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FX ARGENTINA BRAZIL

LATAM FX Talking: Rally likely has a bit further to go

The impressive rally seen in recent weeks showed signs of strain after the widespread profit-taking seen this week. The correction may prove to be temporary, however, if signs of a recovery in economic activity consolidate and Covid-19 health indicators remain under control, as the reopening in business activities gains momentum



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Executive summary

Some currencies are now much closer to what we consider their fair values. Overall, we consider the Brazilian real and the Colombian peso to have the greatest potential to outperform in the shorter term.

Domestic FX drivers are likely to turn more positive in Brazil as well, if next week's monetary policy meeting concludes, as we expect, with a firm indication that the rate-cutting cycle is over. Our view is that the policy rate will drop by 75bp on June 17, to 2.25%, and stay at that level in the foreseeable future. Any additional effort to implement monetary stimulus should be done through alternative credit-boosting initiatives, like the ones already being deployed by BACEN, along with a greater focus on the shape of the yield curve, which remains exceedingly steep.

The Mexican peso should, meanwhile, continue to benefit from its yield advantage in the

shorter term. But, going forward, the Mexican central bank is the one with the greatest scope to cut the policy rate in LATAM. And our bias is for the central bank, faced with the grim economic reality created by the ongoing health crisis, to surprise on the dovish side in the coming months, by cutting its reference rate every month by 50bp until the policy rate reaches 4%.

We are more circumspect about our medium-term outlook for Brazil and for LATAM in general. The impact of the deep recession and of the Covid-related fiscal relief over sovereign debt dynamics is likely to be considerable. As a result, a strong fiscal-tightening bias is necessary to return fiscal trends to a sustainable trajectory in 2021, which may create political friction later in the year. Eventually, this could result in negative credit-rating action for several sovereigns in the region.

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