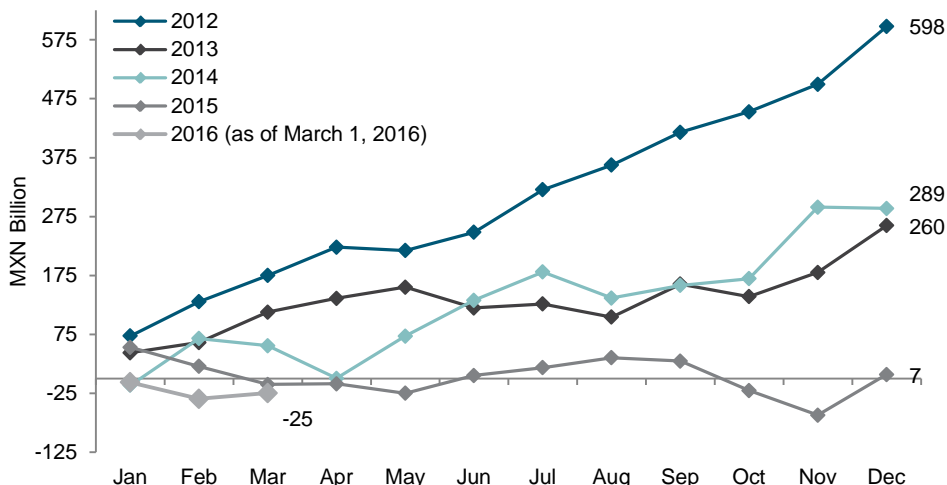

Mexico's Fixed Income Markets

CONTRIBUTOR

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- On Feb. 17, 2016, Mexican authorities launched a coordinated effort to stem the slide in the value of the Mexican peso (MXN). The central bank surprised markets with an interest rate hike and announced a more flexible foreign exchange (FX) intervention program, while the finance ministry announced budget cuts.
- The Mexican peso, which had been among the worst-performing currencies globally through mid-February 2016, gained 5.4% since the announcement and is up 6.9% from the low level seen one week before the announcement.
- After the announcement, the MBono curve, which represents Mexican government development bonds with fixed interest rates, flattened by 40 basis points (bps) (10-year versus 1-year), with the front end driving the bulk of the losses, increasing as much as 40 bps on that day.
- In the four-week period ending March 1, 2016, foreign investors withdrew MXN 28.3 billion (0.8% of total stock) from Mexican government bonds, driven by a reduction in exposure to Federal Treasury Certificates (CETES) of MXN 22.0 billion and to UDIBonos of MXN 13.4 billion. Meanwhile, exposure to MBonos increased by MXN 7.0 billion.
- As of March 1, 2016, net foreign outflows from government bonds were at a historical high on a year-to-date (YTD) basis due to the reduction in positions seen in January 2016, along with the fourth-largest, one-month reduction occurring in February 2016.

Exhibit 1: Cumulative Foreign Inflows and Outflows—Domestic Government Bonds



Source: Banxico. Data as of March 1, 2016. Chart is provided for illustrative purposes.

AUTHORITIES ACT TO STEM DECLINE IN MEXICAN PESO

Banxico’s board of governors announced a 50 bps increase to the target rate during an unscheduled policy meeting, raising the rate to 3.75% from 3.25%.

Mexican authorities coordinated announcements on fiscal spending cuts, a 50 bps rate hike in an unexpected meeting, and a change to the currency intervention policy on the same day, Feb. 17, 2016. These efforts seem to be a demonstration of the Mexican government’s ability and willingness to defend the currency against perceived misalignment from fundamental levels.

On Feb. 17, 2016, Banxico’s (Banco de México; central bank of Mexico) board of governors announced a 50 bps increase to the target interest rate during an unscheduled policy meeting, raising the rate to 3.75% from 3.25%.

The decision surprised markets and analysts, as the board was expected to tighten its policy in lockstep with the U.S. Fed, despite domestic growth and inflation dynamics. Prior to the surprise meeting, a Banamex survey of economists showed that the 3.75% level was what participants expected by year-end 2016, while 28-day interest rate (TIIE) futures were pricing in virtually no hikes in Q1 2016.

The official statement indicated that the motivation for the rate hike included concerns over the performance of the Mexican peso and its pass-through effects on the inflation outlook. The board also indicated that the move was a coordinated effort to support the Mexican federal government in shoring up PEMEX’s, the state-owned petrol company, finances, and that it was a one-off move, not to be taken as a signal of a new tightening cycle.

In addition to increasing the target rate, Banxico suspended the minimum price auction, moving toward a more discretionary sale of U.S. dollars. This

change is significant in that it reduces transparency in how the government is managing the currency. However, there may be a tradeoff for deterring speculators, which is likely why Governor Carstens later clarified that the intervention will be employed rarely.

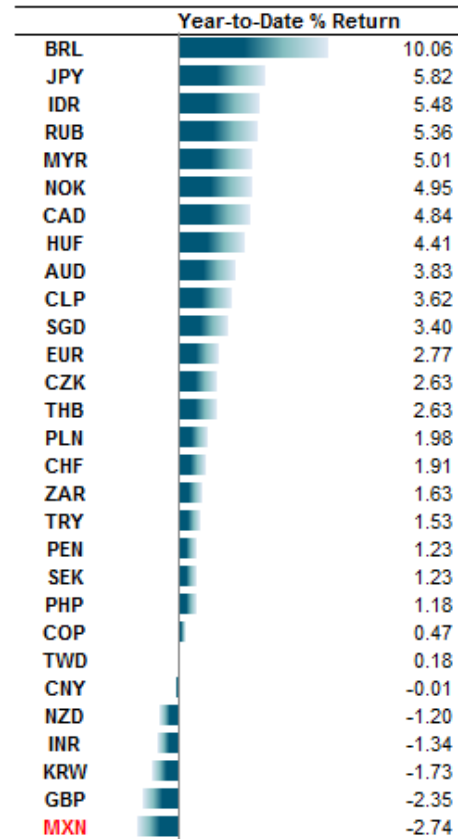
MEXICAN PESO CONTINUES TO UNDERPERFORM PEERS

With the exception of the Argentine peso, which has an idiosyncratic story, the Mexican peso had been the worst-performing currency in 2016 among major emerging and developed currencies as of mid-February. Broadly, currencies were already seeing a turning point when Mexican authorities made their move to support the lagging peso. On the day of the announcements, the Mexican peso outperformed, gaining 2.8%, second to the Russian ruble. However, there has been little lasting impact. As of March 11, 2016, the performance ranking of the Mexican peso was unchanged as the second-worst performer behind the Argentine peso in 2016.

The higher policy rate resulted in a flattening of the curve on the day of the announcement, as one-month CETES jumped 50 bps higher, front-end MBonos were up 55 bps, and the 10-year+ was a marginal 5 bps tighter (see the Feb. 29, 2016 [Mexico Fixed Income Dashboard](#) for the full month's performance).

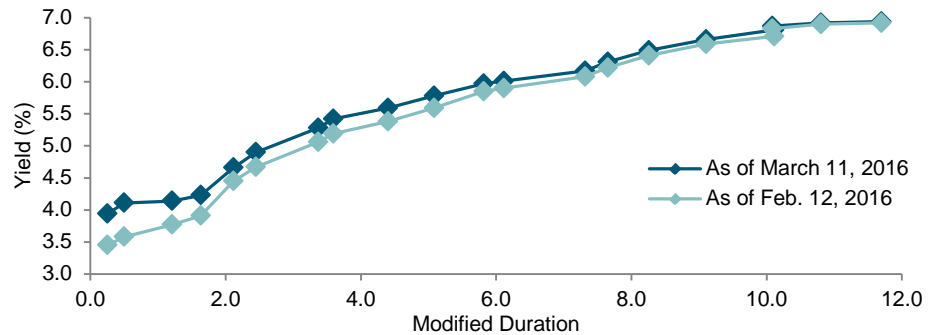
On the rates front, the higher policy rate resulted in a flattening of the curve on the day of the announcement, as one-month CETES jumped 50 bps higher, front-end MBonos were up 55 bps, and the 10-year+ was a marginal 5 bps tighter (see the Feb. 29, 2016 [Mexico Fixed Income Dashboard](#) for the full month's performance).

Exhibit 2: Ranked FX Performance



Source: Bloomberg. Data as of March 11, 2016. Chart is provided for illustrative purposes.

Exhibit 3: Mexican Nominal Bonos Curve



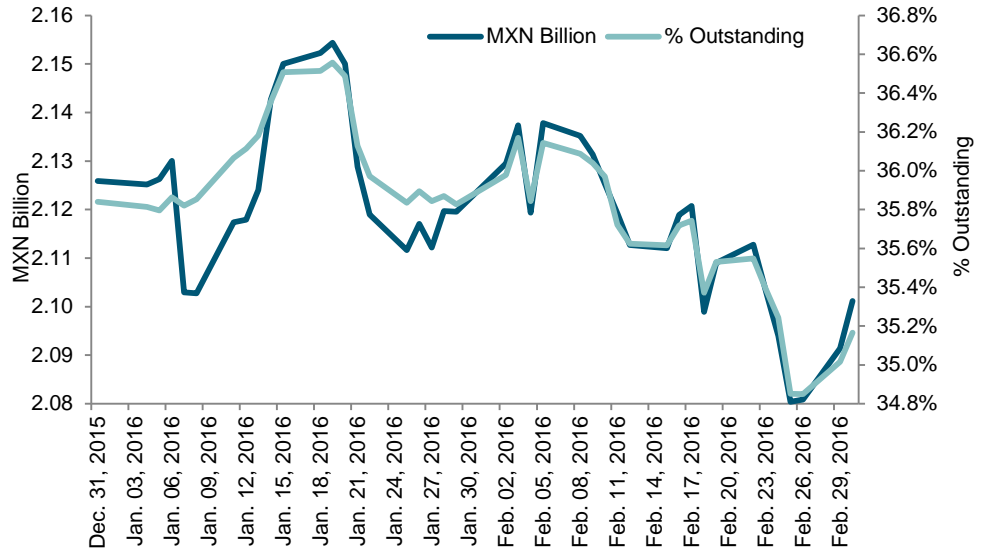
Source: S&P Dow Jones Indices LLC and Valmer. Data as of March 11, 2016. Chart is provided for illustrative purposes.

FOREIGN OUTFLOWS MOUNT

In February, foreign investors withdrew MXN 35 billion, the fourth-largest monthly outflow on record. The outflow was driven mainly by decreasing exposure to CETES. Acceleration in outflows can be seen following the announcement on Feb. 17, 2016, however inflows resumed over the last few days of the month. Foreigners also pared back inflation-linked UDIBono exposure given the hike and increased their MBoNo exposure.

Exhibit 4: Foreign Ownership of Government Bonds (2016)

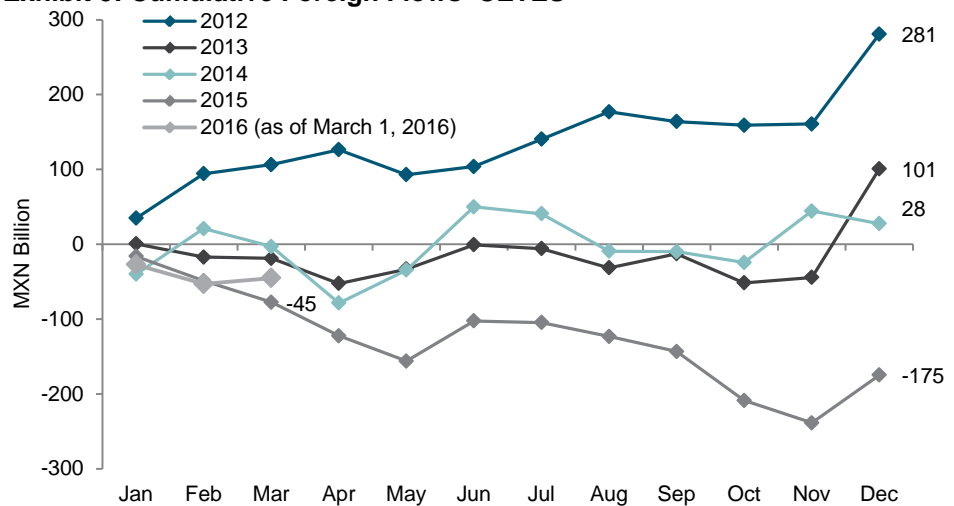
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Source: Banxico. Data as of March 1, 2016. Chart is provided for illustrative purposes.

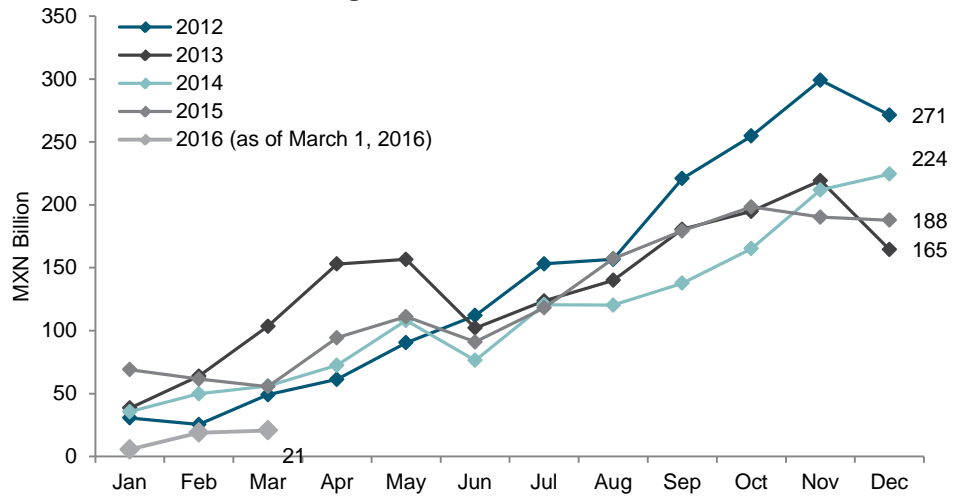
DEMAND-SIDE CHART PACK

Exhibit 5: Cumulative Foreign Flows—CETES



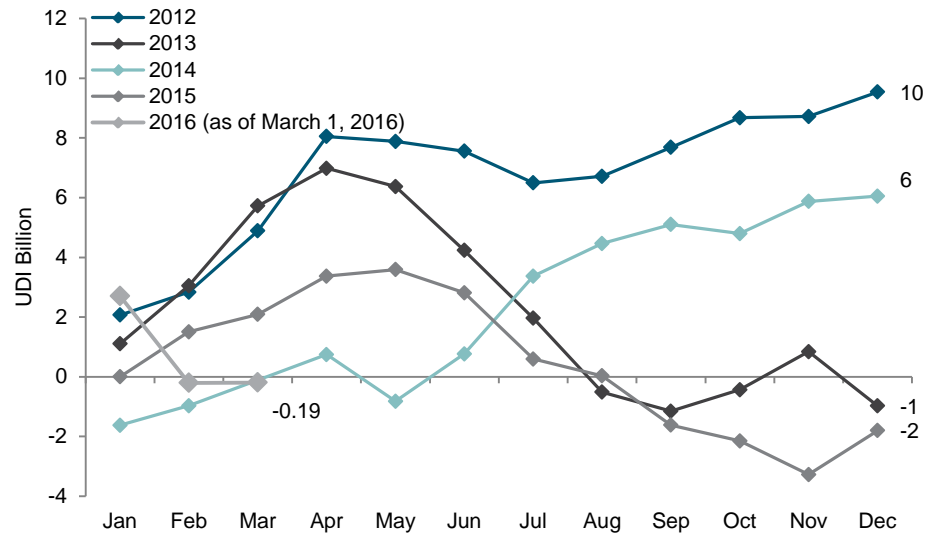
Source: Banxico. Data as of March 1, 2016. Chart is provided for illustrative purposes.

Exhibit 6: Cumulative Foreign Flows–Mbonos



Source: Banxico. Data as of March 1, 2016. Chart is provided for illustrative purposes.

Exhibit 7: Cumulative Foreign Flows: UDIBonos



Source: Banxico. Data as of March 1, 2016. Chart is provided for illustrative purposes.

Exhibit 8: Government Bond Ownership						
Category	Current (%)	1-Month (%)	3-Months (%)	1-Year (%)	3-Years (%)	5-Years (%)
Residents	64.9	64.1	65.2	61.9	63.2	76.2
Pension (Siefores) and Investment Funds	31.3	30.6	30.9	31.1	31.3	34.6
Foreign Investors	35.1	35.9	34.8	38.1	36.8	23.8
Total Outstanding (Billions MXN)	5,983	5,927	5,919	5,683	4,460	3,098

Source: Banxico. Data as of March 1, 2016. Table is provided for illustrative purposes.

Exhibit 9: CETES Ownership						
Category	Current (%)	1-Month (%)	3-Months (%)	1-Year (%)	3-Years (%)	5-Years (%)
Residents	50.7	48.5	55.4	41.9	41.9	63.5
Pension (Siefos) and Investment Funds	15.4	16.0	17.0	17.2	18.6	25.3
Foreign Investors	49.3	51.5	44.6	58.1	58.1	36.5
Total Outstanding (Billions MXN)	825	832	865	1,013	826	546

Source: Banxico. Data as of March 1, 2016. Table is provided for illustrative purposes.

Exhibit 10: MBonos Ownership						
Category	Current (%)	1-Month (%)	3-Months (%)	1-Year (%)	3-Years (%)	5-Years (%)
Residents	41.1	40.7	40.6	40.1	44.6	68.1
Pension (Siefos) and Investment Funds	19.6	19.5	18.8	19.4	22.5	30.4
Foreign Investors	58.9	59.3	59.4	59.9	55.4	31.9
Total Outstanding (Billions MXN)	2,677	2,646	2,632	2,413	1,899	1,566

Source: Banxico. Data as of March 1, 2016. Table is provided for illustrative purposes.

Exhibit 11: UDIBonos Ownership						
Category	Current (%)	1-Month (%)	3-Months (%)	1-Year (%)	3-Years (%)	5-Years (%)
Residents	90.7	89.6	90.9	87.5	86.5	93.7
Pension (Siefos) and Investment Funds	51.5	51.3	52.7	51.7	47.4	55.1
Foreign Investors	9.3	10.4	9.1	12.5	13.5	6.3
Total Outstanding (Billions UDI)	230	228	224	201	161	119

Source: Banxico. Data as of March 1, 2016. Table is provided for illustrative purposes.

GLOSSARY

Federal treasury certificates (CETES): These are zero-coupon bonds that have been issued by the federal government in auctions on a weekly basis since 1978, and they trade at a discount. CETES have been issued for a minimum and a maximum of 7- and 728-day terms, respectively. Currently, CETES are issued for 28- and 91-day terms and at maturities close to six months and one year. For secondary market trading, the current market convention is to quote them by calculating their rate of return.

Federal government development bonds with a fixed interest rate (MBONOS): Fixed-rate MBONOS are currently the largest issues among local government securities in Mexico (43% of total outstanding debt, with an average life of 8.6 years). These securities are issued for terms longer than one year, paying coupons every six months. In the secondary market, the market convention is to quote them by yield-to-maturity. Currently, the government issues 3-, 5-, 10-, 20-, and 30-year bonds.

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