MONARCH GLOBAL STRATEGIES

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CEO's Executive Summary

Congressional approval of the USMCA crept forward in recent weeks, with indications, but unfortunately not clear signs, that it will be ratified before the end of the year. At the same time, migration tensions between Mexico and the United States abated as Mexican efforts to deter the northward flow of Central Americans seemed to be successful, while the spectacular failure of Mexico's attempt to arrest one of the leaders of the Sinaloa drug cartel revived security concerns as a top tier bilateral matter.

The Mexican economy remains stagnant, reflecting weak investment that continues to be driven by the USMCA delay and government actions that undermine investor confidence. In October this role was played by three new laws that make tax evasion a felony and punishable by pre-trial detention without bail and asset confiscation before conviction, and by the Sinaloa operation that increased concerns about security in Mexico. The government's 2020 budget proposal, meanwhile, received praise for its top-line promise of a 0.7% fiscal surplus, but also raised concerns because of the optimistic growth and oil production estimates that underpin this surplus.

In the energy sector, the rhetorical battle between AMLO administration nationalists and pragmatists continued, leaving it unclear if petroleum and electricity auctions will be restarted next year or if Pemex will be permitted to enter into joint ventures with private oil companies. And in infrastructure, the administration is moving closer to an announcement of a massive investment program in conjunction with the private sector, while the Santa Lucía airport project got a boost from the courts.

With Mexican President Andrés Manuel López Obrador's poll numbers still in the high 60s, it is unsurprising that the Morena-dominated legislature continues to move his agenda forward. In October, this included the approval of a presidential recall vote that could be held in early 2022, and the reversal of the 2013 education reform, which the opposition promises to challenge in court. But the Supreme Court that will hear this challenge will have a new composition. The resignation of conservative justice Eduardo Medina Mora under pressure should give AMLO his fourth sympathetic justice, enough to block rulings of unconstitutionality which require the approval of eight of the court's eleven justices.

In Baja California, it remains unclear if the incoming governor, Jaime Bonilla, will serve the two-year term to which he was elected in June or a five year term according to a state law whose constitutionality is being challenged in court. Finally, as noted, the October 17 failure by security forces to capture a leader of the Sinaloa drug cartel turned downtown Culiacán into a war zone, and it raised serious questions about the crime-fighting capacity of the AMLO Administration.

I. USMCA – Getting Closer

It has been over a year since negotiations for the new USMCA were completed, and congressional Democrats and the White House continue to search for a compromise that will convince House Speaker Nancy Pelosi to bring the agreement up for a vote. A major sticking point continues to be enforcement of the agreement's labor provisions, but progress seems to be taking place. Following a two-hour conversation with President López Obrador in Mexico City in early September, AFL-CIO President Richard Trumka softened his tone on the USMCA. Rather than dismissing ratification out of hand, Trumka tweeted that he wants to get to "yes," but continues to have concerns about enforcement.

Five Democratic congressmen then traveled to Mexico City in early October where they met with AMLO and key members of his cabinet. They came away convinced that the

AMLO administration is committed to meeting the labor provisions of the agreement, and to implementing a new Mexican labor law approved earlier this year specifically for this purpose. But the congressmen are not fully convinced of Mexico's capacity to do so. They thus made it clear that ratification of the USMCA depends on Mexico's ability to implement its Labor Reform. To alleviate their concerns, the AMLO team agreed to increase the budget for the Labor Ministry by US$900 million to ensure sufficient financing for implementation of the Labor Reform, and sent its chief USMCA negotiator, Deputy Foreign Minister Jesús Seade, to Washington to reinforce this message.

For its part, the AFL-CIO is insisting on the opportunity for arbitration should Mexico not meet its commitments, and the power to immediately block exports that violate the labor provisions of the agreement. The Democratic House leadership, meanwhile, continues to insist that they will not move forward with a vote without the support of Labor. It is reported that the U.S. Trade Representative's Office agreed to binational inspection teams to ensure that Mexico meets its USMCA commitments, but the two sides have not yet agreed to penalties for failing to meet these commitments.

Other developments also suggest that the two sides are getting to "yes." Contrary to what some analysts suggested when the Democrats announced the start of the impeachment inquiry against President Donald Trump, impeachment is not taking attention away from the USMCA. To the contrary, it is actually adding pressure on Pelosi to pass the trade agreement.

Pelosi wants to demonstrate that the Democrats can make headway on legislation that matters to voters' everyday lives while also investigating the president. Since there are enough votes in both houses of Congress to pass the USMCA if Pelosi were to bring it up, this would be an easy win. Passing this free trade agreement will also help Democrats representing districts won by President Trump in 2016, especially given their likely upcoming vote for impeachment. All of which helps to explain Pelosi's insistence that passage of the agreement will be a victory for the nation, not just for President Trump, and her statement that the negotiations are "on a path to yes." The question is can they get to "yes" this year, before the legislative process is further polluted by the presidential election campaign? Our estimate is 60/40 that the agreement will be ratified before the end of the year.

Our own view continues to be that the USMCA, despite including some elements of managed trade that could be bad for U.S. manufacturing in the long run, is nevertheless a strategic initiative that merits the full support of Congress. While we understand the Democrats' desire to strengthen the labor provisions of the agreement, it is worth remembering that this trade agreement, when passed, will contain the strongest labor provisions of any trade agreement the U.S. has ever negotiated. And our partner, in this particular instance, is an administration in Mexico that clearly favors and supports bona fide labor reform in Mexico. But beyond labor, the agreement represents the affirmation of Mexico and Canada as strategic partners, and the endorsement of a North American approach to U.S. competitiveness, which we believe is critical to our long-term success. We urge congressional Democrats to support bringing the agreement to a vote this year.

II. U.S.-Mexico Relations – Beyond Trade

Reduced tensions over migration and a surprise security crisis in Mexico slightly shifted the focus of bilateral relations in recent weeks. Mexico's ability to meet President Trump's demands to evade a punitive tariff on Mexican exports helped restore a cooperative tone on migration matters. Mexican Foreign Minister Marcelo Ebrard met with U.S. Vice-President Mike Pence in Washington on September 10, the end date of the 90-day window the United States gave Mexico to dramatically reduce the flow of Central American migrants through Mexico. Ebrard was able to demonstrate considerable progress – a more than 50% drop in apprehensions at the U.S. southern border since May.

Pence characterized Mexican actions that produced this outcome as "meaningful and unprecedented." President Trump spoke with AMLO by telephone the next day, deeming the conversation "excellent," and later lauded Mexico's border security efforts in his September 25 United Nations speech. It does not matter that the reduced flow of migrants is also due to bad summer weather, changes in U.S. asylum policies, and smugglers recalibrating their strategies to their new operating climate. For now, at least, the Trump administration is singing Mexico's praises.

Security relations between the United States and Mexico have operated mostly under the radar during the Trump era. That changed in the wake of a failed Mexican effort to capture a leader of the Sinaloa Cartel at the behest of the United States (discussed further below).

President Trump called AMLO on October 19 to express U.S. support for Mexico in the battle against organized crime but, according to Ambassador Christopher Landau, Trump is also now concerned about stability in Mexico. Indeed, a high-ranking U.S. Department of State official noted during congressional testimony on October 23 that Mexico needs to develop, and share with the U.S., a comprehensive strategy for fighting organized crime.

During his phone call with President Trump, AMLO asked for U.S. assistance in implementing detection technologies at the border to freeze the southward flow of arms, like those in the hands of the Sinaloa Cartel. Trump agreed, and the two sides held a follow-up meeting on October 21 at the U.S. Embassy in Mexico City and agreed to meet every two weeks to follow up with what has been dubbed "Operation Frozen." Both sides seem determined to cut through bureaucratic barriers to cooperatively implement this new program. But its success will depend as much on Mexico as on the United States since it will require Mexico to restructure how it manages the border posts where the technology would be employed.

III. Mexican Economy – Little to Cheer About

For the first time ever, Mexico allowed the International Monetary Fund to make public the concluding statement of its report on the status of the Mexican economy following an annual consultation with Mexican officials…a decision AMLO may regret. An IMF official described the report as "quite alarming." While lauding Mexico's "strong fundamentals," the report diplomatically but pointedly criticizes the AMLO administration for policies that undermine growth, for a budget based on optimistic assumptions and lacking a tax reform that is essential to long-term fiscal health, and for an energy policy that risks a "catastrophic second downgrade of Pemex," all in a context of negative domestic and international risks.

Growth and Investment

The report lowers growth estimates for Mexico to just 0.4% for 2019 and 1.3% in 2020, echoing other analyses that continue to cut Mexico's growth prospects, with Moody's on the low side estimating just 0.2% growth for this year. Indeed, according to the Mexican National Statistics Agency, the Mexican economy grew just 0.1% in August 2019 from

July, and was down 0.4% from August 2018, with an average year-over-year monthly economic decline of 0.25% over the last 6 months.

These dreary numbers reflect a continuing collapse of activity in construction and mining, falling auto production (down nearly 10% in August, the largest fall in ten years), and September's fourth consecutive monthly drop in manufacturing. It seems the only thing keeping the economy out of recession is Mexican consumers whose continuing confidence helps explain the expansion in low-end retail sales. But consumer demand does not extend to the auto sector or tellingly to Walmart de México.

Falling investment continues to lie behind these numbers, driven by a further deterioration in the investment climate. Gross fixed investment continues to collapse, falling 9.1% in July, the largest reduction in nearly a decade (and the most recent figure available), helped along by a 15% drop in public investment from January to August. Nor is this expected to change, despite a public commitment from Carlos Slim to invest $5 billion dollars in infrastructure projects, due to new legislation approved by the federal Congress in October to punish tax evasion.

To fight tax evasion, the Congress authorized legislation that makes falsifying tax declarations or invoices in excess of $135,000 dollars (2.6 million pesos) punishable by 3-9 years in prison. For violations orchestrated by three or more individuals in amounts exceeding $400,000 dollars (7.8 million pesos), the fraud will be considered to be a felony and a type of organized crime. As such, violators are ineligible for bail and their properties can be confiscated and sold before conviction. While the motive behind the legislation is sincere – to end the very common practice of using illegal invoices to lower one's tax liabilities – the business community sees it as draconian and threatening. There is fear that businessmen could be denied due process and locked up for a simple accounting mistake, that this will consequently discourage foreign investment, and that more Mexican businesses will choose to evade taxes by staying in the informal sector.

In this context, continuing uncertainty regarding the USMCA (noted above) and increasingly visible cartel-related violence in Mexico (discussed below) in combination with previous government actions on which we have reported (e.g., the cancellation of the Mexico's New International Airport) are apt to further dampen Mexico's investment climate.

Monetary Policy and the Budget

September's 2.97% inflation was the lowest registered in three years and marked the fourth consecutive month that inflation has been within the Bank of Mexico's target range of 2%-4%. In this context, Banxico lowered its benchmark interest rate 25 basis points to 7.75%, although two of the five governors disagreed and called for a larger 50 basis point reduction. In its report on the Mexican economy, the IMF also called for an easing of Mexican monetary policy to promote growth now that inflation is on target and the peso is stable.

Few changes are expected in AMLO's 2020 budget proposal as it winds its way through the Morena-dominated legislature. The top-line figures are reassuring – a primary surplus of 0.7% of GDP and a small increase in government debt, meeting AMLO's repeatedly stated preference for fiscal responsibility. And these numbers are based on realistic estimates for inflation, the peso, and oil prices. But they also reflect very optimistic assumptions about growth, oil production, and resulting tax receipts. Growth is estimated at 1.5-2.5% when the consensus forecast for 2020 is just 1.3-1.4%. Oil production is estimated to increase by 17% next year, an increase not seen since 1982 when the massive Cantarell field was coming online. This estimate is thus deemed highly improbable for a firm beset by years of production declines. And the tax receipts on which the primary fiscal surplus depends are based on these optimistic estimates, so they are considered to be equally optimistic and likely to bring about another round of mid-year spending cuts similar to those implemented this year.

The budget also furthers the administration's rebalancing of resources to benefit Pemex and the energy sector, public security, and welfare programs while cutting funds for the tourism, agriculture, and interior ministries. And while the budget expands taxes to include digital platforms and increases sin taxes (on tobacco, alcohol, and sugary drinks), a real fiscal reform is currently not being considered until 2022. The revenue side of the budget was approved by the lower house on October 18 with almost no changes in the government's proposal and passed along to the Senate for review. The lower house now turns to expenditures where it has the sole authority to legislate.

Regulatory Institutions

Finally, Congress seems to have shot the government in the foot once again. After last year's sharp cuts to the wages and benefits of government workers, new austerity legislation now prevents them from working in firms they might have regulated or supervised for ten years after leaving the government. Efforts to reduce this draconian time frame to three to five years to better match global best practices to prevent corruption or conflicts of interests failed. The most likely short-term outcome of this law will be the departure of skilled regulators, further undermining the regulatory capacity of the Mexican government.

Sector Focus: Energy

Petroleum and Pemex

The IMF report discussed above echoed widespread calls for Mexico to increase the amount of private investment in petroleum production. Nevertheless, AMLO has continued to criticize the previous energy reform and to insist that there will be no new contracts for private firms unless the current recipients invest and produce. He also threatened to publicly name those beneficiaries of the energy reform who are not investing. Energy minister, Rocio Nahle, added that while there is room for private actors in the energy sector, they must operate "in their place".

Putting a positive spin on all this, the head of the Office of the President, Alfonso Romo, noted that this means there will be future auction rounds, if by February firms with rights to produce oil show results. Romo is also reported to have organized meetings with private energy firms to discuss their participation in the sector. But when an unnamed government official in late August released a trial balloon suggesting Pemex would restart joint ventures with private firms, it was left floating in the air. All this leaves us wondering which tendency in the administration will win out – the more nationalist wing or the more pragmatic one.

The IMF also echoed the ratings agencies' concerns about Pemex, calling its finances a top risk to the Mexican economy. Recognizing this risk, government investment in the 2020 budget heavily favors Pemex, providing US$4.5 billion (86 billion pesos) to the firm (although much of this is earmarked for the Dos Bocas refinery project). The government also orchestrated a one-time transfer of US$5 billion to Pemex to permit the firm to retire maturing debt and successfully replace it with a mix of 7, 10, and 30 year bonds. But the ratings agencies qualified this effort as “insufficient" given Pemex’s financial needs.

In the good news department, Pemex production rose 0.7% in August over July. Although this was still down 6.4% from last year, it is a sign that Pemex may finally be on the road to reversing 15 years of declining production.

Electricity

Attention in the electricity sector has turned to the distribution network, which energy minister Nahle described in a September 18 speech as “saturated.” She further stated that the electricity auctions supposedly terminated last January were really just postponed and “probably” will be restarted. But when this happens, they will be focused on transmission lines. Only when the distribution system is consolidated, Nahle said, will the government reactivate bids for clean energy. And even then, clean energy must deal with the argument of the CEO of the Federal Electricity Commission, Manuel Bartlett, that clean energy is expensive in Mexico because base cost estimates do not include the costs associated with backup generation and storage to cover electricity needs when the sun isn’t shining or the wind isn’t blowing.

Sector Focus: Infrastructure

On October 2, AMLO used his morning news conference to comment on a meeting held with business leaders the previous day to discuss infrastructure projects for the next five years. They discussed the president’s priority infrastructure projects, including the Santa Lucía airport outside Mexico City, the Mayan Train, and the Dos Bocas Refinery, as well as private sector project proposals, and a plan for a $400 billion dollar infrastructure program (of which 56% is reported to be private sector investment) in the coming weeks. The private funding will be essential, since funding was cut for all three of the government’s priority projects in the 2020 budget, including allotting just 5% of the estimated funds needed for the Santa Lucía airport.

Regarding the Santa Lucía airport, the courts have eliminated all obstacles to its construction. They agreed to a petition from the Defense Ministry arguing that the military airport at Santa Lucía is a “strategic installation” essential to national security. Under this line of reasoning, the airport's expansion is essential to national security and sovereignty and therefore should not be subject to the hundreds of lawsuits filed against it. Referring to this legal victory as "an historic day," AMLO announced that construction would immediately move forward, but completion of the new civilian airport will be pushed back a year, until April 2022. The core opposition to the airport project, a group called *No Más Derroches*, insisted that this new strategy remains unconstitutional and promised to continue challenging the project in court. So the airport saga will continue.

IV. Mexican Domestic Politics

AMLO's popularity continues to register in the high 60s, with approval of his leadership, honesty and credibility increasing notably in the *El Financiero* poll published in mid-October. Given this level of support, it is unsurprising that the president's first state of the union address given on September 1 repeated the same themes as his inaugural address in December and the speech marking the first anniversary of his electoral victory in July. AMLO argued that the nation is on the right path. Despite slow growth, there is more redistribution under the new regime generating improved well-being for the poor. And he again extended a hand to the private sector, but insisted that their interests will be subordinated to those of the nation.

Following this speech, the legislature's fall session got underway. It has focused on the budget and austerity law (discussed above) with two other core priorities of the president – reforming education laws and changing the Mexican Constitution to permit a presidential recall vote.

Legislature

President López Obrador campaigned on a platform to reverse the 2013 education reform, driven by his firm belief that the reform was unfair to teachers, especially those in poorer regions who were required to pass exams to keep their jobs despite themselves being at an educational disadvantage. After failing during the spring congressional session, the Mexican legislature was able to pass legislation to reverse the reform in September. The new legislation eliminates teacher evaluations and reestablishes union control over teachers' appointments and professional advancement, reopening the door to the previous union practice of selling teaching positions. And at the insistence of the radical wing of the teachers' union (expressed through union blockades of congressional office buildings), the legislation also guarantees a job to every student who graduates from a teachers' college. This is an unmitigated loss for the quality of public education in Mexico. Unable to muster the votes to revise the constitutional changes that formed part of the 2013 reform, however, the government will now face challenges to the constitutionality of the new laws, which appear to be at odds with the remnants of the 2013 reform remaining in the Constitution.

On October 15, the Senate approved a constitutional reform allowing for the recall of the president and governors. The vote can only be requested by at least 3% of eligible voters from 27 states and must be organized by the National Electoral Institute, and 40% of eligible voters must participate for the outcome to be binding. For a presidential recall, signed petitions must be turned into the electoral authorities by December 15, 2021, and, should enough signatures be validated, the vote will take place March 5, 2022. While AMLO's name will thus not be on the midterm election ballot in July 2021, he will continue to be in campaign mode through March 2022.

Supreme Court

In a surprising move without modern precedent, on October 4 Supreme Court Justice Eduardo Medina Mora resigned his position under questionable circumstances. President López Obrador immediately accepted his resignation, despite a constitutional provision that only allows Supreme Court justices to resign for "grave reasons." But Medina Mora did not state the reasons for his resignation in his letter to the judicial council, and has yet to do so. The same day, Mexico's financial intelligence unit announced that it was investigating Justice Medina Mora on possible corruption charges, which he loudly rejected. The timing is suspicious, however, as were statements by the investigating authority, a close ally of AMLO, expressing opposition to Medina Mora's legal decisions. These circumstances suggested to many analysts and opposition politicians that the investigation was a tool used to pressure Medina Mora to resign.

This resignation is particularly important because it opens the door to AMLO nominating his third Supreme Court justice in less than a year. These three would be added to the Court's president, Arturo Zaldivar, who has openly expressed his affection for the objectives of the AMLO administration. This would give AMLO enough allied justices to block efforts to declare laws unconstitutional – a declaration of unconstitutionality requires the approval of eight of the court's eleven justices. At the time of writing, AMLO had not yet sent to the Senate his list of three candidates from which the upper house selects the next justice of the Mexican Supreme Court.

As an aside, and without respect to whatever allegations have been made against Justice Medina Mora, Monarch's principals wish to recognize that while he was the Mexican ambassador to the United States, then-Ambassador Medina Mora was an incredibly effective and constructive advocate for Mexico and partner for the United States. He was instrumental in bringing about the creation of the U.S.-Mexico High Level Economic Dialogue (HLED), the U.S.-Mexico Bilateral Forum on Higher Education, Innovation and Research (FOBESI) and other key bilateral initiatives that brought the U.S. and Mexico to a higher level of strategic cooperation than before.

The "Bonilla Law" in Baja California

Two months after Jaime Bonilla's June election to governor of Baja California for a two year term, the state legislature passed a bill (the so-called "Bonilla Law") that would extend his term in office from two to five years. This act generated an avalanche of criticism, including a statement from President López Obrador suggesting that the issue should be decided by the Supreme Court. The sitting governor, Francisco "Kiko" Vega de Lamadrid, refused to sign the legislation into law.

On Sunday, October 13, the legislature organized a non-binding referendum on the question. Despite polls showing the majority of Baja Californians opposed to the extension of Bonilla's mandate, the referendum generated an overwhelming vote in favor of five years. This was not surprising given bias in the question and in the strategic location of the very limited number of voting booths. The following day, Governor Vega signed it under protest, since it's constitutionally could not be challenged until it was officially state law. He then initiated a constitutional challenge to the law before a Supreme Court whose review could be shaped by the justice who is selected to replace Medina Mora. Governor Bonilla is thus scheduled to take office November 1, but still without knowing if his term will be two years or five.

V. Corruption

During the first nine months of the AMLO administration, corruption complaints against the federal government have increased 40% compared with 2018. Some of these complaints have raised eyebrows, since they have focused on personalities who were problematic for the administration. This includes, as noted, Justice Medina Mora, but also the judge who granted the stays against construction of the Santa Lucía airport who was dismissed by the Federal Judicial Council, and the long-time head of the Pemex workers union who resigned his post. And yet when two Mexican journalists presented information that forced Mexico's anti-corruption agency to open an investigation into Manuel Bartlett, a key presidential ally and the CEO of the Federal Electricity Commission, AMLO attacked the journalists and dismissed their accusations as unfounded attacks by his opponents.

Meanwhile, journalists got a hold of secret recordings of Pemex meetings made by lawyers working for a bankrupt Mexican oil company, Oro Negro, which is suing Pemex for blackballing it for failing to pay bribes. According to reports about the recordings, they point to high ranking officials of President Enrique Peña Nieto administration in plans to solicit bribes and to divert funds from the firm to the PRI political party.

VI. Security

On October 14, Mexican Security Minister Alfonso Durazo announced advances in AMLO's security policy, noting a 0.4% reduction in homicides under the current administration and suggested that Mexico was at an "inflection point." Belying this statement, later in the day 14 police officers were murdered in Michoacán by Mexico's strongest organized crime entity (the Jalisco New Generation Cartel). The very next day 15 died in Guerrero in a clash between the military and a criminal band, and two days later we witnessed the government's failed attempt to capture Ovidio Guzmán, the drug-trafficker son of Joaquín "El Chapo" Guzmán, which turned downtown Culiacán, Sinaloa, into a war zone.

While much remains unclear about this October 17 operation in Sinaloa's capital city, we know that Mexican government forces captured Ovidio Guzmán, said to be one of the leaders of the Sinaloa cartel, at the behest of the United States government according to the Mexicans (the Americans are not commenting). Due to poor planning, however, they were quickly surrounded by Sinaloa gunmen who blocked access to all routes out of the city and threatened to murder military families living in the city by burning their homes to the ground. In this situation, the government forces surrendered Guzmán to avoid further bloodshed.

This shocking defeat caught the attention of the U.S. government, worried about what it suggests for stability in Mexico. It is also apt to embolden organized crime and severely dent public confidence in a security strategy that is focused on fighting poverty and avoiding bloodshed rather than confronting organized crime. It could also undercut confidence in a president who insists that he was unaware of such an important security operation, one that has sharply divided public opinion.

VII. Monarch Events, Speeches, Publications & News

August 12: Monarch Managing Director Andrew Rudman participated in the ***Latin America Advisor*** Q&A to discuss AMLO's proposal to replace the *Seguro Popular* public health insurance program with the newly created Health Institute for Well-Being.

October 1-4: Monarch President & CEO Michael Camuñez accompanied California Lt. Governor Eleni Kounalakis and other California leaders on a trade mission designed to re-establish a Mexico trade office in Mexico City.

October 17: Monarch and Privus Capital published the inaugural edition of their joint newsletter on the cannabis industry in Mexico, the *Cannabis in Mexico Report*. This issue provides an overview of the current legal status of the use of recreational and medicinal cannabis and its derivatives in Mexico, including the status of licenses issued under the prior administration, and describes prospects for legislative action later this year.

October 18: Monarch Senior Advisor José Carlos Rodríguez Pueblita answered the *Latin America Advisor* Q&A on AMLO's plans to curb tax evasion in Mexico.

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