Emerging Insight

Why We Still Like Buying BRL/MXN

06 February 2024

GEM Fixed Income Strategy & Economics
Global

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Key takeaways

- We still like buying BRL/MXN. Recent underperformance due to strong US growth, weak euro exchange rate and high carry in MXN.
- But it is increasingly likely Mexico will cut rates perhaps even decoupling from the Fed given a weak 4Q23 GDP report.
- Cutting rates with sticky underlying inflation, rising budget deficits and a +4% output gap will weaken the Mexican peso.

By Ezequiel Aguirre and Christian Gonzalez

Chart of the day: BRL/MXN spot rate
BRL/MXN significantly undervalued and to benefit from forthcoming rate cuts in Mexico

Source: BofA Global Research, Bloomberg

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Why We Still Like Buying BRL/MXN

We remain bullish on BRL/MXN, first opened in late November despite a 2.6% underperformance so far (see Buy BRL/MXN – 2024 Macro Outlook Favors Brazil Over Mexico). US growth outperformance relative to EU has been a headwind. But we expect forthcoming interest rate cuts in Mexico to negatively impact MXN while real rates in Brazil will be the highest across major currencies by the end of the year.

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Global factors have not helped much but should going forward.

We highlighted the role the euro and US bond yields played in explaining BRL/MXN in the opening trade note. A stronger euro would be positive for BRL/MXN given Brazil's deeper trade links with Europe and Mexico's linkage to the US economy. And lower US bond yields would benefit Brazil more than Mexico given the former's higher debt stock.

The euro weakened 2% against the dollar since we opened the trade. We had estimated a beta coefficient of 1.4 so in a sense this would explain the 2.6% depreciation in BRL/MXN. Bond yields in the US are down by around 20bp since November 28 which should have been positive for BRL/MXN. But the correlation between BRL/MXN and US bond yields is much weaker than that between BRL/MXN and EUR/USD.

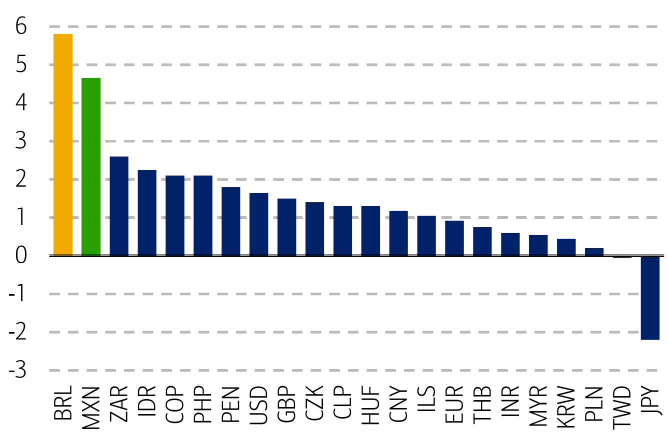
These global factors should help going forward. We forecast the euro to strengthen to 1.15 by end-2024. In our base case, the US economy recouples with the rest of the world, disinflation continues, and the Fed starts cutting rates supporting risk sentiment and weakening the overvalued dollar. Growth moderation in the US in coming months should keep 10y bond yields in a 3.75-4.25% range. Re-emergence of banking sector concerns will likely put downward pressures on yields.

Brazil: Why we are still bullish

We believe there are three idiosyncratic factors that are key for the Brazilian real to outperform: disinflation that keeps real interest rates above 5%, real GDP growth above 2% and a primary budget deficit of around 0.5% this year.

First, the Brazilian real is the quintessential high carry currency that performs well when it delivers investors a positive real carry in addition to low and stable inflation. Our 2024 forecasts are for 3.7% inflation and a terminal benchmark rate of 9.5%. This implies a real rate of almost 6% which would still put BRL at the very top in the carry rankings of major global currencies (see Exhibit 1).

Exhibit 1: Major currencies sorted by real rates by end-2024.
Real rates by end-2024 using consensus forecasts for policy rates and inflation. For Brazil and Mexico, we use our own forecasts.



Source: Bloomberg

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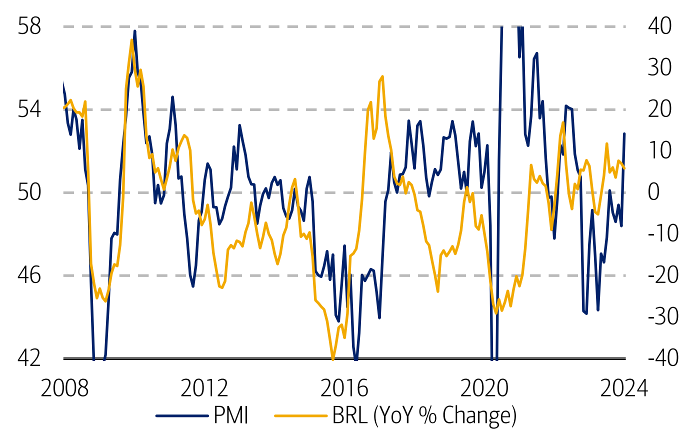
Exhibit 2: Strong growth leads to BRL appreciation.
Brazil's manufacturing PMI and BRL spot returns. Rising PMI tends to lead to BRL spot appreciation.



Source: Haver Analytics

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Second, we forecast Brazil to grow 2.2% this year, well above the 1.5% consensus expectation. Strong growth is key because it attracts foreign capital inflows and helps with debt sustainability. Recent data suggest Brazil's economy is gaining speed, with manufacturing PMI rising to 52.9 in January from 48.8 in 4Q23 (see Exhibit 2). Moreover, the 2017 labor reform, the 2019 pension reform, the 2023 consumption tax reform, several other micro reforms, and the development of pre-salt offshore oil fields are likely to boost potential GDP growth closer to 2.5% than the 2% potential growth estimate held by most analysts (see Brazil Primer: Brasilopedia: The growth awakens).

And third, reducing fiscal deficits are critical for correcting BRL's undervaluation. Brazil needs to eventually run primary budget surpluses of 1-2% of GDP under reasonable assumptions for long-run real interest rates and potential economic growth. We expect the government to reduce the primary deficit to 0.4% this year from 1.3% in 2023. That would be a better outcome than the 0.8% primary deficit predicted by the consensus.

Mexico: Why we are still bearish.

We are bearish Mexico, arguably our most non-consensus view in Latin America. We believe that forthcoming interest rate cuts will negatively impact the Mexican peso. It looks increasingly likely Mexico's central bank may decouple from the Fed, cutting its benchmark rate as soon as March despite the Fed holding its first cut until June. Rate cuts in Mexico would be taking place despite sticky inflation and a tight labor market.

If inflation declines further by February, we believe the central bank is more likely than not to cut rates in March given the weak 4Q23 GDP report. This condition is likely to be met; we expect headline inflation to decline to 4.4% in February from 4.7% in December and core inflation to decline to 4.6% in February from 5.1% in December. Add the sharp slowdown in real GDP growth to 0.3% in Q4 from 4.4% in Q3 and increasing borrowing costs to fund rising budget deficits and the central bank will find it easy to justify a rate cut (see Banxico preview – on hold in February leaving the door open for March).

But on closer inspection the case for lowering rates may be less obvious. First, underlying inflation may be rising, not falling; six-month annualized core inflation rose for three consecutive months to 4.6% in December from 4.1% in September and core services inflation rose to 5.3% in December from 4.6% in September (see Exhibit 3).

Second, the output gap is +4% and the labor market quite tight with unemployment at 2.8%, just 10bp shy of the record low. Wages are growing at more than 10%. This suggests that even if growth decelerates further there will be upward pressures to underlying inflation for quite some time (see Exhibit 4).

Exhibit 3: Inflation is falling in Mexico. Or is it?

Wage growth is YoY % change. Core services CPI is 6m annualized % change

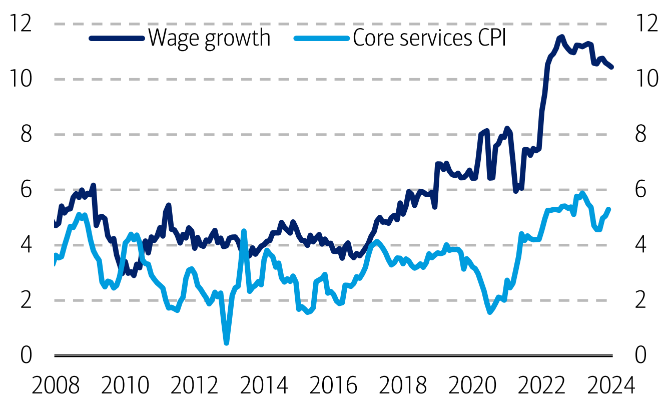

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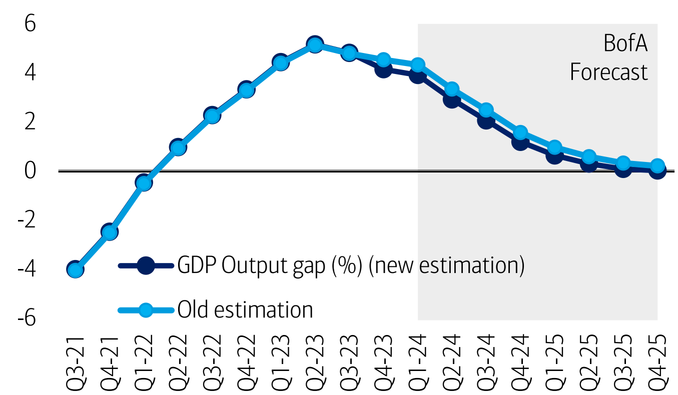
Exhibit 4: Mexico's output gap

We believe that the Mexican economy will remain overheated for some time



Source: BofA Global Research

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And third, the growth slowdown in 4Q23 is likely to reverse in 1Q24. Agriculture contracted by more than 4% in Q4, and a cash-strapped public sector translated into lower public spending. But the government has issued record amounts in capital markets already in January so public spending will likely reaccelerate. We forecast real GDP to grow by 2.3% in 1Q24 (see Mexico's GDP decelerated significantly in 4Q 2023).

Catalyst: A dovish cut by Banxico in March

The main catalyst for BRL/MXN outperformance in the near term is a dovish cut by Mexico's central bank in March, particularly if it happens without the Fed easing policy. There have been five rate cutting cycles in Mexico since 2000: during the pandemic in 2020, gradual and modest cuts in 2013-14, during the 2008-09 global financial crisis, in 2005-06 and a succession of interest rate reductions in 2000-02 which we group together. Broadly speaking the Mexican peso depreciated in all of them. But the most relevant historical episodes are probably the easing cycles of 2005-06 and 2013-14.

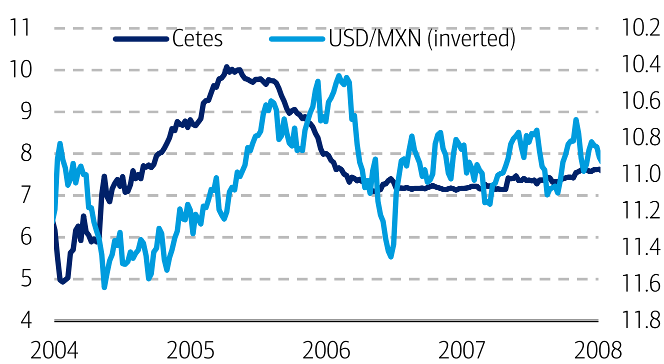
Mexico's central bank started to loosen monetary policy which was reflected in the Cetes rate falling from 10% in April 2005 to almost 7% by May 2006. Core inflation was 3.5% in early-2005 and the economy was slowing down from 4% in 4Q04 to 0% by 2Q05. The Mexican peso first rallied from 11.00 in April to 10.50 by December 2005 – in a US dollar bull market that saw DXY strengthen by 10% during that period – but ultimately weakened to 11.50 by June 2006 (see Exhibit 5).

The central bank also began an easing cycle in March 2013 – core inflation was at the 3% target – with a 50bp rate cut to 4%, cutting to 3% by June 2014. The economy was also slowing down from 3.2% in 4Q12 to -1.7% by 2Q13. Though the Mexican peso strengthened initially to 12.00 from 12.75 – mostly due to optimism on President Pena Neto's reforms – it then weakened to 13.50 by early 2014 (see Exhibit 6).

Risks: Nearshoring in Mexico, fiscal in Brazil

We consider the main risk to the trade to be strong growth in Mexico – particularly if driven by strong manufacturing investment due to nearshoring – that prevents the central bank from easing monetary policy. Strong remittances from the US into Mexico would also keep the Mexican peso appreciated. From the Brazilian perspective, the main risk would be a shift in Lula's administration focus away from fiscal consolidation and toward more public spending to prop-up growth. We expect the government to possibly update its budget targets on March 22. If they change the primary target to a deficit 1% or higher, it would be bad news.

Exhibit 5: Mexico's easing cycle in 2005-06
Three-month Cetes rate and USD/MXN spot



Source: Bloomberg, Haver Analytics

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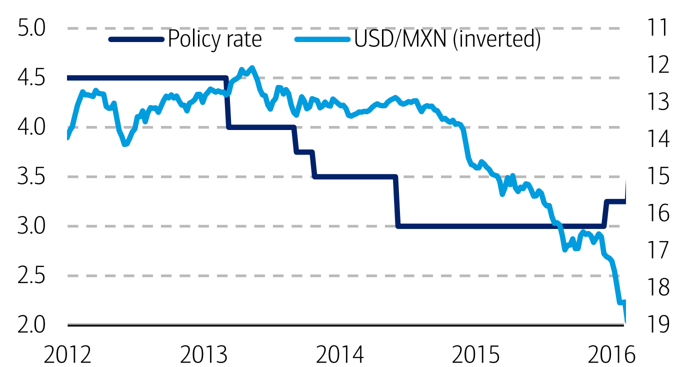
Exhibit 6: Mexico's easing cycle in 2013-14
Benchmark repo rate and USD/MXN spot



Source: Bloomberg, Haver Analytics

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