Where next for LATAM FX?

Political problems in Brazil have damaged BRL's position as the darling of the Latin world. However we would be wary of chasing MXN gains, given election risk in 2018.

Source: iStockphoto

USD/BRL: Political woes partly offset by stronger fundamentals

Political risk intensified again in Brazil, with President Temer perilously hanging onto power amid new corruption allegations. Considering the uncertainties associated with another change in power in Brazil, the selloff in local assets has been relatively mild.

The BRL remains vulnerable but it is supported by the stronger fundamentals seen in external accounts and inflation. The CB also has enough firepower for FX intervention to stabilize the BRL, should demand for FX hedge surges in the coming weeks/months.

Still, the political crisis has clearly harmed prospects for fiscal-enhancing reforms and, as a result, for a robust economic recovery. The monetary easing cycle should continue, albeit more tentatively, assuming the USD/BRL does not overshoot towards 3.5, staying around its medium-term equilibrium, close to 3.2-3.3.

3.30 12-month USD/BRL forecasts

USD/MXN: Making a full recovery from Trump

The MXN outperformed its LATAM peers in recent weeks, becoming the chief beneficiary of the supportive risk appetite for EM FX in the region. For now, the carry seems high enough to compensate for the peso's chief medium-term risks: the NAFTA update and the final outcome of the 2018 presidential race.

Further appreciation is likely if appetite for EM FX remains robust, especially as more cautious investors should continue to shun exposure to Brazilian assets, amid that country's fragile stability.

The higher hedging cost could make the MXN more vulnerable to bouts of risk aversion later in the year, however. NAFTA negotiations will intensify later in 2H while political risk (moderate for now) could intensify after the turn of the year, if polls suggest leftist firebrand Lopez Obrador could win in the July 2018 ballot.

19.00 12-month USD/MXN forecast

USD/CLP: Easing cycle concluded as economy seen stabilizing

The CLP traded within a relatively narrow range in recent weeks, broadly following the outlook for copper prices, which returned to levels seen earlier in the year after plunging early May.

Disappointing domestic drivers had also been weighing on the currency's performance this year but, despite the weak GDP data seen for 1Q, the stabilization of mining output, with the end of the labour strike, along with the lower inflation suggest that domestic drivers could turn more construction from now on.

The CB cut the policy rate again in May, for a total drop of 100bp this year, to 2.5%, and announced that the cycle has been concluded. The bank should maintain a neutral forward guidance, indicating that rate hikes should take a long time to materialize given the benign inflation and lukewarm economic growth.

680 12-month USD/CLP forecast

USD/COP: COP tracks oil as BanRep extends easing cycle

High volatility continues to mark the COP market, with the currency closely tracking oil price trends and, as a result, underperforming its regional peers in recent weeks, as oil prices dropped to levels close to the lows seen in the past year.

Underlying COP fundamentals remain solid, thanks to the ongoing correction of the current account deficit, but the outlook for fiscal accounts turned less constructive on the back of the weaker-than-expected economic activity and the proposed increase in government spending, which largely reverses the fiscal improvement envisaged by the VAT tax increase.

With inflation expectations gradually falling towards the target, BanRep should be able to extend the rate-cutting cycle, with the policy rate returning to the 5.5-5.0% range, from 6.25% now.

2900 12-month USD/COP forecast

USD/PEN: Sideways with mixed drivers

The PEN traded within a narrow range in recent weeks, in line with the mixed performance seen across the metals that compose its export basket (e.g. gold and copper). The currency preserves the bulk of the substantive gains seen since mid-January.

Peru's central bank surprised a majority of analysts by cutting the policy rate in May, while maintaining a cautiously dovish forward guidance. With the inflation outlook improving following the recent food-supply shock, the easing cycle should resume, after the pause in June, with the policy rate dropping towards 3.0-3.5% from 4% now.

Despite the more lukewarm prospects for GDP growth, Peru's fundamentals stand out, thanks to the ongoing rebalance in the current account and superior fiscal sustainability metrics.

3.22 12-month USD/PEN forecast

USD/ARS: Welcoming Brazil's FX market contagion

BCRA authorities should have welcomed the contagion in the ARS market triggered by Brazil's political crisis and the BRL selloff. The bank had recently announced a new FX accumulation policy, aiming to boost reserves to about 15% of GDP and, also, to help prevent the ARS from strengthening too much.

The ARS has since stabilized and shown less sensitivity to BRL moves, but the risk of sudden shifts in the BRL, triggered by new developments, has increased to risk to ARS positions, reducing the appeal of the carry trade, as the CB apparently intended. Still, FX inflows (e.g. external debt issuance) should remain supportive.

Inflation pressures finally eased somewhat, reducing the pressure on BCRA to raise rates and helping consolidate expectations of a faster GDP growth this year, of close to 3%.

16.65 12-month USD/ARS forecast