



Market Commentary  
November 2021

English Version

# Of Latam and the effects of transitory inflation

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## Of Latam and the effects of transitory inflation

“Inflation” has been a recurrent buzzword lately, both in the developed world and in emerging markets. Amid supply chain bottlenecks and disruptions persisting longer than previously expected, central banks, particularly in the emerging world, have become more hawkish. This trend was initially visible in the Financial Conditions Index published in the IMF’s Regional Economic Outlook in October. The corresponding index for Latam displayed a value of 0.4 recently, up from the 0.1 observed in 2Q21, and positioned itself above the aggregated index for EM.

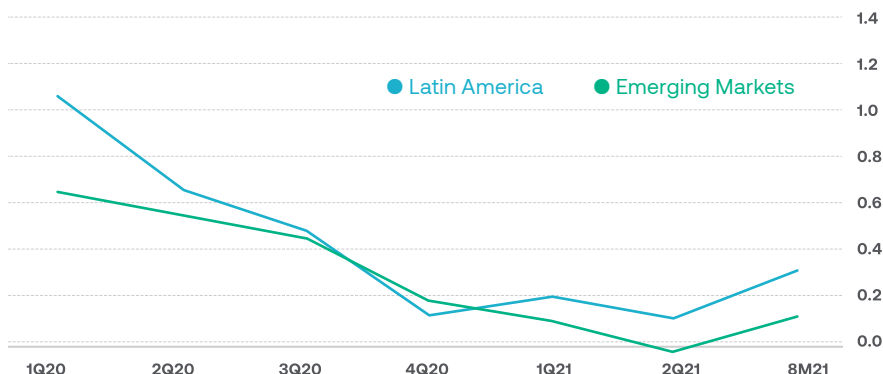
The pressure on Latam central banks are increasingly pointing to tighter monetary policy, which will directly affect how investors position themselves within their fixed income portfolio during this cycle.

According to the OECD CPI indicator, inflation in the developed world has persistently increased over the last three quarters. This could be a sign that inflation may not be as transitory as previously expected and could accelerate the pace of monetary policy normalization. This is occurring amid a growth deceleration in advanced economies as both the Eurozone and the US registered a quarterly decline

### Financial Conditions Index\*

*\*Index developed in the April 2017 Global Financial Stability Report. When the value of the index equals zero, financial conditions are neutral. The higher the value of the index, the tighter the financial conditions. Additional notes to the methodology can be found in the [following link](#).*

Source: IMF | Insigneo



for their 3Q21 GDP readings, with the latter falling from 6.7% QoQ in Q2 to 2.0% QoQ, and the former registering a decline from 14.2% YoY in Q2 to 3.7% YoY in Q3. Supply bottlenecks have been omnipresent throughout the US economy for the last year. Data published by Bloomberg highlighting the frequency of the Fed's use of the word 'shortages' on its Beige Book has increased exponentially throughout the pandemic, standing at 70 times in its latest publication, whereas this same count was around 30 times back in March 2021. Even if some sectors are recovering and bouncing back from these supply shocks, many others are still enduring challenges.

Meanwhile, it seems as if Latam central banks are finding themselves between a rock and a hard place: the implementation of a tighter monetary policy has come against a backdrop of slower growth and higher inflation expectations, which will make policy implementation more difficult. Chile and Brazil stand out as two examples of central bank committees that have not hesitated to hike rates by degrees previously unseen, while acknowledging that some of the risks they face are beyond their control, such as the troublesome fiscal situation in Brazil and the presidential elections in Chile.

Throughout the region, economic activity has been mixed. Economic activity is contracting in Mexico and Brazil, while the growth indicators look much more robust in Chile and Colombia. In fact, the Colombian central bank, BanRep, recently revised its growth forecasts upward for 2021 and 2022 in the country citing strengthening domestic demand. However, they also forecasted higher inflation prints, and consequently increased their forecasts over the same period. This backdrop set the stage for BanRep to hike 50 bps at its latest meeting – a decision that surprised the market.

In Chile, their central bank, the BCCh, also surprised markets when it hiked by 125 bps despite deteriorating inflation expectations. It mentioned concerns over

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the pension fund withdrawals still under consideration in the Congress. Furthermore, in the publication of the minutes from its latest meeting, it was apparent that all members agreed on faster monetary policy normalization, hoping to reach a neutral policy rate by year-end.

**Brazil's situation is particularly worrisome. The COPOM's latest 150 bps hike increased the Selic rate to levels not seen since 2017.** It justified its decision on the following grounds:

- | a less-favorable external environment,
- | higher inflationary challenges, and
- | the deterioration of the fiscal framework.

As mentioned, governmental decisions lately seem to be erring on the side of fiscal largesse, and the country is currently lacking a true and credible fiscal anchor. This may jeopardize economic growth next year with some analysts predicting the possibility of a recession in 2022.

Taken together, these developments demonstrate that, unlike previous instances, Latam central banks do not want to fall behind the curve when it comes to normal-

izing monetary policy. It seems that they would rather pull the trigger before normalization begins in the developed world since most of them have felt the sting of unmoored inflation expectations. They do not want to go down that path again given their past experiences with tightening back in 2015 that left the region with weak growth perspectives for some time. Even if the monetary policy normalization cycle proceeds slower in developed markets, Latam wants to get it right this time.

**In sum, we believe that Brazil and Chile will continue to experience volatility due to heightened political uncertainty. It will be important to keep an eye on the Chilean general elections on November 21, together with the possible runoff on December 19, that should shed some light on the country's political future. In Brazil, until there is no clarity over the fiscal landscape, we recommend investors to limit their exposure ahead of next year's elections.**

To be sure, we still believe that the inflationary landscape in the developed world will prove to be transitory, even if it remains slightly higher and stickier than we previously expected. However, a prudent strategy to weather the storm in the meantime could be to focus on curve moves triggered by central bank communications, especially in markets priced for earlier or more aggressive rate hikes. If they prove to be more dovish in the end, then it would make sense to be exposed to shorter durations. The belly of the curves also appear attractive given that one would expect a bull steepening rather than the bear flattening observed over recent sessions. For now, discretion is the better part of valor as no one – not even central banks – can definitively assert just how transitory inflation may be.

# House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
<b>US Equities<sup>1</sup></b>	OVERWEIGHT	OVERWEIGHT
<b>European Equities</b>	OVERWEIGHT	OVERWEIGHT
<b>Japanese Equities</b>	OVERWEIGHT	NEUTRAL
<b>Emerging Market Equities</b>	OVERWEIGHT	NEUTRAL
<b>Chinese Equities</b>	OVERWEIGHT	UNDERWEIGHT
<b>US Treasuries<sup>2</sup></b>	UNDERWEIGHT	UNDERWEIGHT
<b>Investment Grade Fixed Income</b>	NEUTRAL	NEUTRAL
<b>High Yield Fixed Income</b>	NEUTRAL	NEUTRAL
<b>Emerging Market Sovereign</b>	NEUTRAL	OVERWEIGHT
<b>US Dollar</b>	NEUTRAL	UNDERWEIGHT
<b>Energy<sup>3</sup></b>	OVERWEIGHT	OVERWEIGHT
<b>Precious Metals</b>	NEUTRAL	NEUTRAL
<b>Cash</b>	NEUTRAL	NEUTRAL

<sup>1</sup> Relative to global equities in USD

<sup>2</sup> Relative to aggregate fixed income markets in USD

<sup>3</sup> Relative to an overall commodity allocation



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