LATAM Market Update

- **A couple of thoughts on the Mexican curve**
- **Brazil election crunch-time kicks-off this week**
- **Thursday, July 19th data pipeline**

LATAM FX was a sea of red on Wednesday, with all major regional currencies dropping between -0.2% and -0.5% vs the US dollar. The range of the LATAM currency drop was consistent with the size of moves we saw in global commodity prices, and seems linked to continued trade war jitters, as CNY falls to its weakest level since August 2017. Also souring sentiment towards EM today were reports that US representatives are considering new sanctions against Russia, leading to a continued barrage of news of a relatively complex global political environment. In terms of data, today continues to be quite shallow in LATAM with Colombia's trade balance and Brazil's CNI industrial confidence taking center stage in a barren pipeline.

A COUPLE OF THOUGHTS ON THE MEXICAN CURVE

The Mexican peso cash-curve has steepened about 20bps over the past month, as the rebound in the MXN we've seen the past few weeks prices-out additional hikes by Banxico. A widely established view among Mexican market players is that MXN weakness forces Banxico to hike, thus defending the long of the curve, which is one of the reasons the curve is so flat. As we have argued, we think the long end of the curve is trading wide to fair value (still about 100bps wide according to our model), while the short end will be more dictated by monetary policy. Our estimates suggest that from a purely cyclical perspective (i.e. neutral rates) there are 200bps–300bps of rates premium in the short end of the curve, but Banxico has signaled that they like that premium there to stabilize domestic markets. To us, this suggests that Banxico will not eliminate that "uncertainty premium" by cutting rates until they feel it's safe to do so. What does this mean? Our sense is there are two main reasons for Banxico's desire to keep an uncertainty premium there: 1) NAFTA—hence a positive renegotiation or an end to NAFTA-termination-risk has to take place, and 2) elections—where we think the budget process (which will give us a clearer sense of the new government's fiscal stance) and the final version of the cabinet will provide more clarity. Therefore, we think a steepening of the curve does make sense fundamentally—but the risk to this trade is MXN weakness, which should drive markets to re-price hikes into the short end.

- **To us, the curve steepens** under 2 scenarios: 1) uncertainty fades which drives the short end to drop more than the long end (see our discussion of the "premium on the short and long ends above), or 2) if policy uncertainty with the change in government drives a re-pricing of risk in the long end (i.e. wider long end rates).
- **The curve flattens** if MXN gets hit due to non-fiscal risk reassessment (i.e. higher US rates, NAFTA, etc.), and drives markets to price in Banxico hikes, without triggering a re-pricing of Mexico credit risk.

CONTACTS

Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

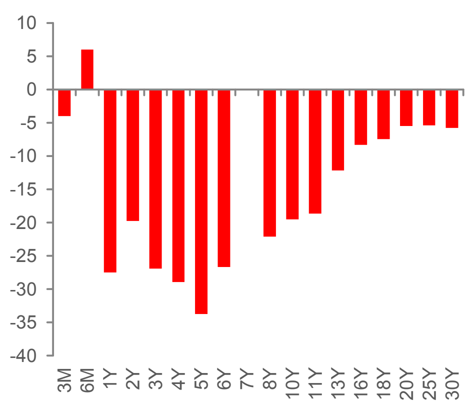
Guillermo Arbe
511.211.6052 (Peru)
Scotiabank Peru
guillermo.arbe@scotiabank.com.pe

Mario Correa
52.55.5123.2683 (Mexico)
Scotiabank Mexico
mcorrea@scotiacb.com.mx

Adriana Rodriguez
506.2210.4000 (Costa Rica)
Scotiabank Costa Rica
adriana.rodriguez.a@scotiabank.com

Benjamin Sierra
56.2.2619.4974 (Chile)
Scotiabank Chile
benjamin.sierra@scotiabank.cl

Change in the cetes / m-bono curve over the past month (bps)



Sources: Scotiabank, Bloomberg.

BRAZIL ELECTION CRUNCH-TIME KICKS-OFF THIS WEEK

The party primaries for the Brazilian presidential election kicks-off this week, and by the end of the first week of August we should have a better idea of what the playing field will look like. At this time, Lula and Bolsonaro remain the candidates to beat, but it remains to be seen whether Lula will be in the ballot. By August 15th, party nominees must register with the top electoral court to appear in the ballot for the first round of the Presidential Election on October 7th. According to PT leadership, if Lula is not allowed to run, an alternate will be named by the former President, but that change can take place later in the election game. The latest Datafolha poll shows the following voter preference:

Candidate	Voter intentions	Candidate	Voter intentions
Lula (PT)	30.0%	D'Avila (PCdoB)	1.8%
Bolsonaro (PSL)	18.5%	Maia (DEM)	1.5%
M. Silva (Rede)	13.5%	Rocha (PRB)	1.0%
C. Gomes (PDT)	9.3%	Meirelles (MDB)	1.0%
Alckmin (PSDB)	6.8%	Boulos (PSOL)	0.8%
Dias (podemos)	4.0%	Amoedo (Novo)	0.3%

Source: Bloomberg.

THURSDAY, JULY 19TH DATA PIPELINE

Country	Indicator	Actual	Consensus	Previous
US	Philly Fed business conditions		21.5	19.9
	LEI		0.4%	0.2%
Brazil	CNI industrial confidence			49.6
Chile	BCCh trader's survey			
Colombia	Trade balance		-$171m	-$328m

RECOMMENDED READINGS:

"The end of NATO" C. Bildt – Project Syndicate (July 18, 2018)

"How to protect workers without trade tariffs" R. J. Shiller – Project Syndicate (July 17, 2018)

"Trumps' trade war may spark a Chinese debt crisis" A. Stevenson-Yang – Bloomberg (July 17, 2018)

"The missing middle of the Trump-Putin meeting" The Economist (July 17, 2018)

"America's cultural divide isn't growing" The Economist (July 17, 2018)

"American democracy's built-in bias towards rural Republicans" The Economist (July 12, 2018)