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Q&A-Brazil to lag EM peers; Mexico to regain pre-pandemic growth levels by 2024; Latam could avoid wage-induced inflation: FrontierView analysts



A weak recovery in the labor market means that Latin American economies may not see wage-induced inflationary pressures, but rising interest rates in developed economies will pressure currencies, **FrontierView analysts** told the Reuters Global Markets Forum on Thursday, March 25.

"Our base case for a while was that most currencies would appreciate on average in 2021, this is starting to look more flat now, especially if we consider heightened political risks in many markets," said Alex Schober, FrontierView senior Latin American research analyst for the Southern Cone.

Senior analysts Ramiro Sugranes and Alejandro Valerio noted that Brazil is likely to underperform other emerging markets as the country is gripped by growing numbers of COVID-19 cases and political uncertainty, while the Mexican economy could take another three years to fully recover from the pandemic's impact.

Following are edited excerpts from the conversation:

Q: Do you think Brazil's economy recovery will lag emerging market (EM) peers in a big way this year, given the pandemic is out of control and the currency has been underperforming?

Ramiro Sugranes: I think we need to frame it from where Brazil is starting from this year, i.e., how much ground they have to recover relative to pre-pandemic levels. This is where Brazil outperformed relative to many EM peers, contracting by about 4.1% while other economies were in many cases close to double digits. This had a lot to do with how much stimulus the government was able to implement, especially cash transfers to support the economy. However, now the tides are changing in 2021. The COVID-19 situation is out of control, leading to the reimplementation of stricter social distancing measures at the local level. Vaccines are rolling out gradually and the government does not have the fiscal ammunition it did last year, and if it were to pursue similar policies it would be flirting even closer with a fiscal crisis scenario. What this means essentially, is that the Brazilian economy will likely underperform relative to other peers, especially in the H1 this year, but we believe vaccination roll out will allow for more sustainable economic reopening and a stronger recovery in H2, although more contagious variants present a key downside risk to this outlook.

Q: As you mentioned, the government doesn't have as much fiscal space as previously. Central bank actions have been supportive, but what other actions are likely to help the economy out of the doldrums?

RS: The government is re-implementing the cash transfer program, but it is being significantly narrowed. We estimate that the new cash transfers will make up near 15% in total value when compared to the total amount in 2020. So although this will help the most vulnerable populations, they will not have the same effect last year where we saw a significant expansion in economic activity, especially in retail and manufacturing, in large part because of all of this stimulus following a period of repressed demand. Other measures the government is considering include bringing forth extra salary payments workers receive or tapping into some severance funds – FGTS (Fundo de Garantia do Tempo e Serviço). So, measures that are fiscally neutral amid fiscal constraints.

An important measure being reconsidered is the Bem Program, which essentially allowed companies to reduce workers' hours or suspend employee contracts to preserve formal jobs, while the government would subsidize the wages of those that had reductions. This is likely to come back as it proved quite effective.

Q: President Jair Bolsonaro's moves at Petrobras caused quite a storm a few weeks ago. Do you expect investors to recover some confidence, and how do you see more action on fuel prices proceeding?

RS: Bolsonaro's move on Petrobras was without a doubt a negative signal for investors. What we need to see however is whether this was more of an isolated event, or whether we are seeing a trend of more populist and interventionist style economic policies materializing, especially in the lead up to the 2022 elections. The main reason we think investors will recover some confidence, especially once COVID-19 is more under control, is that by becoming increasingly interventionist Bolsonaro is spooking investors and

making a fiscal crisis scenario all the more likely, which could hinder his re-election ambitions. So that reality alone we think will have to keep some of these tendencies in check. We will likely see further isolated events, but we see a full interventionist trend as more of a downside risk at the moment.

Q: So, too early to call time on more free-market reforms?

RS: We were already expecting watered down free-market reforms. Some of these projects faced too much opposition from certain political sectors. Now, with the COVID-19 situation the way it is, politicians are focusing entirely on that. This is narrowing the window for things like administrative and tax reforms, which we expect to be significantly watered-down.

Q: Do you think former President Luiz Inacio Lula da Silva may throw his hat back in the ring in next year's elections?

RS: The Supreme Court Judge's decision has upended the political arena. Although it's still early, and we are still more than a year and half out from elections. It is clear that Lula is beginning to build more of a political movement leading up to those elections, his recent speeches definitely resemble those of a candidate. I would say a Lula vs. Bolsonaro match up in 2022 is the most likely scenario right now.

Q: What are your thoughts on Mexico's upcoming interest rate decision?

Alejandro Valerio: Banxico has become a key player helping the economy amid the lack of fiscal stimulus from the (Mexico's President Andres Manuel) López Obrador administration. Although the Bank has decreased the interest rate, it has been quite cautious considering the historical low interest rates established by the Fed. Thus, with an uptick inflation, just recently it was announced that annual inflation increased to 4.15%, I think Banxico will have to balance how to help the economy without setting a rate that further increase inflation beyond Q1. All in all, I think they might cut another 25 basis points, but I would not be surprised (if they) increase it again by August. Throughout 2021, I believe the interest rate will fluctuate between 3.75% and 4.25%.

Q: How do you see Mexico President Andres Manuel Lopez Obrador (AMLO) electricity reforms playing out? If they pass, what sort of repercussions in terms of trade agreements/investment do you expect?

AV: AMLO's electricity reform is the latest round amid a showdown between the government and private investors. The electricity reform from the legal standpoint has been challenged across the board. A recent judicial remedy has stalled the reform, albeit AMLO has pledged to enact the reform even via a constitutional reform.

The electricity reform would have two major repercussions: First, regarding the electricity market, it will increase the market share of the Federal Electricity Commission (CFE) at the expense of renewable energy companies which have gained a lot ground since the first auction in 2016 after the opening of the sector back. The CFE in its strategic plan already outlined it is aiming to invest around MXN 200 billion in generation, instead of distribution, thus it is a clear signal the government will continue to push this reform.

The second repercussion, the electricity reform is a bad message to investment overall that is part of pattern set since October 2018, when then president-elect López Obrador supported and promoted the shutdown of the new airport in Mexico City. Then, in March of last year in the midst of the pandemic, it also through a similar method, shut down a brewery worth MXN 1.4 billion in Mexicali, and now the government is changing the rules in the middle of the game in the electricity market.

All these signals will continue to further depress the weakest component of the economy at this moment, which is investment, coupled with the legal challenges that might arise via the USMCA (United States-Mexico-Canada Agreement) through its chapters of investment and environmental rules. Bear in mind that investment has already around 22 months in decline, I am afraid that this trend will continue stemming from policies such as the electricity reform.

Q: With worries resurfacing about the global reopening after COVID-19 and the subsequent impact on oil prices, do you see more risks for Pemex on the horizon?

AV: Yes, I do see more risks for Pemex on the horizon. The government is investing heavily on Pemex trying to revamp the state-owned oil company but without substantial structural reforms, such as dealing with the bloating bureaucracy and dire debt situation. All this, without having a clear view that the oil prices will remain weak vis-a-vis a decade ago. Despite AMLO's efforts to revamp Pemex, the numbers the company is reporting are quite dire. For example, from January to November, Pemex's domestic and international sales decreased by 41% YOY and 37% YOY, respectively, and oil revenues have plunged by 38% YOY from January to October, showing the government strategy insofar has not been effective.

Q: How do you see Argentina's International Monetary Fund (IMF) reform proceeding, and when could a deal be struck?

Alex Schober: It's clear that there will be a delay in getting the deal done with the IMF. Even though (Argentine Finance Minister) Martin Guzman's original plan was to get a deal inked by May, rhetoric among the governing Peronist coalition clearly signals that they would prefer to wait until after October's mid-term elections. The main reason for this is to avoid politically unpopular decisions regarding perceived fiscal adjustments, especially utility subsidy adjustments. That said, this delay wouldn't be possible without the current soy price surge. This gives the government breathing room until late 2021. In conclusion, I don't expect a deal until November or December 2021 at the earliest.

Q: How is this impacting businesses and investors in Argentina? What steps do you recommend given these uncertainties?

AS: Argentina is relatively stable from a macro standpoint at the moment. There is clear signaling with FX depreciation along the lines of the "crawling peg" exchange rate policy scheme by the BCRA (Central Bank of Argentina). However, the risks become much higher at the end of the year. Argentina owes almost \$20 billion to the IMF in 2022 – in money it doesn't have, so the clock will be ticking very quickly towards the end of this year. I think in the meantime businesses are worried about trade policy and whether we see the tightening of any of these existing measures. I doubt it for the moment; the BCRA should be able to accumulate reserves and avoid a disorderly depreciation/devaluation this year. So, stay the course. But start hedging substantially -- both financially and operationally -- at the tail end of this year.

Q: Latin American markets, like most EMs, were slated for a great year. But given rising U.S. yields, political issues, and spill overs from Turkey, etc., do you see this outlook materially changed?

AS: My opinion about rates/inflation impacting Latam is that the labor market recovery has been extremely sub-par. There won't be the wage induced inflation pressure in most, if not all, markets in Latam, in my view. However, it could impact FX recovery. I think our base case for a while was that most currencies would appreciate on average in 2021. This is starting to look more flat now, especially if we consider heightened political risks in many markets too.

RS: I think the COVID-19 situation continues to dominate. Contagion effects from other struggling EMs like Turkey definitely create a risk. But the priority remains securing sufficient vaccines to get your domestic economic engine running again, that is key, and what I believe investors want to see most across EMs at the moment.

AV: In the case of Mexico, we believe the economy will grow by 4.1% in 2021 mainly driven by exports. However, it is important to bear in mind that Mexico will grow from a low base after contracting by 8.5% in 2020, (its) worst contraction since 1932. We believe that Mexico will recover its pre-pandemic levels by 2024. Although Mexico will experience low growth in the short-term, it will benefit more than any other LATAM market from the expected U.S. economic recovery in 2021 due to its economic ties with the U.S. and the USMCA. Investors should revamp their strategies for short- to mid-term growth, as Mexico's economy remains weak but with strong fundamentals.

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