Sovereign Macro- Weekly Latin America Market Outlook

December 13, 2021

Summary: inflationary pressures are broad and persistent in Latin America and the US. Inflation expectations are high and increasing, eliciting strong policy responses everywhere. For next week I have Mexico hiking by at least 25bp (hopefully 50), Chile by 125bp and Colombia by 50bp, this is in addition to Brazil's 150bp last week. The inflation challenge in the US is significant particularly in goods. Headline goods reached 11.9% and core goods 9.4% and both are higher for instance than in Brazil, Chile or Mexico. Goods inflation is unlikely to recede as long as supply chain bottlenecks persist and there are no signs of progress on that front. In this week's meeting, the FED will double the pace of tapering to 30bn per month looking to end the process in March and be ready to lift interest rates; the labor market is strong enough to justify rate hikes even early in 2022. We will also see new projections and a DOT plot which should include a minimum of two hikes for 2022 and likely three. Beyond next year, I expect the DOTS to approach a neutral of 2.5% in 2024 up from a median of 1.875%. It makes no sense to keep an accommodative policy for so long when the economy is likely to run above potential and inflation is breathing down your neck. The Fed Funds futures would have to reprice upward beyond 2023. Moreover, the most recent update from the CBO said that once the artificial sunsets are accounted for, the BBB bill would cost 4.9tn USD and add 3tn USD to the deficit over the next decade, much larger than the gimmick-riddled original that yielded a deficit of 231bn. While the inflationary impact of BBB would be much smaller than previous plans because it focuses somewhat more on investment, it will not ameliorate near term pressures. The uncertainty associated with Omicron is dissipating slowly but not fast enough to stop new mobility restrictions mostly in Europe. This will probably make the BOE pause and postpone its hike to February, joining a more cautious Bank of Canada. The meeting of the ECB will be interesting. With inflation surprising to the upside and new Covid related restrictions, the message will be difficult to craft, leave it to Lagarde. Luckily for many in EM, China is pivoting its fiscal and monetary policies to a more stimulative stance as the economy continues to slide and more liquidity is needed to absorb the impact of debt restructurings in the property sector; perhaps going long USDCNY would be a good idea. However, the medium-term growth outlook is not as rosy as the pre-pandemic years and economies in Latin America will have to implement pro-growth structural reforms to compensate weaker foreign tailwinds in a context in which government participation and debt burdens have grown significantly -pandemic or not- and now interest rates are on the rise. The old theme of debt sustainability is back in full force. Unfortunately, the resurgence of leftist and extreme leftist movements and their principles are largely incompatible with the implementation of pro-growth, pro-investment policies and a return to financial responsibility. It is always easier to spend someone else's money. We already had a taste in Peru's presidential election. Chile goes to the polls next weekend and the outcome is highly uncertain, but a Boric government could put the country in a dangerous financial path and threaten areas where Chile has been the model of reform, something which we saw already with the pension system saga; institutions, particularly congress, appeared weak. Colombia will be the next country to elect a president with Petro leading the polls by a mile and with a growing chance to win in a single round. Brazil will follow late in 2022 in a highly polarized environment. A "third way candidate" is a hope, but it is possible that Lula makes a

comeback. The FED is only one of the many challenges facing the region in the coming year, fasten your seatbelts.

It will be a full and interesting week in Latin America. In Argentina, the program with the IMF will continue to be debated. The post mission communique excluded references to the egregious imbalance in the FX market and how to address it but stuck all the same principles that the IMF has been recommending. CFK gave a speech over the weekend warning Fernandez about yielding to the IMF and its policy recommendations thus slowing the speed of a potential agreement. I would stay away from Argentina bonds waiting for more clarity on the timing of an agreement. Bonds are already at very low levels and could be attractive if an agreement approaches. That said, it is still an open question whether whatever the country agrees to can be successfully implemented.

In Brazil we will have the minutes of the last central bank decision. I believe that the first reaction of the market to the communique was extreme, and I personally didn't read it as hawkish. The market's reading of the decision focused excessively on the "substantially restrictive" phrase rather than on the overall message which struck a more confident tone that the end of the tightening was now closer. I would try to take a stab at tactically receiving positions particularly in late 2023 DIs or in Jan 24s. I also like short USDBRL. Brazil will present its latest inflation report forecasts which should reflect those of last week's decision.

The BCCH will announce its decision to hike rates, in my view by 125bp. We will see the formal projections of inflation the next day along with a new policy corridor that will obviously have to shift up. I would stay put in Chile and adjust positions after we know the result of the election over the weekend. That said, a dovish communique or decision should be met with larger USDCLP positions and steepeners. The curve is flat as a pancake.

Colombia will also announce its policy decision at the end of the week. I am expecting 50 bp, anything less than should be a trigger for steepeners and a long USDCOP position.

Tough decision in Mexico. A 25 bp decision should continue to favor 2s-10s steepeners because there is no way that the board will agree to a 50bp in their next meeting. I also like one-year Breakevens at 3.9%; inflation would be around 4.5% in my latest projections. I will pay a lot of attention to the communique but will have to discount it a bit because it will reflect a lot of ADDL's thinking and he will not participate in the February meeting. As I said in my preview, a decision to hike 50 bp would hamstring the incoming governor to likely follow through with a faster pace. In such a scenario receiving the 1y1y looks attractive.

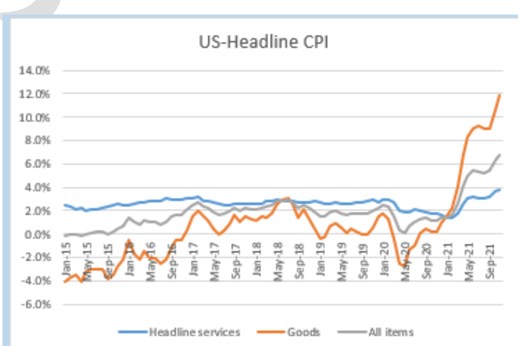
GLOBAL

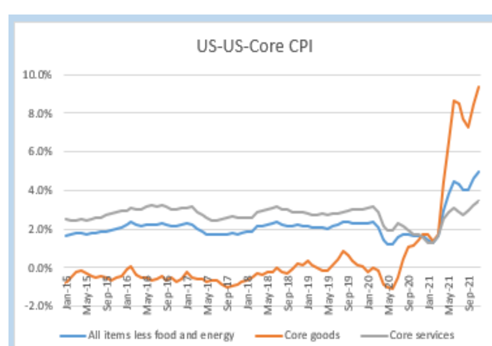
- CHINA: China's policy is now shifting to a stimulative stance. China cut its RRR by 50bp and releasing about 190bn USD into the financial markets. This followed several measures to support small and medium enterprises. The statement of the December Politburo committee stressed the balance between social stability and development as well as the continued fight against corruption. More precisely the strategy for 2022 involves a "proactive fiscal policy and prudent monetary policy". "Fiscal policy must improve efficiency and pay more attention to sustainability. Prudent monetary policy must be flexible and appropriate to maintain reasonable and sufficient liquidity". The purpose is to goose up consumption and investment especially at a time when the property sector is undergoing a significant restructuring including debt defaults by its largest developers. (Evergrande for 19bn of cross defaulted debt and others). Also, the PBOC increased reserve requirements on USD deposits to slow the CNY appreciation. All of this said, the combination of measures to stimulate internal demand, low inflation, falling trade surplus and the prospect of imminent tightening by the FED make a long USDCNY position quite attractive.

US

- INFLATION: another strong print (see table of components below) for headline and core; annual inflation touched a 39 year high, enough for the FED get serious about taking on inflation. Headline accelerated to 6.8%, of which core explained 3.6 points. Headline goods made a new multi decade high of 12% (!), no wonder bagels are so expensive and btw there is a shortage of cream cheese in NYC. Within core, which printed an annual 4.9%, almost 4 points came from the combination of Transportation and Housing. On an annual basis core goods reaccelerated to new multi decade highs (9.4%!) and core services continued its consistent upward trend reaching 3.4%. Just for a fun comparison, annual core goods inflation in Brazil is at around 9% and "only" 7.3% in Mexico. Sequentially core services were at 0.4%, with 0.28% coming from Shelter thus confirming the strong pace of rents that increased by 50bp during the month. Core goods was a strong 50bp in November.

	CPI Weights		YoY				MoM			
	Headline	Core	Sep-21	Oct-21	Nov-21	Nov-20	Sep-21	Oct-21	Nov-21	Nov-20
All Items	100		**5.4%**	**6.2%**	**6.8%**	**1.2%**	**0.4%**	**0.9%**	**0.8%**	**0.2%**
Core	*79.8*	*100.0*	**4.0%**	**4.6%**	**4.9%**	**1.6%**	**0.2%**	**0.6%**	**0.5%**	**0.2%**
Goods	20.3	*25.5*	7.3%	8.4%	9.4%	1.4%	0.2%	1.0%	0.9%	0.0%
Services	59.4	*74.5*	2.9%	3.2%	3.4%	1.7%	0.2%	0.4%	0.4%	0.2%
Shelter	33.3	*41.7*	3.2%	3.5%	3.8%	1.9%	0.4%	0.5%	0.5%	0.1%
o/w OER	24.2	*30.4*	2.9%	3.1%	3.5%	2.3%	0.4%	0.4%	0.4%	0.1%
Medical care	7.3	*9.2*	6.6%	6.9%	8.4%	2.2%	-0.1%	0.5%	0.3%	-0.1%
Transportation	5.1	*6.4*	0.9%	1.7%	2.1%	3.2%	-0.5%	0.4%	0.7%	1.3%
Education & Comm	6.3	*7.9*	3.5%	3.8%	2.8%	2.6%	0.4%	0.2%	0.0%	0.1%
Recreation	3.8	*4.8*	4.4%	4.5%	3.9%	-3.4%	0.4%	0.2%	0.0%	0.1%
Energy	6.1		24.8%	30.0%	33.3%	**-9.4%**	**1.3%**	**4.8%**	**3.5%**	**0.7%**
Food	14.11		4.6%	5.3%	6.1%	**3.7%**	**0.9%**	**0.9%**	**0.7%**	**0.0%**
Food at home	*7.8*		4.5%	5.4%	6.4%	3.6%	0.9%	0.9%	0.7%	0.0%
Food away from home	*6.3*		4.7%	5.3%	5.8%	3.8%	0.5%	0.8%	0.6%	0.1%
Headline	100.0		5.4%	6.2%	6.8%	1.17%	0.41%	0.94%	0.78%	0.18%
Goods	*37.4*		9.1%	10.5%	11.9%	0.22%	0.60%	1.53%	1.39%	0.05%
Durables	*11.0*		11.8%	13.2%	14.9%	3.57%	0.39%	1.42%	1.55%	0.06%
Non Durables	*26.5*		7.9%	9.4%	10.7%	-1.10%	0.43%	1.32%	1.10%	-0.05%
Services	*62.6*		3.2%	3.6%	3.8%	1.74%	0.29%	0.58%	0.37%	0.23%





Today's prints reaffirmed the strong momentum of inflation and support the view of a doubling of the taper pace from 15bn a month to 30bn a month to wrap the process by March.

- DEBT CEILING: House and senate agreed on an unusual one-time procedure to allow for an increase of 2.5tn USD the debt ceiling that will be formally approved this week.
- CBO: the CBO released a note that said that in the absence of artificial sunsetting of programs in the BBB bill, it would increase the deficit in about 3tn USD (15% of GDP) over a 10 year period. This is in sharp contrast to the bill's estimation of 231mn. This, in combination with the high level of inflation will complicate the passage of the BBB. I expect to hear more warnings from senators Manchin and Sinema.

ARGENTINA

- IMF PRESS RELEASE: The IMF released an end of mission statement in which there was little new information. While it said that it had reached general understandings with Argentina, more work needed to be done and highlighted the mutual commitment to an agreement. The substance is well known to investors: the IMF is requesting a credible fiscal path that progressively relies on less monetary financing, a multi-pronged approach to fighting inflation, positive real interest rates and a path to accumulate international reserves. Importantly, nothing was mentioned regarding the FX policy. This is clearly one of the more difficult topics of the negotiation and will probably be left to the last minute. The financing assurances review is also distant since Argentina needs to properly identify sources of financing for its EFF. I was encouraged to see that Argentina has abandoned the losing proposition to be treated differently regarding the financial conditions that the IMF applies to countries that request support.

BRAZIL

- MONETARY POLICY: Bacen hiked its policy rate by 1.5% to 9.25% and indicating an additional increase of same magnitude in its February meeting. The market read the communique as hawkish because it focused excessively on the "substantially restrictive" term instead of reading the communique as a whole. Rates overreacted to the upside after the communique, in my opinion. The decision had a more balanced language regarding inflation and the upside risks, including a fiscal deterioration that seems more or less contained in the short-term. The long term is too long for us to worry about. The readings of inflation in general have been coming a tad lower than expected. I expect Bacen to hike another 150 in February and close the cycle with another 100bp in March. They key is to follow the deterioration of expectations and whether they can stabilize.
- INFLATION: November IPCA came 15 bp lower than expectations and annual inflation was at 10.74%. Core inflation excluding food and energy accelerated to 7.7%. Of the monthly increase of 95 bp, 72 were from transportation which includes

gasoline prices. Another 17bp came from Housing costs where the main contributors were rents and residential electricity. The good news was that the large food shock seems to be unwinding. Food and Beverage was in deflation of 4bp in November, mostly from food at home components. On an annual basis food inflation decelerated rapidly to 8.9% from a recent high of almost 14% in August.

Weight	Category	MoM			MoM - Contribution		
		Sep-21	Oct-21	Nov-21	Sep-21	Oct-21	Nov-21
100	**Total**	**1.16**	**1.25**	**0.95**	**1.16**	**1.25**	**0.95**
20.9	**Food and beverage**	1.02	1.17	(0.04)	0.21	0.24	(0.01)
15.9	**Housing**	2.56	1.04	1.03	0.41	0.17	0.17
3.9	**Household articles**	0.90	1.27	1.03	0.03	0.05	0.04
4.3	**Clothing**	0.31	1.80	0.95	0.01	0.08	0.04
21.0	**Transport**	1.82	2.62	3.35	0.38	0.55	0.72
12.8	**Health and personal care**	0.39	0.39	(0.57)	0.05	0.05	(0.07)
10.0	**Personal expenses**	0.56	0.75	0.57	0.06	0.07	0.06
5.8	**Education**	(0.01)	0.06	0.02	(0.00)	0.00	0.00
5.4	**Communication**	0.07	0.54	0.09	0.00	0.03	0.00

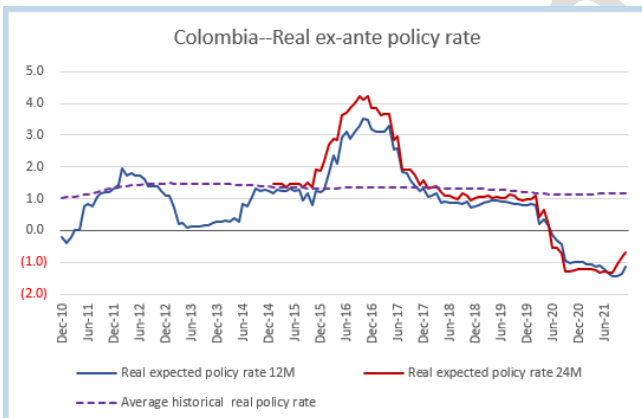
CHILE

- NOVEMBER INFLATION: There was nothing redeeming about the November inflation print. Headline and core inflation were the largest numbers in history for the month. The trimmed mean over the last 12 years for November is around zero for both but it came at 50bp for headline and 52bp for core. Annual headline climbed to 6.7% and core to 5.8%, also highs for both. Moreover, inflation momentum picked up significantly which indicates continued pressure in the near term, somewhat similar to what we saw in 2014-15
- INFLATION EXPECTATIONS: Inflation expectations continue to diverge from the target in 12 and 24 months in the economists' survey and the trader's survey. The latest economists' survey shows a 4.8% expectation in 12 months and 3.5% in 24 months, whereas the traders' survey is at 4.85% and 3.9% respectively. I believe that re-anchoring these is the key to the success of the BCCH's upcoming decisions
- BCCH PREVIEW: the BCCH will have to act decisively and extend its hiking cycle to address the alarming inflation dynamics and to re-anchor inflation expectations, which are at unprecedented levels. The hiking cycle of 2010-2011 provides a useful reference of the reaction function of the central bank. At that time, the hiking cycle -which took a year to implement- set the policy rate 100bp above the 12-month inflation expectations. While there are few similarities in the causes of inflation between the episodes of 2010 and today, the de-anchoring of expectations is an issue that the BCCH is keen to attack. An important difference though is that in 2010 expectations de-anchored for 12 months but not for 24. Today, both show a considerable gap above the target. With all of this in mind, my baseline scenario calls for a terminal rate of 6.25% -125 bp above current 12-month inflation expectations- which can be achieved with a 125bp hike in the upcoming meeting followed by others of 100bp, 75bp and 50bp. Of course, we could be surprised by a faster pace,

but beyond the specific hike of next meeting, I expect that the BCCH will embrace a normalization path that will be deeper and take longer than they expected. The upper end of their September policy band should now be closer to my baseline.

COLOMBIA

- BANREP: after a significant upside surprise in the November inflation, an economy that continues to recover and a trade balance that continues to deteriorate, I expect Banrep to hike interest rates by 50 bp to a still very accommodative 3% at a time when inflation is at 5.3% and an ex-ante real policy rate at -1.1% in the next twelve months and -0.7% in 24 months. Given the international context and a far cry from the neutral real policy rate of 1.7% and with expectations above the target a quickening of the pace sounds like the right medicine.



MEXICO

- NOVEMBER INFLATION: Inflation dynamics continue to deteriorate demonstrably. The November monthly headline inflation was the highest print on record in at least 20 years and was more than 1stdv from its historical trimmed mean. Not only that, but November inflation was also the highest monthly print in 2021. Core was also 1 stdv above its historical trimmed mean. Surprisingly Core goods was relatively well behaved -maybe because of the discounts of the Buen Fin-, especially in non-food, and the real surprise was core services which came at the highest level in the series for November; it printed more than 2x its historical trimmed mean reflecting the effects of the reopening. On an annual basis headline stood at 7.4% showing a sharp acceleration and core reached 5.7%, picking up speed as well. As I have been mentioning over the last couple of months, services inflation is quite concerning and is now at the top of the tolerance band at 3.92%.
- BANXICO PREVIEW: Banxico will likely hike its policy rate by 25bp in its upcoming due to the lack of consensus among its members to tackle a worsening inflationary problem. A 50 bp hike would not be a surprise -I had already called for a 50bp hike in the November meeting and data has only worsened- but it hinges on Governor Diaz de Leon's opinion. He has the key. My call for the terminal rate is now at 7-7.25% from 6.5% previously.

- It has become abundantly clear that the pace of adjustment of the policy rate has been insufficient to control inflationary pressures and anchor expectations despite the strength of the currency and the absence of serious demand pressures. Banxico recognizes that the balance of risks continues to deteriorate and is still on the upside especially after today's eye watering inflation print. The staff will have to revise up once again its inflation projections for 2021 since meeting their q4 headline forecast of 6.8% would require deflation of 16bp in December. Not happening. They will probably hit the projection for core which is a good thing. Their projections for 2022 and the timing of convergence to the target will be revised as well. With this in mind, one has to question – I will get to the pace in a minute- what should be the right policy stance to address the problems I just mentioned. Lacking guidance from the board is unfortunate but in my view the policy stance should move to a contractionary posture as soon as possible, neutral doesn't cut it anymore. Or at the very least to the top of the neutral rate band at 3.4% in real terms. Since inflation expectations on average over the next two years are at 3.8%, it means that the terminal policy rate should be in the 7-7.25% area, not in the 6.5% that I had previously called for. If this were the rate that prevailed at the end of 2022, the spread to Fed Funds -assuming that the futures markets are correct in pricing 3 FED hikes- would be about 6-6.25%, a level comparable to the period of mid 2017-end 2019, high but not extraordinarily so. Now, the pace. Banxico will have to pick its poison between continuing to hike at 25 or at 50bp a meeting. Doing it at a slow pace takes the unnecessary risk of allowing expectations to continue to rise and perhaps require a higher terminal rate and a longer period of tightening. It's like trying to cure Covid with cough medicine. Doing it at a somewhat faster pace is no guarantee of success but it does diminish the risk that expectations continue to rise and may actually shorten the cycle. I firmly believe that this is what Banxico should do as I wrote in the preview of the last meeting when I called for a 50bp hike. But we are in the business of what will happen, not what should happen. The reason why I think a 25 bp is more likely is because the board is divided in 3 between those who want 25, those who are open to, but not convinced, accelerating the pace to 50 and the lone deputy governor who opposes hikes. In the minutes it was clear that deputy governor Borja and governor Diaz de Leon -my sincere apologies if this is not the case- voted for 25 bp and they are the ones that could make a difference. The governor has always believed that gradual adjustments are preferable and more efficient because they allow for the smooth adjustment of financial markets and relative prices. To be fair, we have not seen anything out of whack to suggest that markets are under stress. I believe that the governor will have a hard time to move to a 50bp hike and betray his long-standing belief in gradualism but is not impossible for him to change especially after the latest news on inflation and expectations. Deputy governor Borja has been cautious in her decisions, coming a bit late to the consensus of 25 bp hikes, so I don't expect her to vote for a 50 bp adjustment. This is Diaz de Leon's last policy decision and can set the stage for what is coming in 2022. Hiking by 50bp would probably set a minimum pace for the first meeting next year, saving incoming governor Rodriguez from a tough decision.
- PEMEX: announced an exchange offer of the 2024-2030 maturities in exchange for cash and a new 10 year. It also announced a buyback of bonds maturing 2044 and

2060. In addition, the government announced a capital injection of 3.5bn USD. Importantly, the announcement excluded maturities of 2022-23 because the treasury intends to support the company with additional capital infusions to ensure that it meets its obligations but it clarified that it does not intend to take over the obligations of the company. The company has received a total of about 30bn USD in all forms of federal support during AMLO.

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