

Trade disputes and monetary uncertainty

Portfolio Management team

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Franklin Templeton Advisory Services 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

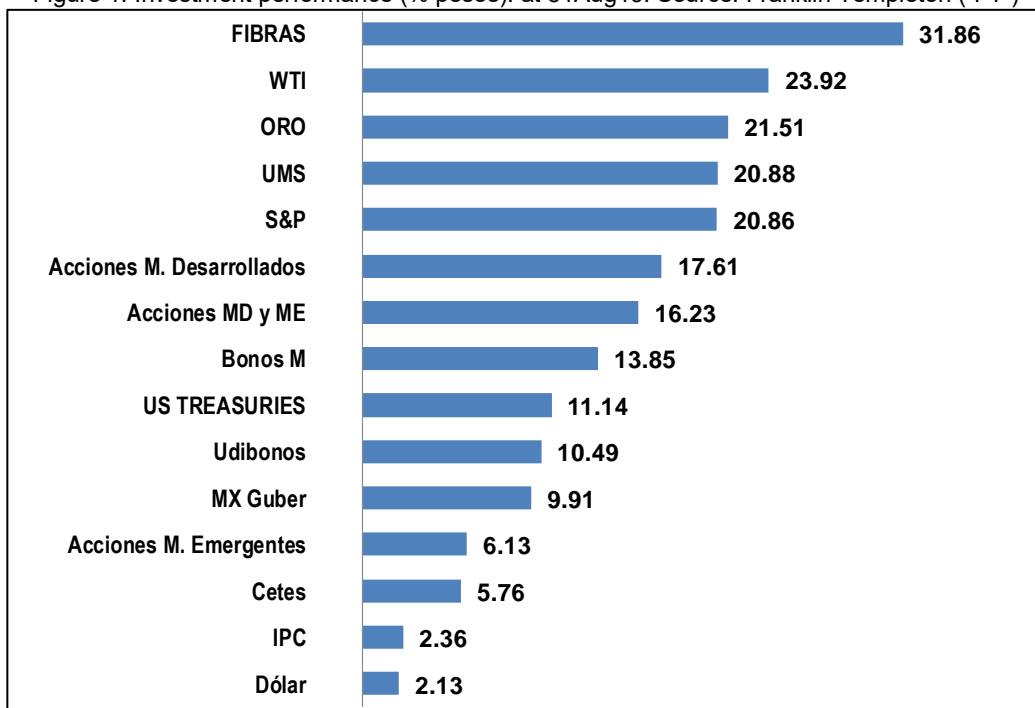
- Global. Bad month for risk assets due to renewed US-Chinese trade wars.
- Mexico, Bank of Mexico easing positive for stocks and debt.
- Global risks 2019-20: sudden slowdown, trade wars, geopolitics, Brexit/Europe, monetary policy, emerging markets.
- Local risks: dysfunctional government, nonratification USMCA in US, investment downgrade.
- Investment scenarios 2019-20 with probabilities: positive (10%), negative (50%), middle (40%).
- For peso portfolios, overweight liquidity and ILS with 1-3-year duration, underweight stocks, benchmark weight fibras.

"My chances of being PM are about as good as the chances of finding Elvis on Mars, or my being reincarnated as an olive." – Boris Johnson

Risk assets: month negative globally, positive locally

Global markets had a negative month owing to the renewal of trade tensions. Locally returns on risk assets were positive owing to global factors and a surprise rate cut by Bank of Mexico (Figure 1). However, many global and local risks persist, making it unlikely that YTD trends will continue for long.

Figure 1. Investment performance (% pesos): at 31Aug19. Source: Franklin Templeton ("FT")



POLITICS

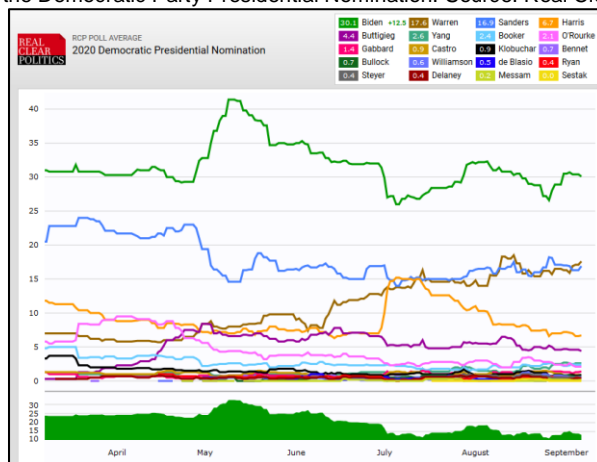
US G7

At the end of August, the 45th G7 summit was held (Germany, Canada, US, France, Italy, Japan and the United Kingdom). The topics covered related to issues of security, energy policy, environment and disease control. There were surprises, such as the unexpected visit of Mohammad Javad Zarif (Iran's foreign minister), but there was no meeting between the U.S. and Iran. When G7 leaders agreed to allocate \$22mn. to fight fire in the Amazon, Jair Bolsonaro, President of Brazil, reacted negatively, arguing that the Amazon is not a world heritage site but that it belongs to Brazil, and that the matter was being treated as if Brazil were no man's land. Trump strongly defended Russia's inclusion at the summit. Although Russia was expelled in 2014 from the former G8 (current G7 plus Russia) owing to its annexation of Crimea, Trump said it would be better if Russia came.

Elections 2020

Of the 26 Democratic pre-candidates competing for the U.S. presidency in 2020, only 10 have qualified for the third round of debates on September 12. Eight candidates who did not qualify for this round may seek inclusion in the fourth round of debates in October, but six candidates have already withdrawn from the contest. There are 3 leading candidates for the primaries: Biden, Warren, and Sanders (Figure 2). According to the latest polls, all three would win against Trump.

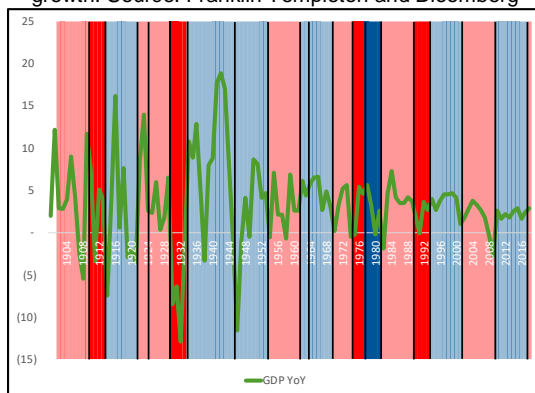
Figure 2: Surveys for the Democratic Party Presidential Nomination. Source: Real Clear Politics, 6/sep/2019



Re-election of Trump and economy

History shows that no U.S. president has been re-elected in times of economic turbulence (Figure 3). The ones that have not been re-elected are Taft, Hoover, Ford, Carter and Bush Sr. Trump will therefore try to revive the economy for the next 12 months. Two likely measures are increased pressure on the Fed to lower rates, and bigger tax cuts by 2020. The problem is that with lower income, US debt would have to increase and, according to some analysts, it is at a dangerous level.

Figure 3: Presidents and economic growth. Red: Republican president; Blue: Democratic president. Strong colors: failed re-election. Green: 12-month GDP growth. Source: Franklin Templeton and Bloomberg



EUROPE

Brexit

Boris Johnson, Prime Minister of the United Kingdom (UK) succeeded in suspending Parliament between 12 September and 14 October, just before the Brexit date of 31 October. His plan is to hinder parliament from blocking a no deal Brexit, the most important promise of his election campaign. On 4 September, the Labour party plus 21 Conservatives passed a law banning a no deal Brexit and a consequent rescheduling of the January 31 deadline: this initiative was also approved by the House of Lords. Johnson reacted with the expulsion of the 21 Conservatives and lost a majority in Parliament. Johnson subsequently lost in Parliament an initiative to hold a general election before October 31.

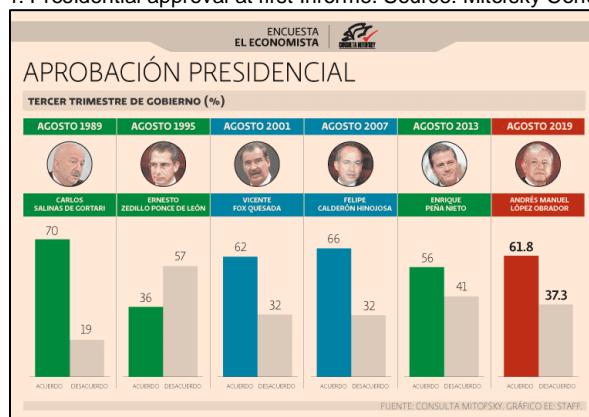
There are two (remote) possibilities for an agreement before 31 October: one organized by Johnson (hard Brexit) and another organized by a more moderate multi-party group (soft Brexit) including the exiles from his own party. Owing to the very short time period, a general election in the last two months of the year is the most likely possibility. It is very difficult to forecast the result. The two big parties (Conservative and Labour) are split between pro (Brexit) and anti-Brexit (Remain) and other smaller parties have been growing (the Liberal Democrats, the Scottish Nationalists and the Ulster Union Party, all Remain, as well as the new Brexit party). It is so complicated that it is not only difficult to predict whether the Remain or Brexit party or coalition will win, but also who would be the leader of the winning party or coalition, especially because Johnson has threatened to resign if he did not get Brexit with or without a deal by October 31. Another factor is that Jeremy Corbyn, Labour party leader, has promised, if elected, to renationalize many industries, including electricity and railways, as occurred in the 1940s, as well as for his government to buy 10% of the shares of UK companies. This has led to a memorable comment by George Osborne, formerly UK Chancellor of the Exchequer with David Cameron, that the next election would be between the "unelectable" (Corbyn) and the "undeliverable" (Johnson's hard Brexit).

MEXICO

First government informe

The first official government "informe" (report) was delivered by AMLO on Sunday 1 September. Morena called it the "third" informe, as in its eagerness to rewrite history it wanted to call the first informe, AMLO's victory speech on July 2, 2018, and his second informe his inauguration speech on December 1, 2018. The informe lasted 95 minutes, and the main themes were combating corruption, budget savings, and security. While the president flaunted his achievements in virtually every branch of government, he acknowledged that security has not improved much, and that much remains to be done. AMLO arrived at the informe with the second highest popularity of any president since Carlos Salinas in 1989 (Figure 4).

Figure 4: Presidential approval at first Informe. Source: Mitofsky Consultation



Reelection Law

After the state congress of Baja California approved the extension of the term of governor-elect (Jaime Bonilla) from 2 to 5 years, and the opposition denounced the extension as unconstitutional, the current governor (Francisco Vega) refused to publish "such an aberration" in the official state newspaper. AMLO decided to leave the resolution of the problem to the appropriate legal bodies. The state congress established a Special Monitoring Commission to submit to popular consultation the extension of the mandate, which they said must be binding, because it reflects the will of "the people". The date of the consultation is not yet defined.

Bartlett Scandal

In a journalistic investigation, it was revealed that several people close to Manuel Bartlett, Director General of the Federal Electricity Commission, own many properties, with a total value of more than \$800mn. pesos. Eréndira Sandoval, Controller General, argued that the properties were bought when Bartlett was not a government employee. AMLO disqualified the investigation as "one of those reports that are made for the purpose of political misinformation", expressing confidence in Bartlett.

Pipeline dispute settlement

In late August, AMLO announced that an agreement had been reached with the companies involved in the construction of the seven-pipeline network. The numbers cited by AMLO seem to be favorable to the CFE (Federal Electricity Commission). They consist of fixed payments to the companies involved (which include Ilenova (US), TC Energy (Canada) and Grupo Carso (Mexico)) for a longer period. The market meanwhile thinks that if the amount of the renegotiated payments is expressed in present value terms, it is more favorable to the companies than the previous amount (which were rising payments over a shorter term). Carlos Slim, majority owner of Carso, was present at the announcement, which pleased investors.

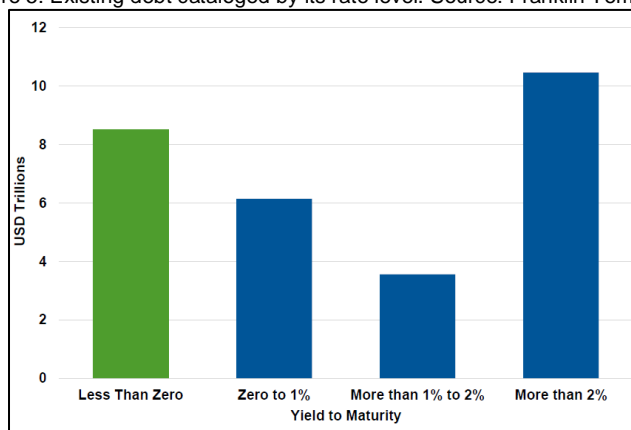
ECONOMY

GLOBAL

Negative rates

In Europe and Japan, rates continued to be negative, and this has increased concern in much of advanced economies. Of US\$28trn. debt outstanding, US\$8trn. (almost 30% of the total) pay a negative interest rate (Figure 5). By mid-September, the European Central Bank (ECB) is expected to further reduce its deposit rate from -0.4% to -0.5%, and to revive the QE program for 40bn. euros per month.

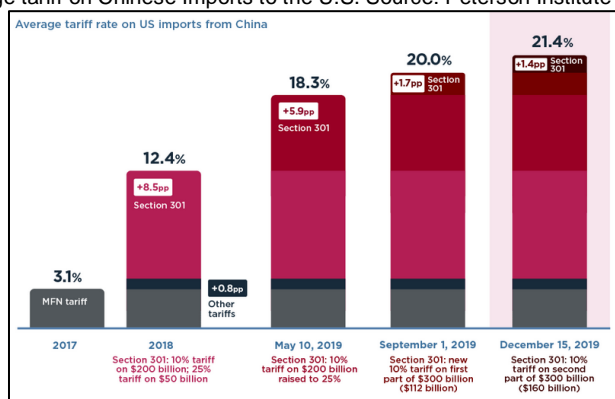
Figure 5: Existing debt cataloged by its rate level. Source: Franklin Templeton



US

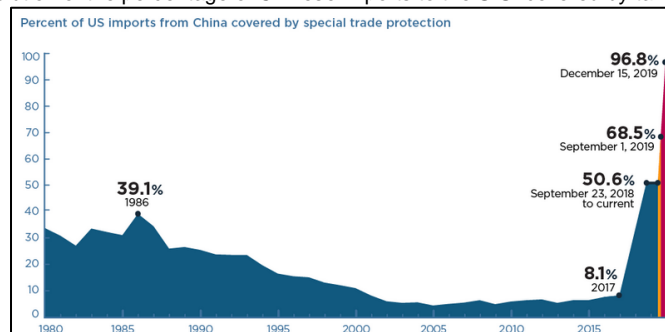
Trade war

Figure 6: Evolution of the average tariff on Chinese Imports to the U.S. Source: Peterson Institute for International Economics (PIIE)



On August 23, Trump announced a new round of tariffs against China. He said he will increase tariffs by 5% on US\$550bn. of Chinese products, which will enter into force on 15 December in order not to affect imports related to the year-end holidays. With this new escalation of tariffs, by 15 December the average tariff on Chinese products will reach 21.4%, compared to 3.1% in 2017 (Figure 6). By December 15, 96.8% of U.S. imports from China will have some kind of tariff, compared to 8.1% in 2017 (Figure 7).

Figure 7: Evolution of the percentage of Chinese imports to the U.S. covered by tariff. Source: PIIE



Monetary policy and Jackson Hole

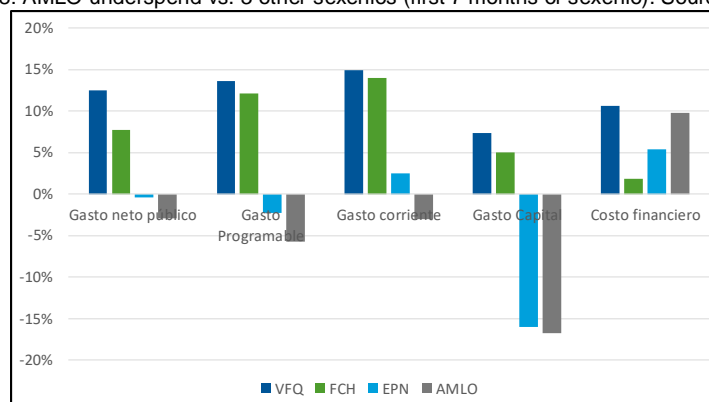
On August 23, Jerome Powell, Fed Chairman, spoke at Jackson Hole, on increased trade tensions and increased pressure on the Fed from Trump. The current challenge of monetary policy was to sustain economic expansion, keeping inflation at 2%. Powell's speech was taken as a hint of a rate cut on September 18.

MEXICO

Budget underspend

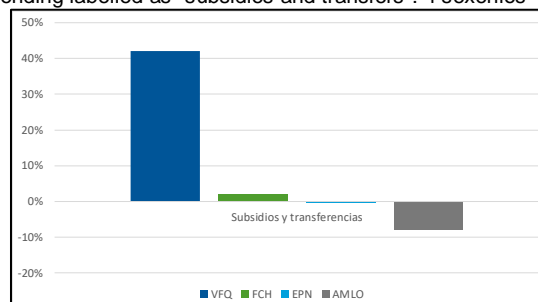
The budget underspend during the first 7 months of the current government has been the highest of the last 4 sexenios. Fox and Calderón increased spend compared to the same months of the previous year, but both Peña and AMLO underspent, with AMLO the biggest underspend of the last 3 years (Figure 8).

Figure 8: AMLO underspend vs. 3 other sexenios (first 7 months of sexenio). Source: SHCP



The underspend has occurred in all areas, including the allocation of subsidies and transfers, which have decreased by 8% compared to the previous year (Figure 9). Although the government flaunts social spending, it has not occurred at the same rate as in previous sexenios.

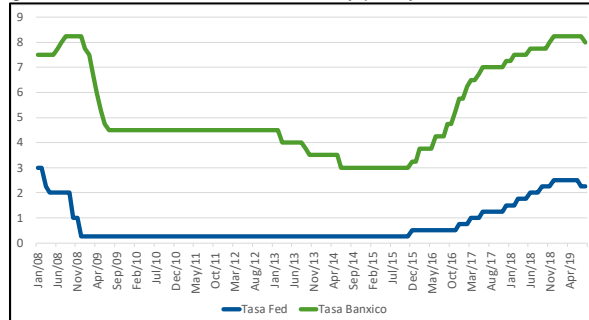
Figure 9: Spending labelled as "subsidies and transfers": 4 sexenios Source: SHCP



Monetary policy

On 15 August, Bank of Mexico decided unexpectedly to lower its benchmark rate from 8.25% to 8%, clearly following the Fed's monetary policy. The decision was not unanimous (4-1), with Deputy Governor Javier Guzmán voting against it. In the minutes of the meeting, there was a mood for easing, owing low to growth forecasts, and contained inflation. Fed easing could therefore help Bank of Mexico, which cannot act alone because the exchange rate would depreciate, inducing inflation (Figure 10).

Figure 10: U.S. and Mexican monetary policy. Source: Bloomberg



Budget 2020

Figure 11: General Economic Policy Criteria. Source: SHCP

Principales variables del Marco Macroeconómico		
	Estimado 2019	Estimado 2020
Producto Interno Bruto		
Crecimiento % real (Rango)	0.6 - 1.2	1.5 - 2.5
Nominal (miles de millones de pesos) ^{*/}	24,851.8	26,254.1
Deflactor del PIB	4.5	3.6
Inflación (%)		
Dic. / dic.	3.2	3.0
Tipo de cambio nominal (pesos por dólar)		
Fin de periodo	19.8	20.0
Promedio	19.4	19.9
Tasa de interés (Cetes 28 días, %)		
Nominal fin de periodo, %	7.8	7.1
Nominal promedio, %	8.0	7.4
Real, acumulada %	4.9	4.5
Cuenta Corriente		
Millones de dólares	-22,876	-23,272
% del PIB	-1.8	-1.8
Variables de apoyo:		
PIB de los Estados Unidos		
Crecimiento % real	2.4	1.8
Producción Industrial de los Estados Unidos		
Crecimiento % real	1.2	1.1
Inflación de los Estados Unidos (%)		
Promedio	1.8	2.1
Tasa de interés internacional		
Libor 3 meses (promedio)	2.3	1.6
Petróleo (canasta mexicana)		
Petróleo, precio promedio (dls./barril)	55	49
Plataforma de producción promedio (mbd)	1,727	1,951
Plataforma de exportación promedio (mbd)	1,115	1,134
Gas natural		
Precio promedio (dólares/ MMBtu)	2.3	2.4

^{*/} Corresponde al escenario de crecimiento puntual planteado para las estimaciones de finanzas públicas.

On 8 September, the SHCP presented its budget initiative for 2020, with these relevant assumptions:

- Estimated growth for 2020 between 1.5-2.5%.
- Inflation contained around 3% by 2020
- Exchange rate for 2020 of \$20/US\$.
- CETES 28 days at 7.1% by the end of 2020.
- Oil rig growth by 13%
- Oil price at US\$49 per barrel.

There is a widespread view that these estimates are optimistic, for example, growth by 2% without confidence in the private sector or the increase in oil production by 13% with a coherent Pemex business plan (Figure 11).

RISKS AND SCENARIOS

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 12.

RISKS	
<i>Global</i>	
• 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>	
• Government	
• Security	
• Corruption	
• Oil	
• Debt rating	
SCENARIOS	
<i>Positive (10%)</i>	
• 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 antiviolence work, ratings upgrade.	
<i>Negative (50%)</i>	
• 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>	
• 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 12. Estimates for scenarios 2019-2020 Source: FT

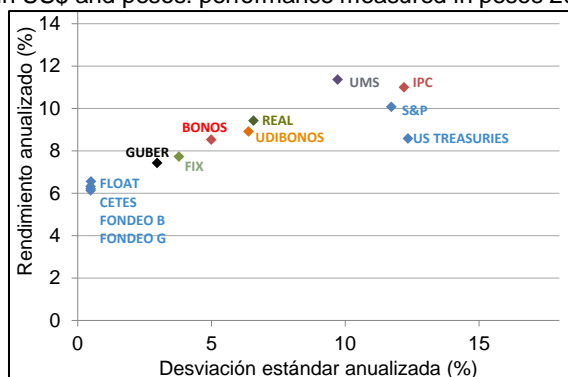
	Escenarios para 2019			2020
	Alto	Bajo	Base	Pronósticos
Probabilidad	10%	50%	40%	
EU				
Crecimiento PIB	> 2.30%	< 2.30%	2.30%	1.80%
Inflación	> 1.80%	< 1.80%	1.80%	2.00%
Déficit fiscal	< 4.40%	> 4.40%	4.40%	4.70%
Déficit cuenta corriente	< 2.50%	> 2.50%	2.50%	2.60%
Tasa T-Bills	> 1.95%	< 1.95%	1.95%	1.80%
TNote 10 US	> 1.98%	< 1.98%	1.98%	2.13%
Petróleo (WTI)	> \$54.19	< \$54.19	54.19	54.69
México				
Crecimiento PIB	> 0.50%	< 0.50%	0.50%	1.39%
Inflación	> 3.31%	< 3.31%	3.31%	3.54%
Déficit fiscal	< 2.50%	> 2.50%	2.50%	2.50%
Déficit cuenta corriente	< 1.50%	> 1.50%	1.50%	1.80%
Cetes28 (fin de año)	> 7.60%	< 7.60%	7.60%	7.12%
Peso/US\$ (fin de año)	< \$19.91	> \$19.91	19.91	20.38

MARKETS

Investments in US\$ and pesos: comparative performance

Following the depreciation of the peso since Trump's emergence, in the long run (2000-2019) the gap between peso and US\$ investments, both converted to pesos, has narrowed. However, investments in pesos have outperformed US\$ investments (Figure 13).

Figure 13. Investments in US\$ and pesos: performance measured in pesos 2000-Aug2019. Source: FT



The US\$ and the peso

The peso had a complicated month due to trade tensions between the U.S. and China. However, by early September it recovered (Figure 14). Sentiment measured by Banxico improved slightly, as 46% of respondents believe that the economic environment will worsen in the next 6 months (vs. 54% of the previous month) (Figure 15).

Figure 14. Peso vs. US\$: 1980-Sep2019. Source: FT

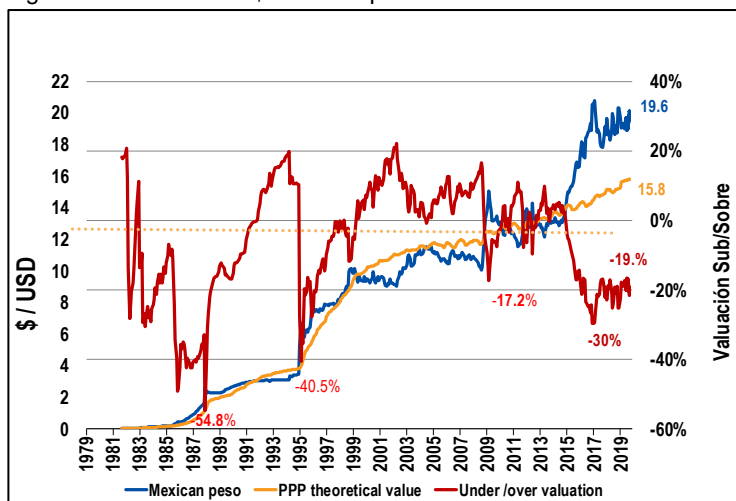
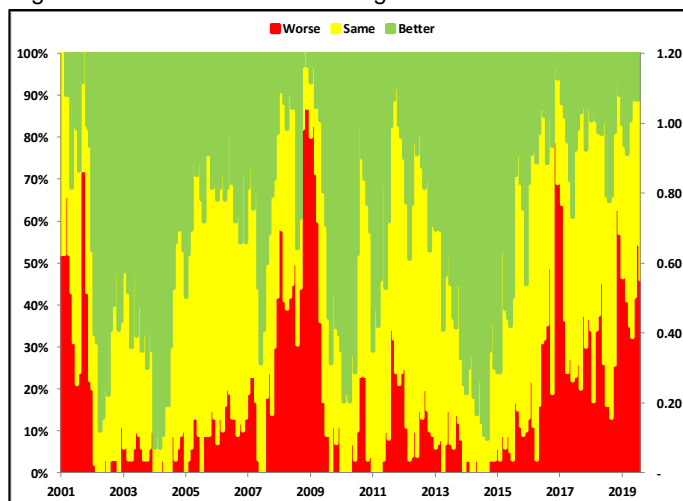


Figure 15. Sentiment Dec2001-Aug2019. Source: Banxico



Debt

Rates are expected to rise across DM by 2020, but only in Russia, Mexico, and South Korea among EM (Figure 16). During August, the curve of 10 year minus 2-year Tnotes became negative. This along with the 10-year Tnote minus 3-month Tbills (negative since December) is considered a strong recession signal in the US.

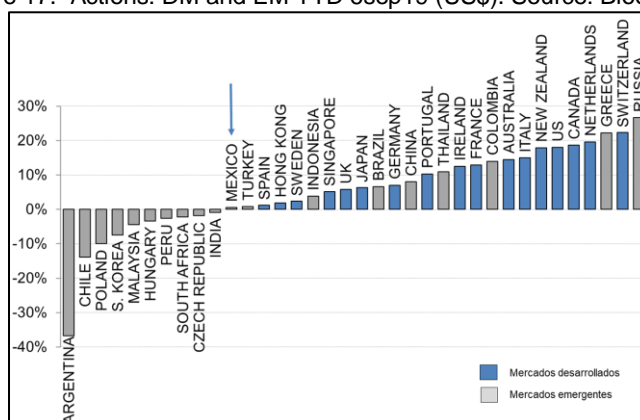
Figure 16. Developed and emerging markets: nominal rates 10 years estimated as June 2020 (Jul19). Source: Bloomberg, FT

Developed				Emerging			
local 10y yields (%)				local 10y yields (%)			
	2Q20e	Actual	(bps)		2Q20e	Actual	(bps)
US	2.03	1.56	47.14	China	2.88	3.02	-13.8
Euro Area	(0.22)	(0.59)	37.4	India	6.34	6.58	-23.8
Japan	(0.12)	(0.27)	15	Rusia	6.96	6.93	3.3
Britain	0.94	0.60	34	Brasil	6.50	7.29	-78.6
Australia	1.19	0.97	21.9	México	8.00	7.02	98.3
Canada	1.65	1.27	38.3	Corea del sur	1.57	1.37	20.5
Germany	(0.22)	(0.59)	37.4	Indonesia	7.04	7.34	-29.9
France	-	(0.29)	29.1	Turquia	15.19	15.49	-30

Stocks

In 2019, there is a marked difference between EM and DM performance. Most EM are negative so far this year, while all DMs have had positive returns. The clear loser is Argentina, owing to the prospect of Macri losing the November elections. (Figure 17).

Figure 17. Actions: DM and EM YTD 6sep19 (US\$). Source: Bloomberg



REITs (Fibras)

Since inception in 2011 REITs have outperformed stocks 2011 (Figure 18). During 2019 they have recovered over 2018, when they were affected by USMCA uncertainty (Figure 19). If interest rates continue to fall, REITs may benefit even more than stocks (Figure 20).

Figure 18. REITs vs. IRT Mar2011(-100)-06Sep19

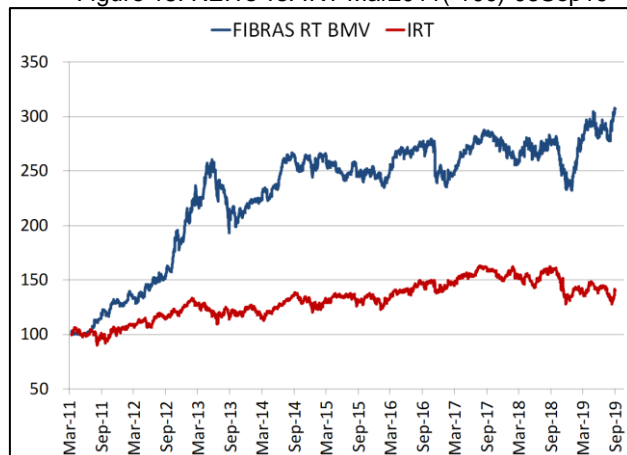


Figure 19 REITs vs. IRT Jan18-06Sep19. Source: Bloomberg

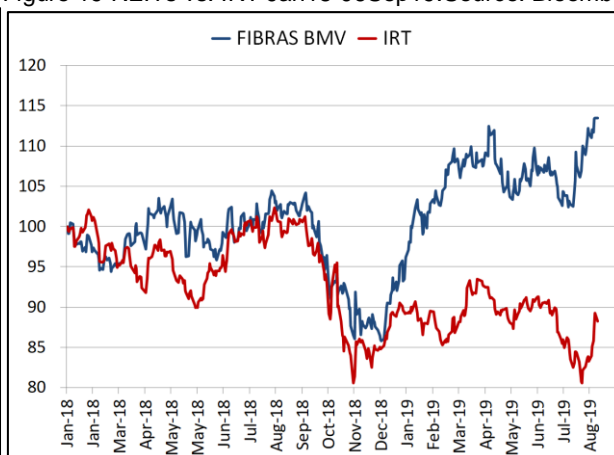


Figure 20. REITs: valuation and dividends (Sep2019). Source: BTG

	Price	Market Cap	Dividend Yield %				Price / NAV		
	(Local)	(US\$mm)	Current	2018	2019E	2020E	2018	2019E	2020E
Mexican FIBRAs									
Fibra Uno	25.59	5,109	9.1%	8.3%	9.1%	9.3%	0.64	0.62	0.62
Fibra MQ	23.13	913	7.7%	6.8%	7.5%	8.6%	0.68	0.62	0.62
Fibra Shop	7.70	197	11.2%	13.3%	11.4%	9.9%	0.36	0.36	0.36
Fibra Terrafina	28.78	1,158	8.5%	9.2%	9.0%	9.1%	0.80	0.81	0.81
Fibra Danhos	26.77	1,884	9.1%	8.7%	8.7%	9.4%	0.68	0.66	0.69
Fibra Prologis	39.89	1,296	5.9%	6.2%	6.1%	6.4%	0.89	0.90	0.90
Fibra Hotelera	7.90	324	11.5%	13.0%	12.0%	12.2%	0.48	0.47	0.47
Fibra Inn	6.79	180	4.3%	14.8%	14.8%	15.0%	0.34	0.34	0.33
Fibra Monterrey	11.85	383	9.9%	8.9%	8.9%	9.1%	0.78	0.78	0.76

Conclusion

Despite the intensification of US trade wars against China, global markets have risen significantly YTD, but risks remain. In Mexico, the budget was well received, although some analysts think macroeconomic variables are optimistic. We advise caution for portfolios denominated in pesos, overweight liquidity and ILS debt of 1 to 3 years, underweight shares and invest in REITs according to the proportions indicated by your benchmark.

Luis Gonzalí
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Editor: Timothy Heyman
September 12, 2019

Key financial variables: performance as of August 31, 2019

During August, in Mexico, the stock index rose 4.31%. Nominal and real rates fell over all terms. The US\$ strengthened 5.67% against the peso. In the US: DJ, S&P500 and Nasdaq fell. Nominal and real rates fell for all oil terms. WTI price fell 5.94%. According to business sentiment measured by Bank of Mexico, optimism remained at 11%, unchanged rose to 43% (34% prior), and pessimism fell to 46% (54%).

Mexico					
Stock market and oil					
	30-Aug-19	31-Jul-19	Month	YTD	2018
IPC	42,622.50	40,863.09	4.31%	2.36%	-15.63%
Local currency (USD/MXN)	20.07	18.99	5.67%	2.13%	-0.06%
Mexican oil mix (USD/bi)	49.54	59.63	-16.92%	10.85%	-20.47%
Nominal rates					
	30-Aug-19	31-Jul-19	Month	YTD	2018
CETES 28	8.24%	8.39%	-16 bps	-18 bps	110 bps
CETES 360	7.11%	7.57%	-46 bps	-138 bps	103 bps
M5	6.86%	7.26%	-40 bps	-166 bps	93 bps
M10	6.97%	7.50%	-54 bps	-169 bps	101 bps
M30	7.47%	7.88%	-41 bps	-142 bps	111 bps
Real rates					
	30-Aug-19	31-Jul-19	Month	YTD	2018
UDIBONO 10	3.22%	3.38%	-16 bps	-89 bps	61 bps
UDIBONO 30	3.47%	3.57%	-10 bps	-65 bps	42 bps
Commodities					
	30-Aug-19	31-Jul-19	Month	YTD	2018
Gold	1,524.90	1,418.01	7.54%	19.07%	-1.70%
WTI (USD/bi)	55.1	58.58	-5.94%	23.29%	-20.47%
UMS					
	30-Aug-19	31-Jul-19	Month	YTD	2018
UMS 10 years	3.38%	3.89%	-51 bps	-154 bps	129 bps
UMS 20 years	4.26%	4.77%	-51 bps	-152 bps	125 bps
UMS 30 years	4.78%	4.64%	14 bps	-106 bps	120 bps
Stock markets (US\$)					
	30-Aug-19	31-Jul-19	Month	YTD	2018
MSCI Developed	8,986.64	9,169.82	-2.00%	15.63%	-8.20%
MSCI Emerging	2,253.44	2,368.23	-4.85%	4.21%	-14.25%
MSCI Mexico	8,157.39	8,187.85	-0.37%	2.45%	-15.29%
MSCI Brazil	6,833.99	7,527.34	-9.21%	8.04%	-0.15%

US					
Stock market					
	30-Aug-19	31-Jul-19	Month	YTD	2018
DJ	26,403.28	26,864.27	-1.72%	13.19%	18.04%
S&P	2,926.46	2,980.38	-1.81%	16.74%	11.97%
Nasdaq	7,962.88	8,175.42	-2.60%	20.01%	23.26%
Nominal rates					
	30-Aug-19	31-Jul-19	Month	YTD	2018
Tbill 90	1.99%	2.08%	-9 bps	-46 bps	194 bps
Tnote 5	1.39%	1.84%	-45 bps	-112 bps	58 bps
Tnote 10	1.50%	2.02%	-52 bps	-119 bps	24 bps
Tbond 30	1.96%	2.53%	-57 bps	-102 bps	-8 bps
Real rates					
	30-Aug-19	31-Jul-19	Month	YTD	2018
Tip 5	0.04%	0.28%	-24 bps	-96 bps	91 bps
Tip 10	-0.05%	0.26%	-31 bps	-103 bps	48 bps
Tip 30	0.35%	0.72%	-37 bps	-86 bps	22 bps

Bank of Mexico survey		
Indicator	2019	2019 anterior
PIB	0.50%	0.79%
Inflation	3.31%	3.62%
Cetes 28	7.60%	7.86%
Local currency	19.91	19.69
Business conditions		
	30-Aug-19	31-Jul-19
Optimism	11%	11%
No change	43%	34%
Pessimism	46%	54%

Source: Bloomberg, Bank of Mexico

IMPORTANT LEGAL INFORMATION

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

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