Postcard From Mexico City: Year Of The Election

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Key Takeaways

- 2024 is the year of the election. But politics are often a distraction from more important macroeconomic forces.
- Mexico, with one of the world's strongest currencies and best-performing stock markets over the last year, has become a near-shoring darling. Much of the good news is now in the price.
- Better opportunities in Latin America exist in commodity-exporting nations that have leverage to the unfolding turn in the global trade cycle. Forstrong's actively-managed emerging market equity ETF (TSX:FEME) is strategically positioned to capitalize on this trend.

The hotel had warned us. Traffic on the day of a heated June 2nd national election would be nearly gridlocked. We were in Mexico City on business the prior week and our departing flight just happened to coincide with the chaos. But thanks to a white-knuckled Uber ride, we arrived safely at Benito Juárez International Airport with a few minutes to spare (miraculously, the driver was still somehow clinging to a solid 4.95 rating).

For political aficionados, 2024 is the year of the election. Large parts of the planet will have the chance to elect new leadership, representing at least 41% of the world's population and 42% of its gross domestic product. From Mumbai to Mexico City, 40 countries are holding national votes (not including the snap parliamentary election just called by French president Emmanuel Macron). Nations heading to the polls vary widely in size and influence, ranging from resource-rich Indonesia to geopolitical hot spot Taiwan — not to mention any of the adolescent showmanship in America. The potential for major market disruptions looms large. Buckle up.

Meanwhile in Mexico City, market fears were met the day we left. Voters handed a landslide victory to Mexico's first female president, Claudia Sheinbaum, whose Morena party also clinched a supermajority in Congress. This outcome significantly strengthens the left-leaning party's position in the legislature, raising the odds of pushing through progressive reforms, such as overhauling the tax regime to distribute wealth more evenly.

The political direction in Mexico is now a decisive headwind for markets. Yet this trend isn't exactly new. Sheinbaum is expected to continue most of her predecessor's signature policies — those of President Andrés Manuel López Obrador or "AMLO" as he is known — which often clashed with business interests as he sought to strengthen the state's role in the economy.

But politics aren't always the main event for markets. In fact, they are often a distraction from more important macroeconomic forces. Today, the bigger story in Mexico is the business opportunity created by the new Cold War. On the surface, the country appears well-positioned to leverage the competition between China and the US. Tensions are re-wiring world trade as the US seeks to reduce supply-chain reliance on geopolitical rivals and source imports closer to home. Mexico ticks both boxes.

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The local brokers, politicians and macro strategists we met with all agreed: Mexico should not miss this moment. So far, facts on the ground support this view. The economy has bounced back strongly since 2021. Underpinned by export growth averaging more than 10%, Mexico recently surpassed China as the largest supplier of goods to the US. Unemployment rates are at record lows. Mexico can also boast one of the world's strongest currencies and best-performing stock markets this year. Not since the signing of the NAFTA in the 1990s has the country held this kind of allure. The country is now a near-shoring darling.

What Is In The Price?

Yet, plenty of obstacles, both old and new, could limit the boom. The near-shoring narrative has garnered significant attention, but how much of it is hype? There's no doubt that parts of Mexico look like industrial boomtowns now. But we also heard frequent reports of plants being hit by power blackouts because the state's electrical grid struggles to keep up with its fast-growing industries.

Infrastructure and capacity are crucial to attracting foreign capital. Local companies are well aware of this and have been reluctant to make new capital expenditures. Multinationals are wary too. Foreign direct investment trends underscore that Mexico is punching well below its weight: the country attracted inflows of just USD $36 billion in 2023, broadly in line with its pre-pandemic average but only on par with

Vietnam (despite its economy being three times larger). AMLO's lack of success in addressing concerns about energy shortages, limited industrial space and water scarcity are clearly constricting fresh FDI.

American politics pose another obstacle. Washington accuses Mexico of serving as a backdoor for Chinese exports circumventing US import tariffs. It is difficult to refute this. Mexico's imports from China are nearly 50% higher than pre-pandemic levels. America could easily turn on Mexico. The upcoming November election in the US could hold more significance for Mexico than its own, especially with the United States-Mexico-Canada Agreement up for review in 2026.

Mexico's price levels also present a challenge. Despite its proximity to the US and relatively low labor costs, the peso is now the most overvalued emerging market currency, while wages have been on the rise. This begs the question: how long can Mexico remain competitive in the race to replace China as a US supplier? Taking all factors into account, the strong performance of Mexican assets is likely to moderate from here.

Green Light For Commodity-Oriented EM Equities

Elsewhere in Latin America, a less discussed trend is brewing: growth is picking up across the continent. Brazil and Chile, despite left-leaning ruling parties (with no national elections scheduled for 2024), are experiencing robust growth. Fragmentation powering investment outside of China is supporting growth — as it is in Mexico. But, quietly, the global trade cycle, led by manufacturing, is turning up strongly. Industrial production numbers, right across the world, are surging. Even longer-running laggards like Germany and China have delivered upside surprises.

Of course, manufacturing growth is the most commodity-intensive growth. Prices for copper and nickel, unsurprisingly, have both blasted higher this year. These industrial metal movements are not just mere numbers on a screen but a narrative of global economic vitality. The perkier the prices the healthier the global economy.

Expect higher prices to last. A long list of reasons support this. Stabilizing Chinese growth. Western nations raising tariffs, which signals they are all-in on domestic industrial revivals. The "electrification of everything" theme, whether it be the replacement of hydrocarbons as a primary fuel source, electric vehicles (which use four times as much copper as their combustion engine peers) or even the mass adoption of AI applications causing a surge in processing power to run them. And, this at a time when the world has under-invested in new supply for more than a decade.

Such expansions offer a solid backdrop for commodity-oriented Latin American equity outperformance. EM economies are more trade-dependent than their DM counterparts, with exports typically accounting for a larger share of their GDP. That explains why EM earnings and stock performance correlate positively with global trade. In fact, the single most reliable indicator of EM equity outperformance is improving export growth.

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Within Latin America, Brazilian and Chilean equities stand out. Both stock markets trade at hefty discounts to EM peers with undervalued currencies. And both export markets are resource-intensive (Chile being the world's largest copper producer). During the last commodity bull market from 2002 - 2008, the MSCI Brazil equity index increased by nearly 20 times over the span of six years (in US dollars). Investors shouldn't overcomplicate the setup here. Current conditions resemble those of the early 2000s, where elections and politics in Latin America were a side show during a raging commodity bull market.

Source: Macrobond, MSCI, S&P Global, Forstrong Global Asset Management

Investment Implications

A strong portfolio starts with a strong connection to the rest of the world. Many investors remain wedded to the idea that China lies at the heart of EM growth. This was true during China's rapid industrialization period from 2002 – 2011. But it is no longer the case. Growth in countries like India, Indonesia and now Latin America have surged since the pandemic. Today, a new boom is unfolding that extends far beyond China with far deeper participation among EM nations.

Foreign investors have been warming up to EM assets since the beginning of the year, tapping into themes such as India's rapid growth and an Asian trade revival. Renewed interest in Latin America is also in early stages. In a world worried about geopolitical risks, the region appears to be a new safe haven. Given the geographic location and abundant natural resources, it remains largely insulated from the world's main conflicts in Ukraine and the Middle East.

Looking ahead, political theatrics will dominate the headlines this year in Latin America and the rest of the world. This won't be a time to keep investment strategies on autopilot. Yet investors need to be opportunistic here: the recent correction in commodities offers an excellent entry point to position for longer-term outperformance.

Don't get left behind in the Latin American bull market. Forstrong's actively-managed emerging market equity ETF (TSX:FEME) is strategically positioned to capitalize on this trend.

Tyler Mordy, June 2024

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