International Commentary — June 11, 2021

Latin America Political Update

Summary

Latin American politics have become increasingly complex over the last few years. In 2021, those complexities have risen and political risk is now more prevalent and widespread across the region. To that point, the constitutional rewrite process in Chile has turned more populist than expected, while a candidate from the Communist Party of Chile is making major headway in this year's Presidential election. Peruvians also appear to have elected a self-proclaimed Marxist as President, marking a potential sharp shift in policy across the country. Politically charged protests have also erupted across Colombia and could lead to a left-leaning candidate in next year's election, while the return of Lula in Brazil adds an additional layer of uncertainty to Brazil's 2022 Presidential election. As political risk permeates across the region, the long-term policy outlook in Latin America is uncertain. This political uncertainty is a key factor contributing to our view for long-term currency weakness in many Latin American countries. In addition, a turn toward more populist style policies could result in a steady deterioration of public finances and result in sovereign credit rating downgrades across the region.

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Political Risks Abound in Latin America

Over the years, Latin America has turned into a "hot spot" for elevated political risk within the emerging markets. Political developments and the associated economic hardships in Venezuela have been well documented, while the Organization of American States (OAS) has highlighted election irregularities in Bolivia, Honduras and Nicaragua in recent years. In 2019, protests tied to election fraud in Bolivia forced long-time President Evo Morales to resign from office, while in Honduras, demonstrations occurred throughout 2017 and 2018 in response to a widely perceived fraudulent re-election of Juan Orlando Hernandez. In the context of the emerging markets, or even Latin America, these countries make up a relatively small component of overall GDP. However, elevated political risk and anti-establishment rhetoric is spreading to the larger and more influential countries across Latin America.

We have highlighted Argentina's political woes for some time as a return to Peronism in 2019 exacerbated yet another sovereign debt default in the country. Since 2019, the once stable environment in Chile has seen political risks rise as it relates to nationwide protests and the eventual rewrite of the nation's constitution. In addition, recent polls suggest Daniel Jadue of Chile's Communist Party is gathering significant momentum ahead of Presidential elections later this year, which could also contribute to elevated political risk in Chile. In Peru, politics have often been complicated, although the country has maintained a certain degree of stability despite multiple impeachments and allegations of corruption at the highest levels of government. However, the likely election of Pedro Castillo could inject new political risks into Peru as Castillo is a self-proclaimed Marxist who campaigned on implementing a policy agenda similar to that of Hugo Chavez and Fidel Castro.

Colombia and Brazil face renewed political challenges of their own as well. In response to a proposal to raise taxes, demonstrations across Colombia erupted and resulted in a violent anti-establishment movement across the country. Economically disruptive protests and deteriorating public finances resulted in S&P downgrading Colombia's sovereign credit rating to non-investment grade territory, while we would not be surprised if an anti-establishment candidate gathers support ahead of Presidential elections in 2022. And finally, in Brazil, despite political risk already being elevated, the return of former President Lula da Silva adds another layer of complexity to Brazil's political situation. Despite elections taking place late next year, Lula is already wildly popular in Brazil and is ahead in polls. A return to a more socialist political environment in Brazil could threaten an already sluggish reform agenda and place Brazil's fiscal and debt trajectory on an even more unsustainable path.

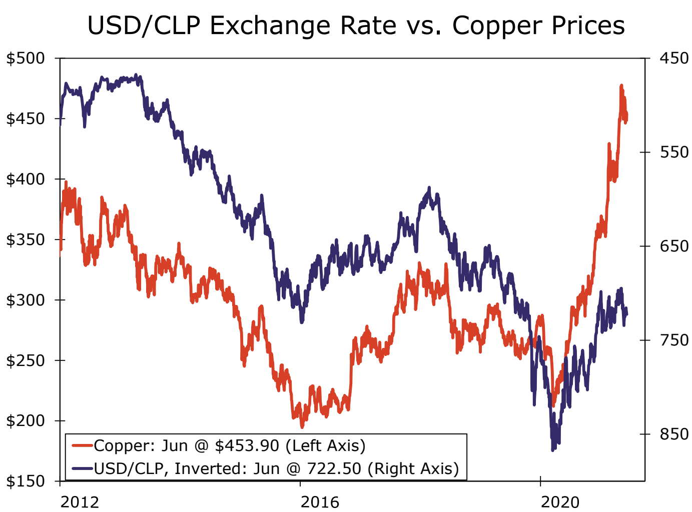
Constitutional Convention Surprise in Chile

Since the redrafting of the constitution in Chile was announced, we have highlighted how political risk in the country is now a concern. As the early steps of the process unfolded, we were surprised at the lack of contention around each referendum vote and the lack of volatility in Chile's local financial markets. However, in May of this year the discord and volatility we anticipated came to fruition. Last month, Chileans held another vote, this time to determine the 155 people, known as the Constitutional Convention, that will be the actual writers of the new constitution. Heading into the vote, we expected right-wing coalitions aligned with centrist and conservative views on economic policy to make up a solid majority of the Constitutional Convention. However, actual results were drastically different. The outcome of the vote revealed Chileans' preference for a sharp about-face from the business friendly policies that made Chile the richest nation in South America toward a more inclusive, diverse, left-leaning policy agenda. As far as the final composition of the Constitutional Convention, the right-wing coalition aligned with the current Pinera government won only 37 seats. 101 seats were won by far-left coalitions and independent candidates who were active in anti-government protests in 2019, while indigenous people, which historically have had an insignificant role in politics, make up the remaining 17 members of the Constitutional Convention.

Far-left coalitions and the inclusion of indigenous populations represents a dramatic shift in Chilean politics, and in our view, is likely to weigh on the Chilean peso going forward. With well over two-thirds of the Constitutional Convention, anti-establishment groups in Chile have enough power to propose and implement broad economic reforms to land and water rights, Chile's pension system as well as the exploitation of the country's natural resources, most notably copper. In addition, according to the OECD, Chile is one of the most unequal countries in the world. Early signs indicate the document the Constitutional Convention will look to draft will focus on principles including wealth and gender equality as well as indigenous rights. While the merits of these reforms could be warranted, the shift to a more populist political stance is likely to make investors nervous going forward. Arguably, political risk concerns are already disrupting the path of the currency. Figure 1 shows how the Chilean peso tends to track copper prices very closely. Since early 2020, copper prices have soared, and while the peso has generally trended in the same direction, political risk concerns appear to be holding the currency back somewhat. Given where copper prices are today, one would expect the Chilean peso should be stronger. It is possible new political risk is dampening sentiment toward the currency and causing the currency's correlation to copper prices to weaken.

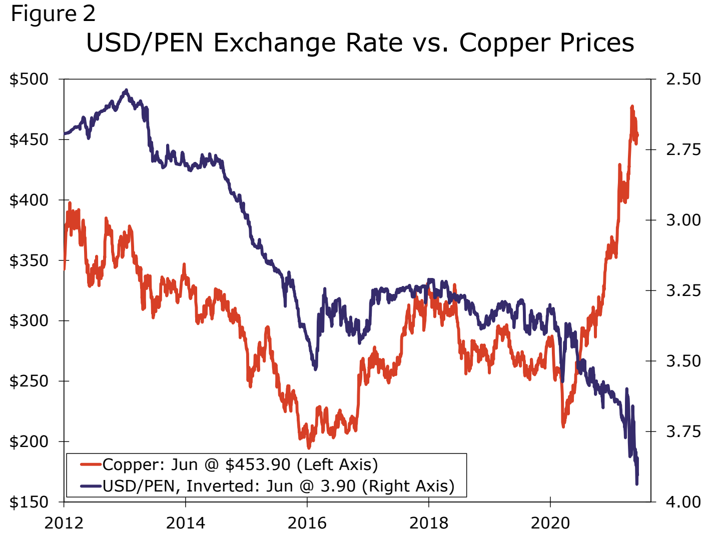
Going forward, we expect the constitutional rewrite process to become more contentious and for political risk to result in a weaker peso over the course of our forecast horizon. Despite the overwhelming majority of left-leaning parties in the Constitutional Convention, we expect coalitions aligned with the current government to push back on many of the proposed details likely to be included in the new constitution. This dissension should result in delays in drafting a document, while the actual approval of a new constitution by Chilean citizens could take years. This uncertainty should contribute to a weaker peso through the end of 2022. In addition, and as mentioned earlier, Chile will host Presidential elections in November of this year. As of now, Daniel Jadue of the Communist Party of Chile is ahead in polls and could be the candidate to beat later in the year. Jadue's policy proposals include a complete overhaul to Chile's economic model. As of now, Jadue is campaigning on tax hikes for the wealthy, limiting the role of the private sector, as well as a state-run pension system that guarantees retirees payouts above the poverty line. The combination of rewriting the constitution along with broad momentum behind Jadue could result in the USD/CLP exchange rate reaching CLP800 by the end of 2022. In addition, elevated political risk and possible deterioration of public finances could result in rating agencies exploring sovereign credit rating downgrades. Chile was already downgraded once this year by S&P, while Moody's has the country on negative outlook, a signal of a possible pending downgrade. It is unlikely Chile's investment grade status is at risk currently; however, a rating trending toward lower does seem likely.

Figure 1



Source: Bloomberg LP and Wells Fargo Securities

Figure 2



Source: Bloomberg LP and Wells Fargo Securities

Peru Goes Marxist

The state of Peruvian politics has been in flux for a while. Over the last few decades, multiple Presidents have been impeached or forced to resign, while many others have been implicated or charged with corruption related crimes. Despite sporadic bouts of financial market volatility tied to political developments, Peru has also been one of the more stable countries in Latin America, both from an economic perspective as well as a policymaking point of view. However, elections this past weekend may have sparked a change on Peru's political front and lifted political risk to new level. While still formally undeclared, it appears as if the self-proclaimed Marxist Pedro Castillo has won the election and will become the next President of Peru.

Castillo, a school teacher and union leader, came out of nowhere to win the first round of the general election in April. While Castillo did not have enough support to outright win the Presidency in April, his platform of revamping Peru's economy and adopting policy agendas similar to that of Hugo Chavez of Venezuela and Fidel Castro of Cuba appealed to many Peruvian citizens. At the same time, Castillo's momentum rattled local financial markets driving up sovereign bond yields and pushing the Peruvian sol to record lows against the U.S. dollar. Similar to the disconnect between the Chilean peso and copper prices, political risk tied to Castillo weighed on the Peruvian sol. The currency and copper prices, historically tightly correlated to one another, have diverged with the sol falling sharply despite the rise in copper prices (Figure 2). The sol has rebounded over the last few days as Castillo has looked to reassure markets that he is committed to paying Peru's debts, will not expropriate foreign assets or nationalize Peru's copper mines. In addition, markets may have felt more comfortable with Castillo as it appears the Peruvian Congress will be highly fragmented. Castillo's ability to implement his policy proposals may be limited even if he does revert to the Marxist policy agenda he campaigned on.

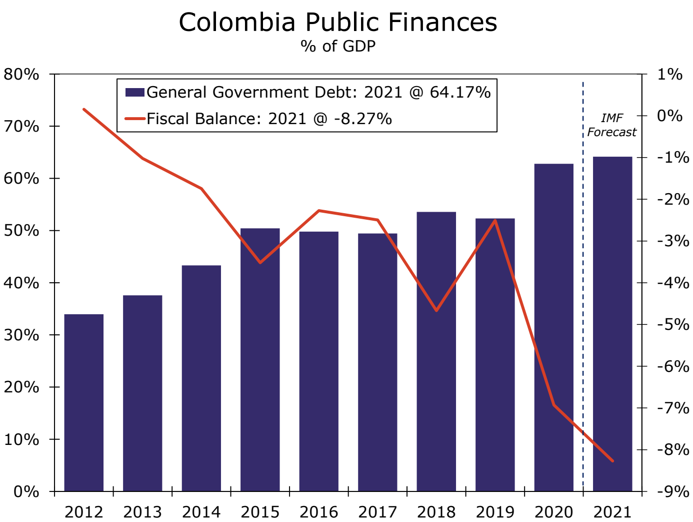
But, in our view, we believe the sticker shock of a Marxist candidate winning the Presidency is likely to hover over the currency for a few more quarters. As mentioned, this election marks a swift change to populist policy in Peru, for the most part, a political platform Peru has been able to avoid in recent years. In addition, it appears as if runoff contender, Keiko Fujimori, will contest the outcome of the election. Fujimori has claimed election irregularities, which could also contribute to additional uncertainty and weigh on the sol. As of now, we forecast the USD/PEN exchange rate to reach PEN3.98 by the end of this year; however, we acknowledge the path of the currency is likely to be bumpy and highly determined by the public rhetoric of Castillo as well as Fujimori. Assuming Castillo is inaugurated, the Peruvian sol will also be highly influenced over what policy Castillo looks to implement as well as cabinet members he appoints. Cabinet members closely aligned with his Marxist views could also rattle financial markets and push the currency toward our Q4-2021 target.

Colombia and Brazil Up Next

When thinking about the more stable countries in Latin America, Colombia also comes to mind. However, the country has been overwhelmed by recent anti-government protests taking political risk in Colombia to new heights. Demonstrations began in response to a government proposal to raise taxes on the lower and middle class populations in an effort to pay for COVID-related fiscal stimulus. As protests intensified, the government dropped its proposal to hike tax rates; however, a significant amount of damage may have already been done. As mentioned, S&P downgraded the country's sovereign credit rating out of investment grade territory as the fiscal deficit is likely to widen this year and debt levels stay elevated (Figure 3). Moody's and Fitch had Colombia on watch for a rating downgrade before protests started, and wider fiscal deficits, an elevated debt burden and renewed political risk could be enough to result in another downgrade. Perhaps more important though is the policy shift that could come as a result of anti-government protests. In May 2022, Colombians will elect a new President, and if the current wave of populist candidates is any indicator, we would not be surprised to see a left-leaning candidate, possibly with little political experience, gather support. As of now, candidates for the election have not been announced, but as we get closer to the end of this year, candidates should start to reveal themselves. We will be focused on the political ideologies of these candidates and their popularity to assess future political risk in Colombia; however, any indications of a socialist wave hitting Colombia would likely weigh on the currency and could force us to re-evaluate our longer-term Colombian peso forecasts.

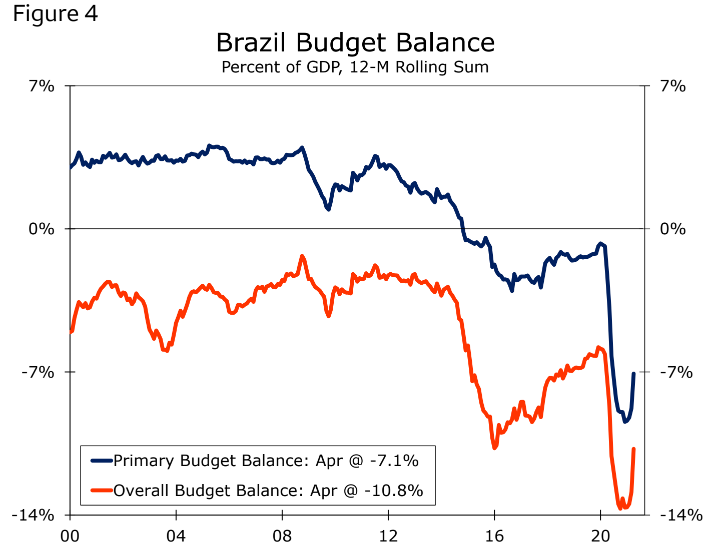
The 2018 election of President Bolsonaro elevated political risk in Brazil; however, we expect politics to play a major role in the country over the second half of this year and as we get closer to the 2022 Presidential election as well. The decision to vacate corruption charges against former President Lula da Silva (Lula) means he is eligible to run for office again and we expect he will formally announce himself as a candidate in the near future. Lula is extremely popular is Brazil and known for starting Bolsa Familia, a program designed to financially support impoverished households nationwide. According to polls, Lula is the top candidate to win the Presidency next year as Brazilians have largely become frustrated with Bolsonaro's perceived inability to manage the COVID crisis effectively. In our view, as Lula continues to gather support, Brazil's long-term reform agenda designed to place fiscal and debt dynamics on a more sustainable trajectory becomes less likely to implemented. Should Lula win office next year, it is likely social spending rises, and the government's fiscal deficit and debt burden would deteriorate. Also, as Lula's support improves it is, in our view, likely Bolsonaro seeks to retain popularity by increasing social spending and de-prioritizing reform items such as tax reform and freezing public sector employee wages. Currently over 10% of GDP (Figure 4), Brazil's fiscal deficit is already a concern and any signs that fiscal consolidation is no longer a priority should weigh on local Brazilian financial markets. In our view, we expect the reform agenda to stall ahead of the election and for the Brazilian real to come under pressure. As far as our forecast for the USD/BRL exchange rate, we forecast the real's recent fortunes to reverse course in Q4-2021 as Lula formally announces his candidacy and Bolsonaro seeks to rally support. Over the course of 2022, we expect the currency to weaken and for the USD/BRL exchange rate to eventually reach BRL5.50 by the middle of next year.

Figure 3



Source: IMF and Wells Fargo Securities

Figure 4



Source: Bloomberg LP and Wells Fargo Securities

Policy Uncertainty a Long-term Concern

With political risk on the rise across Latin America, the policy outlook for the region is highly uncertain. An uncertain political outlook and a potential shift to more socialist-type policies could result in a steady deterioration of economic fundamentals in many of the countries mentioned above. In our view, that political uncertainty and elevated political risk is a major contributor to our longer-term view for currency weakness across the region. Going forward, it will be imperative to monitor political dynamics across the region and continue to identify countries at risk of a major shift in policy dynamics. We will continue to update readers on political risks in Latin America and which currencies could be at risk of a politically driven sell-off over time. On the other hand, if we feel as if political risk is beginning to recede we will keep readers informed as well. Should political risk ease in any of these countries, respective currencies could experience a sharp relief rally.

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