LATAM: Reversal of fortunes

Trade war concerns and the appreciation of the US dollar kept many LATAM currencies under pressure in 2019 but there were significant differences between countries. In 2020, things could look quite different


Mexico's high-carry was the crucial anchor to its stellar FX performance in 2019, but that advantage should shrink in 2020 as Banxico's rate-cutting cycle deepens.

The reduced rate differential suggests that economic fundamentals may play a more central role in determining FX performance within LATAM* in 2020.

Brazil has the biggest upside for improvement in its macro outlook, but resolution of social conflicts across the Andes, and a reduction in trade-war concerns would add material room for correction from stressed FX levels in the Andean region.

Fig 78   Mexico's high interest rates, and Brazil's falling rates, stood out in 2019

Real rates (12-mo expex), %
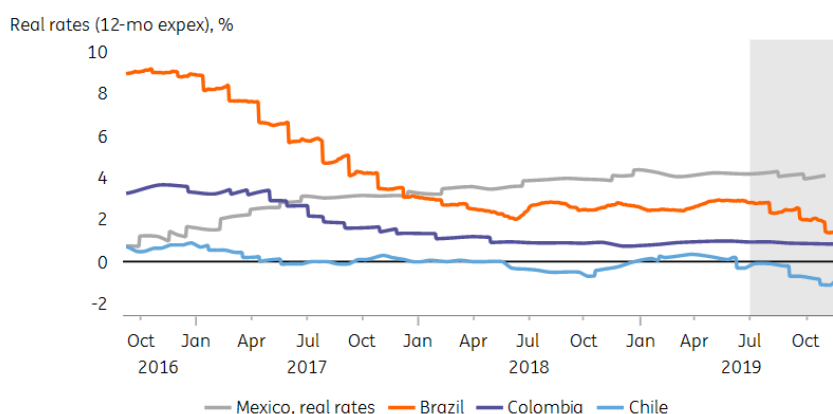
Source: Macrobond

# Interest rate differentials were crucial in explaining relative performance in 2019

External headwinds, as represented by the gradual appreciation of the USD in the past couple of years and persistent trade-war concerns, helped keep LATAM currencies under pressure in the past year. But idiosyncratic risks were large enough to generate substantial intra-regional performance differentiation, especially towards year-end.

The crucial role played by interest rates, in the context of high global liquidity and low volatility across financial markets, stood out. High interest rates were, perhaps, the crucial driver behind the outstanding performance by the Mexican *peso*, especially in contrast with the Brazilian *real* in the latter part of 2019, when Brazil's aggressive monetary easing cycle intensified.

Monetary policy prospects across the region suggest however that, during 2020, the rate differential between Mexico and its peers should drop. This reflects both the much-reduced room for policy easing elsewhere in LATAM and Banxico's new guidance, stating that the bank is finally ready, after almost three years, to decouple from the US Fed.

As a result, Mexico's far-superior ability to conduct monetary easing should reduce its carry advantage and translate into a relatively less resilient MXN in 2020.

Fig 79   High rates helped solidify the MXN's outperformance in recent months
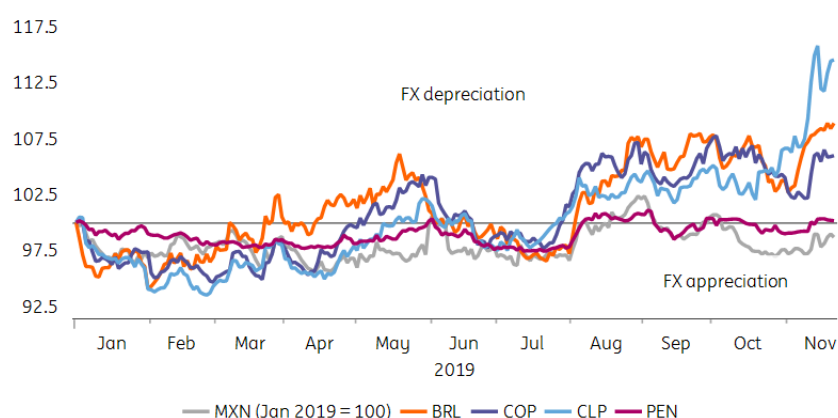
Source: Macrobond

For 2020, idiosyncratic risks seem more favourable to 2019's FX underperformers

As Mexico's monetary policy becomes less of an outlier, interest rate differentials should play a reduced role in driving intra-regional FX performance. This should allow for other catalysts, better aligned with the evolution of economic fundamentals, to determine relative performance in the coming quarters.

Among those catalysts, Mexico's relative weakness in terms of economic activity stands out. In particular, judging by 2020 consensus estimates, Mexico is on track to print two consecutive years with the lowest GDP growth in LATAM.

That poor growth performance helps explain why Mexico, which is the only sovereign with a negative credit rating outlook by two agencies in the region, is the most likely credit to suffer a rating's downgrade next year.

Brazil, meanwhile, stands apart as the credit most likely to be considered for a rating's upgrade. This would be consistent with the recent approval of the social security reform but, in order for that to happen, we suspect GDP growth needs to accelerate and, possibly, surprise market expectations in the coming quarters.

Social unrest should remain an important driver for the region's FX outlook

Episodes of social unrest was another important catalyst for relative value performance in recent quarters. And given that the political environment remains unsettled across much of the Andean region, political risk should remain an important driver for the region's FX outlook.

No major presidential election is scheduled for 2020, but off-schedule elections in Peru and Bolivia are possible, and the renewed energy seen in recent social protests calls for caution throughout the region. In particular, recent episodes demonstrated that, once started, their impact on local financial markets was deeper than initially expected, often demanding a heavy cost in terms of fiscal accounts and loss in economic activity.

The eventual resolution of social conflicts across the Andes, together with reduced trade-war concerns suggest however that there is material room for correction from stressed FX levels in the Andean region.

Even though FX correlation with commodity prices has reduced materially in recent months, especially where those correlations were strongest, ie, in Chile and in Colombia, the outlook for commodity prices should remain an important driver for relative currency performance among the Andean countries.

ING's commodity team expects copper prices, ie, the chief driver for Chile's terms-of-trade, to rise gradually from current levels, while the outlook for oil prices, the crucial driver for Colombia's COP, is more balanced. This suggests greater room for a catch-up correction in the CLP, when compared to the COP.
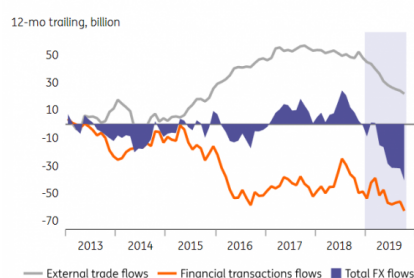
The PEN should, meanwhile, continue to outperform during market sell-offs and to underperform during rallies, which suggests that the currency should underperform its peers in a scenario of relatively benign outlook for risk appetite. Such a relatively benign market environment would benefit especially the currencies that are more sensitive to external drivers and risk aversion generally, such as the COP and the BRL.

Some caution is warranted, however, when considering the unpredictability of social conflicts and the fact that they have also triggered intra-region contagion. Financial market contagion should be relatively short-lived, as intra-regional trade is relatively small in LATAM. Having said that, the possibility of a disorderly default in Argentina late in 1Q should be monitored as a potential catalyst for (temporary) FX weakness, especially in Brazil.

Apart from a stated desire to restructure government debt by the end of 1Q, the policy priorities of the upcoming Alberto Fernandez administration remain far from clear. The continued use of strict FX controls together with the much-improved external trade balance should help moderate FX volatility. However, the expected preference for a deep monetary easing program, together with prospects for difficult negotiations with debt-holders, as Argentina aims to return its debt metrics to a sustainable trajectory, suggests that FX dynamics should remain hard to predict.
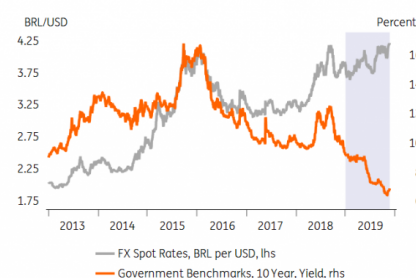
As in the past, an eventual FX policy preference for keeping the ARS at "competitive" levels, as some have suggested as a means to strengthen external trade and growth, would eventually conflict with the need to use FX as a price anchor. And as policy priorities fluctuate between the need to boost exports or, alternatively, to control inflation, the ARS should experience faster or slower depreciation relative to inflation.

Fig 80 FX outflows surged throughout 2019

12-mo trailing, billion

— External trade flows — Financial transactions flows ■ Total FX flows

Source: Macrobond

Fig 81 BRL could catch-up with other local assets in 2020

BRL/USD   Percent

— FX Spot Rates, BRL per USD, lhs
— Government Benchmarks, 10 Year, Yield, rhs

Source: Macrobond

Brazil's BRL has been under pressure as local markets adjust to a new low-rate reality

The approval of the social security reform helped re-anchor Brazil's fiscal accounts and paved the way for the central bank to re-launch a deep monetary easing cycle. As the SELIC rate, which should end the year at 4.5%, has reached new lows, FX outflows have intensified, resulting in a sustained weakening pressure on the BRL.

These outflows reflect, to a large extent, debt-management operations by local corporates that are taking advantage of newly-available cheap local funding to pay down FX-denominated debt. By their nature, these developments are long-term positive for the BRL, as they reduce the stock of FX liabilities by locals, but they are BRL-negative in the short term, when the outflows take place.

As central bank officials have highlighted, this should continue to exacerbate FX outflows and add a persistent near-term weakening bias for the BRL in the nearer term. This should keep the currency close to the upper-end of the 4.0-4.20 range, which we continue to see as a strong near-term reference-range for the USD/BRL.

We still consider these levels to be higher than equilibrium for the pair, but the consolidation of a sub-4.0 level for the currency may take a while to materialise. In our view, it depends chiefly on a faster recovery of economic activity in Brazil, which remains a pre-condition for Brazil to strengthen its fiscal accounts, improve its credit rating and, as a result, improve prospects for FX inflows.

Overall, Brazil's fundamentals should display a more substantial improvement throughout 2020, as the effect of the aggressive monetary easing seen in recent months and the improved fiscal outlook, resulting from fiscal reforms, should result in faster economic activity. But the inability to execute a fiscal stimulus package suggests that this recovery could be slower than past recoveries, with its pace heavily dependent on the private sector's "animal spirits". This suggests that the consolidation of a stronger BRL trajectory is more likely towards the latter part of 2020.
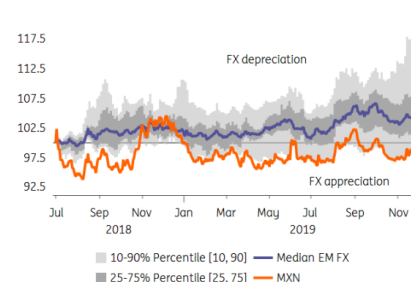
Fig 82   GDP growth expectations show persistent decline

GDP growth forecasts, %

--- 2019 GDP growth forecast   — 2020   — 2021
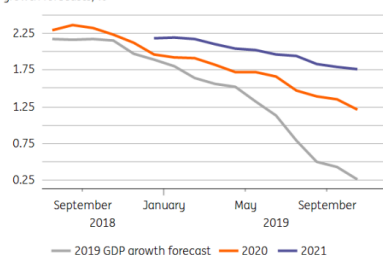
Source: Macrobond

Fig 83   MXN outperformance should be harder to sustain

10-90% Percentile [10, 90]   — Median EM FX
25-75% Percentile [25, 75]   — MXN

Source: Macrobond

In Mexico, we expect a less supportive environment for the peso

Economic data continues to depict a scenario of low growth and low inflation in Mexico. The growth stagnation reflects, to a large extent, the collapse in investment that has taken place in the past year, since approximately the announcement of the cancellation of the Mexico City airport construction.

Investment prospects remain generally dim, as private sector perception of elevated risk in regulated sectors, together with lingering uncertainties in the future of the US/Mexico trade relations, especially in the run-up to the US Presidential election, suggest that a turnaround in investment dynamics is unlikely in the near future.

The government's limited ability, or inclination, to conduct policy stimulus also suggests a reduced scope for a government-led recovery. As a result, after the stagnation seen in 2019, we expect GDP growth to stay low in 2020, coming near consensus at 1.2%.

In the very near term, high interest rates should remain an effective stabilising factor for the MXN, which should keep the USD/MXN trading close to 19.5. A steady pace of 25 basis point cuts suggests, however, that high rates should gradually become a less effective FX anchor, while the risk of a more frontloaded monetary easing cycle has increased, adding greater uncertainty to the outlook for the currency in the longer-term.

Our base case is for Banxico to cut the policy rate an additional 150 basis points, with the policy rate ending 2020 at 6.0%. But poor activity data could increase pressure on the bank to bring monetary policy more firmly into neutral territory (possibly closer to 5.5%), while a change in the board's composition at the end of 2020 could set the stage for a more substantial change in policy bias.

Javier Guzmán, often seen as the most hawkish board-member, concludes his term at the end of 2020, providing President Lopez Obrador with the opportunity to appoint a majority at the monetary policy board. This could weigh on the peso late in 2020.

Overall, our view is that Mexico's inferior GDP growth outlook, lingering risk of credit rating downgrades, among other factors, suggest that the scope for MXN outperformance should become increasingly challenging throughout 2020. In fact, our expectation is that the USD/MXN gradually depreciates towards 20.0 by the end of 2020.

This article is part of our 2020 FX Outlook report.

ING FX forecasts						
	Spot	**4Q19**	**1Q20**	**2Q20**	**3Q20**	**4Q20**
USD/MXN	19.42	19.30	19.20	19.50	19.80	20.00
USD/BRL	4.20	4.20	4.15	4.05	3.90	3.80
USD/CLP	795	780	755	740	735	730
USD/ARS	60.00	61.00	64.00	70.00	77.00	84.00
USD/COP	3,440	3,400	3,350	3,300	3,260	3,240
USD/PEN	3.38	3.37	3.36	3.35	3.34	3.33

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