MyStratWeekly

Market views and strategy

N° 070 // **May 16, 2022**

Topic of the week: Latin America: the return of the Eldorado?

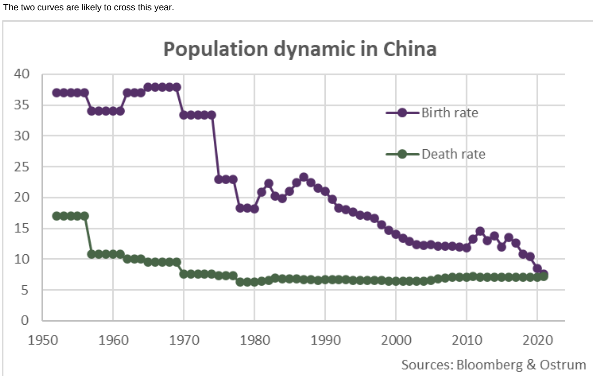
- **The war in Ukraine is an opportunity for Latin America, which should increase its exports to offset shortages ;**
- **The buffer of interest rates accumulated since March 2021 helped cushion the Ukrainian shock;**
- **However, the region faces several headwinds: Ukraine, the Fed and China;**
- **The recently acquired credibility of LATAM's central banks must be preserved to ensure macro-financial stability.**

Market review: Hopeless markets

- **Markets torn apart by both fears of inflation and recession;**
- **Powell reiterates 50 bp hikes are coming;**
- **Liquidation across commodity markets;**
- **Still no alternative to the dollar despite the rebound of the yen.**

Chart of the week

The two curves are likely to cross this year.



Most comments are focused on the recent slowdown in China on the wake of aggressive lockdowns. There's another argument, more structural: active population has been declining for almost a decade in China, reducing potential growth.

The chart shows that total population is also about to turn South. Last year's birth rate was only fractionally above the death rate. The two curves are likely to cross this year.

The population will start to decline.

Figure of the week

7.2

Source : Ostrum AM

$7.210 trillion in Nasdaq capitalization gone up in smoke since the high of last November. This is much more than during the last corrections.

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● **Topic of the week**

Latin America: the return of the Eldorado?

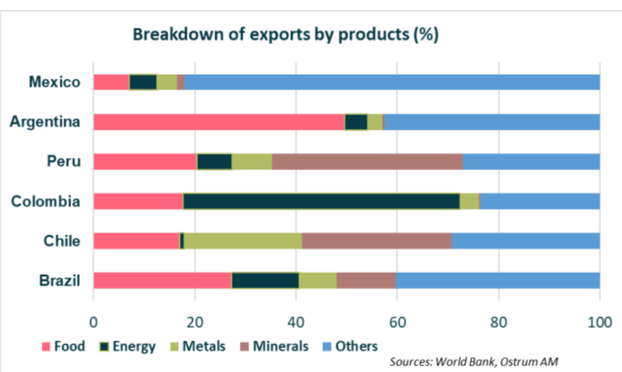
Latin American financial markets posted the best performance in the first quarter, benefiting from higher commodity prices, which the region's soils are full of. The Ukrainian crisis is an opportunity for the region to increase its exports to compensate for shortages. Is this the return of the Eldorado?

A great start to the year

Commodity shock: an opportunity for Latin America

Latin American financial markets posted the best performance in the first quarter of 2022. The increase in raw material prices, which began in 2021, has benefited the region, whose soils are overflowing. The war in Ukraine and Ukraine has strengthened the attractiveness of the region as it is perceived as the one that will help to overcome food, energy and metal shortages.

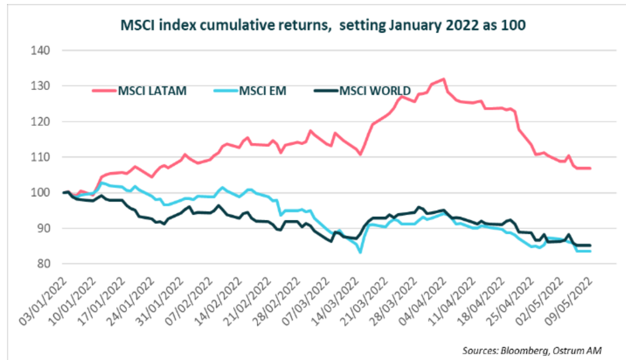
The graph below shows, for a selection of countries in the region, the share of raw materials in their total exports.



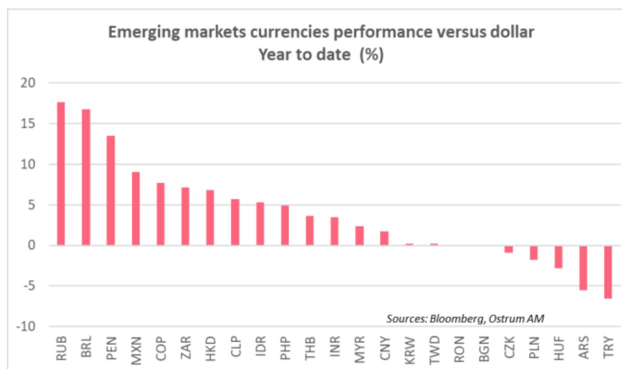
With the exception of Mexico, the share of raw materials in total exports is around 60%. We can also note the great diversity of the region. For example, Colombia exports mainly energy, such as exports of fuels, which account for nearly 55% of its total exports. In contrast, Argentina exports 50% of food products. Chile exports mainly metals and minerals, which account for nearly 53% of its exports.

The region's financial markets posted the best performances of the first quarter of 2022

Latin America was the only region to record positive stock market performance in the first quarter similar to the MSCI LATAM Index with a 28.4% performance over the first quarter, while the MSCI EM (-7%) and MSCI World (-6%) Indices declined.



Those of the region's currencies also explain these very good market performances, as the chart below shows.

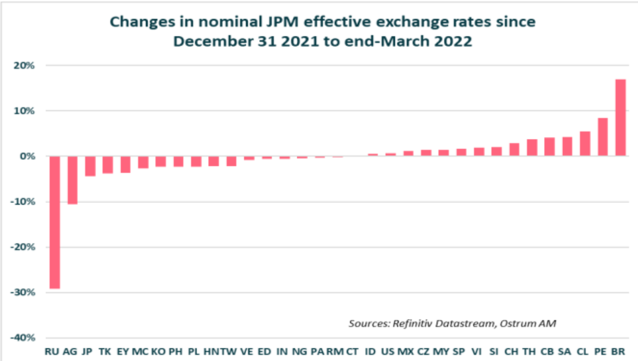


With the exception of the ruble, whose performance is mainly due to the introduction of capital controls, Latin American currencies have recorded the best performance since the beginning of the year against the greenback, reflecting the improvement in the terms of trade.

Improved terms of trade have benefited the LATAM's currencies

The improvement in the terms of trade, that is, the ratio of export prices to import prices for a given product, explains the good performance of the region's currencies.

The chart below shows the performance of nominal effective exchange rates since December 2021 until the end of March 2022.



It can be noted that it is the so-called "commodity" currencies that record the best performances, especially those of Latin American countries (except the Argentine peso). The Brazilian real recorded the best performance at 17%, followed by other currencies in the region such as the Peruvian sol (8.8%) and the Chilean peso (5.5%).

It is interesting to note the performance of the effective nominal exchange rate of the dollar which is almost nil over the period. This explains the relative strength of emerging currencies over the first quarter of 2022. The risk is a strengthening of the dollar linked to higher US interest rates, following more hawkish comments and Minutes from the Fed, which should penalize emerging currencies. The Japanese currency has already paid the price. However, Latin American currencies should be more resilient than other emerging currencies because of their interest rate buffer.

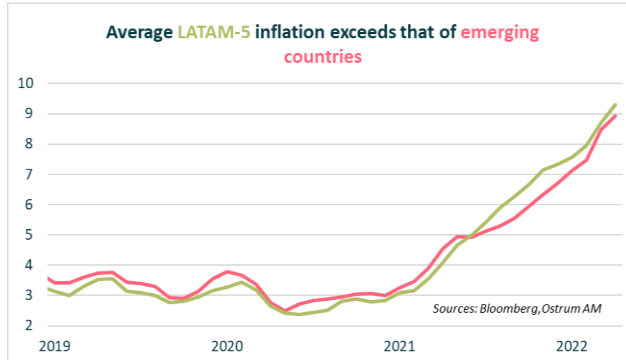
Aggressive rate hikes helped cushion the shock of the Ukrainian conflict and the Fed…

Despite the outbreak of conflict in Ukraine, which has led to a sharp rise in risk aversion in global financial markets, local currencies and interest rates in the region have held up rather well. In addition to the improvement in the terms of trade linked to the acceleration in the price of raw materials, the interest rate buffer, that is the high interest rate differential with respect to the United States, helped to cushion the shock.

Since 2021, monetary policy has been restrictive to counter the acceleration of inflation

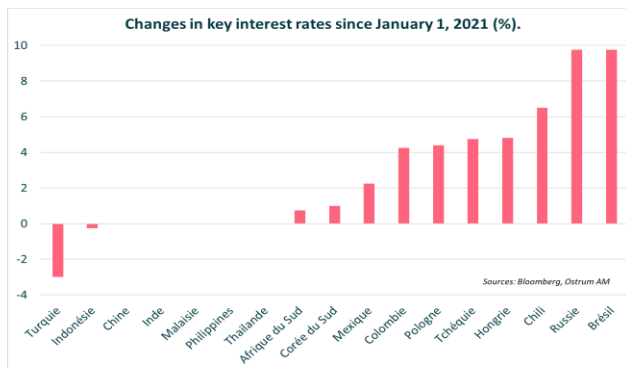
Inflation accelerated as early as 2021, in line with the rapid rise in food prices subject to supply distortions caused by strict mobility restrictions. Food prices have increased by more than 18% on average in LATAM-5 (Brazil, Colombia, Chile, Mexico and Peru) since January 2020.

LATAM-5 inflation exceeds the average EM inflation, as shown in the chart below.



In the face of rapidly accelerating inflation, the Central Banks of Latin America were the first Central Banks of emerging countries to make aggressive rate hikes as early as 2021.

The chart below shows the number of cumulative rates increases since January 2021.

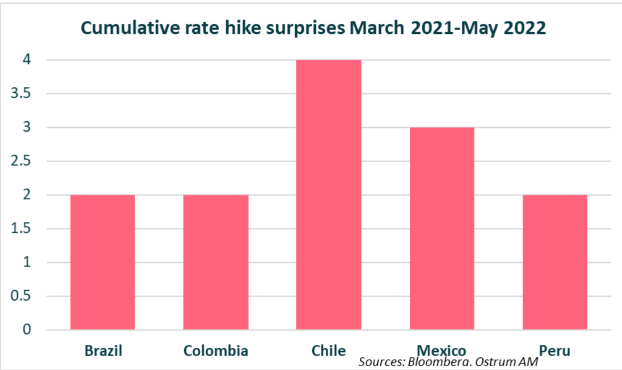


Despite aggressive rate hikes, real rates remained negative in many countries, except in Brazil, which also explains the attractiveness of investors for the real in carry strategies and its very good performance against the greenback since the beginning of the year. Negative real rates also indicate that monetary policy remains accommodative in other countries, supporting the post-Covid recovery.

Strong credibility of Central Banks in the region

Latin America suffered from high and unstable inflation in the 1980s and early 1990s, which explains why Central Banks in the region were the most aggressive in tightening their monetary policies. The Central Banks of the LATAM region have therefore only recently established their credibility. The exception is Argentina, which already had a very high inflation rate before the recent inflationary shock. Inflation was over 55% in March.

The credibility of the Central Banks of the region also explains the good performance of its financial assets, particularly in foreign currencies. The graph below shows the number of surprise rate hikes, that is, the number of times that monetary policy decisions have surprised market operators.



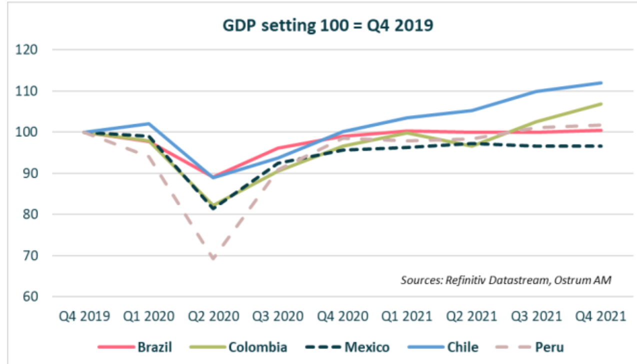
The number of surprise rate hikes is very small, which shows the high credibility of Latin American Central Banks with investors. This is a key factor to take into account and it explains the good performance of the region's currencies in a very uncertain international financial context.

… But the cycle of monetary tightening is coming to an end

Many Central Banks in the region have indicated that they are nearing the end of their tight monetary cycle. This is the case for the Brazilian Central Bank, which reported a further increase in its SELIC rate of 100 bps in May but did not provide any forward-looking guidance for the coming months. The Central Banks of Chile and Colombia also raised their key rates, but less than expected, suggesting the end of their tight monetary cycles. What were the reasons for these decisions?

Aggressive rate hikes have negatively impacted economic activity

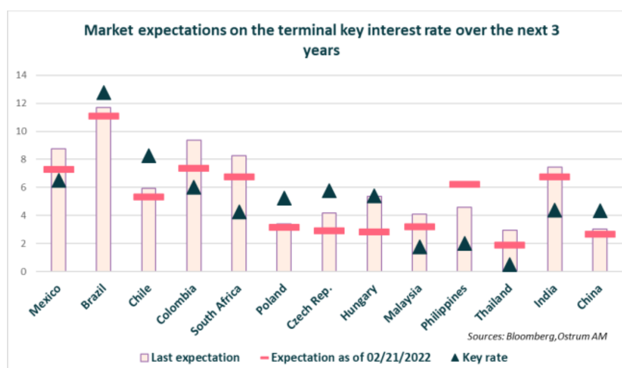
Aggressive policy rate hikes have had an impact on the business profile. The following chart shows the GDP profile of LATAM-5 countries based 100 in Q4 2019.



Chile and Colombia have surpassed their pre-pandemic GDP levels. Both countries still have expansionary fiscal policies, which allowed them to accompany the post-Covid recovery, despite the tightening of their monetary policy. On the other hand, Mexico has still not recovered its pre-pandemic level and has not benefited from the US recovery. Mexico did not have fiscal room to support activity but was able to rely on remittances from its migrant workers to the United States (95%) to support the most vulnerable families. Between 2020 and 2021, remittances rose 41.6% over 2019. In 2021, these remittances reached $51.6 million, up 27% from 2020, reaching a new all-time high. Brazil was the first to withdraw its pandemic-related budget support (12% of GDP) and aggressively raise its rates. GDP has returned to pre-crisis levels, but growth remains sluggish.

Market rate expectations are down.

The chart below shows the market expectations of the landing key rate (at 3 years) for many emerging countries.



Brazil and Chile are very close to the end of the monetary tightening cycle; the latest 3-year policy rate anticipation is lower than the current policy rate. On the other hand, interest rate expectations have increased since February 21, the start of the Ukrainian conflict, for Mexico and Colombia, suggesting further rate increases.

The strong appreciation of currencies since the beginning of the year also allows the central banks of the region to lift their foot off the accelerator. Indeed, an appreciation of the currency acts as a restrictive monetary policy by making the prices of imported goods lower.

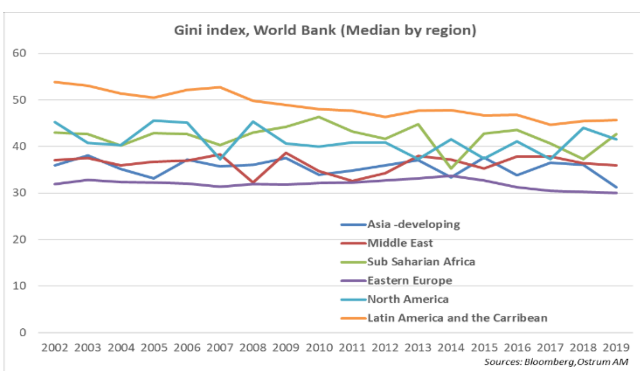
Latin America is facing several headwinds: Ukraine, the Fed and China

The war in Ukraine is a new inflationary shock for the region…

The war in Ukraine is another inflationary shock for countries in the region. If the conflict persisted over time, according to the International Monetary Fund, a 10 percentage point increase (ppts) in crude oil prices could increase the inflation rate in the LATAM-5, while a 10 ppt increase in food prices could lead to a 0.9 ppt increase in the inflation rate. A combined increase of 10 ppts in food and energy prices is expected to increase inflation by 1.1 ppt. On the other hand, inflationary pressures could be exacerbated by wage indexation in some countries. Central Banks in the region will have no choice but to raise key interest rates to ensure macroeconomic and financial stability.

… and increases the risk of social tensions

While Latin America enjoys a privileged position in the current context of rising commodity prices, it is also a region characterized by high income inequalities that make it very vulnerable to the rapid rise in food prices. We remember the social tensions that had erupted in late 2019 and caused high political instability in the region. The graph below shows that the Latin America and Caribbean region is the most unequal.

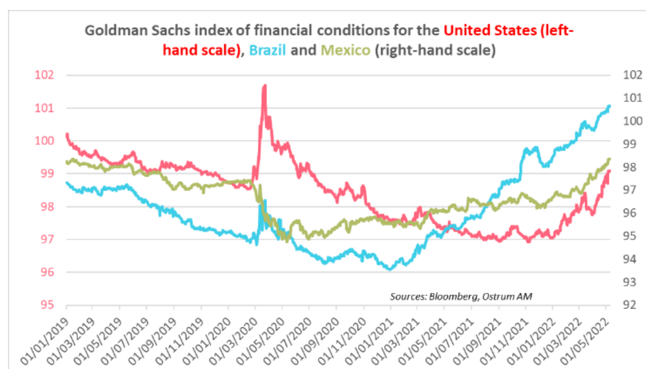


Food accounts for a quarter of the average market basket. For households still impacted by the health crisis, the acceleration of inflation on commodities leaves less to be spent on other goods. In a region where income inequality is highest, the burden is higher for modest households that spend a large part of their income on food. During the pandemic, vulnerable populations were able to support themselves through remittances by migrant workers, including from the United States. According to the World Bank, these flows were particularly high in Latin America, reaching $126 billion in 2021, up 21.6% from 2020, reflecting the US economic recovery. The acceleration of inflation in the United States, 8.5% in March, is expected to penalize migrant workers' remittances. This is a risk to the social stability of these countries. Social tensions have already erupted in Peru and Chile, where people are protesting the rise in gasoline and food prices.

A more “hawkish” Fed and possible escalation of tensions around the Ukrainian conflict could tighten global financial conditions

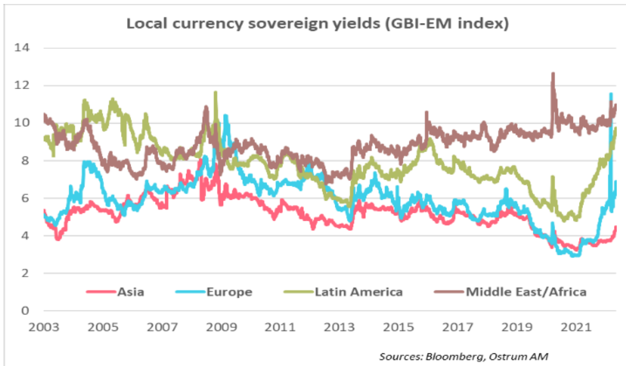
Latin American currencies are currently under pressure due to the strengthening of the greenback from rising US interest rates. This also reflects the strong positioning of investors and the outperformance of the region’s currencies since the beginning of the year, which likely prompted investors to take profits on their long positions.

However, a possible escalation of tensions around Ukraine could lead to tensions in financial markets and tighten financial conditions in the region. The graph below shows that the financial conditions of Brazil and Mexico (Goldman Sachs indices of financial conditions) have tighten in the wake of those of United States

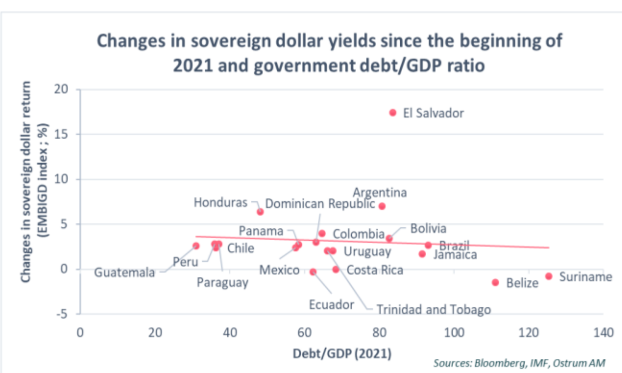


A Fed that becomes more hawkish could also affect overall financial conditions and generate capital outflows. A Fed that raises key rates because of inflation due to a supply problem does not have the same effect on asset classes as a Fed that raises rates because of inflationary pressures from the productive system. Historically, when the US Central Bank raises its Fed funds rates, a rally ensues in risky asset markets. This is likely no longer the case, due to fears of growth.

The consequence would then be higher international returns for the countries in the region, that is, their borrowing costs in dollar terms would increase. However, interest rates are rising everywhere, including sovereign yields. The chart below shows that it is the sovereign yields (GBI-EM indices) of Latin America and Eastern Europe that have increased strongly over the recent period, reflecting the acceleration of inflation.



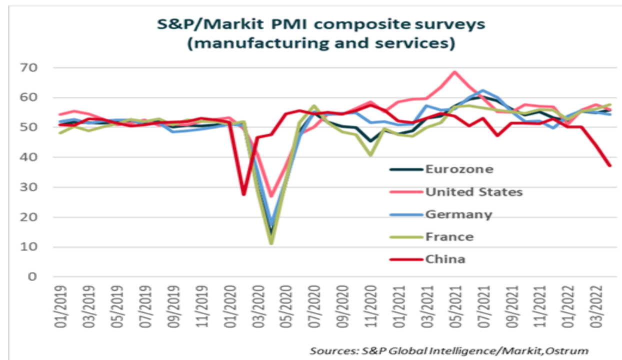
Higher international and sovereign yields could put pressure on countries in the region that have significant public and external financing needs. The chart below shows that countries with a high debt-to-GDP ratio have seen their borrowing costs increase in dollar terms. El Salvador has the greatest vulnerability. The sovereign dollar return has increased by more than 17% since the beginning of 2021, reflecting its fiscal vulnerability (public debt at more than 80% of GDP), but also macro-fiscal vulnerability. The country decreed Bitcoin as the second national currency, which did not please the International Monetary Fund. Other countries above the trend line, such as Argentina, are also at risk.



The International Monetary Fund expects the region to grow by 2.5% this year and next, lower than other emerging markets, with the exception of Eastern Europe, due to rising inflation and higher interest rates. Higher domestic interest rates limit the resources to finance investment, which is the structural fragility that characterizes the countries of the region.

The risk of deflation in China and its knock-on effect on commodity prices

China's growth prospects are deteriorating rapidly, linked to the return of strict mobility restrictions, in order to contain the spread of the Omicron virus, although it is less virulent than its predecessors. Activity contracted sharply in April, as did surveys of the manufacturing and services sectors (graph below).



Labour market prospects have also deteriorated. The Chinese unemployment rate reached 6.1 % in April, the highest since March 2020. The lockdowns also hurt China's growth-driven foreign trade during the two-year pandemic because of supply chain distortions. Political considerations seem to motivate the Chinese president to persevere in his zero-Covid strategy. In the autumn, the Chinese Communist Party (CCP) will meet to decide on a possible third mandate for Xi Jinping as head of the country. The Chinese leader wants to show that his policy, especially on health, has been effective in getting the country out of the epidemic. The Chinese authorities have announced measures to boost growth, including the construction of infrastructure, but have indicated that they will continue their zero-Covid policy. These are two contradictory objectives that will continue to penalize China's medium-term economic prospects.

Deflation risk is also increasing, as the underlying inflation rate slowed to 0.9% in April compared to 1.1% in February and March, reflecting the sharp slowdown in lockdown activity. It is a force opposed to current inflationary pressures linked to a supply problem and which will have consequences for the rest of the world through raw materials. China is the world's largest consumer of raw materials, including industrial metals. In 2020, the country accounted for ¾ of world iron ore imports, up 60% from the last decade. On copper, Chinese imports account for 40% of world imports, also up from 30% of world imports in 2010. Chinese imports of zinc, nickel and tin are also substantial, accounting for between 20% and 30% of world imports. A sharp slowdown in its economy could lower global demand, resulting in lower commodity prices, particularly oil.

Conclusion

After a booming start to the year, clouds are piling up above Latin American financial markets. The war in Ukraine is a new inflationary shock for the region that is likely to provoke social tensions identical to those that erupted at the end of 2019, causing political instability in the region. A more hawkish Fed and escalating conflict in Ukraine could further tighten global financial conditions, putting pressure on heavily indebted countries with significant external financing needs. Finally, China remains the main risk for the region because of its strong appetite for raw materials, including industrial metals. Nevertheless, the Central Banks of Latin America have acquired a credibility with investors that is reflected in the good performance of the region's financial assets, despite the very uncertain international financial environment. This is a key element for the region's currencies, rates and equity markets weathering of this storm from the East.

Zouhoure Bousbih

Market review

Hopeless markets

Market nervousness as a reflection of fears of inflation and recession

The narrative on the financial markets changes rapidly reflecting to inflation fears, the expected slowdown in growth and the assessment of these risks by monetary authorities. It is extremely rare to observe simultaneous outflows from equity funds, bond funds, money market funds and gold according to weekly data from EPFR. This is undoubtedly the sign of a disoriented market. At the same time, positioning causes volatility bouts in both bonds and equities. Over the past week, the US 10-year fluctuated wildly between 2.80% and 3.20%. The Euro Stoxx 50 also traded erratically between 3520 and 3680. The foreign exchange market also showed volatility as the euro-dollar and the dollar-Swiss franc exchange rates near parity, which constitute technical targets for market participants. The yen's rebound towards 128 may hint at changes in investor psychology. Credit and high yield spreads remain under pressure. Conversely, selling pressure in sovereign debt, Italian in particular, is fading. Euro swap spreads finally seem to be stabilizing. Around 80 bp at 10 years, this measure of systemic risk (although systemic risk is supposed to have been reduced by central clearing for swap transactions) stands at an extreme level similar to the peaks of the banking crises of 2008 and 2011. Sentiment shifts are currently the main driver of equity markets despite a solid quarterly earnings season. The risk of recession and the downward dynamic of stock prices are reflected in outflows from equity funds and sector rotations unfavorable to technology and banking. Finally, margin calls now force the liquidation of positions in an increasing number of commodity markets.

As regards monetary policy, the Fed hammers home its message. The upcoming 50bp hikes are now firmly anchored in market expectations. Powell reiterated that 75bp hikes are not under consideration at this stage. However, the US CPI release at 8.3% in April shows that the slowdown in prices was less rapid than expected. The impact of the rise in the dollar on imported prices is limited to a few categories, including clothing. Inflation is accelerating in services to 5.4%, which, given the inertia of service prices, invalidates the hypothesis of a rapid return to the 2% target... and an eventually less hawkish Fed stance? In the euro area, central bankers follow one another to announce a rate hike in July, immediately after the end of net asset purchases. The weakness of the euro has drawn some comments from central bankers. The end of negative interest rates is now also consensus within the Governing council. The cyclical dynamics are most uncertain. Economic surveys appear inconsistent with the stagnation of industrial production in the monetary union. In Asia, Chinese growth also raises questions. The hardening of Xi Jinping's domestic policy motivated by an objective of "common prosperity", the financial difficulties of real estate developers and the zero-covid policy resulting in the confinement of 465 million people have all taken a significant tooll on activity growth. Capital outflows cause a fall in the yuan, which the PBoC does not intend to oppose. The 7% decline since February erases the prior appreciation of the yuan in effective terms since 4Q21. If capital flight accelerates, the PBoC may limit CNY forward sales by Chinese banks.

Caution prevails in financial markets. Surveys of US individual investors show unprecedented pessimism about the US stock market. Implied volatility remains around 30% whilst realized intraday volatility can reach 4-5% on the major equity indices. The scale of the bear market on the Nasdaq is startling with half of the market down more than 50% from the peak. Risk aversion is reflected in outflows from mainly European and emerging equities and, on a sector basis, mostly on technology and financials. The decline in the US market is also symptomatic of a more defensive international equity allocation. The earnings season ended in the United States with an average upside surprise of 5% and annual earnings growth of 10%. In Europe, aggregate earnings growth is similar to the US but sectoral differences are more marked.

In fixed income markets, there was a sharp rally after the sell-off of the previous week. Most speculative accounts reduced their short positions at the start of the week ahead of the CPI release. Profit taking triggered short covering early on last week and fueled the pullback in bond yields from 3.20% at the peak last Monday to 2.80% during Wednesday's session. Outflows from US fixed income do not hit Treasuries. Thus, like speculative accounts, final investors reallocated into US rates. Pension funds are also seeking to hedge the risk of a possible sudden drop in long-term rates. In the euro area, the Bund did not escape this pullback, going from 1.15% at its highest to 0.95% at the end of the week. The narrowing of the 2-10 year spread only highlights the risks of monetary tightening. The flexibility put forward by Christine Lagarde also helps to reduce the selling pressure on peripheral debt. The Italian 10-year spread thus fell from 205 bp to 185 bp. Credit markets are still struggling. New bond issue in the primary market result in higher issuance premiums. The average spread on European credit hovers around 170bp vs. German risk-free bonds. The nervousness of investors is palpable in CDS markets which concentrate both market liquidity and the demand for credit protection. The high yield market is experiencing selling flows that are pushing spreads beyond 500bp.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	16-May-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.16%	-7	+11	+78
EUR Bunds 10y	1%	-9	+16	+118
EUR Bunds 2s10s	83.7bp	-2	+5	+40
USD Treasuries 2y	2.59%	+0	+14	+186
USD Treasuries 10y	2.92%	-12	+9	+141
USD Treasuries 2s10s	31.8bp	-12	-5	-46
GBP Gilt 10y	1.79%	-17	-10	+82
JPY JGB 10y	0.25%	0	+3	+4
€ Sovereign Spreads (10y)	**16-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	51.19bp	-3	-1	+14
Italy	192.25bp	-13	+9	+57
Spain	106.48bp	-5	+3	+32
Inflation Break-evens (10y)	**16-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.82%	-2	-21	+72
USD 10y Inflation Swap	3.01%	-11	-2	+23
GBP 10y Inflation Swap	4.71%	+25	+15	+54
EUR Credit Indices	**16-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	168bp	+7	+35	+73
EUR Agencies OAS	64bp	-3	+1	+15
EUR Securitized - Covered OAS	74bp	-5	+1	+28
EUR Pan-European High Yield OAS	504bp	+16	+94	+186
EUR/USD CDS Indices 5y	**16-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	93bp	-5	+14	+45
iTraxx Crossover	448bp	-21	+73	+206
CDX IG	85bp	-3	+11	+36
CDX High Yield	483bp	-10	+71	+190
Emerging Markets	**16-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	469bp	+25	+57	+101
Currencies	**16-May-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.043	-1.269	-3.293	-8.3
GBP/USD	$1.226	-0.608	-5.853	-9.4
USD/JPY	JPY 129	0.641	-1.908	-11.1
Commodity Futures	**16-May-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$109.9	$4.0	-$0.9	44.90
Gold	$1 800.2	-$54.0	-$178.7	-1.58
Equity Market Indices	**16-May-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 024	-2.41	-8.39	-15.6
EuroStoxx 50	3 680	4.34	-4.39	-14.4
CAC 40	6 340	4.17	-3.79	-11.4
Nikkei 225	26 547	0.87	-2.02	-7.8
Shanghai Composite	3 074	2.32	-4.28	-15.6
VIX - Implied Volatility Index	29.40	-15.40	29.52	70.7

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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