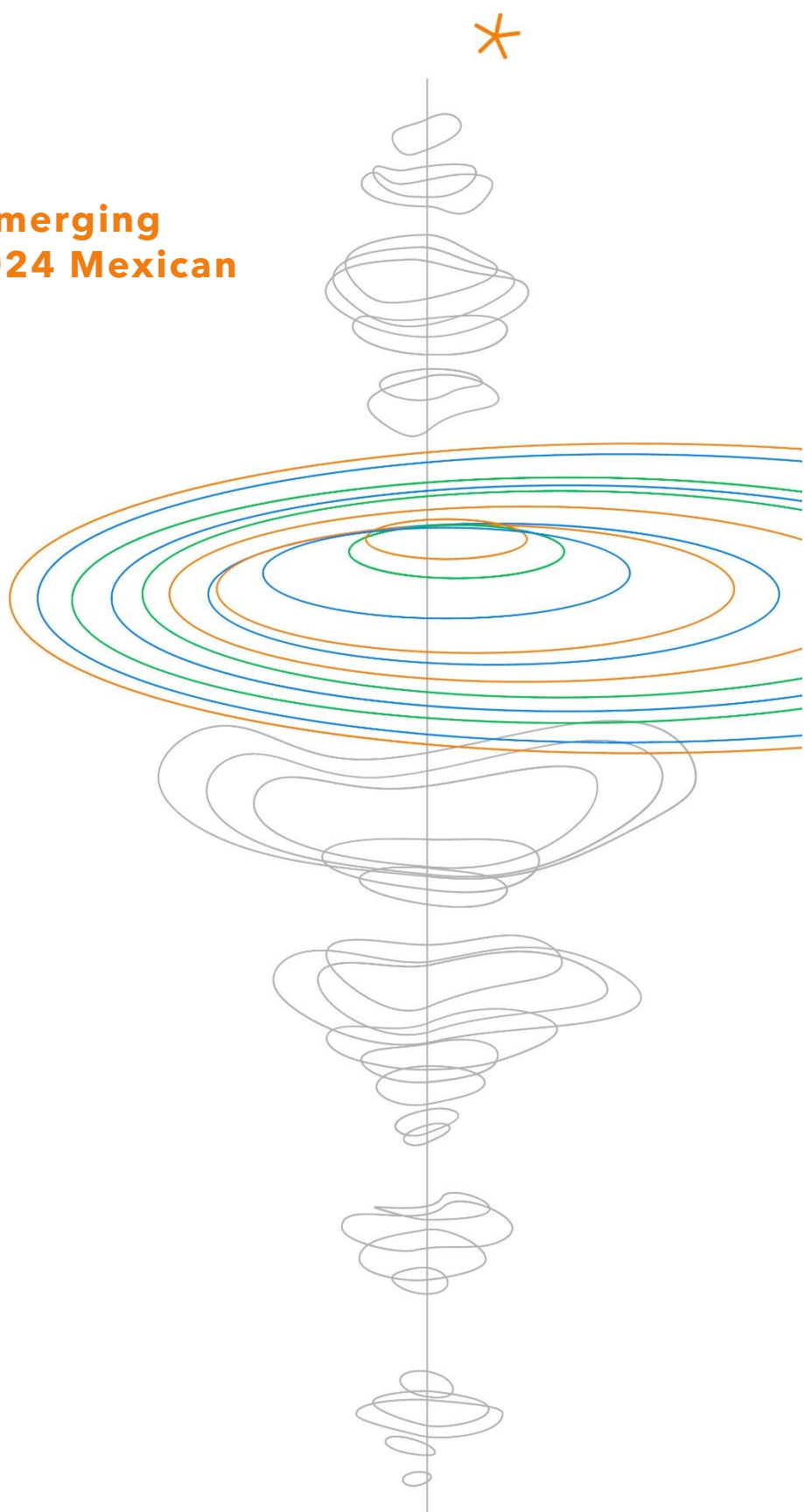


Authoritarian Risk in Emerging markets case study: 2024 Mexican elections

September 2024



I. A politically heavy year for Mexico: 2024 election and reforms

2024 has been a landmark year in Mexico's political landscape, marked by a series of consequential events that have reshaped the country's future. The general elections, held on June 2, brought Claudia Sheinbaum to power as the country's first female president, representing a continuation of the Morena party's dominance under outgoing President Andrés Manuel López Obrador (AMLO). This election was not just significant for its historic turnout and result but also for its broader implications as Mexico faces unprecedented reforms in its judiciary.

Before Sheinbaum's inauguration, Mexican President Andrés Manuel López Obrador while still in charge introduced sweeping judicial reforms allowing popular elections of judges, a first for Mexico. The changes have generated concern among investors due to fears of eroding judicial independence, potentially consolidating Morena's power over all branches of government. This shift could weaken checks and balances, risking legal predictability and foreign investment attractiveness.

AMLO's controversial judicial reform, passed in September 2024, introduced a shift towards the popular election of judges, raising concerns over the independence of the judiciary and prompting negative reactions from investors. These events, paired with the continuing transformation of Mexico's political institutions, have intensified scrutiny from both domestic and international observers.

The key political events in Mexico are listed below:

- **June 2, 2024: Presidential Election Date**

Results: Claudia Sheinbaum, from the Morena party (backed by the Labor Party and Ecological Green Party), won with a historic 35.9 million votes, securing 59.75% of the ballots cast. She is set to become Mexico's first female president, continuing the legacy of outgoing President Andrés Manuel López Obrador (AMLO).

Congressional Elections: Morena and its allies also maintained significant control over the legislative bodies, further consolidating power.

- **September 2024: Judicial Reforms**

Key Reform: The constitutional amendment passed in September 2024 under AMLO allows for the popular election of judges, including those of the Supreme Court. This is seen as an unprecedented change that raises concerns about the judiciary's independence. By 2025, half of the country's federal judges will be elected by popular vote, including Supreme Court justices, while the other half are expected to change by 2027.

- **October 1, 2024:** Sheinbaum's Inauguration.

- **Jan 2025:** Implementation of Judicial Reforms with the first elections for federal judges.

The market reacted negatively, with increased volatility in the peso and stock markets. Credit agencies have also flagged the reforms as a potential risk to Mexico's sovereign rating, raising uncertainties for nearshoring and business confidence. As of the end of September, in USD terms Mexican equities lost -19% year-to-date, which underperforms other Emerging Markets by -35% (*Figure 1*).

Investors recent concerns directly relate to a lack of confidence in Mexican institutions ability to guarantee foreign investors sufficient legal stability and respect of property rights, investor protection measures.

Figure 1 Mexican Equity performance relative to the Emerging Market index in USD
From Dec 29, 2023 to Sept 30, 2024



Source: MSCI, Bloomberg, TOBAM

II. CD Ratings and Mexico exclusion

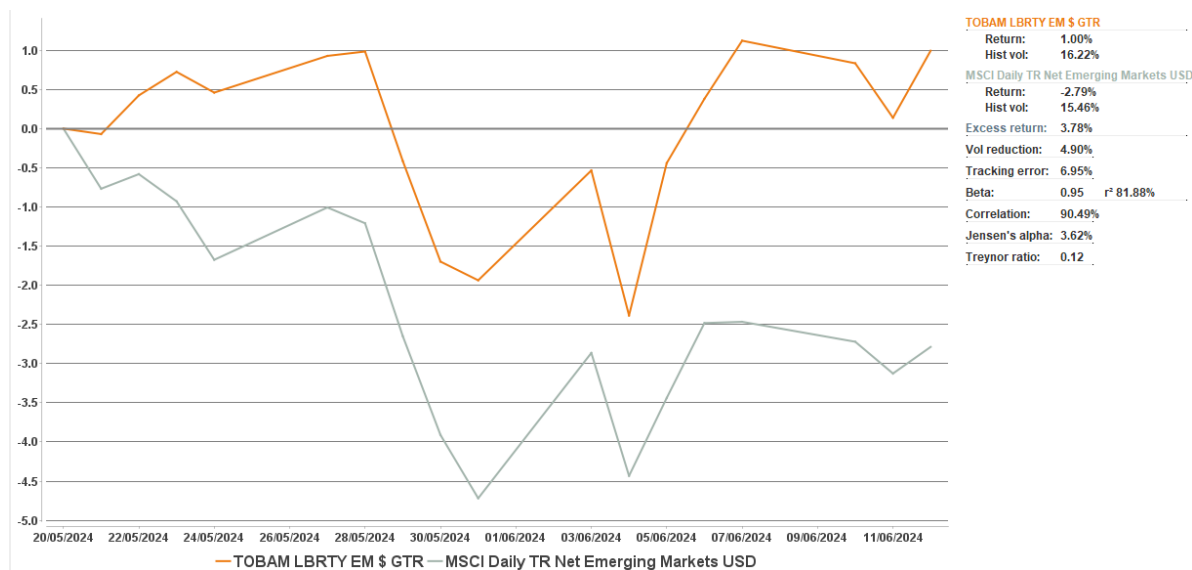
Since the beginning of 2019, our investment process has blacklisted Mexico because its CD rating fell below the threshold of 6¹. This decline was primarily due to significant decreases in **the Functioning of Government** and **Democratic Culture** observed in the year 2018. Indeed, that year was an election year, where widespread corruption scandals eroded public trust, and the government's inability to prevent the assassination of over 130 political candidates before the July elections highlighted severe governance challenges, negatively impacting the Functioning of Government. Concomitantly, unprecedented political violence and the pervasive influence of organized crime led to fear and disillusionment among citizens, causing a sharp decline in the Democratic Culture.

These two pillars are critical for investor confidence. When the government functions effectively, it ensures transparency and the rule of law, both of which protect investments by enforcing contracts and maintaining fair regulations. Similarly, a strong democratic culture promotes political stability and reduces the risks of abrupt policy changes or unrest. The decline in these areas created a less secure and predictable investment climate, justifying Mexico's blacklisting in our investment process. This decision contributed to the outperformance of the LBRTY® EM index (Figure 2)

Interestingly, the recently approved judicial reform weakened further investors' perception of the enforcement of the rule of law in the country. Thanks to the CD ratings methodology, the LBRTY® EM strategy has not suffered from any direct exposure to Mexican equities drawdown in 2024. Most importantly, since Mexico is a well-integrated economy and is one of the most prominent trade partners of the US. Logically political developments in this country have repercussions on other economies, first and foremost the US one. The LBRTY® strategy addresses such an issue through the concept of authoritarian indirect risk control. The Authoritarian Exposure (AE) is a company level metric that aggregates all such indirect authoritarian exposure among amongst all Authoritarian countries, including Mexico.

¹ According to our investment criteria, any country with a CD rating falling below 6 is a priori blacklisted, resulting in Mexico being deemed below the threshold to be investable.

Figure 2: Performance of the LBRTY® EM index vs. MSCI Emerging markets
 From May 20, 2024 to June 12, 2024 (period of major Mexican equity drawdown)

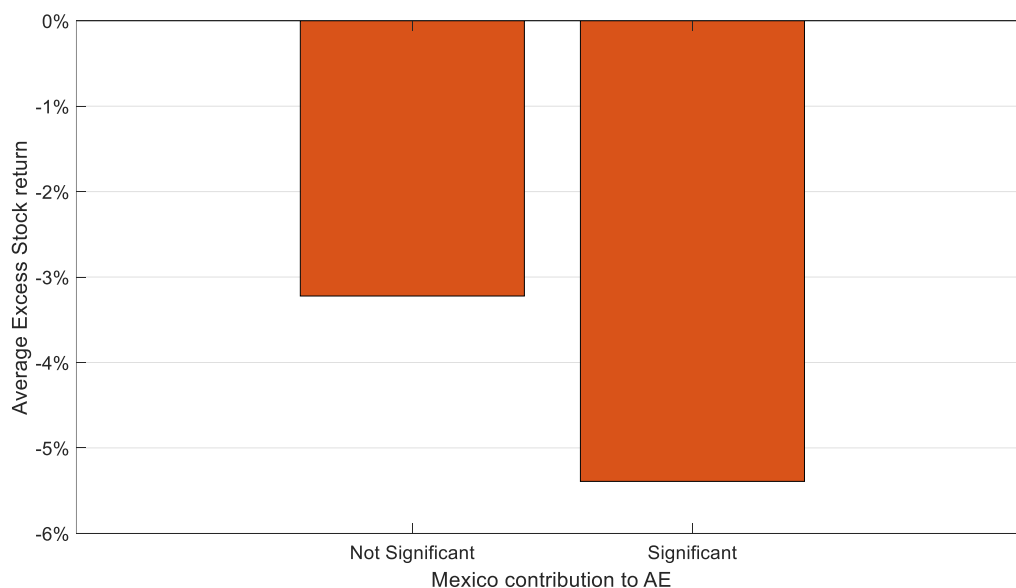


Source: MSCI, Bloomberg, TOBAM

Using TOBAM's Authoritarian Exposure (AE) investors in Global or even US Equities can reduce this indirect risk in their portfolios. The recent market turmoil in Mexico provides an illustration of the magnitude of this risk even for US investors: in the U.S., for example, companies that our proprietary methodology identified as having exposure to developments in Mexico have, on average, underperformed compared to their peers with no significant exposure.

As shown in Figure 3, during the period of turmoil following the election results in Mexico, stocks with significant positive exposure to the Mexican market had, on average, excess returns that were 2% lower than those of their unexposed counterparts.

Figure 3: Average excess stock returns of U.S. companies based on the significance of the contribution of the Mexican dimension in their Authoritarian Exposure
 From May 20, 2024 to June 12, 2024 (period of major Mexican equity drawdown)



Source: MSCI, Bloomberg, TOBAM. Noteworthy, 80% of the U.S. stocks underperformed the U.S. market during this period. Excess return is defined as the market Beta adjusted return.

III. Conclusion

- In June 2024, Mexico held General elections where the grasp of power by the incumbent's Morea party was reinforced.
- The outgoing president Andrés Manuel López Obrador took advantage of the majority in parliament to reform the judicial system in a way that undermine the balance of power.
- Due to a loss of confidence from investors, Mexican equities lost close to 20% in USD and underperformed other EM countries by -35% in 2024 YTD.
- The LBRTY® process effectively mitigated market drawdowns by excluding or reducing exposure to companies with ties to Mexico. This reduction in authoritarian risk contributed to the outperformance of LBRTY® US, ACWI, and EM strategies during the period of turbulence in Mexico.

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