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News

Strong Economies, Falling Rates

Rates in Mexico and Brazil are coming down. Despite cautious guidance, we believe further cuts will be ahead of consensus



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One of the reasons we have maintained our overweight positions in Mexico and Brazil has been our view that the strict monetary orthodoxy that their respective central banks displayed in 2021 and 2022 would create the potential for large interest rate cuts when disinflation was achieved. Their committed policy stances did achieve disinflation, but rate cuts have been slow to come (this hasn't prevented both MSCI Mexico and MSCI Brazil comfortably outperforming the MSCI EM Index over the last three years). With Banxico finally cutting Mexican policy rates in March, our aim here is to review the current prospects for policies, economies and equities in the two big Latin American markets.

Although many developed and emerging market central banks have been cautious on lowering policy rates, 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 deliver hundreds of basis points of cuts in policy interest rates over the next 24 months.

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

Mexican economic data has softened in recent months, with service activity slowing and a drought expected to reduce agricultural production, but overall the Mexican economy continues to do well, supported by a strong US economy. PMIs are well above 50, Q4 2023 GDP growth of 2.5% was above expectations, and unemployment has declined to near record-low levels. In addition, selected stimulus is to be expected ahead of June's election. That economic success is despite the very high level of real interest rates, and a rate-cutting cycle should prove supportive of both domestic demand growth and corporate earnings growth.

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

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

So, in both countries large rate cuts are meeting economies already growing well. Where we expect significant positive surprise is in the quantum of cuts. Our model for the interaction between emerging economics and financial markets emphasises reflexivity, where each feeds 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 at the same time, or everything goes wrong at the same time. In Latin America that tends to mean interest rates overshoot expectations, up or down, through the cycle. We do not expect this cycle to be any different; we think interest rates in both Mexico and Brazil will come in much lower than consensus expects in coming quarters, giving an even more positive boost to economies, corporate earnings and equity market returns.

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