Fitch Downgrades Mexico to 'BBB'; Outlook Revised to Stable

Fitch Ratings-New York-05 June 2019: Fitch Ratings has downgraded Mexico's Long-Term Foreign Currency and Local Currency Issuer Default Ratings (IDRs) to 'BBB' from 'BBB+' and revised the Outlook to Stable from Negative.

A full list of rating actions is at the end of this release.

KEY RATING DRIVERS
The downgrade of Mexico's IDRs reflects a combination of the increased risk to the sovereign's public finances from Pemex's deteriorating credit profile together with ongoing weakness in the macroeconomic outlook, which is exacerbated by external threats from trade tensions, some domestic policy uncertainty and ongoing fiscal constraints.

The impact of the contingent liability represented by Pemex weighs increasingly heavily on the sovereign credit profile, as evidenced by Fitch's two-notch downgrade of Pemex to 'BBB-' from 'BBB+' in January 2019 and the latter's stand-alone credit profile of 'CCC'. Spreads on Pemex's debt over sovereign debt rose materially in 1Q19, leading the government to step up support. The fiscal cost of that support to date represents 0.2% of GDP to the budget in capital injections and lower effective taxes, but in Fitch's view, are not sufficient to provide a long-term solution or prevent continued deterioration in Pemex's credit profile.

Pemex's tax bill (oil accounted for 2.3% of GDP in federal government revenue in 2018) exceeds its FCF, preventing it from investing sufficiently to maintain production and reserves. Fitch expects oil output to contract by 5% in 2019 and 2020. The company's debts, which are largely external, reached USD106.7 billion (8.7% of GDP) in 2018 and are not included in the general government debt metric used by Fitch in its sovereign rating model. However, as our base case expectation is that ongoing sovereign support will be extended to Pemex over the medium term through a combination of a lower tax burden and/or further capital injections, our assessment of the sovereign's public finances is weaker than indicated by the headline gross general government debt to GDP ratio of 42% at YE 2018.

Growth continues to underperform, and downside risks are magnified by threats by U.S. President Trump to impose tariffs on Mexico from June 10 (starting at 5% and rising by a further 5% per month up to a potential 25%) to compel it to stop the flow of migrants across its territory into the U.S., amid a pattern of trade uncertainty. Mexico's five-year GDP growth averages 2.6%, below the 'BBB' median of 3.6%. Excluding the drag from oil production narrows the gap to the median by around half (i.e. 0.5pp). Although full-year GDP growth reached 2% in 2018, the pace of growth decelerated during the year and the economy only narrowly avoided recession, as growth was flat in 4Q18 before contracting 0.2% qoq (1.25% yoy) in 1Q19.

Mexico's growth continues to lag that of the more developed U.S. economy, to which it is closely linked. Fitch expects growth to accelerate from 2Q but despite this it will reach only 1% in 2019; this would be consistent with a pattern of slower growth in the first year of a new administration. Lower inflation and higher wages (stemming from rises in the minimum wage) should support consumption, but the energy sector, characterized by a trend of falling production at Pemex, and weaker investment levels, reflecting lower business confidence,

will continue to weigh on growth. The suspension of private sector bidding rounds that had been scheduled as part of the energy sector reforms is unlikely to help investment sentiment.

The 2019 budget presented in December, followed by the "pre-criterios" or 2020 fiscal policy guidelines released in April 2019, maintain a disciplined fiscal stance. Estimated oil revenue for 2019 has been revised down by 0.5% of GDP, and spending cuts were announced for an equivalent amount. Resources for the government's priority programs were scaled back in the budget relative to pre-budget announcements, and other expenses have been cut. The government targets a primary surplus at the non-financial public sector level of 1% of GDP in 2019 (2018: 0.6% of GDP). The president has also stressed that public debt "will not grow in real terms." General government debt ended 2018 at 42% of GDP, slightly above the current 'BBB' median of 37.5% of GDP, and Fitch expects it to stay around that level in 2019-2020. The general government deficit was 1.9% of GDP, lower than the non-financial public sector deficit of 2.3% of GDP.

In Fitch's view, meeting fiscal targets will become more difficult heading into 2020 and could result in tighter policy that creates a further headwind to growth. The president has pledged not to raise taxes before 2021. In 2020, the fiscal rule demands a further tightening of the public sector primary balance to 1.3% of GDP. The government plans a change to the fiscal rules framework that would increase counter-cyclical space and, by reducing potential over-spending, the credibility of fiscal targets.

Government revenues should benefit from efforts to curb tax evasion and the scrapping of "universal compensation", a provision which allowed corporate tax payers to write off tax due (most frequently corporate tax) against VAT or other tax claims. Meanwhile, spending on new social programs for pensioners and the youth population (which were allotted 0.6% of GDP in the 2019 budget) is likely to undershoot as these get off the ground. Data YTD show revenue and spending were below budget at the public sector level, the former largely owing to lower revenues from Pemex.

It remains to be seen whether the new administration, which has pledged action against crime and corruption, can reverse the trend of deteriorating governance, which began under its predecessors. The president has a stronger mandate than prior administrations, and his coalition has a majority in the lower House of Congress, and close to a majority in the Senate, giving him the ability to effect change. The average of the six World Bank governance indicators used by Fitch is weighing on Mexico's score in Fitch's Sovereign Rating Model and is currently the lowest in the 'BBB' category. Progress in combatting fuel theft, which had become a major problem for Pemex, is a positive achievement. The government has created a National Guard to fight crime and is encouraging the judiciary to pursue corruption cases.

Mexico's ratings are supported by the country's diversified economic structure and a track record of disciplined economic policies that has anchored macroeconomic stability and contained imbalances. While some of the Lopez Obrador administration's microeconomic policy decisions have proved contentious, macro policy choices have been orthodox to date. These strengths counterbalance Mexico's rating constraints, which include economic growth below the 'BBB' median, structural weaknesses in its public finances (a low revenue base compared with peers), shallow credit penetration, and governance scores among the lowest in the 'BBB' category.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
Fitch's proprietary SRM assigns Mexico a score equivalent to a rating of 'BBB' on the Long-Term Foreign Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

--Macroeconomics: +1 notch, to reflect Mexico's track record under successive administrations of prudent,

credible and consistent macroeconomic policies. The authorities continue to emphasize macroeconomic stability in their policy actions, which has contained macroeconomic imbalances.
--Public Finances: -1 notch, to reflect our expectation that ongoing sovereign support for Pemex will result in a lower tax take and/or higher general government debt burden, negatively impacting public finances.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES
The main factors that individually, or collectively, could result in positive rating action include:

--Resilience in investment and growth prospects and policies that support medium-term growth;
--Adherence to a prudent fiscal framework consistent with a stable or declining government debt burden;
--Improvement in governance indicators to a level closer to the rating category median.

Future developments that could individually, or collectively, result in negative rating action include:

--A weakening in the consistency and credibility of the macroeconomic policy framework;
--Sustained macroeconomic underperformance, characterized by continued weak GDP growth outturns that result in a deterioration of key credit metrics;
--A trend increase in the government debt burden.

KEY ASSUMPTIONS
The global economy performs in line with Fitch's Global Economic Outlook.

Fitch has downgraded Mexico as follows:

--Long-Term Foreign Currency Issuer Default Rating (IDR) to 'BBB' from 'BBB+'; Outlook revised to Stable from Negative;
--Long-Term Local Currency IDR to 'BBB' from 'BBB+'; Outlook revised to Stable from Negative;
--Short-Term Foreign Currency IDR to 'F2' from 'F1';
--Short-Term Local Currency IDR to 'F2' from 'F1';
--Country Ceiling to 'A-' from 'A';
--Issue ratings on long-term senior unsecured Foreign Currency bonds to 'BBB' from 'BBB+';
--Issue ratings on long-term senior unsecured Local Currency bonds to 'BBB' from 'BBB+';
--Issue ratings on short-term senior unsecured Local Currency bonds to 'F2' from 'F1'.

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Additional information is available on www.fitchratings.com
Applicable Criteria
Country Ceilings Criteria (pub. 19 Jul 2018)
Sovereign Rating Criteria (pub. 26 May 2019)

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