AURORA

Aurora Mexico Report: Nearshoring's Hangover Meets Trump's Trade Tantrum
February 12, 2025

The Tearsheet

Feb 12	Candidate Registration for Mexican Judicial Elections
Mar 6	30-Day Tariff Negotiation Deadline
Mar 27	Banxico Rates Decision
Apr 10	Banxico Meeting Minutes
Apr 30	Deadline for Trump EO on Tariff Policy Review
May 15	Banxico Rates Decision
May 28	Banxico Quarterly Report
Jun 1	Mexican Judicial Elections
Jun 11	Banxico Financial Stability Report

- In the wake of President Donald Trump's February 1 tariff orders—currently delayed through the end of the month—our base case views the tariffs as a negotiating tool rather than a long-term policy, making full implementation unlikely.
- Nonetheless, the ongoing threat will weigh on Mexico's economy, exacerbating MXN volatility and deepening the FDI drought that began after Morena's electoral landslide last July. The subsequent push to weaken judicial independence through AMLO and Sheinbaum's reforms has further dampened investor confidence. Banxico's cautious stance and political constraints add to the downside risks.
- USMCA renewal is now effectively a full renegotiation, with all issues back on the table. Meanwhile, rising nationalist sentiment in Mexico has solidified Morena's grip on power and boosted Sheinbaum's popularity, though her authority remains constrained by AMLO's control of the party through parallel structures. Trump's confrontationalism won't change that but may provide Sheinbaum with political cover to diverge from AMLO's policies, including a potential shift away from his ineffectual "hugs, not bullets" cartel strategy.
- Mexico's short-term economic outlook points to stagnation or mild recession, though sovereign debt sustainability remains intact. Pemex will avoid default through bailouts and tax relief but will remain undercapitalized, prolonging its debt burden and contributing to widening fiscal deficits.
- While the tariff threat lingers, we expect continued pressure on assets and the MXN, along with a further extension of the slump in FDI inflows—deepening the hangover from a heavily hyped nearshoring party that shut down abruptly and far too soon.

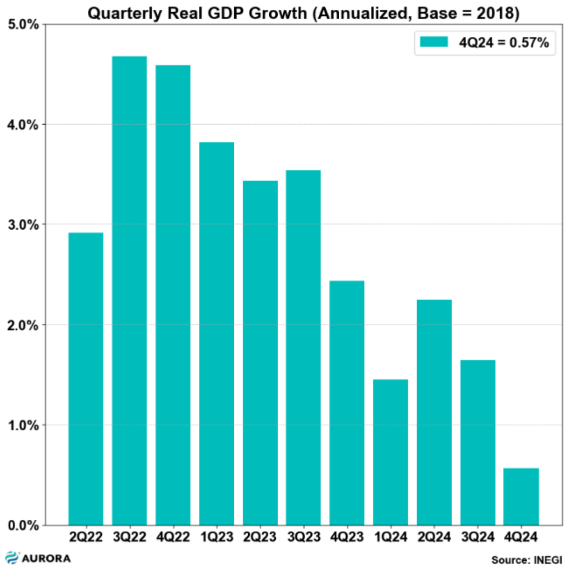
1. The Tariffs of Damocles

- On January 20, President Trump declared a national emergency at the southern border, citing illegal immigration and drug trafficking, then extended it to the northern border on February 1—fulfilling a longstanding campaign promise.
- Invoking the International Emergency Economic Powers Act (IEEPA), President Trump announced 25 percent tariffs on Canada and Mexico starting on February 4. IEEPA grants additional presidential authority in "unusual and extraordinary threats" and the Trump administration cited the "extraordinary threat posed by illegal aliens and drugs, including deadly fentanyl" and an "intolerable alliance" between drug cartels and the Mexican government.
- The move marked a significant expansion of IEEPA presidential authority, both due to its a significant expansion of the term "national security emergency" and its utilization of domestic economic tools for non-economic objectives.

- Sheinbaum, initially skeptical of Trump's threat, vowed a "Plan B" of sanctions and other retaliatory steps if tariffs were enforced. Along with several state governors, she condemned Trump's suggestion of government-cartel ties in Mexico.
- When markets reopened on February 3, U.S. stocks dropped to their lowest levels since Trump took office and MXN fell to a 3-year low, falling as much as 2.9% to 21.2882 per USD.
- But later that day, Trump held separate calls with Sheinbaum and Trudeau, resulting in respective one-month postponement of the sanctions. Mexico's delay was secured after Sheinbaum agreed to deploy 10,000 National Guard troops at the border and form working groups with the U.S. on security and trade.
- She also mentioned an agreement on weapons trafficking—mirroring former President Andrés Manuel López Obrador's (AMLO) 2019 decision to deploy National Guard troops under similar U.S. pressure. Mexican assets rallied.

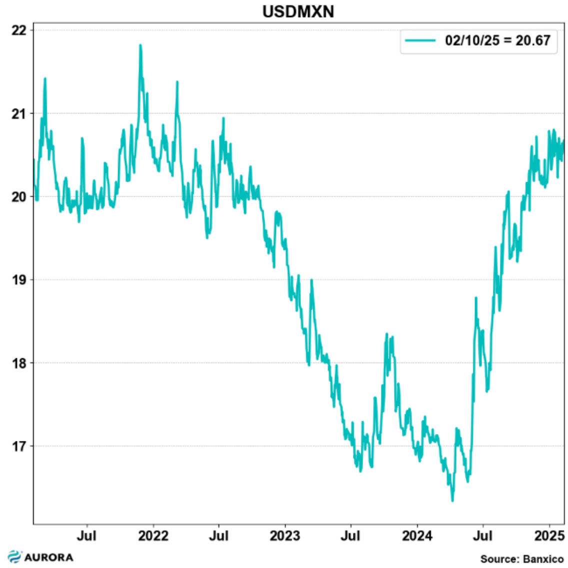
2. Tariff Scenarios All Over the Map

- Even with a swift resolution, the potential for long-term economic harm from tariffs to all three North American economies is undeniable, both in direct economic terms and through the structural weakening of regional competitiveness and damage to U.S. diplomatic relations globally.
- North American trade is vital to the U.S., with $680 billion of its exports sent to Canada and Mexico in 2023, and over 17 million U.S. jobs supported by regional exports, where 50% of trade involves cross-border supply chains.
- Our base case, in line with market consensus, views the tariffs primarily as a negotiation tactic, with full implementation relatively unlikely. However, the uncertainty surrounding their potential impact—along with expected counter-tariffs—has compounded market instability, making it difficult to price in the risk.



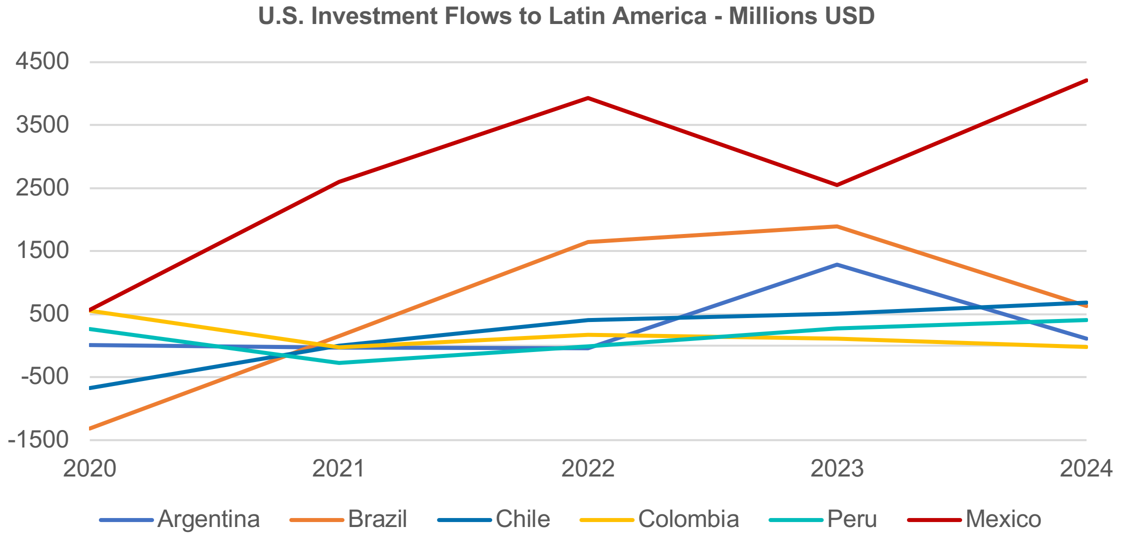
- Estimates of Mexico's downside risks from prolonged tariffs vary widely. At the extreme, the Global Trade Analysis Project (GTAP) projects a 3.5% GDP loss and 9% short-term deflation (6% with counter-tariffs). More realistic, though still grim, estimates include the Peterson Institute forecast of a 0.4% hit to 2025 GDP and a 4% rise in short-term inflation.

- This broad range of outcomes is worsened by Banxico's unusually cautious response. Banxico's latest [Financial Stability Report] offered only general statements, noting that trade shocks could "introduce downward pressure on economic activity" and "raise financing costs across the board."



- The central bank's reluctance to engage may reflect concerns within its leadership, particularly Governor Victoria Rodríguez Ceja, about triggering political backlash, especially given recent attacks on institutional independence at peer entities like INEGI (the independent statistical institute) and the judiciary under ongoing reforms.
- By contrast, Mexican Finance Minister Rogelio Ramírez de la O specifically identified key sectors likely to suffer disproportionate impacts from a 25% tariff on Mexican goods, including automotive, manufacturing, and electronic devices.
- While high-value manufacturing sectors are often viewed as the most vulnerable, it is too early to quantify likely effects, as sector-specific impacts will depend on the details of tariff implementation, with carve-outs and exceptions expected to soften the blow.
- The complexity of USMCA-driven supply chains—where goods cross borders multiple times during production—raises key questions about tariff application: whether cumulatively at each crossing or only on finished goods, and rebate eligibility criteria.
- Although exports in key sectors like motor vehicles and electronic products could theoretically decline by over 50% under certain scenarios, we view such extreme outcomes as unlikely, even under bearish projections.
- Under Trump's February 1 executive order, limited exclusions are available for personal communications, donations, informational materials, and travel-related transactions. However, unlike previous tariff programs, no product-specific exclusion process is currently in place, adding complexity for affected businesses.
- Under such a regimen, country-of-origin classifications will be critical – including for goods that previously entered without them under the general US MFN schedule – as both USMCA marking rules and the substantial transformation test will determine tariff applicability. Importers can potentially mitigate tariff exposure by reclassifying goods processed in third countries under substantial transformation criteria, a strategy that many companies have already begun exploring.

- The as-yet-rhetorical North American tariff dispute is unfolding ahead of the USMCA re-ratification scheduled for July 2026. Once considered a routine process, it is in our view now shaping into a full-scale renegotiation, driven by recent political developments in Mexico (e.g., judicial reform) and the resurgence of a more trade-confrontational Trump administration in the U.S.



Source: BEA

3. Sheinbaum's Outrage Premium

- On paper, Mexico's President Claudia Sheinbaum holds a strong political position, thanks to her highly centralized Morena party, which commands a supermajority in the national legislature, dominates most state governments, and enjoys broad popular support.
- Morena's strong performance in the June 2024 elections secured Sheinbaum a presidential mandate through 2030, reinforced by consistently high approval numbers.
- Now widely credited with delaying the proposed U.S. tariffs, headlines such as "Sheinbaum assures that we are not a colony" or "Mexico unites against Trump" and "Sheinbaum's cool head stops Trump's first attack on Mexico" reflect rising nationalist sentiment backing her administration.
- With this momentum, Sheinbaum would seem uniquely well-positioned to continue casting herself as a heroic defender of Mexican sovereignty against unreasonable U.S. demands and to withstand any resulting economic fallout, supported by strong approval ratings and Morena's backing, both of which remain significantly stronger in Mexico than Trump's in the U.S.
- However, her political strength is partially undermined by the continued influence of her predecessor and mentor, AMLO, who still controls Morena. AMLO has built parallel party institutions – with his son, Andrés Manuel López Beltrán (AMLB), overseeing the transition as Morena's Secretary of Organization – to maintain his grip on power even out of office.
- Sheinbaum's need to consolidate party control and expand her influence relative to AMLO incentivizes her to compromise. This is challenging, as she begins her presidency balancing ambitious populist promises against limited fiscal room—due to AMLO's heavy spending before the 2024 election—and the need to prioritize his legacy projects, such as shoring up the loss-making Pemex, before pursuing her own agenda.

- Trump's aggressive posture has provided Sheinbaum with political cover to deviate from AMLO's playbook on sensitive issues like toughening migration policies and abandoning the failed "hugs, not bullets" cartel strategy—without appearing disloyal to AMLO.
- Sheinbaum secured a key win this week by negotiating a month-long delay on Trump's 25% tariffs in exchange for a commitment to deploy "10,000 additional troops" to the northern border.
- However, much of the military was already stationed there, making it difficult to assess how much of a concession this was. (Notably, a U.S. reconnaissance mission over the Gulf of California and the USS *Nimitz* off Baja California's coast raised speculation about a broader security agreement, which could mean Sheinbaum conceded more than publicly acknowledged.)
- Adding to the perceived Sheinbaumian triumph, Trump is now personally pushing for USMCA early renegotiation, bringing things forward to this year, which will be a high priority for Mexico due to its exposure to market instability.
- As a result, Sheinbaum is widely perceived in Mexico as having outmaneuvered Trump, with support evident in social media, local media, and among business leaders who have historically opposed her and Morena.
- Despite her strong political standing, however, her actual influence over U.S.-Mexico relations remains limited. Significant authority—particularly over the legislature and the party—remains with her predecessor, Andrés Manuel López Obrador (AMLO), and Economy Minister Marcelo Ebrard.
- Ebrard, who previously served as Foreign Minister under AMLO, was appointed Secretary of the Economy by Sheinbaum in June 2024. Their relationship remains strained due to their fierce rivalry during Morena's cutthroat 2024 presidential primary.
- The continuity of key negotiators on both sides is a market-positive factor. Trump, who passed the USMCA, has often touted it as a major success and it would be out of character for him to abandon a deal bearing his brand. Meanwhile, key figures on the Mexican side are also reprising their roles, with the negotiating team—led by AMLO's allies and Ebrard—remaining largely unchanged.

4. Forced to Choose: Uncle Sam or Uncle Chan?

- Mexico may face pressure to unwind recent Chinese foreign direct investment (FDI) in key sectors, a task complicated by AMLO's ongoing relevance and his habitual mistrust of both the U.S. and China as imperialist powers and insistence on neutrality. However, if this becomes one of Trump's non-negotiable demands, we do not expect it to be particularly difficult for Mexico to address.
- The modest scale of Chinese investment offers Mexico something of a silver lining. While Chinese FDI to Mexico has grown considerably since 2018, it has done so from a small base, reaching a 13-year high of $5.6 billion in 2023—the most recent year with credible estimates. This accounts for 15% of total FDI to Mexico and is heavily concentrated in manufacturing sectors, such as automotive parts and electronics assembly.
- In 2023, 72% of Chinese FDI in Mexico was directed toward automotive production, with only 3% going into high-tech or strategic sectors. However, proposed high-tech investments, such as those from BYD, would potentially increase China's role in the value chain over time if implemented.

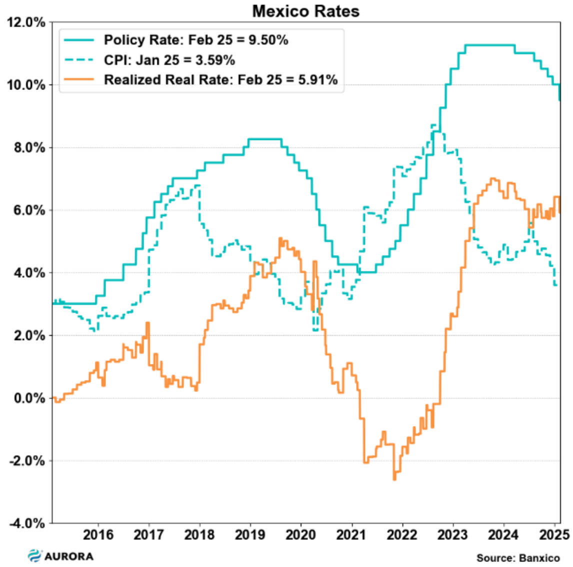
- Escalating U.S.-China trade tensions place Mexico in a difficult position, but we believe the choice is clear: Sheinbaum will curtail Chinese FDI, which is not critical to Mexico's fiscal health, to secure USMCA renewal and avoid U.S. tariffs.
- China exports electronics ($22.33 billion), machinery ($13.67 billion), and vehicles ($10.17 billion) to Mexico, while Mexico exports electrical equipment ($5.82 billion), ores ($4.8 billion), and vehicles ($1.48 billion) to China. These exchanges underscore mutual economic dependence and a diversified trade relationship. In contrast, trade between Mexico and the United States reached over $807 billion in 2023.
- Sheinbaum's government is therefore advancing the Mexico Plan, aimed at replacing Asian imports with domestic and North American manufacturing. The plan targets meeting 50% of internal consumption through local production while boosting manufacturing output by 15% in key sectors such as automotive, aerospace, and pharmaceuticals. However, we expect these measures will not fully meet U.S. demands in their current form, likely requiring further concessions and extending the period of uncertainty.
- While continuity among negotiators suggests some stability, the scope of issues affecting USMCA talks this time is broader and more complex.
- The U.S. designation of Mexican cartels as terrorist organizations, and accusations of government complicity have struck a nerve in Mexico, generating widespread opposition to any unilateral U.S. actions. Meanwhile, domestic pressure is growing on Sheinbaum to demand U.S. action on the "Iron River"—the flow of American firearms fueling cartel violence in Mexico.
- Although we expect USMCA renewal to be the base case, overlapping political incentives—Sheinbaum's for nationalist posturing and Trump's for symbolic threats—suggest the path getting there will be volatile and noisy.

5. Banxico Under a Microscope

- Banxico is currently in the difficult position of addressing a slowing economy while facing significant external trade risks—under the added pressure of political scrutiny as the executive, having weakened the independence of most national institutions, looms over its decisions.
- Despite the one-month delay on tariffs, the ongoing threat continues to hang over billions of dollars in cross-border trade, discouraging investment, pressuring growth, and heightening uncertainty around the medium-term direction of monetary policy.
- MXN volatility has been elevated since last year, driven by Morena's unexpectedly strong performance in the June 2024 elections, which delivered not just AMLO's handpicked successor as president but also a legislative supermajority. The unwinding of the JPY-MXN carry trade further contributed to this volatility.
- Since 2021, Mexico has benefited from the nearshoring trend, with private investment rising 12.6%, 7.7%, 17.6%, and 5.3% annually from 2021 to 2024, respectively. However,

Morena's stronger-than-expected electoral victory and AMLO's clumsy judicial reforms have chilled FDI flows, stalling this momentum, and investment flows have likewise largely paused after the 2024 election.

- The ongoing tariff threat risks turning this pause into a full-blown disruption.
- The economy grew just 1.5% in 2024, contracting more than expected in the last quarter due to plummeting foreign inflows, following two consecutive years of 3.0%+ growth. For 2025, Banxico forecasts GDP growth of 1.2%, with risks tilted to the downside. Aurora's base case anticipates stasis or a mild recession as more likely.
- On February 6, Banxico delivered a half-point rate cut to 9.5%, following four consecutive 25 bp reductions since March 2024. This was its largest cut since early 2020, during the pandemic.
- Banxico found room for monetary easing as inflation has moderated significantly. Annual inflation fell to 3.69% in early January, down from 4.21% in December and more than a percentage point lower than three months prior.

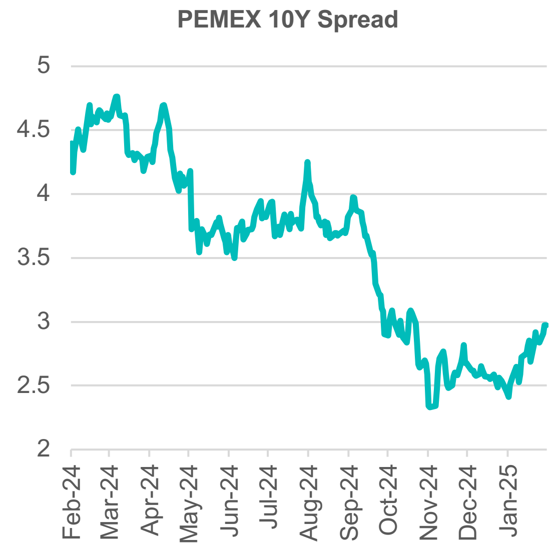


- Core inflation came in at just 3.66%, reinforcing Banxico's comparatively dovish stance relative to peers.
- The cuts are part of a strategy to counter economic weakness and offset trade-related risks. The decision, widely anticipated by analysts, followed a pattern of steady rate reductions.
- As with many recent decisions, the vote was split. Deputy Governor Jonathan Heath, seen as Morena's most loyalist voice on the board, voted for a smaller quarter-point cut, while newly appointed board member José Gabriel Cuadra—initially feared to be similar to Heath—voted with the majority for the half-point reduction.
- Forward guidance suggests further half-point cuts are likely, contingent on manageable inflation risks, with Banxico targeting a policy rate of 8% this year—the upper bound of its neutral range. Barring an unexpected tariff shock, another half-point cut is expected when the board meets in March.
- The MXN gained 0.4% against the dollar following the rate cut, but ongoing volatility is expected due to persistent tariff and trade uncertainties. The MXN remains vulnerable to rapid depreciation if external risks materialize—or if their likelihood increases.
- Banxico acknowledged in its statement that the balance of risks for inflation is tilted upward, driven by the potential for peso depreciation and further U.S. policy shifts.

6. What about the Assets?

- Mexican sovereign yields have come under increasing pressure, with Banxico reporting higher trading volumes, wider bid-ask spreads, and a preference among foreign investors for short-term Cetes over longer-term bonds. These trends could worsen with tariffs but reflect broader challenges seen across emerging markets.

- Should tariffs actually materialize this would have a dual effect on Pemex by curtailing exports and raising domestic energy prices on key goods like imported gasoline.
- Pemex's strategy guidance, issued in late 2024 following its return to nominal SOE status in October, conflicts with IMF recommendations and the government's claimed commitment to rapid fiscal consolidation.
- The Pemex plan, which includes cost-cutting through subsidiary consolidation, investments in new exploration, increasing gas production to 5 billion cfpd, expanding refining capacity, and diversifying revenue streams (e.g., fertilizer production), will require significant new capitalization.



Source: Bloomberg

- As was the case with the previous administration, we expect Pemex to avoid default through a familiar mix of government bailouts, tax breaks, and potential debt reprofiling to buy time—remaining solvent but trapped in its loss-making, unsustainable state, without the means to achieve a true turnaround.
- Mexico's sovereign debt sustainability remains sound, underpinned by ample reserves, well-distributed maturities, moderate external debt service costs, and high liquid assets. Notably, approximately 84% of central government debt is issued in local currency, which limits exposure to (currently heightened) exchange rate risks.
- While the tariff threat persists, we expect continued pressure on assets and the MXN, along with a further extension of the current slump in FDI inflows—prolonging the hangover from a heavily hyped nearshoring party that shut down abruptly and far too soon.

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