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The Proactive Fight Against Inflation

Summary

Recent inflation data in Brazil and Mexico reveal price trends remain elevated in both countries. For the most part, we can generalize that statement and say inflation across the emerging markets is elevated and not as transitory as emerging market policymakers initially thought. With inflation above target or at the upper end of target ranges in many emerging market countries, in our view central bankers in the developing world do not have the luxury of being patient as it relates to monetary policy. In that sense, we believe currencies associated with proactive central banks can outperform, while patient or reactionary central banks could see their currencies underperform.

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All estimates/forecasts are as of 7/9/2021 unless otherwise stated. 7/9/2021 13:28:46 EDT. Please see page 5 for rating definitions, important disclosures and required analyst certifications.
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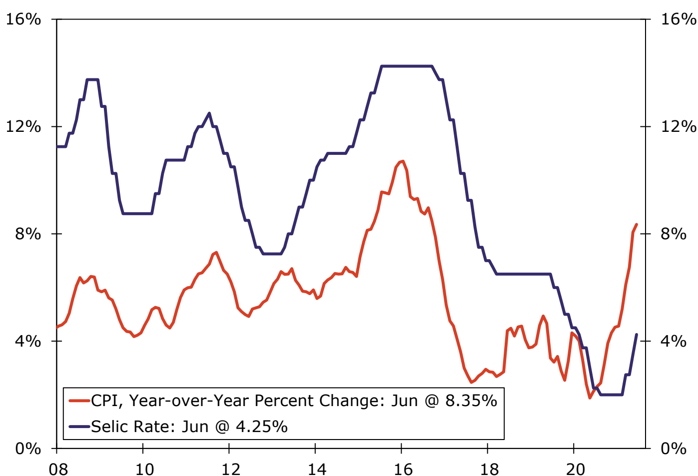
Brazil and Mexico Inflation Still Hot

This week, June inflation data in Brazil and Mexico were released and revealed price growth in both countries remains elevated. In Brazil's case, IPCA inflation, the main gauge of price growth, rose 8.35% year-over-year in June, up from 8.06% in May (Figure 1). June IPCA data continues to show local inflation is well above the Brazilian Central Bank's (BCB) target range of 3.75% +/- 1.50%. In Mexico, the June CPI rose 5.88% year-over-year (Figure 2), essentially flat from a month earlier, although also still well above the Central Bank of Mexico's inflation target range of 3% +/- 1%. The trend of elevated inflation in both countries has been in place for months now. So much so that the Brazilian Central Bank has raised policy rates 225 basis points this year in an effort to contain price growth, while the Central Bank of Mexico surprised markets and raised interest rates 25 basis points at its most recent meeting.

Domestic dynamics as well as external factors have contributed to elevated inflation in both countries. On the domestic side, aggressive fiscal stimulus in Brazil has supported nationwide consumption and in turn pushed prices higher for a range of goods and services. While fiscal stimulus has been absent in Mexico, a notable slowdown in COVID cases and swift re-opening has resulted in renewed economic activity and more normal consumer spending patterns. In addition, severe droughts in both countries have played a role in higher inflation. In Brazil, a lack of rainfall and limited reservoir water supply contributed to a surge in hydroelectricity energy prices, while Mexico is currently experiencing its worst drought in decades, also contributing to higher energy and food prices. Weather disruptions have been cited by Brazilian and Mexican policymakers as rationale for higher inflation in multiple monetary policy meetings over the last few months.

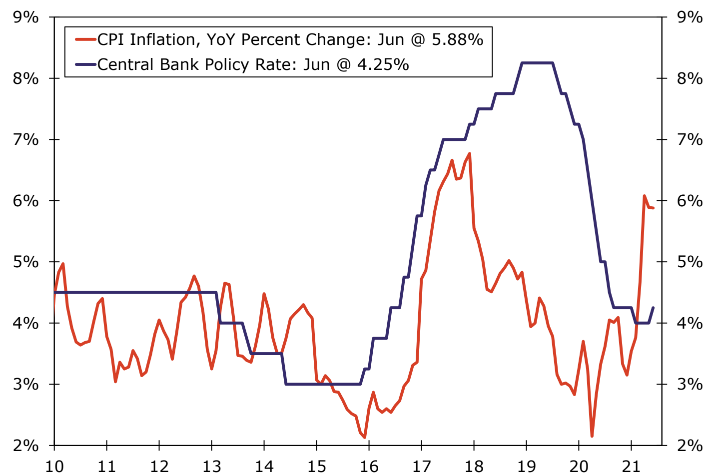
External factors have had a similar impact on price growth as well. To that point, the rise in commodity prices this year has been significant and has played a role in higher inflation. Energy and food represent a significant percentage of Brazil and Mexico's inflation basket, and with oil up over 40% this year and most food prices up, higher commodity prices have contributed to the inflation spike. And finally, global supply chain disruptions have also contributed to price pressures. With COVID still a global phenomenon and the Delta variant of the virus spreading across emerging Asia and Latin America, supply chain-related inflation has been highlighted as contributing to above target inflation by policymakers in both countries.

Figure 1



Source: Bloomberg LP and Wells Fargo Securities

Figure 2



Source: Bloomberg LP and Wells Fargo Securities

Patience is a Luxury Emerging Markets Do Not Have

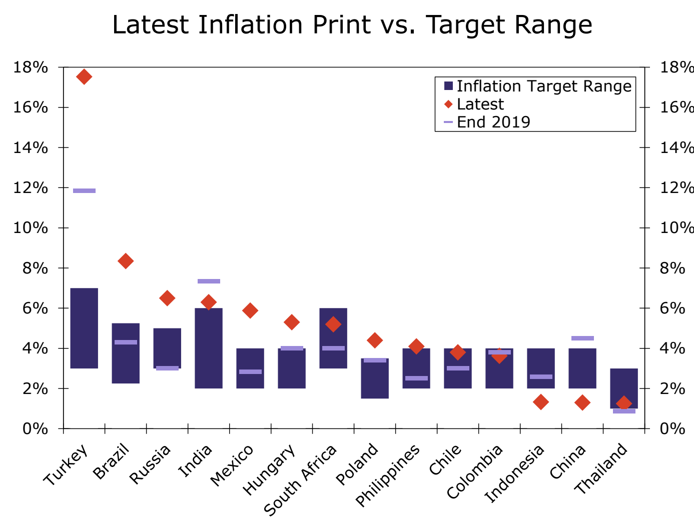
Inflation is running above target in many emerging market countries, not just Brazil and Mexico. Of the major emerging market countries, except for parts of emerging Asia, inflation is either above target or at the upper end of central bank inflation target ranges (Figure 3). The external dynamics mentioned above impact just about all of these countries, while each country also has local developments that has affected respective inflation paths. One takeaway from still elevated inflation could be that price growth within the emerging markets may not be as transitory as policymakers initially expected. For

the time being, commodity prices seem likely to sustain current levels, while supply chain disruptions could be in place longer than expected as the Delta variant makes its way across low-cost supplier countries in emerging Asia. Over the last few months, policymakers in Brazil, Mexico and other major emerging market countries have also highlighted that inflation could stay elevated for longer than originally expected.

As inflation in the developing world pushes higher and may not be as temporary as initially thought, emerging market central banks cannot afford to be as patient as peer G10 central banks when assessing monetary policy. To that point, the Federal Reserve has exercised a fair degree of patience in determining monetary policy settings this year. Inflation and inflation expectations in the U.S. have risen notably; however, the Fed continues to be patient, suggests inflation is transitory, and is keeping monetary policy very accommodative for the time being. On the other hand, rising inflation has forced emerging market central banks to turn more proactive as it relates to tightening monetary policy. In addition to Brazil and Mexico, central banks in Russia and Hungary have also raised policy rates, while the Central Bank of Chile and the South African Reserve Bank have hinted tighter monetary policy could be imminent, with these central banks all citing inflationary pressures.

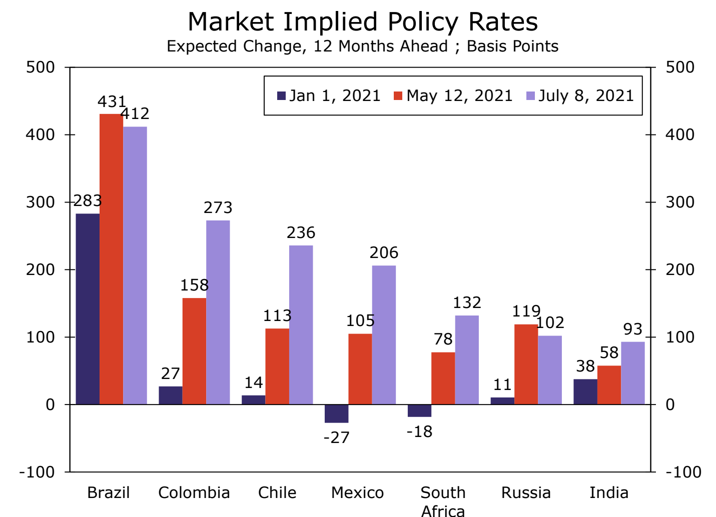
If emerging market central banks were to exercise the same degree of patience the Fed has shown, financial markets would likely sour on their respective currencies. Rising inflation coupled with no, or a late, policy responses has historically resulted in large depreciations to certain emerging market currencies. With many EM economies still struggling to recover from the pandemic induced slowdown, a significant currency depreciation or currency crisis could exacerbate economic problems and postpone the recovery. In that sense, we expect many central banks with above target inflation to continue being proactive and tighten monetary policy or begin tightening cycles before the end of the year. Tighter monetary policy could result in a delayed economic recovery; however, emerging market central banks are likely more willing to raise interest rates than be patient and risk a sizable currency depreciation.

Figure 3



Source: Bloomberg LP and Wells Fargo Securities

Figure 4



Source: Bloomberg LP and Wells Fargo Securities

Proactive Policy to Decide FX Winners

As far as actively fighting inflation, there are multiple emerging market central banks we expect to continue proactively tightening monetary policy through the end of this year. Despite the sharp drop in the U.S. 10-year yield since May, financial markets believe policy rates across the emerging markets are set to rise (Figure 4). In some cases, proactive monetary tightening can support certain currencies and underpins our constructive view on specific currencies through the end of 2021. On the other hand, central banks that are more dovish and resistant to tightening monetary policy should see their respective currencies underperform throughout the rest of this year.

In that sense, with inflation well above target, we expect the Brazilian Central Bank to lift its Selic rate at least another 75 basis points at its next meeting in August. We also expect the BCB to continue

tightening policy at meetings throughout Q4 and for the Selic rate to rise in 2022. As of early July, financial markets are pricing close to 400 basis points of additional tightening over the next 12 months, which the BCB is likely to deliver on. Aggressive tightening can swing interest rate differentials in the Brazilian real's favor and support the currency through the end of this year. In our view, BCB rate hikes can help the USD/BRL exchange rate move back toward the BRL5.00 area by the end of this year.

We also believe elevated inflation will result in additional rate hikes from the Central Bank of Mexico. As mentioned, Banxico surprised markets with a 25 basis point rate hike at its most recent meeting; however, with inflation stuck above the central bank's target range, we believe additional tightening is imminent. In our view, another 25 basis point hike will be delivered in September; however, we now believe another 25 basis point hike will come in Q4. We currently have a bullish view on the Mexican peso, and proactive tightening should help the peso strengthen toward MXN19.50 over the next few quarters.

The Central Bank of Russia (CBR) has also engaged in an aggressive, proactive, tightening cycle lifting its Key rate 125 basis points year-to-date. In addition, policymakers have given explicit guidance that rates will continue to move higher as inflation also trends well above the Russian central bank's target. In our view, another 100 basis points of tightening is possible, which should support the currency going forward. Higher oil prices, solid underlying fundamentals and reduced geopolitical uncertainty should also contribute to a stronger ruble. By the end of the year, tighter monetary policy and favorable external dynamics should help the USD/RUB exchange rate move toward RUB70.00.

However, proactive monetary tightening is not a trend across all emerging markets as outliers do exist. In our view, the Central Bank of Colombia is likely to keep policy rates steady for the time being, while the Reserve Bank of India (RBI) will likely look through the recent spike in inflation and keep monetary policy ultra-accommdative through the end of the year. Just this week, Colombian policymakers highlighted rates are likely to be left unchanged until the local economic recovery gathers more momentum, or an unforeseen spike in inflation were to occur. In our view, markets are priced too aggressively for rate hikes in Colombia, and as markets adjust to lower rate expectations, the Colombian peso could suffer. On a similar note, RBI policymakers are likely to keep rates low and bond buying programs in place until the Indian economy demonstrates it is on more solid footing after the severe second wave of COVID infections. Financial markets believe rates in India will remain at current levels through the end of the year; with rates in other parts of the emerging world set to move higher, the rupee is likely to gradually weaken.

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