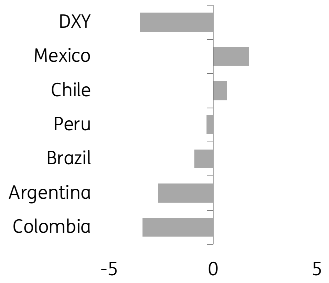
7 August 2020

LATAM FX Talking

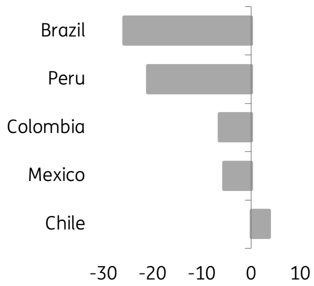
Post-Covid challenges weigh on sentiment

FX monthly change (%)



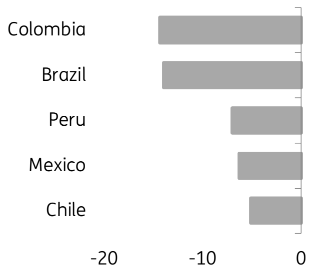
Source: Bloomberg, ING

5yr local rate monthly change (bp)



Source: Bloomberg, ING

5yr CDS monthly change (bp)



Source: Bloomberg, ING

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LATAM currencies have been under pressure, underperforming EM FX generally and, somewhat surprisingly, failing to rally amid USD weakness. That performance is, however, comparable to FX trends seen in the more fragile EM economies. LATAM FX appears weighed down by negative investor sentiment towards the region, which is often considered the "new epicentre" in the Covid outbreak. Moreover, the economic impact of the pandemic is likely to exacerbate the region's existing macro fragilities. The large build-up in public debt that is taking place is particularly worrisome and may result is substantial shifts by credit rating agencies over the next few quarters.

Domestic drivers that should pave the way for intra-region differentiation should consist of data on the ongoing economic recovery and the enactment of legislative initiatives that ensures the long-term debt-sustainability of the public sector.

Recent data from Brazil suggests that the country is recovering a bit faster than its neighbours, while Congress has resisted approving fiscal measures that extend the fiscal stimulus into 2021. That has helped circumscribe the fiscal deterioration to 2020, but pressure is building to approve legislation that suspends or weakens the centrepiece of Brazil's fiscal-sustainability framework, the spending ceiling. That's not our base-case scenario but, should that happen, Brazil's fiscal anchor would be destabilized, adding considerable downside to local assets.

Colombia faces similar challenges and is, additionally, likely to lose its investment grade at some point over the next few quarters. Mexico should face the deepest GDP contraction of the three, but it should avoid the fiscal deterioration that is likely in Brazil and Colombia. For Mexico, the risk of loss in investment grade is a longer-term threat, that would reflect the failure of the current administration to enact growth-enhancing policies, resulting in a slower but more persistent deterioration in fiscal metrics.

Of the three countries, Mexico also maintains a more FX-supportive monetary policy guidance, and the MXN's yield advantage should continue to give the MXN a short-term edge. That could change next year if the central bank, faced with grim economic data, joins its regional peers and lowers its policy rate towards its effective lower bound.

Overall, we remain circumspect about LATAM's medium-term outlook. The impact of the recession and of the Covid-related fiscal relief over fiscal accounts is likely to be considerable. A strong fiscal tightening is necessary to return fiscal dynamics to a sustainable trajectory in 2021, which may create political friction later in the year.

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

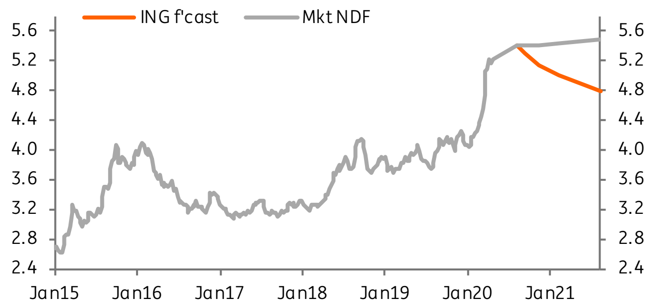
	USD/BRL		USD/MXN		USD/CLP	
1M	5.30	↓	22.35	↓	765.00	↓
3M	5.15	↓	22.10	↓	760.00	↓
6M	5.00	↓	22.30	↓	770.00	↓
12M	4.80	↓	23.00	↓	780.00	↑
	USD/ARS		**USD/COP**		**USD/PEN**	
1M	74.40	↑	3700.00	↓	3.54	=
3M	78.00	↑	3650.00	↓	3.52	↓
6M	85.00	↑	3700.00	↓	3.49	↓
12M	105.00	↑	3800.00	↑	3.46	↓

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

USD/BRL

Negative sentiment and unsupportive local rates

Current spot: 5.40



Source: Bloomberg, ING

- The BRL continues to stand out for its outsized volatility, among the largest in EM. The currency has also been weighed down by negative newsflow regarding the Covid pandemic, along with the central bank's more aggressive rate-cutting stance.
- The CB confirmed that there's now minimal scope for more rate cuts (from 2.0%), but the bank appears more willing than others to test that lower bound, even at the cost of greater FX volatility.
- Domestic drivers that could eventually turn the tide in favour of the BRL include stronger evidence of a faster economic recovery and legislative action that confirms the commitment to a sustainable fiscal trajectory.

ING forecasts (NDF)	1M 5.30 (5.40)	3M 5.15 (5.41)	6M 5.00 (5.43)	12M 4.80 (5.48)

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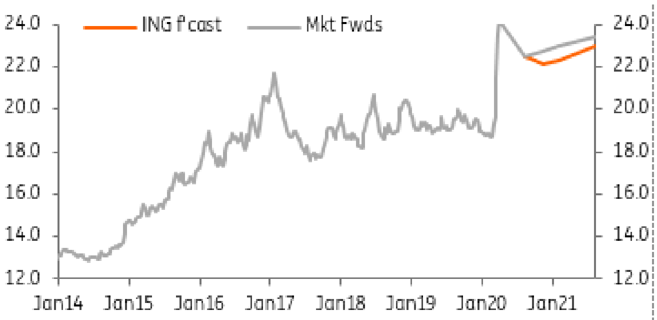
USD/MXN

Yield-advantage partially offset policy mistakes

Current spot: 22.46



Source: Bloomberg, ING

- The MXN performed relatively well in recent weeks, consistent with the supportive carry, and despite the fact that Mexico's post-Covid 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 22.35 (22.55)	3M 22.10 (22.73)	6M 22.30 (22.96)	12M 23.00 (23.43)

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USD/CLP

Copper upside limited by the severe domestic crisis

Current spot: 778.87

Source: Bloomberg, ING

- The CLP was the best-performing currency in LATAM in recent weeks, largely thanks to the sustained rally in copper prices. In fact, if past correlations hold, current price levels for the metal suggests that the currency has further to go.
- High copper prices are partly offset by unsupportive domestic drivers, however. The severe health crisis and latent political and social risks suggest that the likelihood of a more lasting negative reassessment of the country's macro prospects is likely.
- Chile's assertive policy stimulus measures bode well for a faster recovery but the CB's appetite to deliver material additional stimulus through QE could also add downside for the currency.

ING forecasts (NDF)	1M 765 (779)	3M 760 (779)	6M 770 (778)	12M 780 (777)

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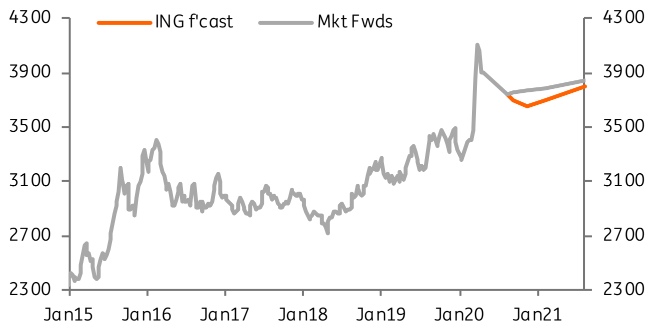
USD/COP

Risk of credit rating downgrades calls for caution

Current spot: 3741.50



Source: Bloomberg, ING

- The COP was the wort-performing currency in LATAM in recent weeks. Concern over lasting post-Covid fiscal damage, and 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.
- Scope for additional rate cuts, from 2.25% now, is also unsupportive for the COP. Current monetary policy guidance suggests that another 25bp cut is likely.
- The recovery in crude prices, a crucial near-term FX driver, reduces fiscal risks but, considering lingering risks to the macro outlook, we see little scope for near-term COP outperformance.

ING forecasts (NDF)	**1M** 3700 (3751.26)	**3M** 3650 (3768.01)	**6M** 3700 (3790.40)	**12M** 3800 (3838.75)

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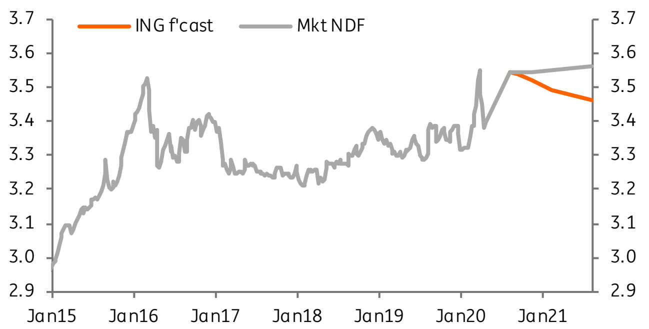
USD/PEN

Aggressive stimulus is unable to prevent a deep recession

Current spot: 3.54



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 and lingering political instability, add important macroeconomic headwinds for the country.
- 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** 3.54 (3.54)	**3M** 3.52 (3.55)	**6M** 3.49 (3.55)	**12M** 3.46 (3.56)

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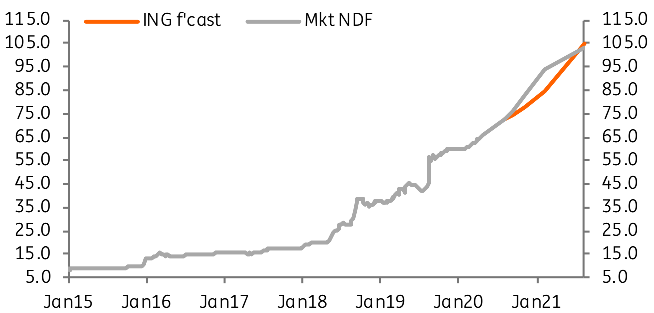
USD/ARS

Optimism as debt-renegotiation concludes successfully

Current spot: 72.76



Source: Bloomberg, ING

- The successful conclusion of the negotiations with external bondholders should allow Argentina to avoid a hard default and start re-negotiating with the IMF.
- Restoring Argentina's macroeconomic outlook towards a sustainable trajectory will be an enormous undertaking, requiring the adoption of a credible policy plan, with the IMF's imprimatur, to revive investor sentiment towards the country.
- The rising fiscal toll and the monetisation of fiscal accounts exacerbated inflationary risks. The premium between the official and the non-official FX rate has widened to almost 70% and remains an important barometer for domestic imbalances.

ING forecasts (NDF)	**1M** 74.40 (75.80)	**3M** 78.00 (83.29)	**6M** 85.00 (94.21)	**12M** 105.00 (103.46)

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