



March 13, 2018

## Mexican election: What if far-left Obrador wins?

### Introduction

Mexico is headed for an election on July 1 with the far-left candidate Andres Manuel Lopez Obrador of the National Regeneration Movement (MORENA) leading in the polls. Mexico's National Action Party (PAN) and Institutional Revolution Party (PRI), which have long dominated the political scene, are trailing far behind. It is widely feared that an Obrador victory will result in key reforms being undone and a much more hardline stance being taken on NAFTA.

The first casualty under this scenario would be Mexico's economy, which would fall well short of IMF projections of 2.3% and 3% growth in 2018 and 2019. This underperformance would be driven by a capital flight, a significant depreciation of the peso and then a spike in inflation, which is already hovering at an uncomfortably high range of 5%-6%.

Despite the widespread nervousness generated by his candidacy among investors, we feel that the risks associated with an Obrador presidency have been widely overstated for reasons explained in this report.

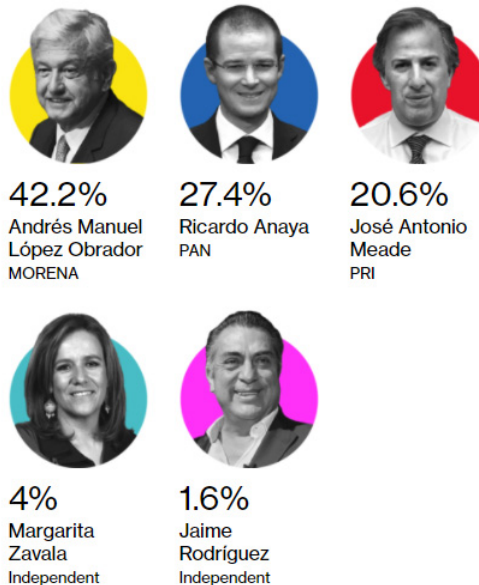
### The three main candidates vying for the presidency

Andres Manuel Lopez Obrador of the MORENA party is currently leading in the polls by double digits. His coalition includes two smaller parties, the left-leaning Labour Party and the conservative Social Encounter Party. This is his third attempt at the presidency.

In distant second place is Ricardo Anaya, leader of the "For Mexico to the Front" coalition, which is made up of the conservative PAN Party and two smaller left-leaning parties, the Democratic Revolutionary Party and the Citizens' Movement.

In third place is José Antonio Meade, candidate for Mexico's ruling PRI party. He recently resigned from his post as Mexico's secretary of finance. The PRI, which has run Mexico for about 90 of the past 100 years, has entered into a coalition with the Green Party and the New Alliance Party.

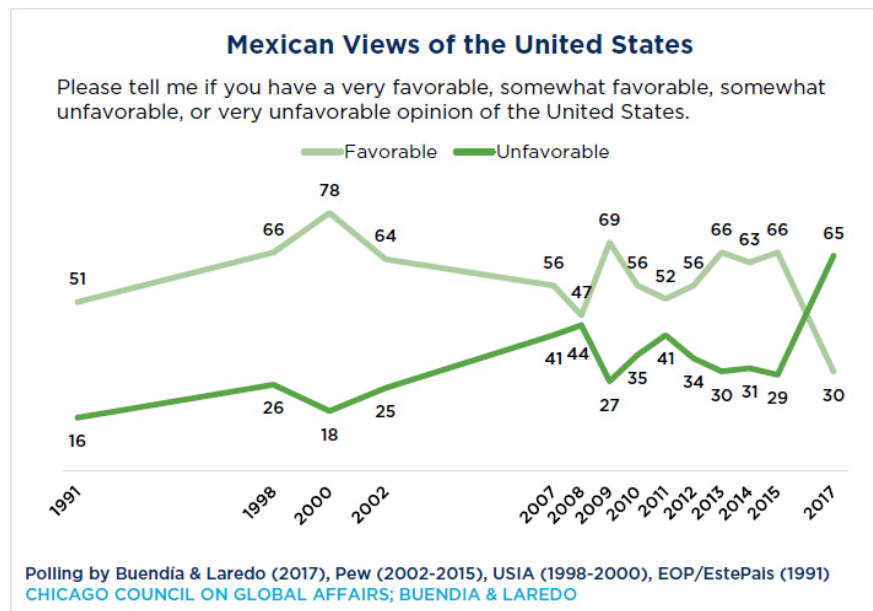
Mexico's increasingly fragmented political landscape and the fact that there is no second-round ballot means someone could win the presidency with as little as one-third of the popular vote.



Mexico's governing and business elite are hoping that Obrador will be defeated in the upcoming vote just as he was back in 2006 and 2012. In 2006, despite leading in the polls ahead of the election, he ended up losing by less than one percentage point. In 2012, he lost by just under seven points. Both times he was hurt by being compared with Hugo Chavez, the populist former President of Venezuela.

While the odds are polls will tighten again as the election approaches, this time around there are three factors working in Obrador's favour.

- President Trump's often inflammatory rhetoric towards Mexico has boosted the popularity of Obrador's nationalist positions. The percentage of Mexicans with a favourable view of the United States has fallen to a low last reached more than ten years ago.



- A wave of corruption scandals implicating Mexico's two traditional ruling parties (PAN and PRI) has boosted Obrador's popularity. At least eight former governors from the PRI party have been arrested or are being investigated for corruption. The attorney general's office is also investigating PAN's candidate, Ricardo Anayah, on suspicions of money laundering related to the sale of an industrial property.
- Public safety has significantly worsened under the current government (more on this later)

## If Obrador takes power, his bark will probably be worse than his bite for the following reasons:

- The total failure of the far-left model in Venezuela (i.e., price controls and nationalizations) has had a moderating effect on left-leaning politicians throughout Latin America, including Obrador. Venezuela's catastrophic collapse has, not surprisingly, received heavy coverage in Spanish-language news media.
- Obrador's reputation as a far-left ideologue does not match his track record. As mayor of Mexico City (2000-2005), he generally got along with business and entered into several public-private partnerships. Debt rose by a modest 9% during his mandate and he left office with an 84% approval rating.<sup>1</sup> Mexico City has a population of close to 9 million, but when you include the surrounding metropolitan areas the figure rises to over 21 million.
- He has named many moderates to his potential cabinet, including Carlos Manuel Urzúa, a former finance minister of Mexico City, as finance minister; Olga Sanchez, a former Supreme Court justice, as interior minister; and Esteban Moctezuma, a former interior minister under President Zedillo, as education minister. He has also placed Alfonso Romo, a prominent businessman, on his campaign team.

<sup>1</sup> "Mexico's populist would-be president," The Economist, May 2017

- Obrador has promised not to raise taxes or debt levels. Whether he succeeds in maintaining his promises, the fact that he has publicly taken these positions highlights his attempt to be seen as a moderate. He also recently stated at a major banking conference: “We will support banks and we won’t confiscate assets,” and “There won’t be expropriations or nationalizations.”
- When it comes to the congressional elections being held on the same day, the odds are strongly against Obrador’s party, MORENA, winning control of either one of the two chambers of Congress. Mexico’s two main parties (PAN and PRI) together presently hold over 300 of the 500 seats in Congress. Obrador’s party holds just 48. In the Senate, PAN and PRI hold 93 of the 128 seats, while MORENA holds only 15.<sup>2</sup> As a relatively new party, MORENA lacks the nationwide support networks needed to have shot at gaining control of the Congress. **The minority status that Obrador’s party is likely to have in Congress will act as a major roadblock to pursuing radical policies.**

## Obrador’s position on NAFTA appears to be moderating

The biggest near-term risk to Mexico’s growth is the possibility that NAFTA negotiations will take a turn for the worse. Over 80% of Mexico’s exports go to the United States.

Like Trump, Obrador has been a long-time critic of NAFTA and has often publicly stated that he would rework NAFTA on his own terms, which includes favouring local companies. However, as the election approaches his public positions on NAFTA have moderated. **Recently, he stated that NAFTA had provided some benefits but could still use major improvements. The person Obrador picked as his economy minister and top NAFTA negotiator, Graciela Marquez, recently stated that NAFTA was a valuable part of the nation’s economy and she would seek to modernize and improve it.**

**As for the United States, we feel the current administration has come to the tacit realization that taking an overly hard line on Mexico would be counterproductive for the following two reasons:**

- There is a significant risk of seeing Mexico fall into a recession if NAFTA is scrapped. Given that Mexico is the United States’ third-largest trading partner (two-way trade valued at \$586 billion annually), this could negatively impact the United States’ economic performance. Further, many states, including those that voted for Trump, have deep trade ties with Mexico. America’s recent decision to exempt Mexico from aluminum and steel tariffs underscores the importance of Mexico’s trade relationship.

Top 14 states	Mexico’s share of total two-way goods trade
New Mexico	38.2%
Arizona	37.8%
Texas	37.5%
Michigan	32.2%
Nebraska	17.2%
South Dakota	16.9%
Iowa	16.9%
Missouri	16.8%
Utah	16.2%
Alabama	13.7%
Wisconsin	13.4%
Colorado	13.3%
Ohio	12.7%
Kansas	12.7%

Source: Atlantic Council, October 2017

<sup>2</sup> “Political Risk Rising in Mexico As Populist ‘AMLO’ Obrador Looks Locked In,” Forbes, October 2017

- The collapse of NAFTA could also reduce Mexico's willingness to cooperate on drug smuggling and illegal immigration. Mexican Foreign Minister Luis Videgaray recently said: "It's good for Mexico that we cooperate with the U.S. on security and also on migration and many other issues, but it's a fact of life and there is a political reality that a bad outcome on NAFTA will have some impact on that." Most of the heroin and opioids coming into the United States is either produced in or shipped through Mexico.

## The challenges facing the oil sector has forced Obrador to change his tune on reforms

Mexico's oil production has dropped to about 1.9 million barrels per day from about 3.4 million in 2004. The main reason for the decline is that up until recently Mexico's constitution granted state-owned PEMEX the sole right to produce oil. **PEMEX has neither the capital nor the technological expertise to develop much of Mexico's remaining oil reserves, such as those found in the deeper waters of the Gulf of Mexico, on its own.**

Five years ago, major constitutional reforms opened up the oil sector to foreign investment for the first time in over 75 years. Mexico awarded 91 exploration and production contracts in the past three years. The government projects that \$150 billion will be invested over the life of these contracts.

Obrador has long promised to roll back these reforms but, with the election looming, his tone has softened. **He recently stated that, barring signs of corruption, private investments would not be reversed. However, he still maintains that any new private investments will be delayed pending a review of the reforms.** We feel that the more oil production comes on line from these private investments, the harder it will be for any government to ignore the positive impacts of this reform. We do feel, however, that Obrador would likely increase payments to poorer Mexicans to help offset the costs of higher gasoline prices, which were deregulated as part of the energy reforms.

We also feel that Obrador would not follow through on his promise to hold a national referendum on recent energy reforms. The reason is simple: Such a divisive move would consume his administration politically and prevent it from advancing other parts of its agenda. Moreover, Mexico's constitution does not permit referendums on budgetary issues.

Finally, the energy reforms could only be rolled back by amending the constitution, which requires the approval of two-thirds of congress and the majority of the state legislatures. This barrier is virtually insurmountable for a party that would be nowhere close to holding a majority in both chambers of Congress. Finally, Mexico's two traditional governing parties, PRI and PAN, worked together to implement the energy reforms and would not support a rollback.

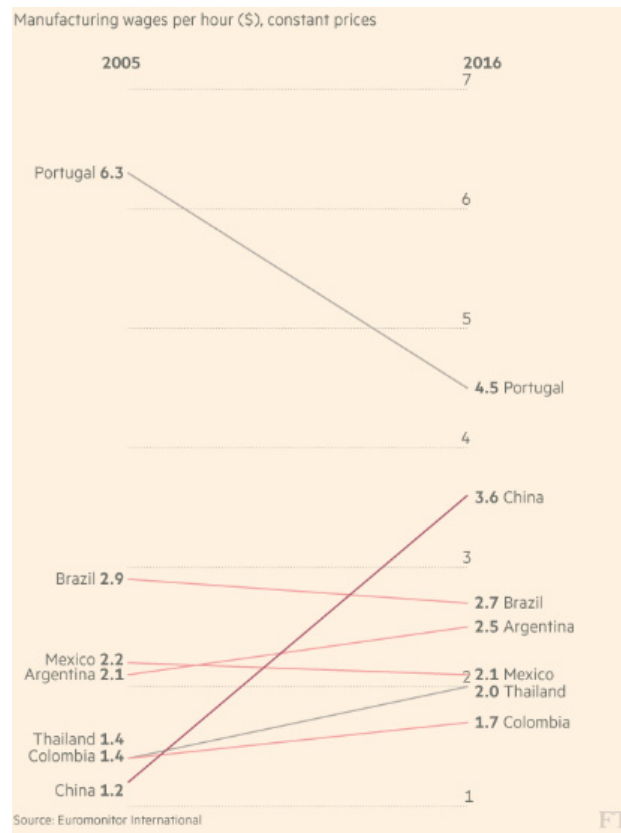
## How would an Obrador victory impact Mexico's manufacturing sector?

Unlike many countries in Latin America, Mexico has not seen its manufacturing sector hollowed out by Chinese competition. The automobile industry is the best example of Mexico's manufacturing prowess. It produced 3.2 million cars and light trucks in 2017, up from 1.98 million in 2006.

The strength of Mexico's manufacturing sector is underpinned by low wages and a web of 46 free-trade agreements. From 2005 to 2016, manufacturing wages fell from \$2.20 to \$2.10 in Mexico, while average hourly wages in China's manufacturing sector tripled to \$3.60.<sup>3</sup>

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<sup>3</sup> "Chinese wages now higher than in Brazil, Argentina and Mexico," Financial Times, February 26, 2017



While low wages have benefitted Mexico's competitiveness in manufacturing, they have also become a sore point for Mexican workers and a source of tension with NAFTA trading partners. Mexico's minimum wage of 88.36 pesos per day (\$4.73) is less than one-third that in Chile and less than half that in Brazil.<sup>4</sup> Further, despite billions in FDI in the past decade, Mexico's auto industry still pays wages that are 12% to 18% of those in the United States. **Both Republicans and Democrats feel that these low wages constitute an unfair competitive advantage.**

Surprisingly, this is one area where there appears to be room for compromise with United States. This is because Obrador's position in favour of significantly increasing wages has strong public support and has forced other candidates to adopt similar stances. The two frontrunners in the election, Obrador (MORENA) and Anaya (PAN), have promised to raise the minimum wage by 171 pesos and 190 pesos (adjusted for inflation), respectively, over the next six years. Anaya has even gone so far as to support a universal basic income scheme.

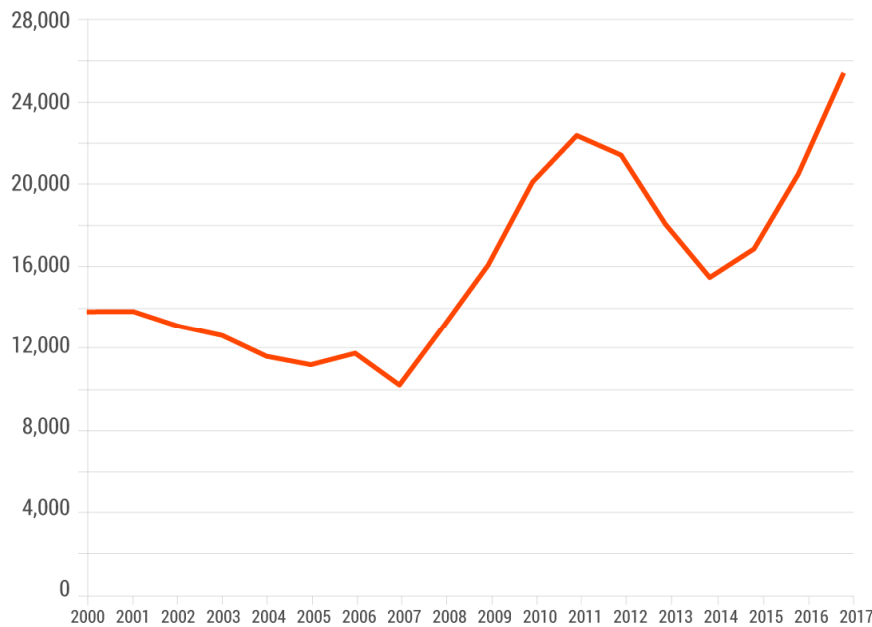
## The major problem of cartel violence

Regardless of who wins the election, one of the major challenges the next government will face is how to curtail the surge in cartel violence. Mexico reported 29,168 murders in 2017, the highest since record keeping began in 1997.<sup>5</sup>

<sup>4</sup> "Mexico's Pro-Business Candidate Wants to Double Minimum Wage," Bloomberg, February 21, 2018

<sup>5</sup> "Mexico had over 29,000 murders in 2017," Associated Press, January 22, 2018

HOMICIDES PER YEAR IN MEXICO



Source: <http://www.inegi.org.mx/>

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Source: Geopolitical Futures, January 2018

One major reason behind this significant increase in violence has been the arrest of many narco kingpins in recent years, which has led to violent battles for control among their underlings and a splintering of the cartels into many smaller groups.

These crime syndicates have also diversified into areas such as extortion and the theft of merchandise and gasoline. Indeed, between 2011 and 2016, the number of unauthorized taps discovered on Mexico's fuel lines nearly quintupled. This has cost the government over \$1 billion annually. **Obrador's plan to increase refining capacity would most likely fail if security is not significantly improved beforehand.**<sup>6</sup> A lack of refinery capacity has forced Mexico to rely on U.S. refiners to meet two-thirds (or over 800,000 barrels per day) of its total domestic demand for gasoline and diesel.<sup>7</sup>

One of Mexico's main challenges will be to improve the rule of law. The government estimates that about 97% of violent crimes in Mexico go unpunished.<sup>8</sup> **This impunity, combined with the spread of the cartels' influence into previously untouched sectors, risks significantly raising the cost of doing business in Mexico. Success on the cartel front will require greater cooperation with the United States on many fronts, including reducing American demand for drugs and curtailing the cartels' ability to easily purchase U.S. weapons.**

Finally, it is also important to note that despite the spike in violence, Mexico still has a relatively low national homicide rate compared with many other Latin American nations. Mexico's homicide rate in 2017 was 20.5 per 100,000 people, versus 27 in both Brazil and Colombia and 60.8 in El Salvador. This rate was far lower in Canada and the United States (1.68 and 6.8, respectively).<sup>9</sup>

<sup>6</sup> "Mexico's drug cartels, now hooked on fuel, cripple the country's refineries," Reuters, January 2018

<sup>7</sup> "Mexican oil shake-up likely if frontrunner wins presidency, says adviser," Reuters, February 2018

<sup>8</sup> "As Mexico Probes a Presidential Candidate for Graft, Many Cry Foul," The Wall Street Journal, March 23, 2018

<sup>9</sup> "Mexico had over 29,000 murders in 2017," Associated Press, January 22, 2018

## Conclusion

In conclusion, we feel that the risks of an Obrador presidency have been overblown. Our view is supported by his moderate record as mayor of Mexico City and the recent softening of his positions on NAFTA and the oil sector. Further, his party's very likely minority status in Congress would act as an additional check on his power.

**As for NAFTA, if a deal was passed by the Mexican congress before the election, we do not feel that an Obrador presidency would be willing or able to reverse it (would require the approval of both chambers of Congress). If NAFTA negotiations continued after the election, we do not feel talks would be any more difficult or easy under a government led by Obrador.**

It is also important to note than any attempt to implement extreme measures such as the nationalization of certain companies and/or the rollback of reforms would immediately trigger a flight of capital, a depreciation of the peso, and a hike in interest rates. This would significantly hurt the economy and leave Obrador with much less fiscal resources to implement major parts of his agenda (i.e., improving the social safety net).

Finally, beyond the election, investors should closely monitor how successful Mexico is in dealing with cartel violence when analyzing Mexico's economic prospects and the cost of doing business across several sectors.

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