Sovereign Macro-Weekly Latin America Outlook November 15, 2021

Summary: this past week was charged with bad inflation news across the region and in the US. Upside surprises were the rule (US, Brazil, Chile, Mexico and Argentina despite price controls), diffusion indices moved higher and pressures on core were apparent particularly on goods -which reflected production bottlenecks- but now also in services, -which have been dormant during the pandemic- the manifestation of a more widespread reopening and higher wage pressures. The running assumption that bottlenecks will ease in 2H of next year is a wish, as is the belief that more workers will join the labor force and ease wage pressures. The JOLTs report on Friday showed a ratio of Openings to Hires close to historical highs and a record number of separations -mostly quits- at 4.4mn in September. Markets in the US were taken aback by the large inflation surprise and responded in kind with steeper curves. The discussion now is about whether the FED will accelerate the taper -and obviously hike earlier than expected-. Inflation will remain very high through year end and a couple of strong jobs report may be enough to push a quicker taper. When you see that inflation touched a 31 year high in all the evening newscasts, the popular psychology is bound to change. Consumer confidence, while strong is now a bit more vulnerable, Biden's economic agenda is in jeopardy, and it is now a close call whether the BBB will pass. The CBO's score will take a couple of weeks to materialize and the pressure from the progressives in the house will grow for a vote without it. Biden now argues his strategy to fight inflation is to spend more on social infrastructure. Democrats in the senate will be unable to get away with ignoring a CBO score because to use reconciliation, it is required. The debate within the FED will be increasingly more intense and we should pay attention about views about a potential acceleration of the taper. I don't see that near term but conditions may change at the turn of the year. In Latin America, central banks' response has been diverse. Banxico thinks it can be patient despite its own admission that inflation dynamics is getting worse, Bacen is fighting many fronts with only one tool and is finding it increasingly difficult to meet its mandate despite their intention to continue to hike in 150bp increments, the BCCH was hoping to get to a neutral rate of 3.5% nominal by December only to see the those hopes shattered. The message for all central banks is clear, there is a lot of messy work to do and to anchor those wobbly expectations, they may need to rethink their playbook. They should all remember Mike Tyson. With inflation rearing its ugly head -November preliminary indications aren't much better than October- markets will continue to test the Central Banks' policy resolve. The dollar will continue to rule.

Next week is somewhat calmer. The FED starts tapering on Monday marking the formal start of normalization. We will witness the drama of the BBB vote in the House, or not, and will have data on Empire State and Philly Fed manufacturing surveys, retail sales and industrial production. There are many FED presidents on the conference docket, and we'll get a chance to see their latest thinking on tapering and hikes after the October inflation surprise. Brazil will release its monthly GDP proxy which, if disappointing, may actually be good news for rates. We will also have a chance to see the damage to inflation expectations coming from the latest IPCA reading. Colombia and Chile will release their q3GDP. The results of the congressional elections in Argentina will be announced with a key focus on the results in the Senate. And next Sunday, we will have the first round of the presidential elections in Chile where Kast and Boric will likely move to the second round. On the same day the PSDB in Brazil will hold its primary elections where the main contenders are Pedro Doria and Eduardo Leite. Away from the region this week we will have inflation in Europe, and I will be curious to see whether we get an inflation whopper as we did almost everywhere else. The running expectation for the December ECB meeting is that there will be a bridge to the PEPP after March and possibly through year end to fend off expectations of a rate hike next year.

1. US

- FED: Quarles resigned. Clarida sees one hike in 2022, 3 in '23 and 3 in '24 and noted that the supply chain disruptions have been broader and deeper than anyone expected. Bullard sees two hikes in 2022. Evans has liftoff in 2023 because the FED can be patient. In its financial stability report, the FED noted the risks coming from the Chinese real estate sector. While there is no direct risk to the US, the high leverage of small and medium size companies coupled with high real estate valuations could have adverse effects in global markets. Powell could be the sacrificial lamb that the president offers to appease the progressives in the democratic party. They have been trying to push Powell out due to the perceived weakening of regulatory standards on banks. The appointment of Lael Brainard would keep them happy and yet maintain a strong leadership at the FED. Biden must nominate Clarida's and Quarles's successors as well as to fill the empty seat at the board.
- INFLATION: _Fastest inflation rate in 31 years._ Much higher-than-expected headline at 0.94% in October and 6.2% annually. Core also a strong 60bp for an annual print of 4.6%. Core goods was particularly strong coming at 1% -used car and truck prices remain a problem- while services advanced 0.4%. Annually, core goods are now at 8.4% and services at 3.2% and grinding gradually higher. The services complex came strong across the board: Shelter 50bp (o/w OER was at 44bp), Medical Care at 50bp mostly from Health Insurance, and Transportation at 40 bp, mostly from car rentals. As I have been pointing out, services inflation is finally waking up because of a more widespread reopening. With foreign travel reopening this week, I believe that services will continue to enjoy a significant boost. Annual core and headline services inflation printed multiyear highs. See summary chart below.

	CPI Weights		YoY				MoM			
	Headline	Core	Aug-21	Sep-21	Oct-21	Oct-20	Aug-21	Sep-21	Oct-21	Oct-20
All Items	100		**5.3%**	**5.4%**	**6.2%**	**1.2%**	**0.3%**	**0.4%**	**0.9%**	**0.1%**
Core	*79.8*	*100.0*	**4.0%**	**4.0%**	**4.6%**	**1.6%**	**0.1%**	**0.2%**	**0.6%**	**0.1%**
Goods	20.3	*25.5*	7.7%	7.3%	8.4%	1.2%	0.3%	0.2%	1.0%	0.0%
Services	59.4	*74.5*	2.7%	2.9%	3.2%	1.7%	0.0%	0.2%	0.4%	0.1%
Shelter	33.3	*41.7*	2.8%	3.2%	3.5%	2.0%	0.2%	0.4%	0.5%	0.1%
o/w OER	24.2	*30.4*	2.6%	2.9%	3.1%	2.5%	0.3%	0.4%	0.4%	0.2%
Medical care	7.3	*9.2*	7.3%	6.6%	6.9%	2.7%	0.3%	-0.1%	0.5%	-0.3%
Transportation	5.1	*6.4*	1.0%	0.9%	1.7%	3.7%	-2.3%	-0.5%	0.4%	0.2%
Education & Comm	6.3	*7.9*	3.5%	3.5%	3.8%	2.6%	0.2%	0.4%	0.2%	0.1%
Recreation	3.8	*4.8*	4.6%	4.4%	4.5%	-5.1%	0.2%	0.4%	0.2%	0.1%
Energy	6.1		25.0%	24.8%	30.0%	**-9.2%**	**2.0%**	**1.3%**	**4.8%**	**0.6%**
Food	14.11		3.7%	4.6%	5.3%	**3.9%**	**0.4%**	**0.9%**	**0.9%**	**0.2%**
Food at home	*7.8*		3.0%	4.5%	5.4%	4.0%	0.4%	0.9%	0.9%	0.2%
Food away from home	*6.3*		4.7%	4.7%	5.3%	3.9%	0.4%	0.5%	0.8%	0.3%
Headline	100.0		5.3%	5.4%	6.2%	1.18%	0.27%	0.41%	0.94%	0.12%
Goods	*37.4*		9.0%	9.1%	10.5%	0.26%	0.58%	0.60%	1.53%	0.12%
Durables	*11.0*		12.8%	11.8%	13.2%	3.41%	-0.21%	0.39%	1.42%	0.09%
Non Durables	*26.5*		7.4%	7.9%	9.4%	-0.97%	0.54%	0.43%	1.32%	-0.03%
Services	*62.6*		3.0%	3.2%	3.6%	1.72%	0.05%	0.29%	0.58%	0.13%

- BBB VOTE: the moderate democrats agreed to vote on the social infrastructure package in the lower house by November 15. It looks difficult to see how this will can happen when the score of the CBO is nowhere near completed. The Penn Wharton model estimated a 400bn addition to the deficit in 10 years and an increase of 25% of the national debt. The CRFB estimates a deficit of 200bn over 10 years. The press is reporting that the BBB bill should reach the senate by early December. The recent inflation surprise is likely to complicate the vote.

2. ARGENTINA:
    - INFLATION: despite widespread price controls, October inflation came at 3.5% and 52.1% annually. Core inflation surpassed 55%.
    - ELECTIONS: Results will be announced late Sunday night

3. BRAZIL
    - INFLATION: another much worse than expected inflation print at 1.25%, lifting the y/y to 10.7%. Almost half of the monthly inflation came from Transportation, but Housing and Food and Beverages also had a good showing and together explained 1 percentage point of the total. The diffusion index rose to 71%. Core inflation, excluding food and energy, advanced further to 7.5%. Same as in the US, services inflation is picking up rapidly, headline reached 4.4% and core 5.4%. Core goods inflation stood at 8%. Transportation was the fastest moving component in the month where we saw public transportation go up by 6.5%, airfares by 33% and Uber like services by 20%, It is hard to see how the momentum of inflation can be stopped all the more when expectations of inflation are revised up almost in real time. I believe that the central bank will have to reconsider its newly adopted pace of 150bp per meeting in light of the new information. The rates market reacted in a positive way to weaker than expected growth indicators perhaps anticipating that inflationary pressures would abate, but I believe it is too early to arrive to that conclusion.
    - BACEN: Fabio Kanczuk will leave at the turn of the year and Diogo Guillen was named director. He is the former chief economist at Itau Asset Management and considered to have hawkish tendencies. Director Guardado said that she believed that the current pace of 150bp of hikes was still appropriate and was confident they would be able to achieve the inflation target of 3.5% next year.
    - ENMENDAS DO RELATOR: SC upheld Justice Weber decision to suspend the budgetary allocations to specific districts. The speaker of the house is looking for ways to comply with the ruling perhaps by providing more information about those budgetary allocations.
    - PRECATORIOS: The lower house passed the precatorios bill in two rounds and now heads to the senate. If there are modifications, the bill would have to return to the lower house but time seems to be running out. Plan B for the President, which is to extend the emergency support for a few months, is still alive
    - POLITICS: Sergio Moro joined Podemos party and is expected to announce formally that he will be running for president. Local press reports speculated that Geraldo Alckmin former presidential candidate from the PSDB could consider to be the vice presidential candidate joining Lula in a potential ticket

4. CHILE
    - INFLATION: large upside surprise both on headline and core (excluding food and energy). Headline was 40bp above expectations coming at 1.3% and an annual 6%. Core was at 1.4%, the largest monthly print since at least 2010, and the first with a 1% handle. The largest monthly increases were in Leisure and Culture (7.8%) which is associated with the reopening as well as Hotels and Restaurants (2.24%); Transportation inflation was 3.9% and Housing and Basic Services 1.27%. The monthly composition of headline inflation (1.34%) was significant since core contributed with about 1 point of the total almost tripling its September contribution. On an annual basis, core explains 3.7% of the

6% headline inflation. Three final points: first, the FX continues to pressure both core and headline inflation. The CLP moved from an annual appreciation of 15% in March to an annual depreciation of 5% in October. Second, inflation momentum (3m cumulative annualized) shot to about 12% in both measures from about 5.1% in August. Third, services inflation continues its upward march now at 5.9% (historical high) after a 37bp monthly print. I don't see how BCCH can moderate the pace of policy normalization and may even consider a further acceleration.

- INFLATION EXPECTATIONS: Economists' expectations of inflation and the policy rate moved sharply higher across the board. Inflation expectations to 12, 24 and 36 months moved to 4.8%, 3.5% and 3% respectively. For December 2022 they stood at 4.5% and for December 2023 at 3.5% and are well above the inflation target within the 24-month policy horizon. Policy rate expectations now stand at 3.75% for the end of this year, which implies a 100bp hike in December taking the rate above neutral and moving to 5% in a 12 and 18-month horizon and declining thereafter. Expectations are clearly unanchored during the relevant policy horizon, and I believe that the BCCH will have to respond decisively with another 150 bp and avoid extending the tightening cycle since the balance of risks has worsened materially.
- PINERA: he was impeached by the lower house but unlikely to be found guilty in the senate
- 4th PENSION WITHDRAWAL: The senate fell short of the required majority and the bill now moves to a special commission and will return for plenary votes in both chambers

5. COLOMBIA
    - BANREP: Governor Villar maintained a dovish message. He said the recovery was coming much stronger than expected with a positive effect on the labor market. He explained that the board needed to act due to inflation moving higher and to the large CA deficit. He saw indexation as a risk and expected that core would end above 3% in 2022. Expectations are also moving up. Villar pointed out that the board also took into account in their decision what other regional CB's were doing. He reinforced the idea that Banrep would continue to normalize at a gradual pace and the policy rate would continue to be expansionary and ultimately reach a neutral rate once the output gap closed toward the end of next year.

6. MEXICO
    - INFLATION: October inflation came above expectations. The monthly prints of 84bp for headline and 49bp for core remain extremely high. Core contributed with 37bp to headline and non-core with 47bp coming mostly from gasoline prices. The concern on core is that core services doubled its contribution to 13bp from 7bp in September. Importantly, all the major components came above their trimmed mean historical averages. Headline was above its historical average by 2 STDVs, core by more than 3, Core goods by more than 2, of which non-food more than 3, and core food-related slightly above 2. Core services was higher by almost 2 STDVs. On an annual basis, headline accelerated to 6.24%, core to 5.2% where goods reached 6.6% and core services 3.6%, the latter still below the top of the inflation target band. Non-core remains high at 9.7% with almost equal contributions from fresh food and energy. The lags between fresh food and core

food related suggest this will accelerate in the months to come. Also, the strength of the currency, which normally anchors core non-food items has been ineffective since 2020. Core non-food is hitting multi year highs while the MXN is appreciating in nominal terms by about 5% y/y. Inflation momentum indicators picked up recently especially on core, where we could see a run to close to 6%.

- BANXICO: Hiked 25 bp in a split 4-1 decision even with massive upward revisions to their inflation forecasts, their admission that the balance of risks was to the upside, and worsened, and inflation expectations continued to move up. In my opinion the bar to accelerate the pace of hiking is extremely high and we should expect the Bank to maintain the normalization pace with the risk that the terminal rate ends up higher and extends for longer than necessary had they accelerated the pace.
- ESQUIVEL: argued that Banxico was not behind the curve and policy should not react to supply shocks. He believes it is unnecessary to accelerate the pace even if other banks are doing so because Banxico has been more conservative in its decisions. In fact, he opposes rate hikes and explained that he votes against them because he disagrees with the reasons cited by the majority, but he is not necessarily against higher rates. He opposes to make decisions -rate hikes in this case- that validate market expectations. He believes recent decisions appear to be mechanical, somewhat lacking sound reasons for hikes; he is particularly against the tightening cycle because Banxico didn't warn markets or elaborate its reasons ahead of time. I believe Esquivel will continue to oppose rate hikes.
- ADDL: in an interview he emphasized the importance of supply bottlenecks on inflation which he believed was both a global and national phenomenon. He highlighted pressures coming from core goods, like in the US. He noted that inflation was high but not out of control and the decision to continue reinforcing the monetary policy stance contributes to the stability of financial markets and avoids a worsening of expectations. ADDL has been the staunchest proponent of gradual policy adjustments.

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