

Analysts

Khoo Ming Hui Ethan

Global Macro Analyst

khoominghuiethan@u.nus.edu

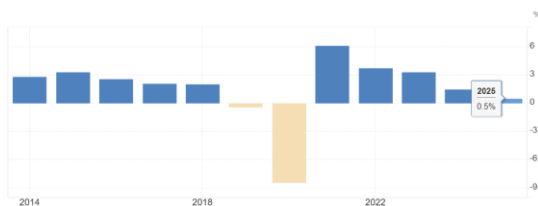
Anastasia Kee

Global Macro Analyst

Anastasia.kee@u.nus.edu

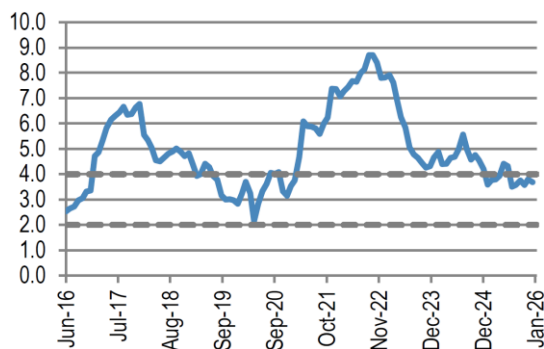
Basic Information

Figure 1: Full Year GDP Growth (%YoY)



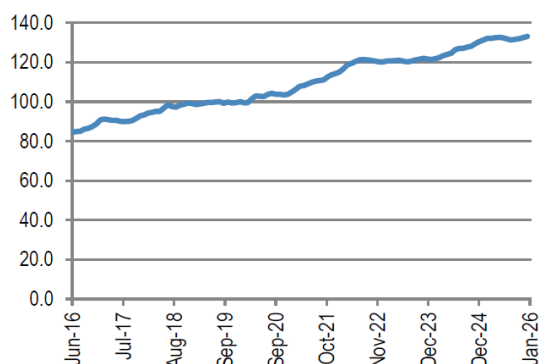
Source: INEGI

Figure 2: Consumer Price Index (%YoY)



Source: J.P. Morgan

Figure 3: Producer Price Index



Source: J.P. Morgan

Overview of Mexico

Mexico is a **federal republic** composed of **32 entities (31 states plus Mexico City)** and stands as the **second-largest economy in Latin America**. Its economic profile is defined by deep integration with the **United States**, particularly through **manufacturing supply chains** and **trade** governed by the **USMCA framework**.

The country's **currency**, the **Mexican peso (MXN)**, operates under a **free-floating exchange rate regime** and is one of the most actively traded **emerging market currencies** worldwide. The **central bank**, **Banco de México (Banxico)**, is tasked with ensuring **price stability**, setting the **policy rate**, and safeguarding **liquidity** and **financial stability**.

On the fiscal side, the **President of Mexico** directs **budget priorities**, **state-led investment** (notably in **energy**), and **social programmes**, while the **Ministry of Finance and Public Credit (SHCP)** executes policy subject to **Congressional approval**.

Recent **economic growth** has been supported by **nearshoring trends**, **resilient US demand**, and **domestic consumption**. However, challenges persist, including **tight financial conditions**, **infrastructure bottlenecks** (especially in **power and water supply**), and ongoing **security-related risks** that raise business costs.

Mexico's economy is primarily **services-led (retail, finance, transport, tourism)**, yet its global relevance stems from **manufacturing exports** such as **autos, electronics, and machinery**, reflecting its deep **North American supply chain integration**. While **oil** remains a contributor to **public finances**, its role has diminished compared to the past.

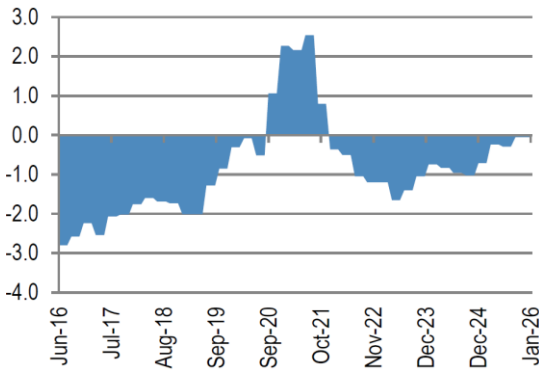
Looking ahead, Mexico's competitiveness will depend on leveraging **nearshoring opportunities** while maintaining **macro discipline**, supported by reliable **logistics**, adequate **electricity capacity**, strong **rule of law**, and consistent **policy predictability**.

Executive Summary

Mexico's economy has been going through a period of **slow growth and cautious recovery**. In 2025, the country's economy grew only **0.5% (Fig.1)**, which is very weak compared to past years. The main reason Mexico avoided a recession was strong performance in **industry (factories, construction, mining)** and **services (like retail, transport, and finance)**. Agriculture, which is a small part of the economy, actually shrank.

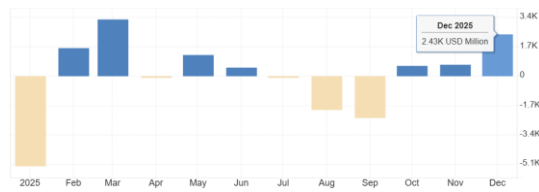
Looking ahead to 2026, growth is expected to improve slightly to about **1.5%**, but this is still modest. The main drivers will be **consumer spending** (households buying more goods and services) and **public investment** (government spending on infrastructure). However, **private investment** (companies putting money into new projects)

Figure 4: Current Account (%GDP, 12 month)



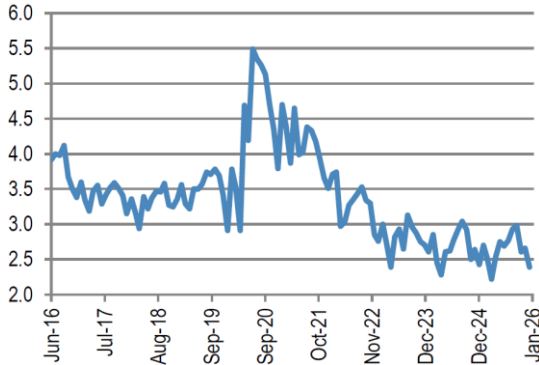
Source: J.P. Morgan

Figure 4: Mexico Trade Balance



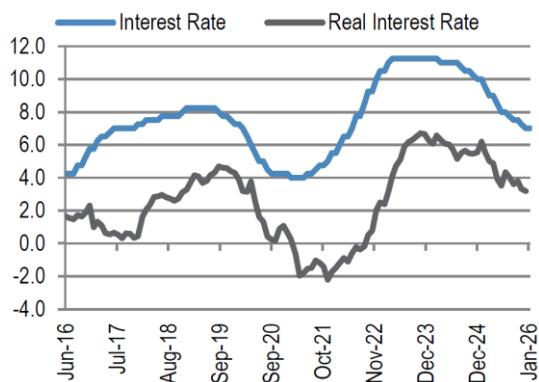
Source: INEGI

Figure 5: Unemployment Rate (%)



Source: J.P. Morgan

Figure 6: Policy Rate (%)



Source: J.P. Morgan

Figure 7: Spot Exchange Rate

remains weak, and much depends on the outcome of trade negotiations with the United States under the **USMCA agreement**.

Inflation (the rise in prices) ended 2025 at **3.7%** (Fig.2), which is close to Mexico’s target. However, new taxes and tariffs introduced in early 2026 are expected to push prices up temporarily. Mexico’s central bank, **Banxico**, has paused interest rate cuts for now, but is expected to start lowering rates again by mid-2026, aiming for a **6.5% policy rate** by the end of the year.

On the **fiscal side** (government finances), Mexico is running a fiscal deficit of about **4.3% of GDP**, and debt levels are around **52.5% of GDP** (Fig.18). The government has raised money through bond sales, including a large \$9 billion issuance in January 2026, and is also experimenting with sustainable debt instruments. While finances are stable for now, rising debt is a concern.

Externally, Mexico recorded a **small trade surplus in 2025 (USD 0.77bn)** (Fig. 4). The **peso currency** has been strong, ending 2025 at **18 pesos per U.S. dollar** (Fig.7), which helps control inflation but makes exports less competitive. Mexico remains the **largest exporter to the U.S.**, which is crucial for its economy.

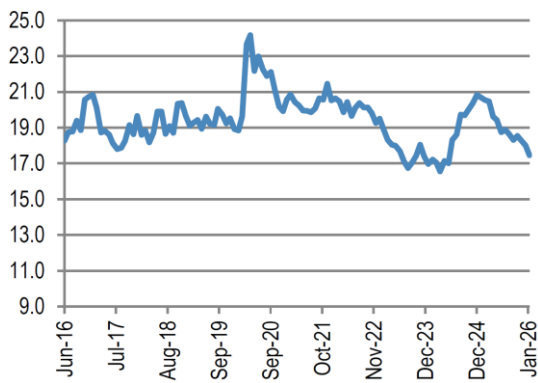
Financial markets have been a bright spot. The main stock index, the **IPC**, rose nearly **30% in 2025** (Fig.23), supported by strong inflows from both local pension funds and foreign investors. Sectors like **financials and materials** performed best.

Politically, President **Claudia Sheinbaum** (Fig.28) ended 2025 with a **69% approval rating**, thanks to popular social programs. However, her administration faces criticism over **security and corruption**. Mexico’s ruling coalition (Morena, PT, PVEM) has reaffirmed its alliance for the 2027 midterm elections. Relations with the U.S. remain tense, especially after President Trump proposed military action against cartels, which Sheinbaum firmly rejected to protect Mexico’s sovereignty. Meanwhile, **USMCA trade talks are 90% complete**, and their outcome will be critical for Mexico’s future.

Macroeconomic Activity and Growth

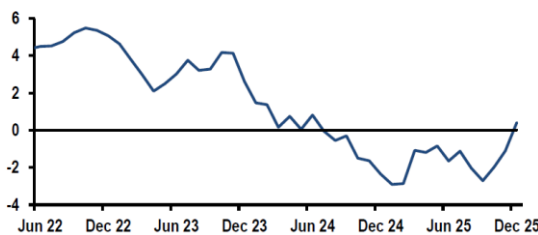
Mexico’s economy in 2025 grew only **0.5 percent**, which is considered very weak. To understand this, it helps to look at the different parts of the economy:

- **Industry (secondary sector):** This includes factories, construction, mining, and utilities. Industry performed relatively well, expanding at an annualized pace of about **3.5 percent** at the end of 2025. Construction was the strongest part, helped by both private building and infrastructure projects. Mining and utilities also recovered from earlier declines. Manufacturing, however, remained weak, with only modest growth and limited investment in machinery and equipment. (Fig.9)
- **Services (tertiary sector):** Services make up the largest share of Mexico’s economy. They grew at a similar pace to industry, about **3.6 percent annualized** in late 2025. This includes retail, transport, finance, and other service activities. Strong services helped offset weakness in agriculture.



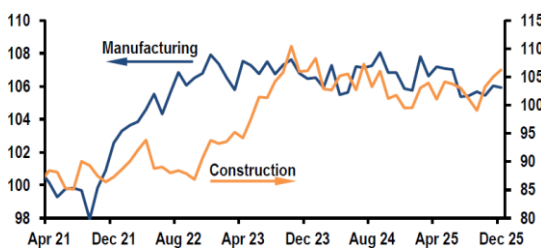
Source: J.P. Morgan

Figure 8: Industrial Production (%YOY)(3mma)



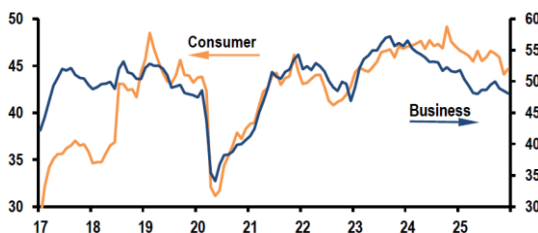
Source: INEGI

Figure 9: Industrial Production : Manufacturing and Construction



Source: INEGI

Figure 10: Consumer & Business Sentiment



Source: INEGI

- **Agriculture (primary sector):** Agriculture is small, contributing less than 4 percent of GDP. It contracted by **2.7 percent** in late 2025, showing volatility that is common in farming due to weather and seasonal factors.

Overall, the economy expanded **0.79 percent quarter-on-quarter in Q4 2025**, which equals about **3.2 percent annualized growth**. This was stronger than expected and gave some optimism for the start of 2026.

Outlook for 2026

- **GDP growth** is expected to reach **1.5 percent**, slightly better than 2025 but still modest.
- **Consumption** (spending by households) is expected to recover after a disappointing 2025.
- **Public investment** (government spending on infrastructure) should improve somewhat.
- **Private investment** is forecast to grow only **1.7 percent**, after contracting by **7 percent** in 2025. This weak recovery reflects low business confidence and uncertainty around trade rules.

External Demand

Exports were crucial in 2025 to prevent a recession. However, in 2026 exports are expected to flatten. The strong peso makes Mexican goods more expensive abroad, and the end of “front-loading” (exporting early to beat tariff deadlines) will reduce momentum. Net exports will no longer offset weak investment.

Sentiment

Consumer and business confidence indices both declined in 2025. Businesses are cautious about new capital spending, and households are still adjusting to slow wage growth. This lack of confidence is a major risk for sustained recovery.

Inflation

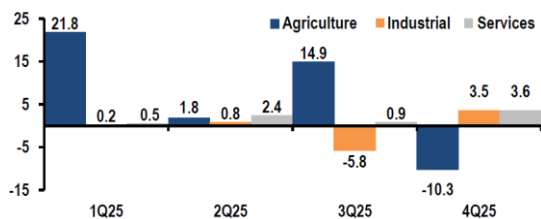
Headline vs. Core Inflation

Inflation measures how quickly prices are rising. Mexico’s central bank, **Banxico**, aims for inflation of **3 percent**, with an acceptable range between **2 and 4 percent**.

- At the end of **2025**, headline inflation was **3.7 percent (Fig.12)**, which is within the acceptable range but still above the ideal 3 percent.
- **Core inflation**, which excludes volatile items like food and energy, was higher at **4.3 percent**. This shows that underlying price pressures remain sticky even though headline inflation looks contained.

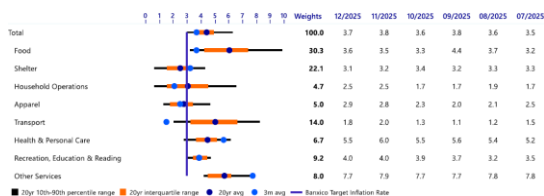
Impact of Excise Taxes and Tariffs

Figure 11: Quarterly Growth - Supply Side (%QoQ)



Source: INEGI

Figure 12: Mexico CPI Inflation Table

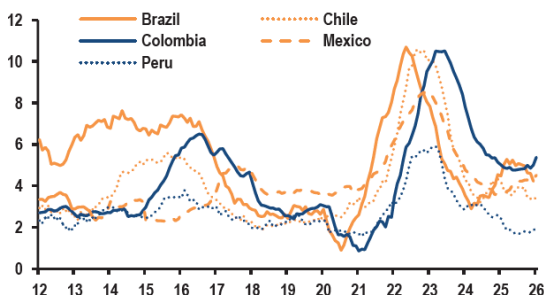


Source: RaboResearch

Figure 13: Banxico's CPI Inflation Projections

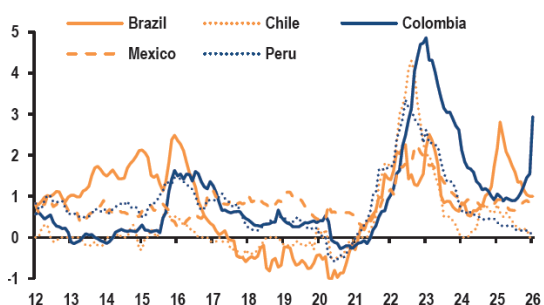
	25Q2	25Q3	25Q4	26Q1	26Q2	26Q3	26Q4	27Q1	27Q2	27Q3	27Q4
Headline CPI											
Dec 18	4.2	3.6	3.7	3.7	3.3	3.0	3.0	3.0	3.0	3.0	3.0
Nov 6	4.2	3.6	3.5	3.5	3.2	3.0	3.0	3.0	3.0	3.0	
Core CPI											
Dec 18	4.1	4.2	4.3	4.0	3.4	3.0	3.0	3.0	3.0	3.0	3.0
Nov 6	4.1	4.2	4.1	3.8	3.3	3.0	3.0	3.0	3.0	3.0	

Figure 14: LATAM Core CPI (%YoY)



Source: Central Banks

Figure 15: Inflation Expectations (% 12m ahead inflation expectations)



Source: Central Banks

In early 2026, new excise taxes and import tariffs are expected to temporarily push prices higher. For example:

- Taxes on certain goods will raise consumer prices directly.
- Tariffs on imports, such as steel and other industrial inputs, will increase costs for businesses, which may then pass those costs on to consumers. Because of these measures, inflation could rise close to **4.9 percent** in the first half of 2026 before easing later in the year.

Non-Core Surprises

Non-core inflation refers to items that are more volatile, such as food and energy. These categories often move sharply due to weather, global commodity prices, or seasonal factors. (Fig. 12)

- In 2025, agriculture prices were volatile, contributing to swings in overall inflation.
- Energy prices also fluctuated, but the strong peso helped limit the impact by making imported fuel cheaper.

Forecast Trajectory for 2026–2027

Banxico expects inflation to gradually decline after the temporary spike in early 2026.

- By the end of **2026**, inflation should move closer to **3.0 percent**.
- By **2027**, inflation is projected to converge maintain close to the **3 percent target**, assuming no major external shocks.

Monetary Policy

Banxico's "Wait-and-See" Stance

In 2025, Banxico began cutting interest rates after inflation started to come down. However, at the start of 2026, it decided to **pause** further cuts. This cautious approach is often described as a "wait-and-see" stance. The bank wants to make sure that new taxes and tariffs do not push inflation too high before continuing with rate reductions.

Expected Rate Path

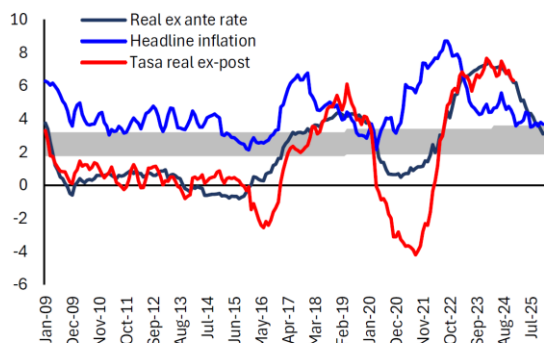
- Banxico is expected to **resume cutting rates by May or June 2026**.
- The policy rate is projected to reach about **6.5 percent by the end of 2026**, down from levels above 11 percent in previous years.
- If inflation remains contained, cuts could even come sooner.

This gradual easing is meant to support economic growth while keeping inflation expectations anchored.

Comparison with Regional Peers

Mexico's monetary policy is part of a broader Latin American trend, but each country faces different conditions:

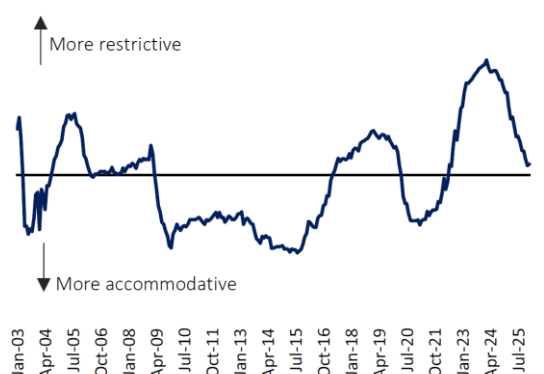
Figure 16: Monetary Policy Stance & Inflation (%)



Notes: Gray shadow indicates Banxico's estimated range for the neutral rate.
Source: Finamex Economic Research with data from Banco de México.

Source: Banxico

Figure 17: Monetary Policy Stance



Notes: The monetary policy stance is calculated as the difference between the real ex-ante rate and the middle point of the r^* range estimated by Banco de México

Source: Banxico

Figure 18: Mexico Debt as a % of GDP



Source: Bloomberg

- **Brazil** has already been easing rates more aggressively, as inflation pressures there have fallen faster.
- **Colombia**, on the other hand, has been more cautious and is still tightening in some areas due to persistent inflation risks.

Mexico sits between these two approaches. Banxico is not rushing to cut rates, but it is preparing to ease once it is confident inflation will stay within its target range.

Fiscal Policy and Public Finances

Deficit and Debt Levels

Mexico's government is currently spending more than it collects in taxes. This gap is called the **Public Sector Borrowing Requirement (PSBR)**. In 2026, the PSBR is expected to be about **4.4 percent of GDP**. GDP is the size of the economy, so this means the deficit is equal to 4.4 percent of total output.

Mexico's **public debt** is around **45.10 percent of GDP (Fig.18)**. This means the government owes an amount equal to just over half of the country's annual economic production. While this is not extremely high compared to some countries, it is rising, which creates concern about long-term sustainability.

Spending Composition

Government spending (Fig.19) has focused heavily on **social programs**, which remain popular with the public and help explain President Sheinbaum's high approval ratings. However, critics argue that Mexico needs to spend more on **capital investment**, such as infrastructure projects, to boost productivity and long-term growth. Public investment is expected to recover modestly in 2026, but private investment remains weak.

Bond Issuance

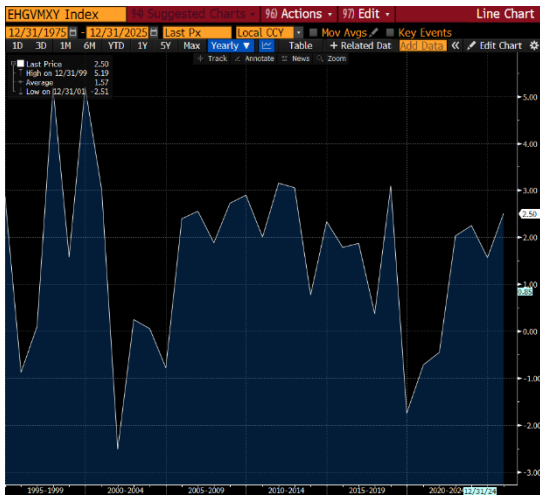
To finance its deficit and refinance debt, Mexico raises money by selling bonds.

- In **January 2026**, the government issued **9 billion dollars of bonds** in international markets, with maturities of 8, 12, and 30 years. Demand was strong, showing investor confidence in Mexico's finances.
- Mexico also issued **4.75 billion euros of sustainable bonds**, linked to the United Nations' Sustainable Development Goals. These instruments attract investors who want to support environmentally and socially responsible projects.

Risks from Weaker Revenues and Rising Debt

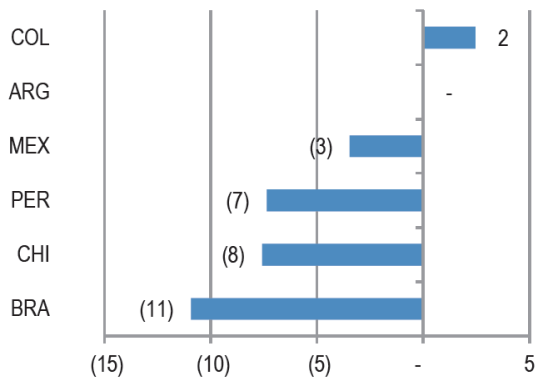
- If economic growth remains weak, tax revenues may fall, making it harder to reduce the deficit.
- Rising debt levels could limit Mexico's ability to respond to future shocks or emergencies.
- Heavy reliance on social spending without enough investment in growth could make fiscal consolidation more difficult.

Figure 19: Mexico Government Spending (%YoY)



Source: Bloomberg

Figure 20: LATAM Credit Default Swaps (bps change)



Source: J.P. Morgan

Figure 20: Trade Balance (%YoY)

Category	Dec-25	Dec-24	2025	2024
Total Exports	17.2	5.0	7.6	4.2
Oil	-32.9	-12.9	-26.4	-13.0
Crude oil	-54.3	-18.4	-33.3	-19.4
Others	58.0	21.8	-3.2	18.3
Non-oil	19.5	6.0	9.3	5.2
Agricultural	-12.7	12.2	-10.8	7.8
Mining	36.4	57.1	26.9	18.6
Manufacturing	20.6	4.9	9.8	4.8
Vehicle & auto-parts	0.8	-7.7	-4.2	2.6
Others	30.1	12.2	17.3	6.1

External Sector and Trade

Trade Balance

Mexico recorded a **small trade surplus in 2025**, about **770.9 million U.S. dollars**. A trade surplus means the country exported more goods and services than it imported. This surplus was achieved even though oil exports were weak, because non-oil exports (such as manufactured goods) remained strong.

Export and Import Dynamics

- **Exports:** Manufacturing exports, especially to the United States, are Mexico's backbone. However, performance was uneven in 2025. Some sectors benefited from strong U.S. demand, while others faced volatility. Oil exports declined due to lower production and weaker global prices.
- **Imports:** Imports grew modestly, with volatility in industrial inputs. Tariffs on certain goods, such as steel from China and other Asian countries, increased costs for importers.

USMCA Renegotiation Progress

Mexico, the United States, and Canada are renegotiating parts of the **USMCA trade agreement**, which governs trade rules among the three countries. By the end of 2025, about **90 percent of the renegotiation process was complete**. The outcome is critical because the U.S. is Mexico's largest trading partner, and any changes could affect exports, investment, and competitiveness.

Tariff Measures

Mexico introduced new tariffs in 2025 and early 2026 to protect domestic industries. For example:

- Tariffs on **Chinese steel** and other Asian imports were meant to support local producers.
- These measures raise import costs, which can increase inflation, but they also aim to strengthen Mexico's industrial base.

Peso Resilience

The **Mexican peso** ended 2025 at **18 pesos per U.S. dollar**, stronger than many analysts expected. A strong peso helps keep inflation low because imports become cheaper. However, it also makes Mexican exports more expensive abroad, reducing competitiveness.

- Forecasts suggest the peso will weaken gradually, to about **18.50 per dollar by the end of 2026** and **18.90 by the end of 2027**.
- This adjustment would help restore competitiveness while keeping financial stability intact.

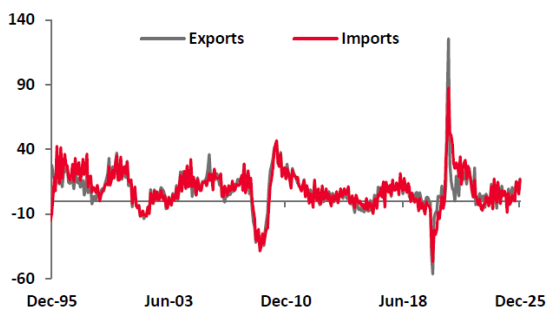
Financial Markets

Equity Performance

Total Imports	16.7	7.6	4.4	5.1
Consumption goods	25.3	-3.9	-1.3	7.3
Oil	-6.1	-7.1	-17.7	-15.9
Non-oil	32.5	-3.1	2.5	14.5
Intermediate goods	17.3	10.8	7.2	4.5
Oil	2.3	-2.5	-0.1	-13.6
Non-oil	18.4	11.9	7.8	6.1
Capital goods	-0.6	4.0	-8.7	6.4

Source: INEGI

Figure 21: Exports & Imports (%YoY)



Source: INEGI

Figure 22: Trade Balance (US\$ Billion, 12 Month Rolling Sum)

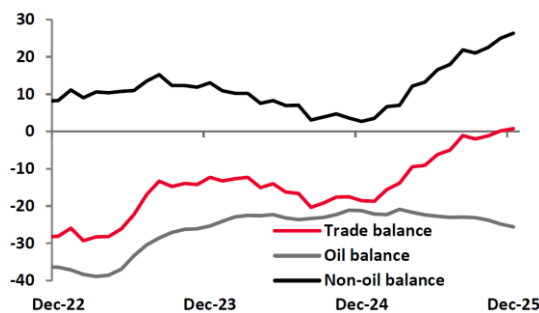


Figure 23: MEXBOL Index



Mexico's stock market was one of the strongest performers in 2025.

- The main index, the **IPC**, rose nearly **30 percent** during the year, reaching record highs. (Fig.23)
- In January 2026, the **MSCI Mexico index** gained **9.5 percent** (Fig.24), showing continued momentum. This strong performance reflects investor confidence in Mexico's financial stability and attractive valuations compared to other emerging markets. (Fig. 25)

Sector Winners and Laggards

Not all sectors performed equally.

- **Financials** and **materials** were the biggest winners, benefiting from strong demand and solid earnings.
- **Consumer discretionary** companies, which depend on household spending, lagged behind due to weak consumption in 2025. This sectoral split highlights the uneven nature of Mexico's recovery.

Capital Flows

Mexico attracted significant investment flows in 2025.

- **Foreign investors** increased their holdings of Mexican equities and bonds, drawn by high real interest rates and a resilient currency.
- Domestic **pension funds (Afores)** expanded their assets to about **24 percent of GDP**, providing a stable source of demand for local markets. These inflows helped support both the equity market and the peso.

FX Reserves

Mexico's **foreign exchange reserves** grew by about **10 percent year-on-year**, reaching **251.8 billion U.S. dollars** at the end of 2025. Reserves are important because they act as a financial buffer, allowing Mexico to defend its currency and reassure investors during periods of volatility.

Industrial and Sectoral Outlook

Industrial Production Trends

Mexico's industrial sector showed mixed results in 2025.

- **Construction** was the strongest performer, recovering thanks to both private building projects and government infrastructure spending.
- **Manufacturing** remained weak, reflecting fragile investment and uncertainty around trade rules.
- **Mining and utilities** improved after earlier declines, but their contribution to overall growth was limited.

This uneven performance highlights the challenges Mexico faces in sustaining industrial momentum.

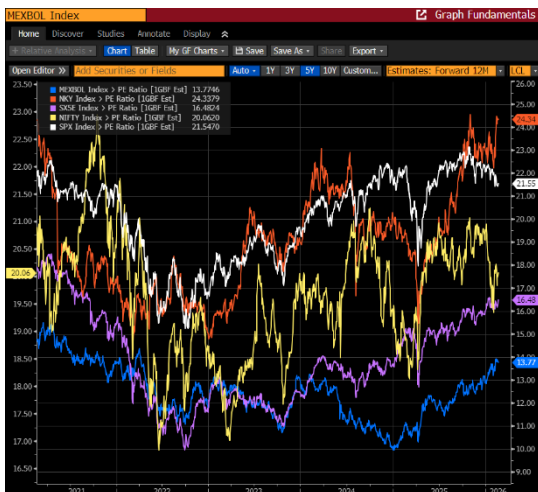
Source: Bloomberg

Figure 24: MSCI Mexico Index



Source: Bloomberg

Figure 25: MEXBOL vs World Indices (P/E) (Blue)



Source: Bloomberg

Figure 25: Mexico Construction Index



Source: Bloomberg

Autos and Vehicle Production Cycles

The auto industry is one of Mexico's most important sectors, closely tied to U.S. demand.

- Vehicle production cycles were volatile in 2025, with periods of strong output followed by slowdowns.
- The sector remains vulnerable to external shocks, such as changes in U.S. consumer demand or new trade rules under the USMCA renegotiation.

Autos will continue to be a key driver of Mexico's industrial exports, but competitiveness depends on stable trade conditions.

Energy Projects

Mexico is investing in new energy projects to boost production capacity.

- The **Trion oil well** and the **Zama field** are major developments expected to support future output.
- These projects are important because oil production has been declining, and new fields can help stabilize Mexico's energy sector.

Energy investment also ties into fiscal stability, since oil revenues remain an important source of government income.

Corporate Developments

Several corporate stories shaped Mexico's industrial outlook in 2025:

- **Viva Aerobus**, a low-cost airline, secured new financing to expand operations, reflecting resilience in the aviation sector.
- **Grupo Herdez**, a major food company, divested some assets, showing how firms are restructuring to adapt to changing market conditions.

These examples illustrate how companies are adjusting strategies in response to both domestic and global pressures.

Political Landscape

President Sheinbaum's Approval

Claudia Sheinbaum became Mexico's first female president in October 2024. She won the June 2024 election with about **59 percent of the vote**, giving her a strong mandate. Since taking office, her approval ratings have remained high, often near or above **70 percent**, and she closed 2025 with around **69 percent approval**. This popularity is supported by her government's focus on social programs and continuity with the policies of her predecessor, Andrés Manuel López Obrador.

Coalition Dynamics

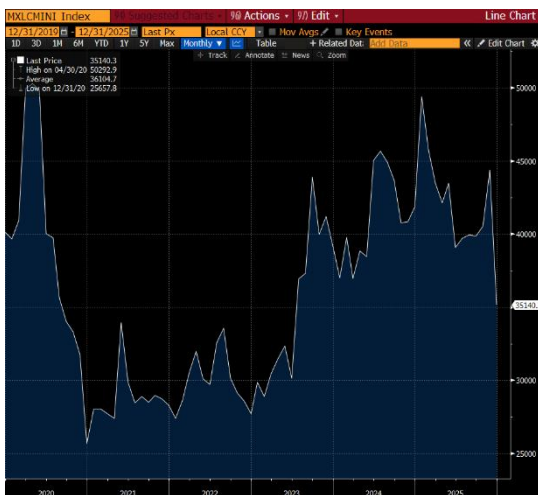
Sheinbaum leads the **Morena party**, which is the dominant political force in Mexico. Morena, together with its allies **PT** and **PVEM**, controls large majorities in Congress. In the Chamber of Deputies, the coalition

Figure 26: Mexico Manufacturing Index



Source: Bloomberg

Figure 27: Mexico Mining Index



Source: Bloomberg

Figure 28: President Claudia Sheinbaum



Source: Google Images

holds two-thirds of the seats, which allows it to pass constitutional reforms. In the Senate, it fell just short of a supermajority but still commands significant influence. This coalition has reaffirmed its alliance for the **2027 midterm elections**, signaling political stability in the near term.

U.S.–Mexico Relations

Relations with the United States remain complex. While trade ties are strong, political tensions have surfaced. In late 2025, U.S. President Donald Trump suggested military action against Mexican cartels. President Sheinbaum firmly rejected this idea, emphasizing Mexico’s sovereignty and independence in security matters. At the same time, negotiations to update the **USMCA trade agreement** have reached about **90 percent completion**, showing progress on the economic front despite political frictions.

Policy Uncertainty and Reform Agenda

Sheinbaum’s administration has proposed ambitious reforms, including changes to the judiciary and regulatory agencies. Supporters see these as part of the “Fourth Transformation” - a political movement aimed at reshaping Mexico’s institutions and redistributing wealth. Critics, however, worry that such reforms could weaken checks and balances. This debate adds uncertainty to Mexico’s policy environment, especially for investors and businesses.

Key Takeaway

Mexico’s political landscape is stable in the short term, with President Sheinbaum enjoying strong approval and her coalition holding majorities in Congress. However, tensions with the U.S. and debates over constitutional reforms create uncertainty. The outcome of USMCA negotiations and the government’s ability to balance reform with stability will be critical for Mexico’s future.

Risks and Opportunities

Structural Challenges

Mexico faces several long-term weaknesses that limit growth:

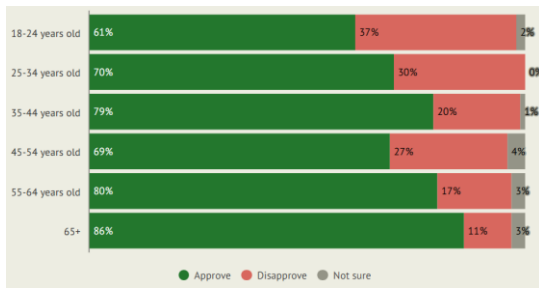
- **Low productivity:** Workers and businesses produce less output compared to peers in other emerging markets. This makes it harder to raise incomes and compete globally.
- **Weak private investment:** Companies have been reluctant to invest in new projects, partly due to policy uncertainty and trade negotiations. Without stronger private investment, Mexico’s growth will remain fragile.

External Risks

Mexico’s economy is highly dependent on external factors, especially the United States.

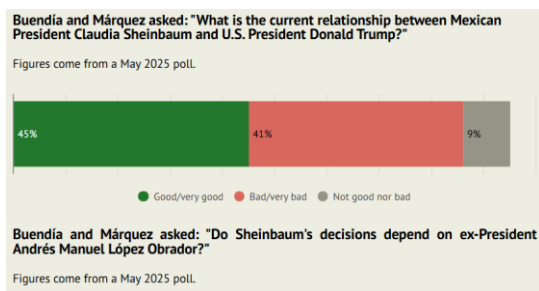
- **U.S. demand:** The U.S. is Mexico’s largest trading partner. Any slowdown in U.S. growth would directly hurt Mexican exports.
- **Trade tensions:** Ongoing renegotiation of the USMCA agreement creates uncertainty. Tariffs on imports, such as

Figure 29: (Poll) Sheinbaum's Approval by Age Group



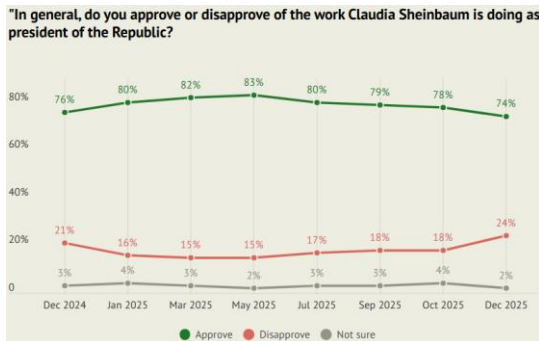
Source: AS/COA

Figure 30: (Poll) Sheinbaum's Relationship with Donald Trump



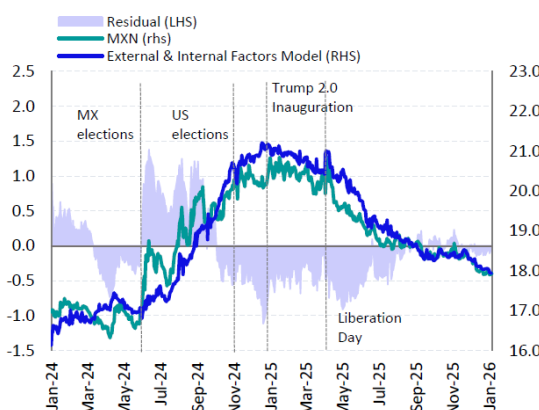
Source: AS/COA

Figure 31: (Poll) Sheinbaum's Public Approval Rate



Source: AS/COA

Figure 32: MXN Financial Factors Model (Pesos per Dollar)



Source: Finamex

steel and industrial goods, could raise costs and reduce competitiveness.

- **Strong peso:** While a strong currency helps control inflation, it makes Mexican exports more expensive abroad, reducing competitiveness in global markets.

Upside Potential

Despite these risks, Mexico has opportunities that could support growth in the coming years:

- **World Cup effect:** Mexico will co-host the 2026 FIFA World Cup. This event is expected to boost tourism, consumer spending, and infrastructure investment.
- **New investment projects:** Energy developments like the Trion oil well and Zama field, as well as corporate expansions, could strengthen industrial output.
- **Equity inflows:** Mexico's financial markets have attracted strong foreign and domestic investment. Continued inflows could support stability and growth.

Key Takeaway

Mexico's outlook is shaped by a balance of risks and opportunities. Structural weaknesses and external pressures weigh on growth, but major events like the World Cup, new energy projects, and resilient financial markets provide potential upside. The challenge will be to turn these opportunities into sustained improvements in productivity and investment.

Trade Idea : Long USD/MXN

Narrative

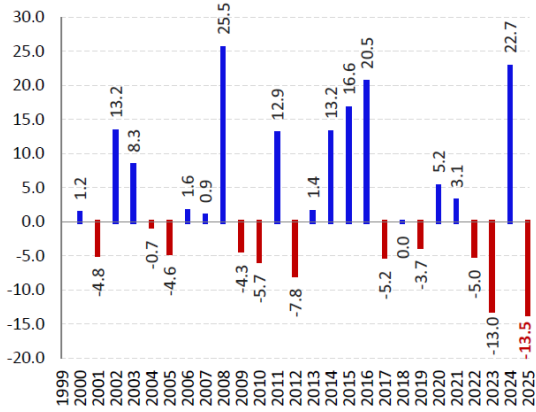
Mexico's **macro backdrop** is **slowing but not collapsing**, and that distinction matters for **FX**. **Growth** in 2025 was weak (**+0.5% YoY**), with momentum increasingly reliant on **external demand** and **nearshoring inflows** rather than **domestic credit expansion**. **Inflation** has moderated to **3.7%** but remains above **Banxico's comfort zone**, while **core inflation (4.3%)** shows sticky pressures.

Banxico's credibility is strong, but that limits its **flexibility**. As inflation cools, pressure will build for **gradual easing**, especially if growth softens further. However, Banxico cannot ease aggressively without risking **peso depreciation** and **imported inflation**. Policy normalization is therefore likely to be **cautious and asymmetrical**.

In contrast, the **Federal Reserve** remains structurally **hawkish**. Even if **rate cuts** materialize later in 2026, **U.S. policy rates** are expected to stay **restrictive** relative to Mexico for longer, particularly if **U.S. growth** continues to outperform. This widens the **policy divergence** narrative back in favor of the **dollar**, especially as **global risk sentiment** becomes less forgiving.

The **peso (MXN)** has been one of the strongest **EM currencies**, supported by **carry**, **nearshoring optimism**, and **capital inflows**. Yet this strength leaves it vulnerable to reversal if:

Figure 33: USDMXN Annual Change (%)



Source: Finamex

Figure 34: Trade Idea (Long USDMXN)



Source: Bloomberg

Figure 35: Trade Idea (Long USDMXN)



Source: Bloomberg

- Fed “higher for longer” rhetoric persists
- Risk-off episodes hit global markets
- Mexican growth disappoints or Banxico eases earlier than expected

We therefore favor **USD strength against MXN**, with risks skewed toward **peso underperformance** from current levels.

Catalysts

- Banxico signaling a **dovish pivot** earlier than markets expect as **growth slows** or **inflation converges faster**.
- U.S. data resilience reinforcing the **Fed’s higher-for-longer stance** and supporting **U.S. yields**.
- Risk-off global sentiment, which historically leads to **MXN underperformance** due to its **high-beta profile**.
- Nearshoring optimism fading at the margin if **infrastructure, energy, or policy uncertainty** delays project execution.

Technical

USD/MXN has traded in a **broad consolidation range** after an extended **downtrend** driven by **carry inflows**. Recent **price action** suggests waning downside momentum, with the pair forming a **base near multi-month lows**.

Momentum indicators (Fig. 35) point to **asymmetric upside risk**:

- RSI has moved out of **oversold territory**
- Price action is stabilizing above recent **support**
- **Bollinger Bands** are compressing, often preceding a **volatility breakout**

For a **2–3 month horizon**, we view recent **lows as support** and prior **consolidation highs as resistance**.

Trade Structure (Fig. 34)

- **Entry:** 17.2
- **Take Profit:** 17.90
- **Stop Loss:** 16.55
- **Risk-Reward Ratio:** 2.0

Overview of Brazil

Brazil comprises of **26 states** and is the **largest economy in Latin America**. Unlike Mexico, whose growth model is tightly integrated with the United States manufacturing cycle, Brazil's economy is more **domestically oriented** and **heavily influenced by global commodity dynamics**. Its size and diversification give it structural importance within emerging markets, but its growth profile is more **cyclical** and **commodity-sensitive**.

The **Brazilian real (BRL)** operates as a **free-floating exchange rate** and is among the **more liquid** emerging market currencies. However, it tends to exhibit **higher volatility** because it reflects shifts in commodity prices, global risk appetite, and domestic fiscal credibility. Monetary policy is conducted by the independent **Banco Central do Brasil (BCB)**, which follows an **inflation-targeting framework** and sets the Selic policy rate to anchor expectations. Brazil has historically maintained **high real interest** rates relative to peers, which strengthens its inflation-fighting credibility but also constrains credit growth and investment.

On the fiscal side, policy direction is shaped by **President Luiz Inácio Lula da Silva** and executed through the Ministry of Finance within the parameters approved by Congress. Brazil recently introduced a new fiscal framework aimed at **stabilizing public debt dynamics** after years of elevated deficits. Nevertheless, **debt levels remain high for an emerging market**, hovering around the mid-to-high 70% range as a share of GDP. Fiscal credibility remains one of the most important macro variables for investors, as slippage in primary balance targets can quickly translate into currency depreciation and higher risk premia.

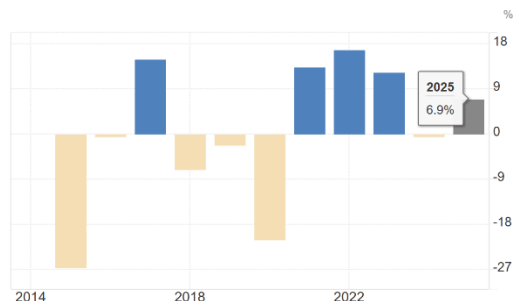
Brazil's economic structure is predominantly **services-led**, with retail, financial services, public administration, and telecommunications forming the core of domestic activity. However, the country's global macro relevance stems from its role as a **commodity powerhouse**. It is one of the **world's largest exporters of soybeans, iron ore, beef, and crude oil**. Companies such as Vale in mining and Petrobras in offshore energy production illustrate how closely Brazil's external accounts are tied to global demand.

Recent growth has been supported by **strong agricultural output**, **resilient labor market** conditions, and a gradual **easing cycle** following an aggressive tightening phase. **Disinflation** has allowed the central bank to lower rates from restrictive levels, offering some cyclical relief to credit-sensitive sectors. However, Brazil's long-term growth potential remains **modest**, generally estimated around 2% annually.

Executive Summary

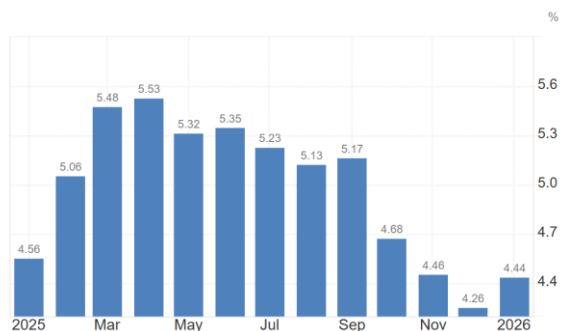
Brazil's economy has demonstrated **greater resilience** than most large emerging markets over the past year, supported by **strong agricultural output, commodity exports, and easing monetary conditions**. In 2025, Brazil's GDP **expanded by 6.9%** (Fig.1), outperforming earlier expectations as a record soybean harvest and firm labor markets boosted activity which contributed to solid household consumption and services-sector momentum.

Figure 1: Full Year GDP Growth (%YoY)



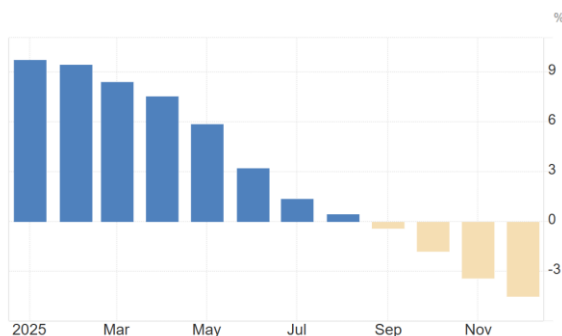
Source: World Bank

Figure 2: Consumer Price Index (%)



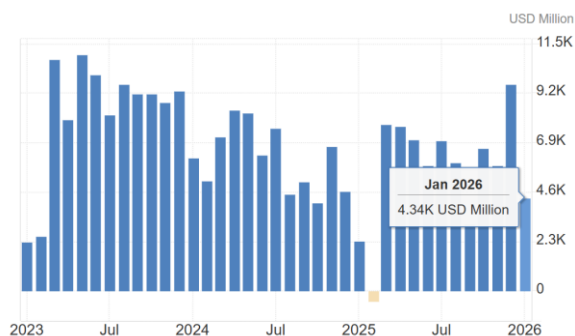
Source: Instituto Brasileiro de Geografia e Estatística (IBGE)

Figure 3: Producer Price Index (%)



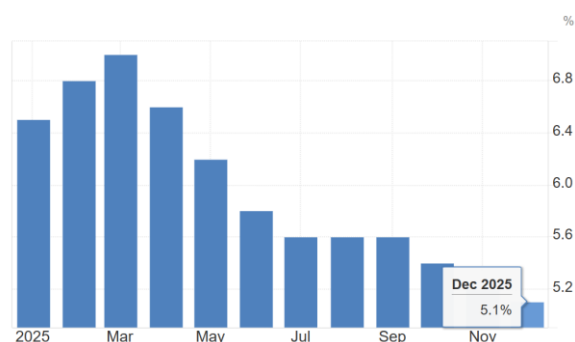
Source: IBGE

Figure 4: Balance of Trade



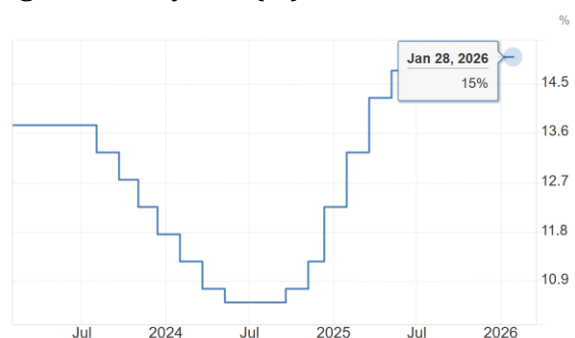
Source: Ministério do Desenvolvimento, Indústria e Comércio Exterior

Figure 5: Unemployment Rate (%)



Source: IBGE

Figure 6: Policy Rate (%)



Source: BCB

Looking ahead to 2026, consensus forecasts from the BCB Focus Survey point to **growth** of roughly **1.8–2.0%**, reflecting a **normalization** from post-harvest strength and **softer global demand**. The main growth drivers are expected to be private consumption supported by **real wage gains** and **public investment** tied to infrastructure and energy transition projects. However, private fixed investment remains cautious, as **corporate sentiment** continues to be **influenced** by **fiscal uncertainty** and global financial conditions.

Inflation has **moderated** significantly from its post-pandemic highs. Brazil's IPCA inflation rate ended November 2025 at approximately **4.26% year-on-year (Fig.2)**, within the tolerance band of the central bank's **1.5%-4.5%** target. With inflation expectations **stabilizing**, the central bank continued its **easing cycle through 2025** after previously maintaining the Selic rate at restrictive levels, leading to an inflation rate of **4.44%** in December 2025. Markets expect **further gradual rate cuts** in 2026, though it will depend heavily on fiscal credibility and currency stability.

On the fiscal front, Brazil continues to operate under its new fiscal framework aimed at **stabilizing public debt**. The primary balance remains in **deficit**, and gross government debt stands near **75–80% of GDP (Fig.8)**. While debt dynamics are **manageable** given Brazil's deep domestic capital market and predominantly local-currency financing structure, markets remain **sensitive** to slippage in revenue assumptions or spending controls.

Externally, Brazil maintains a relatively **balanced** position. The **current account deficit narrowed** in 2024 to around **1.5% of GDP (Fig.9)**, supported by **strong agricultural and oil exports**, particularly to China. However, the deficit has widened to **3.0% of GDP** in December 2025. Moreover, the BRL has remained **volatile** relative to peers, fluctuating in response to commodity prices, US interest rate expectations, and domestic fiscal headlines.

Financial markets have delivered mixed performance. The benchmark Bovespa index posted **moderate gains** in 2025, supported by financials and energy names, though **returns lagged** some regional peers amid fiscal debates and currency volatility. High real yields continue to **attract foreign fixed-income flows**, reinforcing Brazil's reputation as a high-carry emerging market.

Politically, President Luiz Inácio Lula da Silva remains focused on social spending, tax reform implementation, and industrial policy initiatives aimed at reindustrialization and green energy. However, tensions between **fiscal expansion priorities** and **debt sustainability** objectives remain a central macro theme. Congressional negotiations over revenue measures and spending caps will be critical in shaping investor confidence heading into 2026.

In summary, Brazil enters 2026 with **moderate growth, contained inflation**, and a **supportive monetary backdrop**. However, fiscal execution, commodity price trends, and global financial conditions will remain the primary determinants of macro stability and asset performance.

Macroeconomic Activity and Growth

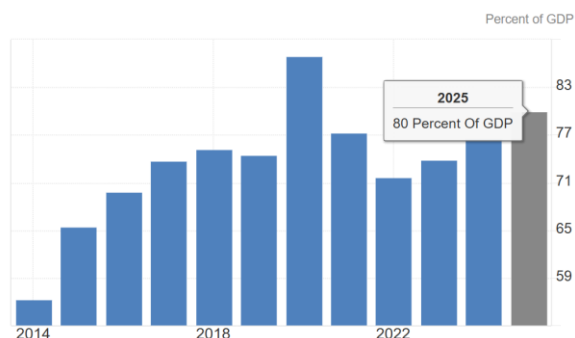
The World Bank **lowered** its forecast for Brazil's economic growth in 2026 from 2.2% to **2%**, versus BCB's more optimistic forecast of 2.3%

Figure 7: Spot Exchange Rate



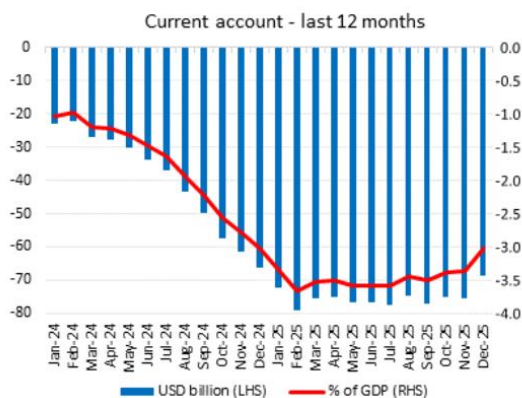
Source: Trading Economics

Figure 8: Government Debt to GDP (%)



Source: BCB

Figure 9: Current Account



Source: BCB

and its MOF forecast of 2.4%. This is a lower growth rate compared to the regional (LATAM) forecast of 2.39%. The downgrade represents the **impact of high real interest rates, headwinds** in global trade and increased **international uncertainty**, tighter monetary and financial conditions, rising **household indebtedness**, well as growing **capacity constraints** on the economy. However, some factors contributing to GDP growth also include election-driven federal fiscal transfers to low-income households and resilient consumer sentiment as household disposable income growth remains strong.

Brazil's Industry sector, which includes manufacturing, construction, mining, and utilities, delivered a mixed performance. **Mining and energy production** remained firm, supported by strong output from iron ore and offshore oil fields, particularly through companies such as Vale and Petrobras. Construction activity showed gradual improvement, helped by public infrastructure programs and lower interest rates during the easing cycle. However, **manufacturing activity** remained relatively subdued, reflecting weak capital expenditure, elevated borrowing costs, and softer global demand.

The Services sector which accounts for roughly 70% of Brazil's GDP, remained the backbone of economic activity. Retail trade, financial services, transportation, and business services continued to expand, supported by a **relatively strong labor market** and **real wage gains**. The services sector played a crucial role in cushioning the slowdown in industrial investment and maintaining overall economic growth stability.

The Agriculture and Commodities Sector was the standout performer in 2024, as Brazil benefited from a **record soybean harvest and strong corn output**. Agriculture is highly volatile due to weather patterns, but in strong years it provides significant upside to GDP. In 2025, output **normalized** from exceptionally high levels, contributing less incremental growth compared to the previous year. Nevertheless, Brazil remains one of the **world's largest exporters of soybeans, beef, sugar, and coffee**, reinforcing its importance in global food supply chains.

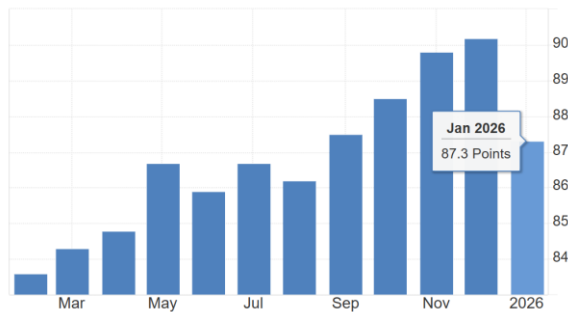
On a quarterly basis, Brazil's economy showed modest sequential growth through late 2025, reflecting stabilization rather than acceleration. While not experiencing recessionary conditions, growth returned closer to its estimated **trend rate of around 2%**, highlighting the country's structural productivity constraints.

Looking ahead to 2026, household consumption is expected to remain the **primary growth driver**, supported by easing inflation, improving credit conditions, and continued formal job creation.

Public investment should also provide **incremental support**, particularly in infrastructure, logistics, and energy transition projects aligned with the government's development agenda.

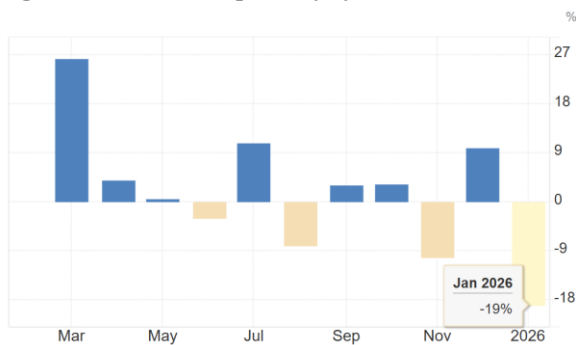
However, private investment is expected to **recover only gradually**. Corporate capital expenditure remains **constrained** by fiscal uncertainty, elevated real interest rates relative to peers, and lingering concerns about global demand conditions. Business sentiment surveys indicate cautious expansion plans rather than aggressive capacity building.

Figure 10: Brazil Consumer Confidence (%)



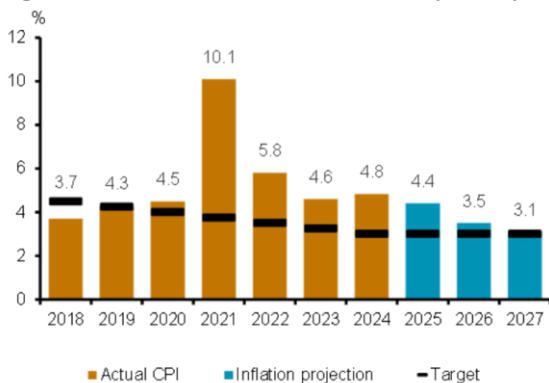
Source: Fundação Getúlio Vargas (FGV)

Figure 11: Brazil Exports (%)



Source: Ministério do Desenvolvimento, Indústria e Comércio Exterior

Figure 12: Brazil Inflation Forecast (YoY%)



Source: IBGE & BCB

As for Brazil’s external demand, its external sector remains **closely tied to global commodity cycles**, particularly demand from **China**.

In 2026, export growth is expected to moderate as agricultural output normalizes and global growth slows. The BRL remains sensitive to commodity prices and US monetary policy. A stronger currency helps anchor inflation but may reduce competitiveness for manufactured exports. Unlike Mexico, Brazil’s trade profile is less dependent on manufacturing supply chains and more exposed to global commodity pricing dynamics.

Additionally, consumer confidence **improved moderately** as inflation eased from post-pandemic highs but remains **below long-term averages** due to concerns over fiscal sustainability and employment stability.

Business confidence has been more **volatile**, particularly in response to **fiscal policy debates** and **tax reform implementation**. Companies remain cautious regarding large-scale capital deployment, reflecting uncertainty over debt dynamics and global financial conditions.

Looking at rates, Brazil operates under an **Inflation Targeting Framework**, with the central bank aiming for **3% inflation**, within a tolerance **band of ±1.5%**, allowing the inflation rate to fluctuate naturally between 1.5%-4.5%.

In December 2025, **Headline inflation (IPCA)** stood at approximately **4.44% year-on-year**, placing it within the target band but still above the 3% midpoint. Inflation declined meaningfully from prior peaks, allowing the central bank to begin easing monetary policy.

Core inflation, which excludes volatile items such as food and energy, remained somewhat stickier, reflecting **persistent services inflation and wage pressures**. This stickiness has required the central bank to maintain a cautious easing stance despite headline improvements.

Impact of Fiscal and External Factors

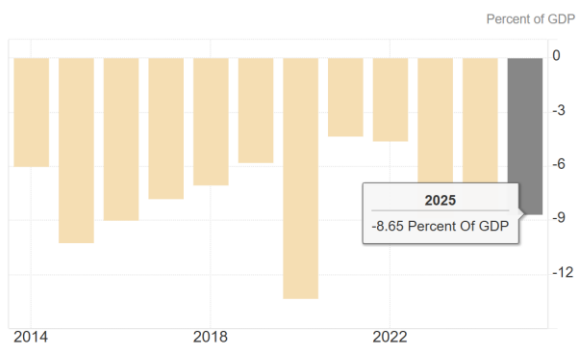
Unlike Mexico, Brazil’s inflation pressures have been less influenced by tariffs and more by **fiscal dynamics and exchange rate movements**. A deterioration in fiscal credibility can weaken the BRL, increasing imported inflation. Conversely, stronger commodity exports can strengthen the currency and ease price pressures.

Energy prices also play a significant role. Domestic fuel pricing policies, particularly those involving state-run oil company, Petrobras, can influence short-term inflation volatility. For example, a rise in January 2026 goods transport tax more than offset recent Petrobras fuel price cuts. Food prices remain highly sensitive to weather patterns, contributing to periodic non-core inflation surprises.

Non-Core Volatility

Non-Core Inflation in Brazil is often driven by food and administered prices. Agricultural shocks, droughts, or global commodity swings can lead to temporary spikes. However, a relatively stable currency in 2025 helped moderate imported fuel costs and limit pass-through effects.

Figure 13: Brazil Government Budget (% of GDP)



Source: BCB

Figure 14: President Luiz Inácio Lula da Silva



Source: Google Images

Forecast Trajectory for 2026–2027

The Banco Central do Brasil projects inflation to gradually converge toward the **3.5%-3.1% target by 2026–2027**, assuming fiscal discipline is maintained and external shocks remain limited.

Markets expect inflation to fluctuate within the tolerance band in 2026 before moving closer to target in 2027. The pace of convergence will depend heavily on exchange rate stability, wage dynamics, and adherence to the fiscal framework.

Banco Central do Brasil’s Calibrated Easing Cycle

In contrast to Mexico’s “wait-and-see” stance, the Banco Central do Brasil has already moved decisively into an **easing cycle** after maintaining one of the highest real interest rates in the world during 2022–2023. Following a prolonged tightening phase that brought the **Selic policy rate** to 15%, the central bank began cutting rates as inflation expectations stabilized and headline inflation moved back within the tolerance band.

By late 2025, policymakers continued to stress **data dependency** and the importance of maintaining anchored inflation expectations. Brazil’s monetary authority has emphasized that the pace of easing must remain consistent with fiscal credibility and exchange rate stability. Any perception of fiscal slippage has the potential to weaken the Brazilian real (BRL), which could reintroduce imported inflation pressures.

Expected Rate Path

Market expectations, suggest that:

- The **Selic rate** is likely to decline gradually through 2026, provided inflation remains within the target band.
- Policy rates could approach **11.50%-12.50% by end-2026**, depending on inflation dynamics and fiscal developments.
- The pace of easing may slow if currency volatility intensifies or if inflation expectations drift upward.

The central bank’s objective is to strike a balance between **supporting domestic growth** and **preserving credibility under the inflation-targeting regime**, which aims for 3% inflation with a ± 1.5 percentage point tolerance band.

Comparison with Regional Peers

Brazil has been among the first major Latin American economies to signal cutting of rates, reflecting earlier progress on disinflation.

- **Mexico** has adopted a more cautious approach due to tariff and tax-related inflation risks.
- **Colombia** has faced stickier inflation pressures, resulting in a slower and more uneven easing cycle.

Brazil’s earlier tightening cycle gave it room to begin easing sooner, but it remains highly sensitive to fiscal credibility and global financial conditions, particularly US monetary policy.

Fiscal Policy and Public Finances

Deficit and Debt Levels

Brazil continues to run a **primary fiscal deficit (Fig.13)**, although the government has introduced a new fiscal framework designed to stabilize debt dynamics over the medium term. According to data from the Banco Central do Brasil, **gross public debt stands near 75–80% of GDP (Fig.9)**, which is high relative to most emerging markets but manageable given Brazil’s large domestic investor base and predominantly local-currency debt structure.

The consolidated public sector borrowing requirement remains elevated, reflecting structural spending rigidities, including constitutionally mandated expenditures and social transfers. Debt sustainability is therefore closely tied to revenue performance and expenditure controls under the new fiscal rules.

Spending Composition

Government spending has remained focused on **social programs, income transfers, and pension obligations**, consistent with the policy priorities of President Luiz Inácio Lula da Silva (Fig. 14). While these measures support consumption and reduce inequality, critics argue that Brazil must allocate a greater share of expenditure toward **capital investment**, including logistics, energy infrastructure, and digitalization, to raise productivity and long-term growth potential.

Public investment is expected to increase moderately in 2026, particularly in infrastructure and green energy projects. However, **private investment remains cautious**, reflecting fiscal uncertainty and relatively high real borrowing costs.

Bond Issuance and Market Financing

Brazil finances its deficit primarily through the **domestic bond market**, which is one of the largest and most liquid in the emerging world. The National Treasury regularly issues fixed-rate, floating-rate (LFT), and inflation-linked (NTN-B) securities to lengthen maturities and manage refinancing risks.

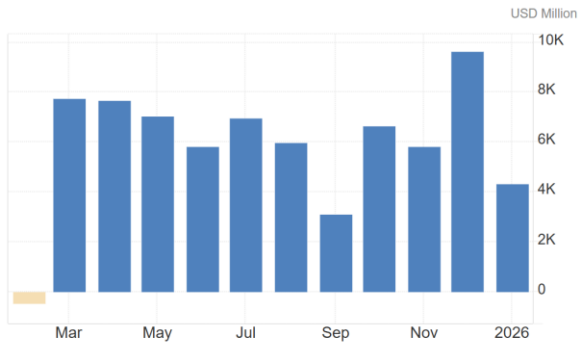
Strong domestic institutional demand, including from pension funds and banks, has historically supported government issuance. However, yields remain elevated relative to peers, reflecting a persistent fiscal risk premium.

Risks from Slower Growth and Rising Debt

Several risks remain central to Brazil’s fiscal outlook:

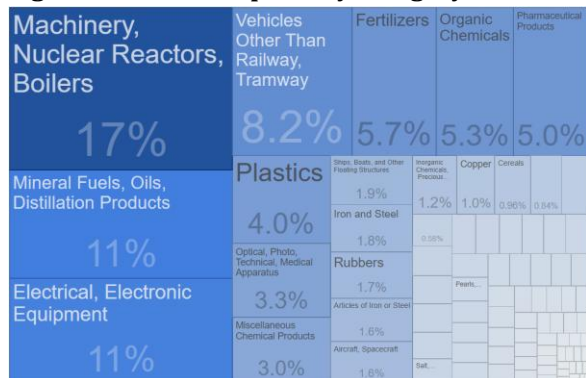
- If **economic growth underperforms**, tax revenues may fall short of projections, complicating deficit reduction efforts.
- Persistent primary deficits could push the **debt-to-GDP ratio higher**, increasing borrowing costs.
- A lack of sustained structural reform could weaken investor confidence and pressure the BRL.

Figure 15: Brazil Balance of Trade



Source: Ministério do Desenvolvimento, Indústria e Comércio Exterior

Figure 16: Brazil Imports by Category



Source: UN COMTRADE

Brazil's fiscal trajectory is therefore one of the most important macro variables for markets. While debt is largely denominated in local currency and supported by a deep domestic investor base, maintaining credibility under the new fiscal framework will be essential to preserve monetary flexibility and macro stability.

Overall, Brazil enters 2026 with a **gradually easing monetary stance**, but fiscal discipline remains the anchor that will determine how much room policymakers ultimately have to support growth without reigniting inflation or destabilizing the currency.

Trade Balance

Brazil maintained a **large balance of trade surplus in 2024 and 2025 (Fig.15)**, reflecting its position as a major global commodity exporter. According to data from the Ministério do Desenvolvimento, Indústria, Comércio e Serviços (MDIC), Brazil remained comfortably in surplus through 2024–2025 as agricultural and energy exports stayed resilient.

Unlike Mexico, whose surplus is driven primarily by manufacturing exports, Brazil's external strength is heavily concentrated in **commodities** and the trade surplus is in part due to a drop in imports.

Export and Import Dynamics

Exports are dominated by agricultural and mineral products. Brazil is the world's largest exporter of **soybeans**, a leading exporter of **iron ore**, and a significant exporter of **crude oil**. China remains Brazil's largest trading partner, accounting for a substantial share of demand for soybeans and iron ore. Companies such as Vale and Petrobras play central roles in the country's export performance.

In 2025, export revenues were supported by **steady commodity volumes**, though price fluctuations—particularly in iron ore and oil—introduced volatility. Agricultural exports normalized slightly following record harvests, but overall volumes remained structurally strong.

Imports consist primarily of capital goods, intermediate inputs, chemicals, and refined fuels. Import growth has been moderate, reflecting cautious private investment and stable domestic demand. A stronger Brazilian real (BRL) during parts of 2025 helped reduce the local-currency cost of imported goods, partially offsetting global price pressures.

Trade Policy and Diversification

Brazil is a founding member of **Mercosur**, its regional trade bloc, and continues to pursue trade diversification strategies beyond traditional commodity markets. Unlike Mexico, Brazil does not rely on a single trade agreement. Instead, its trade structure is more diversified across China, the European Union, and the United States.

Recent policy discussions have focused on strengthening Brazil's industrial base and encouraging value-added production, particularly in green energy, agribusiness processing, and critical minerals.

However, Brazil has not introduced broad tariff measures comparable to Mexico's recent protective policies. Trade policy remains relatively stable, with an emphasis on maintaining export competitiveness.

Exchange Rate and Real (BRL) Resilience

The BRL has been volatile but broadly resilient relative to peers. The currency's performance reflects three core drivers: **commodity prices, fiscal credibility, and US monetary policy expectations.**

A stronger BRL helps contain inflation by lowering the cost of imported goods and fuels. However, it can also reduce competitiveness for manufactured exports. Conversely, depreciation tends to boost export revenues in local currency terms but risks reintroducing inflationary pressure through imported inputs.

Market projections suggest the BRL will remain sensitive to global liquidity conditions and domestic fiscal developments in 2026–2027. A gradual depreciation scenario would not be unexpected if US rates remain elevated, though strong commodity demand could offset downward pressure.

External Stability

Brazil's **Current Account Deficit** has remained relatively contained, hovering around **1–3% of GDP** in recent years, according to the Banco Central do Brasil. Foreign exchange reserves remain robust, providing an additional layer of external resilience.

Overall, Brazil's external position is structurally supported by its commodity surplus, sizable foreign exchange reserves, and diversified trade relationships. However, it remains highly sensitive to fluctuations in global commodity cycles and China's growth trajectory, making external demand a key variable for macro stability.

Trade Idea

Narrative

Brazil's macro environment is transitioning from a phase of **peak monetary restrictiveness** toward **gradual normalization**, and that shift creates asymmetry in FX. Growth is stabilizing, but momentum is no longer accelerating. The boost from record agricultural output has faded, private investment remains cautious, and commodity tailwinds are becoming less reliable.

Inflation has returned within the central bank's tolerance band, but **services inflation remains sticky** enough to prevent aggressive easing. The consensus is that BCB will cut the Selic rate after previously maintaining one of the highest real policy rates globally. While real carry remains positive, it is now compressing. The Brazilian real (BRL) has historically been supported by **high carry inflows**, but FX markets typically turn before the rate differential fully converges. As Brazil's easing cycle progresses, the structural support from extreme real yield diminishes.

Fiscal dynamics represent the more important medium-term vulnerability. Gross public debt remains elevated near **75-80% of GDP**, high by emerging market standards. The new fiscal framework has reassured investors for now, but it relies heavily on **revenue assumptions** and **political discipline**. Any perception of slippage in primary balance targets could widen sovereign spreads and reintroduce a fiscal risk premium into the currency.

Externally, Brazil remains **highly exposed** to **commodity demand**, particularly from China. Iron ore, soybeans, and crude oil drive trade surpluses and capital inflows. If Chinese growth disappoints or commodity prices soften, BRL **sensitivity increases** quickly. In contrast, the Federal Reserve remains comparatively cautious. Even if modest rate cuts occur later in 2026, US real yields are likely to remain structurally elevated relative to global peers. In a less forgiving liquidity environment, high-beta EM currencies such as BRL tend to underperform.

The BRL has been supported by three pillars: **strong commodity exports, high real carry, and anchored inflation expectations**. However, all three supports are entering a more neutral phase. Carry is compressing, commodity upside is less certain, and fiscal discipline remains under scrutiny. This transition phase creates asymmetric upside risk in USD/BRL.

Catalysts

The primary catalyst for USD strength against BRL would be renewed fiscal headlines that call into question adherence to Brazil's debt stabilization path. Additionally, a **correction** in iron ore or crude oil prices would weaken Brazil's external surplus narrative. On the global side, resilient US data reinforcing a **hawkish rate environment** would support US yields and the dollar broadly. A general risk-off episode, particularly one tied to China growth concerns, would likely accelerate BRL underperformance due to its cyclical and commodity-linked profile.

Trade Structure

- Entry: 4.95-5.00
- Take Profit: 5.35
- Stop Loss: 4.80
- Risk-Reward Ratio: ~2.2

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