THE WEEKLY **LATAM** ECONOMIC MONITOR

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ANDRES ABADIA,SENIOR ECONOMIST

Banxico's June minutes suggest that the door is open for further rate hikes...

...But the AMLO-driven MXN rebound likely will allow the Board to keep rates on hold in Q3 and Q4.

The truckers' strike has pushed Brazil's inflation up back to target, complicating policymakers' lives.

The MXN Rebound Likely will Allow Banxico to Keep Rates on Hold

The Banxico minutes from the June 20 meeting, released last Thursday, offered more detail about the outlook for policy in the near term. The Board decided unanimously to hike its reference rate by 25bp, to 7.75%, the highest level since early 2009. The minutes maintained a vigilant tone, leaving the door open for further hikes. The Board said it will act in an "opportune and firm manner" to put a lid on inflation expectations and to push headline inflation down to its 3% target. *But the minutes also revealed that some Board members no longer see rate hikes as a done deal, merely saying that additional hikes "shouldn't be discarded" over the coming meetings.*

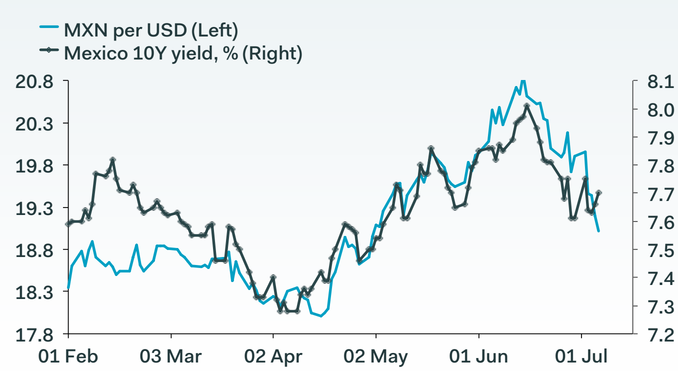
According to the minutes, the main driver behind the rate increase was the deterioration of the balance of risks for inflation, which could delay convergence toward the target in 2019, even though the balance of risks remains negative for growth. Inflation finally has started to fall rapidly this year, as the effect of some of the shocks from last year have faded. But upside risks have increased in recent months following the MXN's sell-off and rising gasoline prices.

The majority of the Board argued that the main upside risk to inflation is the MXN, due to higher global rates, the strength of the USD, NAFTA-related uncertainty and the domestic electoral process, along with post-electoral risk. One member indicated that the risk of downward spiral in the MXN is real. In addition, he stressed vigilance regarding services inflation as the FX pass-through, which is currently absent, could start to increase. Another member remarked that the possibility of future adjustment to the fiscal stance could dent the perception of sovereign risk. Some members are concerned about forthcoming government actions on the fiscal side, and the potential increase in the minimum wage.

The statement summarizes the factors that will eventually drive Banxico to hike rates, and which to some extent are intertwined. We think policymakers will hike rates if the MXN comes under renewed stress due to trade-related fears, driving already sticky inflation expectations higher. An aggressive U.S. tightening has the potential to put the MXN under stress and drive Banxico to move. But this is not our base case. The positive performance of Mexican assets following the presidential election, with the MXN rebounding 3.5% last week, the most in the EM world, will allow Banxico to keep rates on hold over the coming months, providing the peso remains close to its current levels.

The MXN rebound will also allow Banxico to remain on hold after the Fed, despite a marginal compression of rate differentials with the U.S. The bank has hiked

MARKETS HAVE WELCOMED AMLO'S WIN, FOR NOW



significantly in the current cycle, and has room for manoeuvre to avoid a painful portfolio rebalancing that affects foreigners' holdings. Moreover, potential capital outflows driven by the differentials, which usually are accompanied by a weaker FX, likely will be offset by investors' relatively upbeat view of AMLO's new government, at least in the near term.

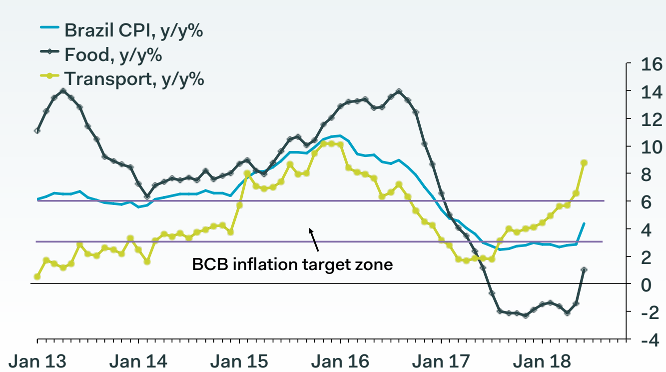
The key story here, though, is that even if rates don't rise further, the scope for *easing* later this year is very limited, unless a NAFTA agreement is reached soon. Moreover, although the pass-through to inflation has been limited so far, if expectations of lingering or further MXN weakness were to become entrenched, this would very likely affect pricing by firms and potentially lead to knock-on effects and higher inflation expectations. This too is not our base case, but risks of further MXN depreciation remain.

The Board is comfortable with a slightly hawkish tone, for now. It will hike again if the MXN comes under renewed pressure, but will try to keep rates on hold as long as possible, given domestic and external considerations. The biggest hurdle, domestic politics, will be on the back-burner over the coming months, but volatility likely will rise when AMLO takes office on December 1, and passes the federal budget by mid-month. In addition, global trade woes, which are the biggest threat to Mexico's financial and economic stability, continue to be a source of uncertainty. This won't allow Banxico to cut rates in the near term.

Elsewhere in the region, **Brazil's** inflation rate soared back to the BCB's target range in June, due mainly to the effect of the truckers' strike, which triggered shortages across the board, and higher regulated prices. The benchmark inflation index, the IPCA, rose 1.3% unadjusted month-to-month in June, pushing the year-over-year rate to jump to 4.4%, from 2.9% in May. The month-to-month increase was driven mainly by a sharp rise in housing prices, including utilities, up by 2.5% in June, in sharp contrast to the 0.8% drop in June 2017. Higher regulated energy tariffs are behind the increase. Food prices, meanwhile, jumped 2.0% in June, in contrast to the 0.5% fall in June 2017. *The strike explains most of the increase due to the hit to the food supply chain.* Indeed, the strike hit the transportation component quite badly.

Inflation is now within the COPOM's target zone, and it likely will continue to edge higher over the next three-to-six months. The effect of the BRL's sell-off since April, about 17%, and some regulated price increases in coming months, will lift inflation. Admittedly, the subpar economic recovery—which is already losing steam—the ample output gap, and soft demand-related pressures will help to keep the headline rate under control. Our base case is that inflation will end the year at around 4¾%, and that policymakers will be able to keep the policy rate on hold through end-Q4. But rate hikes likely will come if the BRL depreciation continues and inflation expectations increase rapidly. Moreover, political risk is on the rise, with non-stablishment candidates still leading the polls.

FOOD DISINFLATION IS OVER IN BRAZIL



INFLATION EXPECTATIONS ARE THE KEY FACTOR TO WATCH

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, July 9

• Chile Trade Balance (6)/8:30 Local
We look for an unadjusted **USD0.7B** surplus in May, up from USD0.3B a year ago. The mining sector remains the key driver. **Consensus: USD0.7B.**

• D: Mexico Consumer Price Index (6)/8:00 Local
We expect consumer prices to rise **0.4%** month-to-month unadjusted in June. Inflation likely will rise to **4.7%** year-over-year, from 4.5% in May. The underlying trend is falling, and the recent FX rebound, following AMLO's win, means that the benign picture will continue in the near term. Pressures, however, will continue to be driven by rising oil prices. **Consensus: 4.6%.**

Tuesday, July 10

• No significant data released.

Wednesday, July 11

• No significant data released.

Thursday, July 12

• D: Brazil Retail Sales (5)/9:00 Local
We expect retail sales to fall **1.0%** month-to-month in May, pushing the year-over-year rate up to **2.5%**, from 0.6% in April. Private consumption is still resilient, thanks to low inflation and interest rates, and the modest but welcome recovery in the labour market. This relatively benign scenario, though, will be challenged over the second half by increasing political risk. **Consensus: 0.6%.**

• D: Mexico Industrial Production (5)/8:00 Local
Industrial production likely rose **0.5%** month-to-month, pushing the year-over-year rate down to **0.8%** in May, from 3.8% in April. We expect the industrial sector to strengthen this year as oil output stabilizes, and public spending supports construction activity 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: 3.8%.**

• Peru Overnight Rate Target /18:00 Local
The BCRP likely will keep its key interest rate on hold at **2.75%**. Inflation is low, the economy is gathering strength, and the PEN is under pressure. We believe that the Board will stick to its neutral bias over the second half of the year as growth risks are tilted to the upside, and inflation will remain low in the short-term. **Consensus: 2.75%.**

Friday, July 13

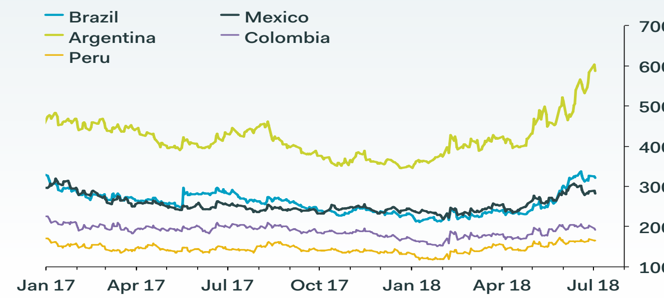
• Colombia Retail Sales (5)/10:00 Local
We look for a **6.0%** year-over-year increase, slightly down from 6.3% in April. We expect the retail sector to remain strong over the coming months, thanks to low inflation and low interest rates. If we are right, this bodes well for GDP growth over the quarter as a whole. **Consensus: N/A.**

• Colombia Industrial Production (5)/10:00 Local
Industrial production should rise **4.2%** year-over-year, slowing from 10.5% in April. Improving economic fundamentals suggest that the industrial economy will continue to do well in the near term. **Consensus: 3.7%.**

PANTHEON'S LATAM FINANCIAL CONDITIONS DASHBOARD

	Currency			Benchmark Stock index		
	Value	Week, %	YTD, %	Value	Week, %	YTD, %
Argentina	27.93	3.6	-33.3	27,653	6.2	-8.0
Brazil	3.87	0.2	-14.4	75,014	3.1	-1.8
Chile	656.8	-0.4	-6.3	5,285	0.5	-5.0
Colombia	2,872	2.1	3.9	12,331	0.1	7.4
Mexico	19.01	4.7	3.4	48,992	2.8	-0.7
Peru	3.28	0.0	-1.4	19,954	0.8	-0.1
Venezuela	114M	-16.5	-100.0	126,583	51.0	9K

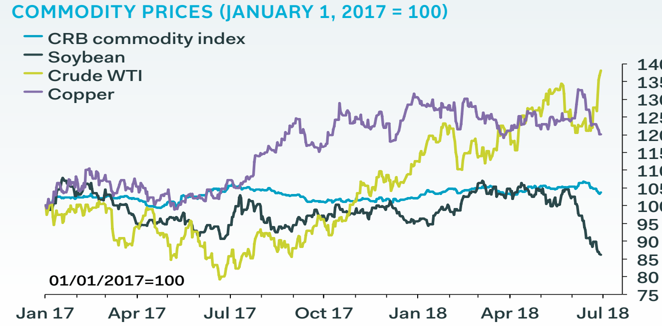
INDEX EMBIG SPREAD LATAM HISTORY



PANTHEON'S ECONOMIC FORECASTS

	Real GDP, y/y%		Inflation, Avg.		Interest rate, Q4	
	2017	2018	2017	2018	2017	2018
Argentina	2.9	1.2	24.8	28.0	28.75	35.00
Brazil	1.1	1.8	3.2	3.9	7.00	6.50
Chile	1.5	4.2	2.2	2.6	2.50	2.75
Colombia	1.8	2.5	4.3	3.3	4.75	4.25
Mexico	2.0	2.6	6.0	4.2	7.25	7.75
Peru	2.5	3.7	2.8	1.3	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		
	Q3F	Q4F	Q1F	Q3F	Q4F	Q1F
Argentina	30.0	32.1	33;3	28,000	29,500	30,600
Brazil	3.90	3.95	3.80	75,600	80,200	85,400
Chile	660	645	623	5,450	5,600	5,850
Colombia	2,950	2,825	2,650	1,600	1,650	1,720
Mexico	19.0	18.8	18.0	48,400	49,200	50,300
Peru	3.28	3.26	3.24	20,100	21,200	22,400
Venezuela	--	--	--	--	--	--