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iFlow
MACRO MORNING BRIEFING

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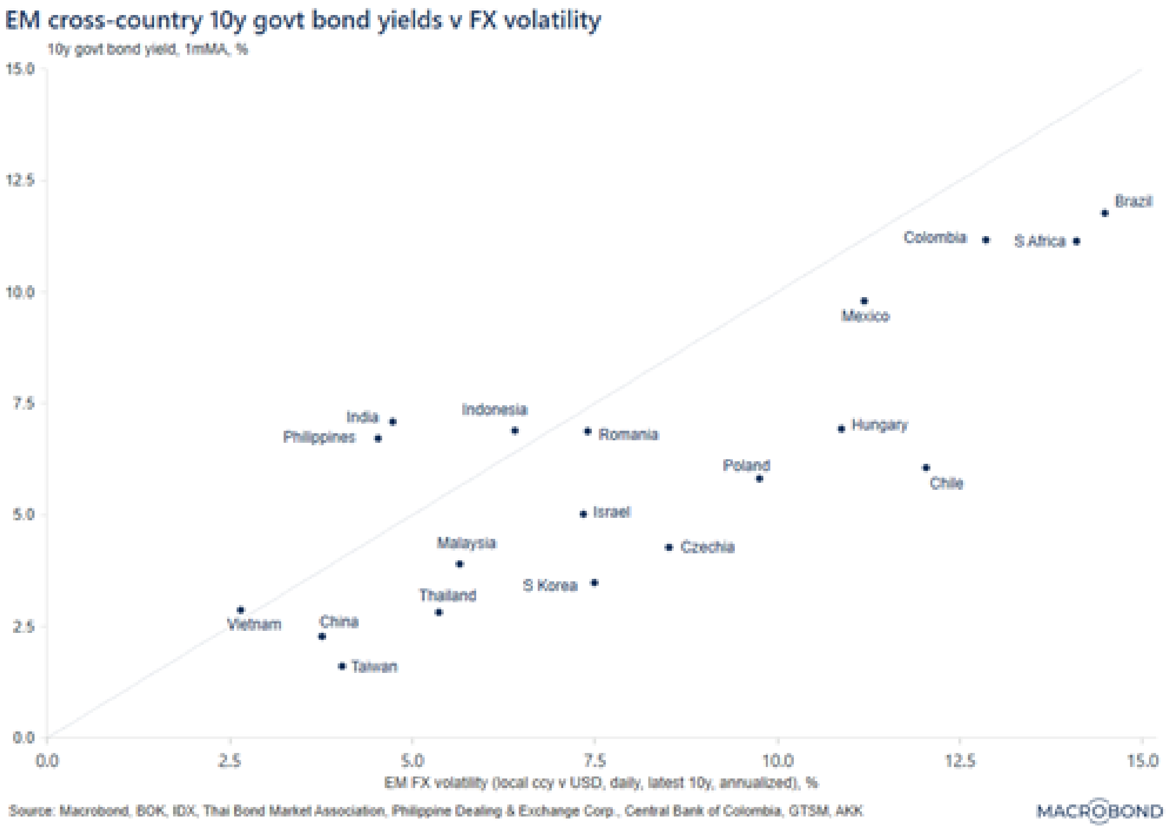
Latin America Politics And Summer Markets

The role of the Federal Reserve's rate policy in Latin America asset flows continues to lead in the blame game for underperformance. However, election risks in Mexico and steep learning curves for new leaders in Colombia, Argentina and Peru make politics as critical a factor in driving capital flows. The carry trade has returned across markets, along with a focus on yields versus volatility. While Mexico and Brazil led money flows in emerging markets in 2023, they have stalled in 2024 – our data shows significant BRL outflows in May. Expectations for commodity booms, better China growth and generally high real rates make LatAm a prime candidate for FX and fixed income carry trades. The reality of the tape is different, however.

- **Politics are a key driver for risk-rethinking.** While Mexico votes this weekend, the battles that start at the ballot box don’t finish in the election tabulation, rather continue as seen in Peru, Colombia, Argentina and Chile.
- **Valuations remain modest:** 1100 companies with market capitalization of $2bn; Brazil and Mexico account for 80% of the total. Mining and food dominate, along with financial sector. Risks for equities in region are in concentration risk and government policy.
- **FX volatility vs. bond yields is expensive** (and cheap in some of APAC). Exhibit #1 shows Chile with the worst in yield-to-volatility metric in LatAm, suggesting investors aren’t getting much risk premium for their exposure.

Exhibit #1: EM Bond Yields vs. FX Volatility

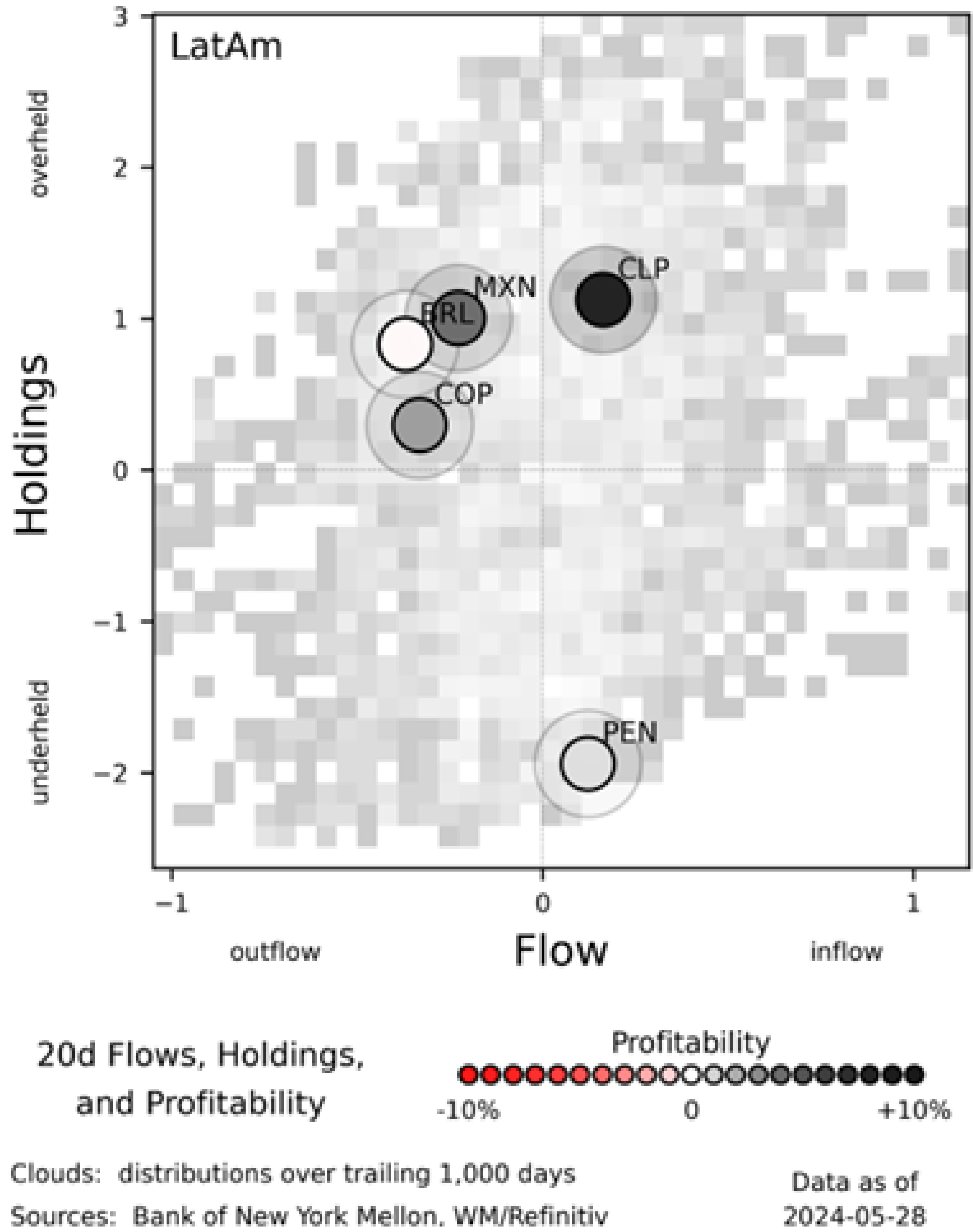


Source: Macrobond, BNY Mellon

In Fixed Income, Brazil and Mexico sovereigns had modestly positive inflows in May. Chile outflows were notable. Only Brazil bonds saw consistent buying in the past quarter, while Argentina bonds were sold.

In FX, CLP has become the most overheld FX position in iFlow. While we see PEN the most likely to move to underheld, it's now seeing short covering. MXN, BRL and COP are overheld, but all of those saw outflows.

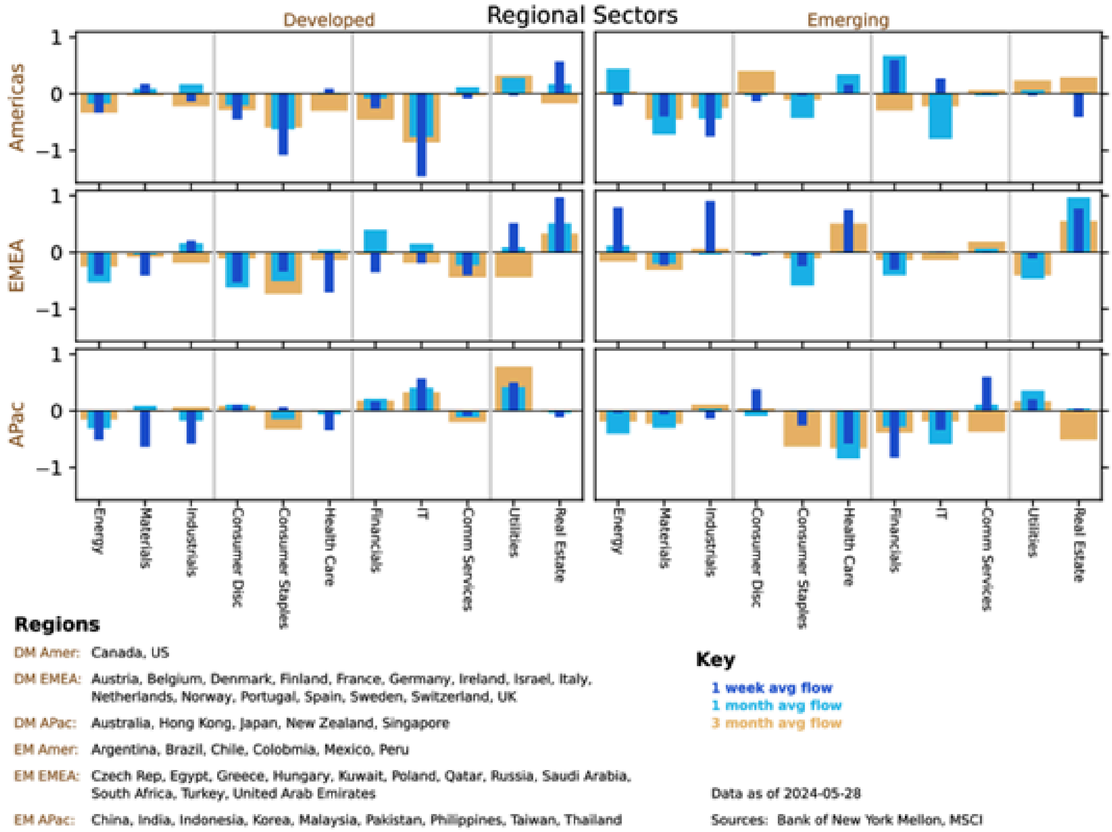
Exhibit #2: Only Chile Seeing FX Inflows



Source: iFlow, BNY Mellon

In Equities, May brought notable buying in Argentina and Brazil but outflows from Mexico. Chile flows were modestly negative, -0.31 scored. There are four leading and lagging LatAm sectors in play for investor flows, with Industrials, Consumer Discretionary, Financials, and Utilities sold. iFlow data shows our investor flows making money both leading and lagging the market by selling.

Exhibit #3: LatAm Equity Flows Uneven



Source: iFlow, BNY Mellon

How do our flows correspond to the current political economies in LatAm?

For Mexico, we have already done a deep dive on the political risks of the weekend election. The outcome will matter not to just Mexico but the rest of the region, as well. Many investors see in the region a trend from left to right policies – given the Bolivia and Argentina votes. Mexico's election also has an expected relief rally for MXN priced into the event – as tail risks of super-majority power matter.

Argentina's not-so-new President Milei continues to battle fiscal excess from decades of unfettered spending. In five months, he has returned the budget to surplus by slashing discretionary spending and allowing high inflation to erode the real value of mandatory spending. Negative real rates will lead to a significant drop in debt-to-GDP but sustainability will require more to stabilize the debt. In a major cabinet shake-up, interior minister Francos has replaced Posse as chief of staff given differences on progress needed to get further reforms passed by the Senate. This seems to be in process now. The current path for 2024 is a primary surplus of 2.2% of GDP and small fiscal surplus of 0.3%, compared to the decade average of a 3.2% deficit in primary and -5.5% for fiscal. Yet, money flows are still positive for equities despite the -2.7% GDP recession expected in 2024. Investors are selling bonds, buying equities, and watching ARS slowly depreciate. Most important for Argentina markets is tipping the cost debt-service to a lower trajectory, from 4.5% of GDP to something closer to 3%, which requires the central bank (BCRA) to continue with easier policy. BCRA has cut rates from 133% in December to 40% in May –

leaving real rates below 20% y/y. Currency controls have helped prevent some of the pain in the peso, which is 44% weaker from the near-300% inflation. **Bottom Line**: May-to-June risk: the stall in fiscal reform in the Senate continues and inflation remains too high, missing the government's 4% m/m autumn target. Upside risks: Milei's push for FDI starts to work and the Senate passes reforms.

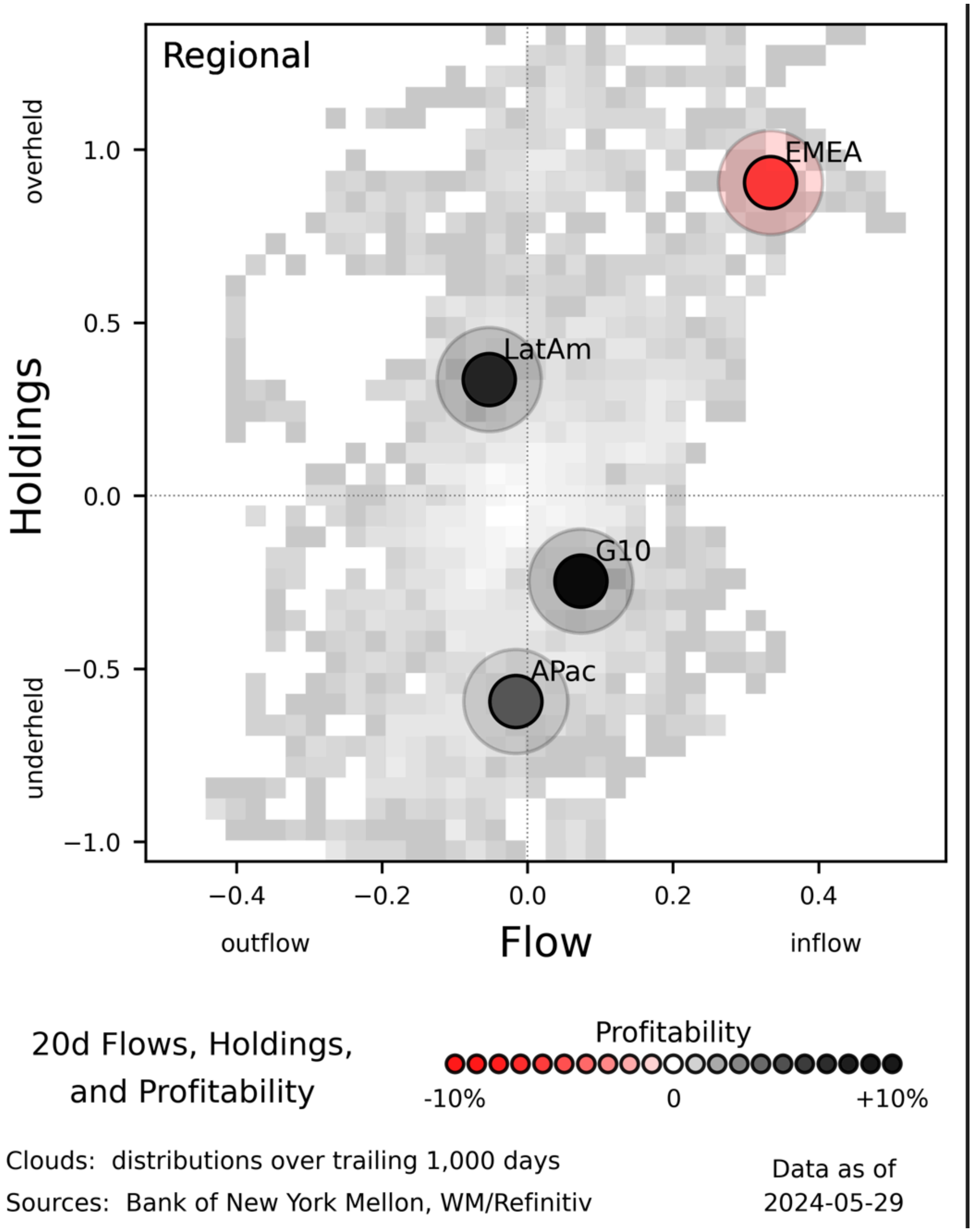
Brazil and the Lula domestic policy noise has been blamed for driving outflows from Brazil, as his appointments to the central bank's (BCB) board are hurting its credibility. The vote for the 25bp rate cut to 10.5% in May was split and consensus sees 9.25% by year-end. Many expect 2025 to be more dovish. However, sticky inflation and lower growth leave assets less attractive in comparison to simple carry trades in BRL. The effects of bad weather – flooding in the South and ongoing El Nino effects – point to risks of less growth and more inflation. This puts the 2% GDP baseline for 2024 at risk and complicates the 4% inflation cap. The currency is off 4% on the year and focus returns to the USDBRL 5.30 April highs as we close the month. The next big risk we see for Brazil money flows will be in the municipal October elections, which could drive a pre-vote spending spree. Petrobas and Vale are becoming more important to the president, and perceptions of government interference in the global champions add to concerns about all equities. The new Petrobas CEO Chambriard pushes for more offshore oil exploration in a gamble to increase national reserves**. Bottom Line**: FX risk is high as BRL weakness beyond 5.30/USD could stall further BCB easing, thereby adding to growth worries; ongoing high rates might cause political friction, as well.

Peru and the failed Boluarte plan for early elections leaves the president a 'lame duck' through 2026. Sweeping reforms are needed to bolster institutional credibility, but a weak president and a sharply fragmented Congress render Peru particularly susceptible to political uncertainty. President Boluarte has seen her credibility erode even faster, with a new IEP poll showing her support at 5%, and her disapproval rating at 90% after multiple impeachment attempts linked to scandals. GDP in Q1 was up 1.4% y/y – led by mining, construction, and consumption – after four negative quarters in 2023. Consensus for GDP this year is 1%. Inflation is lower, 2.4% in April, and seen landing at 2% by year-end. The central bank cut 25bp to 5.75% in May, leaving its policy rate 2ppt lower from the 2023 peak. Downside from here may be limited, however, with real rates nearing neutral – 5.00% is seen near the bottom of cycle in Q1 2025. Flood-relief costs and higher fiscal costs are putting further pressure on the fiscal side, with the primary deficit at 0.6% of GDP and fiscal deficit at 2.5% of GDP. Compared to most of the region Peru appears solid, even with a decade of running deficits. However, government uncertainty and risk of a rating downgrade remain, plus pressure to run a surplus in 2025. **Bottom Line:** The risk of relevance for Peru runs high with outflows from both bonds and stocks minor, and real rates likely insufficient to keep PEN stable given the risks ahead.

Colombia and Petro policy challenges. The mood for Colombia shifted as the policy agenda of the president spooks investors and has led to a judicial and legislative blocking of the most controversial measures. Twin deficits from government spending and larger trade gaps leave focus on policy shifts. The risk of the leftist leader shifting to more radical measures and a more combative stance to the opposition seems large given that he has three more years of control. He took office in August 2022, winning almost 51% of the vote, but polls suggest his support has dropped to 26%. This would appear insufficient to pass any reform from a constituent assembly. The economic downturn with higher unemployment and lower business confidence drives fears about health and pension reforms, higher crime, and the normal business cycle shift linked to lower domestic demand. GDP in Q1 was up 0.7% but is expected to slow through the year, in which case lower rates and slowing inflation will likely follow and counterbalance worst-case risks. **Bottom Line:** The shift of politics from left to right is in play and driving risks for a more combative year with further erosion of confidence and growth. How oil prices play out in 2024 matters now and leaves the currency less attractive.

Chile and Boric giving up on constitutional reform. After two failed attempts to rewrite the constitution, the president shifted focus on tax and pension reforms to finance social spending and more retirement benefits. The role of copper and lithium are key and the strong Q1 growth reflects it. Chile relies more on China than the US for exports, leaving it linked to growth in APAC. Domestic demand may see more relief from slowing inflation and lower rates, but some of the political uncertainty around taxes and pensions hurts investments. The central bank (BCC) cut 50bp to 6% in May – slowing the pace of easing from 100bp in January and 75bp in April. The easing cycle is likely nearing an end after 525bp of cuts since July 2023. BCC expects inflation to dip to 1% but consumers expect 2.7%. The problem is that April inflation rose to 3.5% from 3.2%, while service inflation fell to 5.4% and goods inflation is 1.1% – wages are coming down but unemployment has fallen back and the outlook for 2-3% makes further inflation improvement harder. Any further easing will likely be linked to inflation and the FX market with the spread to US rates nearing zero. This isn't a high growth story either: after a near-recession in 2023, consensus sees around 2.5% GDP this year and next. Slower inflation will help but may be insufficient to keep flows positive. **Bottom Line**: The risk of a copper reversal or China slowdown are obvious issues, but larger concerns remain about budget and fiscal risks leaving the BCC unable to ease further. Currency strength may also prove less helpful in the battle against inflation given non-tradable inflation.

Exhibit #4: LatAm Long And Profitable, But Not Adding



Source: iflow, BNY Mellon

Our flows across the LatAm region have been mixed. Among currencies, BRL and MXN are expected to see modest buying as asset selling in May should lead to unwinding of hedges in USD. In the bigger picture, LatAm appears to have lost out to Europe as a go-to destination for flows. But we think markets could shift back to owning more in the region should politics improve, headlines turn positive, and commodity prices stabilize or move higher. A bit more good weather could help, too.

Disclaimer & Disclosures

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

Bob Savage

HEAD OF MARKETS STRATEGY AND INSIGHTS

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