

LATAM FX Talking: The Brazil vs Mexico divergence gains steam

The external risk environment has turned slightly more benign with US-China trade tensions stabilizing and market relief provided by expected rate cuts in the US and Europe. The Brazilian BRL continues to stand out, even though we have recently moderated our appreciation trajectory for the Real. There is a weakening bias for the Mexican peso



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Executive summary

In the case of Brazil, the much-anticipated approval of the pension reform should reduce uncertainties related to the sustainability of the fiscal accounts and prompt an improvement in the outlook for economic activity and for local assets in general. But market reaction to the approval of the pension reform by the Brazilian Congress has been relatively muted this week, suggesting that much of the approval had already been incorporated into asset prices. Moreover, implementation of a relatively frontloaded monetary easing cycle, by as much as 150bp, starting with a 50bp cut on July 31, suggests that the BRL may lag other local assets.

The outlook for the Mexican peso has become cloudier, with lingering external trade uncertainties and, especially, the deterioration in the outlook for economic activity, as illustrated by the worrying contraction in industrial activity seen today, and the rising risk of credit rating downgrades, for PEMEX and the sovereign. Due to these uncertainties Banxico remains cautious about changing policy guidance, but a deeper divide appears to have emerged inside the board, as suggested by the monetary policy minutes released this week, and the bank appears now more inclined to follow the US Fed and cut the policy rate slightly. Having said that, intense policy focus on maintaining FX stability suggests that high rates should continue to act as the chief FX anchor in the nearer term.

Author

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com