Emerging Insight

LatAm: LatAm in a volatile world

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Global

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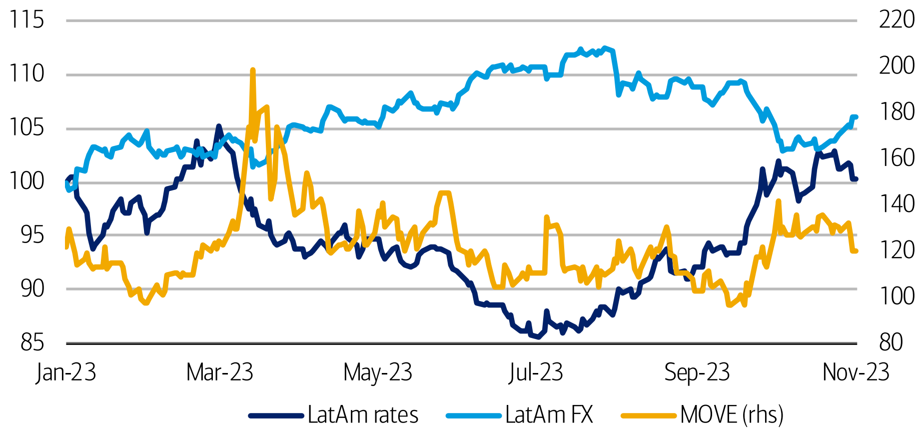
For a complete list of our open and closed trade ideas over the past 12 months, see our Global Emerging Markets Weekly.

Key takeaways

- Our expectation is that core rates volatility will continue to be high, with a US economy that remains resilient.
- We are skeptical about a sustained rally in LatAm FX and prefer risk-reward of selectively expressing views in rates.
- We like receivers in Brazil and Colombia, we turn bearish on Mexican rates and like paying inflation breakevens in Chile.

By Ezequiel Aguirre and Christian Gonzalez Rojas

Chart of the Day: Volatility in US rates creates a challenging backdrop for LatAm local markets
Average LatAm FX and rates (Index = 100) vs MOVE index



Source: BofA Global Research, Bloomberg

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LatAm in a volatile world

Most of the data recently released in the US points to still strong growth and a tight labor market. This means no big rally in US yields is likely in the very near term. Our expectation is that global uncertainty will continue to be high. Therefore, we remain skeptical about a sustained rally in LatAm FX and prefer to selectively express our views in rates, where risk-reward is more attractive. We favor receivers in Brazil, where real yields are high and growth is slowing down, and in Colombia, where policy is shifting in a more business-friendly direction. But we turn more bearish on Mexican yields given strong growth, loose fiscal policy, and sticky services inflation. And we like paying Chilean breakevens which already price average inflation at target.

LatAm rates in a volatile world

Most of the data recently released in the US points to still strong growth and a tight labor market. This means no big rally in US yields is likely in the very near term, so we remain selective in our fixed income recommendations. We favor receivers in Brazil, where real yields are high and growth is slowing down, and in Colombia, where policy is shifting in a more business-friendly direction. But we turn more bearish on Mexican yields given strong growth, loose fiscal policy, and sticky services inflation. And we like paying Chilean breakevens which already price average inflation at target.

Brazil: High real yields and slowing growth

We maintain our Jan-27 DI receiver (current: 11.01) recommendation. Brazil offers one of the highest real interest rates across major emerging markets at around 8% and underlying inflation is gradually declining allowing the central bank to continue with its easing cycle. Core inflation declined to 5% in September (from 5.2% in August) and to 4.9% in the mid-October release (Exhibit 1). We forecast IPCA inflation at 4.8% in 2023 and 3.7% in 2024.

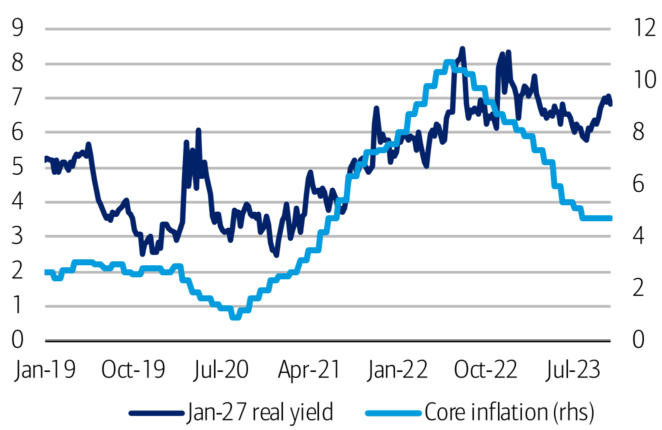
The central bank will keep cutting its benchmark rate to 11.75% by end-2023 and to 9.5% by end-2024. Market pricing has the benchmark rate ending also at 11.75% in 2023 but at 10.75% in 2024. We believe the market has overreacted to President Lula's comments about fiscal spending while we consider recent BCB board appointments to be more market-friendly than initially feared. Risks to the Jan-27 DI receiver are a deterioration of fiscal risks, a hawkish turn by the BCB, a sharp acceleration of inflation or sharply higher US rates.

Mexico: Risks are biased toward higher bond yields

We believe risks are biased toward higher bond yields in the near term. The economy grew 3.7% in 3Q, widening even further the positive output gap. Furthermore, we forecast a strong 1H24 driven by domestic investment and fiscal spending (see Large fiscal impulse will keep supporting growth). Meanwhile, services inflation will remain elevated, as we expect double-digit increases to the minimum wage in 2024.

Tight monetary and loose fiscal policy in both the US and Mexico, imply that long-term bond yields will remain with risks to the upside (Exhibit 2). While headline and core, but not services, inflation are coming down, we do not expect them to go all the way to the 3% target. And with a presidential election scheduled for June 2024, we do not expect the central bank cutting rates until 2H24.

Exhibit 1: Brazil Jan-27 real yields and core inflation (%)
Core inflation declined to 5% in September, but real yields rose



Source: BofA Global Research, Bloomberg, Haver.

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Exhibit 2: 10y MBono vs US spread (bp)
Tight monetary and loose fiscal policy imply upside risks to long-term yields

Source: BofA Global Research, Bloomberg

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Chile: Curb your enthusiasm on inflation

Chile's five-year inflation breakevens have come all the way down to 3.0%, from 5.8% a year ago (Exhibit 3). That is, the market is already pricing that over the next five years, Chile will deliver inflation at the target on average. We disagree, so we recommend buying 5y inflation breakevens (current: 3.02).

First, inflation has historically averaged more than 3% in Chile – 3.9% since 2004 and 4.6% since 2013. Which means that looking forward one should factor in *some* inflation risk premia. Around 50bp of risk premia does not seem far-fetched.

Second, social demands imply there will likely be political pressures for elevated fiscal spending in future years. Indeed, Chile averaged a budget *surplus* of 0.8% in 2004-2019 while in our forecasts it will run a *deficit* of around 2% on average in 2023-2025. Risks to buying 5y inflation breakevens are a sharp deceleration in economic activity or contractionary fiscal policy that pushes inflation below-target for a significant period.

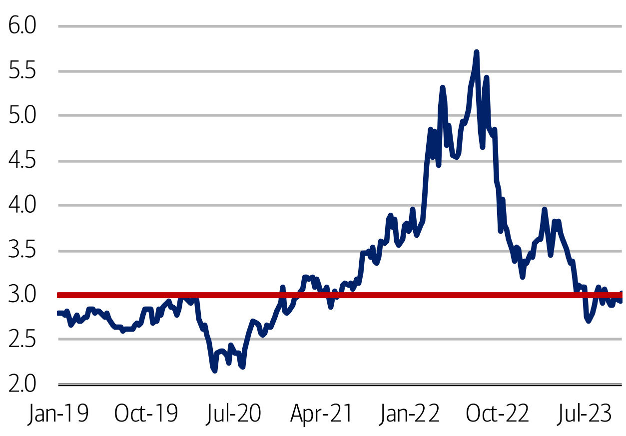
Colombia: Fade mispriced terminal rate, but be cautious on US rates

We like to receive 5y IBR vs SOFR (current: 442). Despite having the most persistent inflationary dynamics in LatAm, our view is that Colombia will be able to embark on a deeper easing cycle than the market expectation, cutting rates closer to 6.0% by 2025-end (Exhibit 4). Granted, the still-high headline and core inflation, as well as the sticky inflation expectations, will most likely push BanRep to delay the easing cycle until at least January 2024, slightly after the December 2023 market expectation (see Pushing back the first rate cut). Yet, the space to cut beyond 8.5% once inflation pressures subside seems evident, and a decelerating domestic economy may provide BanRep with an additional reason to be aggressive during the cutting cycle.

While US rates have rallied modestly on the back of payer unwinds after the 10y rate broke the 5% level, we prefer to be cautious until we clearly see fundamental macro data pointing to a sustained relief in core rates volatility. This will require to see evidence of a deceleration in US economic activity or an improvement in inflation dynamics. In our view, highly volatile rates continue to pose challenges to outright receivers in LatAm despite the attractive valuations. In our view, receiving 5y IBR vs SOFR allows to take advantage of the mispricing of the terminal rate in Colombia and to some extent limit exposure to US rates. Risks are a renewed selloff in US rates under a high beta in Colombian rates, a severe El Niño that may put pressure to Colombian inflation or hawkish BanRep guidance.

Exhibit 3: Chile 5y inflation breakeven (%)

Chile's 5y inflation breakevens have dropped to 3% from 5.8% a year ago



Source: BofA Global Research, Bloomberg

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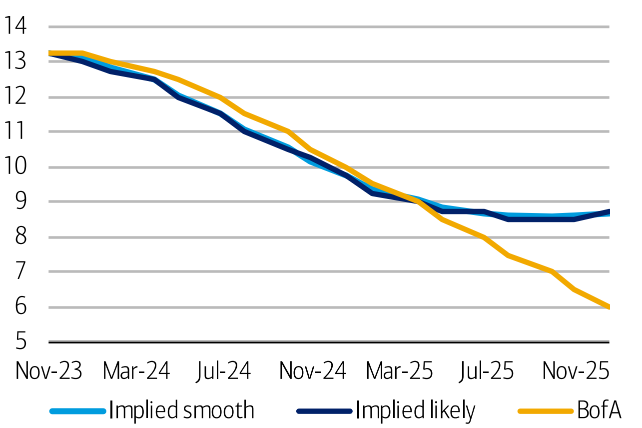
Exhibit 4: Colombia's market-implied policy rate vs BofA forecast (%)

Colombia should embark on a deeper easing cycle than the market prices



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LatAm FX in a volatile world

Higher global volatility amid uncertainty around US rates and a deterioration in geopolitical conditions around the world had a negative impact on EM FX, as the strong dollar narrative became dominant. With rates volatility recently stabilizing, LatAm FX has experienced a relief rally that was also supported by some idiosyncratic factors.

Double whammy dethroned LatAm FX carry

For a moment, LatAm FX had been the regional underperformer. This, in our view, has been the result of the double whammy of looser monetary policy in LatAm and rising volatility (Exhibit 5). Both forces have eroded LatAm's carry-to-vol ratios, triggering an unwind of the carry trades that had been largely popular in LatAm.

In previous reports, we argued that the volatility component of the carry-to-vol ratio would gain importance as central banks approach their easing cycles (see Don't fall into the carry-to-vol trap). More so if global factors become the main driver of rising global volatility, as the appeal of carry declines and the global risk premium effect dominates.

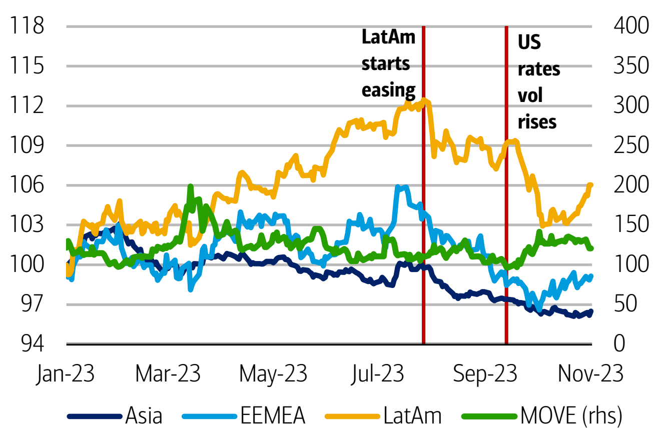
A relief rally that may not be sustainable

Most recently LatAm FX has rallied, in our view mostly driven by a stabilization – even a mild decline – in global rates volatility that has allowed idiosyncratic factors to dominate (Exhibit 5). The bulk of LatAm FX appreciation has taken place in Chile and Colombia, where CLP and COP have rallied by about 5.5% since the most recent trough (Exhibit 6).

In the case of CLP, the main driver of its outperformance was the central bank's decision to slow the pace of the easing cycle to 50bp while simultaneously pausing the reserve accumulation program and the unwind of its NDF position. In the case of COP, a market-friendly result in regional elections prompted a rally in both FX and rates, as the market repriced a lower risk premium on local assets. In contrast, the relief rally in the rest of LatAm has been more modest. On average, LatAm FX remains about 3% weaker than prior to the launch of the region's easing cycles. The fact that high carry does not explain the cross-sectional performance suggests, in our view, that risk-reward of carry trades remains unattractive.

We remain skeptical that the rally in LatAm FX will be sustainable in a highly volatile global backdrop. Our expectation is that global uncertainty will remain, unless US macro data shows more convincing evidence of a soft landing, where inflation converges to target and the economy decelerates, but avoids a recession. Thus, we remain neutral LatAm FX and prefer to express our views in rates, where risk-reward is more attractive.

Exhibit 5: EMFX spot returns and US rates volatility (Indices)
LatAm underperformed, but a relief rally materialized



Source: BofA Global Research, Bloomberg

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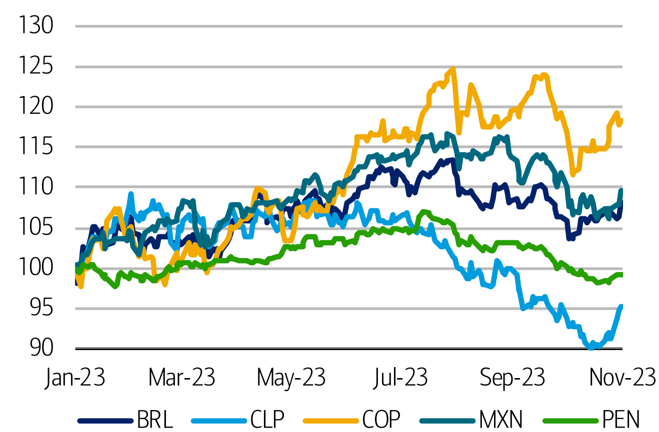
Exhibit 6: LatAm FX spot returns (Index Jan-23=100)
CLP and COP explain most of the recent rally in LatAm FX



Source: BofA Global Research, Bloomberg

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News and Views

Brazil: unemployment rate continues to go down in September

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Unemployment rate reached to 7.7% in September (vs 7.8% in August), according to the Nation-wide Job Market Survey (PNAD), in line with market's expectations. In seasonal adjusted terms, the result also went down to 7.7% (from 7.87 previously). The positive print came with higher occupation with formal contracts (compared to the previous quarter). Real income growth accelerated to 4.8% yoy (vs 4.6% yoy previously), as industrial sector real earnings increased 5.3% qoq sa.

- **To follow:** Looking ahead, as the underutilization rate drops, employment may surprise to the upside in the next months.

Mexico: Hurricane "Otis" Strikes Mexico's Pacific Coast

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The category 5 hurricane "Otis" struck southern Mexico's Pacific coast, hitting the state of Guerrero on October 25th, and is reported as the strongest storm ever to hit the country. With winds reaching 266 km/h, Otis damaged infrastructure that has the affected zone partially isolated in terms of access and communications. Contingency Plan known as "DN-III" has been deployed and military troops are in the area trying to restore accessibility and provide aid to households. Communications have not been fully restored. Preliminary information provided by governor of Guerrero Evelyn Salgado points out that 80% of hotels in Acapulco have been affected.

- **To follow**: Acapulco is the largest city in the state of Guerrero. Guerrero is about 1.4% of Mexico's GDP, while Acapulco represents about 45% of Guerrero's GDP (so Acapulco is about 0.62% of Mexico's GDP or about US$8.7bn). In Acapulco, tourism stands out as one of the main drivers of value. With most of the city and surroundings destroyed, the reconstruction cost would be large and would take many years (for comparison, Katrina's reconstruction cost in New Orleans was about US$ 100bn and took 5 years, Acapulco is smaller than New Orleans). Acapulco is one of the 55 cities that are included in Mexico's CPI, so there is likely to be some impact on inflation's variability. The disaster will also have some fiscal impact due to lower revenues and fiscal costs of assistance and reconstruction, but we believe it is unlikely to deteriorate the primary deficit by more than 0.5% of GDP in 2023/2024. The government has resources this year of MX$13.5bn (about US$ 0.75bn) in a line in the budget for natural disasters (FONDEN) plus the resources from an insurance (catastrophic bond) at about US$0.49bn (about US$1.2bn total).

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