June 28, 2023

Investment Perspectives

Mexico Nearshoring: “Opportunity Knocks”

We believe recalibration of supply chains is already taking root in Mexico, offering an investment theme for Lord Abbett portfolios. Tracking its development will be critical in assessing the full potential of nearshoring for Mexico’s economy.

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Sovereign Analyst

KEY TAKEAWAYS

- Nearshoring is just starting to show up more clearly in Mexico’s economic data, with growing evidence that it is making headway on the ground.
- This new source of investment could boost Mexico’s GDP potential after more than a decade of relatively sluggish economic growth.
- Capturing the full promise of this multi-year opportunity will require enabling policies from the Mexican authorities. Several stumbling blocks still need to be cleared, including energy sector constraints and rule-of-law issues.
- While nearshoring expectations are already baked into some asset prices, we see it as an important theme for the Lord Abbett Emerging Markets Corporate Debt Fund and other investment vehicles.

“Nearshoring” was a key buzzword in our recent visits to Mexico City and Washington, D.C., as countries and companies look to recalibrate their supply chains to make them more resilient to shocks, trade barriers, and national security concerns. Over the past few years, U.S.-China trade tensions, global supply-chain disruptions from the COVID-19 pandemic, and Russia’s invasion of Ukraine have triggered a new global discussion around de-risking supply chains. Onshoring and nearshoring are on the agenda, with the push to bring production back within domestic borders or to nearby friendly countries. In that regard, Mexico and Latin America stand out as potential sourcing alternatives for businesses producing for the United States and Canada.

In our view, Mexico should be the clear nearshoring winner in the Americas, standing out as a manufacturing hub that benefits from geographical proximity, 13 existing free-trade agreements (with 50 countries), labor-cost advantages, and favorable demographics. Nearshoring opportunities are expected to benefit the country but are just starting to show up more clearly in the economic data. Headline foreign direct investment (FDI) in Mexico was stable between 2015 and 2022, but we’re finding more evidence that nearshoring is now underway. The trend is still in an early stage, initially benefiting sectors that have a clear ecosystem already in place (particularly automotive, electronic equipment and machinery, and aerospace). But there are signs that some products that took a hit from China’s entry to the World Trade Organization (WTO) in December 2001 are also starting to come back, including medical goods, furniture, and plastics.
Here are some developments that have caught our attention:

- Mexico has been taking a greater share of the U.S. import market in recent quarters, passing China for the first time since 2003, according to recent data from Bank of America, Haver Analytics, and the U.S. Census Bureau. The participation of Mexico in U.S. imports rose to 15.4% during January-April 2023 (up from 13.8% during the same period in 2022), while China’s year-to-date import share fell to 13.3% (from 17.0% in YTD 2022).

- Industrial park occupancy has neared 100% in some northern cities that are linked to Mexico’s industrial clusters. Rents and wages have also been rising in border states, and economists point to shortages of labor in some areas.
### Availability of Industrial Park Space (%)

- **2019**: 5.5%
- **2020**: 6.3%
- **2021**: 3.8%
- **2022**: 2.2%

Source: de la Calle, Madrazo, Mancera; CBRE/AMP.

### Formal Average Wage by Region

- **North**
- **Center North**
- **Center**
- **South**

Source: Bank of America, National Institute of Social Security (IMSS).
• Headline FDI in Mexico was basically flat between 2015 and 2022. But new investments rose to 48% of FDI in 2022—the highest level seen since 2013. And FDI has jumped so far this year, reaching $18.6 billion during the first three months of 2023; that’s a 48%, year-over-year increase, if you adjust the data for last year’s restructuring of Aeroméxico and merger of media companies Televisa and Univision. (FDI data from Banorte and the Mexican Ministry of Finance.)

![Foreign Direct Investment in Mexico (Bil. US$)](chart)

Source: Banorte, Ministry of Finance.

• Investments in capital goods and machinery and equipment are up significantly, particularly in imported machinery and equipment, which is more than 30% above pre-pandemic levels
We’ve seen multiple examples of auto sector investment announcements over the past few quarters, led by companies like Tesla (with its $5 billion Gigafactory announcement) and BMW ($0.9 billion) in 2023, and Solarever ($1.0 billion), Volkswagen ($0.8 billion), and Nissan ($0.7 billion) in 2022.

### Key Auto Sector Investment Announcements (2022)

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<tr>
<th>Company</th>
<th>Sector</th>
<th>Amount (US$mn)</th>
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<tr>
<td>Solarever</td>
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<td>DANA</td>
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Source for both years: Banorte, press reports. As of June 6, 2023.

- Bank executives in Mexico report seeing (for the first time) significant direct investment interest in Mexico from companies based in China and southeast Asia. China’s share of investment in the country is still very small but has risen rapidly, likely explained by the push effect of higher tariffs on goods produced in China since July 2018 and supply-chain issues during the pandemic.

While we see the Mexican nearshoring trend already underway, our visit to Mexico City underlined several domestic challenges that the Mexican authorities will have to overcome to capture the full potential of this multi-year trend. Here are some of the primary issues they face:

- **Energy policy:** One key risk to nearshoring has come from President Andrés Manuel López Obrador’s (AMLO) nationalistic energy policy, which has favored state-run power utility CFE over private sector renewable energy alternatives. Over the short term, this has weighed on investor sentiment, while longer term, underinvestment in the electricity sector could stand in the way of Mexico’s ability to provide adequate generation and transmission, especially from clean energy. Some estimates suggest that Mexico could face a material power deficit (and more frequent power outages) by 2025 if no capacity additions are executed; other projections see a high risk of electricity demand exceeding capacity in Mexico’s north, northwest, Baja California Sur, and the Yucatán Peninsula in the coming years.
Water availability: Availability of water resources has posed a challenge in Mexico’s border states like Baja California, Nuevo León, and Chihuahua that have been hit by a severe drought over the past few years, and many municipalities are facing water supply stress.

Logistics: Larger manufacturing and export capabilities will require more efficient railroads and ports, better border crossings, the development of Gulf of Mexico trade routes (to boost exports to the U.S. northeast), and an open skies agreement with the U.S.
• **Rule of law and violence:** Regulatory changes under the left-leaning AMLO administration have raised concerns about policy certainty and weighed on investor sentiment. Higher rates of crime and drug-related violence in Mexico since 2007 (and especially 2014) have resulted in high security costs for many firms, although these are generally more manageable for large international companies.

• **Ongoing trade disputes with the U.S. and Canada:** A resolution of dispute settlement talks under the U.S.-Mexico-Canada Agreement (USMCA) on trade about Mexican energy policies and other issues would also help reassure potential FDI investors from the U.S. and Canada.

Addressing these public infrastructure and institutional constraints will largely fall to the next administration in Mexico, with a new president to be selected in the July 2024 general elections. We think that the most likely scenario is that whichever candidate wins the next six-year term in 2024 will pursue a more pragmatic policy agenda on the electricity sector and other challenges—with the degree of pragmatism determined by the candidate and the party balance in congress.

Against this backdrop, there should be room for continued performance from Mexico’s industrial real estate sector (which is the clearest “first wave” beneficiary) and other nearshoring sector stories. As noted earlier, FDI has increased meaningfully already in 2023—and progress in resolving some of the challenges listed above could prove to be a real accelerant to nearshoring, creating new potential areas of investment not yet on investors’ radar. But some political help (from Mexico, the United States, and Canada) will be needed to take full advantage of this multi-year opportunity.

Our teams at Lord Abbett continue to monitor the pace and trajectory of the nearshoring trend worldwide, looking to identify potential winners (and losers). Association of Southeast Asian Nations (ASEAN) countries have so far been the largest investment beneficiary of the U.S.-China trade conflict, but the reallocation of supply chains should continue to gain ground in Mexico and extend to other parts of Latin America, including smaller countries like Costa Rica and the Dominican Republic. We currently see attractive opportunities in Mexican sovereign debt, as well as select corporate opportunities in the logistics and industrial properties space. We believe this trend is positioned to support our investments in emerging-markets debt, both in our dedicated vehicles and in other portfolios that may participate in the asset class.
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