Emerging Insight

Colombia – Contrarian Views on the Terminal Rate

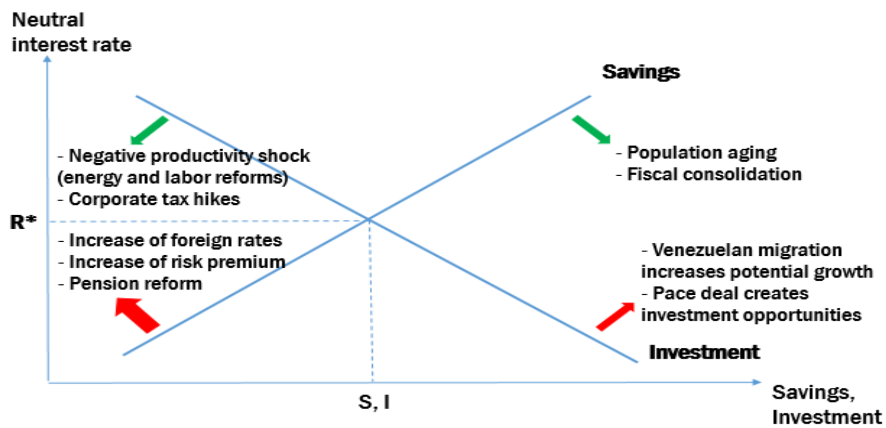
Key takeaways

- We forecast a 6% terminal rate for the monetary easing cycle by 2025, much lower than the 9% value embedded in market prices.
- Market is assuming either a huge increase in the neutral rate or a wage-price-expectations spiral, which we disagree with.
- We like to receive 5y IBR vs. SOFR, considering the mispricing of the terminal rate and limiting exposure to US rates.

By Alexander Müller and Christian Gonzalez

Chart of the Day: Forces shaping the neutral real monetary policy rate (R*) in Colombia

Neutral interest rate is fundamentally pinned down by the balance of savings and investment



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Colombia in Focus

Contrarian Views on the Terminal Rate

The COP IBR (OIS) swap curve is pricing a very high (8.98%) monetary policy rate by December 2025. This implies the market is assuming either a neutral real rate three times higher than the official estimate of the central bank (2.2%) or the economy entering a wage-price-expectations spiral that will make inflation drift above the 3% target for many years. We believe such assumptions are implausible.

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In the same vein, 5y5y forward rates – the cost of 5-year loans in the interbank market five years from now – is at 9.34%. And the yield on the 10y swap and the 10y local currency government bonds (TES) are at 9.14 and 11.94%, respectively. The 10-year yield is a rough proxy of the neutral (nominal) monetary policy rate because theoretically it should be equal to the expected average of future short-term rates..

The fact that the monetary policy rate – currently at 13.25% – is above the 10-year yield (9.14% in IBR, 11.94% in TES) is an indicator that policy is tight, in contractionary terrain. But the slope between the overnight and 10y rate has recently suspiciously narrowed. We see evidence of dislocation in the rates market. In this report we attempt to convince the reader of why the terminal rate of Colombia's (future) easing cycle, and long-term rates in general, seem inordinately high.

Central Bank currently estimates neutral real rate at 2.2%

On a quarterly basis, the Central Bank of Colombia (BanRep) publishes a monetary policy report that includes an estimate of the neutral real monetary policy rate. It is shown in a table at the end of the report, along with forecasts for the main macro variables (GDP growth, inflation, among several others). In the latest report (July 2023) the neutral parameter was estimated at 2.2%, 100bp higher than in 2019 (1.2%).

Granted neutral rate should be increasing, but not spiking

The "Chart of the Day", at the beginning of the report, illustrates what we think are the main forces shaping Colombia's neutral real monetary policy rate (denoted by R*). R-star is fundamentally pinned down by the balance of savings and investment. An event that makes national savings to decrease (increase) permanently will push the neutral rate higher (lower). By the same token, anything that makes investment in Colombia to increase (decrease) permanently will push the neutral rate higher (lower).

Arrows painted in red show the forces driving the interest rate up, and arrows painted in green the opposite (down). The fact the red arrow shifting the savings curve to the left (decrease, as savings are measured on the horizontal axis) is thicker than all other arrows means we believe this is the dominant effect. It is the combination of three shocks: higher interest rates in the US (and core economies), a higher risk premium (after the 2021 social protests and the 2022 presidential election), and the pension reform (that hasn't been approved by Congress yet). However, it would be a mistake to ignore the offsetting forces, the green arrows, preventing a larger increase in the neutral rate.

As a price-taker, open economy, foreign rates matter a great deal to Colombia

The conventional wisdom these days seem to be that the world is entering a new normal of much higher interest rates. US running bulky fiscal deficits, even with full employment; nearshoring of supply chains demanding new investments; artificial intelligence boosting productivity; and the pandemic increasing the natural rate of unemployment, because of churning and worse matching, so economies are more overheated than previously thought (and will require higher rates to get normalized).

The abovementioned arguments deserve merit. But people forget interest rates across the world have been falling for decades. The forces driving that decline haven't gone away. Populations are still aging (saving more for retirement if expecting to live longer). Income inequality was exacerbated by the pandemic (rich people have higher propensity to save). The UN's sustainable development goals (elimination of poverty by 2030) and financial inclusion should be conducive to increase of incomes (and savings). Shortage of global low-risk assets. Secular stagnation and Japanization risk in mature economies. In the case of Colombia, understanding global interest rates is critical to predict where the neutral rate will be. It is fair to question what forces dominate, by how much, and if permanently or not.

Colombia's risk premium may not increase that much after all

In a similar logic as the effect of higher global interest rates, a higher risk premium associated to Colombian financial assets induces domestic savings to leave the country. Colombia's 5-year CDS, the most liquid, spiked 304bp between year-end 2020 and October 2022, following the social protests of 2021 and the 2022 presidential election (when a leftist candidate won the presidency for the first time in history). Before then, Colombia had been the only South American country where a leftist political party had never won a presidential election.

Something that makes Colombia distinctly different in LatAm, at the current juncture, is that there is no country implementing (or debating) so many structural economic reforms at the same time. They are six reforms: tax, energy, pension, labor, health, and land. Only tax and energy are under way. The rest of reforms still need Congress approval. One key fact is that in early 2023 the ruling coalition in Congress broke down, with its number of seats falling from over 70% to around 35%. This is forcing the government to moderate the reform proposals.

Tellingly, the 5-year CDS is now only 150bp wider than in December 2020, not 304bp. The uncertainty of the reform agenda may not last for a long time. Presidential terms in Colombia are rather short, four years, vis-à-vis 6 years in Mexico, for instance.

Pension reform bill has been watered down substantially

The pension reform proposal – which can be summarized as diverting a large flow of contributions from the 401k-like AFPs to the pay-as-you-go regime (Colpensiones) and use that flow of money to pay for new pensions (to underprivileged groups of society) – has been watered down a lot. We wrote two reports on this topic, one analyzing the radical version of the bill (see Pension Reform, Harmful for the Balance of Payments) and another about the new text (see Understanding the Fine Print in Pension Reform). The bottom-line is that the moderate version of the bill has a much smaller negative impact on savings.

Overlooked domestic forces pulling down the interest rate

We believe the energy reform (already in progress) and the labor reform (under debate in Congress) will cause a negative productivity shock that reduces trend economic growth. Lower trend growth, in turn, implies the returns to investments will diminish. Investment should go down, putting downward pressure on the neutral rate. Likewise, the two tax reforms that just kicked-in (Duque's and Petro's) have substantially increased corporate taxes, which should also negatively impact investment. On the savings side, fiscal consolidation (with the Petro administration pledging to respect the fiscal rule) and the aging of the Colombian population partly offset higher foreign rates, the higher risk premium, and the pension reform.

Lack of fiscal dominance makes wage-price spiral unlikely

Since BanRep adopted inflation-targeting as the monetary framework in the early 2000s, inflation has suffered severe shocks such as the rise of global commodity prices in 2007-08 and the triple whammy of 2015-16 (El Niño, truckers strike, sharp COP depreciation). In all those occasions, inflation converged back to the 3% because BanRep made the right decision, hiking rates even in a procyclical way (when GDP was slowing down sharply, like in 2015-16). Currently, the ex-ante real monetary policy rate is at 7.36%, the record-high of the inflation-targeting period whose median value is 1.24%.

There is no fiscal dominance in Colombia. The finance minister only has one vote out of seven in BanRep's board, and the six others have a long tradition of being professional economists. We agree that the high indexation of prices (over 40% of items in CPI are indexed to the previous December's yoy inflation rate, the minimum wage, or the UVT tax unit) will likely prevent inflation from converging to BanRep's tolerance range (2% to 4%) in 2024. But 2025 is plausible. We forecast inflation of 3.5% by year-end 2025.

We forecast 6% terminal rate for easing cycle, by 2025

In our scenario, the easing cycle – which we expect to begin in January 2024 – will have a terminal rate of 6%, to be achieved in December 2025. The initiation of the easing cycle could be delayed by El Niño – if the effects on inflation are very strong – but ultimately the terminal rate of the cycle should be the same. Since the inflation target was lowered to 3% in 2010, as the monetary regime gained credibility, the median spread between BanRep's policy rate and the US Fed has been 350bp (minimum value of 150bp). Our scenario assumes that the Fed funds rate (upper bound) will be at 4% by December 2025, in line with BofA's US economics team forecast.

LDM Strategy: There is value in Colombian rates

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Receive 5y IBR vs. SOFR

We like to receive 5y IBR vs. SOFR (current: 461, entry: 471, target: 360, stop: 530, see our report: EM Alpha: Colombia: Receive 5y IBR vs. SOFR 25 October 2023). In our view, this allows to take advantage of the mispricing of the terminal rate in Colombia and to some extent limit exposure to US rates. Receiving the spread is also less costly in terms of carry+roll (-15bp in 3-month), relative to outright receivers (-22bp in 3-month).

In our view, the main trigger for the spread to rally is a sustained decline in core rates volatility. Yet, short-term domestic factors could also be supportive. A market-friendly result in regional elections on October 29 may provide reassurance that implementation of unfriendly policies in Colombia may be unfeasible, which could reduce risk premium. Positive news on the fiscal front may also act as a domestic trigger. Still, risks to the trade 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.

News and Views

Brazil: September Central Government Primary registered a R$11.5 bn surplus

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The Central Government reported a primary surplus of R$11.5bn in September (vs R$26.4bn deficit in August), after four consecutive months of negative prints. The result was close to market expectations at R$11.0bn. Total revenues were up to R$201.3bn (from R$170.6bn), while transfers to states and municipalities were down to R$31.1bn (from R$36.1bn), resulting in net revenues of R$170.2bn (from R$134.5bn), 10.7% in real yearly terms. Total expenditures were R$158.7bn (from 161.2bn), increasing 11.5% yoy in real terms. The central government primary deficit went to R$73.1 bn or -0.69% of GDP in September (from -R$73.7bn or -0.71% of GDP in the previous month) in 12-month accumulated terms.

- **To follow:** The fiscal scenario has been challenging, as Minister of Finance is aiming to join efforts for approving several legislative measures to boost revenues next year. All in, we continue to forecast a Central Government Primary Balance at -0.9% of GDP in '23 and -0.5% in '24.

Mexico: Biweekly headline inflation in 1H October surprised to the downside at 0.24%

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Biweekly headline inflation in 1H October surprised to the downside at 0.24% (E. 0.33%, BofA 0.37%). However, core inflation was above expectations at 0.24% (E. 0.19%, BofA 0.20%). Core inflation was mainly driven by higher-than-expected (processed) food inflation at 0.29% (sugar at 5.60%) and other services excl. housing and education inflation at 0.41% (airfare at 11.04%). The main drivers to the downside in non-core were lower than-expected fruits and vegetables inflation at -2.27% (tomato at -9.67%) and lower-than-expected livestock inflation at –1.23% (chicken at -3.28%). In annual terms, headline inflation is now at 4.27% yoy from 4.47% yoy, while core inflation is now at 5.54% yoy from 5.74% yoy a fortnight ago. Meanwhile, services inflation decreased at 5.33% from the rebound of 5.37% registered a fortnight ago.

- **To follow**: Banxico will like the overall fall in inflation, but core remains relatively sticky, in particular services. We continue to expect Banxico on hold for many months.

Mexico: Unemployment rate fell to 2.88% nsa in September

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Unemployment rate in September was lower than expected at 2.88% nsa (E. 2.93%, BofA 3.05%), down from 2.96% in August. Once adjusted for seasonality, unemployment fell to 2.70% sa from 2.72% in August. The participation rate increased to 60.53% sa, from 60.35% in August, the informality rate fell to 54.18% sa, from 55.09% in August, while the underemployment surprised to the upside to 7.91% sa, from 7.69% in August. Finally, the urban unemployment increased slightly to 3.35% sa from 3.33% in August.

- **To follow**: The labor market remains very tight, and the unemployment rate fell again. This will continue to put pressure on wages and hence on Banxico.

Mexico: Trade balance posted a deficit of US$1.5bn in September

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Trade balance in September posted a surprisingly wider deficit than expected at US$1.5bn (E. deficit US$0.4bn). Once adjusted for seasonality, the trade balance showed a deficit of US$0.8bn, in contrast to the deficit of US$0.1bn in August. Exports increased 0.3% mom sa (vs -0.4% in August) mostly due to crude oil exports (+9.6% mom sa). Imports grew 1.7% mom sa (vs 1.5% in August) mostly driven by intermediate goods imports (+1.0% in August). Consumption goods imports rose 3.5% mom sa (vs 6.2% in August) while capital goods imports increased 3.6% mom sa (vs 0.2% in August). In oil terms, oil imports increased 6.3% mom sa, while non-oil imports increased 1.2% mom sa.

- **To follow**: The trade balance remains contained, consumption remains strong and investment as both types of imports are increasing.

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