THE WEEKLY **LATAM** ECONOMIC MONITOR

JUNE 11, 2018
ANDRES ABADIA,SENIOR ECONOMIST

Inflation is under control in most LatAm economies, but the FX rout in recent days is a headache.

Brazil's inflation surprised to the upside in May, but sluggish growth is helping to keep the headline low.

Inflation in Mexico keeps falling, but the recent MXN' sell-off will slow the downtrend this year.

Poor Growth is Keeping Inflation Low, Offsetting FX Pressures

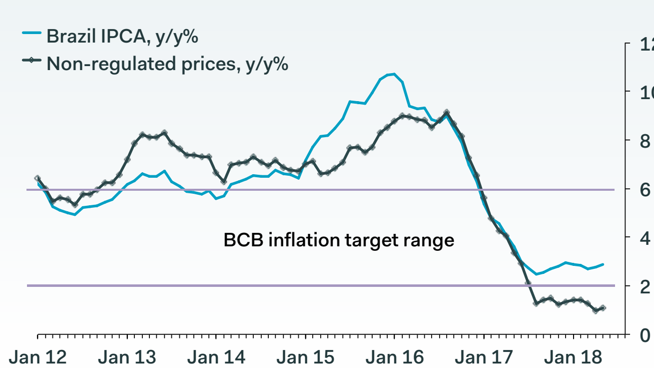
Inflation is under control in most LatAm economies, and we expect headline rates to remain close to current levels in the very near term. But recent shocks, in particular the FX sell-off, has tilted the balance of risks to the upside. In **Brazil**, sentiment has deteriorated significantly in the past few weeks. The more fragile global environment and rising concerns about fiscal reforms are no longer on the back-burner. The truck drivers' strike and the broad negative sentiment on most EM, including LatAm, has taken a toll on the BRL and local rates; all these factors will push inflation up.

Data released on Friday showed that Brazil's unadjusted CPI index rose 0.4% month-to-month in May, above the consensus, 0.3%. The year-over-year rate rose slightly to 2.9%, from 2.8% in April. The truckers' strike and the BRL sell-off are starting to hurt, but the underlying trend remains relatively stable, consistent with the sluggish cyclical recovery, the ample output gap, and modest demand pressures. Indeed, prices were virtually stable last month.

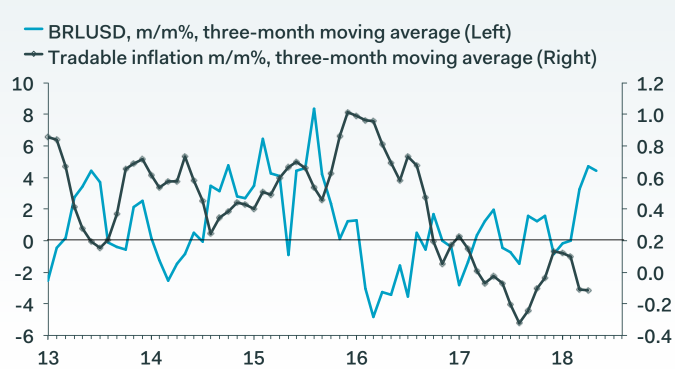
May saw a sharp increase in housing prices, including utilities, up by 0.8% in May, but this was much less than the 2.1% increase in May 2017; the data are unadjusted. Higher regulated energy tariffs, up by 1.0%—usual at this time of the year—were behind the jump. Food prices, meanwhile, rose 0.3% in May, in contrast to the 0.4% *drop* in May 2017. This was the third consecutive monthly increase, and the truckers' strike in the final week of the month contributed to the rebound. In addition, transportation costs rose by 0.4% month-to-month, due mainly to rising gasoline prices, and the effect of the strike. Other key components, particularly those closely related to the domestic economic cycle, rose at a relatively modest pace. Core and services inflation are still low.

These data underscore both the effect of the temporary shocks, and the limited degree of domestic inflation pressures in Brazil, consistent with the subpar turnaround, still-ample spare capacity, and a record-high unemployment rate. We still expect inflation to rise slowly this year. But the effect of the 10-day strike will generate temporary upside pressures, particularly

INFLATION IN BRAZIL REMAINS LOW, BUT RISKS ARE RISING



THE BRL'S SELL-OFF IS A THREAT BUT NOT RIGHT NOW



on food prices and transportation in June's report. As a result of the strike, the government announced that domestic diesel prices would be cut by 0.46 BRL per litre—about 13% of the current price at the pump—and remain frozen for 60 days, and that it would exempt empty trucks from tolls. Most importantly, to satisfy truckers, the government has introduced a minimum freight fare, which has boosted costs. According to the National Agriculture Confederation, transportation costs will jump as much as 150% from current levels.

The BRL, meanwhile, has been under severe stress since late March. This will drive inflation pressures over the second half of the year. The pass-through effect is relatively modest, despite the BRL's 12.8% fall this year, but it will be enough to push inflation up by 1.5-to-2.0 percentage points late this year and in early 2019, on top of its initial trend. We still believe that the sell-off will be contained, and the currency's performance on Friday was positive. It rebounded by 5.3% ending the week at 3.70.

Policymakers' announced on Thursday night that they would increase their intervention in the FX market this week—another USD20B through swaps on top of the USD0.8B that they already were offering—and suggested that they are prepared to meet the market's demand for USD using other tools. The measures seemed to have calmed investors. If the BRL stabilizes, as we expect, inflation expectations won't suffer that much.

Overall, the key story here is that inflation remains benign despite the effect of recent supply shocks. Inflation will accelerate towards 3.5% year-over-year in June, due to the effect of the strike, but it likely will stabilize around 3.8% over the second half of the year. These forces, however, will be partially offset by favourable inertia, still-soft market-set price increases, and spare capacity in the economy. As such, we don't expect the headline inflation rate to accelerate dramatically, as the recovery has lost momentum in the first half of the year, and downside risks to growth have increased significantly in recent weeks.

Under these circumstances, our base case is that the central bank will remain on hold later this month. Policymakers have stepped up intervention in FX and local bonds, and they likely will continue to do so in order to avoid a painful interest rate increase, now that the recovery seems to be faltering. On Thursday night, at the same press conference, policymakers indicated that they have no intention to hike rates just yet. But risks remain, and they are rising rapidly. Political uncertainty and concerns about fiscal sustainability and the reform effort have reappeared ahead of the presidential election in October. And investors will continue to cut holdings of EM assets as the Fed continues tightening. All these factors point to a bumpy ride ahead. As such, if the BRL weakens to more than 4 per USD, and stays there, we think that the COPOM won't be able to stay put.

In **Mexico**, meanwhile, the combination of favourable base effects, the relatively soft economic recovery, and the stable MXN—until mid-May—have helped to bring inflation down in recent months. But recent U.S trade policy, and the escalating retaliation from Mexico, have put the peso under severe stress in recent days. If sustained, the sell-off will push up both inflation expectations and current inflation in due course. More immediately, unadjusted consumer prices fell 0.2% month-to-month in May, pushing the year-over-year rate down to 4.5% from 4.6% in April.

Last week's report confirms that inflation pressures are modest, for now. The month-to-month May fall was driven by the non-core component, which dropped 1.4%, slightly more than the decline in May last year, due mainly to lower non-processed food prices. Energy tariffs also fell; that's normal at this time of the year, but they dipped by less than in May 2017. Core prices, meanwhile, rose 0.4% month-to-month, similar to the increase in May last year, but the recent MXN sell-off is already putting some pressures on the non-food goods component. The year-over-year core rate was unchanged at 3.7%.

Overall, we expect inflation to keep falling this year, ending the year around 3.4%. But risks are rising, particularly over NAFTA and the presidential election. We have to wait for news on the NAFTA front, but if no progress is seen over the coming days, Banxico will be forced to hike rates on June 21 to stem the bleeding, if FX intervention doesn't help. Further action will be data-and NAFTA-dependent, despite headline inflation maintaining a downtrend.

Andres Abadia **+44 191 2600 309**
andres@pantheonmacro.com Twitter: @Andres__Abadia

THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, June 11

• D: Mexico Industrial Production (4)/8:00 Local
Industrial production likely fell **0.4%** month-to-month, pushing the year-over-year rate up to **3.4%** in April, from -3.7% in March. A favourable base effect will help. We expect the industrial sector to strengthen this year as oil output stabilizes, and public spending supports construction activities ahead of the elections. The manufacturing sector, meanwhile, will be helped by stronger U.S. demand. But the NAFTA talks are now a big risk. **Consensus: 3.6%.**

Tuesday, June 12

• No significant data released.

Wednesday, June 13

• D: Brazil Retail Sales (4)/9:00 Local
We expect retail sales to rise **0.6%** month-to-month in April, pushing the year-over-year rate down to **4.5%**, from 6.5% in March. **Consensus: -0.7%.**

• Chile Overnight Rate Target /18:00 Local
The BCCh likely will keep the main interest rates on hold at **2.50%**, as the economy is improving. We think that policymakers will start a slow normalization cycle in Q4 or early next year, consistent with a faster domestic economic recovery and rising inflation. **Consensus: 2.50%.**

Thursday, June 14

• Argentina Consumer Prices (5)/16:00 Local
The index should rise **2.3%** month-to-month in May, due to regulated price increases. The year-over-year rate should rise trivially to **25.7%** from 25.5% in April. Inflation pressure will remain high this year. **Consensus: 2.5%.**

• Peru Economic Activity Index (4)/No specific time
The index likely will increase **5.6%** year-over-year in April, up from 3.9% in March. The underlying trend is rising, an we expect a good Q2 as a whole, consistent with the strength of leading indicators. **Consensus: N/A.**

Friday, June 15

• Brazil Economic Activity Index (4)/8:30 Local
The index likely will increase **2.0%** year-over-year, up from a 0.7% fall in March. The trend is falling, but we expect a decent Q2. Downside risks have increased significantly in recent weeks, due to the truckers' strike, the BRL sell-off and rising political uncertainty ahead of the presidential election. **Consensus: 3.5%.**

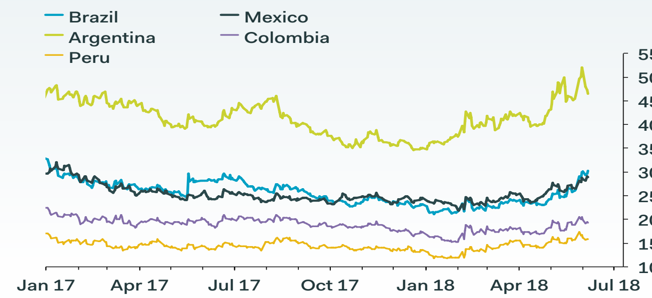
• Colombia Retail Sales (4)/10:00 Local
We look for a **6.8%** year-over-year increase, up from 5.5% in March. We expect the retail sector to remain strong over the coming months thanks to low inflation and low interest rates. If we are right, this bodes well for growth over the quarter as a whole. **Consensus: 4.8%.**

• Colombia Industrial Production (4)/10:00 Local
Industrial production should rise **4.0%** year-over-year, accelerating from -1.4% in March. Improving economic fundamentals suggest that the industrial economy will continue to do well in the near term. **Consensus: 4.5%.**

PANTHEON'S LATAM FINANCIAL CONDITIONS DASHBOARD

	Currency			Benchmark Stock index		
	Value	Week, %	YTD, %	Value	Week, %	YTD, %
Argentina	25.34	-1.4	-26.5	31,444	10.6	4.6
Brazil	3.71	1.5	-10.7	72,942	-5.6	-4.5
Chile	630.8	0.1	-2.4	5,523	0.9	-0.7
Colombia	2,859	0.3	4.4	12,252	-0.4	6.7
Mexico	20.29	-1.7	-3.1	45,940	2.1	-6.9
Peru	3.26	0.3	-0.8	21,204	0.9	6.2
Venezuela	79M	0.0	-100.0	40,544	12.0	3,109

INDEX EMBIG SPREAD LATAM HISTORY



PANTHEON'S ECONOMIC FORECASTS

	Real GDP, y/y%		Inflation, Avg.		Interest rate, Q4	
	2017	2018	2017	2018	2017	2018
Argentina	2.9	2.0	24.8	23.5	28.75	30.00
Brazil	1.1	2.0	3.2	3.4	7.00	6.50
Chile	1.5	4.2	2.2	2.6	2.50	2.75
Colombia	1.8	2.5	4.3	3.0	4.75	4.25
Mexico	2.0	2.6	6.0	4.2	7.25	7.50
Peru	2.5	3.7	2.8	2.0	3.25	2.75
Venezuela	-10.5	-8.0	1500	5000	--	--

COMMODITY PRICES (JANUARY 1, 2017 = 100)

PANTHEON'S FINANCIAL FORECASTS

	Currency			Benchmark Stock index		
	Q2F	Q3F	Q4F	Q2F	Q3F	Q4F
Argentina	24.0	24.5	25.1	32,000	32,800	32,200
Brazil	3.60	3.65	3.50	85,600	88,100	90,100
Chile	610	605	603	5,850	6,100	6,350
Colombia	2,800	2,783	2,670	1,670	1,750	1,890
Mexico	19.8	19.1	18.9	47,900	49,800	51,300
Peru	3.23	3.24	3.22	21,300	21,600	21,900
Venezuela	12.0	12.0	12.0	--	--	--