Trending…

June 2019

PGIM FIXED INCOME

An Overdue Recalibration of the Credit Ratings for Mexico and Pemex

Long before the threat of U.S. tariffs emerged, we anticipated a downward revision of the credit ratings for Mexico and Pemex. We were relatively early to observe the effect that heightened uncertainty in economic policy, Pemex's growing burden on the sovereign, and the country's persistently subdued growth would have on their credit profiles. While the now-suspended U.S. tariffs could have also posed a severe external shock, trade tensions could still resurface given that immigration will likely remain a major theme in the 2020 U.S. presidential election. This paper discusses the dynamics that led our internal credit ratings on Mexico and Pemex below the average of the rating agencies, our outlook going forward, and how this view is expressed in our investment strategy.

On June 5, 2019, Fitch Ratings and Moody's negatively adjusted the credit ratings and outlook for Mexico and Pemex. Fitch downgraded the sovereign to BBB with a stable outlook, while Moody's revised its outlook to negative (while keeping the A3 rating). The following day, Pemex became high yield in Fitch's appraisal when it downgraded the company to BB+ while maintaining a negative outlook, and Moody's assigned it a negative outlook (maintaining the Baa3 rating), thus placing the company on the brink of losing its investment-grade status from two of the three major credit rating agencies. **PGIM Fixed Income expected changes in this direction as our internal ratings on Mexico and Pemex were below the agencies' average, and that remains the case for the sovereign even after Fitch's downgrade.**

However, these downgrades were about far more than the threat of tariffs. In addition to the challenges posed by the potential trade dispute (the rating agencies' action came before the tariff suspension), **heightened uncertainty over the trajectory of economic policy, increased risk that Pemex may become a heavier burden on the sovereign, and Mexico's persistent underperforming growth supported the actions taken by Fitch and Moody's. In our opinion, this is an appropriate characterization of the mounting headwinds to Mexico's creditworthiness, thereby warranting the downward calibration of the ratings and outlook.**

Mired in Policy Uncertainty

Since President Andrés Manuel López Obrador (AMLO) took office last year, a raft of policy choices has consistently eroded the predictability of economic policy—including Mexico City's cancelled airport, the stalled opening of the energy sector, an erosion of bureaucratic capacity, and the use of public consultations to shape policy, among other decisions. The risk of crystallized contingent liabilities related to Pemex continues to rise with the secular deterioration of the company's credit fundamentals and its worrisome outlook amid the shifts in energy policy. The deeper link between Pemex and the sovereign under the AMLO administration has translated into a series of tepid support packages that have fallen short of meaningfully buttressing the company's financial footing. **This piecemeal approach stems from the administration's lack of strategy to solve the trade-off between providing substantial support to Pemex and maintaining fiscal metrics consistent with the stability of the sovereign's debt-to-GDP ratio.**

Francisco Campos-Ortiz, PhD

Lead Economist, Latin America,
Global Macroeconomic Research Team

Nick Ivanov, CFA

Head of Emerging Markets Corporate
Bond Research

Matthew Duda, CFA

Portfolio Manager, Emerging Markets
Debt Team

This increasingly uncertain backdrop exacerbates Mexico's structural growth shortcomings—underscored by its average annual growth rate of 2.4% over nearly four decades.

Without more meaningful sovereign support over the near to intermediate term, which could include a partial or full-explicit guarantee on some or all of Pemex's debt, we believe that Moody's is more likely than not to act on its negative outlook and eventually downgrade Pemex. The sovereign-Pemex dynamic is set to continue without any revenue-boosting fiscal reform; otherwise, any significant support for the company would compromise the administration's fiscal targets. Alas, the forward guidance provided by authorities indicates that fiscal reform is unlikely to be undertaken before the 2021 midterm elections. **More generally, the AMLO administration's modus operandi for policymaking is unlikely to materially change given its strong ideological leanings, which does not bode well for any meaningful restoration of policy predictability and growth-enhancing policies.** A potential downgrade by S&P, which currently rates Mexico BBB+ with a negative outlook, is also in the cards as the agency's ratings criteria are similar to those that triggered the latest action from Fitch and Moody's.

Pemex's Standalone Credit Fundamentals

Pemex's credit fundamentals have gradually deteriorated over several years amid a series of interrelated factors: its heavy tax burden; insufficient investment in exploration, production, and refining capacity with its consequent output decline in all segments (oil and gas, petrochemicals, and fuels); and a relentless increase in leverage. The deterioration of Pemex's fundamentals accelerated over the last five years as its supergiant mature hydrocarbon field (Cantarell, discovered in 1976) started experiencing a swifter natural rate of decline.

Even with its deteriorating credit fundamentals, the market has largely given Pemex the benefit of the doubt based on the assumption that its strategic importance to Mexico would force the government to do whatever necessary to fully bail out the company, if needed. **However, this deterioration has become a heftier contingent liability on the sovereign, and the shifts in energy policy under the AMLO administration have amplified these concerns.** Although the AMLO administration's steps to support Pemex have been pointed in the right direction, they have been insufficient to stabilize the company and have fallen short of the rating agencies' expectations. These developments and the downward revision of the sovereign's creditworthiness—the entity mooring Pemex's higher rating relative to its stand-alone assessment—brought the company to a tipping point that prompted the market and credit rating agencies to reassess their views.

Outlook and Positioning

In early June 2019, Moody's set a timeframe of up to 18 months to decide how to address its negative outlook on Pemex. Given the lack of a strategy to address the company's structural weaknesses and Moody's expected downgrade of Mexico, we believe Moody's will likely downgrade Pemex as well. Notwithstanding this perspective, **we hold the strong conviction that the AMLO administration will do whatever it takes to prevent a Pemex default. Beyond the legal restrictions to a default, the AMLO-Pemex relationship is anchored by the president's view that the oil industry is an expression of national sovereignty, which is core to the administration's nationalistic ethos.**

Given this conclusion and the potential for near- to medium-term spread volatility, our longer-term strategy is to remain underweight Mexico's sovereign debt (relative to the broad EM hard currency benchmark) and overweight Pemex debt. While we would fully expect the differential between Pemex and Mexico spreads to immediately widen if Moody's or S&P were to downgrade Pemex to high yield, we believe this scenario could present an attractive buying opportunity.

Looking ahead, the AMLO administration will likely bolster its explicit support for Pemex through various channels (a likely scenario even without a second downgrade to high yield). If the company loses its investment-grade status, the opportunity to buy bonds that are "forced sales"—only by virtue of their credit rating and expulsion from an index with investment grade rated inclusion criteria—would present a window to capitalize on this temporary technical factor and on the ultimate spread compression that we envision as Mexico and Pemex become more closely linked.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of June 2019

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; and (iii) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore. Prudential Financial, Inc. of the United States is not affiliated with Prudential plc, which is headquartered in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. **All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.**

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

In the United Kingdom and various European Economic Area ("EEA") jurisdictions, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Firm Reference Number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued by PGIM Limited to persons who are professional clients as defined in Directive 2014/65/EU (MiFID II). In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co., Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the Financial Conduct Authority (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In South Africa, PGIM, Inc. is an authorised financial services provider – FSP number 49012.

2019-2818