PRESS RELEASE

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Mexico's Economy: more difficult times ahead

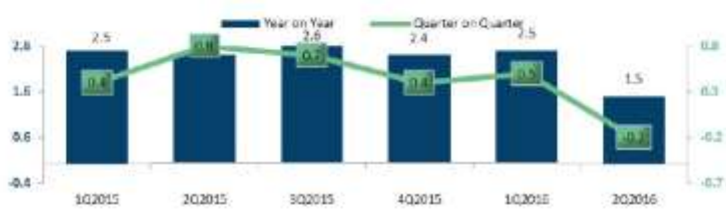
- **GDP is expected to grow by 1.6 % in 2016 and by 1.5% in 2017**
- **Public debt rose to 42.3 % in 2015, up from 38.3 % in 2013. It is expected to reach 45 % by the end of this year.**
- **Government presents budget cut of 240bn MXN (approximately 12.9 bn USD and 1.2 % of GDP)**
- **Outlook for deteriorating macroeconomics is clearly impacting the micro level**
- **Proximity to the US presidential elections continues to bring uncertainties**

A cloudy economic outlook

In the 2nd Quarter of 2016, seasonally adjusted activity decelerated to 1.5 %, down from 2.5% y/y reported in the previous period. Industry, which shrank by 1.5% q/q, was the main contributor to this weak result, due to the fall in oil production and challenges faced by manufacturing and construction industries. The services sector also slowed during the period, to a growth rate of 2.4% YoY, down from 3.4% for 1Q2016.

Chart 1

GDP quarterly evolution (%)



Source: INEGI

Income fundamentals are expected to gradually loose strength

José Antonio Meade, the country's newly appointed Finance Minister, has presented a 2017 budget that signals the government's intentions to step up austerity. The budget announced a 240bn MXN cut in expenditure (approximately 12.9 bn USD and 1.2 % of GDP). This is well above the cuts of 169 bn MXN for 2016 and 124 bn MXN in 2015. Most of the reductions will come from funding of the state owned oil company PEMEX (-5.3 bn USD). It would therefore seem that the government is shooting itself in the foot, as lower investments in the oil company will further reduce oil production, thus limiting future tax revenues.

In addition to these budget cuts, the sharp depreciation experienced by the Mexican peso this year (which led to higher import prices and inflation) has reduced consumer purchasing power. In a comparison of 61 currencies, the Mexican peso reported the third largest negative variation during the period from January to September 2016 (-12% YoY). It stood only behind the British pound and the Argentinean peso.

The environment will remain challenging in the short term and momentum is therefore slowing in private consumption-related sectors. Coface is downgrading its risk assessment for the country's retail and automotive sectors, while commodity dependent sectors remain at risk.

Sector Barometer

Automobile industry: experiencing slow down. Between January and September 2016, the industry's performance slowed to 0.9%, on a year on year basis. As the Mexican auto industry is highly export-oriented, this lacklustre result is mainly due to lower exports – and particularly weaker sales to the US.

Agro/food: risks mainly linked to agro activity. The segment remains at high risk due to several factors including low international prices, currency depreciation impacting the costs of imported fertilisers, the sector's longer terms of payment, the importance of good cash flow management for financing crops and challenging weather conditions.

Chemical Industry: not yet benefitting from oil reforms. The positive effects of the landmark energy reforms approved in December 2013 have not yet been felt, as lower international oil prices have reduced the segment's attraction for investors. The recent budget cuts, of 5.3 billion USD in funding for the country's public oil company, will be a further factor in declining oil production.

Construction: civil construction undermined by scarce public resources. Some infrastructure projects have been delayed or cancelled, due to lower tax revenues from the oil industry. The Mexican Chamber of Construction Industry expects public investments in construction to be reduced by 30% in 2017.

Services: growth expected to decelerate. The relatively good performance of the services sector is backed by positive income fundamentals. In the near future, this rhythm of expansion is expected to slow, as the population begins to more intensely feel the counter effects of the tightening monetary and fiscal cycle.

Pharmaceuticals: activity supported by increasing life expectancy. The segment shows good long term perspectives, as the country has a population around 120 million inhabitants and life expectancy is rising. In the short term, however, the sector will be impacted by cuts in the federal budget.

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Retail: income fundamentals expected to deteriorate in the near future. After being impacted by the 2008-2009 economic crisis, the segment has since reported solid growth. In July 2016, sales showed an increase of 7.9% year on year. Nevertheless, growth should start to decelerate, as consumers begin to feel the effects of rising inflation and interest rates.

Steel: weak global and domestic scenario. Mexico's steel production decreased by 0.3% in the first eight months of this year, YoY. The environment will remain sensitive in the near future. From a global perspective, it would appear that China´s pledges to reduce its total capacity will take some time to materialise. Meanwhile, Mexico's domestic market will continue to be partially undermined by the lackluster activity in construction.

MEDIA CONTACTS:
Gert LAMBRECHT – T. +32 (0)2 404 01 07 Gert.lambrecht@coface.com
Maria KRELLENSTEIN - Tel. +33 (0)1 49 02 16 29 maria.krellenstein@coface.com
Justine LANSAC – T. +33 (0)1 49 02 24 48 justine.lansac@coface.com