inflation	2.96%	3.07%
Cetes 28	3.44%	3.53%
Local currency	15.08	14.97

Business conditions	29-May-15	30-Apr-15
Optimism	63%	61%
No change	28%	33%
Pessimism	9%	6%

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