

Markets vs. global cycle, local dissonance

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Franklin Templeton Servicios de Asesoría Mexico (FTSAM)

- Established 2013.
- Subsidiary of Franklin Templeton Investments.
- Investment solutions for our clients taking into account their needs and the global and local environment.
- Portfolio management team with more than 20 years' experience.
- Pioneers in Mexican investments*.

Franklin Templeton: Culture and Values

- Put clients first.
- Build relationships.
- Achieve quality results.
- Work with integrity.

SUMMARY

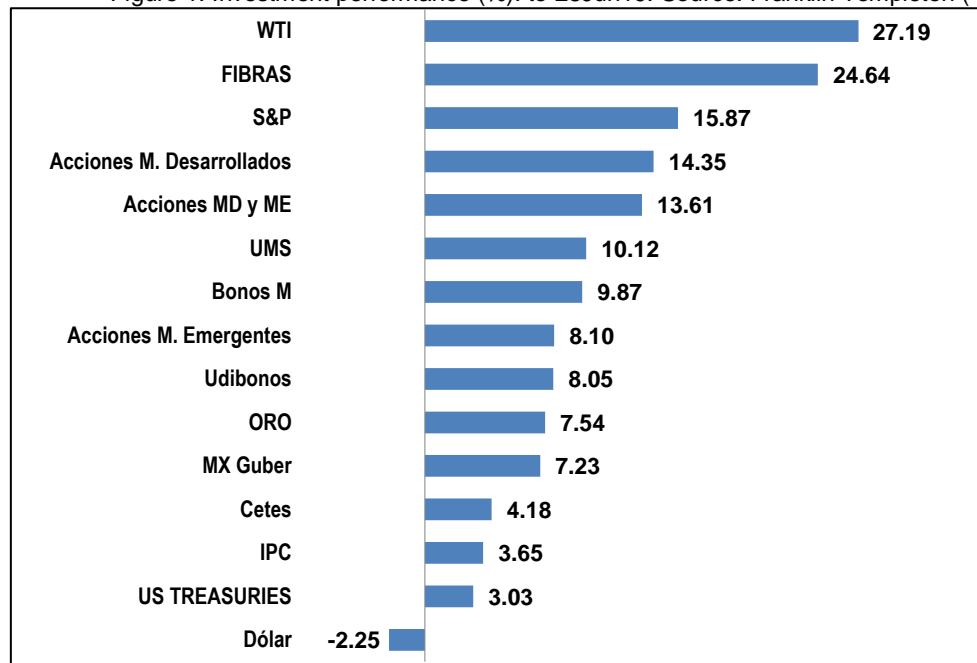
- Global. Risk assets rise, due to positive trade outcome from G20 meeting in Japan, positive central bank tone, and continued OPEC cut.
- Mexico. Risk assets rise due to resolution of tariff dispute with US, local ratification of USMCA, and strong peso due to interest rate differential.
- Global risks 2019: abrupt slowdown, trade wars, monetary policy, geopolitics, Brexit/Europe, emerging markets.
- Local risks: dysfunctional government, USMCA non-ratification in the US, loss of investment grade, flight of foreign capital.
- Investment scenarios 2019 with probabilities: positive (10%), negative (50%), middle (40%).
- For portfolios in pesos, overweight liquidity and ILS debt duration 1 to 3 years, underweight stocks and fibras (REITs).

"It is widely said 'Think globally, act locally'..... well the disaster happens when people do the opposite." – Sameh Elsayed

Positive performance vs. global and local concerns

During the first semester the performance of both global and Mexican risk assets has been positive, mainly due to the absence of trade wars and global monetary policy. Meanwhile, globally, there is concern about the end of the longest recovery since World War II. In Mexico, the triumphalism expressed by AMLO a year after his election contrasts with economic policy and reality.

Figure 1. Investment performance (%): to 28Jun19. Source: Franklin Templeton ("FT")



POLITICS

US

China: pause in trade tensions

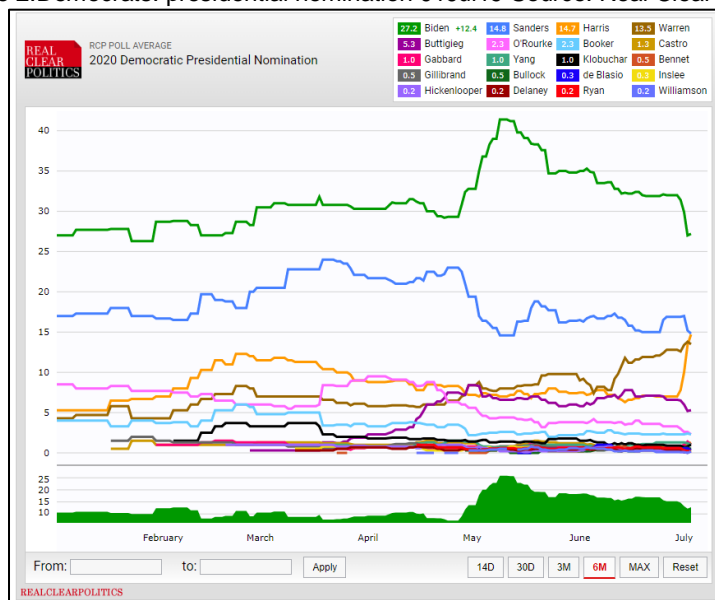
During the G20 summit on June 28-29 in Osaka, Japan, the leaders of the US and China held a bilateral meeting after the breakdown of negotiations in May. As a result, an agreement was reached that the US will not impose additional tariffs on Chinese products and ease sanctions on Huawei, and China will buy an unspecified quantity of agricultural products from the US.

The news was well received by the markets. However, analysts remain skeptical about a short term solution, which does not solve the cause of the conflict, and concerned that over the long term trade problems could recur.

Trump: re-election campaign launch

On June 18, President Trump officially began his campaign in Florida looking towards reelection in November 2020. Trump focused his speech on the economic strength of the US and on stopping illegal immigration. With more than 20 Democrats vying for the presidential nomination, Joe Biden is the current leader with 27.2% support: after the first Democratic debate, Kamala Harris gained ground and currently ranks third (Figure 2).

Figure 2. Democrats: presidential nomination 01Jul19 Source: Real Clear Politics



Iran: tensions in the Middle East

On Thursday, June 20, Iran's Revolutionary Guard shot down an American drone. Iran claimed that the aircraft had entered its airspace on an espionage mission. The US denied it and said that the aircraft was doing reconnaissance in international airspace. The US cancelled an attack on Iran in retaliation but announced new sanctions. Tension has increased since the beginning of June, when the US began to strengthen its military presence in the Middle East and Tehran announced that it suspended some of its obligations to the nuclear agreement signed in 2015.

Mexico

US-Mexico agreement on migration

After Trump's threat on May 30 to impose tariffs on all products imported from Mexico as of June 10, if Mexico did not take the necessary action to stop the flow of illegal migrants to the US, President Lopez Obrador (AMLO) sent him a letter of negotiation. This was followed by the dispatch of a team of officials, led by Marcelo Ebrard, Secretary of Foreign Relation, who met with a Trump team to reach an agreement.

In the US, Republican and Democrat legislators discussed the possibility of blocking the imposition of tariffs on Mexico because of the economic repercussions on American consumers, in view of the elections to be held in 2020. Ebrard even met with Nancy Pelosi, the Democratic leader in Congress and other key congressmen to the ratification of the USMCA to follow up on the process.

Under pressure from Trump who called Mexican proposals insufficient, on Friday, June 7, a deal was reached, which delayed the application of tariffs to be reassessed after 45 days, subject to the effectiveness of following measures to be adopted by the Mexican government:

- Deployment of the National Guard throughout the national territory, giving priority to the southern Mexican border to dismantle human trafficking organizations.
- Coordinated actions to improve security at the US-Mexico border.
- Mexico is committed to receiving migrants who apply for asylum to the US and are awaiting resolution of their applications.
- Mexico and the US are committed to a comprehensive development plan for Central America with the aim of reducing the number of migrants mainly from countries such as El Salvador, Guatemala and Honduras.

Four weeks after reaching the deal, Trump called the actions taken by the Mexican government "a great job," and discarded the imposition of tariffs on Mexico, for the time being.

USMCA approval

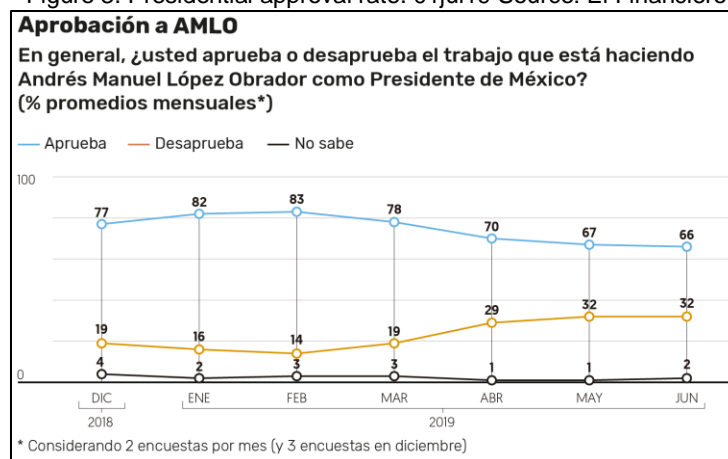
On June 19, the Mexican Senate approved the USMCA by a wide margin. This places the burden of the approval on the other trading partners, with the focus on the evolution of the process in the US, where we expect delay by the Democrats in the runup to the 2020 election. We don't rule out more commercial threats from Trump as part of his electoral strategy to pressure USMCA ratification by the Democrats.

AMLO: one year after his election and seven months after his inauguration

On July 1, AMLO celebrated the first anniversary of his election triumph at Mexico City's Zocalo with a musical event and a speech focused on achievements during the first seven months of his administration. According to AMLO, he has kept 78 of the 100 promises he made when he took office on December 1, 2018. He highlighted the positive economic environment, the revival of the oil and electricity industry, government austerity, the implementation of social policies and the creation of the National Guard. In addition, he confirmed the cancellation of the new Mexico City airport at Texcoco and its construction of St. Lucia, the continuation of a policy of non-confrontation with the USA and the need for a good relationship with the private sector.

According to a survey conducted by *El Financiero* (Figure 3), AMLO has a 66% approval rate, the lowest level observed since taking office. According to this same survey, the most popular measures of his administration have been the sale of the presidential plane, the creation of the national guard, citizen consultations and austerity measures of government.

Figure 3. Presidential approval rate. 01jul19 Source: El Financiero



The most unpopular government measures, according to a survey conducted by Consulta Mitofsky for *El Economista* are: non-punishment of corruption, decisions by consultative rallies, financial support of El Salvador to reduce migration and the cancellation of the Texcoco airport. In addition 60% consider that the security situation has deteriorated (Figure 4). If it does not improve, AMLO's popularity could continue to deteriorate.

Figure 4. Perception of security. 01jul19 Source: El Economista



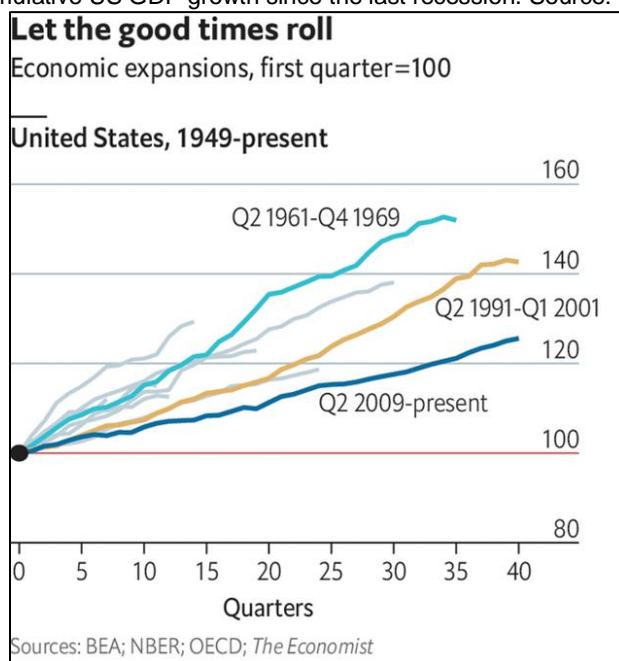
ECONOMICS

GLOBAL

Economic cycle

The current economic cycle measured since June 2009 has continued uninterrupted for more than 120 months making it the longest in history, followed by the 1991-2001 cycle (Figure 5). While the duration of the current cycle is impressive, the cumulative growth of 39 quarters has been 22%, well below the 39-quarter growth achieved in the 1991-2001 cycle of 43%. A mature economic cycle increases the risk of a recession. In the meantime, it is argued that "this time is different". The explanations for the long cycle include: the severity of the 2008-9 financial crisis, the highest ever level of globalization (interaction of information, ideas, people, goods and services) accelerated by technological change (information and transport systems), the shift of the political paradigm towards global populism, and the monetary policies of central banks. The abolition of economic cycles is all that needs to be declared.

Figure 5. Cumulative US GDP growth since the last recession. Source: The Economist



Growth

Global growth is expected to slow in 2019, according to analyst consensus. By 2020 there could be a recovery, however, it is expected to be lower than growth recorded in 2018. In both China and the US, lower growth is expected than in 2019 (Figure 6).

Figure 6. Expected global growth. Source: Bloomberg

Developed markets				Emerging markets			
Growth(%)	Growth(%)			Growth(%)	Growth(%)		
	2020 E	2019 E	2018 E		2020 E	2019 E	2018 E
World	3.30	3.30	3.70	World	3.30	3.30	3.70
Developed	1.61	1.81	2.29	Emerging	4.87	4.77	4.97
US	1.80	2.50	2.90	China	6.00	6.30	6.60
Euro Area	1.30	1.20	1.80	India	7.11	7.00	7.40
Japan	0.40	0.70	0.70	Rusia	1.70	1.40	1.80
Britain	1.40	1.35	1.40	Brasil	2.10	1.00	1.22
Australia	2.50	2.10	3.00	México	1.70	1.20	2.10
Canada	1.80	1.40	2.10	Corea del sur	2.40	2.20	2.70
Germany	1.20	0.80	1.50	Indonesia	5.10	5.10	5.20
France	1.30	1.30	1.50	Turquia	2.50	(1.30)	3.00

US

Fed: high expectations of rate cuts

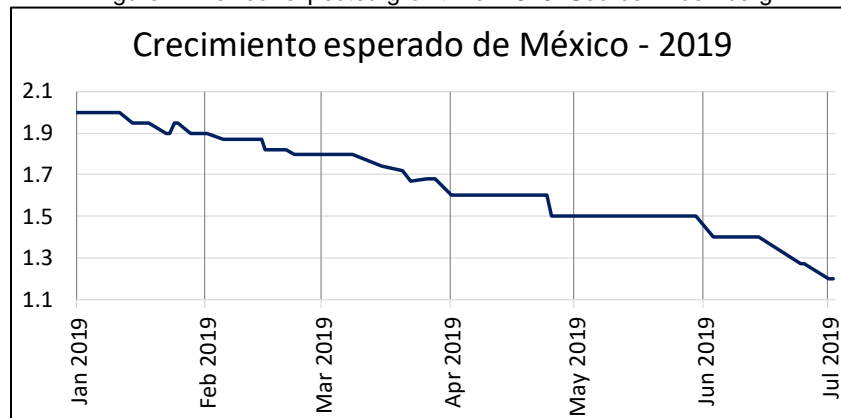
The Fed decided to keep the reference range at 2.25%-2.50%. The statement leaves the door open for future cuts in the benchmark rate. The futures market implies a 100% probability of a cut at the next Fed meeting this July.

MEXICO

Expected growth downwards

Expected growth has been lowered since the new administration took power (Figure 7). According to the consensus of analysts consulted by Bloomberg, expected growth for 2019 stands at 1.2%. The last to cut growth expectations was S&P (1.3%) due to the continued decline in oil production and the weakening of the service sector.

Figure 7. Mexico: expected growth for 2019. Source: Bloomberg



CFE: gas pipeline contract arbitration lawsuits

On June 11, the Federal Electricity Commission (CFE) received notification of the completion of the Texas-Tuxpan pipeline by TransCanada and Ienova, planned to increase 40% of current natural gas import capacity. However, CFE refused to issue a proof of acceptance with a start date for commercial operation, on the argument that certain clauses caused "damage to the nation" and decided to send the contract for international arbitration in the UK and France, along with six other projects by Fermaca, Carso, Ienova and TransCanada that were similarly halted.

The "take or pay" clauses of the relevant contracts include the parties' liability for fortuitous and force majeure events, as well as the reimbursement of payments related to such events, which the CFE had initially agreed to but now considers improper.

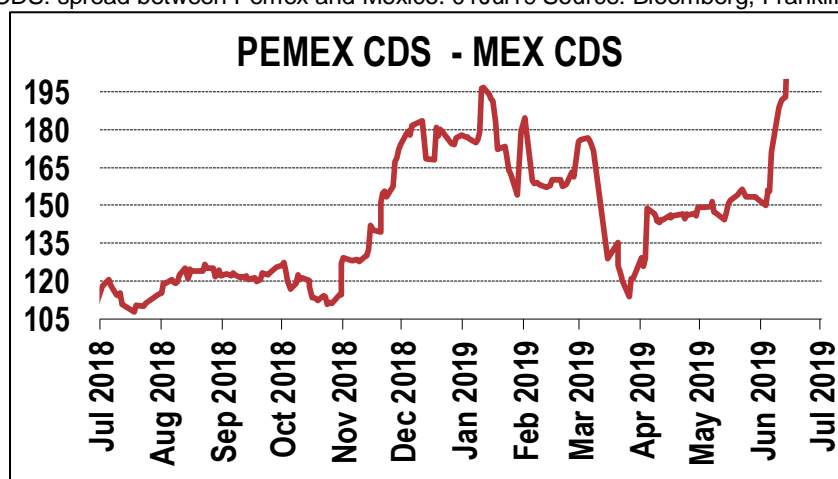
The immediate effect of this decision is the non-transmission of 2.6 bn. cubic meters of gas. In the long term, it reduces the likelihood that there will be other investments in this type of project, because of the legal uncertainty. Canadian Ambassador Pierre Alarie said he is concerned that the Mexican government does not honor pipeline contracts. According to AMLO and the CFE itself, the companies involved are willing to renegotiate contracts.

Pemex

On June 6, Fitch cut Pemex's rating to BB+ with a negative outlook from BBB-, i.e. from investment to speculative grade. Moody's changed Pemex's outlook from 'stable' to 'negative', in line with the sovereign outlook. A second rating cut to a speculative grade by some other rating agency, could trigger a massive sale of Pemex bonds, as many funds by mandate can only invest in investment grade bonds. The market has already discounted this scenario, as Pemex CDS is listed as "high yield", its worst level since AMLO's election (Figure 8).

On June 27, Pemex's \$2.6bn. debt refinancing plan was formalized. Along with the renewal of two US\$5.56bn. revolving credit lines with 23 international banks. When this plan was announced on May 13 there were only 3 banks that were committed. The market welcomed the news as a short-term solution, but the continued decline in production and the lack of a viable business plan has continued to depress the price of Pemex bonds. Pemex's next key event will be the publication of its Business Plan in the second week of July, which will need to contain measures to reverse the decline in crude oil production along with the required funding sources.

Figure 8. CDS: spread between Pemex and Mexico. 01Jul19 Source: Bloomberg, Franklin Templeton



RISKS AND SCENARIOS FOR 2019

The objective is Mexican economic growth. In the positive scenario, all risks turn out favorable for growth, in the negative, unfavorable, and in the middle, mixed. Estimates for each scenario are given in Figure 9.

RISKS	
<i>Global</i>	
<ul style="list-style-type: none"> US: monetary policy, recession, dispute between executive and legislative branch Global: trade wars Geopolitics: Europe, Middle East, Russia, China, North Korea, Venezuela EM: crisis and contagion 	
<i>Mexican</i>	
<ul style="list-style-type: none"> Government Security Corruption Oil Debt rating 	
SCENARIOS	
<i>Positive (10%)</i>	
<ul style="list-style-type: none"> US: expansion continues, trade disputes but no major consequences Monetary policy does not derail cycle. Rapid ratification USMCA. Geopolitical risks do not materialize. Global growth. EM: no crisis or contagion. Mexico: government functions, spending drives infrastructure/consumption, measures anticorruption and antiviolen work, ratings upgrade. 	
<i>Negative (50%)</i>	
<ul style="list-style-type: none"> US: expansion stops, trade wars affect global commerce. Monetary policy derails cycle. USMCA not ratified, elimination threatened. Geopolitical risks materialize. Global recession. EM: crisis and contagion. Mexico: government dysfunctional, spending out of control, anticorruption and violence measures backfire, ratings downgrade. 	
<i>Middle (40%)</i>	
<ul style="list-style-type: none"> US: slow expansion continues, rhetorical trade disputes. Adequate monetary policy, but uncertain. USMCA approved late, with changes. Geopolitical: risks materialize partially. Global slowdown, unsynchronized. EM: crisis and some contagion from vulnerable countries. Mexico: government partially functional, continued mixed signals, ratings stable. 	

Figure 9. Scenarios for 2019. Source: FT

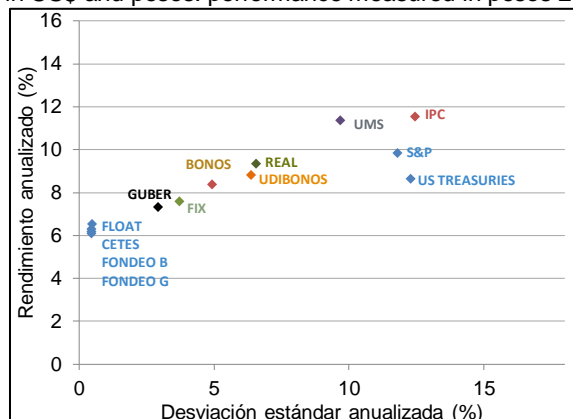
	Escenarios para 2019			2018
	Alto	Bajo	Base	Observados
Probabilidad	10%	50%	40%	
<u>EU</u>				
Crecimiento PIB	> 2.50%	< 2.50%	2.50%	2.90%
Inflación	> 1.90%	< 1.90%	1.90%	2.50%
Déficit fiscal	< 4.50%	> 4.50%	4.50%	4.20%
Déficit cuenta corriente	< 2.60%	> 2.60%	2.60%	2.50%
Tasa T-Bills	> 2.50%	< 2.50%	2.50%	2.50%
TNote 10 US	> 2.65%	< 2.65%	2.65%	2.69%
Petróleo (WTI)	> \$52.93	< \$52.93	52.93	45.41
<u>México</u>				
Crecimiento PIB	> 1.32%	< 1.32%	1.32%	2.00%
Inflación	> 3.75%	< 3.75%	3.75%	4.87%
Déficit fiscal	< 2.50%	> 2.50%	2.50%	2.10%
Déficit cuenta corriente	< 1.60%	> 1.60%	1.60%	1.60%
Cetes28 (fin de año)	> 7.96%	< 7.96%	7.96%	8.42%
Peso/US\$ (fin de año)	< \$19.92	> \$19.92	19.92	19.65

MARKETS

Investments in US\$ and pesos: comparative performance

Following the depreciation of the peso due to Trump, in the long run (2000-2019) the gap between peso investment and US\$, both converted to pesos, has narrowed. However, investments in pesos have outperformed US\$ investments (Figure 10).

Figure 10. Investments in US\$ and pesos: performance measured in pesos 2000-Jul2019. Source: FT



US\$ and peso

After the tariff agreement was reached the peso improved from \$19.76 to 19.2 (Figure 11). Sentiment measured by Banxico: optimism improved from 5% to 11%, but pessimism increased from 32% to 42%, with no change moving from 62% to 47% (Figure 12).

Figure 11. Peso vs. US\$: 1980-Jul2019. Source: FT

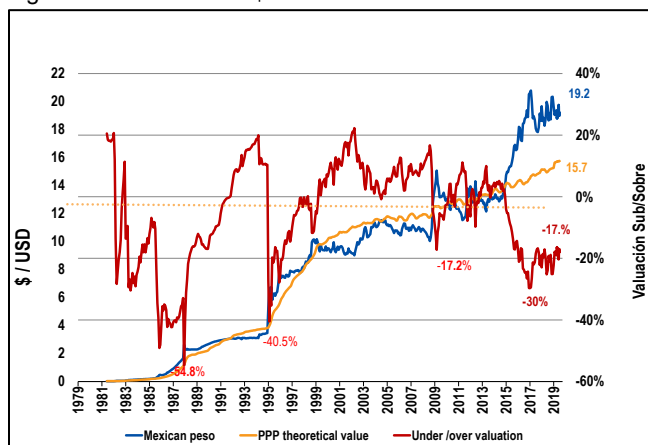
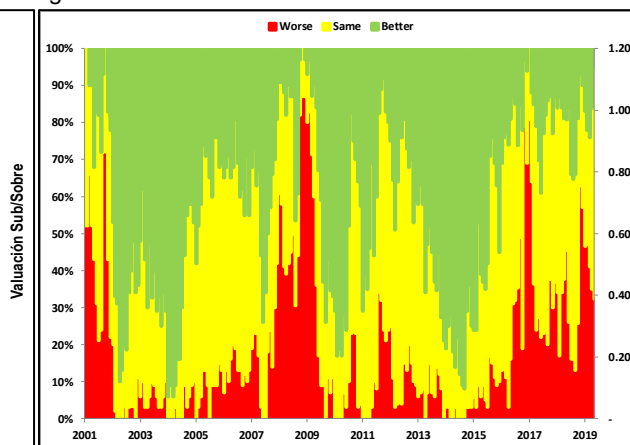


Figure 12. Banxico: index Dec 2001-Jul2019. Source: Banxico



Debt

Rates are expected to rise in DM and EM (Figure 13).

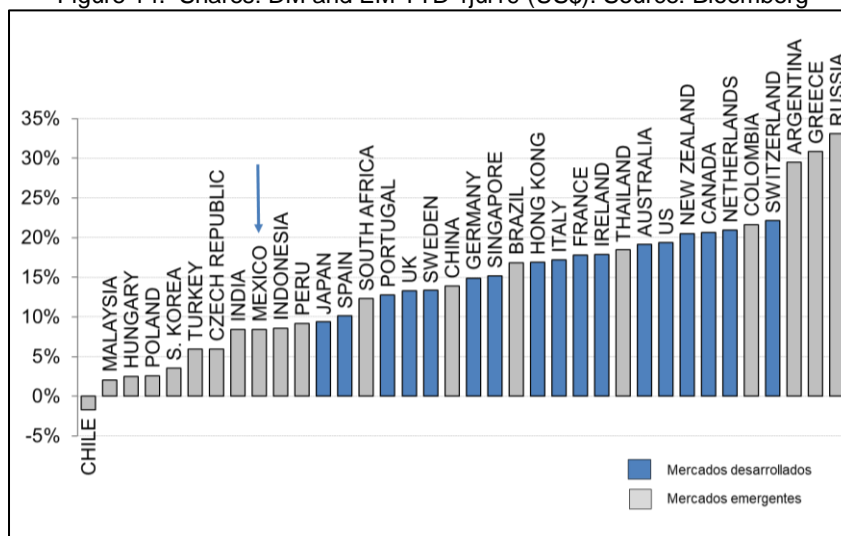
Figure 13. Developed and emerging markets: nominal rates 10 years estimated at the end of 2019 (Jul19). Source: Bloomberg, FT

Developed				Emerging			
local 10y yields (%)				local 10y yields (%)			
	4Q19e	Actual	(bps)		4Q19e	Actual	(bps)
US	2.35	2.03	32.04	China	3.13	3.25	-12.3
Euro Area	0.03	(0.31)	34.1	India	7.27	6.93	33.8
Japan	(0.04)	(0.15)	10.5	Rusia	8.11	7.29	82.3
Britain	1.18	0.82	36.4	Brasil	7.88	7.70	17.8
Australia	1.54	1.28	26.2	México	7.88	7.73	14.9
Canada	1.74	1.48	26	Corea del sur	1.90	1.60	29.8
Germany	0.03	(0.31)	34.1	Indonesia	7.52	7.43	8.9
France	0.36	0.01	34.6	Turquia	18.76	16.39	237

STOCKS

In the first half of 2019, the US\$ stock performance has been positive for most markets, following the widespread declines observed in 2018 (Figure 14).

Figure 14. Shares: DM and EM YTD 1jul19 (US\$). Source: Bloomberg



Fibras

Since inception, Fibras have outperformed stocks (Figure 15). During 2019 they have recovery strongly from 2018, when they were impacted by USMCA renegotiation. They have also benefited from low interest rates (Figure 16).

Figure 15. Fibras vs. IRT (base=100) Mar2011-01Jul19

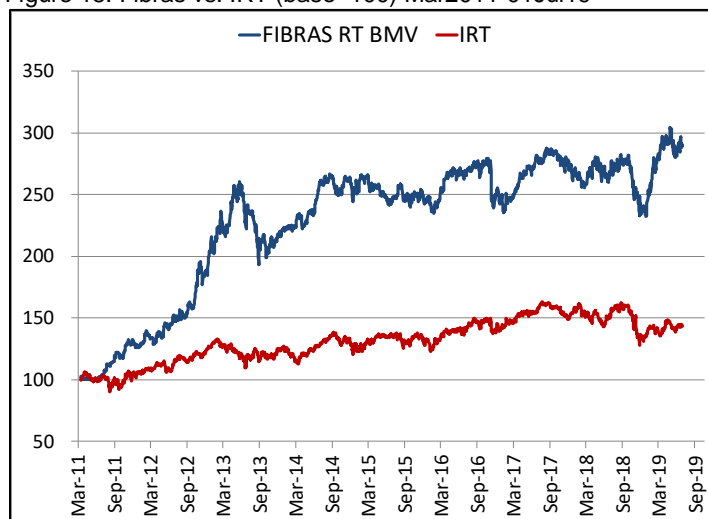


Figure 16. Fibras vs. IRT Jan18-01Jul19. Source: Bloomberg

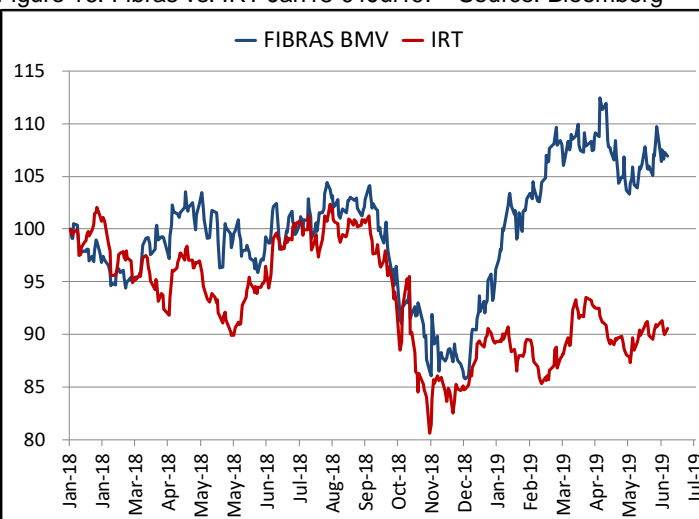


Figure 17. Fibras: valuation and dividends (Jul2019). Source: Bloomberg

	Mcap (M)	Calendarized						
	(MXN)	2015	2016	2017	2018	2019	2020	2021
FUNO11 MM	99,545	5.3%	6.2%	7.0%	10.1%	9.2%	9.9%	9.9%
DANHOS13 MM	36,334	5.6%	6.8%	7.4%	4.7%	9.5%	10.0%	10.0%
DANHOS13 MM	36,077	5.6%	6.8%	7.4%	4.7%	9.6%	10.1%	10.1%
FIBRAPL MM	25,987	6.5%	7.5%	7.8%	10.4%	6.2%	6.7%	7.1%
TERRA13 MM	23,884	7.6%	7.1%	6.9%	7.8%	9.2%	9.5%	10.2%
FMTY14 MM	7,585			8.6%	8.8%	9.1%	9.5%	9.7%
FIHO12 MM	6,491	5.6%	7.3%	9.0%	10.6%	11.8%	12.9%	12.1%
FSHOP13 MM	3,880	5.4%	8.2%	9.4%	110.5%	10.6%	12.8%	10.5%

Conclusion

During the first semester, the performance of risk assets has been positive, but concerns remain about the end of the longest recovery since World War II. In Mexico, investments have also performed satisfactorily, but the triumphalism expressed by AMLO a year after his election contrasts with economic policy and reality. We expect a second semester with greater challenges, uncertainty and volatility. We recommend for peso-denominated portfolios, overweight liquidity, study opportunities to increase 1 - to 3-year debt, and underweight stocks and Fibras.

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Nadia Montes de Oca
Ramsé Gutierrez
Luis Gonzalí
Jorge Marmolejo
Editor: Timothy Heyman
July 5, 2019

Key financial variables: performance as of June 28, 2019

During June, in Mexico, the IPC rose 0.96%. Nominal and real rates fell for all terms. The US\$ weakened 2.21% against the peso. In the US: DJ, S&P500 and Nasdaq rose. Nominal and real rates fell for all terms. WTI price is up 9.29%. Regarding the business climate according to Banxico, optimism rose to 11% (5% previous), no change was 47% (62%), and pessimism rose to 42% (32%).

Mexico					
Stock market and oil					
	28-Jun-19	31-May-19	Month	YTD	2018
IPC	43,161.17	42,749.16	0.96%	3.65%	-15.63%
Local currency (USD/MXN)	19.21	19.64	-2.21%	-2.25%	-0.06%
Mexican oil mix (USD/b)	61.08	56.57	7.97%	36.67%	-20.47%
Nominal rates					
	28-Jun-19	31-May-19	Month	YTD	2018
CETES 28	8.38%	8.47%	-9 bps	-4 bps	110 bps
CETES 360	7.73%	8.05%	-32 bps	-76 bps	103 bps
M5	7.35%	7.86%	-52 bps	-117 bps	93 bps
M10	7.54%	8.07%	-53 bps	-112 bps	101 bps
M30	7.83%	8.45%	-62 bps	-106 bps	111 bps
Real rates					
	28-Jun-19	31-May-19	Month	YTD	2018
UDIBONO 10	3.43%	3.76%	-33 bps	-68 bps	61 bps
UDIBONO 30	3.57%	3.96%	-39 bps	-55 bps	42 bps
Commodities					
	28-Jun-19	31-May-19	Month	YTD	2018
Gold	1,410.03	1,305.80	7.98%	10.10%	-1.70%
WTI (USD/b)	58.47	53.5	9.29%	30.83%	-20.47%
UMS					
	28-Jun-19	31-May-19	Month	YTD	2018
UMS 10 years	3.88%	4.26%	-39 bps	-105 bps	129 bps
UMS 20 years	4.83%	5.14%	-31 bps	-95 bps	125 bps
UMS 30 years	4.64%	5.00%	-36 bps	-120 bps	120 bps
Stock markets (US\$)					
	28-Jun-19	31-May-19	Month	YTD	2018
MSCI Developed	9,122.09	8,554.77	6.63%	17.38%	-8.20%
MSCI Emerging	2,395.54	2,253.09	6.32%	10.78%	-14.25%
MSCI Mexico	8,511.45	8,222.01	3.52%	6.89%	-15.29%
MSCI Brazil	7,338.84	6,911.82	6.18%	16.02%	-0.15%

US					
Stock market					
	28-Jun-19	31-May-19	Month	YTD	2018
DJ	26,599.96	24,815.04	7.19%	14.03%	18.04%
S&P	2,941.76	2,752.06	6.89%	17.35%	11.97%
Nasdaq	8,006.24	7,453.15	7.42%	20.66%	23.26%
Nominal rates					
	28-Jun-19	31-May-19	Month	YTD	2018
Tbill 90	2.12%	2.35%	-23 bps	-33 bps	194 bps
Tnote 5	1.76%	1.93%	-17 bps	-75 bps	58 bps
Tnote 10	2.00%	2.14%	-14 bps	-69 bps	24 bps
Tbond 30	2.52%	2.58%	-6 bps	-46 bps	-8 bps
Real rates					
	28-Jun-19	31-May-19	Month	YTD	2018
Tip 5	0.23%	0.35%	-12 bps	-77 bps	91 bps
Tip 10	0.31%	0.40%	-9 bps	-67 bps	48 bps
Tip 30	0.78%	0.74%	4 bps	-43 bps	22 bps

Bank of Mexico survey		
Indicator	2019	2019 anterior
PIB	1.13%	1.32%
Inflation	3.63%	3.75%
Cetes 28	7.96%	7.96%
Local currency	19.85	19.92
Business conditions		
	28-Jun-19	31-May-19
Optimism	11%	5%
No change	47%	62%
Pessimism	42%	32%

Source: Bloomberg, Banco de Mexico

IMPORTANT LEGAL INFORMATION

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