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MACRO MORNING BRIEFING

October 25, 2024

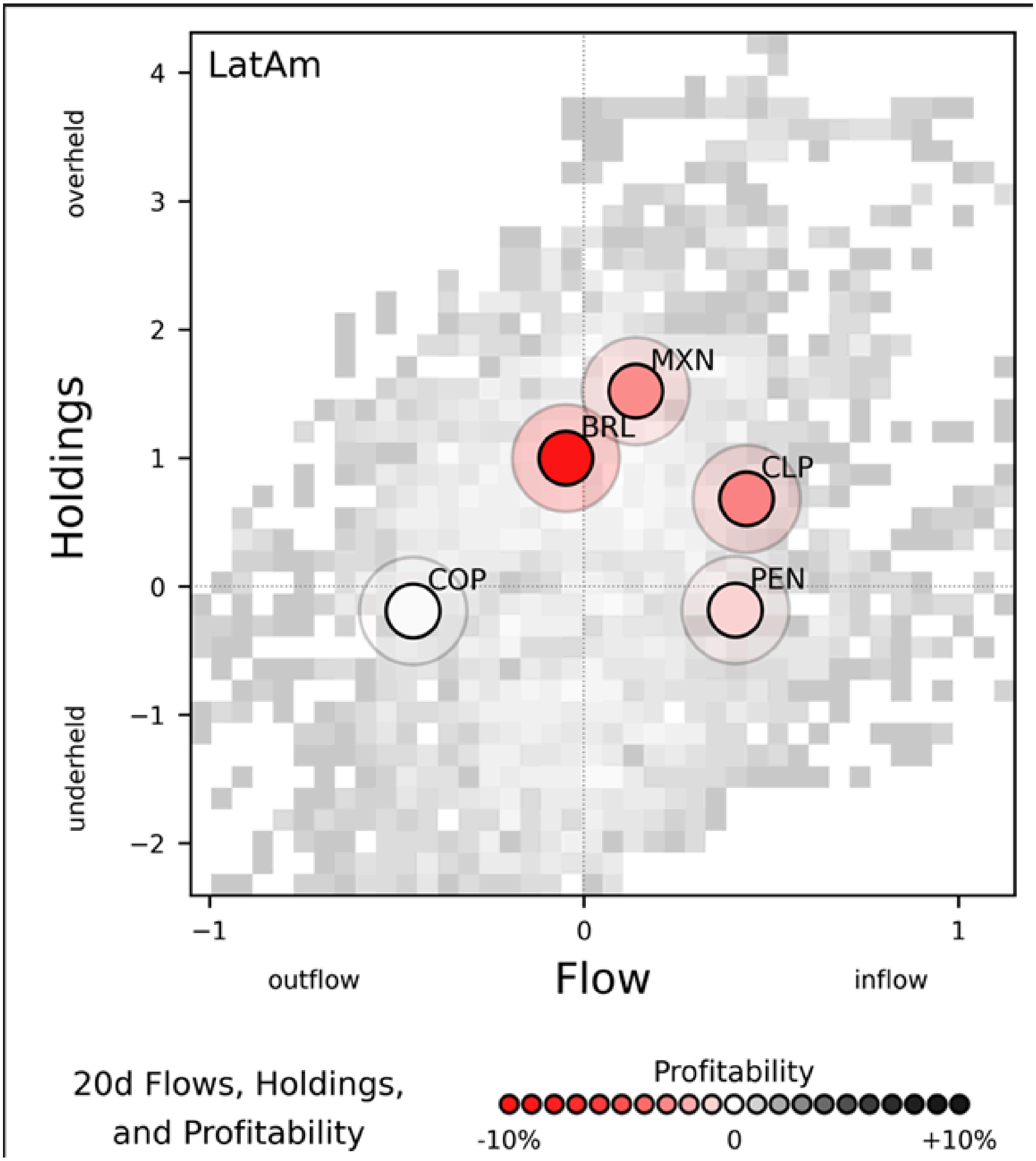
LatAm and Paradise Lost

- **Mexico has been part of the “Trump” trade for markets**. The currency has used the 2016 playbook to climb above 20 – iFlow continues to show long MXN holdings.
- **Brazil has been hit with BCB tightening** due to higher-than-expected inflation and fiscal concerns. BRL will see BCB defense at 6.0 to squelch import inflation risks.
- **The role of LatAm in a Harris or Trump presidency** will differ significantly. A US tariff push by Trump would put LatAm at a disadvantage. China is South America’s largest trading partner at $450bn in 2023.
- **LatAm growth was revised higher by IMF WEO,** but it is still a problem – in 2023 it was 1.9%, below the 3.2% global average and now on a run rate for 2.1% in 2024, below the 3.1% global average. The outlook for 2025 is 2.3%.
- **Brazil vs. Mexico remains the key focus for our investors** and the one that most reflects geopolitical factors. The entire region matters and remains a crucial source for future investment growth, commodities and an educated workforce. The IMF raised Brazil growth for 2024 to 3%, up 0.9pp and cut Mexico growth to 1.5%, off 0.7pp.

In 2023, the FX markets saw Brazil and Mexico as a paradise for the carry trade even as the US raised rates and Brazil cut them. The region outperformed, with currencies holding and high real rates attracting capital. However, 2024 has not been so kind and as the focus globally shifts from inflation to growth, the entire region is suffering. The re-election of Luiz Inácio Lula da Silva in Brazil in late 2022 has highlighted the concerns about fiscal policy and relationships to the US. The recent election of Claudia Sheinbaum in Mexico and her supermajority has already raised concerns about the rule of law as a result of the change from appointing to electing judges. The summer election hurt FDI flows in Mexico, and US election concerns have added to investor uncertainty over trade and border policy into 2025. In some ways, the analogy of Paradise Lost for the region has some validity as the free will of policy shifts has led to a fallen angel reaction in markets. The role of the US and China in the region aggravates the growth views linked to trade and investment for 2025 but also highlights how the region is not the center of focus for either superpower.

Holdings in LatAm FX are still long BRL and MXN but with less profitability and with only PEN showing some short covering. COP looks least supported with slightly short positioning seeing further outflows with no money lost – as investors seem to be happy to hedge any COP exposure.

Exhibit #1: iFlow Shows FX Vulnerability in LatAm



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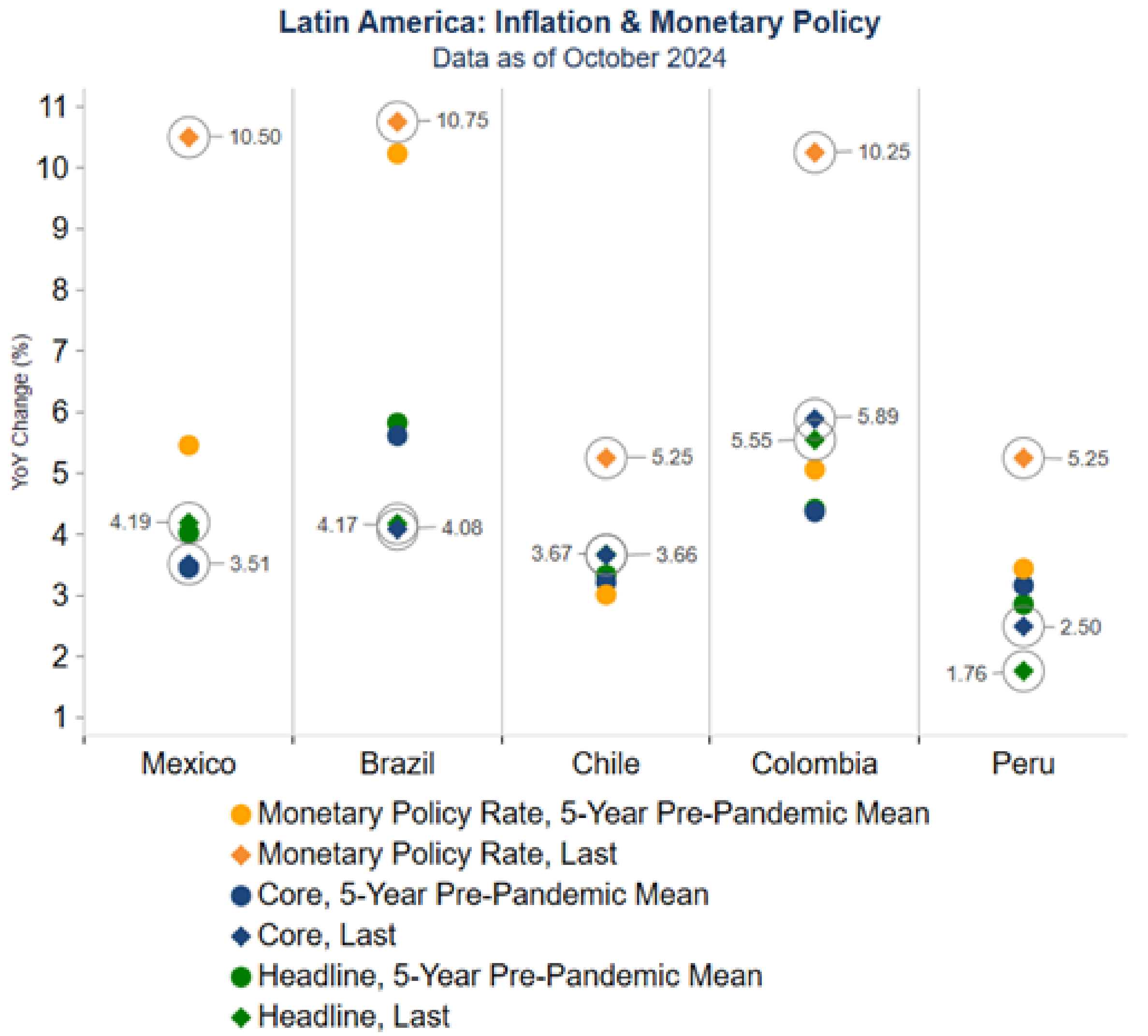
Source: iFlow, BNY

The MXN Trump trade from 2016 drove MXN from 18.80 to 20.80. The current moves have been mixed with the Mexican election, which accounted for the reversal from 17 to 20. The FX options markets have a 2% US election premium in MXN 1M options now. Most see the USD upside risk limited to 21-22 given current rate differentials, ongoing trade and the ability of Banxico to intervene and cap excess volatility.

BRL has no clear Trump trade attached to it. In 2016, BRL was stuck in a range of 3.05-3.35, with a focus on growth and inflation, as President Dilma Rousseff was impeached in 2015 and removed from office at the end of 2016. The role of the BCB in keeping the currency stable during this politically volatile time stands out. BRL has reversed sharply in 2024, with higher inflation and weaker FX linked to and blamed on Lula's fiscal policies.

Overall, the region has become significantly divided by politics, with Argentina electing Javier Milei in 2023 on promises to end decades of growth stalled by Peronism, rising debts and the devaluation of ARS. The role of politics and how the region interacts with the US and China remains a vital component of trade, growth and inflation risks. The role of China in South America remains significant. Latin American exports to China include soybeans, copper, petroleum, oil and other raw materials that the country needs to drive its industrial development. In return, the region mostly imports higher value-added manufactured products, a trade some experts say has undercut local industries with cheaper Chinese goods. As of 2023, Beijing has free trade agreements in place with Chile, Costa Rica, Ecuador and Peru, and 21 Latin American countries have so far signed on to China's Belt and Road Initiative (BRI). However, the region's largest driver continues to be policy, and rates there are significantly higher than most of the world while inflation is sticky. The pre-pandemic rates are still far from current policy levels while the currency devaluations are notable – with the moves since 2010 and the commodities boom notable, led by Argentina, followed by Brazil, Chile and Colombia.

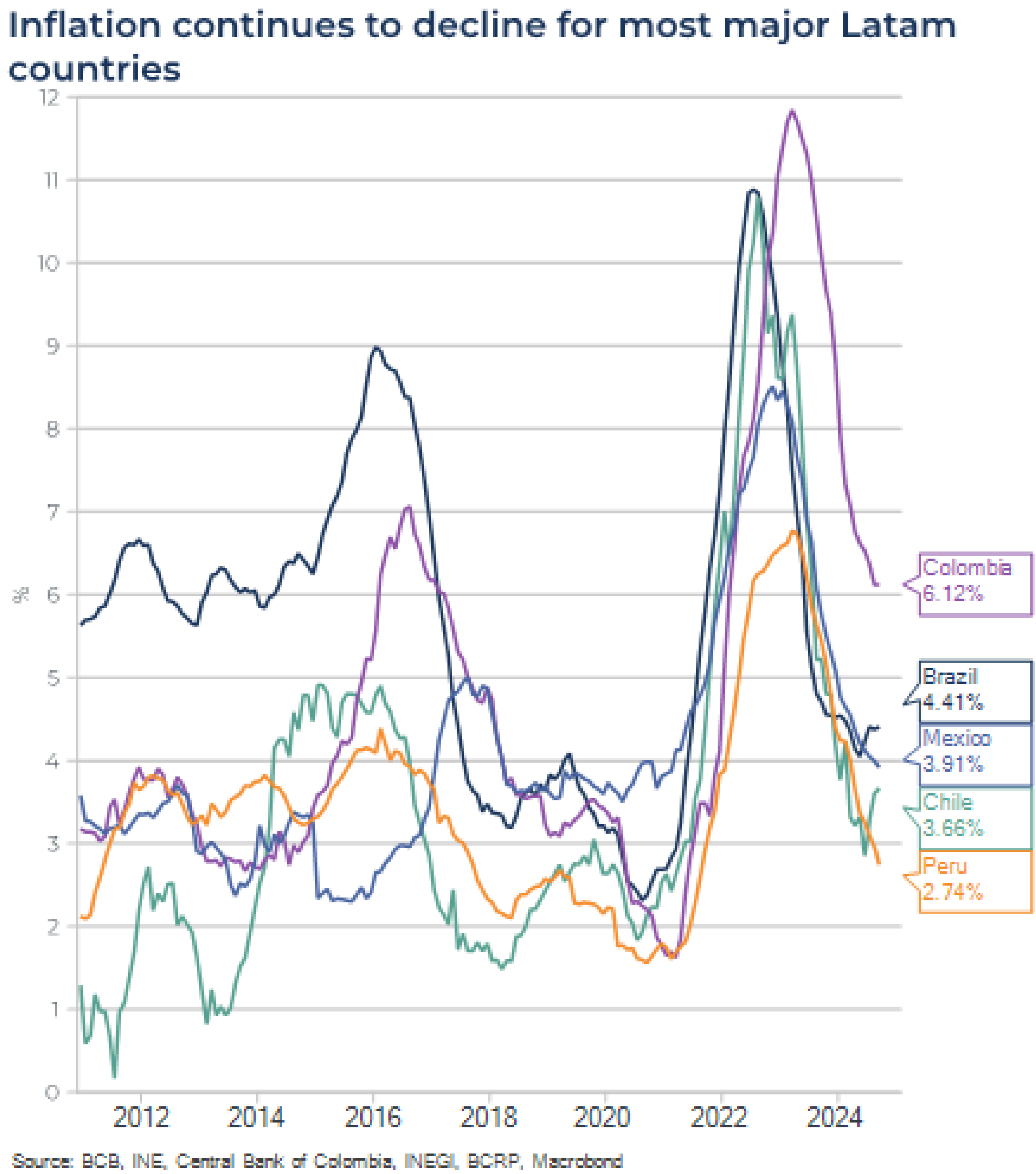
Exhibit #2: LatAm Inflation and Policy Have Not Returned to Pre-Pandemic Levels



Source: Macrobond, BNY

The good news for the region is that inflation has reversed in 2024. The drop in rates has allowed more easing, with Peru, Chile and Mexico all approaching central bank targets. The contrast in Brazil and its troubles stand out. The BCB has the dual challenge of sticky prices from fiscal dominance problems and the weakness of BRL.

Exhibit #3: Inflation Is on the Right Path but Stuck in Brazil

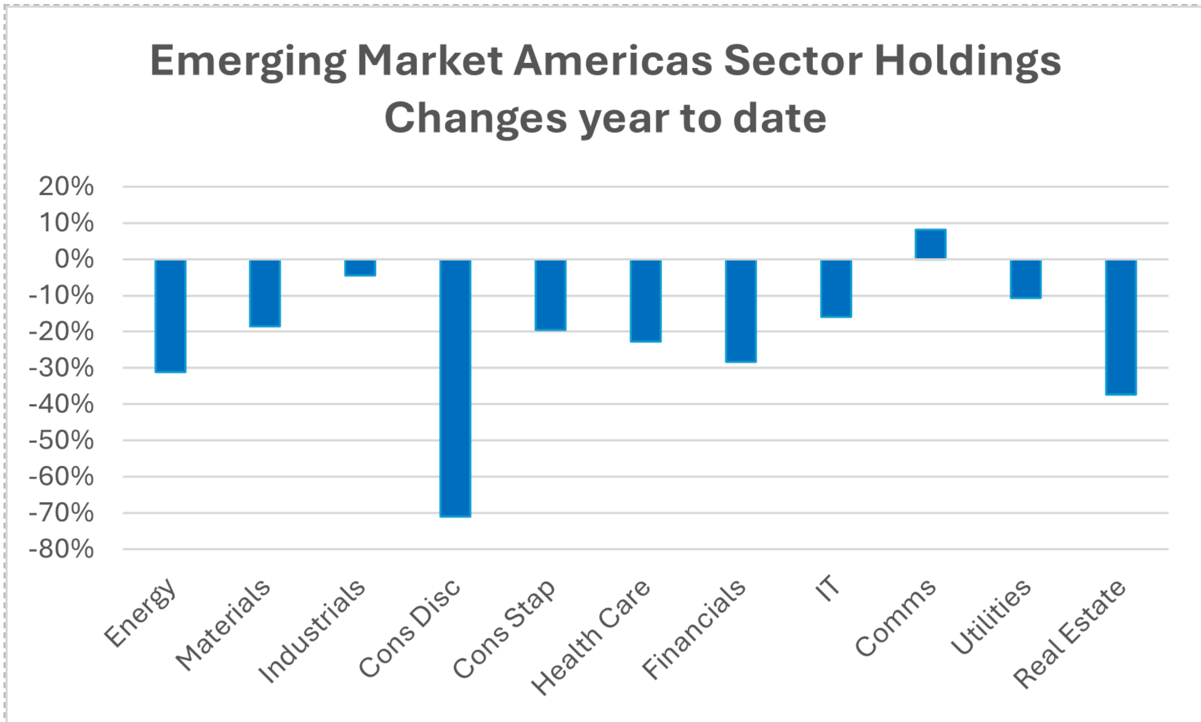


Source Macrobond, BNY

The role of trade in the region and the cost of goods vs. labor drives much of the economics and the flows into shares or bonds for the region. While growth is linked to Mexico and Brazil, as they remain the largest economies, the role of commodities particularly food matters, with soy, wheat and other crops important, along with copper and lithium. The focus on commodities in 2024 has been linked to China's growth and demand and the fits and starts of hopes for a recovery. China's sagging growth has led to net stagnant commodity prices in the Brazil commodity basket. On the year, oil is off 2%, copper is up 12%, coffee is up 34%, soybeans are down 23%, and wheat is off 8%. The net result has been that lower growth has been linked to uneven demand and lower equities for the region. All holdings for Emerging Market

Americas are down on the year – with a sector average decline of 22% – but notably consumer discretionary has fallen by 71% year to date, while energy sector holdings are off 32%, materials are off 23% and real estate is off 32%.

Exhibit #4: Sector Holdings Show Notable Equity Outflows



Source: iFlow, BNY

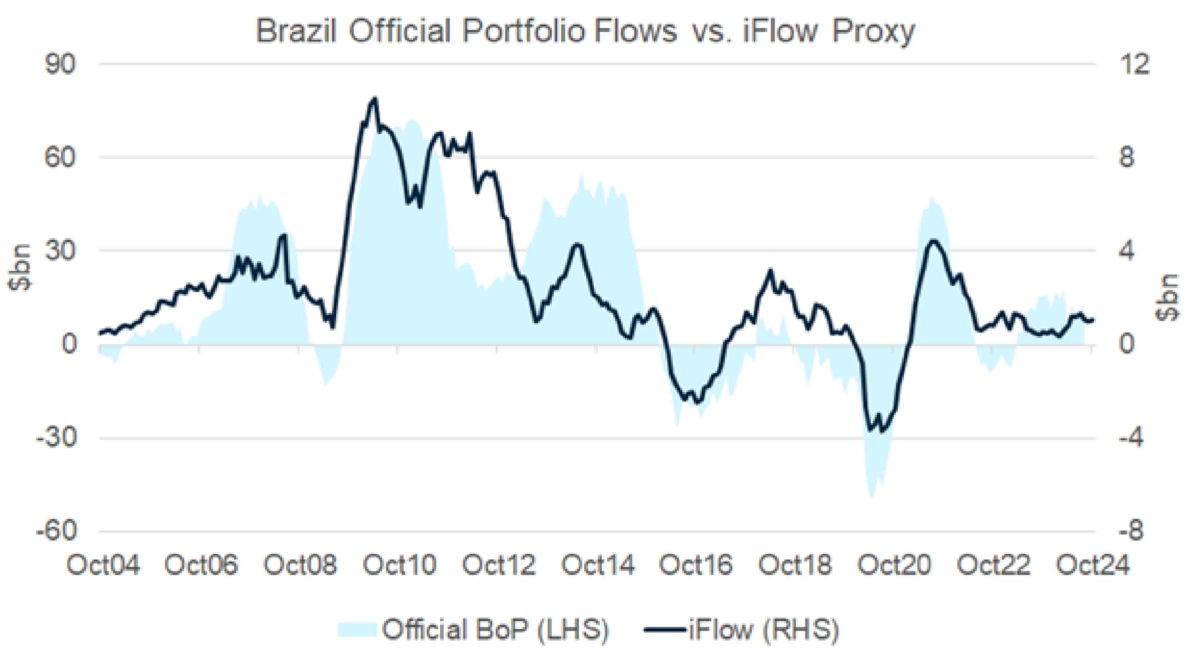
Fixing the investment flows into the region is not only about equities or bonds but also the private investments that show up in FDI. The Mexico FDI story matters significantly to MXN and to the region. MXN GDP is bouncing back modestly in Q3 given the August activity data but the outlook for the region remains murky.

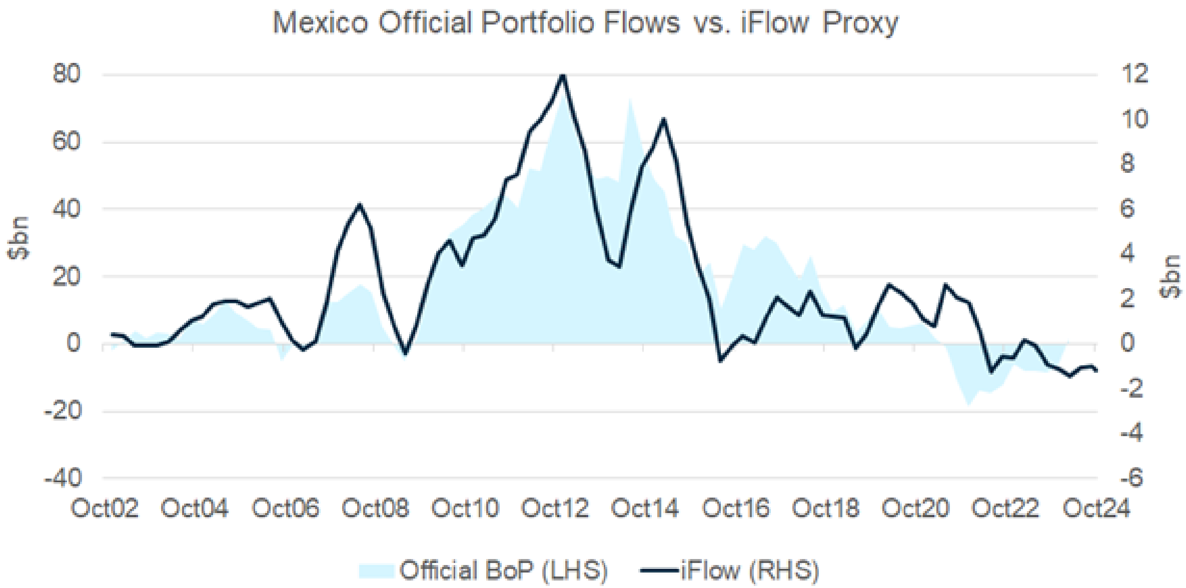
In the first half of 2024, Mexico received $31.1 billion in FDI, a 3.2% decrease from the same period in 2023. This was due to lower new investments and intercompany accounts, but reinvestment of profits increased 18.7%. The manufacturing sector was the leading destination for FDI, followed by financial services. The automotive industry was a significant driver of job creation, accounting for 44% of total job creation. This will be the focus of risk for the US election and any new USMCA discussions in 2025.

The top investors in the first half of 2024 were the United States, Germany, Japan, Canada and Belgium. The Mexican private sector announced 209 FDI projects in the first nine months of 2024, which will create more than 99,700 jobs. About 46% of FDI was concentrated in Mexico City, followed by Nuevo Leon, Baja California and the state of Mexico. The US continues to be the leading investor in Mexico, with a share of 44.1% of the total. As of Q2 2024, FDI from the US was $13.7 billion.

Bottom Line: The US election will matter to LatAm FX as will the success of Chinese stimulus plans. However, both are less important than the overall mix of economic, fiscal and monetary policies in the region. The growth potential for the region is in the shift from commodity export dependency to a more regionally linked supply chain providing goods and services. The focus will continue to be on Mexico and Brazil, but the opportunity set in Argentina, Peru and Chile is likely to have significant opportunities into 2025. Our flows suggest there is plenty of room in the region for new paradise found.

Exhibit #5: BOP vs. iFlow Shows Room for Investors in Both Brazil and Mexico





Source: iFlow, Bloomberg, BNY

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Please direct questions or comments to: iFlow@BNY.com

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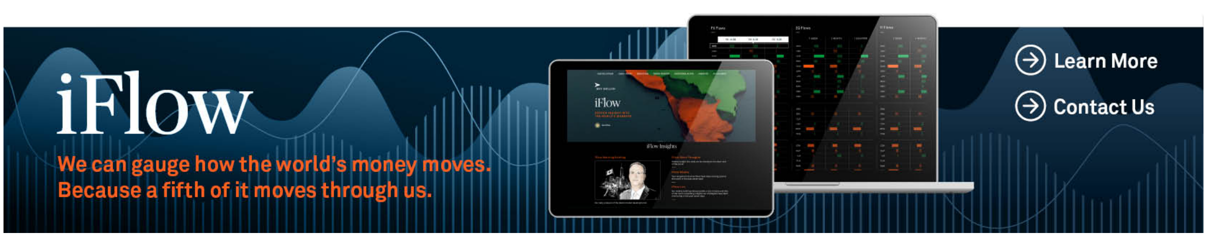

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