LATAM: Political risk calls for caution

- **Rise in political uncertainty, with competitive presidential elections scheduled for Mexico, Brazil and Colombia, should intensify FX volatility in 2018.**
- **A stronger macro footing, with robust external accounts, lower inflation and faster GDP growth, suggest a more contained FX weakening bias however.**
- **Election polls (and NAFTA news) should drive the BRL and MXN performance, while our constructive outlook for commodities suggests a more resilient CLP and PEN.**

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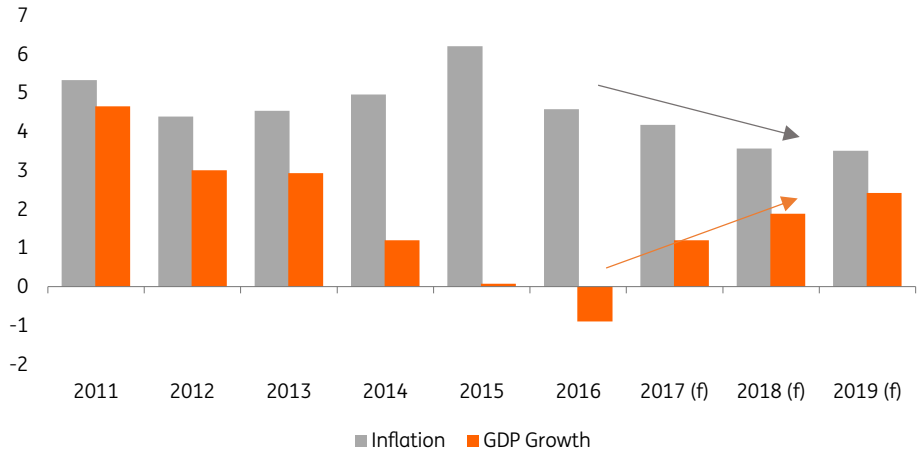
Macro strength contrasts with political vulnerabilities

After two years (2015-16) marked by high inflation and low growth/recession, due in large part to a combination of the end of the commodities boom and Brazil's political crisis, 2017 was the year in which Latin America re-entered a period of stronger macroeconomic stability. This greater macro stability, enhanced by solid external accounts, would in principle bode well for the region's currencies in 2018. But LATAM FX will be tested by a combustible political environment, marked by high-stakes presidential elections in Mexico, Brazil and, to a lesser extent, Colombia.

Recent political events in the region have, in fact, added support to local assets, with market-friendly results in Argentina and, possibly, Chile (where a second-round vote remains too close to call). But the Mexican and the Brazilian races carry a bigger risk of a left-leaning shift, which should weigh on market sentiment towards local assets. These electoral results will be critical to determine the outlook for reforms, economic policy and activity growth for the region's two biggest economies.

Fig 1 2017 marked the end of a deep 2-year adjustment in the region (%)



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FX Strategy Team

Across the Andes, local assets should remain well-supported by domestic dynamics marked by lower inflation, lower rates, and higher growth, in the context of reduced political risks. The outlook for commodity prices will remain critical however to determine currency performance in the Andean region. ING's commodity team maintains a broadly bullish outlook for metals, which are chief drivers for terms of trade of Chile and Peru while the outlook for oil, the chief driver for Colombia, is more range-bound. But, overall, the well-supported outlook for terms of trade suggest an outperformance bias for these currencies.

> *" ING's commodity team maintains a broadly bullish outlook for metals, which are chief drivers for terms of trade of Chile and Peru "*

The COP should remain the most vulnerable of the three, given Colombia's more fragile fiscal and external footing, the risk of larger-than-expected rate cuts, moderate electoral risk and the less constructive outlook for oil, when compared to metals. Thanks in part to still-large (albeit declining) inventories and a record-high US production, ING expects oil prices to drop from recent highs and maintain a lower average in 2018.

Presidential elections are set for May 2018, with the peace agreement with the FARC looming large over voter preference. Unless unorthodox leftist (and former Bogota mayor) Gustavo Petro becomes a likely winner, which we see as a low-probability scenario, we expect financial markets to have a muted reaction to the ballot. Questions about the government's commitment to a fiscal consolidation effort suggest meanwhile some risk of a credit-rating downgrade.

Copper prices should meanwhile remain the primary driver for Chile's CLP, and considering ING's generally bullish outlook for copper, underpinned by a lingering deficit in global copper production amid improving global demand, the CLP should outperform.

> *" CLP should outperform this year "*

Peru's PEN should meanwhile continue to be marked by the balance between favourable FX flows, with a surging trade surplus, and BCRP's fear-of-float and high-propensity towards FX intervention. Peru's fundamentals also continue to stand out, with an unmatched record as the region's fastest-growing economy, much-improved current account dynamics and superior fiscal sustainability metrics. This should result in a low-volatility slight-appreciation bias for the PEN, with a more marked outperformance taking place during bouts of global market risk aversion.

> *" Peru's fundamentals also continue to stand out, with an unmatched record as the region's fastest-growing economy "*

MXN volatility to spike with NAFTA uncertainties

For Mexico, the combined impact of uncertainties relative to the NAFTA negotiations, which are now scheduled to last at least through to the end of 1Q18, and the presidential election (July), suggest that the Mexican peso should maintain a weakening bias in the foreseeable future, with the end of the first quarter potentially marking an important catalyst for a deeper sell-off, should negotiations fail to conclude successfully.

The difficulties encountered in the latest rounds of negotiations suggest that it is unclear if the three countries will be able move past the considerable differences that became evident in the fourth round of negotiations. Unless the US stance on demands such as the sunset clause and the high US-specific content requirements ease somewhat, a break-up scenario could become a high-probability event.

Investors remain highly sensitive to the outlook for trade negotiations, but it is too soon to assess the ultimate impact of the end of NAFTA, as the terms of an eventual break-up are also far from certain (e.g., would trade relations follow WTO directives?). But, in any

case, the uncertainty generated by new export tariffs, reduced prospects for export-oriented investment and the potential disruption in some manufacturing supply chains would likely trigger a selloff in both FX and local debt markets. Rating agencies are also likely to react, possibly deciding for a one-notch downgrade amid rising uncertainties for Mexico's external accounts and lower-growth prospects.

NAFTA difficulties would be compounded with the risk of material changes to economic policy directives, following the July 2018 election. Left-wing candidate Andres Manuel Lopez Obrador continues to lead opinion polls and his candidacy could strengthen with the heated rhetoric surrounding US-Mexico relations and the fragmentation of the political centre.

> *" NAFTA discussions and the threat of economic policy changes after the July 2018 Presidential election suggest a weakening bias and heightened volatility for Mexican assets throughout 1H18 "*

Both of these risk factors suggest a weakening bias and heightened volatility for local assets throughout 1H18. But thanks to the rise in interest rates, Mexican assets should be more resilient than they were earlier last year. The USD/MXN could return to the 20-21 range but we don't expect the currency to overshoot to the near-22 high seen in January. The specific path and timeline should be heavily dependent on newsflow related to both NAFTA and AMLO's electoral prospects.

Following the July 2018 presidential ballot, and assuming a market-friendly result in the presidential race or the announcement of a market-friendly economic plan by AMLO, the currency could gradually retrace back towards its medium-term fair-value. That value would be closer to 18 if NAFTA survives and closer to 20 if the treaty is abandoned.

> *" The weaker peso should give Banxico no choice but to be relatively hawkish throughout 1H18 "*

Should risk factors fail to materialise, the peso is likely to rally and allow Banxico to consider cutting the policy rate, sometime later in 2H18.

Binary post-election scenario looms for Brazil

Brazil is the other country in the region with great potential for election-related volatility in 2018, with general elections scheduled for 7 October. This reflects the fact that Brazil's fiscal consolidation effort remains unfinished, with a social security reform still missing from the otherwise substantial achievements obtained so far by the Temer administration.

The Temer administration and Congressional leaders still seem committed to a last-ditch effort to pass a (watered-down) version of the reform, before political gridlock sets in. Legislative success remains unlikely, but Congressional leaders could still surprise and, in that case, the BRL could temporarily rally, towards 3.0.

Without a substantive social security reform, Brazil's fiscal trajectory is likely to continue in the current explosive trajectory, ensuring further credit downgrades, and severe economic and political instability over the next two-three years. For the BRL, this would mean a weakening bias and a more volatile trajectory, closely linked to the likelihood of an electoral result that maximises the likelihood of additional fiscal consolidation. Given the dire fiscal outlook, market reaction to the election of a candidate that rejects fiscal austerity would be severe.

> *" We expect the BRL to weaken towards 3.50 ahead of October elections "*

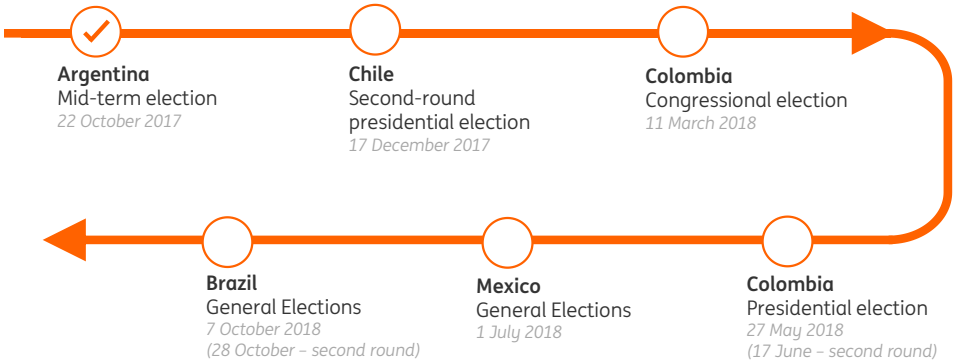
It is too soon to have clarity on how electoral dynamics will play out and affect financial markets. Candidates are not yet known and former President Lula's ability to run may not be decided (by the courts) until 2Q18. But we expect polls to be very volatile, with potential for non-traditional candidates and significant fragmentation in the centre, as it

remains unclear if the big parties that compose President Temer's governing alliance (PMDB, DEM, PSDB) will remain allied or will support separate candidates, adding uncertainty to the electoral result.

In any case, we expect the BRL to weaken towards 3.50 ahead of the elections, with a rally towards the 3.2-3.3 range following the election of a fiscally conservative candidate, or an initial selloff towards 3.7-3.8 in the event of the election of an unorthodox candidate.

This pre-election FX trajectory suggests some risk that BACEN will intervene in FX markets, with the sale of FX swaps or direct spot intervention, in an effort to limit market volatility. But we don't expect BACEN to consider hiking the policy rate. Inflation trends should remain broadly benign in 2018 and we expect the bank to operate with the assumption that the new administration will continue to abide by current fiscal rules. In that case, BACEN would assume a prolonged period of fiscal tightening, allowing for sustained monetary stimulus and a SELIC rate stabilised at an historical low for an extended period of time. This seems consistent with a scenario of heightened political uncertainties and FX volatility.

Fig 2 LATAM electoral calendar



Source: ING

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