MONARCH GLOBAL STRATEGIES

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CEO Executive Summary

The 2018 Mexican presidential election is finally coming into clearer focus, as President Peña Nieto announced his decision to back his finance minister, José Antonio Meade, as the PRI's presidential candidate. The party publicly fell in line behind this decision, ensuring that Meade will face Andrés Manuel López Obrador, likely Ricardo Anaya for the PAN-PRD alliance, and a handful of independent and small-party candidates in the July 1, 2018, election. Meanwhile, the fifth round of NAFTA modernization talks achieved some tangible advances, but they were overshadowed by the sharp opposition from Mexico and Canada to so-called "poison pill" demands the United States tabled in round four. Canada and Mexico appear to be taking slightly different approaches to the U.S. intransigence, but both parties are united in their firm commitment not to allow for a worse outcome than the status quo.

Despite a productive recent visit to Washington by Secretary of the Economy Guajardo, Mexico continues its efforts to prepare for a world without NAFTA. This included significant movement toward a TPP without the United States, an update of the EU-Mexico free trade agreement expected by the end of the year, and progress in trade talks with Brazil and Uruguay.

Due to the impact of hurricanes and earthquakes, the Mexican economy contracted in the third quarter as expected and is on pace to finish the year with about 2% growth. The inflation story is a bit more troubling, but the new Bank of Mexico governor, Alejandro Díaz de León, should continue with a monetary policy designed to bring down inflation. The Chamber of Deputies completed the budget process, approving a relatively austere spending plan that is in line with the predilections of the new finance minister, José Antonio González Anaya. And the new CEO of Pemex, Carlos Treviño, is expected to continue his predecessor's approach to cutting expenditures and increasing production, as government auctions of petroleum tracts continue apace.

I. Mexican Domestic Politics

On November 27, President Enrique Peña Nieto announced the resignation of José Antonio Meade as finance minister in preparation for his December 3 registration as the presidential candidate for the PRI. This move necessitated other changes in the Administration. Pemex CEO José Antonio González Anaya replaced Meade at Hacienda, and Pemex's Chief Administration Officer, Carlos Treviño, ascended to become CEO of Pemex. With Meade out of the running for the Bank of Mexico, President Peña Nieto tapped Deputy Governor Alejandro Díaz de León Carrillo to be the new governor of Mexico's central bank. We will discuss these changes below, focusing first on the presidential sweepstakes.

As is typical of a PRI presidential candidate selection, Meade immediately received the formal backing of each sector of the party and an avalanche of public support from PRI politicians. Meade, known more as a technocrat than a retain politician, has held more cabinet posts than any other modern Mexican presidential candidate, has served presidents from two different parties, is not a member of any political party, and is free of allegations of impropriety. This profile is expected to be attractive to the majority of Mexican voters who are independents. Meade, who is well known to the Monarch team, presents a formidable candidacy, but not without challenges. His background makes him suspect to the PRI base, skeptical of a candidate who has not made a career as a "PRI guy." Indeed, Meade will need to appear sufficiently loyal to the party to ensure PRI unity behind his candidacy, while cultivating an independent profile that can overcome the anti-PRI attitudes expressed by the majority of the Mexican electorate. Meade also begins his candidacy with his party in third place, a position from which no

Mexican presidential candidate has risen to win election. And he begins the race as the personal selection of Mexico's most unpopular president in a generation. He also faces significant headwinds from his association in the public eye with one of the most unpopular and hurtful hikes in gas prices while he was Finance Secretary (the so-called *gasolinazo)*.

Mexico's other declared presidential candidate, Andrés Manual López Obrador ("AMLO"), presented his program for government on November 20. Understanding that victory depends on his ability to expand his appeal to include moderate voters and not scaring off the private sector, AMLO, the current leader in most polls, presented a center-left campaign platform that offers qualified support for NAFTA while promising a frontal assault on corruption and austerity, including a promise to keep Mexico's current macroeconomic policy. He also committed what appears to be a major gaffe by proposing amnesty for drug lords. AMLO formally registered as a candidate on December 12 and will present the names of his proposed cabinet members within two days.

The other main force in Mexican presidential politics, the electoral coalition *Por México al Frente*, among the PRD, PAN, and Citizen's Movement parties, formally registered with Mexican electoral authorities. Overcoming profound disputes regarding candidate selection, the parties agreed their presidential candidate would come from the PAN. The PAN promised an internal party election to select the candidate, but the process and the candidate list suggests that former party leader Ricardo Anaya will come out on top. The PRD Mayor of Mexico City, Miguel Mancera, who had hoped to secure the Frente's nomination, has now dropped out of the race. Regarding independent candidates, the signature collection process suggests than only one candidate, Nuevo Leon Governor Jamie "El Bronco" Rodriguez, has a realistic chance of collecting enough signatures to qualify by the February 19 deadline. But don't assume this will keep former first lady Margarita Zavala off the ballot. One of Mexico's marginal political parties, the Social Encounter party, has expressed interest in having her be their presidential candidate.

Finally, as the murder rate in Mexico continues to rise, on pace to set a new homicide record in 2017, the PRI majority in the lower house of the Mexican Congress rammed through a bill that provides a legal foundation for the military to continue acting as a police force in Mexico. Opponents worry this will reinforce human rights violations in the fight against organized crime and give governors another excuse to postpone improving the quality of state and municipal police forces. The bill is expected to receive final approval from the Senate in early December.

II. U.S.-Mexico Relations/NAFTA

The fifth round of the NAFTA modernization talks began on November 15 in Mexico City, two days earlier than originally announced to give the negotiators more time to discuss the complex issues at hand. This was the first round in which each country's chief negotiator did not participate, a calculated decision that toned down the rhetoric and made room for substantive talks on areas where there is significant consensus. While progress was slow and without major breakthroughs, there were tangible advances on several non-controversial chapters.

That said, no chapters were closed and a telecom chapter said to be close to being closed was thrown open again. The U.S. made a proposal purportedly at the behest of AT&T to effectively reverse a recent decision by the Mexican Telecommunications Commission that would allow Carlos Slim's América Móvil to charge interconnection fees in exchange for letting competitors access to its network. In response, the Mexican government rejected the U.S. demand that NAFTA enshrine the previous zero rate interconnection fee.

On November 17, the U.S. Trade Representative's office responded to Congressional demands and published an updated version of the U.S. negotiating objectives, including references to the more stringent U.S. demands on rules of origin, dispute resolution, and government procurement, and the sunset clause. While this text was hard-nosed, specifically calling for a reduction in the U.S. trade deficit, the elimination of chapter 19, and incentivizing production, specifically in the United States, it also left room for compromise. There was no mention of a U.S.-specific rule of origin, and its reference to the sunset clause excludes any mention of terminating the agreement. It instead calls for "a mechanism for ensuring that the Parties assess the benefits of the Agreement on a periodic basis." This latter position created an opening for a Mexican counter-proposal for a periodic substantive review of NAFTA that the U.S. may find acceptable.

Still, statements by U.S. Commerce Secretary Wilbur Ross and U.S. Trade Representative Robert Lighthizer reinforced the harder edge of the U.S. negotiating position. Speaking at the Wall Street Journal CEO Council, Secretary Ross insisted that Mexico would ultimately give into U.S. demands because a U.S. withdrawal from NAFTA "would be devastating to the Mexican economy." For his part and alone among the lead negotiators, USTR Lighthizer published a statement at the close of the fifth round on November 21. Lighthizer chastised Mexico and Canada for failing to "seriously engage" on the U.S. poison pill demands to allow for "meaningful progress before the end of the year", not so discreetly implying that absent significant progress by year's end an impatient President Trump just might pull the U.S. out of the agreement.

In this game of chicken, Mexico and Canada refused to veer away. Their negotiators refused to respond to the U.S. rules of origin proposal, arguing they would not make counteroffers on proposals they consider unacceptable. And while Mexico did make a counterproposal on government procurement, it was designed less to elicit a U.S. response and more to send a message to U.S. firms doing business with the Mexican government that they could lose access to an important market if they did not pressure the U.S. government to back down.

In part, the Mexican and Canadian strategy of not engaging on the U.S. poison pill proposals reflects their belief that pressure from the U.S. business sector and the U.S. Congress will force USTR to soften its negotiating position. This strategy seems reasonable on automobile rules of origin given that the auto industry has stepped up its lobbying efforts, including a direct warning to Vice-President Pence that the administration's proposal could hurt the auto industry, and the 70 members of the U.S. House of Representatives who urged the Trump administration to back down. And it is apt to seem even more reasonable should the U.S. Congress give final bi-cameral approval to tax reform. Until then, lawmakers and business leaders will be hesitant to challenge an administration that could deliver this other key issue on their legislative bucket list.

Where does this leave us? Our assessment is that it is still too early to know what will happen, but time is definitely not on the negotiators' side. It is well known that the U.S. Congress has little to no appetite to take up a trade vote in a mid-term election year, and the longer the parties take to get a deal on the table, the worse the political calculus becomes. And with Mexico's presidential campaign unfolding, the Peña Nieto government will soon find its hands tied and political capital even further diminished. While negotiators in Mexico maintain a stiff upper lip in public, as evidenced by Secretary Guajardo's extremely positive and optimistic characterization of his recent visit to Capitol Hill, privately senior officials lament what may well be coming: an expected withdrawal notice by Trump. Mexico is moving aggressively to shore up its trade relations with other partners. As one senior official recently commented: "At this point, Plan B is really Plan A." Meanwhile this realism has crept even into the public. According to Mexican Ambassador Gerónimo Gutiérrez, Mexican negotiators now consider a NAFTA collapse a 50% probability. As we write, negotiators are convening in Washington for "technical" talks and will meet in Montreal from January 23-28 for the sixth formal round of negotiations.

III. Mexican Trade Policy

As noted, Mexico continued its efforts to diversify its trade relations in anticipation of an eventual United States exit from NAFTA. As part of this strategy, Mexico participated in talks on the sidelines of the APEC conference in Vietnam early last month to advance the Trans-Pacific Partnership among the eleven countries remaining in the talks after the U.S. withdrawal.

The TPP-11 countries reached agreement on core elements of the Trans-Pacific Partnership, but fell short of signing an agreement in principle. This was due to Canadian opposition, with Mexican backing, to provisions covering autos, intellectual property rights for biologic drugs, and exemptions for cultural industries. This unified Mexican and Canadian TPP position is apt to have implications for the NAFTA negotiations. Not only is their unity on the treatment of biologic drugs likely to extend to NAFTA, Mexico's willingness to support Canada in the TPP talks should be reciprocated in the NAFTA talks.

The sixth round of the Mexico-European Union talks to update their free trade agreement also concluded last month. The joint statement released on December 1 indicates that the parties reached agreement on political and cooperation issues putting the talks on track to finish before the end of 2017. Additionally, in a very busy month for Mexican trade negotiators, the country advanced discussions with Brazil and Uruguay.

IV. Mexican Economy

The Mexican economy shrank for the first time in nearly two years during the third quarter, by 0.3% compared to the second quarter, due to the impact of hurricanes and earthquakes on oil production and tourism. The economy is expected to return to growth in the fourth quarter, as evidenced by a series of positive economic figures for October, including: a record number of workers employed in the formal sector, record auto production, and a 2.1% expansion in same-store sales. Still, the Bank of Mexico cut its growth forecast for 2017 to 1.8-2.3% from 2.0-2.5%. The finance ministry, however, held its expected 2017 growth steady at 2.0-2.6%.

The inflation story is a bit more troubling, as energy prices drove a November uptick in inflation to 6.6%. This helped inform the Bank of Mexico President's recommendation for "prudent" wage increases, which translated into a 10% increase in the minimum wage. Despite being well ahead of inflation, this increase was less than what the private sector had recommended, and it leaves the living standards of minimum wage earners below the national poverty line.

After sinking to an eight month low in the middle of November, the peso recovered on the back of higher oil prices and the workman-like nature of the fifth round of the NAFTA talks before sliding again on concerns about fiscal reform in the United States. The peso closed out the month at 18.6 pesos to the U.S. dollar but jumped to 18.9 in the first week of December. In this context and as expected, the Bank of Mexico held interest rates steady at 7% in their final meeting under the leadership of Agustín Carstens. In his final days as Bank of Mexico President, Carstens also agreed with the IMF's call for Mexico to improve the rule of law as an essential prerequisite for more rapid economic growth.

In his first days as Governor of the Bank of Mexico, Alejandro Díaz de León Carrillo echoed his predecessor's preference for a cautious monetary policy to ensure that inflation, absent any sudden changes in the peso/dollar exchange rate, trends back toward the Bank's 3% target rate by the end of 2018. He also oversaw receipt of a replacement 2-year flexible credit line from the IMF totaling $88 billion designed to support Mexico through a financial crisis. The line has never been tapped since it was first issued in 2009, but it provides confidence in Mexico's economic stability at a time of much uncertainty around the impact of the NAFTA renegotiations, tightening U.S. monetary policy, and the 2018 Mexican presidential election.

The Chamber of Deputies approved the spending side of the 2018 budget in the early morning hours of November 9, six days ahead of schedule. The bill took advantage of the additional 43.3 million pesos created by small alterations to the income side of the ledger – a higher average oil price and higher peso/dollar exchange rate, which we reported last month – to channel funds into earthquake relief. Otherwise, the budget sailed through the Congress with minimal changes. With hindsight, this unusually smooth budget process seems designed to ease former Finance Minister Meade's transition to his new role as PRI presidential candidate.

Mexico's new Finance Minister, José Antonio González Anaya, takes the helm of the ministry where he served ten years before being named the director of IMSS in 2012 and later moving over to Pemex early last year. In the latter two positions, his performance was marked by spending reductions and the efficient use of limited resources. Among his first statements as Finance Minister, González Anaya admitted that Mexico will have to adjust its budget policies should the U.S. approve a sharp cut to the corporate tax rate.

Sector Focus: Energy

Prior to the fifth round of NAFTA talks, the energy ministers from Mexico, Canada, and the U.S. met in Houston to discuss trilateral energy cooperation, specifically in cross-border energy regulation, security, and safety. They praised current cooperation in the sector and pointed to the energy sector as an example of mutually beneficial cross-border economic collaboration.

Concerns that NAFTA's cloudy future might limit investment in the Mexican oil sector do not appear to be borne out by corporate actions so far. For Mexico's round 2.4 auction of 29 deep water blocks scheduled for January 31, 2018, 29 firms have prequalified to bid including oil majors such as BP, Chevron, China Offshore Oil Corporation, ExxonMobil, Repsol, Shell, Statoil, and Total. The Energy Ministry is also moving forward with preparations for the third round of oil and gas bidding, obtaining the National Hydrocarbon Commissions authorization for the licensing of onshore oil and gas fields in round 3.2.

Pemex's new CEO, Carlos Treviño, worked closely with his predecessor as Pemex's chief administration officer. As a result, little change in corporate strategy is expected with the change in director. Oil output and exports rose in October, after a September collapse caused by natural disasters, keeping the firm on pace for stabilizing its output in 2017. The challenges at Pemex, however, remain immense. As the firm considers farmouts to develop the largest onshore find in 15 years, it failed to attract any bidders to market the petroleum output accruing to the government under the new exploration and production contracts. Pemex estimates it will lose 15% of the gasoline market to private companies, it faces the continuing problem of pipeline thefts, and a new report from the Federal Auditor's Office (ASF) found that the company pays more to import gasoline than it would cost to refine it.

Finally, the Energy Regulatory Commission (CRE) moved up the date for the full liberalization of gasoline prices to November 30. In the electricity sector, Mexico's third power auction delivered record low prices, including among the world's lowest prices for clean energy generation, pulling in an estimated $2.4 billion in investment.

V. Monarch Events, Speeches, Publications

November 9: MGS Managing Director Andrew Rudman delivered a presentation in Mexico City on NAFTA and the implications of a U.S. withdrawal at a forum entitled *"La Innovación como Herramienta de Productividad, Competitividad y Desarrollo Económico, así como su Relación con la Propiedad Industrial"* that was sponsored by La Asociación Mexicana de Industrias de Investigación Farmacéutica (AMIIF) and by the Judiciary.

November 21: MGS President and CEO Michael Camuñez was interviewed on Canada's Business News Network (BNN) following Round 5 of talks to update NAFTA in Mexico City, where little progress was made largely due to the Trump administration's tough stance on major issues that Canada and Mexico see as extreme and not a viable starting point for negotiation.

November 27: Michael Camuñez spoke to Reuters about the U.S. delegation's attempts to get Mexico's telecom reforms written into a new NAFTA agreement without regard to the Mexican Supreme Court's recent ruling on the topic and without applying the principles of telecom reform equally across all three countries.

November 28: MGS Chairman Ambassador James R. Jones participated in the Inter-American Dialogue's *Latin America Advisor* Q&A discussing the Mexican Supreme Court's recent ruling that América Móvil can resume charging interconnect fees for calls made to customers on its network.

November 28: MGS Managing Partner Luis Rodríguez spoke about NAFTA at the Universidad de Monterrey.

November 30: Michael Camuñez gave remarks on the NAFTA renegotiation at the National Lieutenant Governors Association 2017 business meeting.