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Monetary Measures Reshape Economy

Decisive monetary policy has brought inflation under control in Mexico and Brazil, helping to lift the value of their currencies and support growth.

KEY POINTS

- Emerging markets display synchronized patterns of economic growth, equity market performance, and currency fluctuations, influenced by domestic-focused or export-led dynamics.
- Despite challenging conditions, Mexico and Brazil have experienced strengthening currencies, robust economic growth, and positive returns in their equity markets.
- Central banks in Mexico and Brazil have implemented interest rate hikes to combat inflation, resulting in positive outcomes.

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One of our observations about the history of emerging markets is that more domestically-focused emerging economies tend to see synchronous upswings (and downswings) in economic growth, equity markets and currencies. In more export-led markets, weaker currencies boost competitiveness and growth. Still, those countries that tend to run current account deficits have net external financing requirements, so the capital inflows that support currencies also drive economic growth.

Two markets that have historically displayed this pattern are Mexico and Brazil. Despite some more challenging conditions for emerging markets in general, both have seen strengthening currencies in recent years. To what extent is this accompanied by stronger growth and/or good market returns?

Banxico, the Mexican central bank, was arguably late to begin hiking interest rates in response to rising inflation but has pushed through 725bp of hikes since June 2021. Inflation, which peaked at 7.7%, is now declining sharply, with CPI of 6.3% in the year to April, and the Bank's monetary policy comments show a shift to a more neutral interest rate stance for the rest of the year.

These interest rate hikes have not prevented a period of strong economic growth in Mexico. GDP growth in the first quarter of 2023 surprised positively at 3.9% YoY, and there has been a consistent upward revision in consensus forecasts for Mexico's GDP growth in 2023. Consumer confidence is around the peak levels seen in pre-Covid 2019, and both exports and remittances from overseas citizens are at record levels.

This economic growth has fed through to the equity market. Earnings growth has been strong, consensus earnings estimates have been steadily revised upwards, and, in USD terms, MSCI Mexico has substantially outperformed emerging and global equities over the last three years. The portfolio has benefited from being overweight Mexico and is an example of our philosophy and process working.

The Brazilian central bank has been even more hawkish than its Mexican peer. It began lifting policy interest rates in the first quarter of 2021 at the peak of the Covid pandemic in Brazil. Over the course of two years, the BCB increased the policy rate from 2% to 13.75%, driving a powerful disinflationary process. CPI inflation has declined from over 12% in April 2022 to 4.2% a year later. With real interest rates approaching 10%, it is not surprising to observe the strengthening of the Brazilian real, but also not a surprise that growth has slowed. Notably, GDP growth in the first quarter reached a substantial positive surprise at 4.0% YoY, while consumer confidence has also picked up strongly.

Brazilian equities have had more volatile relative performance than Mexican equities. They have outperformed emerging equities over the last three years, albeit slightly lagging global equities. One of the primary factors contributing to this trend was the weakness observed in Brazilian assets around the 2022 election. Nevertheless, the portfolio has benefited from being overweight Brazilian equities.

Looking forward, market expectations for the next twelve months indicate approximately 175bp of rate cuts in Mexico but 300bp in Brazil. Considering the growth dynamics in both economies, the strengthening currencies and with earnings growth coming through, the impact of interest rate cuts is expected to stimulate growth and contribute to a potential rerating of equity markets. This, in turn, further supports the self-reinforcing positive cycles we see in both markets. We remain overweight both Mexico and Brazil in our portfolios.

Source for all data JOHCM/Bloomberg (unless otherwise stated)