Sovereign Macro- Weekly Latin America Market Outlook

February 14, 2022

Summary: inflation data and global central bank rhetoric are becoming more aggressive and markets are acquiescing. Inflation in the US came higher than expected by a respectable 10-20bp for the month. Pressures on core look sticky both on goods and services and dissemination is growing both in tradables and in non-tradables. Conditions in the labor market are such that wages are already spilling over to core services sending a warning about a potential wage price spiral and as you can see, the Phillips curve just went parabolic. (See charts in the US section). That said, Bullard seemed a bit unhinged calling for 50bp in a potential intermeeting decision, but luckily deferred the decision to Powell; cooler heads should prevail. I am more sympathetic to Barkin's points (see below and recommend to listen to his interview on Bloomberg last week). The FED is not EM. Well, maybe it is becoming part of it and may be why crypto currencies are booming. In any case, I believe that the hurdle to pre-empt a large increase in rates is still high, but one must recognize that the chances of a 50bp hike followed by more of equal size have increased; I am staying with 7 hikes of 25bp each. The only reason to justify a large increase is if suddenly expectations became persistently unhinged. The FED's CIE showed expectations at 2.08% in December. While other measures of expectations have moved higher mostly on account of oil prices (the 5y5y BE is at 2.1%), they haven't broken out materially, in my view. This can change if the situation in Ukraine escalates and pushes oil and inflation expectations higher. My subjective probability of a 50 bp hike for now is at 30%. In the meantime, the monetary policy outlook in Europe continues to evolve as the Germanic contingent is pushing for quick action -hiking rates this year- while the moderates led by Lane and Lagarde preach patience advocating flexibility and gradualism. We heard a similar message from the BOE where chief economist Huw Pill, said that a large increase (50bp) could be potentially perceived as a sign of panic; he favored a gradual adjustment that could take the policy rate to somewhere below 1.2%. I agree with him that lack of opportune policy action to anchor expectations, increases the risk of larger and more prolonged rates increases. The new monkey wrench in the inflation outlook is the events in the US-Canada border which are already having an impact on supply chains, -potentially globally- exacerbating price pressures in transportation. The anti-vaccine mandate movement is gathering steam globally and could complicated the outlook even more. One thing that we have learned over the last two years is that supply chain disruptions, regardless of their nature, have "stagflationary" consequences. And since we are speaking about borders, we should not ignore what is happening in Russia/Ukraine because the breakout of hostilities could disrupt energy markets and potentially part of the global payments system. The presence of Russian General Gerasimov in Belarus and orders to vacate the American and Russian embassies in Ukraine are bad omens. Markets started to price a higher likelihood of an invasion soon producing a clear flight to quality; breakevens moved higher while TIPS rallied, both consistent with the "stagflationary" nature of the war. If hostilities start, financial conditions will tighten and the FED would potentially postpone the hiking cycle. EM generally fares badly when investors seek the comfort of the US dollar and adopting a more cautious risk-taking attitude may be in order. In Latin America inflation is not letting up, Brazil 10.4%, Mexico 7.1% and Chile 7.7% with expectations moving higher. The job is far from done. Chile is likely to hike 200bp to 7.5% and Brazil should go as far as 12.75%

while Mexico should maintain the pace of 50bp a pop, but the new governor appears to hesitate saying that if the FED hikes, Banxico may not hike one for one, contradicting the even more dovish wing of Banxico. In my opinion, a *minimum* policy spread of 600bp between Mexico and the US is necessary and forwards already price something close to 7%.

This week we will have a lot coming out of the FED. We have an early interview of James Bullard on Monday, let's hope he doesn't throw another stinker. We will have the minutes and also Mester, Williams and Waller, who seems to be the sensible policy maker at the board. Markets will continue to focus on the chances of a 50bp hike in March and potentially a faster reduction of the BS, which I have at 100bn/month. In Colombia and Chile we will have fresh inflation surveys and this will give central banks the opportunity to gauge where they should position their stance.

GLOBAL

- ECB: Lagarde reiterated that the ECB would not hike before the end of net asset purchases and wanted to maintain flexibility. Any policy changes would be gradual. She also repeated that they "will look at data and projections in the March meeting and decide what is the best path forward" but acknowledged that they were now "more likely to meet their (inflation) target". She said that there was no rush to arrive to premature conclusions. Lagarde avoided saying that it was "very unlikely" that the ECB would lift interest rates this year. Klaas Knot the board member from the Netherlands urged the board to end its APP as soon as possible and hike this year. Joachim Nagel and Isabel Schnabel both expressed concerns about the inflation outlook and the need to start increasing interest rates as soon as this year.
- CHINA TSF: it beat expectations significantly coming at 6.2tn RMB, the highest level since the refurbished series started publication in 2017. It increased almost 19% annually. Bank lending was the largest contributor to the increase in response to several easing measures including interest rate cuts and increasing credit allocations. As a result, deposits grew significantly and M2 also expanded close to 10% from 9% in December
- BOE: if second round effects are not contained then a larger monetary response would be required. 5y5y inflation expectations are now at 4.1% vs a historical average of about 3.5%; the upward move has been uninterrupted since the beginning of the pandemic. Chief economist Pill opposes 50 bp because it can give the perception of panic and of putting the foot to the floor on the brakes. He doesn't like to think of a predefined neutral rate but make decisions one step at a time without unusually large policy steps. He suggested that the FEB projections indicated that the bank rate would end somewhat below 1.2%

US

- DALY: supports a 25 bp hike of FF in March "without a big surprise in the data"
- BULLARD: support hikes totaling 100bp by July 1, that is in the next 3 meetings including a 50 bp increase in March, but he will differ to Powell to decide on 50bp. He also opened the discussion of an intermeeting decision

- BARKIN: open to a 50 bp increase but needs convincing. Covid will still be a factor, unclear the FED's response to events in Russia if the conflict escalates; forecasting inflation will represent a significant challenge. Two questions: 1) is LFP going to improve to pre covid or was that the outlier (LFP generally lags)? 2) Will we return to 1.9% inflation? If a wage price spiral becomes a threat, does FED need to go to restrictive? In his view, there is no need to move to restrictive territory. Q&A he believes that the norm for the labor market will turn to tight as opposed to lose. Supply chains likely to remain strained through this year; onshoring and nearshoring appear difficult due to lack of workers. **Fed will do adjustment steadily toward neutral**. **Timing, size and scope will be based on data**. **Warns that short term rate decisions don't have an effect on current inflation but more on expectations**. Open to 50 conceptually, need to do it now? I would need to be convinced
- US CPI FOR JANUARY: monthly and annual inflation came above expectations for both headline and core. Headline came at 7.5% and core 6% y/y. Headline goods hit a fresh high of 12% and headline services at 4.6%, Core goods was at 11.7% and services a more subdued 4.1%. Sequentially, the data shows relatively large and sticky prints for both core services and goods. Since October of last year core services is printing around 40bp per month while core goods around 1%. The composition of services is changing with Shelter inflation losing participation but is fully compensated by an increase in the share of medical care, transportation, and recreation. The configuration of core goods hasn't changed much with transportation providing the largest share (motor vehicles) and household furnishings and recreation goods also pitching in. The monthly inflation print was certainly an eye popper especially because the numbers are persistent and much broader. For instance, 2.41 points of annual core (6%) come from housing costs including rent, and another 2.2 points from transportation. One purely non-tradable and the other almost entirely tradable. The current problems with truckers' blockades in Canada should have an adverse effect on car prices due to further disruptions in the supply chains. If there is one thing we have learned over the last two years is that supply shocks tend to be ultimately "stagflationary".
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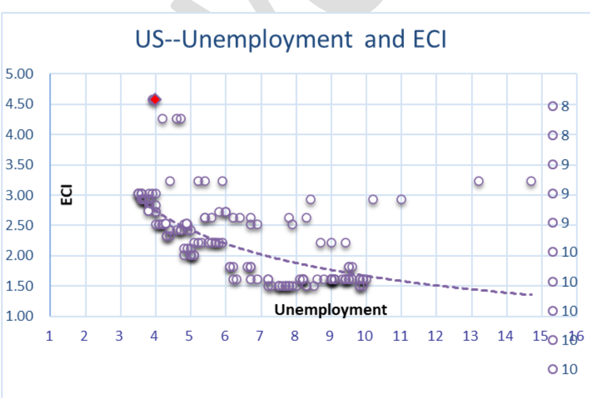

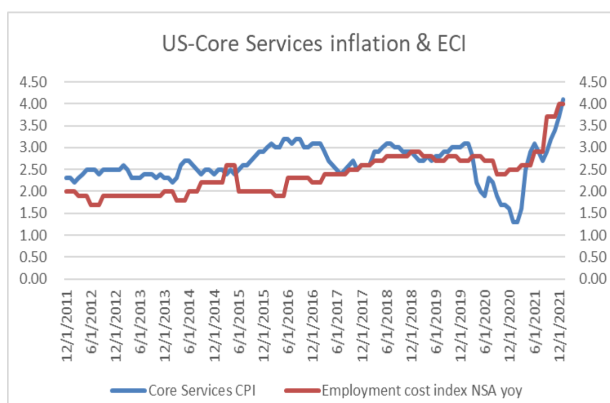

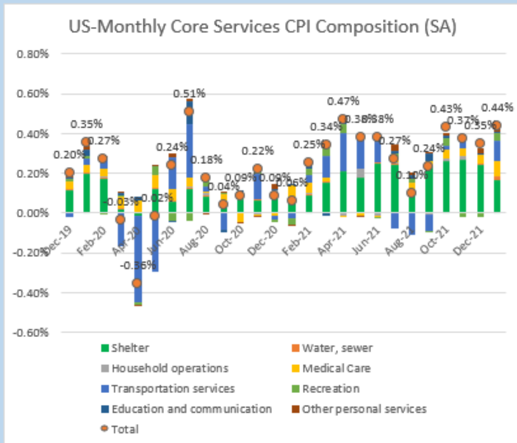

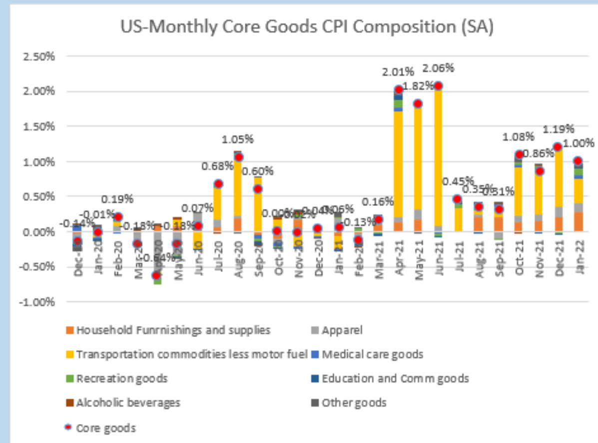

ARGENTINA

- IMF: Guzman said in an interview that between "this deal and default, I prefer this deal". He noted that if the deal had been conditioned by a strong fiscal adjustment, things could have been different, but since this deal has a small fiscal expansion, then it was acceptable. Guzman intimated that the staff was given orders to wrap up the negotiations thus giving up on a more stringent fiscal plan. This was definitely not what investors would like to hear. Funny, nobody likes this deal. Investors see this deal as too easy on fiscal adjustment, even if there are no important details, while the government is having serious issues to gather the required congressional support for its approval. It is apparent that nobody will want to take ownership of the deal and its fate appears highly uncertain. The opposition is willing to support the deal but only if the government coalition fully backs it. Frankly, even if this deal is finally inked, it seems that the odds of success are limited. The government is already running into serious problems trying to implement the reduction in subsidies, the key spending reduction measure.
- PBOC SWAP: The balance of the swap increased by 3bn to 21.7bn USD

BRAZIL

- MINUTES: the minutes of the latest Copom decision were uncharacteristically hawkish -in contrast with the somewhat dovish communique- in my view. The board stressed that the fiscal risks remained high -notwithstanding the recent fiscal outturn- and warned that further weakening of the fiscal framework would result in a higher structural rate of interest of the economy as well as a higher neutral policy rate, which consensus places now at around 4%. While I agree with Bacen's take about the ongoing fiscal risks and what they mean for their reaction function, at some point it has to stop chasing the fiscal gnomes because the costs of endlessly compensating the fiscal deterioration will outstrip the benefits of meeting the inflation target. In the decision, Bacen said that to ensure convergence of inflation to the target and given the balance of risks, they used a higher path of interest rates than in the baseline scenario, which had the Selic peaking at 12% and declining to 11.75% at the end of the year. Moreover, Bacen noted that future adjustments to the policy rate -using plural- would be smaller than 150 bp. My interpretation of the minutes is therefore that, at a minimum, we should see the Selic at 12.25% -one 100 and one 50- keeping it through end 2022. But more realistically -and despite a very wide range of potential policy paths- and given the potential materialization of some fiscal risks and thus a higher neutral policy rate, I could see the terminal Selic rate at 12.75% and staying there for the rest of the year. This will take the ex-ante real policy rate close to 7%. As I said in my commentary on the decision, the disinflationary value of rates much higher than 12% is probably limited and could inflict unnecessary costs to the economy

- BACENSPEAK: Bruno Serra and Roberto Campos gave presentations in which they reinforced the hawkish nature of the message in the minutes. It was clear that we are likely to see 2 hikes at least but the size seems somewhat inconclusive. It was equally unclear what kind and size of fiscal risks they were assuming in their baseline scenario. The policy outlook was left in my opinion left a bit open ended and it would be useful to see Bacen tighten the communication a bit more.

CHILE

- MINUTES: the minutes show clear concerns about the nature of inflation including strong persistence and doubts about the speed of deceleration even if food and energy prices slide. The strength of core inflation and expectations above the target in the policy horizon add to the BCCH's worries. Moreover, their decision to weigh "risk management considerations" more heavily is important. My interpretation is that they are going a bit off script trying to tackle the unmeasurable risks of not sending a strong policy signal to stabilize expectations. Importantly the minutes noted that new inflation surprises could result in a faster pace of policy adjustment. The minutes correspond to the meeting that took place before the significant inflationary surprise of January.
- INFLATION: the January inflation release was a reminder that there is no such thing as a free lunch, or a free pension withdrawal for that matter. The economy is seriously overheated with a large monetary overhang that has been underestimated by everyone. True, there are many shocks behind the surge in inflation but unfortunately inflation persistence has rooted in expectations and to pull it out will be a slow and difficult task. It needs a root canal not just a new crown. The new leadership in the BCCH no doubt is aware of the importance of its upcoming decisions because its credibility is at stake, it will act with resolve to meet the challenge. I believe that using models to make decisions to anchor expectations has limited value because those decisions take time to work and time is what is in short supply for the BCCH; and more basically, models have failed to predict what we are witnessing today (not the shocks because they are unpredictable, but their persistence). In my opinion, the board will have to act decisively to get ahead of the likely deterioration of expectations -we will see the first sign later in the week with the release of a new survey. After all they are now in risk management mode. In my view the BCCH should consider an increase of at least 200bp in its policy rate in March to 7.5% and reassess. In my opinion, the minimum terminal rate is in the order of 8%

including a 12month ahead inflation expectation of around 6% and a 2% real ex-ante policy rate. However, given the serious deterioration of expectations in the policy horizon and beyond, it would be advisable to consider a terminal rate that provides a cushion and quickens the convergence of expectations to the target, in the order of 9%. Upcoming decisions are more art than science, in my view. The economy is booming, and such a tightening of policy is, more than warranted

MEXICO

- BANXICO DECISION: in a widely expected split decision, Banxico decided to hike its policy rate by 50 bp to 6%; deputy governor Esquivel preferred 25 bp. With this decision the real ex-ante policy rate is at 1.8% or at the bottom of the neutral band that has an upper limit of 3.2% (mid of 2.6%). This is a step in the right direction and, if nothing else, shows that the bank is acting responsibly. However, inflation dynamics remain problematic and by the Board's own admission inflationary pressures have been larger and of longer duration than anticipated, with risks to the upside. To back up the board's affirmation, inflation projections were once again revised higher substantially -between 20-30bp- for the short term but still with headline at 4% at the end of the year, which appears unrealistic – I have only seen those projections in the Metaverse. In their projections, core will stay above 6% during the first half of the year while headline recedes to 5.4% from 6.2% and 7% presently. Core, which in principle is more sensitive to policy, appears irreparably sticky with potential upside risks to expectations. With the global backdrop leaning quite hawkish and seriously problematic internal inflation dynamics, Banxico's actions must be unwavering, the job is far from done. In my opinion, the policy stance should move to the top of the neutral band (a real ex-ante policy rate of 3.2%), taking the policy rate to around 7.5%. I believe that this could be done with two consecutive bp hikes to 7% and reassess thereafter whether to proceed with two additional hikes of 25 each and pause, or a third 50bp hike. In my view, it is imperative to keep the current pace of adjustment to quicken the pace of convergence of expectations to the target and reduce the risk that they become excessively entrenched because if this were to happen, then Banxico would have to extend the cycle to re-anchor them to the target with potentially larger costs to the economy. With the move in the TIIE curve, in part due to an emotional statement by the FED's Bullard, and perhaps also to the belief that we would get a 25 bp hike or that the end of the cycle was near, the 1y1y forward at almost 8.25% looks even more attractive
- RODRIGUEZ INTERVIEW: prices of raw materials are starting to decline, and we are following those closely, they have not manifested themselves in the CPI. Banxico will not necessarily match the FED moves one for one

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