

## Latam FX Outlook 2023: Too good to be true?

When putting together our Latam FX outlook this time last year, we speculated on the 'Return of the Pink Tide' or a leftward shift in local politics. That has indeed materialised in presidential elections in Colombia, Chile and Brazil. We think 2023 will be another tricky year for Latam and continue to favour Mexican peso outperformance



Former Brazilian President Luiz Inácio Lula da Silva wins the second round of the Brazilian presidential election, Sao Paulo, Brazil - 30 Oct 2022

Source: Shutterstock

### Real rates in focus in Brazil

The [leftward shift in Latin politics in 2022](#) has had a mixed effect on local currency markets. The election of left-leaning presidents in both Colombia and Chile has, rightly or wrongly, been associated with heavy currency falls. The pesos of Colombia and Chile are down 15% and 5% year-to-date against the dollar. The Brazilian real on the other hand has until very recently been the darling of the EM FX world, delivering 5% nominal gains and much more when taking Brazil's attractive carry into account. The Mexican peso has also done well with a 5% year-to-date gain.

Turning first to Brazil. The independent central bank moved early and aggressively with tighter policy to contain inflation. The policy rate is now 13.75% and headline inflation has already corrected to 7% from 12% – leaving Brazil with very attractive real interest rates. The market is

starting to price a 200bp easing cycle for the second half of 2023, which in theory could make Brazil's local currency bonds very attractive.

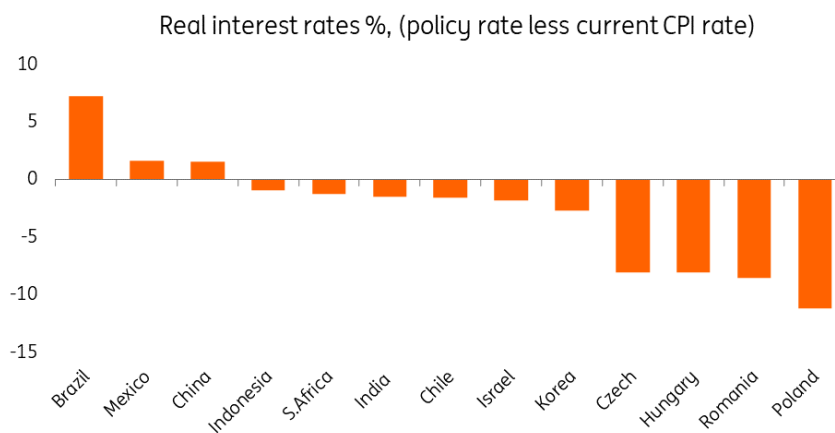
Our concern for the real, however, is that former President Lula has been re-elected on a ticket of welfare spending. Brazilian growth may sink from near-3% this year to close to zero next year. And in a difficult international environment for bond markets, fiscal pressure could see the real ending the year much weaker than the 5.15 USD/BRL levels expected by the consensus.

Chile's Achilles' heel is its large current account deficit – worth 8% of GDP this year and only expected to narrow to a 5% deficit next year. Sizable current account deficits are a distinct disadvantage at a time when core rates are rising and abundant liquidity is being withdrawn. USD/CLP will likely make another run at 1000 and despite securing an IMF Flexible Credit Line, we expect the peso to remain vulnerable – especially in early 2023 when China remains weak and the dollar strong.

Interestingly, the IMF recommends that Chile substantially restore its FX reserves – arguing that even in the good times, USD/CLP will not spend too much time below 900.

Turning finally to Mexico, we feel the peso has a lot going for it. Banxico's efforts to effectively manage USD/MXN near 20 stand to create the virtuous cycle of lower volatility and higher risk-adjusted returns. We much prefer the Mexican peso to Brazilian real exposure, given that the real trades on nearly twice the volatility as the peso. Mexico also looks much better placed in terms of debt, and its higher sovereign rating should provide some protection in the face of deteriorating external conditions. Finally, Mexico could become a major beneficiary of 'nearshoring' following recent supply chain challenges over the past three years – suggesting Foreign Direct Investment trends should be monitored carefully in 2023.

## Real interest rates in Latam seem attractive...



Source: Refinitiv, ING

## USD/BRL: Fiscal challenges

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/BRL	5.30	Bullish ↗	5.50	5.75	5.80	5.90	6.00

**How fiscally aggressive can Lula be?** A ‘resurrection’ is how President-elect Lula describes his return to office after narrowly beating the incumbent Bolsonaro in a second-round run-off. His pitch for a return to office was very much one based on welfare support and also a complete reversal of Bolsonaro’s free-market approach to the Amazon. Brazilian assets initially responded positively to Lula’s win in that he may be fiscally limited due to right-wing politicians having done well in congressional elections. Hence, Congress could prevent fears of unfunded social giveaways exacerbating what is likely to be an annual budget deficit of 7% of GDP and debt to GDP heading towards 90% next year.

**Why we are more bearish on BRL:** Consensus expects USD/BRL to head back down to the 5.15 area by the end of 2023. The view here is that inflation has topped and that Brazil’s central bank can embark on a 200bp easing cycle in the second half of 2023, which should be good for the local currency bond market. We are a little more concerned that the legacy of a near 14% policy rate will be much weaker growth in Brazil next year, which will bring fiscal pressure to the fore in what will still be a challenging year for bond markets. After all, Brazil’s five-year sovereign CDS trades near 280bp for a reason. Any changes in the fiscal rules would be negative.

**Greater links with China?:** The return of President Lula could also re-invigorate the BRICS geopolitical grouping. Where that goes in 2023 remains to be seen, although there was at some stage a suggestion of working towards some kind of BRICS currency arrangement. We doubt that Brazil would want to get entangled with such a venture, but any higher profile of the BRICS would serve as a reminder of Brazil’s heavy trade links with China – 31% of Brazil’s exports went to China in 2021. Sluggish Chinese growth could prove a headwind to Brazilian exports and push Brazil’s current account deficit towards 2% of GDP next year.

## USD/MXN: Peso enjoys high, risk-adjusted yield

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/MXN	19.40	Neutral	20.00	20.00	19.50	19.25	19.00

**High yields, less volatility:** In tracking Fed tightening this year, Banxico deserves a lot of credit for keeping USD/MXN stable. Here, three-month realised volatility is just 9.9% compared to 19.3% for USD/BRL. In response, expected volatility is substantially lower for USD/MXN as well. This has implications for the ‘carry-to-risk ratio’ – or risk-adjusted yield which is now 50% higher for the Mexican peso versus the Brazilian real. Barring Banxico ending its tightening cycle well ahead of the Fed, we expect USD/MXN to remain relatively well-contained near or under 20.00 over the next three-to-six months even as external market conditions deteriorate.

**Mexico well-placed for nearshoring:** Disruptions to global supply chains from the pandemic and this year’s Russian invasion of Ukraine have questioned globalisation and raised the prospects of ‘friendshoring’ or ‘nearshoring’ – i.e. moving supply chains closer to home. Mexico stands to benefit from US nearshoring, sharing as it does a land border with the US and now engaged in a new USMCA trade deal. Mexico features prominently in the White House’s supply chain resilience plan, focusing on semiconductors, batteries, critical minerals, and pharmaceuticals. At \$3.50/hour, Mexico’s average manufacturing industry wage compares very favourably with the US (\$30/hr), but also with Latin America, e.g. Brazil and Chile at \$4.71 and \$5.74/hr, respectively.

**Remittances still rising:** Remittances back to Mexico from the US are still rising and are currently worth \$5bn per month. Presumably these slow at some stage when US unemployment turns higher, but they have proved remarkably resilient so far. Mexico also has a relatively modest current account deficit of less than 1% of GDP – making remittances quite meaningful. In terms of politics, it is not clear how much President Andres Manuel Lopez Obrador can get done before elections in the summer of 2024, but his fiscal rectitude during the pandemic certainly provides insulation as global borrowing costs continue to rise. Investors continue to see Mexico as a good quality credit, trading its five-year sovereign CDS at around 140bp, compared to 280bp for Brazil.

## USD/CLP: Growing pains

	Spot	Year ahead bias	4Q22	1Q23	2Q23	3Q23	4Q23
USD/CLP	885.00	Neutral	950.00	1000.00	950.00	925.00	900.00

**Controlling social tension in a recession:** Left-wing President Gabriel Boric was voted into office in March 2022 on a ticket for social reform. This followed the widespread social uprising in 2019. President Boric has struggled to make progress here, with his constitutional reform package widely rejected in September – providing somewhat of a reprieve to the mining industry. 2023 stands to prove a difficult year for Chile. The IMF projects the economy will contract 1.3% next year and unemployment will rise. Balancing how to advance social reform, while keeping the mining industry onside – softening mining taxes being a recent example – will be a major challenge.

**Where's copper heading?** As the largest copper producer in the world, the Chilean peso is very much driven by these prices. USD/CLP hit 1050 in July and had to seek IMF support when copper fell 25%. Our commodities team believes copper will struggle over the next six months. Incidentally, participants at the recent London Metal Exchange (LME) gathering were quite split on copper's path. Our house view is that the continued weakness in China's construction sector amidst the over-supply in the residential sector will keep copper on the back foot for the next three-to-six months. Equally, widespread labour unrest in the industry is hitting Chile's copper production, recently running at a 16-year low.

**Limited scope for FX intervention:** The exchange rate has proved a useful shock absorber for Chile's economy. The macro imbalances created by strong consumption during the pandemic – leaving Chile with an 8% of GDP current account deficit – make the peso vulnerable to the international environment. Chile has lost 17% of its FX reserves in defence of the peso this year. And whilst it does have the precautionary support of an \$18bn IMF Flexible Credit Line, it will not want to use it. A strong dollar environment into year-end and potentially through 1Q23 can see USD/CLP head back to 1000 and perhaps also drag the local central bank into some further tightening. Interestingly, the IMF has also said that Chile needs to rebuild FX reserves, suggesting USD/CLP struggles to trade under 900 on a sustained basis over the next couple of years.

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