

Long CLP/MXN

Background:

- An aggressive Fed hiking cycle and geopolitical risks jeopardise inflows to EM FX. Generally, LatAm FX has proved resilient. Local hiking cycles improved carry and strong commodities improved terms of trade. This has made LatAm currencies appealing to investors shifting capital from riskier regions impacted by the Ukraine conflict. Yet, currencies vary in exposure to risk sentiment, oil prices, and political risks.

Thesis: Given lower exposure to EM risk sentiment, the Fed hiking cycle, and elevated oil prices, I expect that the Chilean peso will outperform the Mexican peso. I also believe that Chilean political risk is minimal.

Risk sentiment exposure, Fed hikes

- I regressed an EM ETF over MXN and CLP to track EM risk sentiment exposure. The Mexican peso was much more exposed ($\beta = .46$, $R^2 = .36$) than the Chilean peso ($\beta = .22$, $R^2 = .11$) (Appendix A).
- As the Fed hikes rates and tightens financial conditions to rein in inflation, Mexico has additional exposure beyond general EM sentiment to the Fed hiking cycle due to the high proportion of its trade activity linked with that of the US.

Elevated commodity price exposure

- Even though Mexico is the second-largest oil producer in LatAm, they also import more than their peers, especially refined products. Over the past 12 months, Mexican oil imports accounted for 4.2% of GDP, while Chilean oil imports over the same period accounted for 3.4% of GDP.
- While Mexico's exports consist of finished products and durable goods, Chilean exports largely consist of metals, ags, lumber, and other commodities. Chilean exports will continue to perform better than Mexican peers in the near-term inflationary, slower-growth environment. I expect that elevated commodity prices will support superior Chilean terms of trade, which will strengthen the currency over the Mexican peso.

Chilean political risks

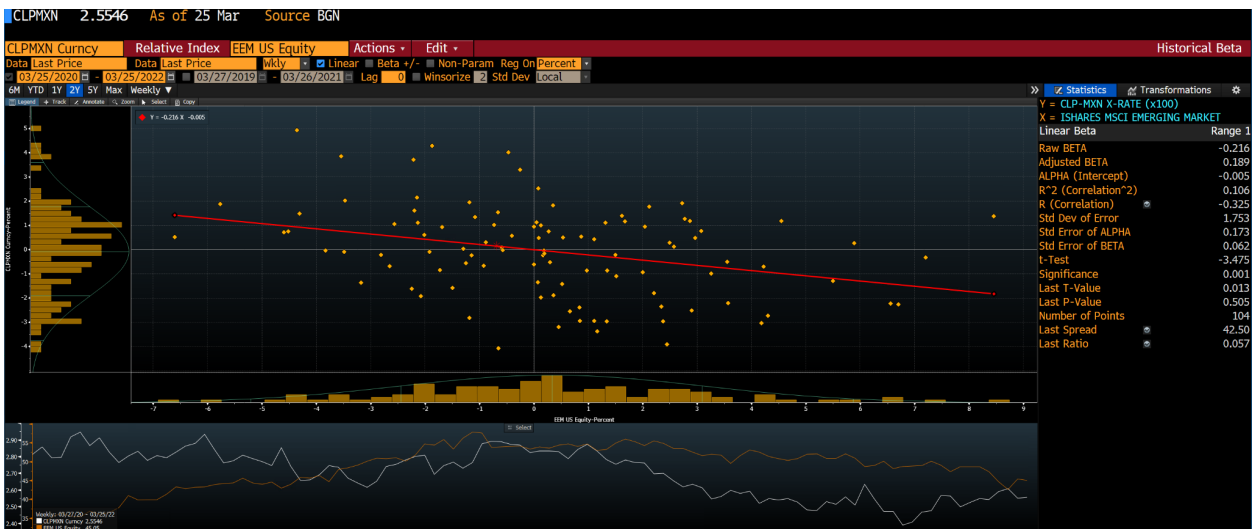
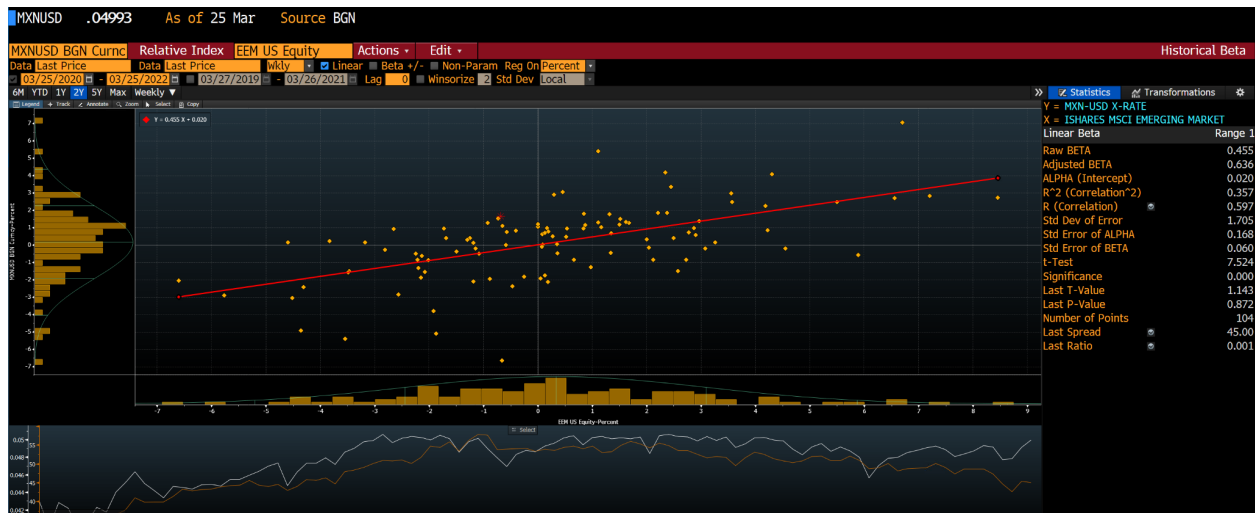
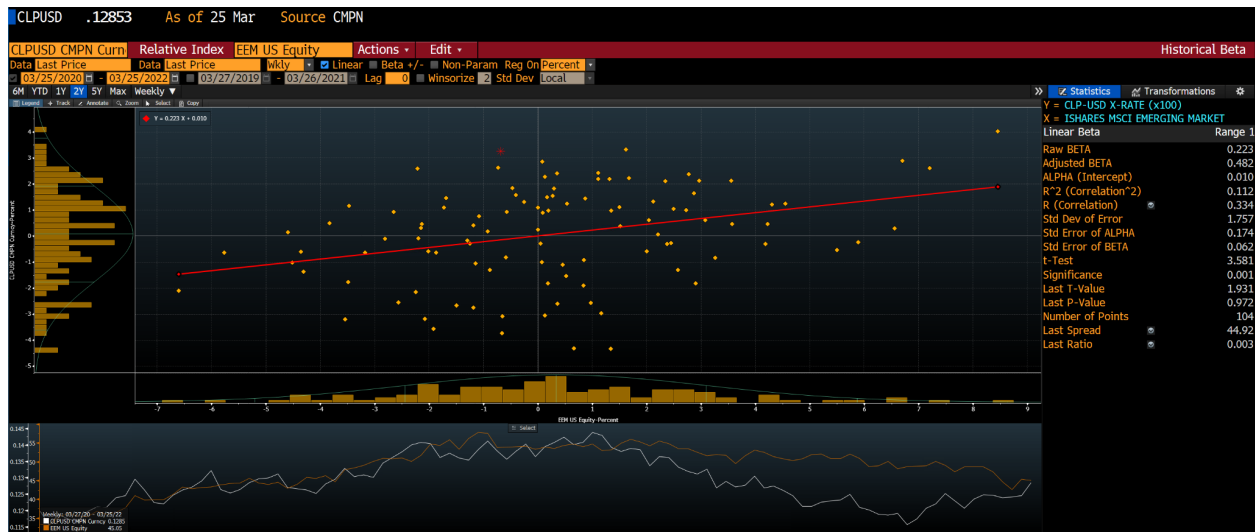
- In Chile, a leftist environmentalist Gabriel Boric has assumed the presidency and the Chilean constitution is being rewritten by largely left-leaning delegates. There are concerns that environmental policies, increased taxation, and a harsher economic stance may hurt activity.
- While I think that these are legitimate risks, I think Boric and the Constitutional Convention will have to toe a moderate line in order to implement reforms successfully. Moderate reforms could support social stability and economic development.

Inflows/outflows

- Chilean equity ETFs have posted greater inflows since November, whereas Mexican equity ETFs posted net outflows (Appendix B). This dynamic has intensified since the Ukraine conflict led to capital shifting away from risky/affected regions. These flows support the thesis that Chile has become relatively more attractive for foreign investment in comparison to Mexico. As the aforementioned reasons behind this shift intensify, the case will only build.

Appendix

A. Chilean, Mexican peso exposure to EM risk sentiment



B. Chilean, Mexican equity ETF inflows/outflows

