

SOVEREIGN MACRO-Weekly Latam Market Outlook

October 10, 2021

Summary: Market sentiment was damaged by uncertainty about the -still unresolved- issue of the debt ceiling in the US, further increases in oil and natural gas prices and news of another potential default, this time of Fantasia, a property developer in China, where the outlook is becoming more challenging. Inflation news in Mexico, Brazil and Chile were ugly leaving no room for complacency for their central banks, especially in Chile, where I expect an acceleration of the normalization this week. New Zealand joined South Korea and Norway in increasing their policy rates and the BOE is making noises about tightening policy as early as this year. The dollar remains the world's currency of choice and could add pressure to EM central banks to be even more aggressive in their policy decisions and maintain high rates especially in 2022. In the meantime, the US yield curve continues to steepen, now a good 25 bp after the hawkish FED surprise of September. Most of the move has been in breakevens -not TIPS- which appears counterintuitive since the FED has indicated that it will do what is necessary to keep inflation under control. But it may be that the 10 year is just reacting to rising oil prices which bear a strong correlation with market-based inflation expectations. That said, even a weak headline payroll number was not enough to stall the upward move in the 10s. DM long yields are all moving in tandem. The start of a new earnings season will test the rates market again. My standing call is for a 10 year at 2% by year end. This short week in the US is full of action. We will have the FED minutes, where I don't expect surprises but the confirmation of taper in November at 15bn per month to end by mid 2022. We will also have inflation in the US, the surveys for the Empire manufacturing and the University of Michigan, and the retail sales report. On the FED, Quarles ends his role as head supervisor on the 13th and we could see the announcement of his substitute. Also, despite the vicious attacks of senator Warren on Chair Powell, I still believe he will be reappointed but there is no small chance that the progressives once again push for a change to their liking. Chile will have its policy decision where I believe they will accelerate the pace to 100bp, look out for my preview of that meeting. Banxico will publish the minutes of its latest decision; I am focusing on the comments of deputy governor Borja. China will be reporting its aggregate financing figures that will give us a glimpse of the pace of expansion in light of all the headwinds that continue to appear. I am also following the IMF meeting discussions about policy and about the future of Georgieva as a leader of the institution. These are bad news for Argentina who was hoping to get a softer treatment under her leadership in their impending negotiation. See more detailed comments below.

US

- **TRADE POLICY:** Ambassador Katherine Tai laid out her vision of how the trade relationship with China should evolve. It will be challenging to enforce the existing agreements and include new themes like industrial policy and state subsidies. She will look for support of Europe and Japan in negotiations. While she said that her plan is looking to keep bilateral tensions in check, it is hard to see that she will be successful. In my view, her offering of exempting certain items from tariffs will have limited impact and I expect that tensions will rise in an environment in which China is looking more inward to implement Xi's plan for shared prosperity.
- **DEBT CEILING:** A classic kicking the can down the road, now to early December. This will coincide with the deadline for the extension of the CR to avoid a government shutdown. I expect Democrats to end up extending the CR and increasing the debt limit to a specified dollar amount under reconciliation. The threat of carving out the filibuster -so that it can be done with simple majority-is meaningless since senators Sinema and Manchin said they would vote against such contortion. In the meantime, discussions about the spendathon continue and Democrats are vowing to "reduce the cost" by unabashedly cutting the programs expiration date, instead of the normal 10 years. The social infrastructure bill of 3.5tn already had some of these gimmicks and some independent think tanks estimated that the true 10-year window cost was close to 5.5tn if scored properly. By the way the CBO this week noted that they would be unable to score the spendathon before it goes to congress because they lack information.
- **PAYROLLS:** This was a mixed bag in my view. NFP slowed down to 550k jobs on average over the last 3 months from 806k in August. There were upward revisions to July and the shortfall vs February 2020 declined to 5mn jobs. NFP in the private sector were 317k, of which 265k were in services industries. Average hourly earnings were strong for September but revised down for August. In the household survey unemployment declined to 4.8% as well as U6 and the LFP declined marginally but put downward pressure on unemployment. It is somewhat concerning that more people are leaving the labor force despite the large availability of jobs and higher compensation, We had good news on the EPOP ratio increasing to 58.7 but still well below the 61 of pre Covid. The number of average weekly hours was also encouraging at 109.7 but still below the 112 of pre Covid. In terms of FED action, I think that even if this report was weak on the headline NFP it has good enough to justify the start of tapering in November.
- **THE COMING WEEK:** This week we will have inflation for September which the market expects at 30bp and 5.3% y/y. We will also have the FED minutes where we will find out more about the discussions on tapering although I don't expect surprises to the path already

set. There are plenty of FED speakers during the week including Clarida, Brainard and Williams.

BRAZIL

- INFLATION: a very high print for September across the board with inflation dynamics generally poor, strong forward momentum remains intact and strong. Deflation in the IGPM and the IPA should have eventually a positive effect on non-core inflation due to their high correlation. This print doesn't change the policy outlook for Bacen which should stay at 100bp per meeting to my target of 10.25%.
- BACEN: Governor Campos reiterated in several venues that the bank is looking at meeting the inflation target of 3.5% in 2022. Given the lags with which policy operates, it seems an aggressive objective that could have adverse consequences for growth. That said, adding carry to the market will make the BRL increasingly attractive and help slow imported inflation.

CHILE:

- INFLATION: it came much worse than expected at 1.2% much higher than the recent October 5 survey of expectations that put it at 80bp. Of the headline number of 1.2%, 68 bp came from core. Annual inflation was at 5.3% where the contribution of core was 3.7 percentage points. The composition was also quite alarming as the recent currency depreciation seems to be passing through a lot more into the general index. The ex-ante real policy rate is at a whopping -2.7% -which could be -3% if we took the most recent survey of financial intermediaries. So much for gradualism.
- BCCH DECISION: this week we have the BCCH policy decision. Confronted with rapidly deteriorating inflation dynamics, worsening expectations and still the threat of a fourth pension withdrawal, the BCCH is likely to act decisively. There are two issues that need to be addressed. One is the next decision coming this week, where I believe the BCCH will have to accelerate the pace of normalization to 100bp to 2.5%. even if this is the case, policy will still be extremely accommodative. Two, they need to adopt a new flight plan because reaching neutrality – a 3.5% policy rate by Q1 2022-may not be enough to anchor expectations. I believe that there is a good chance that the BCCH will signal a move to a restrictive stance.

MEXICO

- BANXICO: the communication of board members shows a very wide range of views about policy. Heath believes that the hiking cycle is near the end and maybe one or two more rate hikes may be warranted. Espinosa is open to considering accelerating the pace of

normalization if justified by the data. Esquivel opposes normalization and believes it is counterproductive and fuels higher inflation expectations.

- **INFLATION:** while inflation came in line with expectations, core remains problematic. September inflation confirms that Banxico needs to stay the course until it reaches at least the middle of the range of the real neutral policy rate which would be equivalent to a nominal rate of at least 6%. This means that the gradual adjustment of the policy rate is very likely to continue under the incoming governor Arturo Herrera.
- **THIS WEEK:** This week we have the minutes of the last policy decision in which the board increased the policy rate by 25 bp in a 4 to 1 vote. The opinion of deputy governor Borja is important to follow because it may strengthen the vote of the majority and make future decisions less unpredictable. We will also have industrial production figures.

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