

Mexiconvexity: Credit ideas on the IMF Pemex funding

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Recent reports indicate that the Mexican government is targeting funding/refinancing Pemex by a covid funding program allocated by the IMF.¹ AMLO² has explicitly argued for credit rating convergence between the sovereign and its oil company.

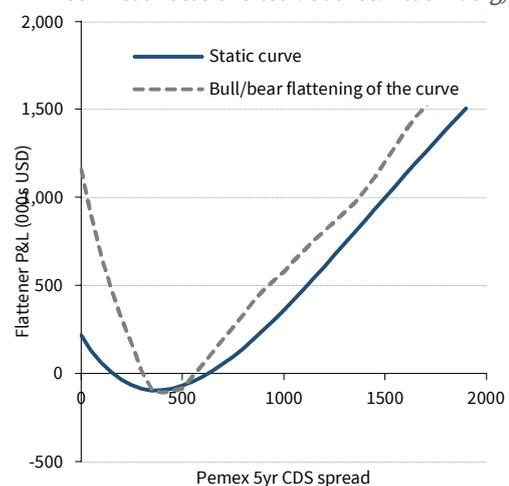
In this context, we note that forward funding rates for the state-owned oil producer currently are very high. The 5x5 forward, i.e. 5yr credit spreads starting in 5yrs time, is hovering around 550-600bp whereas the current 5yr spreads being in the range 350-400bp.³ One can make a fundamental case that with a high debt load (USD115bn) and clear capex needs just to maintain a crumbling fossil infrastructure – or alternatively investing for an energy transition aligned with the Paris targets – such high forward spreads, if they were to be realized, are likely prohibitively expensive for Pemex at a longer horizon.

We see three general outcomes in this situation:

- AMLO is credible: Pemex spreads converge which would drive the curve flatter and put Pemex forward funding rates at a ‘sustainable’ (from a financial perspective) level => **Bull flattening**.
- Status quo: Pemex continues in a limbo of semi-official support from the government, implicit support from the IMF, and dodges any commitments coming out of COP26 => **Trading sideways/curve neutral**.
- AMLO’s statements are not credible, and/or IMF support turns out to be Paris-aligned, thus leaving Pemex with a weaker government support and crystallizing investor concerns about the longevity of the Mexican government’s support for Pemex: This is likely to drive spreads significantly wider and flatten the credit curve => **Bear flattening**.

With these new announcements, there should be elevated probability for the flattening cases to crystallize. DV01-neutral flatteners on Pemex – i.e. buying protection (selling bonds) at the 5yr point and selling protection (buying bonds) at the 10yr point, at a ratio of approximately 1.4x could be attractive here. We illustrate a potential P&L payoff profile in Figure 1.

Figure 1. Pemex USD10mn DV01 neutral flattener hypothetical P&L to 1 Dec 2021. Technical notes overleaf. Source: Bloomberg,

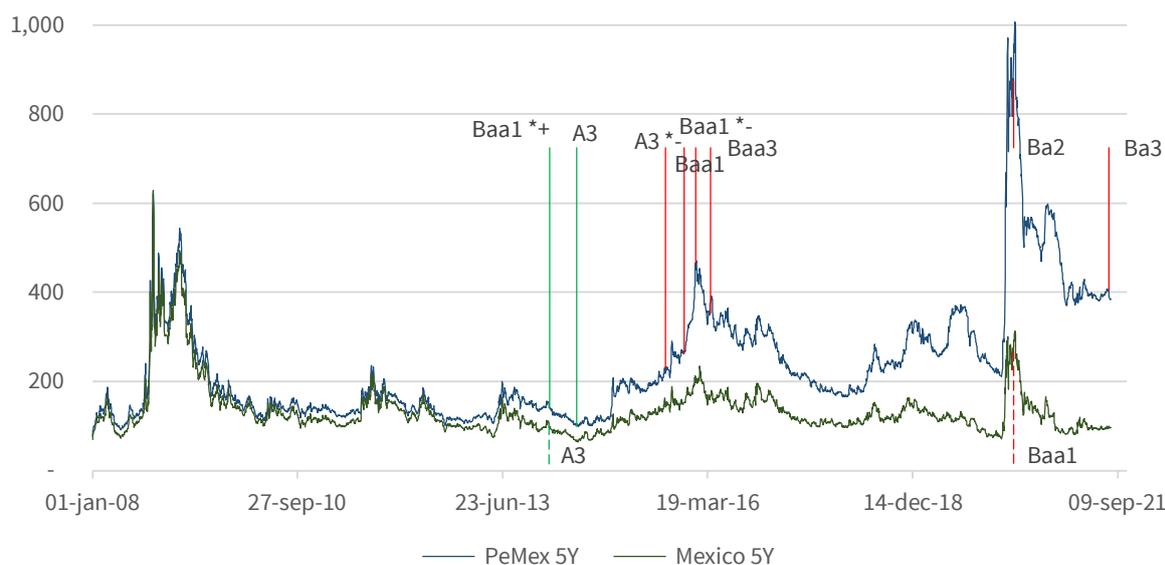


¹ ”[Mexico is Refinancing Pemex Debt After Getting IMF Reserves](#)”, Bloomberg, 6 Sep 2021.

² Andres Manuel Lopez Obrador (AMLO), Mexico’s president.

³ Markets are currently moving around on the back of the IMF news. Levels will need to be refreshed, and trade notional ratios can be used to tilt a trade in a more bullish or bearish way.

Figure 2. Pemex and Mexico sovereign CDS 5yr with ratings changes. Rating changes from Moody's. Source: Bloomberg, Markit, AFII.



Flatteners are long convexity, making them good for “disequilibria” trades where the underlying credit either should go wider or tighter. In the case in Figure 1, this is reflected in the U-shaped format of the P&L profile of the trade. The trough of the U is for the range of spreads close to where it trades today, and P&L increases in the wings.

An attractive flattener will have a small trough versus large wings. The **Bull flattening** scenario would play out to the left of 380bp (current spread) on the x-axis, and the **Bear flattening** to the right of it. If we assume the “Bull/bear flattening of the curve” graph, we can see that the trade would hypothetically be profitable if Pemex trades below 325bp or above 550bp at the 5yr point.

The maximum expected loss if the spreads stay within that range is around USD100k, which should be weighed against the upside if either wing scenario materializes. For example, if Pemex fully converges to Mexico spreads (approx. 90bp on the 5yr), the resultant P&L is expected to be approximately USD700k. The upside will be even larger if the company becomes distressed. Jump-to-default exposure is negative USD4.1mn, which could be useful if Pemex debt were for example to be forcibly restructured.

In terms of ratings, Pemex is currently rated Ba3/BBB/BB- by Moody's/S&P/Fitch. The Mexico sovereign is rated Baa1/BBB/BBB-. Notable here is that S&P effectively already rates Pemex equal to the sovereign.

The carbon footprint implications of the hypothetical DV01 flattener is neutral, further commented below. For avoidance of doubt, we believe the IMF's Covid funding⁴ which will lead to the bailout of Pemex as presented so far is likely one of the bigger fossil subsidization programs of recent years. A Panglossian view would be that there is considerable energy transition conditionality in the IMF Covid program, but we are not party to such information as of yet. In this context, also consider whether AMLO will use the funding for Pemex, e.g. “[Analysts doubt AMLO's plans to use IMF funds for Pemex debt](#)”, LatinFinance, 8 Sep 2021.

⁴ The fundings is in the form of being allowed to repay debt with Special Drawing Rights (SDRs). The amount reported is USD12bn.

Technical notes on the trade

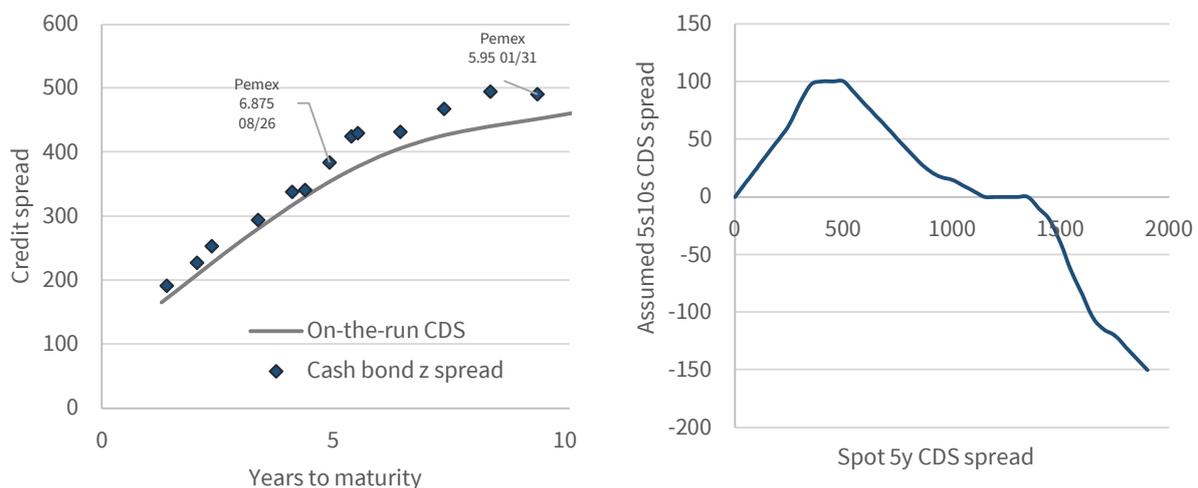
Investors looking at potential trade on the Bloomberg terminal should be aware of the large discrepancy on the pricing of Pemex 10yr CDS depending on pricing source. The default source (CBIN) appears to underestimate the spread, and we would advice to switch to alternative sources such as CMAN, or to use independent and validated third party sources such as Markit.

On the trade, we assume Dec contracts and spreads struck at 100bp. Notionals are USD14.1mn on the 5yr and USD10mn on the 10yr. Contact the authors for assumptions on roll-down that has been applied to P&L scenario analysis. The “Static” P&L case reflects the convexity in the trade holding the 5s10s curve constant at the current rate. The “Bull/bear flattening” case assumes a 5s10s curve that shifts in steepness based on the 5yr spread as illustrated in Figure 3 (right panel). For further details on this, please refer to (external link) [CDS Curve Trading Handbook 2008](#), p. 31-32 and p. 35, or reach out to the AFII team.⁵

Please note the considerable negative time-value of the trade, through negative carry and rolldown. Holding the trade for longer or shorter time than the stipulated 3 months will change the dynamics of P&L. We do not factor in bid-offer spreads in the above analysis.

Note that benchmarked cash investors may apply similar reasoning and logic through altering their exposures vs the benchmark across the curve rather than applying CDS. For example, selling the Pemex 6.875 08/26 (US71654QCB68) versus buying the 5.95 01/31 (US71654QDE98) in duration adjusted notionals. This would, in our view, be considered a carbon-neutral rebalancing (more nominal bonds are sold than bought, but on a duration risk-adjusted basis the trade is by design neutral). The same logic applies to the CDS trade. Please refer to “[Carbon negative leveraged investment strategies](#)”, AFII, 21 Aug 2021, for more detail.

Figure 3. (Left) Pemex cash bond (large cap bonds only) curve and CDS curve. Assumed 5s10s shape based on the 5yr spreads. Source: Bloomberg, AFII.



⁵ Our model is not as smooth as we would have wished – as a new organisation, AFII has not had the capacity to build a fully-scaled, dynamic curve model yet.

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