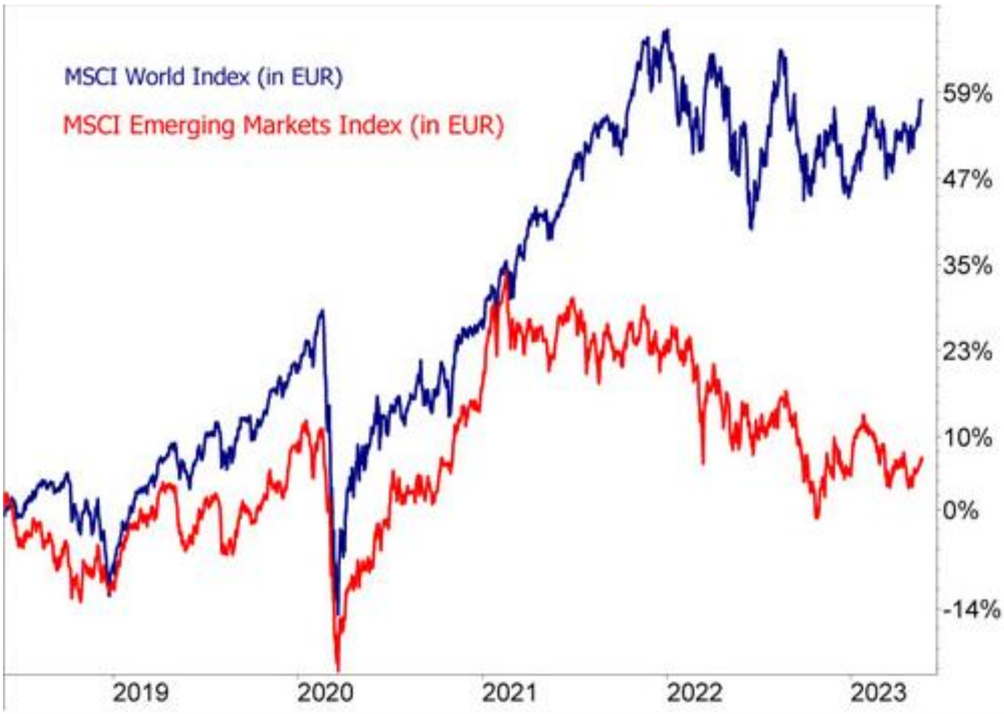
Capital Management

Dear reader,

The stock markets of emerging countries have exhibited a clear underperformance in recent years compared to the exchanges of so-called industrialized nations. We already addressed this matter in the previous report, which focused on China. The weak performance of Chinese stocks has exerted downward pressure on the MSCI Emerging Markets Index, the benchmark for emerging markets, particularly since the beginning of 2021.

Currently, Chinese stocks dominate the MSCI Emerging Markets Index with a share of 31.4 percent, although this share has been significantly higher in the past. Taiwan follows in second place with 14.8 percent, followed by India with 13.7 percent, and South Korea with 12.2 percent. Whether Taiwan and South Korea should still be classified as emerging markets, just like China, remains highly debatable. However, that is a separate topic.

In any case, since the beginning of 2021, the MSCI World Index has exhibited an outperformance compared to the MSCI Emerging Markets Index. In the benchmark for industrialized country markets, U.S. stocks currently hold a share of 67 percent.



However, such broadly diversified indices, where stocks are weighted by market capitalization, obscure the view of individual markets. Over the past 5 years, some industrialized countries' stock markets have performed below average, while certain emerging markets have shown notable outperformance. This holds true, for example, in the case of Mexico.

Not many investors have Mexico on their radar, despite the fact that it possesses the second-strongest economy in Latin America, following Brazil. It ranks first in terms of foreign trade, largely due to its proximity to the United States. Many U.S. companies have manufacturing operations in Mexico, resulting in significant exports and imports.

Such intra-industry trade initially inflates the trade balance, but what matters is the value creation that occurs in Mexico. And it is substantial. Many Mexican households rely on income generated from work in these factories. As a result, Mexico's gross domestic product (GDP) is roughly equivalent to that of Italy, although Mexico is home to a significantly larger population of 130 million people.

Mexico is a significant emerging market, even though Mexican stocks account for only 2.7 percent of the MSCI Emerging Markets Index. Particularly since the beginning of 2022, the MSCI Mexico has performed notably better than the MSCI Emerging Markets Index, surpassing the previous record high from 2015.

Mexico benefits from tensions with China

An important factor contributing to this outperformance is the trend towards "nearshoring" among U.S. companies. The political confrontation with China and the war in Ukraine have prompted many executives to reassess and rethink risks. Production that was previously outsourced to China, for instance, is now being relocated to Mexico. In Mexico, labor costs are also low, there is a well-educated population, and the political risk for investments is significantly lower.

This is also reflected in the growth rates. After a growth of 4.8 percent in 2021, the GDP increased by 3.1 percent in 2022. It is expected to grow by an additional 2.5 percent this year, which is significantly higher than in any other country in the region. In 2024, the GDP could grow by another 1.4 percent, but this is highly dependent on the economic performance of the United States. A recession in the neighboring country would also impact Mexico. However, the trend of outsourcing production by U.S. companies would likely be reinforced due to growing cost pressures.

Apart from serving as the workshop for the United States, Mexico also boasts traditionally solid public finances and moderate indebtedness. The country enjoys one of the best credit ratings in Latin America among lenders. An indicator of this is that approximately 80 percent of external debt is denominated in Mexican pesos. This is significant for investors as it makes the Mexican peso less vulnerable to weakness.

In terms of government revenue, Mexico heavily relies on the oil sector, specifically the exports of the state-owned oil company, Pemex, which is why the stock market occasionally reacts to changes in oil prices. However, commodity-related stocks have almost no role in Mexico's stock market, as evidenced by the heavyweight components of the MSCI Mexico Index. Instead, companies from the consumer sector dominate the market.

The 10 heavyweight companies in the MSCI Mexico Index are as follows:
(attached is the percentage representing the weightage of the stocks)

America Movil	16,8
Walmart de Mexico	12,0
Grupo Financiero Banorte	12,0
FEMSA	10,9
Grupo Mexico	7,9
Cemex	5,5
Grupo Bimbo	3,9
Grupo Aeroportuario del P.	3,6
Grupo Aeroportuario del S.	3,1
Grupo Financiero Inbursa	2,8

The top 10 positions combined make up 78.5%.

The largest holding by far is America Movil, the leading telecommunications services provider in Latin America. The company owns several telephone companies, including many major mobile network operators in Central and South America. However, America Movil is not solely active in the American continent but also has a presence in Europe, such as in Austria, Croatia, and Serbia.

WalMart de Mexico (Walmex) is the largest subsidiary of the U.S. retail giant Walmart, making Mexico its second home market. In total, over 2,800 stores are operated throughout Mexico, including large hypermarkets and discount stores, which positions the company as the largest retailer in Latin America with a revenue of approximately 40 billion euros. Walmex holds a market share of around 68 percent in Mexico.

Grupo Financiero Banorte, also known as Banorte, is one of the four largest banks in Mexico and Latin America in terms of assets and loans. As a traditional commercial bank, Banorte operates more than 1,200 branches nationwide.

Mexico's largest beverage manufacturer, FEMSA, is not only involved in numerous beer brands throughout the country but also has a stake in the Dutch brewery, Heineken. FEMSA operates over 10,000 convenience stores of the Oxxo chain in Mexico. Additionally, the company is considered one of the world's largest bottlers of beverages under the Coca-Cola brand.

It is no wonder that with this composition, the growing remittances from Mexicans living in the United States and the solid Mexican job market have recently not only strengthened local consumption but also provided a boost to the MSCI Mexico Index.

No opportunities without risks

Like other emerging markets, the risks in Mexico primarily lie in politics. President Andres Manuel Lopez Obrador has focused on combating corruption and expanding social expenditures. While this is generally positive, the president pays little attention to the concerns of businesses, leading to a decline in investor confidence. Additionally, there is the growing issue of drug-related violence.

Increased government spending becomes problematic when revenue from the oil sector fails to keep pace. Further downgrades from rating agencies, such as Moody's downgrade last year, would put pressure on the peso and further limit the government's room for maneuver through higher interest rates.

Moreover, interest rates are already very high. The central bank began combating the high inflation rate with interest rate hikes in 2021, reaching a record level of 11.25 percent in April. However, inflation has not yet been brought within the target range. As the economy loses momentum, further rate hikes are not expected.

Our conclusion

Mexico will benefit in the long term from its proximity to the United States and the trend towards nearshoring. We also anticipate a medium-term increase in oil prices. Despite the mentioned political risks, the country has remained relatively stable, including its state finances. The Mexican stock market is favorable due to the high proportion of companies focused on the domestic market, which benefit from population growth and rising incomes.

However, the MSCI Mexico Index has recently retreated from its record high, and there is a potential for further correction, especially if the US economy weakens. Therefore, we have chosen to take the profits on our position in a Mexico ETF in the medium-term oriented „Actively Managed Portfolio“ of our Premium Investment Letter. Nonetheless, we still consider the market promising in the medium and long term, and we will wait for an opportunity to re-enter.