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Liquid Insight

Hedging MXN amid USD uncertainty

14 February 2024

Rates and Currencies Research
Global

Key takeaways

- Recent investor feedback shows many lack directional USD conviction, while interest to hedge MXN weakness is rising.
- Consider USDMXN-USDBRL or USDMXN-USDCLP dual-digis to cheapen cost of MXN downside hedges while stay USD neutral.
- EUR-based dual-digis vs MXN and CLP may serve as alternative for investors who do not want to fade elevated USD correlation.

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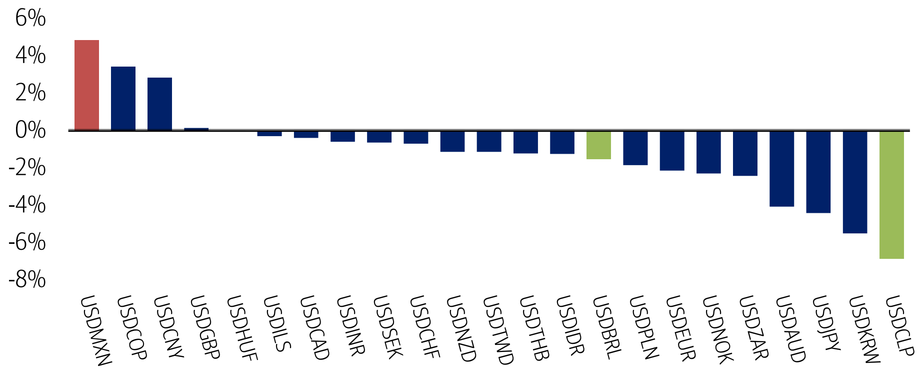
Exhibit 1: Investors could consider USDMXN-USDBRL or USDMXN-USDCLP dual-digits to cheaply hedge MXN downside risks while keeping a USD neutral view

BofA forecasts for end of Q2 vs spot for USD-based pairs (positive value = forecast of USD appreciation)



Source: BofA Global Research, Bloomberg. Positive values mean our forecasts look for USD appreciation vs current spot; negative values mean our forecasts look for USD depreciation vs current spot.

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Dual-digital: hedge MXN downside & stay neutral USD

Recent FX client feedback suggests many investors currently lack a directional USD view, while the interest to hedge MXN downside has picked up.

A dual-digital structure that looks for higher USDMXN amid lower USD vs another LatAm currency like BRL or CLP could be appealing in this context. This structure is not only supported by our quarterly forecast and quantitative valuation, but also allows investors to stay USD-neutral and provides notable premium cheapening, given the elevated realized correlations between the currency pairs. For investors who are hesitant to fade the elevated USD-based correlation, using EUR as the base currency could serve as an alternative. The main risk to the structure is that MXN stays resilient, in contrary to our spot forecast.

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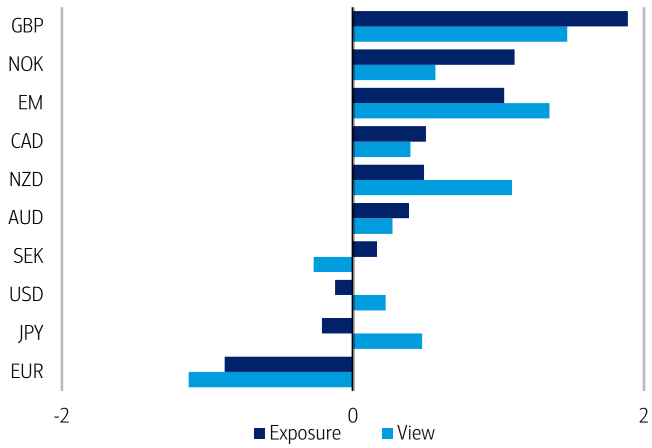
FX investors lack USD directional conviction so far in 2024

Bearish USD consensus was formed at the end of 2023 with positioning also turning short (FX Viewpoint: 16 January 2024). But with the USD starting the year up by more than 2%, we find many FX investors now lack directional conviction. Notably, our latest FX & Rates Sentiment Survey also shows across major currencies, investors have the most neutral exposure and view on the USD vs the past year (Exhibit 2).

Exhibit 2: 1-year FX Exposure and View (z-score)
EURGBP bearishness stands out within a 1Y timeframe



Source: BofA Global Research FX and Rates Sentiment Survey; Note: Data for FX Exposure starts in January 2004 for USD, EUR, GBP, JPY, CAD and EM, while for AUD, NZD, NOK and SEK the start date is January 2016; Data for FX View starts in December 2011 for USD, EUR, GBP, JPY, CAD and EM, while for AUD, NZD, NOK and SEK the start date is January 2016

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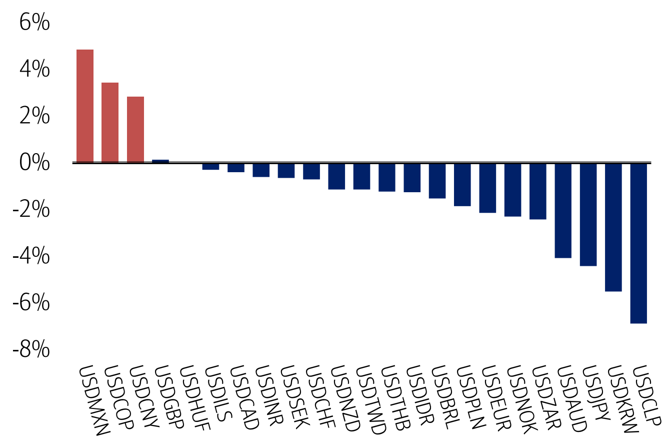
Exhibit 3: We still expect the USD to depreciate vs most G10 and EM currencies by mid-year; MXN, COP and CNY are outliers
BofA forecasts for end of Q2 vs spot for USD-based pairs



Source: BofA Global Research, Bloomberg. Positive values mean our forecasts look for USD appreciation vs current spot; negative values mean our forecasts look for USD depreciation vs current spot.

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We are still broadly bearish USD vs both G10 and EM currencies

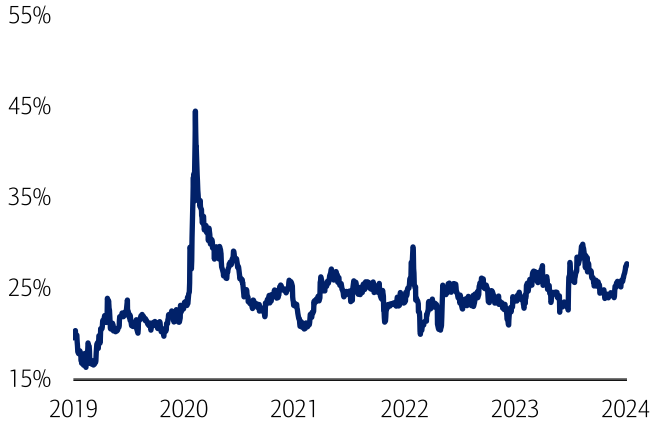
Relative to current bilateral spot prices, our forecasts are for the USD to broadly depreciate by midyear (Exhibit 3). January FOMC and recent data (NFP and CPI) raises near-term upside risks for the USD. However, the lack of follow through from implied vols also suggests USD upside may be limited and the momentum could fade after the initial reactive rally (FX Quant Insight: 12 February 2024). MXN, COP, and CNY are the 3 standout currencies where our fundamental strategists continue to see material USD strength against for the first half of 2024. Out of these 3 currencies, our forecast is most bearish on MXN.

Consider dual-digi structure to cheapen USDMXN calls with another LatAm peer

MXN has been one of the best-performing currencies over the past two years due to favorable carry dynamics. But with Banxico looking to cut rates in 2024 (Mexico Watch: 08 February 2024), our fundamental strategists expect MXN to eventually underperform (Emerging Insight: 06 February 2024).

Many investors are wary of the potential for MXN to depreciate once the carry yield starts to decline. However, hedging MXN selloff with medium-term OTM (out-of-money) MXN puts can be expensive, given 6m USDMXN skew is now at 91st percentile for USD calls vs recent history (Exhibit 4).

Exhibit 4: 6m USDMXN skew is at 91st percentile vs 5y history
6m USDMXN skew (25-delta risk reversal / atm vol)



Source: BofA Global Research, Bloomberg

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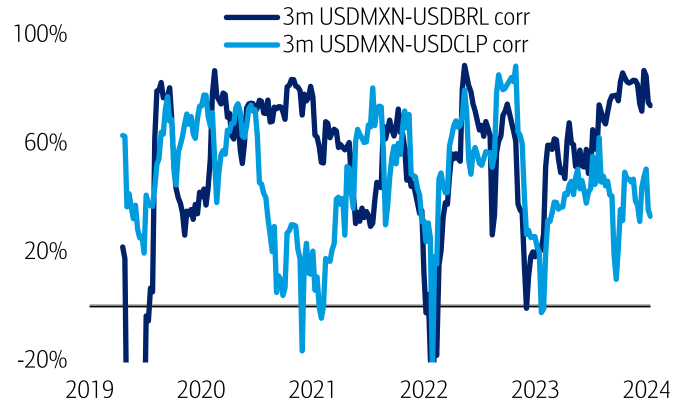
Exhibit 5: USDMXN vs USDBRL realized correlation is high vs history; USDMXN vs USDCLP realized correlation is also positive
3m rolling realized correlation for USDMXN vs USDBRL and vs USDCLP



Source: BofA Global Research, Bloomberg

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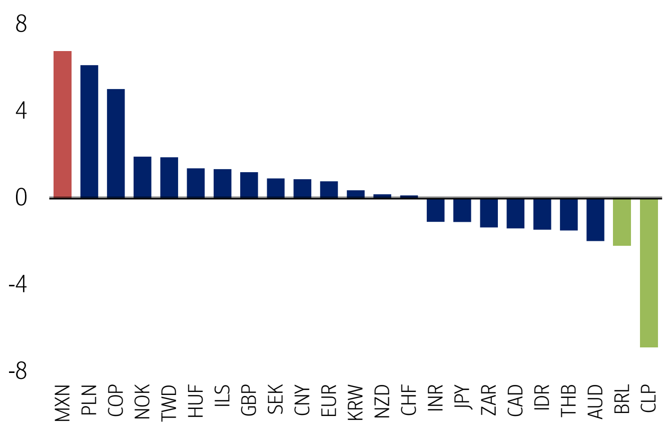
For investors that prefer to continue keeping a USD-neutral exposure for the near-term, a dual-digital structure that looks for higher USDMXN but lower USD vs another LatAm currency like BRL and CLP could be appealing. 3m USDMXN-USDBRL realized correlation currently sits at 74%; implied correlation is slightly lower at around 59%. This level of implied correlation allows for around 40% premium cheapening effect vs owning zero-correlation dual-digital options on USDMXN and USDBRL (Exhibit 5). To a lesser extent, a USDMXN-USDCLP dual-digital should also achieve some premium savings given the relatively smaller but still positive realized correlation.

At the same time, our dynamic factor valuation model for major currencies show MXN is currently the most overvalued while BRL and CLP are the most undervalued currencies against the USD (Exhibit 6). As a result, the direction of the dual-digital should be in-line with spot convergence towards fair value.

Exhibit 6: Dynamic factor model shows MXN is expensive; BRL and CLP are cheap
Dynamic factor model FX valuation vs the USD



Source: BofA Global Research, Bloomberg

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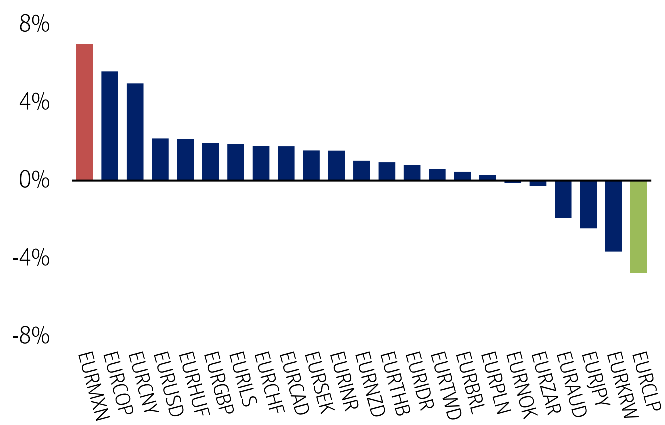
Exhibit 7: Our forecasts also look for EUR appreciation vs MXN and depreciation vs CLP
BofA forecasts for end of Q2 vs spot for EUR-based pairs



Source: BofA Global Research, Bloomberg. Positive values mean our forecasts look for EUR appreciation vs current spot; negative values mean our forecasts look for EUR depreciation vs current spot.

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Our fundamental view: Bearish MXN, bullish BRL

While other factors like remittances have provided support to MXN, we believe that MXN resilience has been mostly driven by carry. Therefore, we expect the forthcoming interest rate cuts in Mexico will have a negative impact on MXN. In our view, it is increasingly likely that Banxico may decouple from the Fed, launching an easing cycle as soon as March despite the Fed holding its first cut in June.

The statement from the most recent Banxico meeting supports our view. It removed forward guidance that Banxico would keep rates at the current level “for some time” and introduced guidance that the board would consider the “possibility of adjusting the reference rate” in coming meetings. If inflation declines further by February, we believe Banxico is more likely than not to cut rates in March given the weak 4Q23 GDP growth.

Other factors are also negative for MXN in the medium term. Fiscal policy will no longer support the peso, on the back of a significant deterioration this year. While we expect consolidation to take place, we remain concerned the market may be pricing little risk premium. Moreover, on the policy front, Mexico is set to enter a volatile environment. Domestically, Mexico will hold general elections in June, which should generate some policy uncertainty and increase the volatility of the peso. In fact, historically MXN weakens in the 3 months prior to the Mexican presidential election. Uncertainty stemming from US elections later this year may also increase volatility. If the peso had been supported by a high carry-to-vol ratio, not only would carry decline on the back of Banxico’s easing cycle, but also volatility may increase on the back of high policy uncertainty.

Meanwhile, we remain constructive on BRL, as there are three idiosyncratic factors that support its outperformance. First, BRL is the quintessential high carry currency that performs well when it delivers investors a positive real carry in addition to low and stable inflation. In our view, disinflation should keep real interest rates above 5%, keeping Brazil at the top of the carry rankings. Second, we expect strong growth in Brazil, which should attract foreign capital and help with debt sustainability. Both factors should provide support to the currency. Finally, our baseline is a better-than-expected fiscal story in Brazil, which should help lower BRL risk premium.

Using EUR-based dual-digital vs MXN and CLP as alternative

For investors who want to cheaply hedge MXN downside but still think USD correlation could stay elevated, using EUR as the base currency for the dual-digital may be an alternative. Our forecasts also look for higher EURMXN and lower EURCLP by midyear vs prevailing spots (Exhibit 7). To the extent that a substantial amount of long MXN carry trades have been funded with EUR (as EURMXN had higher carry vs USDMXN), EURMXN could also see sharper rally in the scenario of carry unwind. The main risk for the dual-digital structure is MXN staying resilient in H1 2024 and does not weaken according to our forecasts.

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- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Carry me away, **Liquid Cross Border Flows**, 12 Feb 2024

Rates, FX & EM trades for 2024

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: Still in search of a safe landing 09 February 2024

Global Rates Weekly: Ranger danger 09 February 2024

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