International Commentary — July 30, 2021

Sol In The Hole

Summary

We have highlighted emerging political risks across Latin America for some time, most notably in Chile and Peru. Over the last month, we felt as if conditions in Peru were improving as newly elected President Pedro Castillo dialed back rhetoric on his unorthodox policy agenda. However, in a dramatic turn, Castillo recently shifted back toward the populist-style platform that won him the Presidency, in-turn spooking local financial markets. While still too early to make adjustments to our Peruvian sol forecasts, political risk in Peru is still prevalent and risks around our USD/PEN exchange rate forecast are heavily tilted to the downside.

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Renewed Political Risk Weighs on Peru

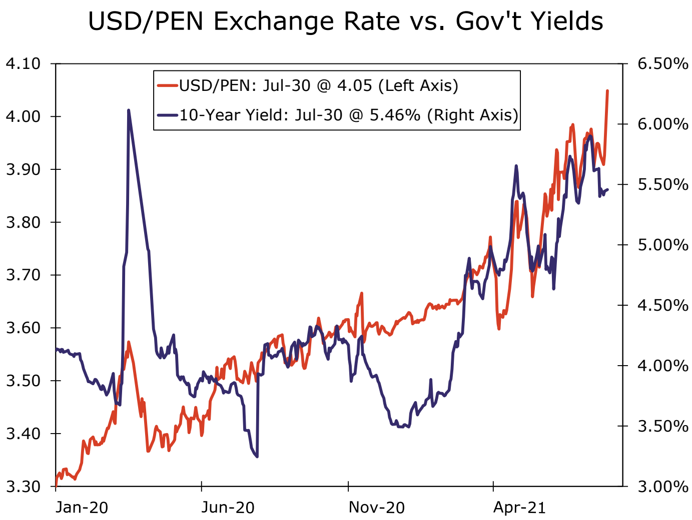
Throughout the entire COVID crisis, we have highlighted how a consequence of such sharp economic contractions could be a shift toward more populist-style policymaking, especially within the emerging markets. Up until now, Latin America is where this theme has played out the most with countries such as Chile and Peru already showing support toward candidates with socialist political ideologies, while Colombia and Brazil may be next as each country hosts presidential elections next year. We have publicized our concerns regarding the state of Latin American politics in a report earlier this year as well as voiced our worries in our Mid-Year Outlook. At a high level, a shift to populist political frameworks in these countries would likely place public finances on worsening trajectories, raise regulatory and expropriation risks, and could act as an impediment to foreign direct investment or multi-national corporations wanting to operate in each country. These risks have somewhat materialized in Chile amid the constitutional rewrite process; however, the election of the self-proclaimed Marxist Pedro Castillo as President of Peru has culminated in the manifestation of these concerns much quicker.

Castillo, a school teacher and former union leader, has a relatively radical political agenda. His platform focuses on significantly increasing social spending, redistributing wealth, higher tax rates, limiting the independence and decision-making abilities of Peru's institutions, and possibly nationalizing the country's copper mines and other natural resources. However, after a contested election, Castillo tried to walk back some of his platform and become a more moderate political figure. In that sense, Castillo tried to align himself with more centrist party members and calm financial markets by insisting he would respect Peru's constitution as well as the assets of foreign companies operating in the country. Early indications seemed to suggest Castillo was following through on these promises as he retained the head of the central bank, a well known and respected technocratic monetary policymaker, and appointed a former World Bank economist as his chief economic advisor.

On July 28, Castillo was formally inaugurated as President; however, his inauguration speech seemed to suggest a turn back toward the populist agenda that swept him into office, rather than the moderate promises made after being declared winner of the election. During his speech, Castillo suggested a referendum vote on the nation's constitution and that Peru needed to recover sovereignty over its natural resources. In addition, Castillo appointed left-leaning, also self-proclaimed Marxist political figures, to key cabinet roles such as foreign affairs minister as well as prime minister. And finally, and maybe most notably, Castillo failed to name a finance minister, which in our view, suggests his orthodox and technocratic chief economic advisor will probably not get the job.

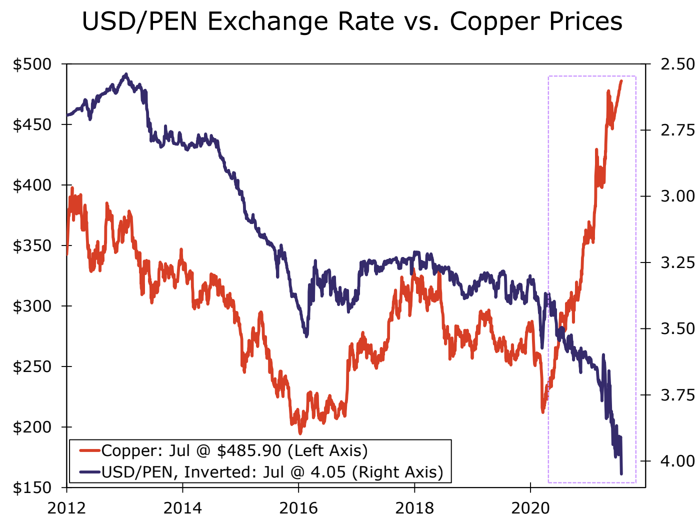
The reaction to the shift in rhetoric has been swift and caught market participants, including us, by surprise. Ahead of the inauguration, we felt as if Castillo would in fact be a more moderate president and that political risk in Peru was receding, especially given the Peruvian Congress is heavily fragmented and most of Castillo's policy agenda would likely not be implemented. In our most recent *International Economic Outlook*, we adjusted our USD/PEN exchange rate forecast to reflect perceived reduced political risk associated with a Castillo administration. However, following a few days of local markets being closed, the sol opened significantly lower selling off over 3% and breaking through the key PEN4.00 technical level to reach a record low against the U.S. dollar (Figure 1). The USD/PEN exchange rate has also continued to diverge from copper prices, historically a reliable indicator to determine the direction of the currency, which in our view reflects the renewed political risk hovering over the country. (Figure 2).

Figure 1



Source: Bloomberg LP and Wells Fargo Securities

Figure 2



Source: Bloomberg LP and Wells Fargo Securities

While the recent rhetoric and new cabinet member decisions are certainly concerning, we are hesitant to make any snap adjustments to our USD/PEN forecasts. We feel as if the current market moves are a knee-jerk reaction and the sol can recover ground in the coming days and weeks. Despite Castillo's rhetoric, the Peruvian Congress remains very segmented and the likelihood of Castillo pushing through radical policy items is still rather low. Also, the more unorthodox Castillo becomes we believe his ability to govern will be reduced. Given the fragmented state of Congress, Castillo will need to rally support from many political parties to implement even more moderate proposals. Far-left ideologies and proposals can only weaken his position and ability to negotiate with more centrist parties, and could create a state of political paralysis across the country.

Despite not adjusting our forecasts, risks around our expected path for the sol are tilted to the downside. Should rhetoric intensify and Castillo name a left-leaning finance minister, it is likely the sol continues to weaken. A cabinet of unorthodox policymakers could also result in sovereign credit rating downgrades that could also weigh on investor sentiment and place downside pressure on the currency. From here, we will be watching for commentary from Castillo and how committed he is to his populist-style platform, or if he shifts back toward a more centrist position. In addition, we will be monitoring developments on who Castillo chooses as finance minister as this decision could lead to new government borrowing and a rising sovereign debt burden over time.

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