Report | 27 August 2019 FX ARGENTINA BRAZIL

LATAM FX Talking: Playing defensive

The external risk environment has deteriorated over the past month, with rising trade-related risk aversion. The near-term environment for EM assets should remain testy, and, specifically in LATAM, the rising risk of a credit event in Argentina could also have some negative impact. Defensive positioning should continue to benefit the MXN and the PEN

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Executive summary

The BRL has been the big underperformer in the region over the past month, excluding Argentina. This is somewhat surprising, considering the favourable evolution of the fiscal agenda and the fast drop in the sovereign's risk premium. The spread on Brazil's 5-year CDS is trading at a 5-year low, the best-performer in the region YTD, while the BRL was the worst performer in the same period.

Even though we remain especially bullish on the BRL in the longer-term, the currency's short-term prospect remains weighed down by stronger-than-expected FX outflows. These outflows have been triggered by debt liability management operations by local corporates, which are borrowing locally at record-low levels of interest rates, and using the proceeds to pre-pay debt abroad. Given their nature, these outflows are long-term positive for the currency, but they have been disruptive in the nearer term and, according to the central bank, they are likely to be long-lasting, as suggested by favourable prospects for an additional 100bp cut in the policy rate, to 5%. For the BRL to outperform, those outflows must be offset by inflows, but those should only rise when activity data strengthen materially, which may happen only gradually.

Argentina is, meanwhile, once again undergoing episodes of extreme volatility, as the risk of a credit event has resurfaced following the surprising electoral result of the recent presidential primaries. The primaries revealed that opposition candidate Alberto Fernandez is highly likely to become Argentina's next president. And given Fernandez's unorthodox economic policy credentials, the ARS has sold off massively, while the government's ability to roll over maturing debt amortizations has been severely hampered. A debt default is not inevitable, but it would likely require a considerable policy tightening that seems, arguably, unrealistic to expect from Fernandez.

Author

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

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