Emerging Insight

LatAm: Easing to neutrality and beyond

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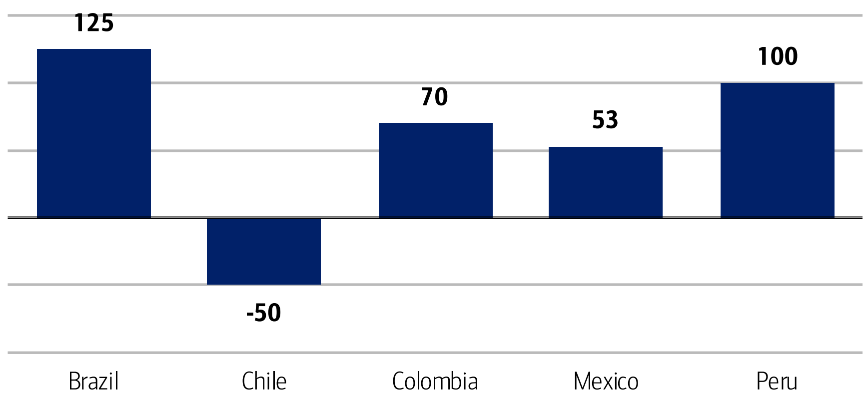
Key takeaways

- We compare market-pricing of terminal rates in LatAm with our subjective assessment of neutral real rates
- With the exception of Chile, the market seems to be underpricing LatAm easing cycles across the board
- We keep receiving rates in Brazil and Colombia, but paying in Chile. We remain neutral in Mexico and have a long bias in Peru

For a complete list of our open trades and closed trades over the past 12 months see our latest Global Emerging Markets Weekly.

By Ezequiel Aguirre & Christian Gonzalez Rojas

Chart of the Day: Market-implied '25-end real policy rates vs. real neutral rate spread (bp)
With the exception of Chile, markets seem to be underpricing easing cycles in LatAm



Source: BofA Global Research, Bloomberg

BofA GLOBAL RESEARCH

LatAm: Easing to neutrality and beyond

Almost all major inflation-targeting central banks have already began easing monetary policy, with Mexico the only exception. The relevant question now is how far they will go. We answer this by looking at market pricing for end-2025 – a reasonable horizon for the end of this cycle – and how that pricing compares with estimates of neutral real rates. In LatAm, the market seems to be underpricing the easing cycle in Brazil, Colombia, Mexico and Peru, while it expects Chile to cut benchmark rates below neutral. As such, we remain long rates in Brazil and Colombia, while we have a long bias in Peruvian rates. We remain neutral in Mexico and pay rates in Chile.

Almost all major inflation-targeting central banks have already began easing monetary policy, with Mexico the only exception. The relevant question now is how far they will go. We answer this by looking at market pricing for end-2025 – a reasonable horizon for the end of this cycle – and how that pricing compares with estimates of neutral real rates. Only Chile is expected by the market to cut benchmark rates to below neutral. All other economies are priced to have real policy rates still above neutral by end-2025, in part because inflation will still be somewhat above target levels, as shown in Exhibit 1. Are markets underpricing the easing cycles? In most cases, our answer is yes.

As a rule of thumb (a Taylor rule, say) real policy rates should exceed neutral real rates by 0.5 times the excess of actual inflation over target inflation: if inflation is 100bp above target then real rates ought to be approximately 50bp above neutral. By this metric, the market is pricing monetary policy to still be excessively tight by the end of 2025 in Brazil, Colombia and Peru while excessively loose in Chile. Mexico is a more ambiguous case that depends on inflation and neutral real rate assumptions.

Our trade recommendations are consistent with this analysis. We recommend Jan27 receivers in Brazil and long TES 2034 in Colombia given excessively tight monetary policy being priced by the market and 3y2y CLP swap payer in Chile given excessively loose monetary policy being priced. We have a bias toward long Soberanos in Peru and are neutral on Mexico for now.

Exhibit 1: Real rate forecasts by end-2025 (Market vs BofA)

Most central banks are still priced by the market to have real policy rates above neutral by end-2025

	Current		Market, end-2025			BofA, end-2025			Neutral Rate	
	Policy rate	Inflation	Policy rate	Inflation	Real rate	Policy rate	Inflation	Real rate	Official	BofA
Brazil	11.75	4.7	9.75	3.5	6.3	9.50	3.5	6.0	4.50	5.00
Chile	8.25	3.9	4.25	3.0	1.3	5.00	3.1	1.9	1.00	1.75
Colombia	13.00	10.2	7.50	3.8	3.7	6.00	3.5	2.5	2.40	3.00
Mexico	11.25	4.7	7.75	3.7	4.1	7.50	4.2	3.3	2.60	3.50
Peru	6.75	3.2	5.50	2.5	3.0	4.00	2.5	1.5	2.00	2.00

Source: BofA Global Research. Official neutral real rate estimates are obtained from the latest inflation reports for each central bank. BofA estimates are our own subjective estimates of neutral real rates which may deviate from official estimates.

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Brazil: Be ambitious when real yields are high

We keep our Jan27 receiver recommendation (current 9.90%) despite the recent 140bp rally from 11.30% in October. That rally does not look excessive when one considers that US yields also rallied 100bp over the same period and Brazil's inflation decreased around 60bp since September. Risks to the trade are a deterioration of fiscal risks or a hawkish turn by the BCB.

Exhibit 1 shows that the market expects a benchmark rate of 9.75% and inflation at 3.5% by end-2025. That implies an ex-post real policy rate of 6.3% by then, around 130-180bp above neutral depending on whether one uses the BCB or our own estimate of neutral, when inflation will be just 50bp above target. Moreover, what really matters is the ex-ante real rate which should be even higher since inflation expectations for 2026, conditional on 2025 inflation being 3.5%, are likely to be lower than 3.5%.

Chile: The market may already be pricing below neutral rates

We keep our 3y2y CLP swap payer recommendation (current 4.59%) because we believe the market is already pricing terminal rates below neutral by end-2025. To some extent this is because we think Chile's central bank estimate of neutral – which was recently raised 25bp to 1% - is still too low. If the neutral real rate in the US is thought to have risen to around 1% after the pandemic, Chile ought to have a somewhat higher neutral real rate than that. We think 1.75% is a more appropriate estimate. Risks to the trade are a deeper-than-expected easing cycle or lower fiscal risks.

The fixed income market is pricing a benchmark rate of 4.25% by end-2025 with inflation by then at the 3% target level. This yields a real policy rate of 1.25%, *above* the

1% central bank's estimate of neutral but *below* our own neutral estimate of 1.75%. Since inflation is expected to be at target by then – market is at 3% and we only barely above at 3.1% - there should be no reason to have real policy rates below neutral.

Colombia: Still significant room to receive

We also maintain our long 10y TES recommendation (current: 9.85). While rates have already rallied substantially, we have strong conviction that there is still significant room for rates to decline. Specifically, we continue to believe that the market is underpricing the easing cycle, while we remain constructive on the policy and fiscal front. Risks to the trade are inflation pressures not subsiding, a deterioration in the policy outlook or fiscal underperformance.

The market is pricing a terminal rate of 7.50%, below the 6.00% we expect BanRep will be able to reach. In fact, the real-rate implied by market expectations is 3.7% by end-25, which is well above official estimates of the real neutral rate at 2.40% and our own assessment of the real neutral rate at 3.0%. With inflation gradually declining and an economy that continues to decelerate, we believe that BanRep will not hesitate to continue cutting rates.

Mexico: Remain neutral in the absence of large mispricings

In Mexico, we remain neutral for now as we do not observe a significant mispricing of terminal rates. In fact, Mexico arguably has the curve with the least value in LatAm. We are currently expecting a terminal rate of 7.50%, which is very close to the 7.75% priced by the market.

While the market is pricing a real rate of about 4.1%, we believe it is not meaningfully different from our 3.5% assessment of the neutral real rate. In fact, most of the difference can be attributed to our expectation that inflation will be 4.2%, while consensus is closer to 3.7%. If our call of 4.2% inflation is correct, the market-implied real rate would be closer to 3.6%, almost in-line with our assessment of the neutral rate. More importantly, the fact that the market is pricing a real rate above neutral is consistent with inflation remaining well above target. According to our rule of thumb, if inflation is 120bp above target, the real policy rate should be roughly 50bp to 60bp above neutral, as is roughly priced.

Peru: Biased towards long Soberanos

In Peru we are biased towards long Soberanos, as the market seems to be underpricing the easing cycle. Extracting precise market expectations of the monetary policy path is not straightforward in Peru amid the lack of a liquid swaps market. Therefore, we use bond forwards to assess the market's expectation of the terminal rate.

Bond forwards are currently pricing a terminal rate of 5.5%, well above our expectation of a 4.0% policy rate by 2025-end. In fact, the market-implied real rate of 3.0% is well above the central bank's and our assessment of a 2.0% real neutral rate. This, in our view, suggests that there could be some space for rates in Peru to continue rallying.

News and Views

Mexico: Investment surprised to the upside in October at 25.5% yoy nsa

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Investment in October surprised to the upside at 25.5% yoy nsa in real terms (E. 23.0%, BofA 23.0%), up from 21.9% in September. At the margin, investment grew 1.9% mom sa, up from from -1.5% mom sa in September. Construction grew 4.0% mom sa (vs -4.9% in September). By components, residential construction grew 11.3% mom sa, while non-residential construction grew 1.6% mom sa. On the contrary, manufacturing fell -0.6% mom sa (vs +2.7% in September), driven by the decrease of both domestic manufacturing goods at -1.7% mom sa and imported manufacturing goods at -0.5% mom sa. Year to date, investment increased 20.2% sa in real terms.

- **To follow**: Investment remains in a boom in Mexico, driven by non-residential construction, in turn driven by nearshoring and by government infrastructure projects.

Mexico: Private consumption surprised to the upside in October at 5.2% yoy nsa

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Private consumption surprised to the upside in October at 5.2% yoy nsa in real terms (E. 4.7%, BofA 4.7%). In monthly terms, consumption fell -0.3% mom sa (vs +0.8% mom sa in September). Imported goods consumption decreased -1.6% mom sa (vs +1.6% in September), domestic goods consumption increased 0.4% mom sa (vs +1.2% in September), and domestic services consumption decreased -0.7% mom sa (vs +0.3% in September). Year to date, consumption increased 4.0% sa in real terms.

- **To follow**: Consumption remains strong in Mexico, in particular domestic consumption, which will likely continue to pressure prices up in the following months.

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