



Weekly Geopolitical Report

By Thomas Wash

July 9, 2018

The Return of AMLO

On July 1, Andres Manuel Lopez Obrador, or AMLO for short, became Mexico's first leftist president in over three decades,¹ running on anti-establishment and anti-corruption platforms. The 64-year-old activist won with over 53% of the vote, the most since Mexico moved to a multi-party system. For the first time in nearly a century, Mexico elected a president who did not belong to either of the two traditional parties, PRI or PAN. Furthermore, his political party, the National Regeneration Movement (MORENA), was also victorious, winning the majority in both the Senate and the Chamber of Deputies. As a result, AMLO will be the most powerful Mexican president since the PAN party ended PRI's 70-year rule in 2000.

AMLO, who had run for president twice before, overcame stiff opposition from establishment candidates in the PRI and PAN parties. Since winning the presidency, AMLO has promised to balance the government budget, lower the crime rate and negotiate with the Trump administration on immigration and trade. His victory has caused market uncertainty as many people are not sure how he will handle Mexico's relationship with the United States. The U.S. and Mexico have been re-negotiating NAFTA since last August and are expected to resume negotiations again next year. In addition, the U.S. and Mexico are still trying to find a solution to the immigration

problem. In this report, we will examine how and why AMLO was so successful, briefly describe his history and then discuss how he might run his government. As usual, we will conclude with possible market ramifications.

How did AMLO win?

In order to understand AMLO's unprecedented rise, we must first discuss his predecessor. In 2012, Mexico was experiencing relatively high levels of unemployment as a result of the global recession. Enrique Peña Nieto, a former governor of the State of Mexico, argued that opening Mexico to foreign investment would be the best approach to solve the employment problem. His political adversary, AMLO, disagreed. Peña Nieto was able to beat AMLO by six points in the general election, although AMLO alleged that there was massive voter fraud.

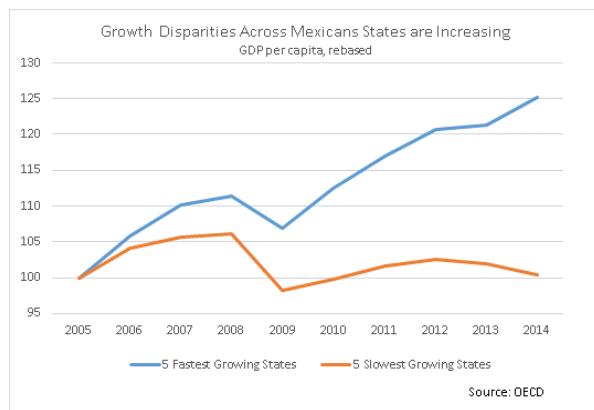
As president, Peña Nieto's economic policies were mixed. During his time in office, the auto industry expanded rapidly throughout Mexico due to an increase in direct investments from foreign car makers such as Kia Motors (KMTA, \$30.30) and BMW (BMW, €80.32).² As a result, the unemployment rate fell sharply from 5.0% to 3.2% as exports became a critical component of the Mexican economy. During this time, exports as a percentage of GDP increased from 30% in Q1 2013 to 38% in Q1 2018.³ That being said, GDP growth wasn't spectacular, averaging 2.5% per year compared to 4.2% of all emerging markets.

¹ The last leftist Mexican president was Miguel de la Madrid, who presided from 1982 to 1988.

²<http://www.mexiconews.net/news/225153337/automaker-kia-plans-1-bn-assembly-plant-in-mexico>

³ Source: Haver Analytics

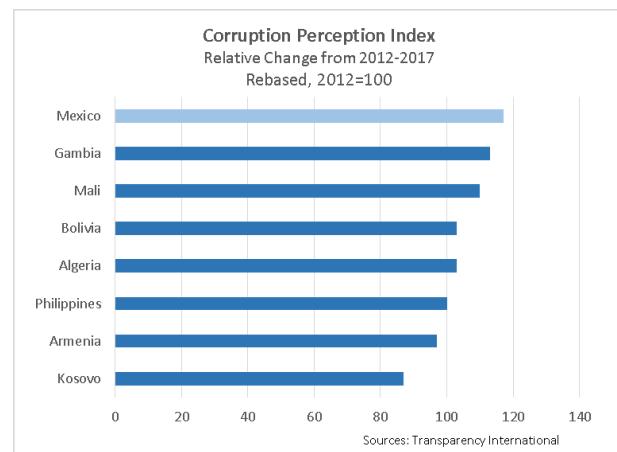
Although Peña Nieto's economic policies were somewhat validated by the drop in the unemployment rate, they were criticized for favoring certain states and leading to higher economic dispersion. Nevertheless, his economic reforms did convince the Mexican people to accept free markets.



Despite his economic success, Peña Nieto had record-low approval ratings due to government scandals and rising homicide rates. His administration was plagued with scandals such as the kidnapping and murdering of students that remains unsolved, illegal surveillance of its citizens and government corruption. The perception of corruption grew during Peña Nieto's tenure. The chart below shows the relative change in the Corruption Perception Index among countries that had an identical score to Mexico in 2012. According to the chart, produced by Transparency International, the Mexican public's perception of corruption increased more than any of its peers. Additionally, rising security concerns remained a prominent talking point during the election cycle as over 100 Mexican politicians were killed by suspected gang members.⁴ AMLO was able to capitalize on this issue by conflating the two issues into

⁴ <https://www.cnbc.com/2018/06/26/more-than-100-politicians-murdered-in-mexico-ahead-of-election.html>

one insult by labeling the establishment parties PRI and PAN as the “Mafia Powers.”



AMLO's reputation for being honest, humble and incorruptible was the key to his victory. His desire to rid the government of political corruption by reducing the salaries of the highest paid government workers and sacking corrupt officials appealed to voters. However, in order to win the election he distanced himself from populist rhetoric and promised to keep Mexico open to foreign investment.

Who is AMLO?

Although AMLO has been compared to former Brazilian President Lula de Silva and Venezuelan President Hugo Chavez, neither leader accurately matches his personality. As a lifelong social activist and politician, AMLO does not have the business ties of de Silva. Furthermore, as mayor of Mexico City he was able to increase social spending and balance the city's budget, which suggestss he is more pragmatic than Mr. Chavez. Nevertheless, AMLO's commitment to fighting for the poor while simultaneously improving the economy has allowed him to draw supporters from diverse ideological backgrounds. AMLO has built a cult of personality that allows people to view him as a projection of hope.

While AMLO has worthy goals such as reducing violence and ridding the government of corruption, his strategies to achieve such goals are vague and sometimes contradictory. He claims to be a fiscal conservative but advocates for an increase in government spending. He has vowed to keep Mexico open to private investment while also pledging to put on hold the oil tenders that began under the previous administration. Although he labeled President Trump's immigration policy as racist and oppressive, he has also stated he would like a warm relationship with the U.S. president. The lack of ideological cohesion can also be seen in his political party, MORENA, which includes members that vary across the political spectrum.

AMLO's lack of clarity seems to be the result of moderating his views to attract a wider base while remaining loyal to his original supporters. Earlier in his career he embraced neo-Cardenismo, which is a brand of populism that favors government control of natural resources and land. In fact, he was previously a staunch critic of NAFTA, stating that it opened up the country to exploitation by foreign interests and hurt Mexican farmers. As his political career began to evolve, AMLO became more restrained in his critiques of NAFTA. In particular, with the exception of foreign investment in PEMEX, he seems to support direct foreign investment in other areas of the economy and advocates for companies that do invest to be conscious of the effects they have on the poor.

How will AMLO govern?

AMLO is a nationalist at heart and prides himself on being a fighter for social justice. As a result, we believe he will spend most of his time working on social issues. During his presidential campaign, AMLO declared he would like to end poverty and corruption,

and make Mexico more self-reliant. He stated that he can honor his promises by expanding government programs without taking on additional debt. In addition, he mentioned that he would like to curb direct foreign investment into Mexico's energy sector. We would expect AMLO to use his presidential authority to help improve the lives of the poor, particularly those that live in the south. However, achieving these goals will be difficult.

Since the president of Mexico has the power to call for referendum, AMLO will likely use his influence to push through tough legislation. We suspect he will use his referendum power to cut the wages of government officials, which is one of the ways he plans to find money to pay for his social programs. However, the referendum does have its limits. A law passed in 2014 prohibits the use of a referendum on issues related to human rights, national security, elections or fiscal matters; therefore, any attempt to overturn the energy reforms passed by the previous administration will likely be challenged in the Supreme Court.

In an ideal world, AMLO would prefer a Mexico that is insulated from global trade but he realizes that most Mexicans do not agree with this philosophy. As a result, he has selected establishment-type individuals to manage foreign policy. His lead trade representative for NAFTA will be Jesus Seade, who not only used to work for the IMF but also played an integral part in the original NAFTA negotiations. With Mr. Seade as lead representative, we expect trade negotiations to pick up steam, especially since he and U.S. trade representative Robert Lighthizer have known each other for over two decades.⁵

⁵ <https://www.bloomberg.com/news/articles/2018-06-26/amlo-nafta-negotiator-hopes-for-deal-in-next-couple-of-months-jiw4wr9r>

Furthermore, AMLO's administration has already expressed a willingness to improve working conditions in Mexico as well as increasing the North American content requirements in autos. On the other hand, he has expressed resistance to raising wages.

Ramifications

In the movie *The Candidate*, Robert Redford plays Bill McKay, a young anti-establishment candidate who against all odds gets elected to the U.S. Senate. Having just won the election and feeling overwhelmed, Bill asks his political consultant Marvin Lucas, played by Peter Boyle, "What do we do now?" only to have supporters rush into the room before Marvin is able to respond.⁶ This scene captures the situation AMLO will likely face upon taking office. We expect AMLO to struggle to maintain his image as a man of the people while working within the political machine.

AMLO dreams of being able to take Mexico back to the 1930s during the Cardenista era, a time when the government controlled the

economy and the energy sector was nationalized. Unfortunately for AMLO, he faces three constraints: 1) the general public favors free markets; 2) members of his party may not share all of his views; and 3) the Supreme Court will keep him from making drastic changes to the government. It is unlikely that AMLO will have the same contentious relationship with President Trump as his predecessor. AMLO appears to be willing to take a backseat in NAFTA negotiations and will likely help President Trump fight drug trafficking.

In conclusion, we expect AMLO to maintain a healthy relationship with the U.S. and cooperate on NAFTA negotiations and immigration policy. Despite an early sell-off in the Mexican peso, we expect Mexican equity markets to stabilize and possibly rally as it becomes clear that AMLO will not drastically alter Mexico's relationship with the U.S.

Thomas Wash
July 9, 2018

⁶ <https://www.youtube.com/watch?v=myEpap3TxVs>

This report was prepared by Thomas Wash of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm's portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.