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The Mexican Peso and High Bond Yields

Buy Mexican Peso high yield bonds and a long Peso currency play

Royce Equity Management analysts feel, with a current 7% yield, Mexican bonds are a buy. In addition, Forex cross-trades that are long the Peso will result in profitable currency trades.

The currency risk premium on Mexican bonds is now at an overvaluation within the bond pricing spread. Any reduction of that currency risk premium will generate good capital gains from owning Mexican bonds. We would recommend holding bond investments in Peso denominated Mexican bonds.

Royce is expecting Mexican inflation to peak "in the coming months" and that the balance of risks in this area are now "neutral". This compares to the previous statement from Royce where the risks to inflation is stated to have "moderately deteriorated". What's more, the forward looking portion of the statement hints that Royce sees the tightening cycle near an end. Royce feels that the current level of the policy rate is "congruent" with inflation returning to target. For the first time in a number of months, we see that one member of the five person Banxico board has voted to keep the benchmark rate unchanged.

With tentative signs from data that inflation is close to peaking, it appears that policymakers are increasingly of the opinion that their work could be done with a final +.25 rate rise later this year; possibly June or July. As such, we're happy with our view that further hikes in late 2017 would be unlikely.

Economists at Banxico have stated in a recent report that the arguments in favor of not hiking the policy rate beyond an early summer action include market expectations that inflation could soon start falling due to lower international prices and a stronger MXN which could push local gasoline prices and prices of other goods downwards. "We continue to believe that inflation will peak in either August or September We think annual inflation will start trending marginally lower in October and hit between 5.70-6.10% by year-end. The big drop in inflation will likely occur in March 2018, when we expect it to be below the upper bound of our target band (4%)." The report noted.

Our Royce analysts like local-currency bonds in Mexico and believe rate cuts from Banxico are likely to begin mid-2018.

"The Mexico Peso, at 21 Pesos per 1 US Dollar, has some room to strengthen against the dollar, and yields on local bonds now look attractive. With rate cuts expected next year in Mexico, repricing could be positive." Commented Royce's Head Forex Trader, Robert Perry, CFA

"At 7% for the 10-year bonds, local Mexican asset yield is interesting versus other area developing countries. You take the currency risk, but that is a much higher yield versus Colombia or Peru, which are high-rated investment grade markets but with lower yields", explained Royce fixed income manager Rex Von Wyatt. He continued, "Inflation is falling in Mexico, so rates could fall and that could help with capital gains on bonds."

Mexico bonds are A rated.

We like a long Mexican peso currency play and a Peso denominated long Mexican bond play.

Check with your account representative on the most optimal risk mitigated government and corporate bond positions. We are now looking for high yield bond and currency plays. Each customer will have individual risk aversion parameters evaluated before taking a position in foreign currency denominated bonds.

There is still the overall country risk that needs to be evaluated; case in point Venezuela.

We will advise you appropriately.

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