Emerging Insight

Colombia – Pushing back the first rate cut

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GEM Fixed Income Strategy & Economics
Global

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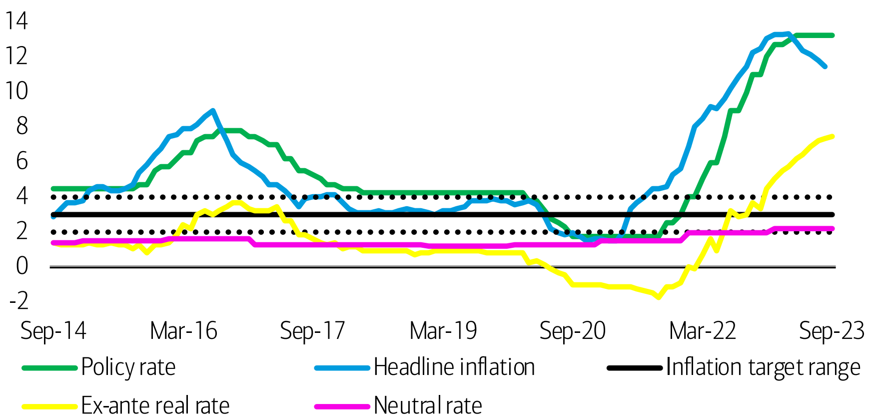
Key takeaways

- We note a fundamental change in the guidance. Majority says initiating an easing cycle now might be unsustainable.
- We are changing our policy rate forecasts for year-end 2023 (to 13.25%, from 13%) and 2024 (to 10%, from 9.25%).
- The market prices an easing cycle that is too early and too shallow. We favor flatteners, but are cautious about US rates.

By Alexander Müller and Christian Gonzalez

Chart of the day: Monetary policy stance (%)

The ex-ante real rate (discounting 12-month, survey-based inflation expectations) is at 7.5%, more than three times the neutral parameter estimated by the central bank, 2.2%



Source: BofA Global Research, Central Bank (BanRep), Statistics institute (DANE)

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Colombia in Focus

Flip flopping on the guidance to initiate an easing cycle

We note a fundamental change in the guidance of the Central Bank (BanRep) about the initiation of an easing cycle. The change is in the hawkish direction. Back in the June press conference, Governor Villar and Finance Minister Bonilla emphasized that if inflation and inflation expectations decreased, that would open space to reduce the nominal policy rate. We described this wording as BanRep making a bolder move to signal its preferred course of action (see From Delphic to Odyssean Guidance).

Timestamp: 02 October 2023 07:25PM EDT

At the following rate decision, in late July, Governor Villar made a statement to clarify BanRep doesn't do forward guidance. We felt like he was talking to us. Probably that was not the case. Regardless, we view this clarification as imprecise. Forward guidance is any information that helps markets infer how the central bank will adjust the future path of short-term rates. As Ben Bernanke has said, monetary policy is 98% talk, 2% action. BanRep's forecasts of inflation and the output gap, presented in the quarterly inflation report, are a form of forward guidance. So is the discussed balance of risks on these variables, if tilted to the upside or downside. And definitely, as well, saying that a reduction in inflation and inflation expectations could create space for cuts in the nominal policy rate.

Of course, there are stronger forms of forward guidance. The central banks of New Zealand, Norway, Sweden, and the US (dot plot) publish their own policy rate forecasts.[1] Between 2003 and 2004, Colombia did that too. BanRep's staff published their own policy rate forecasts, as a policy tool to influence market expectations. It didn't go well, which is why they don't do it anymore. We think that when Villar said "BanRep doesn't do forward guidance", he might have been referring to that particular experience.

Starting cutting cycle now might be unsustainable

The new guidance is substantially different compared to the one described in the first paragraph of this report. It is written in September's statement, and the Governor also spent time explaining it. In the written statement, there is a new sentence that reads: *"with the available information it would not be prudent to initiate an interest rate reduction process, whose sustainability over time would face important risks".* The statement also mentions board members acknowledge the "dilemma" (new word) and introduced a paragraph that stresses the consequences of high inflation for the economy. Overall, it's much more hawkish than the previous one. In the same vein, at the press conference, Governor Villar explained the majority view is that BanRep should not initiate an easing cycle until they are convinced such decision would not need to be reversed later. A reversal (hiking after cutting), in his view, would damage the credibility of BanRep.

Split decision, with two out of seven voting for a 25bp cut

In the September 29th meeting, BanRep decided to maintain the policy rate unchanged at 13.25%, in line with market expectations and our view. The decision came in the context of an upward inflation surprise in August (23bp above the median in the Bloomberg survey) and weak activity (GDP contracted 1% qoq in Q2, and the monthly GDP proxy showed another contraction for July). Against this backdrop, BanRep's board voted in a split way. Five people supported the decision to stay on hold, and two voted for a 25bp cut. Banrep has the policy of not revealing the individual votes of board members, unlike the Bank of England. Although Finance Minister Bonilla made it clear – during the press conference – that he was in the dissenting camp. We think the other board member who voted to cut was Olga Lucia Acosta. She and Bonilla are the only appointees of the Petro administration. Acosta is a development economist, more than a macroeconomist, and used to work at ECLAC, the economic arm of the UN in LatAm, known for having progressive views.

Pushing back the first rate cut to January

Given the new guidance from BanRep, we are changing our policy rate forecasts for year-end 2023 (to 13.25%, from 13%) and 2024 (to 10%, from 9.25%). We no longer expect the first cut of the easing cycle to happen in December 2023, but rather in January 2024. Moreover, we see BanRep proceeding cautiously, with small cuts (25bp), and only switching to the pace of 50bp by mid-2024. Our projected policy rate path is shown in Exhibit 2. A cut in October now seems extremely unlikely given the new guidance and something else Governor Villar mentioned at the press conference. He

[1] In the case of the US, the dot plot shows the "appropriate" level of the fed funds rate considered by FOMC members. In Sweden, Norway, and New Zealand the central banks published the policy rate path that its projected by their staffs.

argued the interest rate trajectory in advanced economies implies capital flight risk if Colombia does premature cuts. In other words, Colombia should not cut until the Fed is done with hikes. Lastly, we cannot end the report without mentioning the finance minister admitted there is a discussion in the government about possible reforms to the fiscal rule. But he was also emphatic to say such discussion is only "philosophical" and any changes would need to be approved by Congress. Changes to the fiscal rule, in our view, are a red line for markets, and pose a depreciation risk on the Colombian Peso.

Exhibit 1: BofA's inflation forecasts for Colombia

Our scenario includes the pause in regulated gasoline price increases in October, announced today by the government

	CPI		Core (CPI ex food & energy), DANE measure	
Weight (%)	**100.00**		**78.05**	
Period	mom	yoy	mom	yoy
Dec-22	1.26	13.12	0.90	9.23
Jan-23	1.78	13.25	1.61	9.71
Feb-23	1.66	13.28	1.65	10.15
Mar-23	1.05	13.34	0.95	10.53
Apr-23	0.78	12.82	0.91	10.59
May-23	0.44	12.37	0.58	10.54
Jun-23	0.30	12.13	0.39	10.54
Jul-23	0.50	11.79	0.42	10.37
Aug-23	0.70	11.43	0.45	10.09
Sep-23	0.55	11.02	0.42	9.79
Oct-23	0.32	10.58	0.29	9.54
Nov-23	0.68	10.49	0.32	9.26
Dec-23	0.51	9.66	0.52	8.84
Jan-24	1.26	9.11	1.35	8.56
Feb-24	1.16	8.58	1.38	8.27
Mar-24	0.72	8.22	0.66	7.96
Apr-24	0.52	7.94	0.35	7.36
May-24	0.38	7.88	0.35	7.11
Jun-24	0.26	7.83	0.37	7.09
Jul-24	0.27	7.59	0.27	6.92
Aug-24	0.14	6.99	0.20	6.65
Sep-24	0.26	6.67	0.27	6.50
Oct-24	0.14	6.47	0.20	6.40
Nov-24	0.16	5.92	0.21	6.29
Dec-24	0.38	5.79	0.41	6.18
Jan-25	0.61	5.12	0.51	5.30
Feb-25	0.65	4.58	0.69	4.58
Mar-25	0.45	4.31	0.29	4.20
Apr-25	0.47	4.25	0.23	4.08
May-25	0.29	4.17	0.23	3.96
Jun-25	0.09	3.99	0.25	3.84
Jul-25	0.08	3.79	0.15	3.72
Aug-25	0.08	3.74	0.09	3.60
Sep-25	0.24	3.71	0.17	3.49
Oct-25	0.05	3.62	0.09	3.39
Nov-25	0.09	3.55	0.14	3.31
Dec-25	0.32	3.49	0.34	3.23

Source: BofA Global Research, Statistics institute (DANE)

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Exhibit 2: BofA's monetary policy rate forecasts for Colombia
We foresee a terminal rate of 6% at the end of the easing cycle in 2025

Month	Monetary policy rate (%)
Dec-22	12.00
Jan-23	12.75
Feb-23	12.75
Mar-23	13.00
Apr-23	13.25
May-23	13.25
Jun-23	13.25
Jul-23	13.25
Aug-23	13.25
Sep-23	13.25
Oct-23	13.25
Nov-23	13.25
Dec-23	13.25
Jan-24	13.00
Feb-24	13.00
Mar-24	12.75
Apr-24	12.50
May-24	12.50
Jun-24	12.00
Jul-24	11.50
Aug-24	11.50
Sep-24	11.00
Oct-24	10.50
Nov-24	10.50
Dec-24	10.00
Jan-25	9.50
Feb-25	9.50
Mar-25	9.00
Apr-25	8.50
May-25	8.50
Jun-25	8.00
Jul-25	7.50
Aug-25	7.50
Sep-25	7.00
Oct-25	6.50
Nov-25	6.50
Dec-25	6.00

Source: BofA Global Research, Central Bank (BanRep)

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LDM Strategy: Headwinds from the North

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The sharp selloff in US rates has pushed local rates higher across LatAm. Colombia is not an exception, with the belly and back end of the curve selling off by roughly 160bp and 190bp, respectively. While front-end rates have also trended higher, the curve has been less sensitive as it has been pegged by monetary policy, which has led to a steepening of the curve. In FX, another global shift to a stronger dollar narrative has weakened the Colombian peso (COP) along with the rest of EM FX.

Rates: Value that is tough to unlock

Our view is that there are multiple mispricings along the local yield curves in LatAm. In Colombia, we remain convinced that the market is pricing an easing cycle that starts too early and is too shallow (Exhibit 1). We expect that still-high inflation and inflation expectations will push BanRep to maintain its hawkish stance and prevent them from launching an easing cycle this year. We also believe that BanRep will have space to lower rates beyond the roughly 9% that is priced by the market.

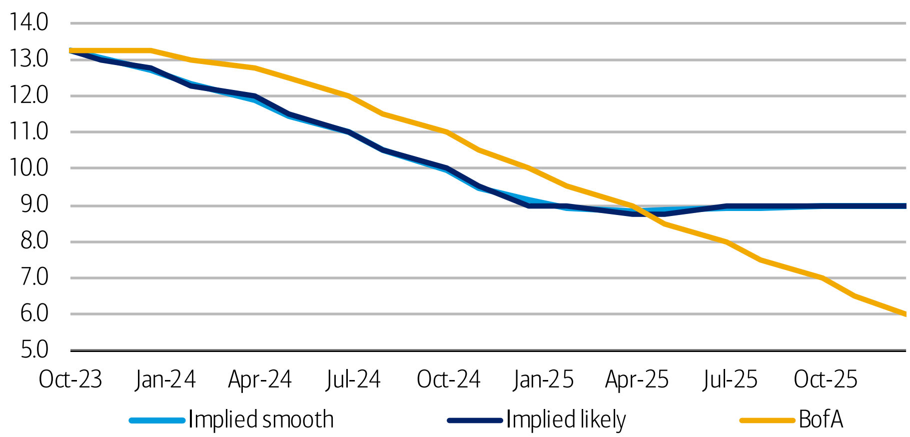
Therefore, we see value in both, paying the front-end and receiving the belly of the curve. However, we acknowledge it is particularly difficult to fade the mispricings amid a continuation of the US rates selloff. In our view, given the uncertainty in US rates, the best way to position is to avoid exposure to the level of the curve and, in that sense, we favor flatteners between front-end and belly and keep recommending 1s5s flatteners (current: -250). Risks to our view include a significant steepening in US rates or dovish surprises from BanRep.

FX: Domestic support to COP amid global pressures

We believe that the hawkish BanRep outlook should provide some support to COP, as it may help keep its appeal as a carry currency for longer than initially expected. However, carry is only relevant when uncertainty around the global backdrop is relatively low and, therefore, a strong dollar narrative may dominate price action in the short term. Yet, we believe COP may outperform the rest of LatAm once headwinds from US rates and the strong dollar dissipate.

Exhibit 1: Market-implied policy rate vs. BofA forecast (%)

The market is pricing an easing cycle that starts too early and is too shallow



Source: BofA Global Research, Bloomberg

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News and Views

Brazil: No major changes in Brazilian Central Bank's (BCB) consensus survey

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According to the Brazilian Central Bank's (BCB) weekly survey (Focus), GDP growth expectations were stable for the whole forecast horizon: 2.92% for YE23, 1.50% for YE24, 1.90% for YE25 and 2.00% YE26. The same happened to Selic consensus: unchanged at 11.75% for YE23, 9.00% for YE24, 8.50% for YE25 and YE26. Median IPCA forecast slightly increased for 2024, to 3.87% (from 3.86%), while stood still for 2023 (at 4.86%), 2025 (3.50%) and 2026 (3.50%). At last, exchange rate expectations compared to the previous week showed a slight depreciation for 2024 (R$5.02/US$1 from R$5.00/US$1) and 2026 (R$5.20/US$1 from R$5.19/US$1) but remained stable for 2023 at R$4.95/US$1 and 2025 at R$5.10/US$1.

- **To follow:** This week focus should be on the August Industrial Production, for which we expect an increase by 0.6% momsa (vs -0.6% in July). For now, consensus for IPCA is above our forecasts of 4.8% for 2023-end and of 3.7% for 2024-end. Regarding interest rates, consensus view is similar to our year-end Selic for 2023 at 11.75%, but more dovish for the rest of the 2024-26 horizon. GDP consensus is below our 3.0% growth expectation for 2023, and 2.2% in 2024. Regarding the FX, market participants foresee a weaker currency than us in year-end 2023 (R$4.90/US$1), stronger than us for YE24 (R$5.10/US$1) and in line for YE25 (R$5.20/US$1).

Brazil: trade balance accumulated $71.3 bn surplus YTD in September

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The trade balance posted a US$8.9bn surplus in September (following a $9.5bn surplus in August). Exports totaled US$28.4bn in the month, declining 1.8% yoy, while imports were down by 21.8% yoy, now at US$19.5bn. This is another monthly record result.

Soybeans and corn exports increase continued to support the month´s reading. The increase in oil prices also contributed positively for the result. Manufactured goods, on the other hand, contracted in September.

- **To follow:** We expect a trade balance surplus of US$65bn in 2023 (upside risks).

Brazil: net formal job creation surprised to the upside in August

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The CAGED (General workforce registration system) reported the net creation of 220,884 formal jobs in August (from 142,702 in July), above market expectations of 173k jobs. July's reading was slightly revised up to 143k jobs (from 142.7k). In 12-months accumulated terms, net formal job creation declined to 1.5mn (vs 1.6mn previously). In seasonally adjusted terms, net job creation was of 101k (vs +75.4k in July), however 3mma continued to move down. Recovery was widespread amog sectors, notably better performance of industrial sector.

- **To Follow:** Services sector continued to be the greatest contributor to the result.

Mexico: Remittances were in line with expectations at US$5.6bn in August

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Remittances in August were in line with expectations at US$5.6 bn (E. 5.6 bn, BofA 5.6 bn). In annual terms, remittances increased 8.6% yoy (vs 7.9% last year), the number of remittances increased 5.2% (vs 6.9% last year) while the average remittance increased 3.3% yoy (vs 0.8% last year) to US$403. In MXN, remittances fell 8.4% yoy (vs +8.1% last year), while the average remittance fell 12.8% yoy (vs +1.0% last year). Year to date, remittances totaled US$41.5 bn (15.5% ytd).

- **To follow**: Remittances keep growing in dollar terms, which continue to support the MXN and activity in Mexico (although in pesos remittances are falling and hence there is less support for consumption).

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