Emerging Insight

Mexico – Why isn't MXN weaker?

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GEM Fixed Income Strategy & Economics
Global

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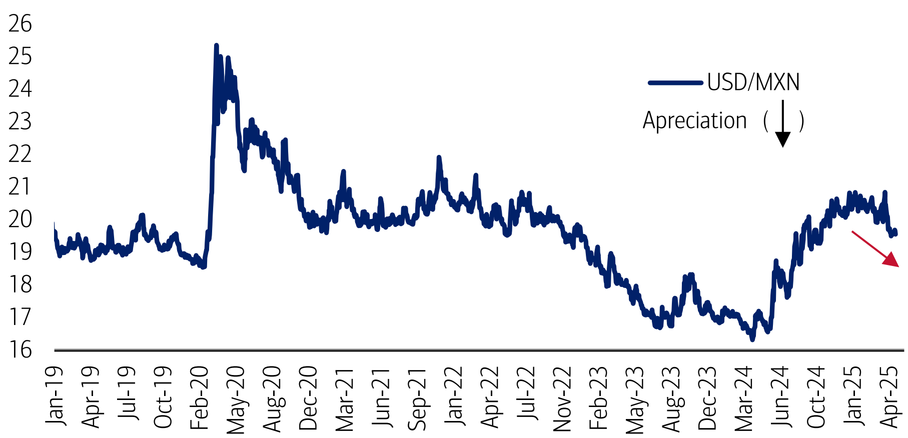
Key takeaways

- We see 5 reasons why the peso isn't weaker: (1) US dollar weakness; (2) Mexico faces relatively low effective US tariffs;
- (3) Mexico's CA deficit is almost zero; (4) Mexico's real interest rates remains high; and (5) Light MXN positioning.
- We are cautiously constructive MXN, expecting it to weaken to 20.50 as Banxico cuts rates. Main risk is USMCA cancellation.

By C. Capistran, C. Gonzalez Rojas & E. Aguirre

Chart of the day: MXN is strengthening despite higher US tariffs
Mexican peso (USD/MXN)



Source: BofA Global Research, Bloomberg

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Why isn't MXN weaker?

MXN has strengthened 6% so far this year, despite US tariffs, weak growth, and aggressive interest rate cuts by Banxico (see Chart of the Day). Why isn't MXN weaker? We see five reasons why: (1) US dollar weakness; (2) Mexico (and Canada) facing lower effective US tariffs than the rest of the world due to USMCA; (3) a rather small, almost zero, current account deficit in Mexico; (4) still high real interest rates in Mexico; and (5) light MXN positioning. We expect MXN to weaken slightly from here as Banxico continues to cut rates, but the Mexican peso is likely to continue to be supported relative to other currencies. We expect MXN at 20.50 by end-2025, although we do not discard some further MXN strength in the short term.

Why isn't MXN weaker?

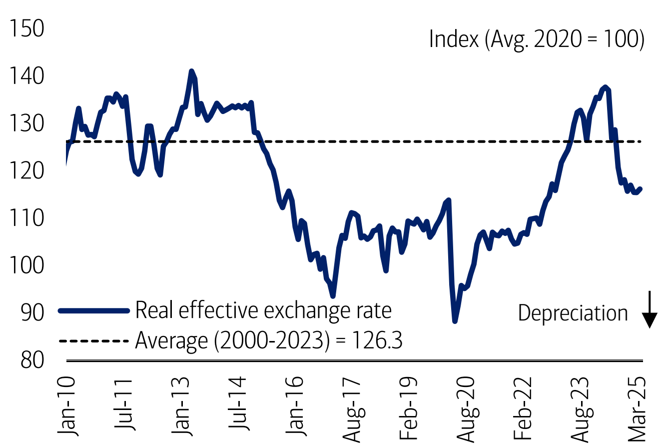
MXN has strengthened 6% so far this year, despite US tariffs, weak growth, and aggressive interest rate cuts by Banxico. Why isn't MXN weaker? We see five reasons why, which we discuss below. All in all, going forward we expect the MXN to weaken slightly as Banxico continues to cut rates, but the Mexican peso is likely to continue to be supported relative to other currencies. In the case of Mexico's real exchange rate, it is not weakening anymore and could start to increase going forward (see Exhibit 1).

1) USD has weakened substantially

Recent US dollar underperformance driven by the April market turmoil has led many to question the dollar's so-called "safe haven" and reserve currency status. However, while many of the pillars that have given the dollar this status over time have been damaged to various degrees, our G10 FX strategy team believes that these pillars remain intact in absolute terms and relative to all viable alternative currencies (see report: Bent but not broken: FAQ on the USD's "safe haven" status). Meanwhile, vast dollar liabilities in the global system remain supportive for the USD during global market turmoil.

The US dollar has weakened significantly, and we expect it to continue weakening going forward (see Exhibit 2). Our G10 FX strategists forecast EUR/USD strengthening to 1.17 by 2025-end, as they think that the uniqueness of this situation has caused investors to rethink large underhedged asset exposures to the US. This alone could still lead to a prolonged valuation adjustment lower in the dollar without unseating the dollar's place in global reserves or its ability to appreciate in a non-US centric shock. In addition, investors were still net-long dollars on balance coming into April, and the dollar remains near historically high valuation levels by nearly all measures. As such, the dollar was and continues to be vulnerable to US centric shocks.

Exhibit 1: Tariff uncertainty hit Mexico REER, but it is stable now
Mexico real effective exchange rate (REER), (index, avg. 2020 = 100)



Source: BofA Global Research, BIS, Haver

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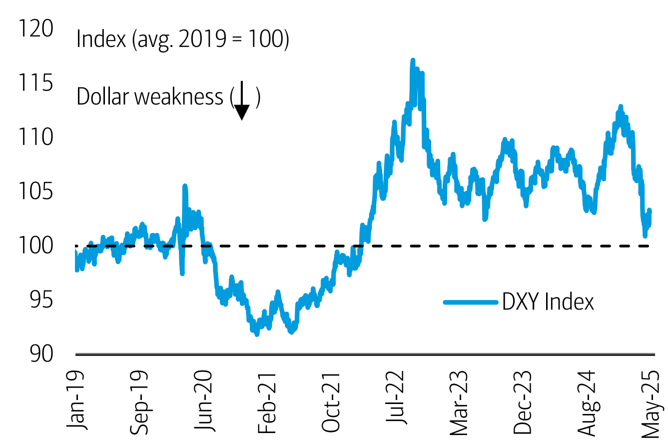
Exhibit 2: Uncertainty led the USD to weaken significantly
DXY Index (avg. 2019 = 100)



Source: BofA Global Research, Bloomberg

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2) Relatively lower US tariffs bode well for MXN

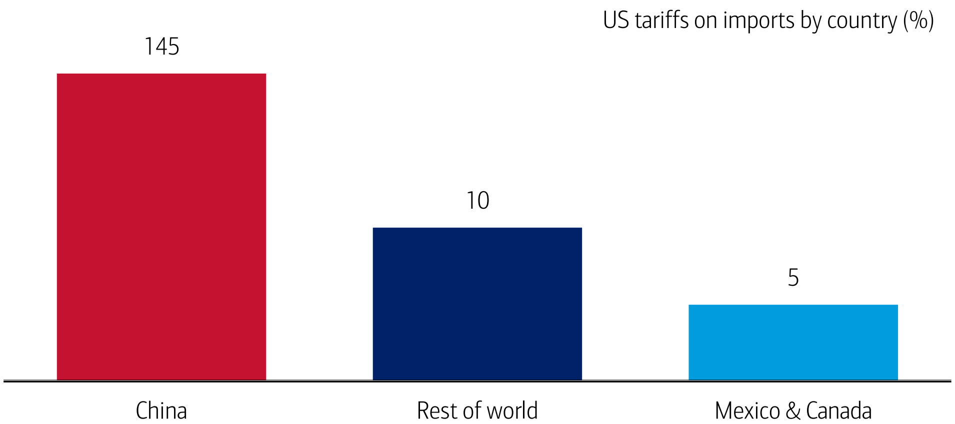
The US imposed tariffs to Mexico, and in some cases large tariffs. For example, the US imposed 25% tariffs across the board given the problems of fentanyl and migration at the US-Mexico border, as well as 25% on autos and auto parts. In principle this should weaken the peso. However, the US also imposed tariffs to other countries and Mexico got a lot of exemptions due to the USMCA trade agreement.

In terms of other countries, China – who competes with Mexico for the US market – is currently facing a 145% tariff with the US. This is likely to be revised to the downside, but it is unlikely to end up being below 50%, in our view. Other countries face a 10% tariff across the board, and then specific tariffs to products such as autos, steel, and aluminum. Although potentially bilateral deals are in the making, as was the case with the recently announced US/UK deal, we believe that countries other than China, Canada and Mexico will likely face a minimum 10% tariff going forward.

We estimate that Mexico is facing a US effective tariff below 10%. Mexico has a 25% fentanyl/migration tariff, but this does not apply to USMCA-compliant goods. The latter are about 50%, but this number is in the process of increasing to 80/90%, as firms complete the necessary paperwork to comply with USMCA given the new tariffs they are facing. Many comply with USMCA requirements, but decided not to use USMCA because they had a negligible tariff even without USMCA.

Mexico also faces 25% tariffs to autos and auto parts, but the latter were recently exempted, and the former get an exemption for US content (if the auto is USMCA compliant). Mexico also faces 25% tariffs on steel and aluminum. We estimate the effective tariff Mexico faces is 7.8% and we expect it to be 5% after negotiations in the following months. Therefore, Mexico is a relative winner in the tariff game (see Exhibit 3). This should bode well for MXN.

Exhibit 3: Mexico (and Canada) are benefitted by lower US tariffs
US tariffs on imports by country (%)



Source: BofA Global Research

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3) The CA is narrow thanks to high remittances

The third factor behind MXN strength, in our view, is the narrow current account (CA) deficit observed in Mexico in recent years. As of 2024, the CA deficit sits around -0.3% of GDP, significantly lower than its historical average of -1.1% (see Exhibit 4).

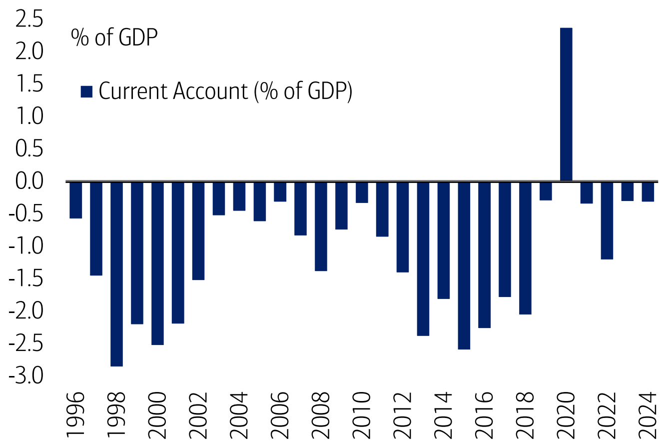
What has driven the narrowing of Mexico's CA? Looking at its breakdown, the Mexican economy has been a net importer for some time now (both goods and services balances show outflows on a regular basis). However, as of late 2020, the income balance – comprised mostly of remittances– turned positive (i.e., cash inflow); thus, offsetting the trade balance deficit almost entirely (see Exhibit 5).

Remittances into Mexico posted steady growth in the years prior to the pandemic, with a compound annual growth rate of 5.3% from 2010-19. Nonetheless, these surged soon after to a compound annual growth rate of 9.2% from 2020-24, most likely on the back of additional disposable income in the US due to the large fiscal stimulus on the pandemic years, and the exceptional GDP growth observed afterwards (see Exhibit 6).

Consequently, as remittances reached US$64.7bn of 2024, an all-time high equivalent to 3.5% of GDP. Yet, remittances into Mexico have started to decelerate, while foreign direct investment (FDI) into Mexico has not increased. Hence, remittances have also served as a buffer against the outflows stemming from the financial account (FA), from portfolio investments and other investments such as bank deposits (see Exhibit 7).

Remittances have been Mexico's lifeline as they continue to finance its external accounts and the resulting small current account deficit continues to be an anchor for the MXN (see [report: Remittances continue to be Mexico's lifeline](#)). Still, the outflows in the FA are significant, and could worsen given current domestic and external uncertainty. Moreover, remittances have risks to the downside from a deceleration in the US and potential changes in US policy, such as a potential tax to remittances.

Exhibit 4: Current account deficit is quite narrow
Current account (% of GDP)



Source: BofA Global Research, Banco de Mexico, INEGI, Haver

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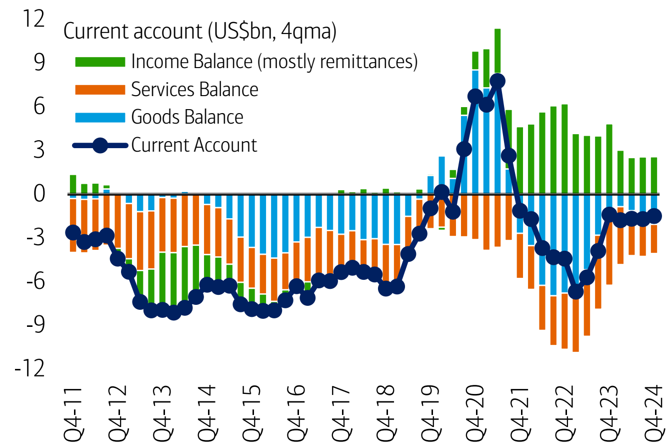
Exhibit 5: The current account remains narrow, mostly on remittances
Mexico current account breakdown, 4qma (US$bn)



Source: BofA Global Research, Banco de Mexico, Haver

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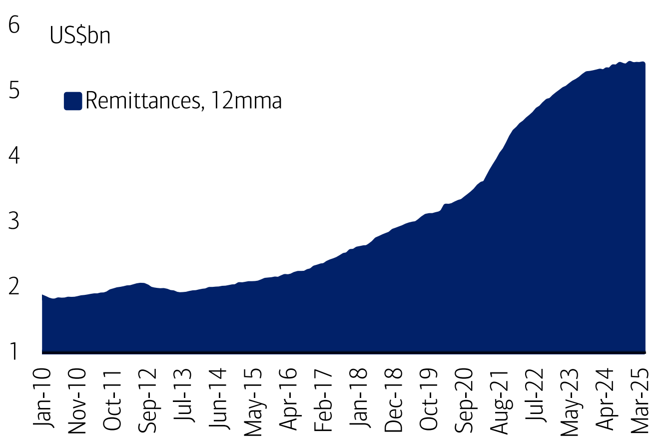
Exhibit 6: Remittances surged in the verge of Covid-19 pandemic
Remittances, 12mma (US$bn)



Source: BofA Global Research, Banco de Mexico, Haver

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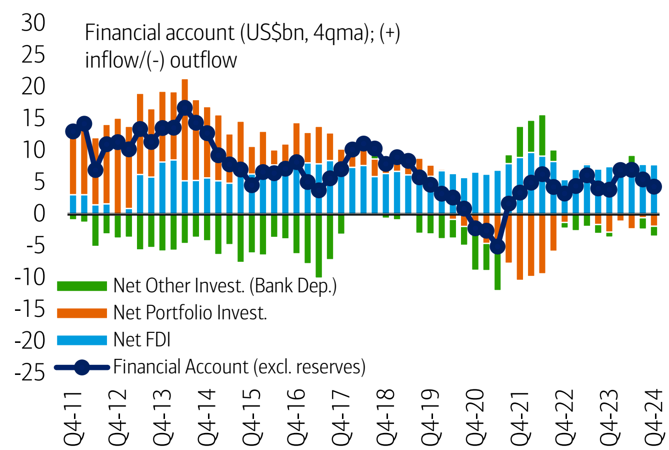
Exhibit 7: The FA has had significant portfolio outflows
Mexico financial account breakdown, 4qma (US$bn)



Source: BofA Global Research, Banco de Mexico, Haver

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4) Real rates are still high in Mexico

The ex-ante real interest rate is still high despite Banxico's recent 50bp cuts (see Exhibit 8). This acts as an anchor for the Mexican peso, especially since the current real rate stance is still favorable compared to other countries with investment grade.

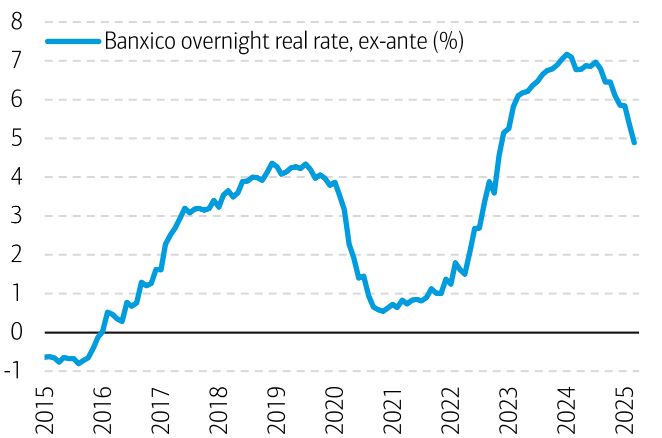
We expect Banxico to continue cutting this year. Specifically, we see one more 50bp cut in May 15, and then two more 25bp cuts to leave the policy rate at 8.00% by year-end. Banxico moving to clips of 25bp cuts should slow the pace at which the policy rate spread between Banxico and the US Fed's is falling (see Exhibit 9). This slowdown in the reduction of the nominal spread should lead to a slight depreciation in the MXN throughout the remainder of the year. Although Banxico could do one more 50bp in June instead of two 25bp (June and August).

One of the main reasons why we believe it is unlikely that Banxico cuts below 8.00% this year is because Banxico will likely be mindful of the nominal interest rate spread. Lowering it too much could lead to a sharper MXN depreciation. This may in turn fuel merchandise inflation, which is currently already on an upward trend. Banxico may be able to ease monetary policy further once the US Fed resumes cuts. We expect both the Fed and Banxico to cut 100bp in 2026.

The slowdown in domestic activity, lower oil prices and the lack of retaliatory tariffs from the Mexican side in the US trade war could lead to lower inflation expectations. This, in turn, would lead to an even more gradual decline in the ex-ante real rate, putting only slight upside pressure on the MXN. However, core inflation is currently on an upward trend and, in our view, is unlikely to converge to the 3% target in either 2025 or 2026, which makes it difficult for inflation expectations to decrease significantly (see report: Core inflation trending up could slow Banxico down after May).

We see downside risks to our 8% policy rate for the end of 2025 and 7% for the end of 2026, but even if Banxico were to cut more than what we expect, the real rate will continue to be relatively high vs other countries with investment grade (see Exhibit 10).

Exhibit 8: Real rates remain high in Mexico
Banxico overnight rate, real ex-ante (%)



Source: BofA Global Research, Banco de Mexico, INEGI, Bloomberg
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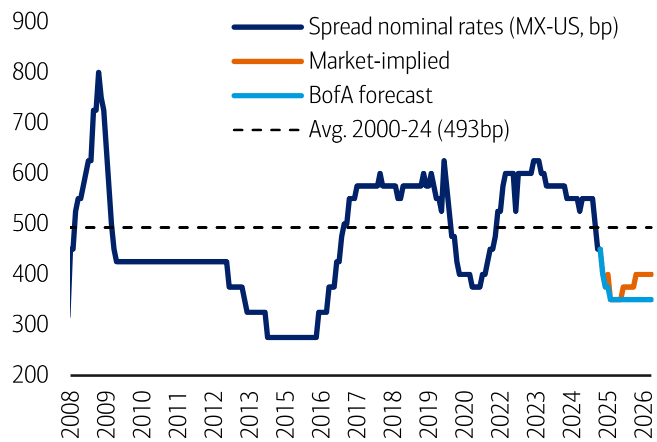
Exhibit 9: MX-US spread falling rapidly, but we expect it to stabilize
Nominal rates spread (MX-US, bp)



Source: BofA Global Research estimates, Banco de Mexico, US Fed, Bloomberg
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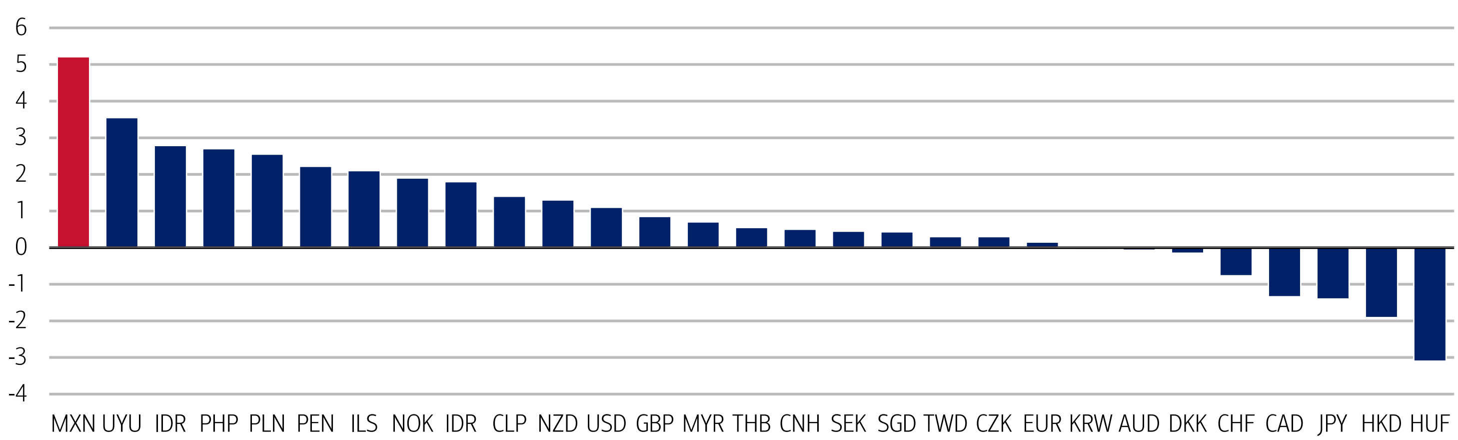
Exhibit 10: Mexico has the highest ex-ante real rate across major investment-grade economies
Ex-ante real interest rates (%)



Source: BofA Global Research, Bloomberg, Haver
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5) MXN positioning remains light

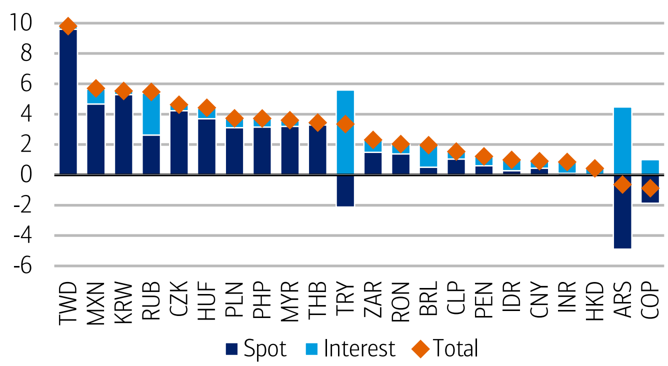
The Mexican peso has been a major outperformer in emerging markets since Liberation Day (see Exhibit 11). This is largely consistent with a better-than-expected outcome in terms of US tariffs following reciprocal tariffs, high real rates, and the absence of evident external imbalances in Mexico. However, it is equally important to note the recent dynamics of positioning.

Positioning in the Mexican peso remains remarkably light (see Exhibit 12), according to our Liquid Cross Border Flows. This is unlike last year when the market was heavily long MXN against low-yielding currencies. Now, the market in general seems to be very light on MXN risk. Similarly, our real money tracker suggests that real money funds remained only slightly underweight local bonds and FX (see report: Derisking ahead of tariffs and Exhibit 13). Finally, our CTA model for EM FX also suggests that trend-followers remain neutral on the Mexican peso (see our CTA Monitor in EM section in the report: Turning weak EM hands into strong). A lightly positioned market reduces the risk of a sharp Mexican peso depreciation, such as the one observed in mid-2024.

Moreover, we have seen a strengthening of the Mexican peso of almost 5% since April 2. Yet, our positioning indicator has hovered around neutral levels since then. This suggests that the most recent MXN outperformance has taken place without a significant increase in long MXN positions. Therefore, there is still room for investors to add more long MXN positions, which may support MXN resilience.

Exhibit 11: MXN has outperformed nearly all of EM since April 2

Spot, interest, and total return of major EM FX (%)



Source: BofA Global Research, Bloomberg

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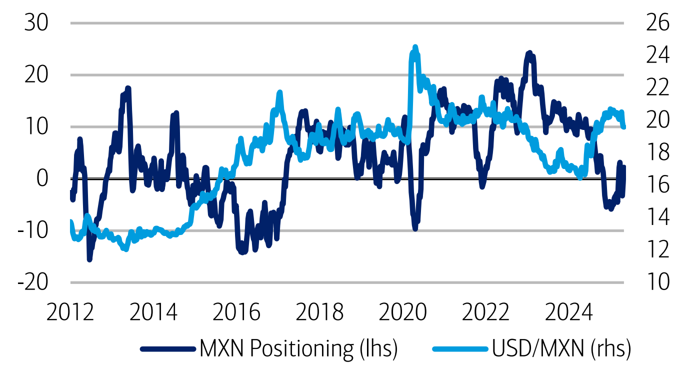
Exhibit 12: Mexican peso positioning remains light

MXN positioning indicator (+50/-50 denotes max long/short) and USD/MXN



Source: BofA Global Research, Bloomberg

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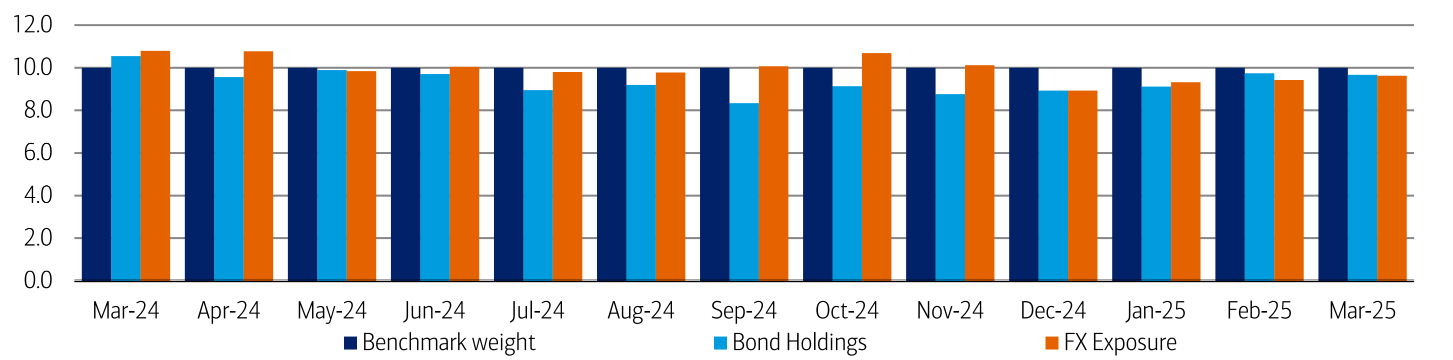
Exhibit 13: Real money funds exposure to Mexican bonds and FX (%)

Funds we track kept their absolute exposure to bonds fairly at Feb levels while increasing their exposure to MXN in March 2025



Source: BofA Global Research, fund factsheets

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News and Views

Brazil - April IPCA and core continued to accelerate

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Inflation in April was 0.43% mom, down from 0.56% in March. The print was in line with consensus expectations (BofA: 0.40%, consensus: 0.42%). In 12 months, inflation reached 5.53% yoy, up from 5.48% previously. On a monthly basis, average core decelerated to 0.50% mom, from 0.51%, while on a yearly basis it accelerated to 5.24% yoy, from 4.99%. Core services decelerated to 0.61% mom, from 0.65%, while the yearly print accelerated to 6.73% yoy, from 6.43%. Regarding other measures of underlying inflation, diffusion index (percentage of items that recorded inflation in the month compared to last month) increased to 66.8% from 64.5% in the previous month. Core inflation momentum, measured by 3mma saar decreased to 5.48% from 5.85%. The heated labor market and strong personal income, together with currency weakness and expensive commodities are still harming local inflation.

- **To follow:** We continue to expect the IPCA to reach 5.4% by year-end 2025 and to remain at a steady downward trajectory towards 4.5% by 2026YE.

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