Sovereign Macro-Weekly Latin America Outlook November 1, 2021

Summary: the global economy is showing clear signs of slowing during the third quarter -perhaps more than expected- at a time when many central banks are in the process of normalizing their policies sooner and faster than expected pressured by hard evidence of worsening inflation dynamics. Inflation remains high, and in some cases increasing. Supply chain disruptions and wage pressures are the next challenges to figure out for central banks. Supply chain disruptions, which according to experts, were expected to ease in 2H of 2020 and later to q1 2022, are now likely to persist well into 2022 and add to the downward rigidity of goods inflation. Wages are starting to perk up and services inflation is coming to life, almost everywhere, as the global economy reopens more fully. The debate of whether inflation is permanent or temporary is unhelpful; inflation is indeed more complex than in previous episodes because it is not just an oil shock or a food shock, Covid is forcing a complete reconfiguration of global manufacturing in a context in which governments have expanded irreversibly. Instead, markets should be discussing how long high inflation is likely to persist and whether converging to the target will require higher central bank terminal rates than those prevailing before the pandemic, among other things because of higher fiscal risk premia. But coming back to this week's events, they promise a lot of action. The FED will start tapering this week, joining other central banks like Australia, England, Canada that are on the verge to reduce accommodation. The ECB will do it in some form. The FED is unlikely to surprise anyone emphasizing ample flexibility of implementation. The more relevant part for the FED decision is the discussion about the start of the hiking cycle -which incidentally already started in September- and how they reassess their views about "maximum employment", is 3.5% the relevant benchmark? My count is that 4 of the 10 voting members already see a hike in 2022 (6 of the whole 18 members). The market pricing of hikes right after the end of tapering is appropriate in my view. We will have a fresh read of the job market in a context in which wage pressures are mounting; ECI for Q3 came at 1.3% q/q and 3.7% y/y and AHE stands at 4.6%. The expectation for AHE for October is at 4.9% y/y and for unit labor costs for Q3 at 5.6%. The US Congress hopefully will vote the Biden reconciliation bill at a misleading 1.8tn USD; misleading because it relies on gimmicks that estimate the cost over a period of less than 10 years when everyone knows that social spending, once enacted, will never decline. There are also several regional elections -Virginia's governor importantly- that will take stock of the balance of political forces in the US and the future of Biden's progressive agenda. In the region, we will get the minutes of central bank decisions in Brazil and Colombia. The BCB should clarify its flight plan including the new pace and some guidance of what "even more restrictive" policy means. Banrep will have to do the same and explain why it is not considering going into restrictive territory; it will provide fresh projections in its latest monetary policy report; Dane will release inflation for October. Banxico will publish its latest survey of expectations and I will be curious to see what policy expectations are for the next meeting after two

seriously bad inflation prints. Chile will release the latest survey of expectations among market makers.

US

- FOMC DECISION: tapering is finally here. The FED will announce formally the start of tapering that will start operationally either in November or December with a 15bn reduction per month ending by mid-2022. I expect that the decision will include ample optionality to accelerate or slow the pace based on the assessment of the risks to the outlook.
- RATE HIKES: The most important section of the FED's decision will not be tapering itself but the discussions about the start of rate hikes. This will not be part of the decision, but Powell will likely be asked in the presser and the minutes will include it in earnest. The minutes of the September meeting already included discussion on this topic, which appeared premature, but going forward, they are likely to take more relevance. Since the inflation part of the mandate is essentially fulfilled, the focus will be on the maximum employment part where the board will also have to allow flexibility for all the peculiarities that we have seen in the labor market.
- CHANGES AT THE BOARD: changes or confirmations at the FED should come at any minute. Powell's and Clarida's terms expire in January-February and a new head of supervision should be named. There are two vacant seats at the board which could be filled. My money is with Powell, and it is unclear who will be appointed in Clarida's place.
- RECONCILIATION PACKAGE VOTE: Pelosi indicated that the vote on both the bipartisan infrastructure bill and reconciliation will take place on Tuesday. The "framework" is a proposal for new spending for 1.75tn over 10 years but the actual cost may be grossly underestimated since many provisions unrealistically sunset in much shorter periods. The taxes to fund the spending are still in flux. I would be surprised to see a vote on Tuesday but something will definitely pass. Both infrastructure bills will have a combined headline price tag in the order of 2.5-3tn USD.
- TREASURY REFUNDING: The treasury will announce its quarterly refunding plans on November 3 marking the start of reductions in bill and notes supply as the fiscal deficit is likely to decline from 2.8tn to about 1.2tn or from 13% of GDP in 2021 to a "mere" 6% in 2022, ouch.

ARGENTINA:

- IMF: the government is trying to extract payment concessions from the IMF which is unrealistic. Former IMF officials believe that Argentina will end defaulting to the IMF.

Curing such an event will be very costly, cumbersome, and protracted. Reincorporating Argentina to the global financial markets after a default to the IMF will take several years and tough economic medicine.

BRAZIL:

- BACEN: Hiked 150bp to 7.75% indicating that the new pace was appropriate to ensure convergence of inflation to the target and an even more restrictive stance was justified. Hawkish without a doubt
- INFLATION EXPECTATIONS: the main event was that expectations for 2023 and 2024 started to rise by a small 2bp but enough to send a message that anchoring of expectations is at risk.
- IPCA 15: the monthly inflation number came above expectations at 1.2%. Transportation, Housing and Food contributed together with 1 percentage point. Services inflation seems to be coming back in sectors related to the reopening of the economy, food at home and away from home, private transportation and airfares were particularly strong. Electricity and propane were also quite strong. Services inflation, which was somewhat well behaved up to now, was 1.2% in the month and reached 5% annually. Core services wasn't much better coming at 5.3% y/y. Core inflation overall, excluding fresh food and energy, stood at 7.2% with core goods inflation ticking 7.9%. The overall inflation outlook looks somber and is likely to push expectations higher for longer.
- PRECATORIOS: a vote to partially suspend/default the scheduled payment of 90bn BRL for 2022 was postponed to this week. In related news the new treasury director indicated that the new method of calculation of the spending cap and the partial default of precatorios will result in 92bn BRL additional spending for next year of which 47bn came from the recalculation of the cap and another 45bn from the default of precatorios. The demands for the additional spending are piling up rapidly including the increase in the Auxilio Brasil to 400BRL per month per person, new congressional amendments, and the new subsidies for transportation and low-income consumers of propane. The government indicated that if changes to precatorios were not approved, it would consider the extension of the "state of calamity" by which emergency payments for $400BRL per person per month would be maintained through end 2022, without the need to compensate through other measures.

CHILE:

- MINUTES: the board specifically wanted to surprise the market with 125bp to indicate its intention to frontload the adjustment and reach the 3.5% neutral policy rate by year-end. This means that the next policy adjustment would be of 75bp, which will be awkward. If the board decided to do so, it may surprise the market but in the opposite direction. If they had done 100bp of hikes both in October and December they would have reached the same policy rate at year end but with a cleaner message. In my view the BCCH should rethink its flight path and do what is necessary to tackle the inflation challenges at hand. They need to be more candid as to whether moving toward neutrality is the policy objective or if a restrictive stance is more appropriate, and whether 3.5% is indeed the neutral policy level. The minutes indicated that in the December meeting they would calibrate future policy moves.

- PENSIONS: the senate constitution committee approved the 4th withdrawal of pensions that would put another 20bn USD in an already overheated economy

COLOMBIA:

- BANREP DECISION: the bank decided to hike by 50bp to 2.5% in a 5-2 vote which means that two members decided to cross the picket fence. My call for a tight 25bp hike underestimated the influence of recent global trends for tighter policies on the board and upward revisions to growth and inflation projections. That said, governor Villar noted that the policy rate was still accommodative, below current and expected inflation. Policy will remain expansionary during much of 2022 and for now they have decided to get to neutrality which should be around 4.75%. He reinforced his message saying that it was "absolutely premature" to think about taking the policy rate into restrictive territory. I expect another 50 bp hike in December to close the year at 3% leaving an additional 175 bp of hikes if Banrep holds to its new policy path.
- QUARTERLY MONETARY POLICY REPORT AND MINUTES: Banrep will publish its monetary policy report where it will present fresh projections that presumably motivated the acceleration of the pace of hiking. We will learn the content of the discussions that led to last week's decision in the minutes.

MEXICO:

- GROWTH: the economy slowed in Q3 to 4.6% y/y well below the market consensus of 6%
- BANXICO SURVEY: Banxico will release its latest expectations survey.

Jaime Valdivia
Sovereign Macro
Founder and Chief Economist
jaime.valdivia@sovereignmacro.com