Economic & Financial Analysis

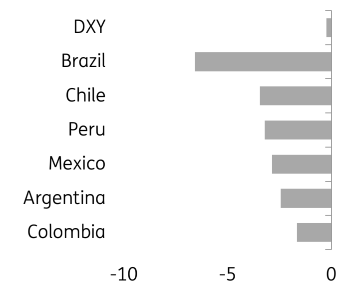
FX

6 July 2020

LATAM FX Talking

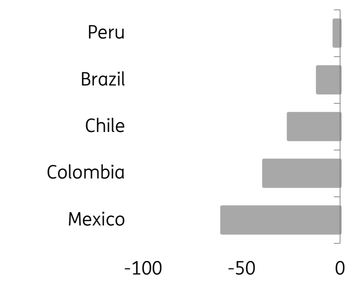
Reaching the limit of rate cuts

FX monthly change (%)



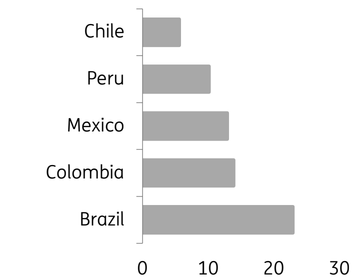
Source: Bloomberg, ING

5yr local rate monthly change (bp)



Source: Bloomberg, ING

5yr CDS monthly change (bp)



Source: Bloomberg, ING

A preoccupation with stability in local financial markets, especially FX, is now driving the monetary policy decisions of several countries in LATAM. Apart from Mexico, which has traditionally weighed FX considerations heavily in its reaction function, central banks in Colombia and Brazil are also now highlighting the risk of financial market instability, possibly driven by FX outflows, if rates drop much lower than they are now.

This means that, apart from Mexico, LATAM's biggest economies are now at, or very near, their lower bound in terms of their rate-cutting cycles. For FX, this suggests that domestic factors should take the backseat to external drivers, such as risk appetite and the USD, when considering the near-term dynamics for the region's major currencies.

Covid-19 continues to spread across LATAM but, given mounting economic costs of stay-at-home orders, governments are shifting to more targeted social isolation guidelines. As movement restrictions have been gradually eased since April, economic activity has, likewise, recovered some ground, but it's still too soon to assess recovery prospects.

The recovery should be uneven, as suggested by evidence from Peru and Chile, for instance, where the health crisis is the deepest and where strict lockdowns have been extended. Generally, we expect the recovery trajectory to reflect the trajectory of the health crisis, the ability to re-open economies and the economic policy decisions taken place over the past few months.

Robust economic policy responses should help lessen the recession but will leave behind severe fiscal challenges that should alter intra-region relative performance post-pandemic. In particular, the larger fiscal stimulus adopted by Brazil, followed by Colombia (medium), and Mexico (small) may help highlight important divergences about the policy choices adopted in each country.

Brazil's (and Colombia's) more generous fiscal package should help expedite the recovery but create severe fiscal challenges in the future. But Mexico's "fiscal prudence" may also exacerbate the risk of greater permanent damage to the economy, while keeping the risk of credit-rating downgrades elevated. In any case, this may provide room for performance differentiation in the coming quarters, but it's still too soon to say with conviction which policy path will prove most effective in the current context.

ING's 12-month currency view vis-à-vis forward/NDF market forecasts

	USD/BRL		USD/MXN		USD/CLP	
1M	5.20	↓	22.20	↓	790.00	↓
3M	5.10	↓	22.00	↓	780.00	↓
6M	4.70	↓	22.00	↓	760.00	↓
12M	4.50	↓	22.50	↓	770.00	↓
	USD/ARS		**USD/COP**		**USD/PEN**	
1M	72.20	↓	3600.00	↓	3.50	↓
3M	77.00	↓	3550.00	↓	3.50	↓
6M	83.00	↓	3450.00	↓	3.45	↓
12M	98.00	↓	3450.00	↓	3.40	↓

>/=/< indicates our forecast for the currency pair is above/in line with/below the corresponding market forward or NDF outright

Source: Bloomberg, ING

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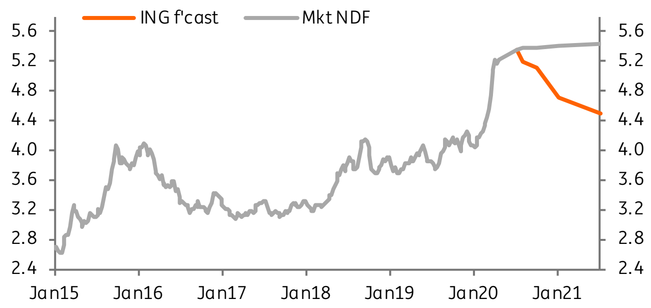
USD/BRL

Focus on external drivers amid softer domestic agenda

Current spot: 5.36



Source: Bloomberg, ING

- The BRL continues to stand out for its outsized volatility, perhaps the largest in EM. But we expect greater clarity on the domestic front (ie, monetary policy) to gradually bring about a more closely synchronized BRL trend, when compared to its EM peers.
- The large drop in interest rates was, in our view, the single most important BRL driver in the past year. But with the SELIC rate now very near its lower-bound, material additional cuts are unlikely.
- As a result, even though current interest rate levels are not particularly attractive, from a carry perspective, the chief near-term BRL driver should be external factors, such as global risk appetite, likely linked to Covid-19 developments, and the USD.

ING forecasts (NDF)	1M 5.20 (5.37)	3M 5.10 (5.39)	6M 4.70 (5.41)	12M 4.50 (5.44)

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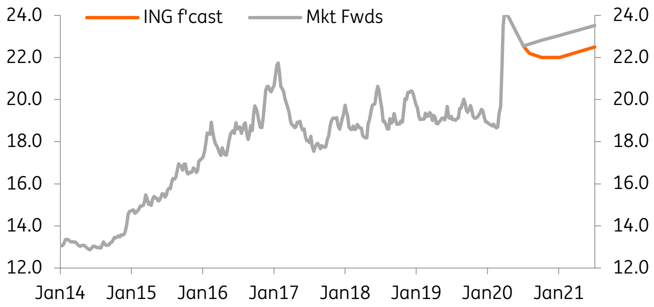
USD/MXN

Yield-advantage only partially offset policy mistakes

Current spot: 22.54



Source: Bloomberg, ING

- The MXN underperformed in recent weeks, which may reflect the fact that even though the currency still offers a relatively high carry, Mexico's macro outlook appears especially worrisome.
- Mexico's GDP is likely to face one of the deepest slumps in LATAM this year, but the country has opted for modest countercyclical initiatives, exacerbating the risk of greater permanent damage to the economy, and delaying the eventual recovery.
- The administration's frequent public disputes with the private sector also continues to undermine investor confidence and call into question whether the MXN's persistent yield advantage would suffice to ensure a supportive environment for the MXN.

ING forecasts (mkt fwd)	1M 22.20 (22.63)	3M 22.00 (22.81)	6M 22.00 (23.04)	12M 22.50 (23.51)

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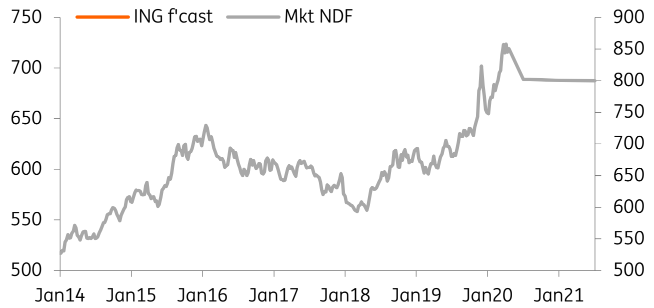
USD/CLP

Severe health crisis and the extended lockdown stands out

Current spot: 802.18



Source: Bloomberg, ING

- The especially severe health crisis seen in Chile, together with the more extended lockdown, suggest that the likelihood of a more lasting negative reassessment of the country's prospects is possible, especially considering latent political and social risks.
- Chile stands out for its assertive policy stimulus measures, with a large fiscal package and aggressive rate cuts, along with the commitment to keep the policy rate at its "technical minimum" of 0.5% for a long period, apart from official appetite to deliver material additional unconventional stimulus.
- Unsupportive domestic drivers are partly offset by rising copper prices, a key short-term FX driver adding important CLP upside.

ING forecasts (NDF)	1M 790 (802)	3M 780 (801)	6M 760 (801)	12M 770 (800)

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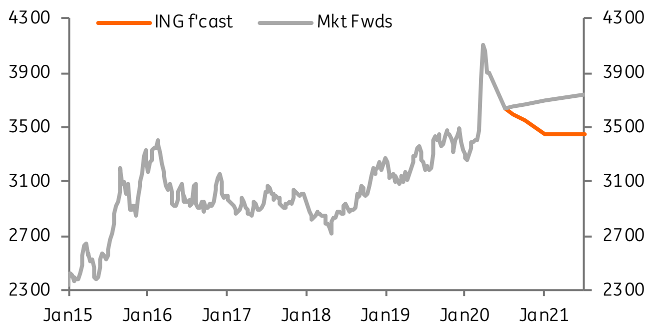
USD/COP

Risk of credit rating downgrades calls for caution

Current spot: 3645.39



Source: Bloomberg, ING

- Colombia's economic policy reaction to the ongoing crisis has been considerably tamer than the ones seen in Chile and Peru. The hawkish surprise in its latest monetary policy meeting, in fact, highlights a growing concern over local financial market instability, potentially driven by non-resident FX outflows.
- The concern over lasting fiscal damage, especially considering Colombia's precarious "investment grade" status amid continued elevated risk of rating downgrades, suggests that risk of outflows should persist until long-term fiscal dynamics are re-anchored.
- The recovery in crude prices, a crucial near-term FX driver, reduces fiscal risks but the COP looks fairly priced.

ING forecasts (NDF)	**1M** 3600 (3656.23)	**3M** 3550 (3673.89)	**6M** 3450 (3698.89)	**12M** 3450 (3744.47)

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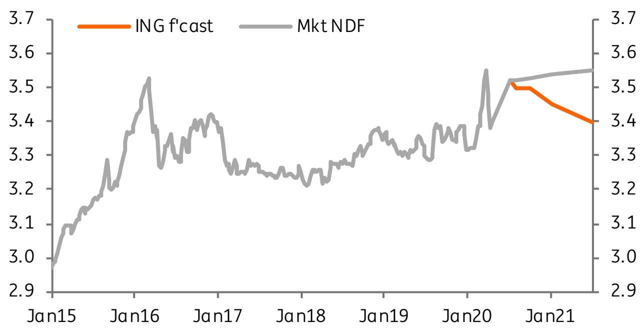
USD/PEN

Aggressive stimulus is unable to prevent a deep recession

Current spot: 3.52



Source: Bloomberg, ING

- Like Chile, Peru is suffering one of the most severe consequences of the Covid-19 outbreak in LATAM. This, together with controversial initiatives advancing in Congress, perhaps help explain the unusually large FX correction seen in recent weeks, when compared to historical patterns for the PEN.
- Peru's superior ability to deploy economic policy stimulus, including large fiscal outlays and the lowest policy rate in LATAM, should help alleviate the impact of the crisis, but having had the worst contraction in the region so far, it's hard to be optimistic.
- Large FX reserves suggest, however, that Peru should be able to continue to heavily manage its FX dynamics, and shield the PEN from the wider fluctuations that typically affect its EM peers.

ING forecasts (NDF)	**1M** 3.50 (3.52)	**3M** 3.50 (3.53)	**6M** 3.45 (3.54)	**12M** 3.40 (3.55)

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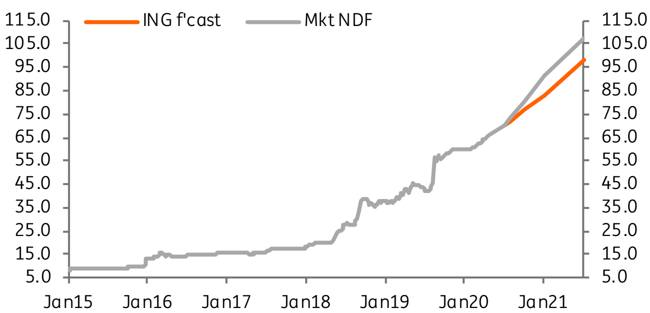
USD/ARS

In default but still hopeful of a compromise solution

Current spot: 70.58



Source: Bloomberg, ING

- Argentina opted to cease servicing external bonds but decided to extend negotiations with external bondholders once again, keeping alive the possibility of a negotiated compromise solution that would "cure" the default.
- Stringent FX controls have, meanwhile, helped limit the widening premium between the official and the non-official FX rate. But at about 50%, that premium remains exceedingly high, illustrating both Argentina's difficult predicament and the limits of the government's strategy.
- Covid-19 appears to have both added urgency and complicated the negotiating process. A compromise solution is still possible, but uncertainty prevails, deepening local market instability.

ING forecasts (NDF)	**1M** 72.20 (73.43)	**3M** 77.00 (80.60)	**6M** 83.00 (91.58)	**12M** 98.00 (107.68)

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