BNY MELLON

iFlow

MACRO MORNING BRIEFING

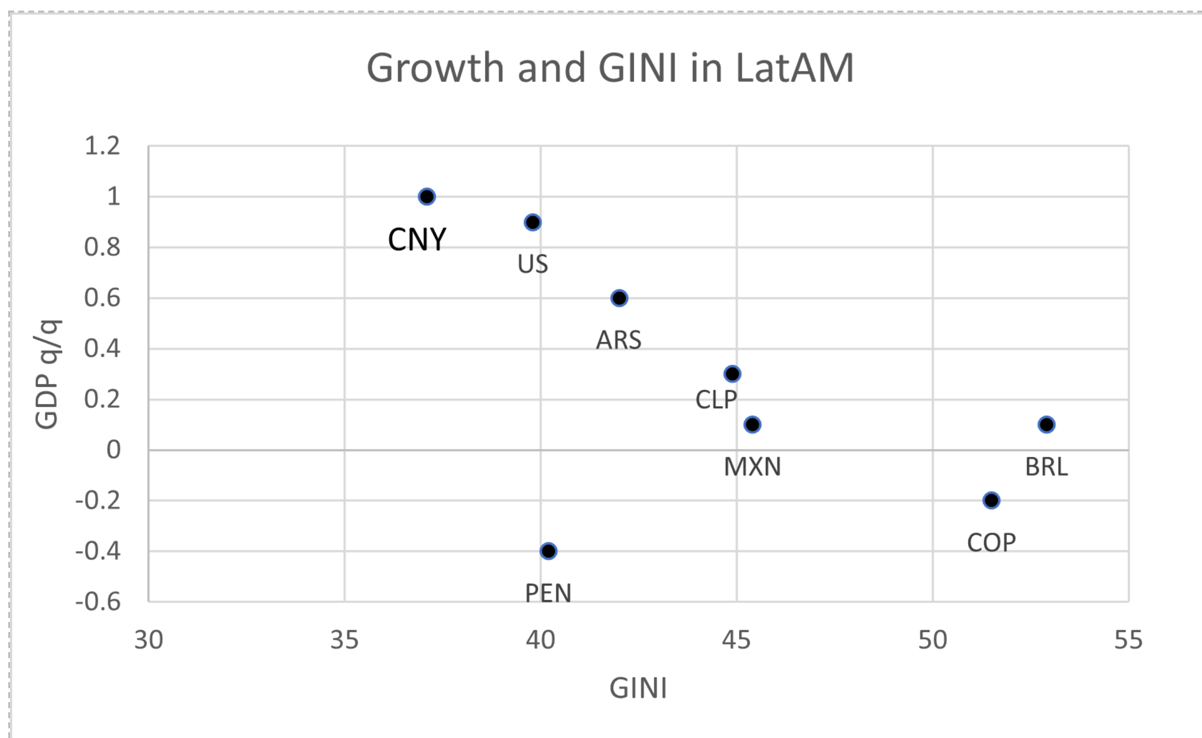
February 23, 2024

LatAm FX: Gauging The Risks & Rewards

- Tail risks for Latin America revolve around geopolitics, along with energy costs, El Nino weather, climate change, high global interest rates, and constraints on both fiscal and monetary policies.
- The region has suffered significantly in the post-pandemic recovery; dependence on China demand and commodities are part of the problem.
- Political risks have also been notable, but the 2023 trend to vote out incumbents in favor of anti-establishment candidates, e.g., in Argentina (and in Guatemala), is not expected to continue.
- FX volatility has fallen even as the USD as climbed and proven to be a constraint on faster easing of policy. The carry trade is intact but positioning and other risks require some premium to keep investors content.

The political risks for the region are captured in the Economic Policy Uncertainty index and show that 2024 is expected to have more risk than 2023, but far less than in more tumultuous times. This is important to consider – particularly when you look at the nations most at risk by this measure vs. the elections ahead. Brazil may be a current favorite for investors but remains at risk for political and economic policy noise that could surprise. The growth vs. social inequality risks across the region show clearly and may be a good place to start understanding the post-pandemic uncertainty. The GINI coefficient measures the income inequality of a nation – both the US and China are below 40 but all of LatAm higher. GDP is important as a counter to inequality in politics, as the social mobility of a nation matters significantly to politics.

GDP & Economic Inequality Drive LatAm Politics



Source: World Bank, BNY Mellon

Investors continue to point to political risks across the region as an impediment to larger investment flows. While many see Mexico's June 2 election as key, the ongoing debate in Brazil about fiscal rules seems more important to actual growth and risk. The rest of the region has 'neighborhood' woes, with the Venezuela/Guyana oil fields conflict adding to Colombia troubles, and Ecuador violence along with Uruguay’s version posing troubles for Argentina and Brazil. Violence and rule of law is a rising issue in 2024. Ecuador, long an anchor of stability in the region, has experienced a surge in violence caused by Narcos gangs. For Colombia, 2024 will be decisive as regards President Gustavo Petro's 'total peace' plan. Uruguay is now also requesting international support to fight gang violence. The relationship of the region to China vs. the US continues to be a divide, with the shift of Argentina notable. Dependence on food production and other commodities leaves the region sharply divided economically, with polarized politics and policies.

- **In Brazil**, the fiscal story is central. The Lula government has given key sectors another year of special benefits reduction payroll taxes, putting the fiscal deficit back at risk. The central bank has been patient and supported growth with early rate cuts. The Selic benchmark rate stands at 11.25%. Markets price it to fall to 9.5% by the end of the cycle. Inflation is forecast to ease to 3.9% by the end of the year, according to a Bloomberg survey. Price pressures are expected to stay low, with the inflation breakeven rate implied by 3y bonds at 4.44%, near a three-year low. This seems optimistic considering the political risk around the deficit and the BRL.
- **In Mexico**, recent protests against AMLO seem limited in their impact on the June election outcome, but congressional approval of reforms may be

problematic. Polls show Sheinbaum at 65% support and Galvez at 30% – need something more to change the risk here. Mid-February CPI at 4.45% y/y – down from 4.9% y/y – was sufficient to spark further talk of Banxico cutting in March. The slowdown in Q4 GDP to 0.1% q/q adds to the political pressure on Banxico. Expectations for 100bp of cuts in 2024 are priced.

- **In Argentina**, new President Milei has shifted from an "omnibus bill" to fix the fiscal situation to one where measures by decree attempt to right the deficits. The Chamber of Deputies is seen as a key block to faster reforms – leaving the risk of persistently high inflation. Rates at 100% and inflation over 250% leave no room for normalization until fiscal resolution. ARS and local assets remain out of liquidity focus for most investors, with IMF negotiations critical for getting a path towards re-entry into global capital markets.
- **In Colombia,** political risks are increasing as President Petro seems set to intervene more aggressively in the economy. Red tape from new regulations around the economy and uncertain tax risks may stall investments. The power of Petro on fiscal spending may mean a rise to levels that provoke larger opposition. This risk doesn't yet appear priced or in the economic uncertainty index. The central bank started modest rate cuts in January, -25bp to 12.75%. Forecasts are for more but with CPI expected at 5.7% and GDP at 1%, along with the difficult politics, the speed of change for rates is more dependent on COP, which broke some of its oil linkage from 2023. Only if oil squeezes over $85/bbl will that likely matter again.
- **In Chile**, the new Minister of Finance Marcel announced plans for taxpayer compliance. At the same time, the PGU (guaranteed universal pensions) seeks 1.5% of GDP – with overall tax increases of 2.7% of GDP if approved. This will dominate the debate to May, even with the PGU effective since December. Growth risks from tax hikes will be watched by investors. The central bank left rates at 8.25% in January – FX is clearly a factor in holding back, even with CPI falling below 5%. The market has backed away from more aggressive easing, with risk of 6.5% by year-end.
- **In Peru**, the cabinet changes are seen as noise and unlikely to succeed in shifting President Boluarte's low approval, stuck below 10%, with an 85% disapproval rating seen as linked to the recession. Peru's central bank has always intervened in markets, as the country's economy is highly polarized, and many citizens and companies have dollar-denominated debt with local banks. FX swaps and the sale of USD in the spot market have been the preferred method used by officials, especially near the close of each session, which indicates an intention to impact pricing. This last week was no different and likely puts pressure on PEN short positions, likely keeping the 3.80-3.90 zone open for further intervention.

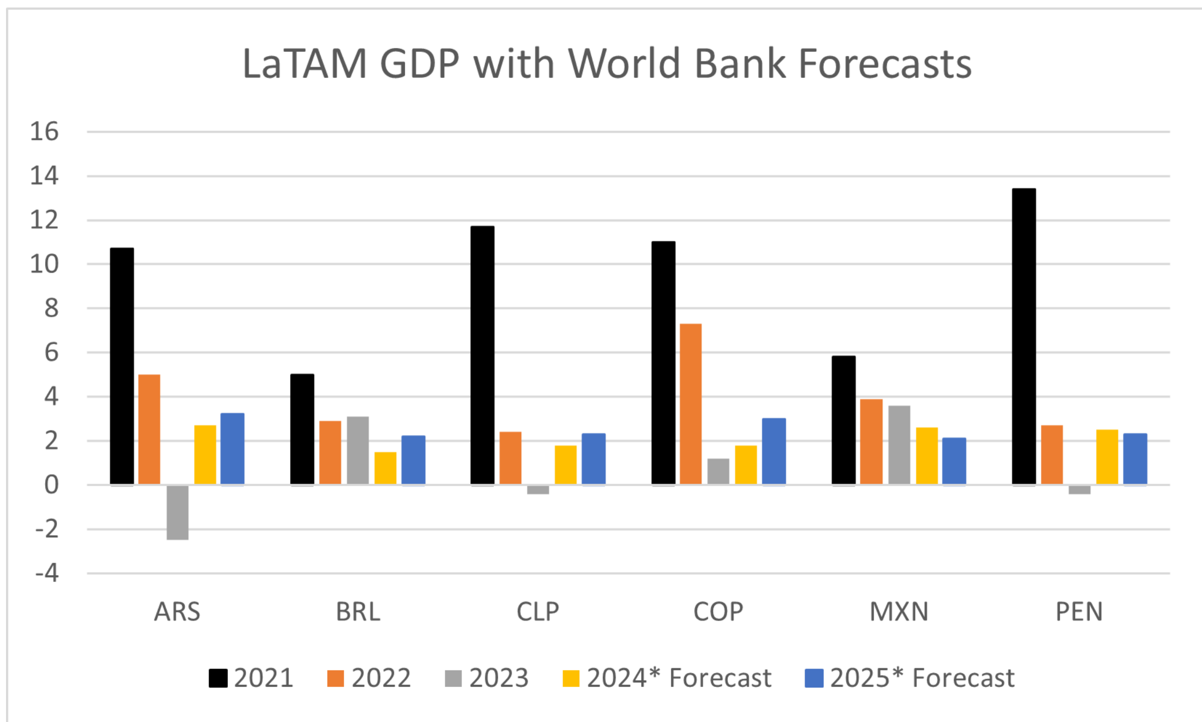
Economic Uncertainty Modest For The Region

-

Source: Macrobond, Economic Uncertainty Index, BNY Mellon

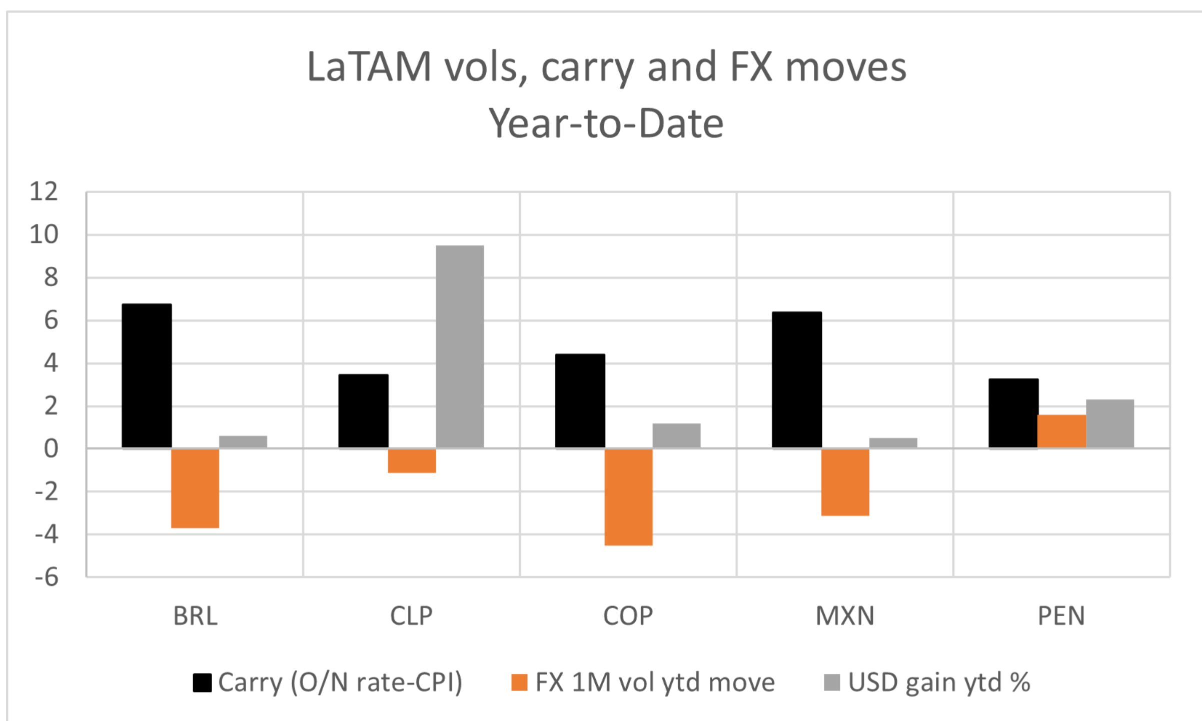
LatAm central banks have added to growth woes with higher real rates after the pandemic spending and the push higher in global rates. Most of the central banks are dovish but reluctant to cut faster with FX the key barometer. In the next two years, the outlook for growth is best in Chile, Colombia and Argentina, while Mexico, Peru and Brazil are expected to continue to slow. Growth in all is well below the 2021 post-pandemic highs. The carry trade that dominated 2023 led to outsized positions in MXN, BRL and COP being unwound in Q4, but the revival in carry in February stands out as a key factor for understanding 2024 risks.

GDP Has Not Recovered From Post-Pandemic Bounces



Source: World Bank, BNY Mellon

Options volatility in LatAm FX has been calm – the drop in 1m volatility has been significant and a factor driving the "carry trade" in the region despite uncertainty around both monetary and fiscal policies. Some of this reflects central bank action and policy, and some the broader drop in FX implied volatility. That currencies in the entire region have lost ground against the USD is both a reflection of the overall broad dollar strength coupled with the hangover of carry-trade positions from 2023.



Source: iFlow, BNY Mellon

Source: iFlow, BNY Mellon

Bottom Line: Investment flows into LatAm are balanced between political risks and the carry trade. This leaves economic uncertainty high – and risks higher than

rewards in some of the region. The current iFlow LatAm cloud (above) seems to reflect all of these factors, indicating only PEN and CLP as likely movers in the weeks ahead. The leadership of BRL and MXN in the LatAm carry trade may well continue, but likely pivots on political risks and the speed of future rate cuts.

Please direct questions or comments to: iFlow@BNYMellon.com

Bob Savage

HEAD OF MARKETS STRATEGY AND INSIGHTS

CONTACT BOB

.

bnymellon.com

BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may be used as a generic term to reference the corporation as a whole and/or its various subsidiaries generally. This material and any products and services may be issued or provided under various brand names in various countries by duly authorized and regulated subsidiaries, affiliates, and joint ventures of BNY Mellon, which may include any of the following. The Bank of New York Mellon, at 225 Liberty St, NY, NY USA, 10286, a banking corporation organized pursuant to the laws of the State of New York, and operating in England through its branch at One Canada Square, London E14 5AL, UK, registered in England and Wales with numbers FC005522 and BR000818. The Bank of New York Mellon is supervised and regulated by the New York State Department of Financial Services and the US Federal Reserve and authorized by the Prudential Regulation Authority. The Bank of New York Mellon, London Branch is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV, a Belgian public limited liability company, with company number 0806.743.159, whose registered office is at 46 Rue Montoyerstraat, B-1000 Brussels, Belgium, authorized and regulated as a significant credit institution by the European Central Bank (ECB), under the prudential supervision of the National Bank of Belgium (NBB) and under the supervision of the Belgian Financial Services and Markets Authority (FSMA) for conduct of business rules, and a subsidiary of The Bank of New York Mellon. The Bank of New York Mellon SA/NV operates in England through its branch at 160 Queen Victoria Street, London EC4V 4LA, UK, registered in England and Wales with numbers FC029379 and BR014361. The Bank of New York Mellon SA/NV (London Branch) is authorized by the ECB and subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV operating in Ireland through its branch at 4th Floor Hanover Building, Windmill Lane, Dublin 2, Ireland trading as The Bank of New York Mellon SA/NV, Dublin Branch, is authorised by the ECB and is registered with the Companies Registration Office in Ireland No. 907126 & with VAT No. IE 9578054E. The Bank of New York Mellon, Singapore Branch, subject to regulation by the Monetary Authority of Singapore. The Bank of New York Mellon, Hong Kong Branch, subject to regulation by the Hong Kong Monetary Authority and the Securities & Futures Commission of Hong Kong. If this material is distributed in Japan, it is distributed by The Bank of New York Mellon Securities Company Japan Ltd, as intermediary for The Bank of New York Mellon. If this material is distributed in, or from, the Dubai International Financial Centre (“DIFC”), it is communicated by The Bank of New York Mellon, DIFC Branch, regulated by the DFSA and located at DIFC, The Exchange Building 5 North, Level 6, Room 601, P.O. Box 506723, Dubai, UAE, on behalf of The Bank of New York Mellon, which is a wholly-owned subsidiary of The Bank of New York Mellon Corporation. This material is intended for Professional Clients only and no other person should act upon it. Not all products and services are offered in all countries.

The information contained in this material is intended for use by wholesale/professional clients or the equivalent only and is not intended for use by retail clients. If distributed in the UK, this material is a financial promotion.

This material, which may be considered advertising, is for general information purposes only and is not intended to provide legal, tax, accounting, investment, financial or other professional advice on any matter. This material does not constitute a recommendation by BNY Mellon of any kind. Use of our products and services is subject to various regulations and regulatory oversight. You should discuss this material with appropriate advisors in the context of your circumstances before acting in any manner on this material or agreeing to use any of the referenced products or services and make your own independent assessment (based on such advice) as to whether the referenced products or services are appropriate or suitable for you. This material may not be comprehensive or up to date and there is no undertaking as to the accuracy, timeliness, completeness or fitness for a particular purpose of information given. BNY Mellon will not be responsible for updating any information contained within this material and opinions and information contained herein are subject to change without notice. BNY Mellon assumes no direct or consequential liability for any errors in or reliance upon this material.

This material may not be distributed or used for the purpose of providing any referenced products or services or making any offers or solicitations in any jurisdiction or in any circumstances in which such products, services, offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements.

The terms of any products or services provided by BNY Mellon to a client, including without limitation any administrative, valuation, trade execution or other services shall be solely determined by the definitive agreement relating to such products or services. Any products or services provided by BNY Mellon shall not be deemed to have been provided as fiduciary or adviser except as expressly provided in such definitive agreement. BNY Mellon may enter into a foreign exchange transaction, derivative transaction or collateral arrangement as a counterparty to a client, and its rights as counterparty or secured party under the applicable transactional agreement or collateral arrangement shall take precedence over any obligation it may have as fiduciary or adviser or as service provider under any other agreement.

Pursuant to Title VII of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the applicable rules thereunder, The Bank of New York Mellon is provisionally registered as a swap dealer with the Commodity Futures Trading Commission (“CFTC”) and is a swap dealer member of the National Futures Association (NFA ID 0420990).

BNY Mellon (including its broker-dealer affiliates) may have long or short positions in any currency, derivative or instrument discussed herein. BNY Mellon has included data in this material from information generally available to the public from sources believed to be reliable. Any price or other data used for illustrative purposes may not reflect actual current conditions. No representations or warranties are made, and BNY Mellon assumes no liability, as to the suitability of any products and services described herein for any particular purpose or the accuracy or completeness of any information or data contained in this material. Price and other data are subject to change at any time without notice.

Rates: neither BNY Mellon nor any other third party provider shall be liable for any errors in or delays in providing or making available the data (including rates, WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates) contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees’ negligence. The WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates are provided by The World Markets Company plc (“WM”) in conjunction with Reuters. WM shall not be liable for any errors in or delays in providing or making available the data contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees’ negligence.

The products and services described herein may contain or include certain “forecast” statements that may reflect possible future events based on current expectations. Forecast statements are neither historical facts nor assurances of future performance. Forecast statements typically include, and are not limited to, words such as “anticipate”, “believe”, “estimate”, “expect”, “future”, “intend”, “likely”, “may”, “plan”, “project”, “should”, “will”, or other similar terminology and should NOT be relied upon as accurate indications of future performance or events. Because forecast statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict. iFlow® is a registered trademark of The Bank of New York Mellon Corporation under the laws of the United States of America and other countries.

This document is intended for private circulation. Persons accessing, or reading, this material are required to inform themselves about and to observe any restrictions that apply to the distribution of this information in their jurisdiction.

Currency Administration is provided under and subject to the terms of a definitive agreement between BNY Mellon and the client. BNY Mellon exercises no investment discretion thereunder, but acts solely pursuant to the instructions in such agreement or otherwise provided by the client. Unless provided by definitive agreement, BNY Mellon is not an agent or fiduciary thereunder, and acts solely as principal in connection with related foreign exchange transactions.

All references to dollars are in US dollars unless specified otherwise.

This material may not be reproduced or disseminated in any form without the prior written permission of BNY Mellon. Trademarks, logos and other intellectual property marks belong to their respective owners.

The Bank of New York Mellon, member FDIC.

© 2020 The Bank of New York Mellon Corporation. All rights reserved.