Peso: depreciation vs. inflation

SUMMARY

- From 2013 to end-August 2015, the US$/peso rate has risen 29.5%: in 2015, 13.85%.
- Main reasons have been: since 2011 the fall in commodity prices, mainly oil, since 2013 the expectation of a rate hike in the US, since August 2015 the Yuan devaluation. The peso's status as most traded emerging currency distorts the process.
- In August 2015 Mexican inflation reached a historic low of 2.59% annual.
- The paradox between high currency depreciation and low inflation has structural and coincident causes.
- The structural cause was the flotation of the peso in 1995 and the adoption of a monetary policy with an inflationary objective.
- Coincident causes have been: the output gap in the economy, fall in commodity prices since 2011, and the loosening of internal energy and telecoms prices.
- With the parallel of a previous period from 2011-2012, it is possible that there will be significant pass-through from depreciation to inflation in the future.
- With increased inflation uncertainty, we prefer inflation-linked debt securities (ILS).
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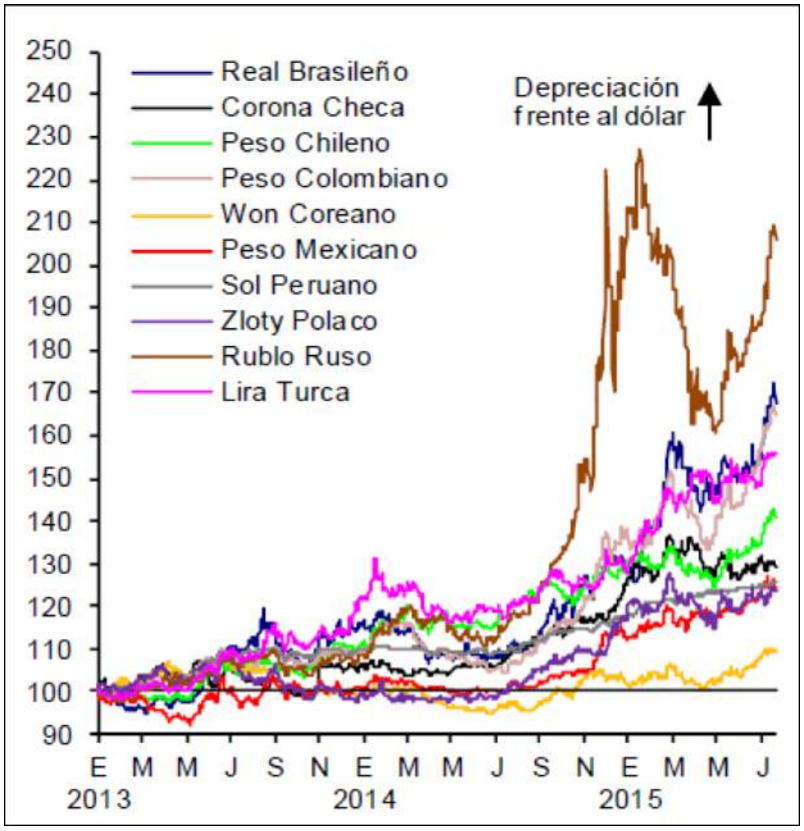
"Confusion is the hallmark of a transition" – Anne Grant

PESO DEPRECIATION

Between 2013 and June 2015, the peso/US$ rate depreciated 21%, less than many emerging currencies (Figure 1).

Figure 1. Emerging currencies: depreciation vs. US$ 2013-June2015. Sources: Bloomberg, Banxico

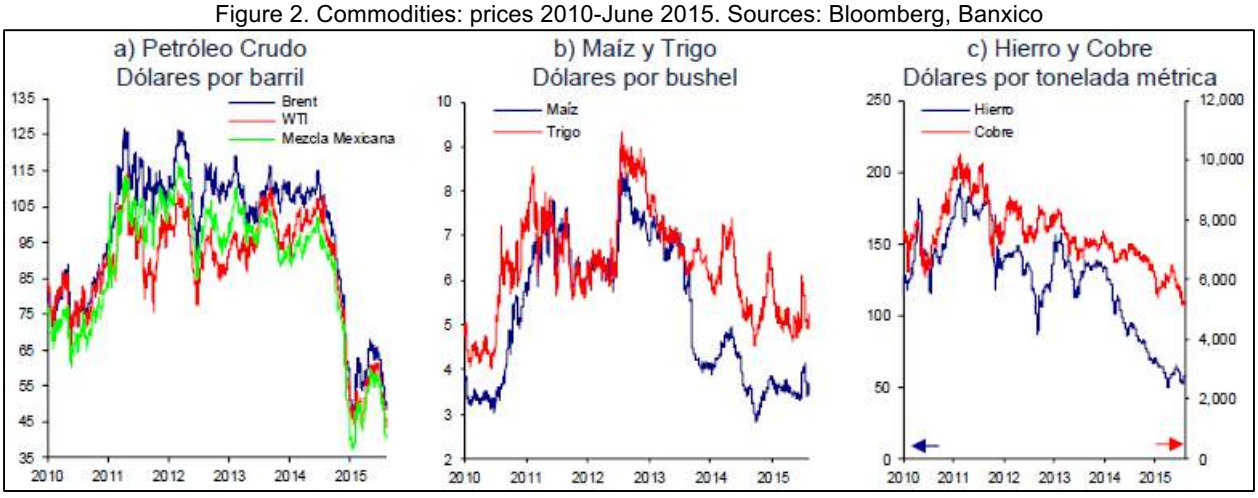


* Timothy Heyman, President of FTSAM, founded Heyman y Asociados in 1985. In 2013, Franklin Templeton established FTSAM and joined forces with Heyman y Asociados.

Commodities

One cause was the fall in commodity prices from 2011 due to the change in Chinese economic policy from investment to consumption, with a consequent fall in GDP growth from 14% in 2007 to 7% in 2014. Price falls began with metals (Figure 2c), then food (Figure 2b). Oil prices fell drastically in November 2014 when OPEC decided not to support oil prices (Figure 2a).

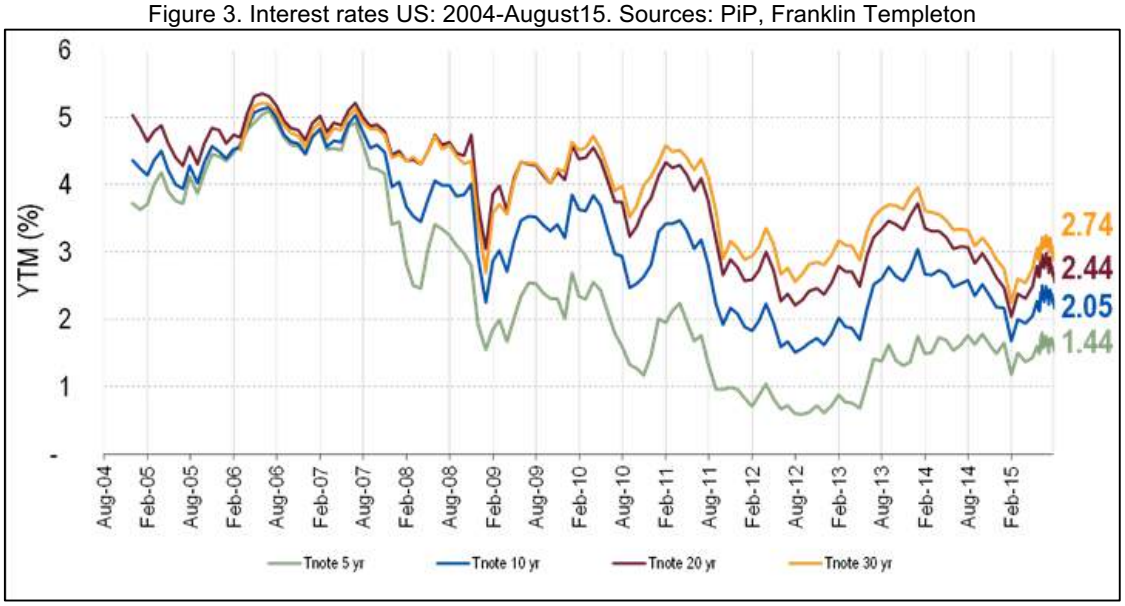
Figure 2. Commodities: prices 2010-June 2015. Sources: Bloomberg, Banxico



Interest rate rises in the US

Another cause was the expectation of a rise in Fed rates, first recognized in May 2013, as the US economy was recovering (Figure 3). Even though the rate rise has not yet occurred, expectations have caused rises in long term interest rates from minimum 2012 levels, contributing to the appreciation of the US$ against other currencies.

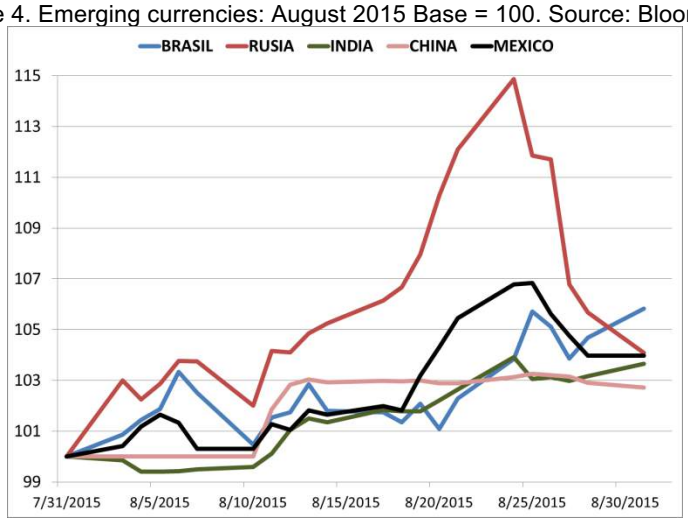
Figure 3. Interest rates US: 2004-August15. Sources: PiP, Franklin Templeton



Chinese devaluation

On August 11, 2015, the Chinese government announced a 2% devaluation of the Yuan (also known as *renminbi*), as the beginning of a move towards flotation of the currency, so that it be included in the basket of reserve currencies recognized by the International Monetary Fund (IMF). This affected emerging currencies owing to fear that weakness in the Chinese economy might affect countries dependent on exports to China, and that it could lead to more Yuan depreciation, with a negative effect on other emerging currencies. During August the peso depreciated by 4.39% (Figure 4). This change in the global economy, similar to the OPEC shock in November 2014, is still being assimilated by the markets.

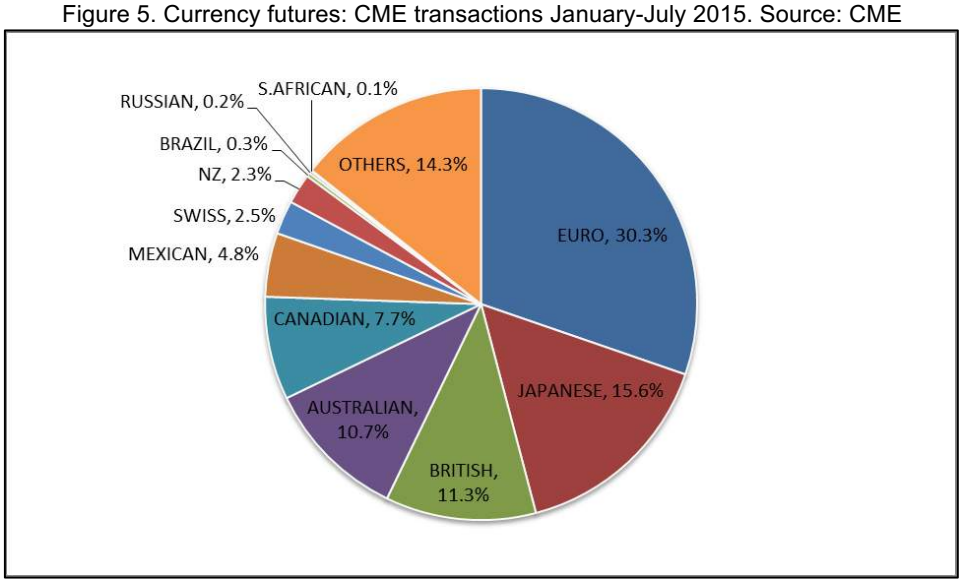
Figure 4. Emerging currencies: August 2015 Base = 100. Source: Bloomberg



Emerging currency markets

During 2015 YTD to the end of July, Forex represented 13% of trading on the Chicago Mercantile Exchange (CME). The Mexican peso accounted for 4.8% of all Forex operations, placing it in sixth place for all currencies, and as the top emerging currency, followed far behind by Brazil, Russia and South Africa. This reflects the fact that the peso is used as a hedge for any investment in emerging currencies, an incalculable distortion of the peso parity.

Figure 5. Currency futures: CME transactions January-July 2015. Source: CME

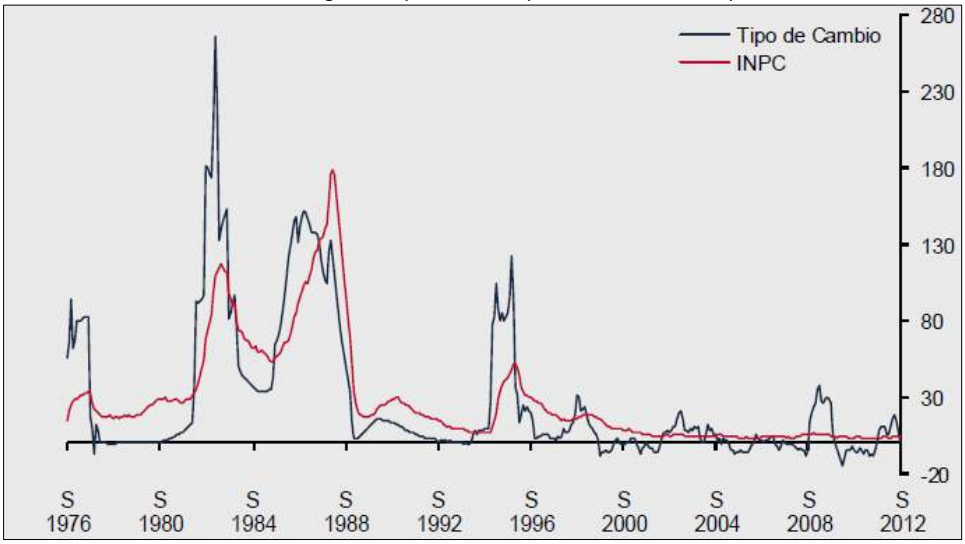


INFLATION

Structural causes

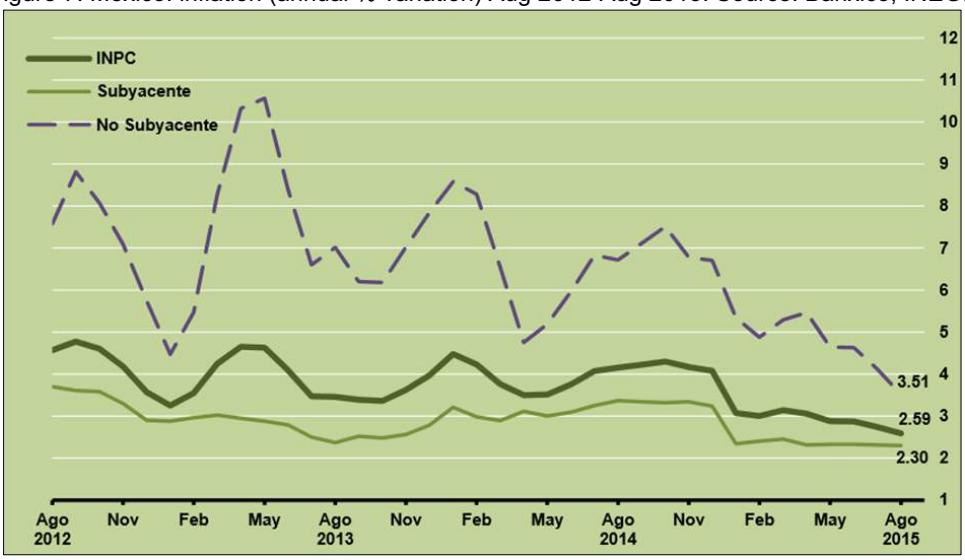
Between 1976 and 1995, there was a clear correlation between devaluation (in a fixed exchange rate system) and inflation (Figure 6). After 1995, the correlation declined substantially due to the adoption of a floating exchange rate system in that year. Instead of the sharp shock on a fixed exchange rate with its corresponding effect on inflation, there has been gradual depreciation, with a lower and more gradual effect on inflation. The change from fixed to floating exchange rates coincided with a change in monetary policy, from an exchange rate to an inflation objective.

Figure 6. Mexico: inflation and exchange rate peso/US$ (annual % variation) 1976-2015. Source: Banxico



For Mexico, the current inflation objective is 3%. During 2015, it has overshot on the downside, reaching a record minimum of 2.59% in August (Figure 7). The Mexican Treasury (SHCP) estimates 2016 inflation at 3%.

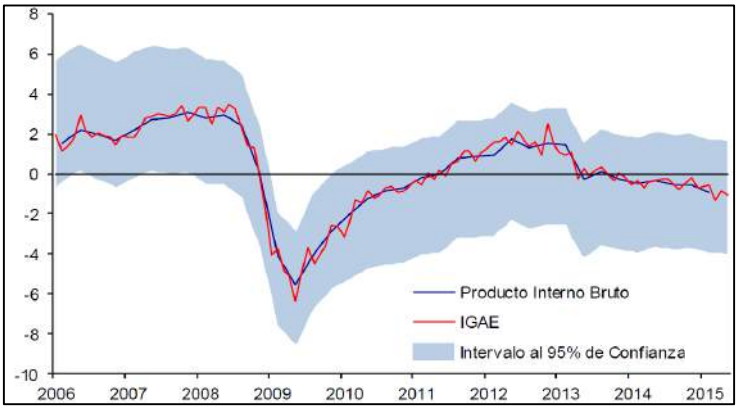
Figure 7. Mexico: inflation (annual % variation) Aug 2012-Aug 2015. Source: Banxico, INEGI.



Coincident causes

A coincident cause is the slack in the economy, known as the output gap, the difference between current and potential production, currently estimated at -2% (Figure 8). This gap reduces price pressure from external shocks, such as peso depreciation.

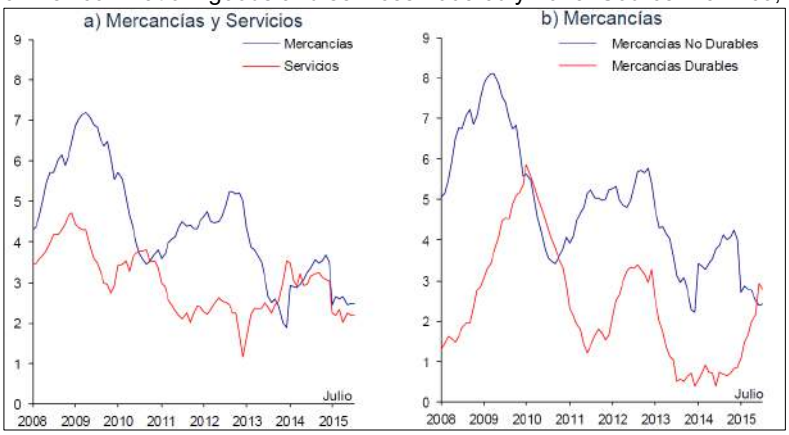
Figure 8. Mexico: output gap 2006-July 2015. Source: Banxico, INEGI



Falls in commodity and controlled prices

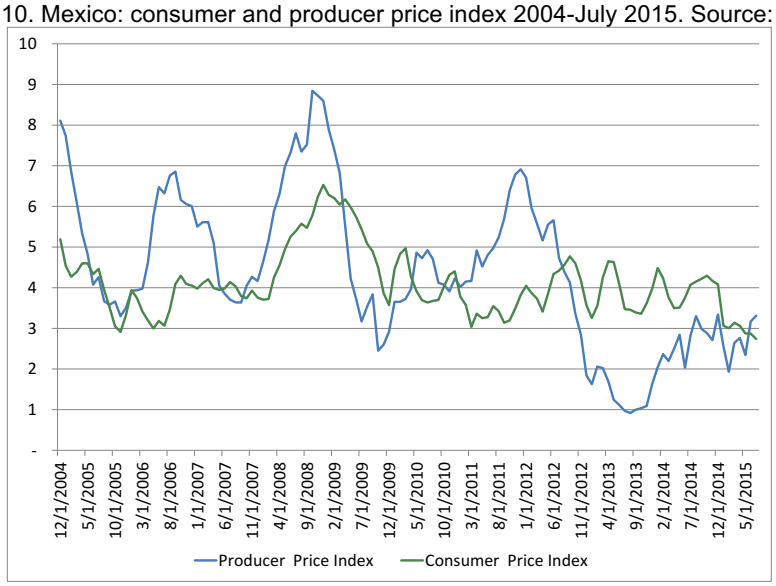
Prices of non-durable goods have been pressured downwards by the fall in commodity prices and prices controlled by the government such as energy and telecoms, with a corresponding effect on the Consumer Price Index in Mexico (INPC). Durable goods have been affected by peso depreciation and push inflation upward (Figure 9).

Figure 9. Mexico inflation: goods and services 2008-July 2015. Source: Banxico, INEGI.



In July 2015, the National Producer Price Index, which includes a high content of imported durable goods, overtook the IPC. This index tends to subsequently have a pass-through effect on the CPI (Figure 10).

Figure 10. Mexico: consumer and producer price index 2004-July 2015. Source: INEGI.



PASS-THROUGH OF PESO DEPRECIATION TO INFLATION

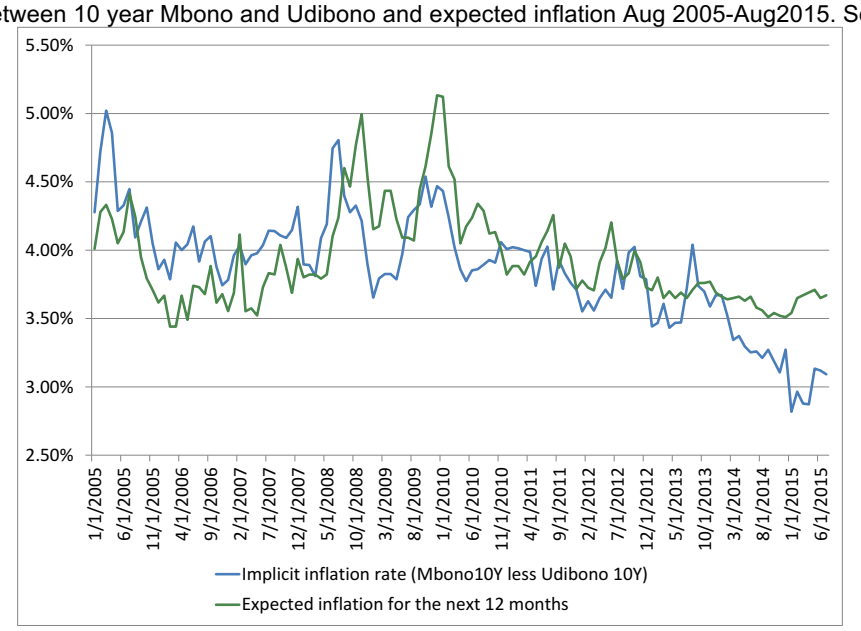
Since 2000, pass-through of peso depreciation to inflation has been less than prior years for the reasons mentioned on page 4, above all in periods of high volatility such as 2008-9 and 2011-12 (Figure 6). The Bank of Mexico has researched this phenomenon[1]. Taking the most recent period of peso volatility, August 2011- September 2012, the most similar to the current situation (with commodity prices falling and the change in Chinese economic policy) it finds that peso depreciation was 11.42% higher than the average of economists' expectations published in July 2011, and that this added 0.34% to the 4.77% annual inflation registered in September 2012. Currently, peso depreciation for a similar period, from July 2014 to August 2015 has been 29.5% above expectations published in June 2014. Even though the negative effects on inflation of commodity and government controlled prices are likely to continue, it is possible that, with a much higher peso depreciation, there will be significant pass-through from depreciation to inflation in the future.

Inflation estimates

An estimate of inflation implied by the debt market can be calculated as the difference between the rate on 10 Year Mbono (nominal) and Udibono (inflation-linked) bonds, which is currently 3.12% (Figure 11). Expected inflation of 3.82%, according to the Bank of Mexico survey of September 2015, is more congruent with our conclusion in the previous paragraph, than the debt market.

[1] *Informe sobre la Inflación Julio – Septiembre 2012. Banco de México, 2012*

Figure 1. Implied inflation between 10 year Mbono and Udibono and expected inflation Aug 2005-Aug2015. Sources: Bloomberg, Banxico



Conclusion

The inflation outlook is uncertain owing to abnormal conditions in the global economy, emerging currency markets and the possibility of pass-through from peso depreciation to inflation in Mexico. Given this outlook, we consider the most suitable debt instruments under current market conditions to be inflation-linked securities (ILS – *bonos udizados*).

September 9, 2015
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