

# Fixed Income & Economics Daily

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## FX & RATES STRATEGY RESEARCH

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### STRATEGY

- **Brazil: 1Q18 Quarterly Inflation Preview**
- **Argentina: Central Bank warns the policy rate will be adjusted if inflation does not recede**

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- **Brazil: Exchange Rate -- Falling Interest Rate Differentials Leading to BRL Weakness**
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#### BRAZIL: 1Q18 Quarterly Inflation Preview

- Today, the Central Bank of Brazil will publish its Quarterly Inflation report for 1Q18 (7am NYT).
- Last week, the BCB surprised the market with a more dovish statement than expected, suggesting that further easing would be appropriate given the current inflationary dynamics.
- The inflation report should provide more insights on the drivers behind the baseline presented in last week's communique, where the BCB lowered its inflation forecasts to 3.8% and 4.1% for 2018 and 2019 respectively, from 4.2% for each year.
- Governor Goldfajn will be interviewed following the report, which will become a regular feature of the report's release from now on.

#### ARGENTINA: Central Bank warns the policy rate will be adjusted if inflation does not recede

- The statement contrasted with market expectations.
- Bear in mind that the CB's poll of economic forecasters envisages a downward rate policy path, while discrepancies among analysts are limited to the negative slope of the track.
- The Monetary Policy Committee met for the second time in the month on Tuesday and maintained the monetary policy rate at 27.25% as expected by the market.
- Interestingly, the inflationary acceleration recorded in the last few months is viewed by the CB authorities as temporary.
- They see it as driven by significant increases in regulated prices – mostly public utility rates – and the rapid

depreciation of the peso that took place between December and February.

- Once these transitory factors are overcome, inflation should resume its downward trend, according to the CB's communique.
- The Central Bank's diagnosis of an eventual return to a downward inflationary path is supported by:
  - the contractionary monetary policy currently underway;
  - 2018 wage contract negotiations that are mostly in line with the government's 15% inflationary target;
  - the deceleration of regulated price adjustments that will materialize in May; and
  - the Central Bank's FX intervention aimed at capping the dollar quote below ARS20.40/USD.
- Based on the above, we would not expect any change in the policy rate next month, as Central Bank FX dollar interventions should cease in the weeks to come.
- If Central Bank greenback sales do not dissipate in April, market participants will view FX interventions as an additional argument in favor of an increase in the policy rate.

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# LATAM ECONOMICS

## ARGENTINA

### ECONOMICS

#### Economic Activity Grew 4.1% Annually in January

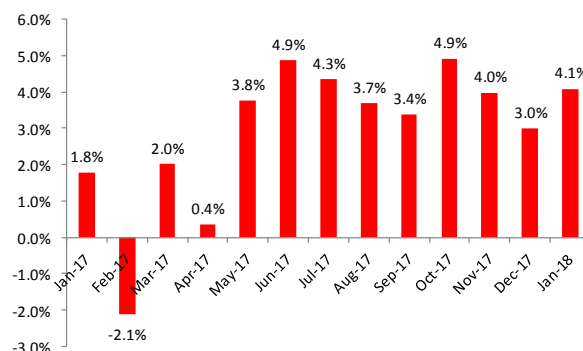
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The monthly economic activity estimator (EMAE) grew 4.1% y/y during January, INDEC announced on Wednesday. Economic activity figures in the first month of the year support our view of solid economic performance in 1Q18. The sectors with the strongest growth were fishing (+44.9% y/y), construction (+14.3% y/y), and agricultural production (+8.2% y/y). Keep in mind that among the 15 main economic sectors, only utilities (electricity, gas and water services) was in contractionary territory.

#### GDP expanding healthily



Monthly economic activity annual growth. Sources: INDEC and Santander.

**Solid economic growth in construction and industry in February.** During February, construction expanded 16.6% y/y (reaching an average expansion of 17.8% y/y in the first bimester). The solid economic growth in the construction sector combined with the capital goods imports growth of 18.3% y/y registered in January-February suggests that gross private investment should continue to be the main driver of economic activity. Also, the Monthly Industrial Estimator expanded 5.3% y/y last month (averaging +3.9% y/y in January-February), driven by car production (+27.4% y/y), basic metals (+22.2% y/y) and construction materials (+13.6% y/y).



## Brazil – Exchange Rate

### Falling Interest Rate Differentials Leading to BRL Weakness

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- The Brazilian *real* has been strongly underperforming other emerging market high-yield currencies, even during a period of U.S. dollar weakness against other major currencies and falling country risk (measured by CDS spreads).
- We attribute this underperformance mostly to falling overnight policy rates, which are leading interest rate differentials and hedging costs to the lowest levels in many years. The spread between BRL overnight rates and the average rate of seven high-yield currencies collapsed to -280 bps (as of February 28), from almost 600 bps only 12 months ago. These falling interest rate differentials make short-term investment in Brazil less attractive in both absolute and relative terms.
- We believe the combination of low hedging costs, domestic companies' balance sheets with large currency mismatches, and uncertainty about the presidential election to be held in October may be leading to high demand for USD hedges, also contributing to the BRL weakness.
- Those drivers are likely to remain active during the next few months, in our view, as interest rate differentials are likely to continue falling (as we expect the Brazil Central Bank to keep cutting until May, and the Federal Reserve and other central banks should remain in tightening mode) and electoral uncertainty should prevail until close to the voting date, October 7.
- We reaffirm our 2018 and 2019 year-end BRL/USD forecasts of 3.50 and 3.57, respectively.

Figure 1. BRL/USD Interest Rate Differential and Hedging Cost Gauge

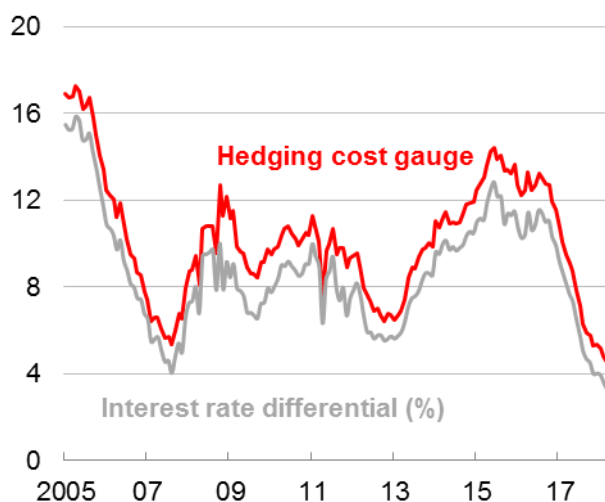
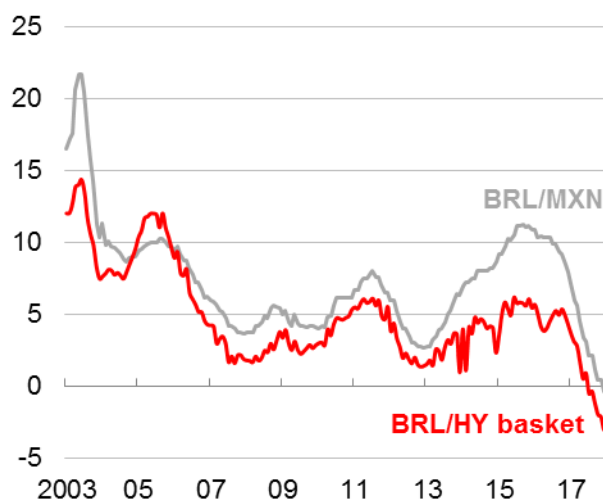


Figure 2. BRL/High Yield (HY) Basket and BRL/MXN Overnight Interest Rate Differentials (%)



Difference between six-month BRL and USD (*cupom cambial*) domestic rates. The hedging cost gauge adds six-month USD/BRL ATM volatility to that differential. High-yield basket includes MXN, IDR, INR, ZAR, TRY, COP, and ARS. Sources: Bloomberg and Santander estimates.

### Underperforming BRL and a significant correlation breakdown

The Brazilian *real* has been strongly underperforming throughout the last year (see Figure 3). In a period when the U.S. dollar lost value relative to other major currencies (as measured by the DXY index), the BRL weakened even more, depreciating against the USD and underperforming a basket of other high-yield currencies (by our definition, major emerging market currencies whose domestic interest rates are currently higher than 4% – Mexican peso, Indonesian rupiah, Indian rupee, South African rand, Turkish lira, Colombian and Argentinian pesos). Furthermore, since the beginning of 2017, a long-standing correlation between the BRL/USD rate and Brazil five-year CDS has broken down: while the CDS spread practically halved, BRL/USD traded sideways (see Figure 4). Just for the sake of comparison: in October 2014, when the CDS was trading around current levels (174 bps), the BRL/USD rate was at 2.43, around 37% stronger than currently.



Figure 3. Currencies' Performance (%)

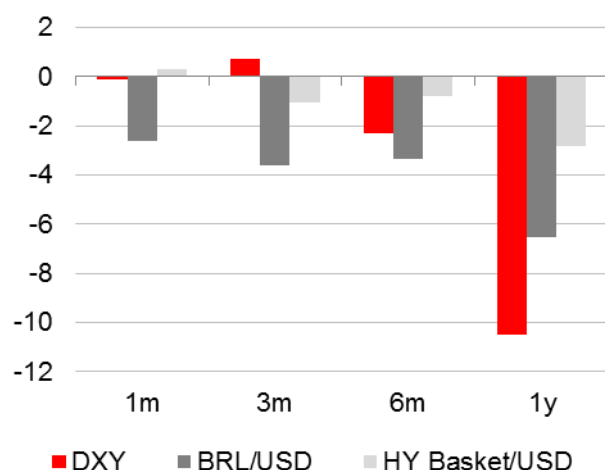
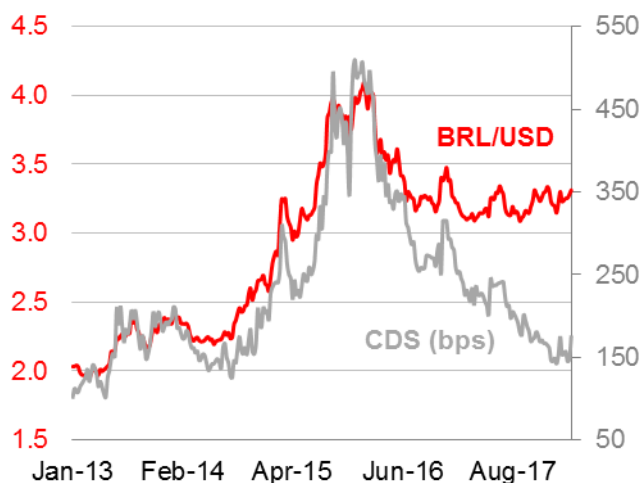


Figure 4. BRL/USD Rate and Brazil Five-Year CDS



Negative changes mean underlying currency/index losing value. High-yield basket includes MXN, IDR, INR, ZAR, TRY, COP, and ARS. Sources: Bloomberg and Santander estimates.

In our report *Why Has the BRL Weakened in 2017?* (January 8, 2018), we argued that the aggressive monetary easing over the last 18 months was the main factor behind the BRL depreciation, and that interest rate differentials are playing a larger role in the currency price. Here we extend that analysis, looking at different types of interest rate differentials and at a metric for hard currency hedging costs.

## Lowest interest rate differentials and cheapest hedging cost in years

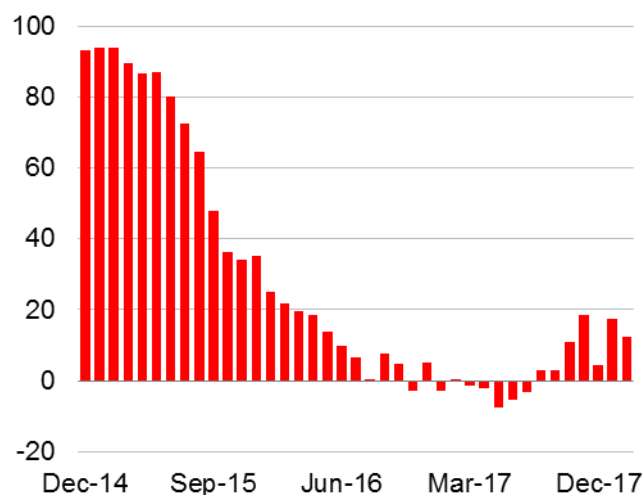
The Brazil Central Bank's aggressive cycle of monetary easing, following strong disinflation led by food prices and high levels of economic slack, brought the benchmark overnight rate to its lowest level in 60 years (see *Coming – The Lowest Interest Rates Ever?* October 10, 2017). Meanwhile, many central banks around the world have been following the Federal Reserve and hiking rates. As a result, interest rate differentials between Brazil and the U.S. and Brazil and other high-yield countries are also at multiyear lows (see Figure 2).

That conjuncture reduces both the absolute and relative attractiveness of the BRL in the so-called “carry trade”: (i) using the USD as a funding currency, expected returns from holding BRL longs are the lowest in many years; and (ii) BRL returns are now, also for the first time in decades, lower than those of a basket of other high-yield currencies (defined above) and of the Mexican peso, the other highly liquid currency in Latin America. In theory, this should reduce hot-money flows to Brazil, and this is suggested by balance of payments data. Although this is hard to measure, since most of the trades are done in over-the-counter derivatives markets, Brazil Central Bank data shows that foreign currency inflows more sensitive to domestic interest rates (intercompany loans, bonds, mutual funds, and short-term loans) have been diminishing, despite the local economic recovery and the recent good performance of domestic assets (see Figure 5).

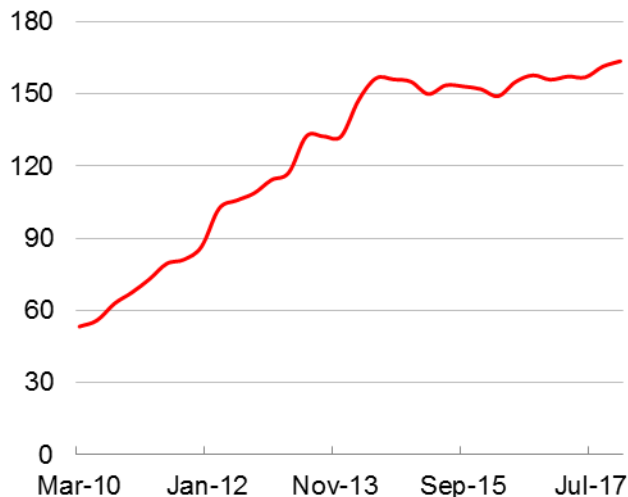
This narrowing interest rate differential, coupled with relatively low market volatility, suggests to us that hedging costs are also falling strongly. We built a simple gauge for these costs by adding the interest rate differential between local BRL and USD (*cupom cambial*) six-month rates to the USD/BRL six-month ATM implied volatility (calculated by Bloomberg) – hence, hedging costs could actually become more expensive if interest rate differentials led to higher implied volatility. This indicator shows that hedging costs more than halved over the past 12 months and are now also at the lowest level in the past 13 years (see Figure 1).



**Figure 5. 12-Month Cumulative Flows, Items More Sensitive to Domestic Interest Rates (USD billion)**



**Figure 6. Outstanding Foreign Debt, Non-Financial Corporations (USD billion)**



Items more sensitive to domestic interest rates include intercompany loans, bonds, mutual funds, and short-term loans. Sources: Brazil Central Bank, BIS, and Santander.

Considering that large Brazilian companies carry substantial currency mismatches in their balance sheets (since domestic capital markets are expensive and not deep enough for large debt issuances – see Figure 6), and given the high political/policy risk associated with October presidential elections, demand for hedging has been increasing substantially, according to our observations. Similarly, probably for the first time in many years, it makes sense, in our opinion, for foreign institutional investors to hedge currency exposure in their bond and equity portfolios, whose expected returns are now considerably higher than short-term BRL rates. This increased demand for hard currency has been, in our view, the main culprit behind the recent BRL weakness.

### Looking ahead: expect more weakness to come

The Brazil Central Bank has been signaling that the monetary easing cycle will be extended at least until May (see *Brazil Macro Compass: A Surprisingly Dovish Central Bank*, March 23, 2018), while we believe the Federal Reserve is likely to keep hiking for the next year or more. This will lead the interest rate differential to further narrow over the next few months, reducing BRL attractiveness and cheapening hedging costs. Electoral angst is unlikely to dissipate in the short term, in our view, as the number of presidential pre-candidates points to an open and fragmented race, which will narrow down to fewer choices only closer to the deadline for candidacy registration, on August 15. Unless commodity prices, historically the main driver for the BRL's value, start to rally strongly, the BRL is set for further weakness, in our view. We maintain our forecast at BRL/USD 3.50 for the year-end rate. An increase in hedging costs led by higher currency volatility is unlikely to decrease domestic demand for hard currency, in our view – we think the opposite is more likely to happen, if the BRL weakening trend starts to accelerate.

Looking at a longer time horizon (from 4Q18 on), the results of the October presidential election are likely to be a key variable, in our opinion. If a market-friendly candidate prevails, and assuming a gradual normalization of U.S. rates, we believe those currency hedges will likely start to be unwound, and Brazil's growth potential may attract a large flow of foreign investments, turning the BRL into an outperformer. For 2019 year-end, we maintain our forecast of a BRL/USD rate at 3.57, as we believe even a good relative performance should lead to additional weakening in a perceived more challenging environment for emerging countries.



# Strictly Macro

## Synchronized Growth & Politics

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### Macro Overview: Synchronized growth at last

The Latin America region appears well positioned, in our view, to weather external shocks coming from a faster increase in core interest rates, global trade disruption due to far-reaching U.S. protectionism, and a weaker China, with a corresponding toll on commodities. Our confidence is rooted, first, in steadier macro fundamentals, highlighted by solid economic growth. We expect the Brazilian economy—accounting for the lion's share of total output in our seven-country universe, at 43%—to outperform by growing in excess of 3% this year, faster than both its potential rate (about 2%) and its average pace since 2000 (2.5%). Indeed, we expect all countries (except Colombia) to deliver GDP growth above or close to potential rates. Moreover, the upbeat outlook we see for the region coincides with two key influences, in our view: (i) a synchronized world expansion for the first time since the global financial crisis (featuring global trade increasing 4.5%, its fastest pace since 2010); and (ii) muted local inflation, both of which improve the prospects for a sustainable expansion. In our view, another supportive element for the region as a whole is improving funding dynamics, albeit from elevated levels. Thus, the systemic risk alarm, which sounds when countries run swelling deficit positions in both current account and public sector balances, looks likely to be muted, in our opinion. For all countries except Argentina, we expect lower CA deficits compared to their average balances since 2008. Mexico, although under FDI stress due to NAFTA uncertainty, has been surprisingly resilient. Regarding public gaps, we expect all governments (except Peru) to maintain their fiscal consolidation efforts.

Local assets have performed relatively well despite pressures from the big selloff in U.S. rates, global equity stresses (volatility spike), and some tough trade actions (such as sovereign risk; see middle chart next page). Capital inflows are still linked to investors' expectations of gradual hikes by G-3 central banks and steady USD, which has indeed been highly supportive for risky assets. Our G-10 strategy team confirmed their long-held view that the Fed will deliver three hikes this year, followed by a similar dose in 2019. They expect 10-year Treasury yields to close at 3.25%, while euro rates should replicate about half of the overall U.S. rate increase, with the correlation to gain steam by end-2018. But even if the Fed hikes rates to around 3% (neutral), this is lower than the 5.25% at the end of the 2005-06 hiking cycle. On the negative side, a full scale U.S.-China trade dispute would put significant stress on the region's outlook, in our view, given LatAm's significant dependence on demand from the U.S. (mainly for Mexico) and China (rest of countries). Overall, we believe these two global tail risks could run in parallel with the idiosyncratic risk catalysts for the year: presidential elections in Colombia, Mexico, and Brazil, along with stabilization of inflation in Argentina.

**For more information, please see the full report.**

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