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LATAM FX Talking: Incipient recovery in risk appetite brings relief

The incipient improvement in risk appetite seen in recent weeks led to considerable gains for most LATAM currencies in recent weeks. The Brazilian BRL continues to stand out for its relatively poor performance, but recent sessions suggest that an inflection point may have been reached. The Mexican peso continues to benefit from its yield-advantage

Executive summary

Given the elevated uncertainties regarding the health crisis and the still unstable global risk appetite, it may be too soon to tell, but it seems that LATAM's worst-performing currency (the BRL) may have found a bottom. This reflects, to a large extent, the greater certainty provided recently by Brazil's central bank. Recent statements by Brazilian officials suggest greater resolve to support FX markets by limiting additional rate cuts. The dramatic reduction in Brazil's reference rate that has taken place since the approval of the social security reform last year was, arguably, the chief responsible for the BRL's underperformance for almost one year now.

Despite the constructive market environment seen in recent weeks, the economic outlook for LATAM economies looks grim, as the Covid-19 health crisis remains

unabated despite the strict social-distancing procedures that have been implemented since March.

The growing economic pain resulting from the collapse in economic activity, together with widespread labour informality throughout the region, suggest that extending social-distancing measures should become increasingly difficult. This suggests that "lockdowns" may be lifted even though there's limited evidence of "curve flattening" throughout the region. As a result, the toll represented by the Covid-19 outbreak should remain hard to assess and could take longer to abate.

These uncertainties suggest that it's going to be hard to be optimistic about in region's outlook. A particular source of concern is likely to be the fiscal toll represented by the deep recession and the greater spending needed to fight the pandemic, and each country's ability to keep fiscal accounts in a sustainable trajectory. Brazil should remain an especially important source of concern here, but we also worry about the potential deterioration in Mexico and Colombia.

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