Since the start of the global pandemic, the MSCI Mexico Index has lagged the broader MSCI Emerging Markets Index. At the same time, the unevenness of the global recovery has given investors an extraordinarily rare opportunity to take advantage of market dislocations. Mexico’s relative weakness may be overdone.

Investors considering Mexico should focus on the four C’s: COVID, commodities, China and the central bank when considering opportunities. Herein, we consider investments in Mexico against this backdrop.

- Mexico is experiencing its third wave of the coronavirus pandemic, having recently reported the highest daily increase since January 2021. This could provide an opportunity for investors who can see past the troubling headlines to higher vaccination rates in the coming months.
- Ongoing drought conditions have led to substantially higher prices and can disorient consumers. Above average rainfall is needed to support agriculture and drive confidence in the Mexican economy, which is expected to grow 6.8% this year.
- The US is reassessing its relationship with China. Mexico should benefit from the spillover effects given its proximity to the US and strong economic ties.
- Mexico’s shift to tighten monetary policy may reduce capital outflows, limit inflation surprises and stabilize the Mexican peso.
COVID-19. Mexico is experiencing its third wave of the coronavirus pandemic, having recently reported the highest daily increase since January 2021 (see Exhibit 1). The country’s rapid reopening and less restrictive pandemic-related policies likely contributed to the surge in new cases.

Exhibit 1: Delta Variant Cases Growing in Mexico

Unlike other countries, Mexico has been hesitant to impose strict lockdown measures. As it stands, Mexico is only half as restrictive as it was in its first-wave peak. This compares to the US, which is still two-thirds as restrictive as it was during its new-cases peak in the fourth quarter of last year (see Exhibit 2).

Exhibit 2: Mexico’s Pandemic-Related Policy Response Peaked Ahead of US

Note: Policy responses are tracked and coded into 23 indicators, such as school closures, travel restrictions and vaccination policy. These policies are recorded on a scale to reflect the extent of government action. Source: Bloomberg, Oxford University, Morgan Stanley Wealth Management Global Investment Office as of July 23, 2021.

US officials have made plans to send millions of vaccine doses to slow the spread of the delta variant. This will support the economy, which is still reopening. In one survey, Morgan Stanley’s AlphaWise research team found that visits to shopping malls and eating out at restaurants in Mexico have increased 24% and 50%, respectively, since March.

Limiting the economic impact of potentially more restrictive pandemic-related policies is critical to the country’s near-term outlook. We think that consumer sentiment is key. Mexico’s underperformance within emerging markets discounts its low vaccination rate of 19.1 per 100 peoples. This could provide an opportunity for investors who can see past the troubling headlines to higher vaccination rates in the coming months.

Commodities. Income inequality has decreased over the past two decades, but we anticipate a spike (see Exhibit 3) given higher food prices, which make up a larger share of consumer spending. Fragile global supply chains, the release of pent-up demand and Mexico’s ongoing drought conditions have led to substantially higher prices and will be a challenge for Mexico’s policymakers.

Exhibit 3: Income Inequality Is a Factor in Social Unrest

While disrupted supply chains can be repaired, we worry that Mexico’s higher food prices can disorient consumers. According to World Food Programme data aggregated by the United Nations Office for the Coordination of Humanitarian Affairs, median wholesale prices of long-grain rice and imported black beans have increased 38.5% and 38.1%, respectively, since just before the pandemic.

The surge in prices is far from over. According to satellite data collected by the National Aeronautics and Space Administration (NASA) in April, Mexico faces drought conditions in nearly 85% of the country. Furthermore, according to the same dataset, reservoirs in northern and central Mexico are below 25% capacity. The next couple of months will be critical, as much of Mexico gets between 50% and 80% of its rainfall between July and September. Above-average rainfall could provide drought relief, support agriculture and drive confidence in the Mexican economy, which is expected to grow 6.8% this year.
China. The US is reassessing its relationship with China, its largest trading partner. The shifting global landscape benefits Mexico given its proximity to the US and strong economic ties (see Exhibit 4). Mexico’s investment in manufacturing, lower labor costs and stronger intellectual property laws provide a favorable backdrop for companies seeking to shift supply chains. This compares to longstanding views on doing business in China, which were reinforced by President Biden’s warning to companies operating in Hong Kong last month.

Mexico is linked to the US economy and offers a catch-up opportunity, having decoupled from economies in Latin America. Mexico should benefit from the spillover effects from strong growth and accommodative fiscal and monetary policy from its neighbor to the north.

Exhibit 4: Mexico Is Poised to Benefit from Shifting Global Relationships

<table>
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<tr>
<th>US Imports of Goods from Partners (Billions)</th>
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<td>China</td>
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<td>Ireland</td>
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<td>Taiwan</td>
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Source: IMF; Morgan Stanley Wealth Management Global Investment Office as of December 31, 2020

Central Bank. Mexico’s central bank raised its key rate by 0.25% to 4.25% in June. The move came as somewhat of a surprise to forecasters and signaled that Mexico may become more reactive to Federal Reserve tightening than previously assumed. Given the stronger than anticipated inflationary pressures, Morgan Stanley & Co.’s strategists see a hiking cycle extending into 2022 before a pause. While many investors are unsure whether the sharp increase in inflation is here to stay, getting inflation under control is a priority for Mexico’s central bankers who saw their economy print a 5.88% year-over-year increase in headline consumer price inflation, just off of its highest rate since 2017. We see the shift to tighten monetary policy reducing capital outflows and stabilizing the Mexican peso.

Investment Implications

Mexico faces near-term headwinds, but its recovery remains on track. Since the start of the global pandemic, the MSCI Mexico Index has lagged the broader MSCI Emerging Markets Index. We think that the unevenness of the global recovery has given investors an extraordinarily rare opportunity to take advantage of market dislocations and that Mexico is in pole position in Latin America. A strong rebound in the American economy has bolstered export-related sectors like manufacturing and agriculture, with many of them closing in on their pre-pandemic levels.

Please refer to important information, disclosures and qualifications at the end of this material.
Chats You Can't Miss

Exhibit 5: Mexico Has Outpaced Other Latin American Countries in 2021

MSCI Country Indexes Year-to-Date Performance

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 30, 2021

Exhibit 6: Mexico Poised to Close Performance Gap with Emerging Markets

MSCI Index Mexico / Emerging Markets

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 30, 2021

Exhibit 7: Federal Reserve’s Hawkish Rhetoric Pressures Mexico’s Central Bank

Bank of Mexico Official Overnight Rate

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 30, 2021

Exhibit 8: Morgan Stanley & Co. Latin America Real GDP Growth Estimates

MS & Co. GDP Forecasts 2021

Source: Morgan Stanley Economics, Morgan Stanley Wealth Management Global Investment Office as of July 26, 2021

Please refer to important information, disclosures and qualifications at the end of this material.
### Current Readings From Our Quantitative Framework

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<thead>
<tr>
<th>Top 5</th>
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Levels: Unfavorable, Neutral, Favorable
Changes: Deteriorating, Unchanged, Improving


### Ongoing Development Spotlight

Positive spillover from strong US economic growth should support Latin American economies. Our analysis of the region shows that Mexico and Brazil will benefit from stronger growth, whereas Chile, Peru and Colombia will participate to a lesser degree. Investors that fled emerging markets during the pandemic are slowly returning, which should support the region as a whole.

### Exhibit 9: Sensitivity of MSCI Country Indexes to Broad Indexes

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 26, 2021
Disclosure Section

Risk Considerations

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies. Technology stocks may be especially volatile.

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies. Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

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