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# Mexico heads for an historic constitution reform

Mexico heads for an historic constitution reform as the global manufacturing cycle shows signs of turning positive.

| Emerging Markets | Index level/ yield | Spread over UST | 1 week change |
|---|---|---|---|
| MSCI EM | 958 | | 0.51% |
| MSCI FM | 561 | | 1.90% |
| GBI-GD | 6.48% | | 0.07% |
| ELMI+ | 4.35% | | -0.32% |
| EMBI GD | 5.75% | 310 bps | -0.78% |
| EMBI GD IG | 4.83% | 215 bps | -0.93% |
| EMBI GD HY | 9.01% | 657 bps | -0.45% |
| CEMBI BD | 5.66% | 347 bps | -0.52% |
| CEMBI BD HG | 4.79% | 259 bps | -0.56% |
| CEMBI BD HY | 7.56% | 539 bps | -0.35% |

| Global backdrop | Index level/yield/ FX rate/price | 1 week change |
|---|---|---|
| S&P 500 | 1,710 | 1.48% |
| VIX Index | 11.98 | -10.53% |
| 5 year UST | 1.37% | -1 bps |
| 10 year UST | 2.62% | 1 bps |
| 10 year Bund | 1.64% | -2 bps |
| EURUSD | 1.3269 | 0.05% |
| USDJPY | 98.46 | 0.51% |
| Brent | $109 | 0.00% |
| Copper | $326 | 2.26% |
| Gold | $1310 | -1.45% |

## Emerging Markets

### Mexico and Emerging Market PMIs

Potentially one of the most important developments in Mexico's recent economic history took place last week when the opposition PAN party submitted a proposal to the Senate to alter key clauses in Mexico's 1917 Constitution governing the role of the private sector in oil production and electricity generation and distribution.

PAN's proposal would change the constitution's Articles 27, 28, and 29 to (a) introduce private sector participation in oil production, (b) allow a partial sale of PEMEX stock for listing on the local exchange, (c) remove the PEMEX union from the company's board, and (d) break the state monopoly on electricity generation and distribution.

PAN's proposal is more than a curiosity, because President Pena Nieto of the governing PRI party is widely expected to submit a similar reform to parliament this week. PAN and PRI look set to merge their proposals. The outcome is likely to be a reform, which is not quite as aggressive as PAN's proposal, but which will nevertheless be very positive for Mexico going forward.

Between them PRI and PAN (with the help from minor parties) should be able to muster the two-thirds support in Congress and the backing from half of Mexico's state legislatures required to pass the reform package. The other main opposition party, PRD, is opposed to the bill, but controls only 20% of seats in the two houses of Mexico's parliament.

Mexico's constitution is in dire need of overhaul. The role of the state as laid out in the constitution still reflects Mexico's bygone troubled relations with its erstwhile imperialist northern neighbour. A succession of lame duck Mexican governments meant that deeper surgery in to the constitution was impossible until now, and Mexico was only able to carve out greater competitiveness over the past two decades through high unemployment. PAN's reforms would increase competitiveness in key strategic sectors such as oil and electricity and hence materially improve the outlook for the Mexican economy, including the country's trend growth rate.

### The week's other important development in Emerging Markets was the release of manufacturing data.

The bottom-line is that manufacturing continues to be soft. On average, manufacturing PMIs declined to 49.4 in July from 50.0 in June, the sixth consecutive decline. However, as one would expect in a group of more than 65 investable countries there was considerable variation across countries. China's PMI returned to expansion territory in July (with a print of 50.3), while PMIs also rose in Poland, Czech Republic, South Africa, and Singapore. Looking forward, however, the most important observation is probably that manufacturing activity is now turning positive in the US and Europe. This bodes well for manufacturing in Emerging Markets too, because of the highly integrated nature of the global manufacturing supply chain. Having said that, manufacturing is not the same as growth. Over the past five years changes in PMIs have had much greater impact on short-term sentiment and asset prices than on growth rates, particularly in the HIDCs (Heavily Indebted Developed Countries). Indeed, each manufacturing upturn in the US in the past five years has singularly failed to translate into 'exit velocity'. This fact is of course not likely to deter the market from repeating the same mistake again this time.

*Continued overleaf*

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## Global backdrop

Sentiment about the outlook for developed economies improved sharply over the past week, despite – or perhaps due to – a very weak payroll print in the United States.

The past week witnessed a plethora of important data releases of which we would highlight the following: (a) Fresh GDP data showed that the US economy grew 1.3% yoy in Q1 and 1.4% yoy in Q2, down from 3.3% yoy and 2.8% yoy during the same periods last year; (b) Non-farm payrolls disappointed at 162K vs.185K expected; (c) ISM manufacturing ripped higher to 55.4 vs. 52 expected; (d) Mortgage applications set a new low post tapering as higher real interest rates continue to snuff out new business in the housing sector.

In its July meeting, the Fed's FOMC was distinctly dovish, noting that "inflation persistently below its 2% objective could pose risks to economic performance". The Fed's dovish message helped to push S&P500 through 1700 and a strong ISM number kicked 10-year US treasury yields back above 2.7%, only for yields to crash back to pre-ISM levels in response to the weak payroll print.

The decline in mortgage applications perhaps best illustrates the Fed's conundrum as it heads towards tapering of quantitative easing (QE) in September: Sure, forward guidance can help to anchor the short end of the treasury curve, but how will the Fed prevent bear steepening of the yield curve without QE? A back-up in long-term yields could yet undermine a fragile recovery in an economy saddled with total debts of more than 400% of GDP.

Elsewhere, there was a vicious 'sell the fact' dynamic in the Japanese stock market following Prime Minister Shinzo Abe's win in Japan's Senate election. It remains to be seen if Abe will expend his political capital to deal with Japan's major structural economic challenges, or whether he will focus more on populist endeavours such as changing the country's constitution and foreign policy.

In Europe, PMIs picked up sharply from 48.8 in June to 50.3 in July, the first time the PMIs have been above 50 since 2011. Sensibly, however, the European Central Bank repeated its dovish message. Indeed, ECB President Mario Draghi went as far as to criticise market's pricing of higher interest rates as "unwarranted".

We now head into a week with fewer data releases, but with plenty of appetite for clarification from the Fed about what the very mixed data picture means for monetary policy.


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