MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes Mexico's outlook to negative from stable; affirms A3 ratings

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New York, June 05, 2019 -- Moody's Investors Service ("Moody's") has today changed the outlook on the Government of Mexico's ratings to negative from stable. Concurrently, Moody's has affirmed the A3 foreign-currency and local-currency issuer ratings.

Moody's also affirmed Mexico's A3 foreign-currency and local-currency senior unsecured ratings, the A3 local-currency senior secured rating, the (P)A3 foreign-currency and local currency MTN senior unsecured ratings, and the (P)A3 foreign-currency senior unsecured shelf rating.

Moody's decision to change the outlook to negative on Mexico's A3 ratings reflects the rating agency's concern that the policy framework is weakening in two key respects, with potential negative implications for growth and debt. First, unpredictable policymaking is undermining investor confidence and medium-term economic prospects. Second, lower growth, together with changes to energy policy and the role of PEMEX, introduce risks to Mexico's medium-term fiscal outlook, notwithstanding the government's near-term commitment to prudent fiscal policy.

The A3 rating affirmation balances the country's large and diversified economy, its high fiscal strength and low susceptibility to event risk, against ongoing challenges related to weak growth rates, weaker-than-peers institutional strength and a large informal sector.

Mexico's long-term foreign-currency bond ceiling remains unchanged at A1, and the long-term foreign-currency bank deposit ceiling remains unchanged at A3. With regard to the short-term foreign-currency ceilings, the bond ceiling remains unchanged at P-1, and the deposit ceiling at P-2. The local-currency country ceilings for bonds and bank deposits remain unchanged at Aa3.

RATINGS RATIONALE

RATIONALE FOR CHANGING THE OUTLOOK TO NEGATIVE FROM STABLE

LESS PREDICTABLE POLICYMAKING IS ADVERSELY AFFECTING ECONOMIC GROWTH PROSPECTS AND INTRODUCING MEDIUM-TERM RISKS TO MEXICO'S FISCAL OUTLOOK

According to Moody's, the predictability and effectiveness of economic policymaking in Mexico is weakening. Mixed messages, unexpected policy announcements and reversals, such as the government's recent lack of clarity on the use of the Stabilization Fund for Budgetary Revenues, are introducing elements of policy uncertainty and unpredictability, which are weighing on investor sentiment and growth prospects.

Inability to articulate and execute a clear set of policies has eroded the credibility of the administration's economic program. Lack of policy coherence, which has undermined economic sentiment and investor confidence, is having a detrimental impact on Mexico's economic prospects.

Moody's anticipates a challenging year for Mexico's economy and expects growth to slow to 1.5% in 2019 from 2% in 2018 with risks tilted to the downside given a persistent weakness in private investment. Moreover, Moody's believes that the government's mixed messages and unclear policy signals will continue to negatively affect business confidence and investment prospects.

Consequently, the rating agency's current view regarding Mexico's medium-term economic prospects differs from the base case scenario assumed at the time of its decision to stabilize the outlook a year ago. At the time, Moody's expected the economy to expand by over 2% in 2019, and by nearly 3% in 2020 and beyond. Now, the rating agency expects sluggish economic activity to carry into 2020 with growth subdued at around 1.8%. And looking further ahead, the balance of risks in the coming years is tilted to the downside, as lower investment is likely to constrain growth prospects beyond 2020. Lower medium-term growth would erode the economy's resilience to shocks, which supported sovereign creditworthiness in previous years.

Weaker growth prospects in the coming years, combined with the prominent role assigned to PEMEX in the context of the country's new energy policy, is also raising concerns regarding the trajectory of government debt. The expanded mandate assigned to PEMEX by this administration, the precarious financial health of the state-owned oil company and its increasing difficulties in accessing capital markets suggest that the company's ongoing financial support needs may be substantial and therefore material from a sovereign credit standpoint.

So far this year, the government has pledged a multi-year total of $7 billion (0.6% of GDP) on a cumulative basis to the national oil company -- excluding previously pledged transfers from the Stabilization Fund for Budgetary Revenues -- via a capital injection, an exchange of promissory notes owed to it by the sovereign (which is a below-the-line operation that does not have an impact on fiscal performance), and a reduction in its tax burden. Increased questions among financial investors about PEMEX's new business model have led to materially higher funding costs. This has restricted the company's ability to access markets, increasing the need for sovereign support, and putting additional pressure on the fiscal accounts. Providing recurrent assistance to PEMEX for meeting its financing needs could result in a fiscal cost of 1%-2% of GDP on a yearly basis over the next five years if the company is unable to tap market funding.

As a result, the government is likely to face increasingly challenging trade-offs in the coming years between its stated intention of maintaining a conservative fiscal stance on the one hand, and, on the other, the need to support PEMEX and the government's desire to expand social programs and public infrastructure spending. A low growth environment will further complicate the government's ability to meet its fiscal goals by weakening its revenue intake. While federal government debt has been broadly stable at around 35% of GDP in recent years, lower growth and the tension between policy priorities may lead to a rise in debt ratios in the coming years that could erode the country's fiscal strength.

RATIONALE FOR AFFIRMING THE RATINGS AT A3

The rating affirmation reflects Mexico's large and diversified economy, which is the second largest (after China) among 'A' category peers, its lack of major macroeconomic imbalances, and its high fiscal strength, which is broadly aligned with 'A'-rated peers. Weak growth rates and weaker-than-peers' institutional strength remain credit challenges. Mexico's track record of prudent macroeconomic policymaking has enabled it to face shocks over the past decade, including the oil price shock and trade agreement renegotiations with the US, while anchoring domestic and foreign investor confidence.

Moreover, the A3 rating is also supported by a healthy banking system and an improved government revenue structure that has curtailed its dependence on oil income as a result of the steady increase in tax revenues due to the 2014 tax reform.

WHAT COULD CHANGE THE RATING UP

Although a rating upgrade is unlikely in the near future, a return to a stable outlook could result from regained confidence in the government's ability to lay out and implement predictable policies. Much higher and sustained growth, combined with a material strengthening of the government's balance sheet could over time lead to an upgrade of Mexico's rating.

WHAT COULD CHANGE THE RATING DOWN

Further evidence that medium-term growth is in decline, whether as a result of policies that actively undermine growth or because of continued policy unpredictability, would put downward pressure on the rating. Increasing fiscal deficits that cause the debt trajectory to shift upward, whether due to financial support to PEMEX or for any other reason, could also lead to a downgrade. The horizon over which these trends might materialize is uncertain. While policy action or inaction could lead Moody's to conclude that these risks will crystallize, a period of up to 18 months may be needed to assess the credit consequences of the uncertainties and tensions inherent in government policy and their interaction with investor sentiment.

GDP per capita (PPP basis, US$): 20,602 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 2% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4.8% (2018 Actual)

Gen. Gov. Financial Balance/GDP: -1.8% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -1.8% (2018 Actual) (also known as External Balance)

External debt/GDP: 36.4% (2018 Actual)

Level of economic development: High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 31 May 2019, a rating committee was called to discuss the rating of the Mexico, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have decreased. The issuer's institutional strength/framework has decreased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in November 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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