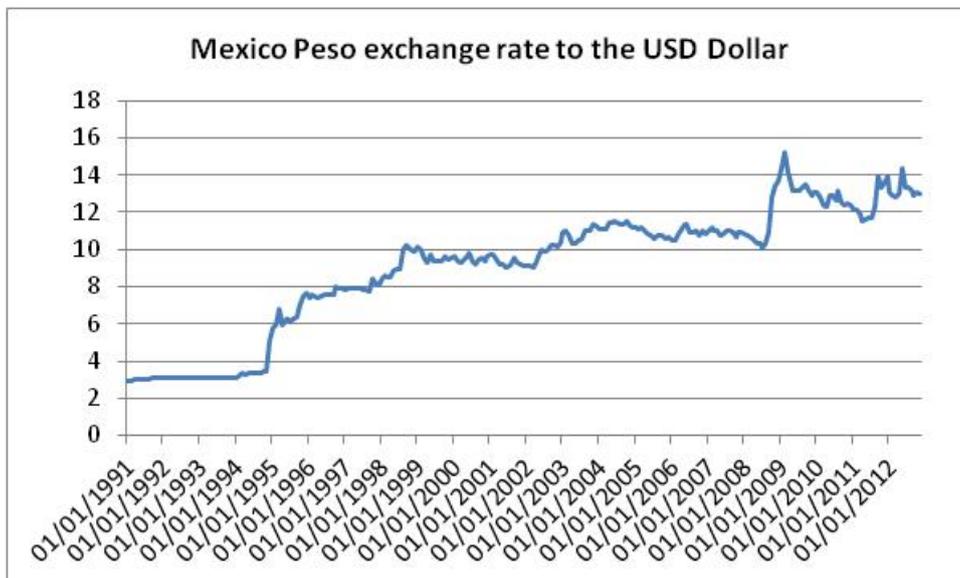


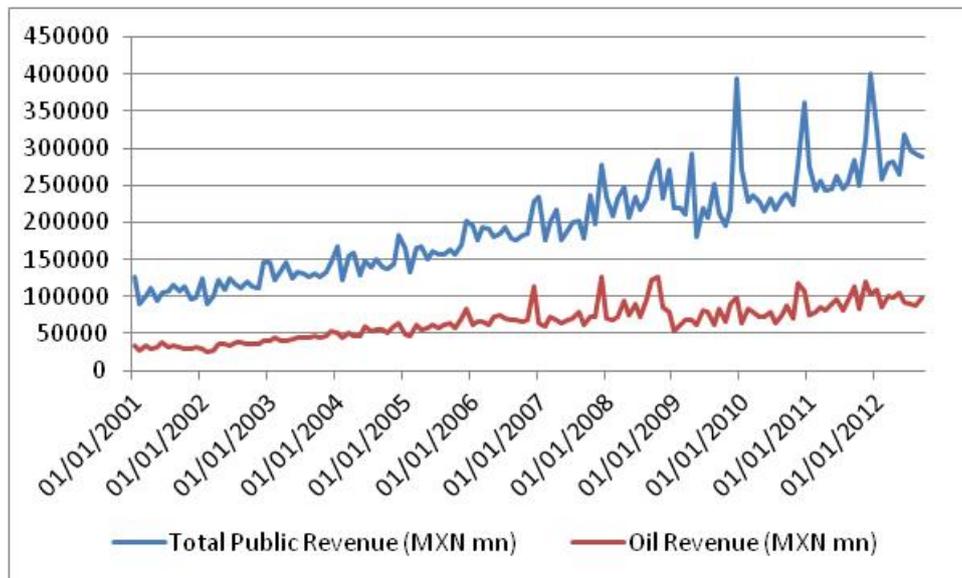
THE MEXICAN PESO



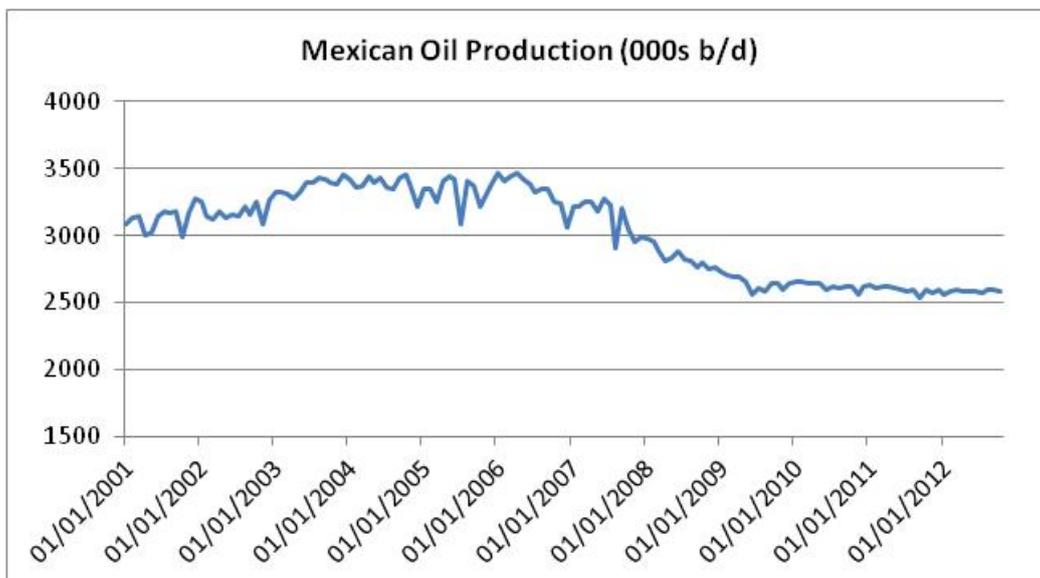
The Mexican Peso is seen by many investors as an attractive investment, as interest rates are much higher than those available in the US. It has faster growth - and the combination of the Peso devaluation in 2008 and the continued appreciation of the Chinese Yuan, has made Mexico a more attractive outsourcing destination than China for some US companies. Furthermore, some investors see the Peso as a way to play the recovering US economy, as the US is Mexico's largest trading partner.



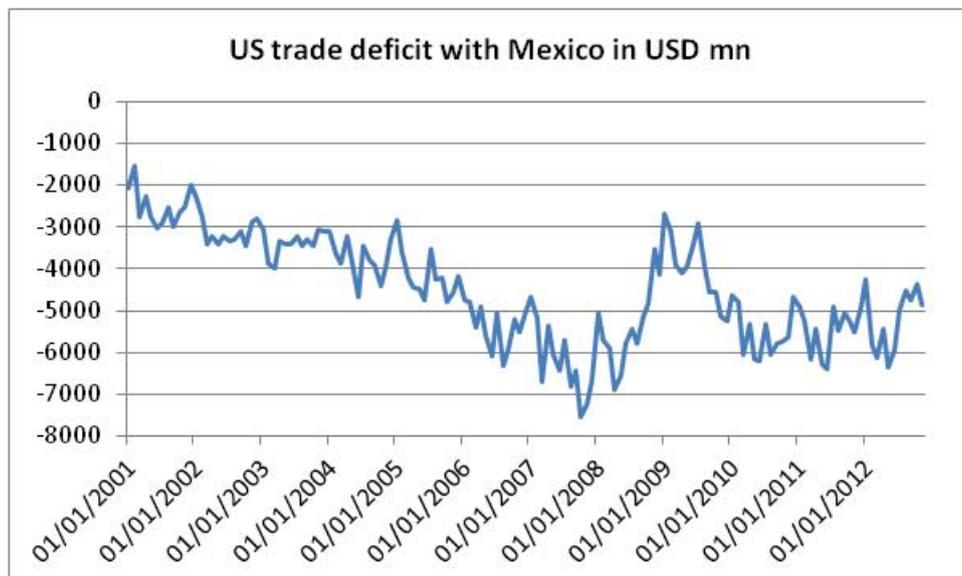
I have always found investors' enthusiasm for the Peso hard to understand. Over the last ten years a combination of fiscal spending and ultra-loose monetary policy in the US has allowed most currencies to appreciate versus the US dollar. The Peso has signally failed to do so.



The key issue for the Mexican Peso is that its oil exports provide the government with a large share of its revenues. Oil revenue as a percentage of total public sector revenue has remained relatively stable at around 30%. Despite oil prices having risen significantly over the last decade, Mexico has seen a significant drop off in oil production.

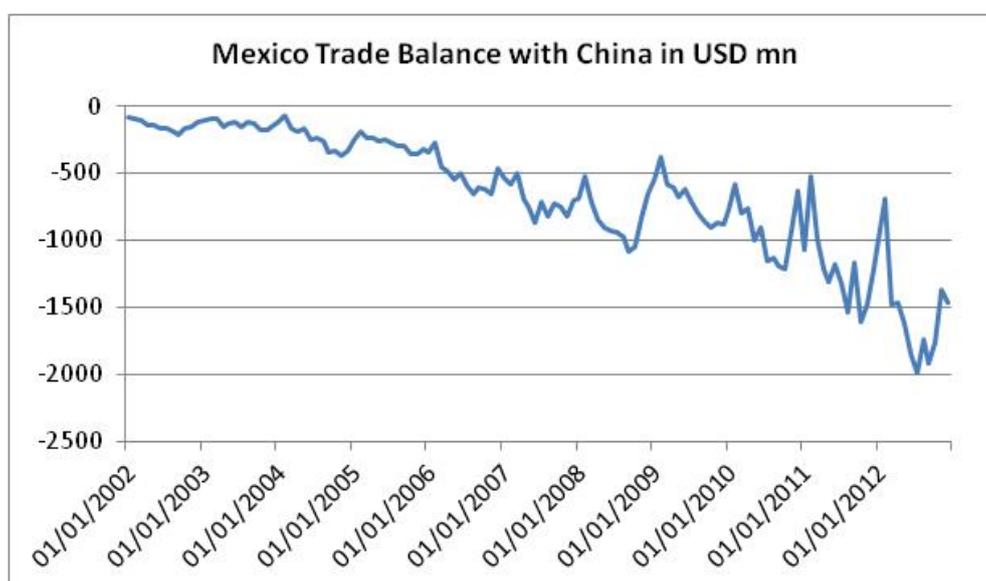


As the US has needed less energy and Mexican oil production has declined, the US trade deficit with Mexico has declined over the last few years. Given recent trends in US oil production growth, it seems likely that the US trade deficit with Mexico will continue to decline.

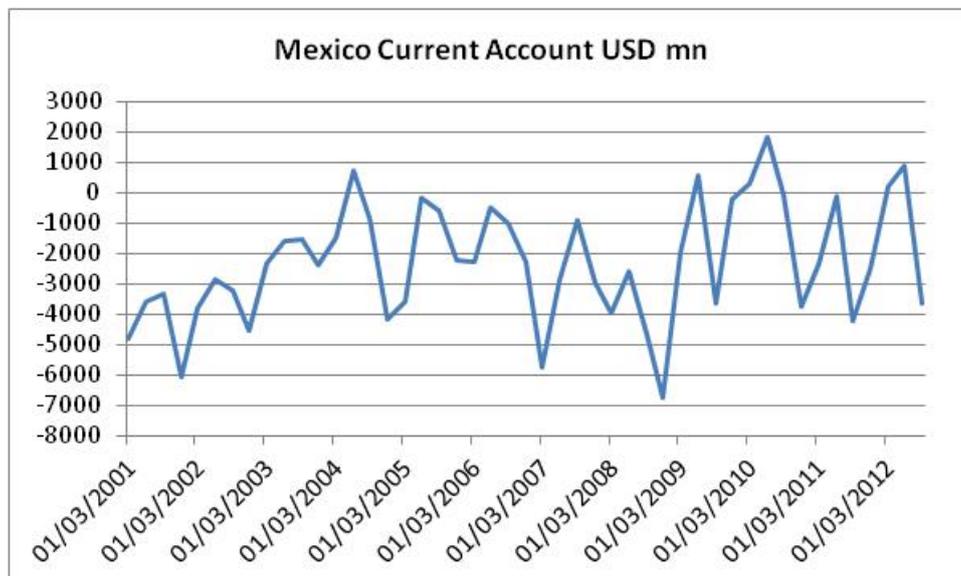


In my view, the Mexican Peso tends to fall to a level that allows the government to maintain a stable level of revenue. I take this view because, uniquely among oil exporters, Mexico has hedged its entire oil output every year since 1991 using options. Interestingly, according to the FT, for the first time in the history of its hedging program, Mexico has tried to reduce the cost of its hedging program by allowing it to be exposed to price falls below 60 USD a barrel for WTI. Despite its hedging program, the Mexican Peso has been highly correlated to the oil price, and should its hedges not cover prices below 60 USD a barrel, this would leave it extremely exposed to lower oil prices. On my very rough calculations, for the government to maintain a constant level of income from oil after a move to 60 USD on barrel, the Peso would need to devalue to an exchange rate of 20.

The other bullish argument put forward for the Mexican Peso is that it has now become competitive with China as an outsourcing destination. I believe this is true for items that are costly to transport, like cars. However, this improving competitiveness is not exhibiting itself in the trade numbers between the US and Mexico, which shows the US has become more competitive. It is also not showing up in the bilateral trade balance with China, which shows that the Mexican trade deficit with China is surging.



Despite being an oil exporter Mexico continues to run a current account deficit. In my mind we would need to see a sustained move to current account surplus to make the Mexican Peso an appreciating currency.



In summary, I believe the Mexican Peso is a depreciating currency. It has an inbuilt tail risk as its oil revenues are exposed to a fall in the WTI below 60 USD a barrel. Furthermore, according to CFTC, speculators have accumulated their largest ever long position in the Peso. The risk reward to being short looks compelling.

INFORMATION

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