EM Alpha

Peru: Fade the rally in USD/PEN

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GEM FI & FX Strategy
Emerging Markets Global

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The trade: Sell USD/PEN

We like to tactically sell USD/PEN (entry: 3.84, target: 3.70, stop: 3.90) to fade the recent selloff in PEN, which we believe is overdone. In our view, recent price action has been inconsistent with the evolution of fundamentals. Over a three-month period, the historical volatility of the trade is 3.5% (7.0% annualized) and the carry is 0.0% (0.3% annualized). Recent BCRP spot intervention (USD 216mn so far this month) may act as a trigger, while recent cabinet announcements have generally been market-friendly. Risks are a faster BCRP easing cycle, a stronger-than-expected dollar, weak copper prices or higher policy risks.

Underreacting to copper, overreacting to USD

The positive correlation between PEN and copper prices currently seems lower than usual. This decoupling may have been warranted in early 2023 given the sharp compression in risk premium after the exit of President Castillo in late-2022. However, given that political noise has substantially declined since then, we would expect the correlation to gain strength. A stronger correlation, coupled with our bullish outlook for copper, implies that PEN should strengthen.

Similarly, while the dollar has in general strengthened year-to-date, we believe that USD/PEN has overreacted. We should expect both a normalization in the usual dynamics between USD/PEN and overall dollar, as well as a weaker US dollar outlook to provide some additional support to our view.

Risk premium does not explain the selloff

We have strong conviction that the PEN selloff is not explained by higher risk premium. While a cabinet reshuffle has recently taken place, the outcome was generally market-friendly. Similarly, fiscal risks remain contained despite a marginal underperformance of fiscal targets. In fact, we believe that the short-term fiscal underperformance will be insufficient to trigger credit rating downgrades amid Peru's still low debt-to-GDP ratio.

Absent clear triggers, we turn to the bond and CDS market to understand if the market is pricing higher risk premium. If PEN underperformance is driven by the accumulation of risk premium, we should observe a wider spread between Peruvian and US rates or a wider CDS. Evidence suggests the market has not priced additional risk premium.

Macro outlook and FX intervention provide some support

Given the lower interest rates, the government stimulus plan, a rebound of agriculture and fishing, as well as new infrastructure, we expect GDP growth to accelerate in 2024 to 2.6% from -0.5% in 2023. Our expected growth is about 40bp higher than the Bloomberg consensus, which currently stands at 2.2%. Moreover, while still not large by historical standards, the central bank has stepped up intervention by selling USD in the spot market. So far, BCRP has sold USD 216mn this month. Yet, a wider intervention may provide additional support to PEN.

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

BCRP- Central Reserve Bank of Peru

Timestamp: 15 February 2024 10:48PM EST

Sell USD/PEN to fade the recent rally

We like to tactically sell USD/PEN (entry: 3.84, target: 3.70, stop: 3.90) to fade the recent selloff in the Peruvian sol (PEN), which we believe is overdone. In our view, recent price action has been inconsistent with the evolution of fundamentals. Over a three-month period, the historical volatility of the trade is 3.5% (7.0% annualized) and the carry is 0.0% (0.3% annualized). Recent central bank (BCRP) spot intervention (USD 216mn so far this month) may act as a trigger, while recent cabinet announcements have generally been market-friendly. Risks are a faster BCRP easing cycle, a stronger-than-expected dollar, weak copper prices or higher policy risks.

Underreacting to copper…

Given Peru's status as the world's second-largest copper producer, it is not surprising that PEN is highly correlated with copper prices. While this correlation tends to be weaker than in countries like Chile, it is still nonetheless meaningful.

However, more recently the positive correlation between PEN and copper prices currently seems lower than usual (Exhibit 1). This decoupling may have been warranted in early 2023 given the sharp compression in risk premium after the exit of President Castillo in late-2022. However, given that political noise has substantially declined since then, we would expect the correlation to gain strength.

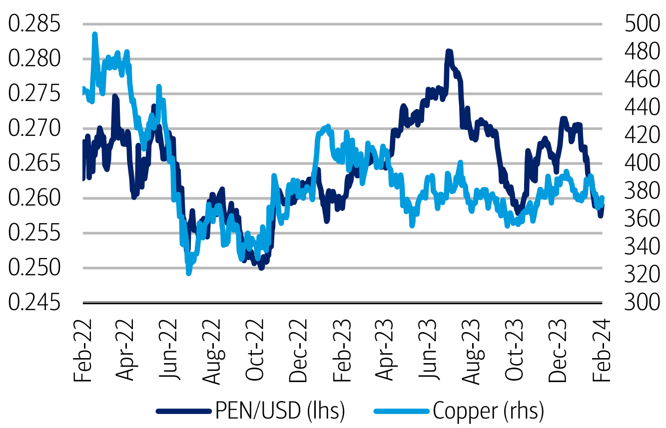
A stronger correlation, coupled with our bullish outlook for copper, implies that PEN should strengthen. In fact, our commodities team argues that green spending will continue to support copper demand in 2024 (see Copper markets tighten, despite China's battle with the 3Ds). Therefore, a tight copper market should push prices to USc/lb 420 by the end of 2024. Our bullish view on copper prices should provide an additional support to PEN.

… overreacting to USD

Similarly, while the dollar has in general strengthened year-to-date, we believe that USD/PEN has overreacted (Exhibit 2). We should expect support from the dollar on two fronts. First, the normalization of the usual dynamics between USD/PEN and the overall dollar should be consistent with a stronger PEN.

Second, while a hawkish Fed may provide near-term support to the dollar, we continue to have a bearish medium-term view on the US dollar (see 3 FX questions after a big macro week). This, in general, should be supportive for EM and PEN.

Exhibit 1: PEN/USD and copper prices
The positive correlation between PEN and copper prices currently seems lower than usual



Source: BofA Global Research, Bloomberg

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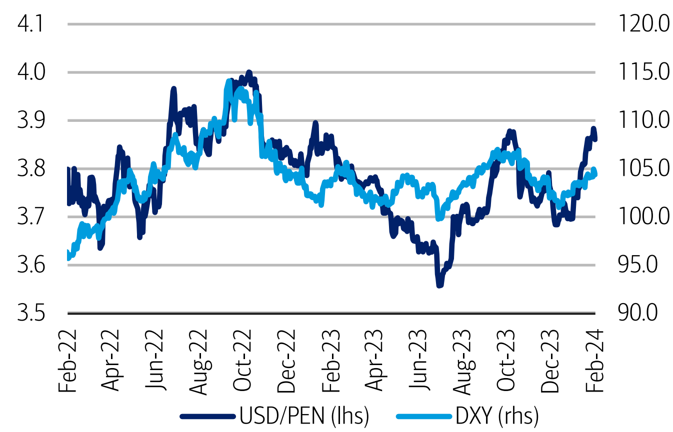
Exhibit 2: USD/PEN and DXY dollar index
While the dollar has in general strengthened year-to-date, we believe that USD/PEN has overreacted



Source: BofA Global Research, Bloomberg

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Risk premium does not explain the selloff

We have strong conviction that the PEN selloff is not explained by higher risk premium. While a cabinet reshuffle has recently taken place, the outcome was generally market-friendly. Similarly, fiscal risks remain contained despite a marginal underperformance of fiscal targets. In fact, we believe that the short-term fiscal underperformance will be insufficient to trigger credit rating downgrades amid Peru's still low debt-to-GDP ratio.

Absent clear triggers, we turn to bonds and credit default swaps (CDS) to understand if the market is pricing higher risk premium. If PEN underperformance is driven by the accumulation of risk premium, we should observe a wider spread between Peruvian and US rates or a wider CDS. We do not. The spread between 10y Soberanos and US Treasury bonds has even declined by about 13bp since PEN depreciation began. In the case of CDS, spreads have roughly remained constant over the same period. Therefore, evidence suggests the market has not priced additional risk premium. Hence, we believe that it is highly unlikely that PEN depreciation has been triggered by policy or fiscal risks.

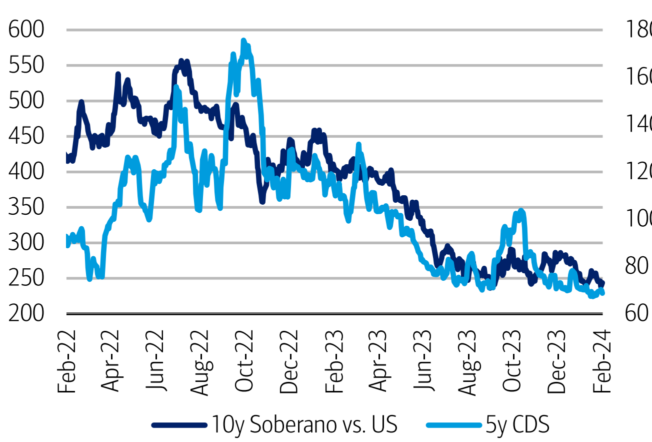
Macro outlook and FX intervention provide some support

Lower interest rates, the government's stimulus plan, higher real wages (because of lower inflation), the rebound of agriculture and fishing, and new infrastructure (2nd line of subway, Chancay port, expansion of Lima's airport) should make GDP accelerate in 2024. In fact, we forecast GDP growth at 2.6% in 2024. This is not only well above the -0.5% in 2023, but also roughly 40bp higher than the Bloomberg consensus, which currently stands at 2.2%.

We also see a substantially lower probability of a strong El Niño. In fact, the government's commission that studies El Niño has substantially reduced its estimated probability of a strong shock happening in Peru in 1Q24, to 3% (last official statement, January 12th). This estimate was 43% in November and 50% in October. This is good news for both inflation and economic activity.

We expect inflation to keep gradually declining towards the 2% target, reaching 2.55% by 2024-end. This should allow the central bank to continue cutting rates. Our baseline is that BCRP will keep the current pace of monetary policy easing, cutting at 25bp in each meeting until it reaches 4.0%. We do not anticipate BCRP to accelerate the pace of rate cuts, preventing a much more significant erosion of carry. Moreover, while still not large by historical standards, the central bank has meaningfully stepped-up FX intervention by selling USD in the spot market (Exhibit 4). So far, BCRP has sold USD 216mn this month. Yet, a wider intervention may provide additional support to PEN.

Exhibit 3: 10y Soberano vs. US spread and 5y CDS spread
Evidence suggests the market has not priced additional risk premium



Source: BofA Global Research, Bloomberg

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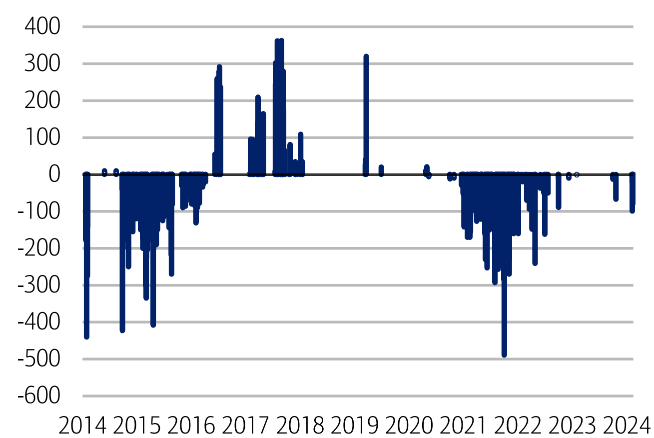
Exhibit 4: BCRP dollar spot purchases (USD mn)
BCRP has stepped up FX intervention by selling USD in the spot market



Source: BofA Global Research, Haver

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