Sovereign Macro- Weekly Latin America Market Outlook

October 18, 2021

Summary: the global outlook is turning more complex and challenging for EM. The talk of global stagflation appears exaggerated since growth has substantial forward momentum -allowing many economies to grow above potential next year-, and inflation should stay high and sticky for at least the next six months but decelerating. That said, financial conditions in the US continue to tighten in tandem with inflation worries and the imminent start of policy normalization. China is still the weaker engine of global growth; the latest bank lending data slowed to under 12% annually for the first time since 2005 and my estimation of TSF annual growth also slowed for the 7th month in a row. The PBOC noted that problems in the property sector were overblown, it was acting to maintain stable liquidity, and denied direct support to the property sector or intentions to ease on the broader objective of deleveraging the economy; rate cuts seem unlikely. Ongoing problems related to energy shortages and the path forward for the property sector will take time to resolve thus denting confidence. Europe, including the UK are still facing strong headwinds due to sharp increases in energy prices and solutions such as helping producers financially or reducing taxes sound good on paper but will not provide a sustained solution. Even China is letting energy prices rise. There are other developments in the US that attest to the challenging dynamics of the labor market. More companies are facing labor strikes such as in John Deere (10k workers), Kellog's (1400) and Kaiser Permanente (34k). Demands include higher pay and better benefits. Conversely, it is not uncommon to hear radio adds recruiting truck drivers all over the country. At the same time people are quitting jobs at an alarming rate, some are calling it "the great resignation". The anecdotal evidence of a seriously impaired labor market is mounting, and this should result in further and more permanent wage pressures. The government is trying to ameliorate pressures on the supply chain for instance by announcing a reopening of the border with Mexico to facilitate trade flows. A new buzz word is *nearshoring* (as opposed to offshoring) to indicate that companies are simplifying their logistics to geographically closer locations and avoid the nightmare of dealing with an unpredictable and unfriendly China; Mexico and Brazil stand to benefit. Elsewhere in policy land, this was a hawkish week for central banking. The IMF added its two cents recommending central banks to be "very very vigilant" and act early to avoid large inflation upside surprises, too late perhaps. More controversial was its suggestion that anchoring expectations should be more important than letting the labor market heal. The FED's minutes reaffirmed the start of the normalization process, and it was noteworthy that members already discussed the prospects of rate hikes. Brazil's Bacen continued to press its case to meet the 3.5% inflation target in 2022; Chile surprised with so far the largest hike in the region of 125bp; Mexico published hawkish minutes. Colombia's BCRP board members are still reluctant to accelerate the pace of normalization. EM will have to reassess its relative monetary position going forward. Old parameters are likely to be challenged.

US

- MINUTES: there was no additional information regarding tapering. There is still disagreement on progress in repairing the labor market and what the parameters of "maximum employment" will be when it comes to raise interest rates. Some believe that patience will restore the market to its previous condition and others are skeptical. In the outlook for inflation, there is also division. Some think that downward pressure will persist and be hard to keep inflation at the target even with a rate close to the ELB. Others think that inflation is more persistent and may force the FED to hike in 2022.
- INFLATION EXPECTATIONS: The latest NY FED inflation expectations survey indicated another increase in one and three-year expectations to 5.3 and 4.2% respectively from 5.2 and 4% previously; it inked its 11th month of increases. These are the highest levels since 2013 when the survey started.
- INFLATION: The main takeaway is that services are accelerating both in core and headline, sequentially and annually. Core goods decelerated for the second month in a row but remains extremely high and sticky due to mounting problems in the supply chain including from inputs for production all the way to distribution. Core services are accelerating mostly due to Shelter categories including rents and OER in response to the rapid appreciation of real estate property, reinstatement of eviction rules and all reinforced by the normal indexation practices. Rents explained 24bp of the 26bp monthly core services inflation. Shelter is a category that once it starts to accelerate, it is likely to be persistent. There is a lag of about 18 months between home price increases and rentals. Headline CPI moved up a bit to 5.4% and core stayed put at 4%.
- FEDSPEAK: Clarida inflation at 2.9% "is well above what I would consider to be a moderate overshoot of our 2% goal". FED will let the relative price adjustments work out as well as bottlenecks unclogged, and then inflation should be closer to the target. Risks are to the upside and need to watch core including CIE. Believes that SFP was met in prices but not quite yet on employment. He didn't appear ready to vote for a hike in 2022 but it somewhat irrelevant since he will be out by January
- COLA: adjustment for cost-of-living adjustment in 2022 will be 5.9%, largest in 40 years.

ARGENTINA

- EXPORT RESTRICTIONS: new export restrictions now on corn in addition to meat. Import restrictions are also mounting in order to preserve FX.

- IMF: negotiations with the IMF started and Georgieva's troubles make IMF flexibility less likely. Alberto Fernandez said that the government would take its time to negotiate an agreement with the IMF and completed in 2022. The outlook for the negotiations will be clearer after the November 14 congressional elections.
- INFLATION: surprised on the upside and now is at 52.5% on headline and 57% on core. The government introduced price controls on 1200 items for 90 days to help its chances to revert the disastrous preliminary election of result of the PASO in the upcoming congressional elections.

BRAZIL

- FISCAL ACCOUNTS: Government considering announcing a "national calamity" to sidestep congress and approve an extension of the Coronavoucher, which ends in October. It is also possible that such support is extended through year end 2022 but changing its name from "emergency support" to "temporary support. It would be complemented with a more generous Bolsa Familia program thus abandoning at least temporarily the Auxilio Brasil program. This obviously requires the solution to the problem of precatorios which may be voted on this week.
- ICMS ON ENERGY: Congress approved a change for the ICMS tax to apply a fixed tax instead of a percent on gasoline prices. This will reduce revenue of the states; the bill now moves to the senate where states have a stronger influence and may vote against the change.
- KANCZUK: he said that the current pace of normalization was appropriate but terminal rate is what matters more. He reaffirmed the board's message that it is focused on meeting target in 2022. He explained that if they don't meet target in 2022 it will be difficult to do it in 2023. In his opinion, inertia is more important for services. 100bp is not a commitment, if inflation worsens, we will change our dose.
- CAMPOS: reinforced the idea of seeking the target in 2022 and if necessary, would be open to accelerating the pace. As with Kanczuk, he said that the terminal rate was more important than the pace. Optimal approach is to keep the pace and have time to assess the nature of shocks.

CHILE

- BCCH: it surprised the market with 125 bp hike to 2.75%, still accommodative. It communicated that the policy rate would reach neutrality sooner than anticipated. They will revisit their plan in the December 14-15 monetary policy report. They suspended their reserve accumulation program.

- MARCEL: two days after the publication of the minutes, governor Marcel indicated that the policy rate would likely be at the neutral rate (3.5%) around year end, which means that the next rate increase is only of 75bp, which appears insufficient

COLOMBIA

- BANREP: Governor Villar said that the normalization process of interest rates could take about one year or "a long period". The policy rate is now at 2% and the terminal rate in nominal terms should be between 4.5-4.75%.
- STEINER: The deputy governor indicated that it would be premature to indicate where the policy rate should be in the next 12 months in sharp contrast to governor Villar. Moreover, he said that the board was "not obsessed with inflation" since the mandate established in the charter is for low and stable inflation. While there are upward pressures on expectations, they are reasonably anchored.
- JARAMILLO: the deputy governor was very much in tune with Villar and Steiner and explained that the effects of the normalization of tariffs post pandemic, price increases due to road blockades and food shocks, they explained about 150bp of headline and therefore the inflation would be at the target. He anticipated that normalization would be gradual but not necessarily to a restrictive level. In his opinion reassessing the pace would have to include what is happening to inflation data, indexation, the output gap and what are global pressures on interest rates.

MEXICO

- ENERGY SUBSIDIES: The government already maxed out its subsidies budget for electricity as of July. As a result, we should see more persistent price pressures in on energy prices or a larger deficit in CFE
- ELECTRICITY REFORM: the government proposed a damaging electricity reform that would take the country back to a model of state control. The reform makes certain private activities illegal and is likely in violation of USMCA; as many as 239 small private electricity generators could shut down -even if their prices are as much as 25% lower than CFE's- and long term energy supply contracts would be canceled. The PRI vote holds the key in the senate; its approval requires 2/3 majority in both chambers. The vote is expected in mid November. Its approval could likely trigger another ratings downgrade.
- MINUTES: the rhetoric of the minutes turned hawkish but with nuances. While Espinosa encouraged the board to consider whether a faster pace of normalization would be appropriate under the current circumstances and showed willingness to consider a 50 bp hike, Heath said that current inflation dynamics may require to move policy to a

neutral stance or even restrictive. Diaz de Leon and Borja seem to prefer a more gradual approach and do what is required without pre-commitment. ADDL emphasized that the minutes indicated that the board decided to readjust the “required trajectory” of policy so that inflation converges to the target in the forecast horizon. It may be interpreted as that normalization is ongoing and more “reinforcements” may be required.

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