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Rate Decisions in Strong Latin American Economies

Potential for large interest rate cuts in Mexico and Brazil, despite robust economic growth, provides opportunities for policies, economies, and equities.

KEY POINTS

- Mexico's central bank finally cut interest rates this month after a year on hold at high rates.
- Brazil's central bank cut rates as expected but moved to more cautious forward guidance.
- Real interest rates remain very high in both countries, and consensus expects rate cuts.
- We believe rate cuts will be more than the consensus expects, creating further potential for positive surprises. We remain overweight in Mexico and Brazil.

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We have maintained our overweight positions in Mexico and Brazil for a reason. We believe that the strict monetary orthodoxy their respective central banks displayed in 2021 and 2022 would create the potential for large interest rate cuts when disinflation was achieved. Although their committed policy stances achieved disinflation, rate cuts have been slow to come. However, this hasn't stopped both the MSCI Mexico and MSCI Brazil indexes from outperforming the MSCI EM Index over the last three years. Banxico has finally cut Mexican policy rates this month, and this piece aims to review the current prospects for policies, economies, and equities in the two big Latin American markets.

Many central banks in developed and emerging markets have been cautious about lowering policy interest rates. However, Latin America has seen a broad rate-cutting cycle that expanded this month to include Mexico. Whilst some Latin American central banks that were quick to cut are now turning more cautious – notably in Chile and Peru – we believe that both Mexico and Brazil should be able to decrease policy interest rates by hundreds of basis points over the next 24 months.

In response to rising inflation, Banxico hiked Mexico's official overnight rate to 11.25% in March 2023, when CPI inflation was 7.6%. Banxico then maintained the same rates as inflation declined to 4.4% in the year to February 2024. During the Banxico meeting in March 2024, the beginning of the easing cycle was confirmed with a broadly expected 25bp cut to 11%. The supporting statement suggested the easing should continue through the next few meetings, a positive surprise for markets. Current consensus expectations are for Mexican policy rates to decline to 9.5% by the end of 2024 and 7.5% by the end of 2025.

Mexican economic data has softened in recent months, with service activity slowing and a drought expected to reduce agricultural production. Overall, the Mexican economy continues to do well, supported by a strong US economy. Purchasing Managers'

Indexes ("PMIs") are well above 50 and Q4 2023 GDP growth of 2.5% was above expectations. Unemployment has also declined to near record-low levels. Additionally, selected stimulus is to be expected ahead of June's election. Despite very high levels of real interest rates, the Mexican economy is still successful. A rate-cutting cycle should prove supportive of both domestic demand growth and corporate earnings growth.

Meanwhile, the BCB policy committee unanimously voted for a sixth 50bp cut in Brazil, bringing rates to 10.75% (while CPI inflation is at 4.5%). The committee's statement shortened the horizon of guidance to only a 50bp cut in May, after which policy decisions will be data dependent. The consensus is that policy rates will be at 9.0% by the end of this year and 8.5% by the end of next year.

The central bank has issued a more cautious guidance, which reflects strong economic growth in the first part of this year. The PMIs look very strong, retail sales and output of services have exceeded expectations, and January's economic activity index rose 0.60% MoM, following a 0.82% increase in December. As in Mexico, drought may reduce agricultural output, but not enough to drag down the broader economy.

Both Mexico and Brazil are implementing large rate cuts despite robust economic growth in both countries. We expect significant positive surprises in the quantum of cuts. Our model emphasizes reflexivity in the interaction between emerging economies and financial markets, where each influences the other. We believe that the histories of booms and busts in individual emerging markets are driven by this process, where generally, everything goes right or wrong at the same time. In Latin America, this tends to mean interest rates overshoot expectations, either up or down, through the cycle. We do not expect this cycle to be any different; we think that interest rates in both Mexico and Brazil will come in much lower than what the consensus expects in coming quarters. This will provide an even more positive boost to economies, corporate earnings, and equity market returns.

Source: Bloomberg/MSCI/JOHCM.
The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries*. With 1,441 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
The MSCI Mexico Index is designed to measure the performance of the large and mid cap segments of the Mexican market. With 24 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Mexico.
The MSCI Brazil Index is designed to measure the performance of the large and mid cap segments of the Brazilian market. With 49 constituents, the index covers about 85% of the Brazilian equity universe.
*EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.