Emerging Insight

LatAm – Unlocking value in local markets

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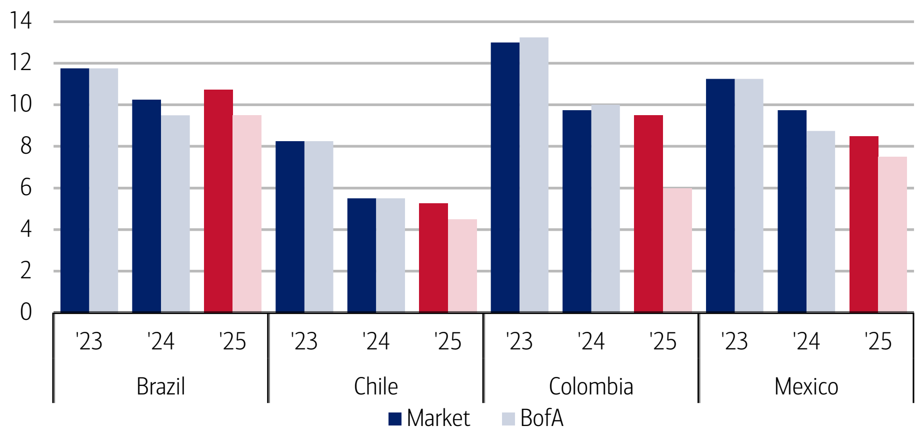
For a complete list of our open trades and closed trades over the past 12 months see our latest Global Emerging Markets Weekly.

Key takeaways

- LatAm is currently navigating a complex environment for local markets following the rise in US rates.
- We see market pricing of terminal rates in LatAm as clearly dislocated, leaving select opportunities to unlock value.
- We like outright receivers in Brazil, receivers vs US in Mexico, and flatteners in Colombia.

By Christian Gonzalez and Antonio Gabriel

Chart of the Day: Market-implied policy rates vs BofA forecasts
Pressure from US rates has resulted in a significant mispricing of terminal rates in LatAm



Source: BofA Global Research, Bloomberg

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LatAm: Unlocking value in local markets

LatAm is currently navigating a complex environment for local markets. In the US, a November hike is still possible, the Fed continues to give hawkish signals, and US rates have failed to stabilize credibly. This backdrop supports the unwinding of carry trades, even if BanRep and Banxico remain on hold, and poses a challenge for receivers, even if central banks in Chile, Brazil and Peru have already launched their easing cycles. At the same time, market pricing for terminal rates in LatAm is clearly dislocated, leaving opportunities to selectively unlock value (Chart of the Day).

See our full analysis in our latest report: EEMEA vs LatAm – who has more room to cut?

We have strong conviction that the best way to unlock value in this challenging environment is by remaining selective on receivers or favoring relative value trades. In Brazil, we prefer outright receivers as the curve shows one of the most evident terminal rate mispricings in LatAm. In Mexico, we prefer the risk-reward of spread receivers against US rates to position for a repricing of Mexico's terminal rate without exposure to US rates. In Colombia, the curve is pricing an easing cycle that is too early, but also too shallow, leading us to favor flatteners.

In bonds, however, we believe total returns may be challenged by FX weakness, rendering them less attractive, in our view. In fact, we believe that crowded high-carry currencies (i.e., MXN, COP) may underperform in a risk-off scenario relative to those with more neutral positioning (i.e., BRL, CLP, PEN), and we remain short MXN/ZAR (current: 1.06).

Brazil: receive Jan-27 DI to position for a lower terminal

In Brazil, the BCB has cut rates once again by 50bp, to 12.75% (see Copom cuts 50bp: cruising speed). In our view, disinflation will allow the easing cycle to continue. However, we do not expect acceleration in the pace as risks to inflation remain, including higher oil prices and El Nino (see El Niño: Bad boy, whatcha gonna do?).

In recent months, the combination of the US rates selloff and some pickup in fiscal uncertainties have driven Brazil rates higher. At the same time, the balance of risks in Brazil is skewed towards a lower terminal rate relative to our current 9.5% forecast (Exhibit 1). In this context, we like to receive Jan-27 DI (current: 10.85) to fade the recent selloff and position for a potentially lower terminal rate (see Receive Jan-27 DI and After the Q3 fall, Winter… 6 October 2023). Risks include deterioration of fiscal risks, higher inflation in Brazil, or higher US rates.

Mexico: receive 5y TIIE vs US to minimize exposure to US rates

The market has gradually been moving closer to our call for a late start of the easing cycle in Mexico (see Mexico is having a good run = Banxico will likely take longer to cut). Yet, the curve is now pricing a policy rate path that is significantly above our forecasts for the later stages of the cycle. While we remain of the view that the terminal rate is likely to reach 7.5% in Mexico, the market is currently pricing a significantly higher 9.0% by end-2025 (Exhibit 2) (see Breaking monetary policy rules).

Yet, given the highly uncertain outlook for US rates, we prefer the risk-reward of Mexico vs US spread receivers over outright TIIE receivers. In our view, the spread between 5y TIIE and SOFR rates has widened too much amid an abnormally large positive beta of

Exhibit 1: We like to receive Jan-27 DI in Brazil
BofA vs market-implied policy rates (%)

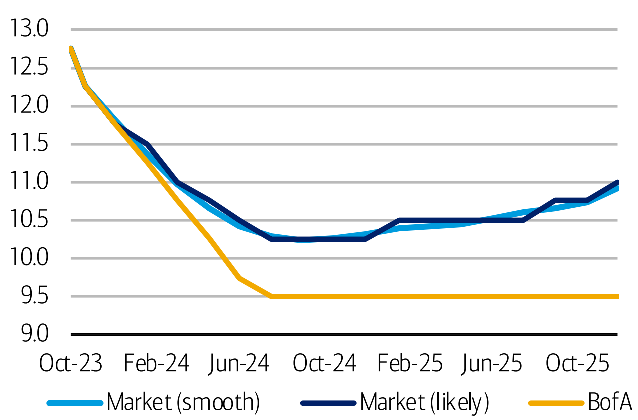

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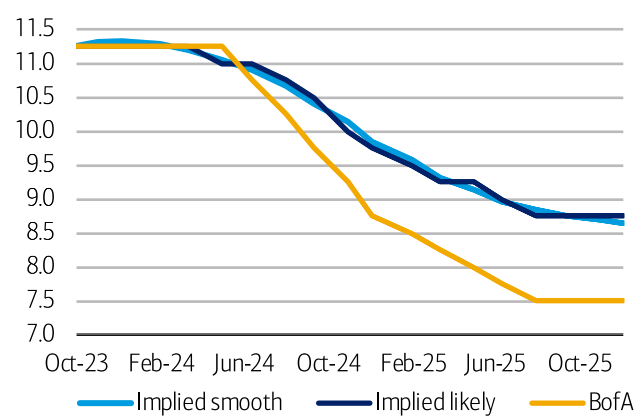
Exhibit 2: TIIE vs. SOFR spreads are our preferred expression in Mexico
BofA vs market-implied policy rates (%)



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Mexican rates to US rates. Hence, we like to receive 5y TIIE vs SOFR (current: 510) to position for a repricing of Mexico's terminal rate without meaningful exposure to US rates. Risks are a further selloff in US rates under a high-beta regime in Mexico, hawkish guidance on Mexico's neutral rate, or increased medium-term fiscal concerns in Mexico.

Colombia: cuts may be delayed, and the priced-in terminal rate is too high
Following a hot inflation print, we have updated our policy rate forecast for BanRep. As headline and core inflation are still high and proving stubborn, and risks from El Nino and higher oil prices remain, we now expect the central bank to stay on hold until the January meeting, later than the December market pricing (Exhibit 3). Additionally, we continue to expect a significantly lower terminal rate than the market.

We think 1y5y IBR flatteners (current: -266) are the best expression to position for a lower terminal rate and a delayed easing cycle, though continued pressure from US rates has challenged this view. Risks include a dovish turn from BanRep, lower-than-expected inflation or activity in Colombia, or ever higher US rates.

Chile: risk-reward is more attractive elsewhere
In Chile, the BCCh cut rates by 75bp following the larger-than-expected 100bp cut in July. While market-implied policy rates are roughly in line with our forecasts (Exhibit 4), we are still marginally more conservative than the market regarding the pace of cuts. If the BCCh continues easing policy as currently priced, we would expect sustained CLP underperformance. However, we see asymmetric risks around this view as we believe CLP weakness and the recent inflation surprise increase the risk that the BCCh needs to slow the easing pace by more than is currently priced by the market. In rates, while we also see a mispricing of the terminal rate, as in other countries in LatAm, we believe the risk-reward is more attractive for receivers elsewhere.

Peru: we begin to see value in Soberanos
In Peru, the BCRP delivered a second 25bp cut in its October meeting. Since the beginning of the easing cycle, the PEN has weakened by almost 3.5%. This led us to close our buy USD/PEN recommendation after hitting target (see Target hit, close buy USD/PEN). With further FX depreciation risks having moderated somewhat and bond yields drifting higher amid the US selloff, we begin to see value in long Soberanos positions. However, the risk-reward is limited by pressure from US rates, and we prefer to wait for core rates to stabilize before entering any position.

Exhibit 3: IBR flatteners continue to look attractive in Colombia
BofA vs market-implied policy rates (%)

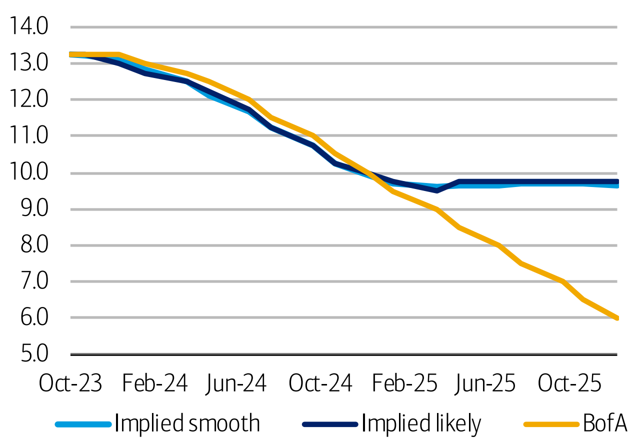

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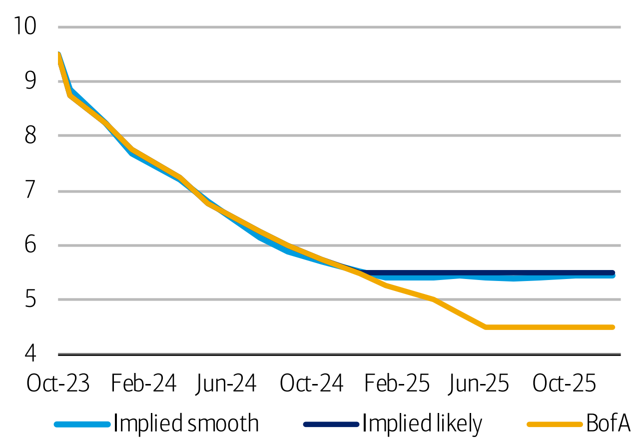
Exhibit 4: We expect a deeper easing cycle in Chile
BofA vs market-implied policy rates (%)



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News and Views

Mexico: Government issued a decree on fiscal stimulus to boost nearshoring

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According to the decree published in the Federal Government's Official Gazette, the fiscal stimulus is targeted at key export-focused industries like semiconductors, electric vehicles, medical devices, and pharmaceuticals. In particular, the stimulus consists of tax relief on investments in new fixed assets, with the rates of the relief ranging from 56% to 89%, depending on the nature of the asset. These tax breaks can be made effective anywhere in Mexico and are applicable for the 2023 and 2024 fiscal years.

- **To follow:** This will help investment to keep its strong record this year and throughout 2024, which in turn will boost growth, especially next year. However, this represents an upward risk for inflation, since we believe the economy is overheated and the output gap is nowhere near to closing.

Mexico: Headline inflation was below expectations at 0.13% in 2H September

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Biweekly headline inflation in 2H September was below expectations at 0.13% (E. 0.17%, BofA 0.17%). However, core inflation was in line with expectations at 0.11% (E. 0.11%, BofA 0.10%). Core inflation was mainly driven by higher-than-expected food inflation at 0.15% (sugar) and lower-than-expected education inflation at 0.01% (as the seasonality of education has ended). The main drivers to the downside in non-core were lower than-expected fruits and vegetables inflation at -0.98% (tomato) and lower than expected livestock at -0.20% (chicken). In annual terms, headline inflation is now at 4.47% from 4.44% yoy, while core inflation is now at 5.74% from 5.78% yoy a fortnight ago. Important to note that services inflation has rebounded to 5.37% yoy from 5.08% yoy a fortnight ago.

- **To follow**: Core inflation keeps falling but very slowly and the level is still high. Banxico will remain on hold for many months, in our view. We have Banxico starting its cutting cycle until after the June 2024 election.

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