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Week Ahead in Latin America

Mexico: Revisiting the Policy Continuity Debate

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Since the July 1 election Mexican stocks and currency have outperformed their peers amid rising optimism about the prospects for policy continuity – a debate we decided to revisit this week at the midpoint of the presidential transition period. Progress with US trade negotiations has clearly played a supportive role, yet the main driver behind the improved sentiment seems to be the incoming administration's softening of its tone on several of the more unorthodox aspects of its campaign platform. So with investors seemingly turning more comfortable with the future policy mix, the debate is shifting to questions about the extent and durability of this more pragmatic stance. Understanding the sequencing of policy priorities, we think, supports the case for continuity at least during the early part of the six year term: policymakers' priority seems to be pushing initiatives, some of them requiring constitutional amendments, to further consolidate the executive's ability to dictate policy. So during this period – which may extend beyond next year – we argue that any major shifts in economic policy are likely to take a back seat, thus ensuring that the pillars of Mexico's investment narrative remain largely in place.

What's new?

While elections dominated the debate in **Brazil**, as polls show some consolidation on voting intentions, the central bank signaled for the first time that, despite the healthy inflation outlook, if the currency continues to weaken they are ready to hike, albeit gradually. With the month-end deadline approaching, we are keeping a close eye on Canada-US trade talks which so far have failed to produce a breakthrough. While there are major question marks about the US administration's ability to get approval from congress for a bilateral deal with **Mexico**, at least the preliminary car agreement may shield Mexico from the risk of potentially stiff US auto tariffs. Busy week in **Argentina**: the finance minister presented the details of the 2019 budget to congressmen; negotiations may last several weeks but early signs from provincial governors were positive. On the data front, the August budget figures keep showing the government tightening the fiscal belt while the second quarter GDP showed a strong contraction in the economy on the back of the impacts from the drought and the onset of the confidence crisis. **Colombia**'s July manufacturing and retail sales reports kept showing the economy growing at a moderate pace; the trade balance report for the period, meanwhile, confirms that the external adjustment has run its course: the current account is likely to remain close to the 3% of GDP handle for now. In **Peru,** political tension eased after the executive won a vote of confidence from congress backing his reform initiatives aimed at addressing corruption, including stricter rules for campaign financing and a ban on reelection of legislators.

What's next?

In **Brazil**, elections should remain in the spotlight, but we have a series of important data points in this coming week, from balance of payments to fiscal figures. We believe the minutes from the central bank on Tuesday could shed a little more clarity on what is the pain threshold from the BCB to finish its stimulative policy. The IGAE for the month of July should confirm that, after a contraction in the second quarter, activity in **Mexico** is normalizing, moving back to a positive, moderate growth path; inflation, which has been surprising to the upside since May, should move above the 5.0% threshold in the first half of September – this should mark the peak for the annual rate of headline inflation. Some of the currency strength seen this week in **Argentina** may be linked to some opinions that negotiations on the updating of the IMF package deal are advanced and, on top of the anticipation of disbursements, may come with an expansion of the credit line; we will keep you posted. **Colombia**'s central bank hosts another policy decision: we expect rates to remain on-hold for the time being as unfavorable external conditions do not favor easing despite domestic inflation remaining well behaved and activity still running below potential. The September 5 minutes is the highlight from **Chile,** which could provide important clues on whether the new hawkish guidance that tightening may start "in coming months" potentially involves an October move – which swaps are fully pricing in – or whether it was meant to reinforce previous guidance that the first hike would likely take place in December.

Saludos,

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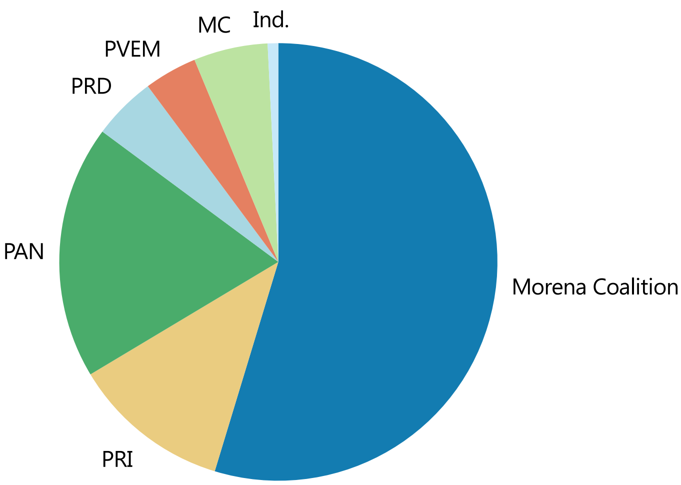
Mexico: Revisiting the Policy Continuity Debate by Luis Arcentales and Nikolaj Lippmann

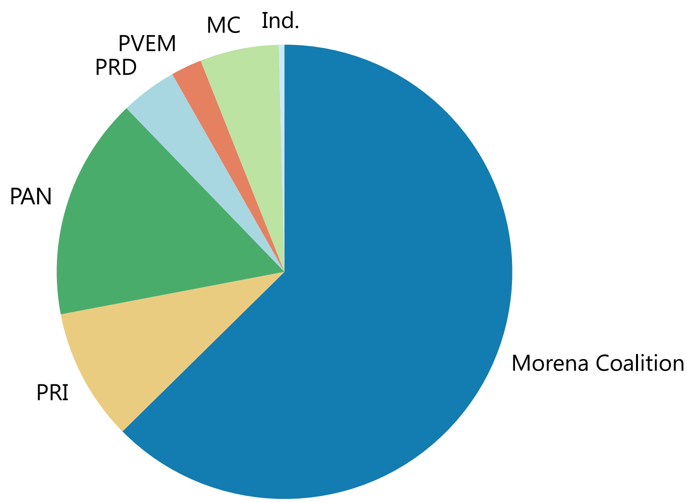
Nearly halfway through the five-month-long presidential transition period, the debate about policy continuity in Mexico remains very much alive. And that should not come as a surprise given the wide latitude to bring about policy changes that the incoming administration is likely to command. Voters handed a historically strong mandate to the president-elect (see "Mexico: Strong Mandate and Fundamentals, but Uncertainty Lingers," July 2, 2018). The coalition led by his party, moreover, enjoys a majority in both chambers of congress (see Exhibit 1 and Exhibit 2). Though still short of the two-thirds threshold required for constitutional amendments, an apparent lack of effective opposition – the other two main parties endured major setbacks on July 1 – should allow space for the next administration to reach consensus with other congressional groups to advance its initiatives, even constitutional ones. Importantly, the coalition also controls over half of state parliaments (19 out of 32), which removes one of the hurdles to pushing through constitutional changes.

Exhibit 1: Mexico: Senate Composition (% of seats)



Source: Mexican Congress

Exhibit 2: Mexico: Lower House Composition (% of seats)



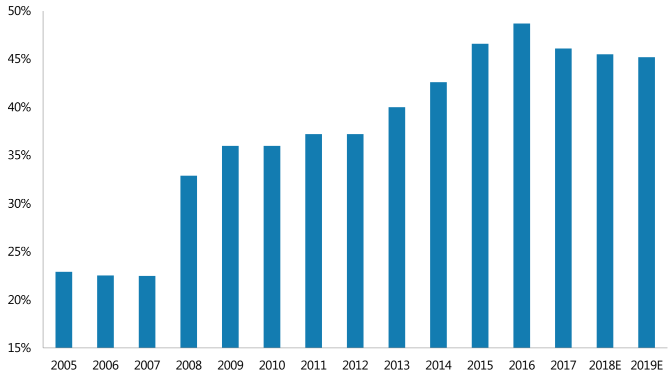
Source: Mexican Congress

Exhibit 3: Mexico: MSCI Mexico versus MSCI EM (June 29 = 100)

Source: MSCI

Despite the ability to reshape the policy mix that a strong mandate provides to the incoming administration, there seems to be growing optimism since the election about the prospects for policy continuity in areas such as fiscal management and trade. The stock market has been gaining ground, outperforming the emerging market benchmark (see Exhibit 3). Since the election, the peso has been the best-performing major emerging market currency versus the dollar, and this favorable performance across various asset classes has coincided with a meaningful decline in volatility. The feedback from both companies and investors attending our Latin America conference in London last week, moreover, supported our view that investors are becoming more comfortable with the future policy mix (see "Latin America: Macro Notes from London," in Week Ahead in Latin America, September 14, 2018).

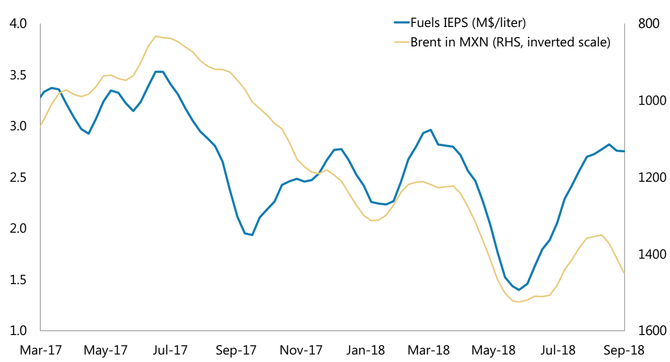
Exhibit 4: Mexico: Public Sector Gross Debt (as % of GDP)



Source: SHCP

It is not hard to pinpoint reasons behind the improved post-election sentiment, in our view. Probably the most important factor is the incoming administration's softening its tone on several of the more unorthodox aspects of the campaign platform. The next administration is reviewing expert opinions about the viability of Mexico City's new airport. While the final decision on the airport is likely to be a political rather than a technical one, this review process represents a shift from campaign calls for an immediate cancellation of the project. Oil auctions scheduled for September were postponed, but apparently not permanently scrapped. Even as the next administration keeps signaling its intention to expand the role of the state in the energy sector, it seems that foreign and private companies – who were awarded over 100 contracts for oil & gas exploration and production since 2015 – will be allowed to continue operating. Though details about the costs and timelines are lacking, the original promise to build new refineries seems to have been scaled back. Last, prospective members of the economic team continue to emphasize the importance of central bank independence and maintain healthy fiscal accounts as a prerequisite for macro stability. While specifics about new social programs and other spending commitments remain unclear, a legislator leading the largest block in congress recently previewed that the 2019 budget would include the parameters from the preliminary guidelines presented in March, such as borrowing requirements (2.5% of GDP) and a primary surplus (0.9% of GDP), which in our view would allow debt ratios to maintain a gradually improving trend (see Exhibit 4).

Exhibit 5: Mexico: Fuels IEPS and Brent in Local Currency (4-week rolling)



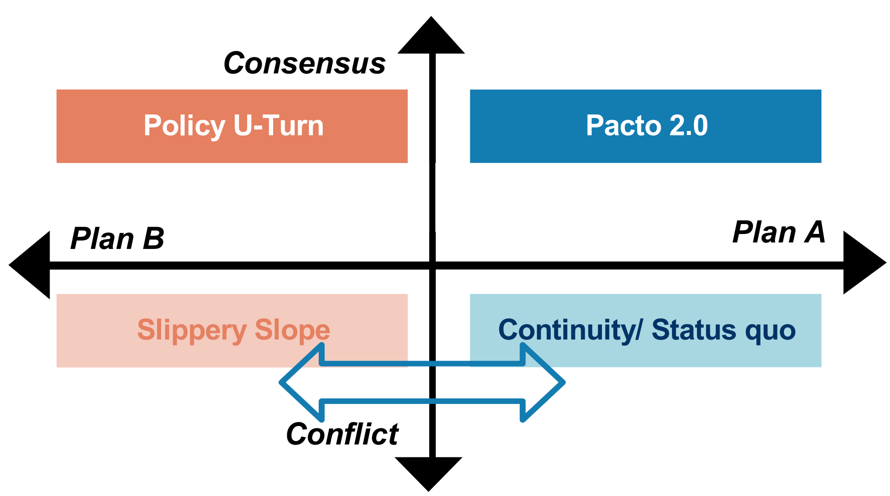
Source: SHCP, EIA, Morgan Stanley Latam Economics

We believe one sign that the pledge to submit a conservative 2019 budget may be credible is the recent jump in fuel taxes. From a low of M$1.1 per liter of regular gasoline in May, taxes are now approaching M$3.0 per liter – a difference representing additional revenues of 0.5% of GDP for the government over a year. The tax hike, it is worth highlighting, has come despite increases in fuel prices (due to both higher crude benchmarks and the exchange rate); in fact, the last time fuel costs were at current levels, taxes were between one-quarter and one-third lower than they are today (see Exhibit 5). Without obvious political incentives for the current administration to push up taxes and thus prices at the pump, we suspect that behind the tax hike could be an understanding between the current and next administrations about the importance of this revenue stream for public coffers – amounting to some 5% of the budget (equivalent to 1.1% of GDP) in the past year.

Trade-negotiation progress with the US has also been supportive of Mexico's investment narrative. Uncertainty regarding NAFTA has been a drag on sentiment and investment, which is likely to ease now that both countries have reached a preliminary understanding (see "Mexico: NAFTA 1.1 – Lighter than a 2.0 Reboot," August 30, 2018). Of course, the jury is still out on how Mexico's auto sector will evolve in response to new requirements for increasing local sourcing (to 75%) and greater content from higher-paid workers (40-45%); the endgame seems to be a switch to more costly suppliers that would entail an adjustment in Mexico (see "NAFTA Remix and Autos: Sentiment over Substance?" August 29, 2018). That said, we still see any deal – even such as the current one that involves concessions by Mexico – as a better outcome than no deal at all. Moreover, even if the auto-sector agreement leaves Mexico at a disadvantage vis-à-vis current conditions, having a preliminary deal in place may be enough to shield Mexico's existing production from the risk of potentially stiff US tariffs on all auto imports under Section 232. To be clear, our US public policy team sees multiple barriers to US congressional approval of a deal that excludes Canada; if that were the case, their base scenario would be for NAFTA 1.0 to remain in place and for negotiations to carry on (see "US Public Policy: Trade FAQs – NAFTA, China and Autos," September 12, 2018).

While Mexico watchers (and asset prices) are welcoming tentative signs of policy continuity, there is still plenty of questioning about the extent and durability of the apparent commitment to this more orthodox policy path. Based on our conversations, investors seem to assume that policy will deteriorate over time, shifting gradually from the "status quo" toward the "slippery slope" scenarios of our electoral-cum-policy framework (see Exhibit 6 and "Mexico: Mexico's Choice Between Plan A and B: Elections, Institutions and Policy Continuity," April 8, 2018). More specifically, Mexico watchers frequently argue that the incoming administration's redistribution imperative will add pressure on public coffers, undoing the fiscal-consolidation efforts of recent years that successfully put debt ratios on a downward path since 2017. The goal of greater state intervention, moreover, would likely lead to at least a slowdown in the opening of the energy sector or, at worst, to a reversal of energy reform, with negative implications for potential growth. Regarding expectations for this shift to be a slow process, Mexico watchers often provide reasons ranging from the challenges of changing current structures – such as a reengineering of public spending, of which over 90% is earmarked, based on our estimates – to the relative inexperience of prospective members of the incoming government and the vagueness of many of the potential policy initiatives, which may reflect a lack of consensus within the next administration.

Exhibit 6: Mexico: Morgan Stanley Research Potential Scenarios



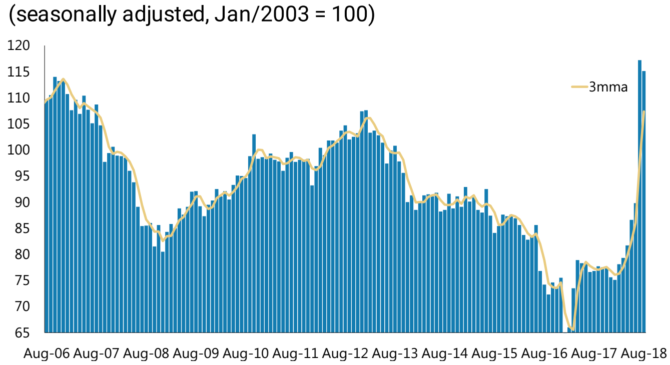
Source: Morgan Stanley Research

To better understand continuity prospects, it is helpful to focus on the broader

political picture and the likely sequencing of policy priorities, which lend support to the case for economic policy continuity early on, in our view. The election results yielded a concentration of power to an extent that Mexico has not seen in decades. Several initiatives that the incoming administration seems to be considering – some of which may be presented to congress in the current session that began September 1 – appear aimed at providing the executive with tools to further consolidate its ability to direct policy by removing existing barriers. These may include plans to amend the rules regulating referenda to remove current limits to their scope – issues that may impact fiscal accounts or electoral laws, for example, are unconstitutional – and to their timing (currently, they have to be held in conjunction with elections). The creation of new posts of state coordinators – who will act as liaisons between the federal and state governments, replacing current federal delegates – may expand the executive's influence since these new officials may have oversight over social programs and possibly transfers to states. In Mexico, states – most of which are controlled by opposition governors – raise very little revenue of their own (roughly one-tenth of their total spending), thus relying overwhelmingly on transfers from the federal government. Congress is already discussing a motion that would strip public servants of immunity and may push for classifying corruption as a "severe" crime (no right to freedom on bail), without yet advancing pending initiatives to strengthen the autonomy of the office of the attorney general, for example.

With such political initiatives likely to remain a priority early in the six-year term, we suspect that any major shifts to the economic policy direction could take a backseat. Congress has made rapid progress with austerity measures, such as capping salaries and benefits of public servants, for example, but many of the other probable initiatives that the incoming administration has hinted at advancing, either now or after December 1, could require constitutional amendments. While a strong mandate likely allows room to pass such constitutional changes, the process tends to be more lengthy as it requires additional steps vis-à-vis other proposals. For example, education reform took nine months to approve (including the enabling laws), whereas the energy reform took a full year. During this period at least, our sense is that the fiscal policy stance is likely to remain largely inertial, meaning without major deviations from the conservative path presented in the preliminary guidelines, including a stable deficit and a primary surplus. And areas such as energy may be subordinate to the finance ministry – in close coordination, as has been the case since 2016 – whose prospective members have highlighted their intention to maintain a prudent fiscal stance.

Exhibit 7: Mexico: Consumer Confidence - Country Outlook (seasonally adjusted, Jan/2003 = 100)



Source: INEGI, Morgan Stanley Latam Economics

Ultimately, the incoming administration will be judged by its ability to address Mexico's most pressing challenges, principally shortcomings with the rule of law, public security, and delivering more inclusive growth – all of which were issues that ranked highly with voters. The population has high expectations, as shown by the historic post-election gain in how Mexicans see the future outlook for the country (see Exhibit 7). Whether the apparent move to centralize power represents a step towards more forceful efforts to tackle these shortcomings remains to be seen. Successfully addressing these challenges likely requires building stronger institutions and tackling barriers that hinder productivity, objectives that would be well served by preserving the main pillars of Mexico's investment narrative – trade openness, an independent central bank, prudent fiscal policy, and allowing reforms, such as energy, to advance. At least during the early period of the term, when political initiatives should be the focus of policymakers, and possibly beyond, we see scope for these pillars to remain in place.

Bottom Line

Halfway through the government transition period, there seems to be growing optimism among Mexico watchers regarding the prospects for policy continuity. The main driver of this improved sentiment has been the incoming administration's softening of its tone on several of the more unorthodox aspects of its campaign platform. Against this backdrop, more Mexico watchers have been questioning the extent and durability of this more pragmatic stance. While the situation remains fluid, we argue that understanding the sequencing of policy priorities supports the case for continuity at least during the early part of the six-year term. Policymakers' priority seems to be pushing initiatives to further consolidate the executive's ability to dictate policy; during this period, which may extend beyond next year, any major shifts to the economic policy direction are likely to take a backseat, thus ensuring that the pillars of Mexico's investment narrative remain largely intact.

O Que Aconteceu? / ¿Qué Pasó?

Recent Economic Releases (Sep 14 - Sep 20)

Argentina

GDP (2Q)
Actual: -4.2% y-o-y; Consensus: -4.2% y-o-y

Activity sank 4.0% q-o-q, the strongest contraction since late 2008, thanks to the impact from the drought which led to a 14.2% q-o-q fall on export volumes. Broader set of figures also discouraging such as investment (-6.9% q-o-q) and private consumption (-1.1%) as confidence crisis starts to take toll on growth.

Unemployment Rate (2Q)
Actual: 9.6%; Consensus: 9.0%

Unemployment rose by 0.9 pp. versus same period a year ago and touched the highest level since current administration took office. The occupation rate shrank at the margin but still remains above levels seen a year ago (41.9% in 2Q2018 versus 41.5% in 2Q2017), but underemployment began rising.

Budget Balance (August)
Actual: -Ar$ 10.4 billion ; Consensus: n/a

Fiscal adjustment on track: revenues (+32.3% y-o-y) grew in line with inflation in period while primary spending (+20.8% y-o-y) is adjusting on the back of further cuts in the capex (+2.1% y-o-y) and opex (+14.1%) bills. YTD primary deficit at -0.9% of GDP, half the 1.8% level seen in same period a year ago.

Brazil

Monetary Policy Meeting
Actual: 6.50%; Consensus: 6.50%

In a hawkish tone, the central bank decided to keep rates unchanged at 6.50%. The monetary authority recognizes that if the currency stays at weak levels, following the election results, and this moves inflation expectations for 2019, they would be ready to hike rates.

GDP Proxy (IBC-Br) (July)
Actual: 2.6% y-o-y; Consensus: 1.9% y-o-y

Despite all coincident indicators contraction in July, GDP Proxy increased sequentially by 0.6% m-o-m. Industrial production (-0.2%), broad retail sales (-0.4%) and services sector (-2.2%) deteriorated and only agriculture edge up (0.3%). This number comes on the back of the recovery from the truckers' strike.

IGP-10 - FGV (September)
Actual: 1.20% m-o-m; Consensus: 0.77% m-o-m

IGP-10 accelerated to 1.20% m-o-m from 0.51% last month. Upward pressures came from agriculture wholesale prices (2.23% from 0.42%), due to the recent FX depreciation and air fares tariffs (+20.93% from -14.78%). On the opposite direction, electricity tariffs prices decelerated by 0.53% from +3.57%.

Colombia

Industrial Production (July)
Actual: 3.5% y-o-y; Consensus: 2.9% y-o-y

Manufacturing posted shy +0.2% sequential bounce – leaving output at the start of 3Q largely unchanged versus the 2Q average. Roughly three-fourths of sub-sectors (29 out of 39) posted positive annual growth, the same ratio seen throughout the prior quarter.

Retail Sales (July)
Actual: 3.2% y-o-y; Consensus: 5.5% y-o-y

Pace of annual growth moderated at the start of 3Q – second quarter ran at a strong 6.2% clip – yet growth remains broad with 12 in 16 product classes posting positive annual growth. Main drivers remain the food and auto sectors, likely benefitting from encouraging price trends in their respective categories.

Consumer Confidence (August)
Actual: 4.7; Consensus: 9.0

Sentiment keeps losing steam down 5.1 points at the margin (and -10.8 since June peak) driven by losses on expectations component (9.4), likely related to wearing off of post-electoral optimism. Important to watch for signs of deceleration on consumer front.

Trade Balance (July)
Actual: -$558 million; Consensus: -$600 million

Trade adjustment likely ran its course, rising by $96 million versus year ago. Energy segment keeps driving export growth – up 16.2% y-o-y lifted by oil's 45.8% y-o-y expansion – with lackluster performance elsewhere; imports rising across the board (+15.9% y-o-y) posting double-digit growth on all classes.

Mexico

GDP - Supply and Demand (2Q)
Actual: 4.0% y-o-y; Consensus: 3.4% y-o-y

The economy contracted -0.2% from first-quarter levels dragged by a drop in fixed investment (-0.7%) – both private and public and outlays shifted lower – and a surprising stagnation in private consumption (-0.1%). Exports the bright spot (+2.3%), posting strong gains for the third straight quarter.

Peru

GDP (July)
Actual: 2.3% y-o-y; Consensus: 2.3% y-o-y

Activity contracted sequentially for second straight month, wiping out near half the gains enjoyed during the period of surprisingly strong growth of March-May. Most downside came from fishing and mining; non-commodity sectors holding up better staying near flat in past two months.

Unemployment Rate (August)
Actual: 6.1%; Consensus: 6.1%

Seasonally-adjusted unemployment rate holding up slightly above 6.0%, the lowest level since late 2014. August jobs moved slightly lower (off -0.4% sequential), but last month's dip comes after very strong gains over the past half year that brought overall employment levels to near historic highs.

Source: Government data, Morgan Stanley Latam Economics

What's Next? – Upcoming Data Releases (Sep 21 - Sep 28)

Friday, Sep 21

	MS Forecast/ Consensus	Last[2]
Brazil		
CAGED - Formal Job Creation (August)[1]	n/a n/a	47,319
IPCA-15 (September) (See Exhibit 8)	0.15% m-o-m 0.18% m-o-m	0.13% m-o-m
Tax Collections (August)	n/a n/a	R$ 129.6 billion
Colombia		
Economic Activity Index (July) (SeeExhibit 9)	n/a 3.0% y-o-y	2.9% y-o-y
Mexico		
Retail Sales - INEGI (July)	n/a 2.8% y-o-y	3.7% y-o-y

Monday, Sep 24

	MS Forecast/ Consensus	Last[2]
Brazil		
FGV - Consumer Confidence (September)	n/a n/a	83.8
Current Account Balance (August) (see Exhibit 10)	-$1.7 billion n/a	-$4.4 billion
Chile		
Monetary Policy Minutes (see Exhibit 11)	n/a n/a	n/a
Mexico		
CPI (1H September) (See Exhibit 12)	0.32% 1H/2H 0.35% 1H/2H	0.30% 2H/1H

Tuesday, Sep 25

	MS Forecast/ Consensus	Last[2]
Brazil		
Monetary Policy Minutes (See Exhibit 13)	n/a n/a	n/a
CPI-FIPE (Third Preview) (Aug 23 - Sep 22)	n/a n/a	0.30 m-o-m
Mexico		
IGAE (July) (See Exhibit 14)	2.6% y-o-y n/a	1.1% y-o-y

Wednesday, Sep 26

	MS Forecast/ Consensus	Last[2]
Argentina		
Economic Activity Index (EMAE) (July) (See Exhibit 15)	n/a n/a	-6.7% y-o-y
Trade Balance (August)	n/a n/a	-$789 million
Brazil		
Credit Indicators (August)	n/a n/a	n/a
Chile		
Retail Sales - CNC (August)	n/a n/a	-2.2% y-o-y
Mexico		
Unemployment Rate (August)	3.6% n/a	3.5%

Thursday, Sep 27

	MS Forecast/ Consensus	Last[2]
Argentina		
Consumer Confidence (September)	n/a n/a	36.25
Balance of Payments (2Q) (See Exhibit 16)	-$9.0 billion n/a	-$9.6 billion
Brazil		
FGV - Business Confidence (September)	n/a n/a	99.7
IGP-M (Final) (September)	n/a n/a	0.70% m-o-m
Inflation Report (3Q) (See Exhibit 17)	n/a n/a	n/a
Mexico		
Trade Balance (August)	n/a n/a	-$2.9 billion

Friday, Sep 28

	MS Forecast/ Consensus	Last[2]
Brazil		
National Unemployment Rate (August) (See Exhibit 18)	12.2% n/a	12.3%
Primary Budget Balance (August) (See Exhibit 19)	-R$ 25.6 billion n/a	-R$ 3.4 billion
Chile		
Unemployment Rate (August) (See Exhibit 20)	7.1% n/a	7.3%
Manufacturing Output (August)	2.9% y-o-y n/a	-1.4% y-o-y
Mining Output (August)	n/a n/a	-2.5% y-o-y
Colombia		
Monetary Policy Meeting (See Exhibit 21)	4.25% 4.25%	4.25%
Urban Unemployment Rate (August)	n/a n/a	10.1%
Mexico		
Bank Credit to the Private Sector (Real) (August)	n/a n/a	7.0% y-o-y
Tax Revenues (Real) (August) (See Exhibit 22)	n/a n/a	3.6% y-o-y

n/a = not available or not applicable

[1] Earliest possible release date

[2] *Last* denotes last published data by a non-Morgan Stanley source.

Source: Morgan Stanley Latam Economics estimates

On the Horizon

	AR	BR	CL	CO	MX	PE	VE	Region**
Real GDP growth (%)								
2015	2.7%	-3.8%	2.3%	3.1%	3.3%	3.3%	-6.2%	0.2%
2016	-2.2%	-3.6%	1.3%	2.0%	2.9%	3.9%	-16.5%	-0.4%
2017	2.9%	1.0%	1.5%	1.8%	2.0%	2.5%	-15.6%	1.7%
2018E	-2.3%	1.5%	3.7%	2.5%	2.0%	3.3%	-15.8%	1.5%
2019E	0.1%	2.1%	3.3%	3.0%	2.3%	3.4%	-12.4%	2.2%
Inflation (year-end, %)								
2015	26.9%	10.7%	4.4%	6.8%	2.1%	4.4%	181%	9.1%
2016	39.3%	6.3%	2.7%	5.7%	3.4%	3.2%	482%	8.7%
2017	24.8%	2.9%	1.9%	4.1%	6.8%	1.4%	1829%	6.5%
2018E	41.4%	4.3%	2.6%	3.2%	4.0%	2.0%	857604%	8.1%
2019E	24.4%	4.6%	3.0%	3.3%	3.3%	2.6%	26266146%	6.1%
FX rate (year-end vs. US$)								
2015	12.94	3.90	707	3149	17.21	3.41	6.3	
2016	15.87	3.15	667	3001	20.73	3.35	n/a	
2017	18.60	3.31	615	2984	19.64	3.24	n/a	
2018E	44.00*	3.90*	630*	3000*	20.50*	3.26*	n/a	
2019E	48.00*	3.40*	555*	2740*	18.00*	3.15*	n/a	
Current account balance (% GDP)								
2015	-2.7%	-3.4%	-1.9%	-6.4%	-2.5%	-4.8%	n/a	-3.3%
2016	-2.7%	-1.3%	-1.4%	-4.4%	-2.1%	-2.7%	n/a	-2.0%
2017	-4.8%	-0.5%	-1.5%	-3.4%	-1.6%	-1.9%	n/a	-1.7%
2018E	-5.7%	-0.8%	-1.6%	-2.9%	-1.8%	-0.9%	n/a	-1.9%
2019E	-2.6%	-1.3%	-1.9%	-2.9%	-2.1%	-1.0%	n/a	-1.8%
Trade balance (US$ bn)								
2015	-3.0	19.7	3.5	-18.1	-14.7	-2.9	6.2	-9.4
2016E	2.0	47.7	5.4	-13.5	-13.1	1.9	6.6	36.9
2017	-8.5	67.0	7.9	-8.3	-10.9	6.5	21.0	74.7
2018E	-8.2	61.0	6.9	-3.8	-12.3	5.2	10.8	59.6
2019E	-6.3	52.0	3.7	-4.5	-18.6	4.0	14.9	45.2
Interest rate (year-end)								
2015	33.00%	14.25%	3.50%	5.75%	3.25%	3.75%	n/a	
2016	24.75%	13.75%	3.50%	7.50%	5.75%	4.25%	n/a	
2017	28.75%	7.00%	2.50%	4.75%	7.25%	3.25%	n/a	
2018E	60.00%	6.50%	2.50%	4.25%	7.75%	2.50%	n/a	
2019E	34.00%	7.50%	3.50%	5.00%	6.00%	3.50%	n/a	
International reserves (US$ bn)								
2015	25.6	356.5	38.6	46.7	176.7	61.5	16.4	722.0
2016	39.3	365.0	40.5	46.7	176.5	61.7	11.0	740.8
2017	55.1	374.0	39.0	47.6	172.8	65.0	9.5	762.9
2018E	62.6	375.0	38.0	48.0	170.0	65.0	9.3	767.9
2019E	68.0	375.0	38.0	48.1	170.0	65.0	9.1	773.2
Public sector balance (% GDP)								
2015	-5.2%	-10.4%	-2.2%	-3.1%	-3.4%	-2.1%	n/a	-6.3%
2016	-5.9%	-9.0%	-2.7%	-3.8%	-2.5%	-2.6%	n/a	-5.6%
2017	-6.1%	-7.8%	-2.8%	-3.6%	-1.1%	-3.1%	n/a	-4.7%
2018E	-5.5%	-7.5%	-2.1%	-3.1%	-2.0%	-3.6%	n/a	-4.7%
2019E	-3.3%	-6.9%	-1.9%	-2.6%	-2.2%	-3.3%	n/a	-4.2%

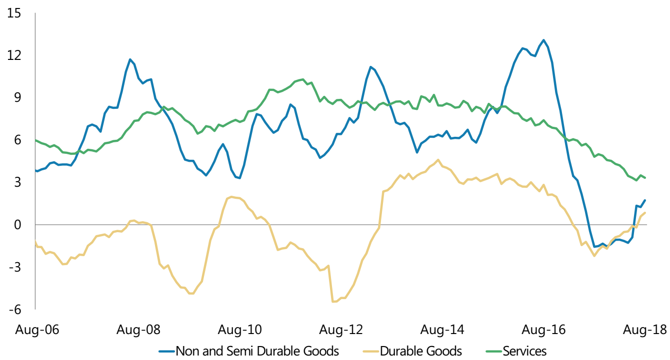
E = Morgan Stanley Forecast

Source: Morgan Stanley Research, *FX Strategy Team, Updated forecasts in bold, **Regional inflation and GDP figures exclude Venezuela

What's Next? – A Closer Look

Friday, Sep 21

Exhibit 8: Brazil: Goods and Services Inflation (% change y-o-y)



Source: IBGE, Morgan Stanley Latam Economics

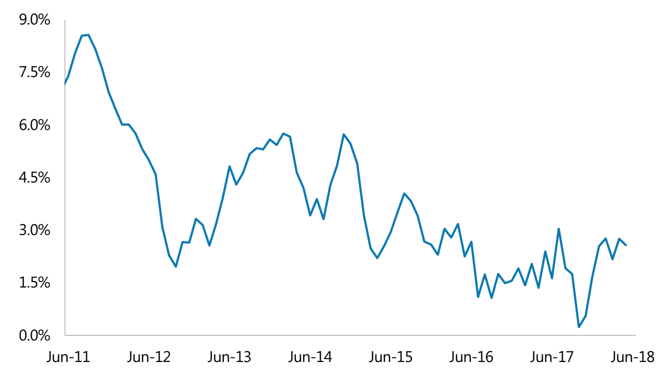
Brazil's September IPCA-15

Morgan Stanley Forecast: 0.15% m-o-m; Consensus: 0.18% m-o-m

- Inflation up to mid-September should accelerate compared to August' print (-0.09%). Two opposite vectors should roughly offset each other. On one hand, fuel prices should continue to normalize after the truck drivers' strike and air fares should pick up. On the other hand, food inflation is likely to keep its deflationary trend.

- Looking ahead, we will look for signs of whether the recent FX depreciation will generate enough second round effects on inflation to worry the Central Bank and potentially increase risks around our baseline scenario of no rate hikes this year. With services inflation maintaining its gradually decelerating trend, we haven`t seen many signs of second round effects so far. But if the currency depreciation generates expectations de-anchoring we believe that the central bank could eventually hike rates this year.

Exhibit 9: Colombia: Economic Activity Index (3mma, % change y-o-y)



Source: DANE, Morgan Stanley Latam Economics

Colombia's July Economic Activity Index

Morgan Stanley Forecast: n/a; Consensus: 3.0% y-o-y

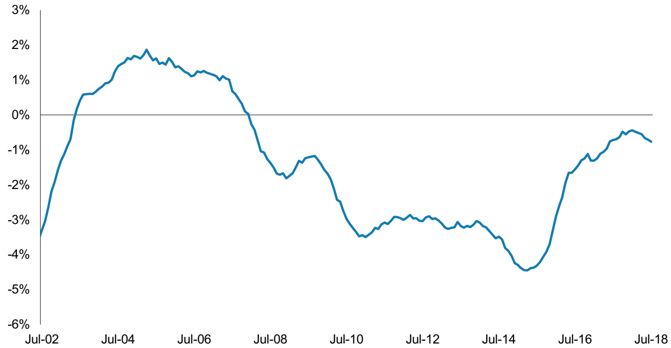
- High frequency data so far into July has been mixed: a solid labor market report is overshadowed by lackluster performance on exports beyond the positive price effect within the energy segment; cement shipments, meanwhile, kept struggling – signaling construction activity remains sub-par – while sentiment indicators have shifted lower at the margin but still hold up at optimistic levels.

- A broader look at Colombia's recent growth trends points to a consumption-led growth profile. Investment growth remains flat so far this year on weak construction activity and muted machinery & equipment growth despite higher oil prices; private consumption, meanwhile, has been growing at a moderate 2.9% annualized clip in the first half of the year mostly on strength in the services segment.

- Contingent on continuity of positive momentum on the consumer front – data so far supports this trend – we could see a slight pickup on growth ahead as oil-related investments pick up and the infrastructure agenda advances.

Monday, Sep 24

Exhibit 10: Brazil: Current Account Balance (12-month sum, as % of GDP)



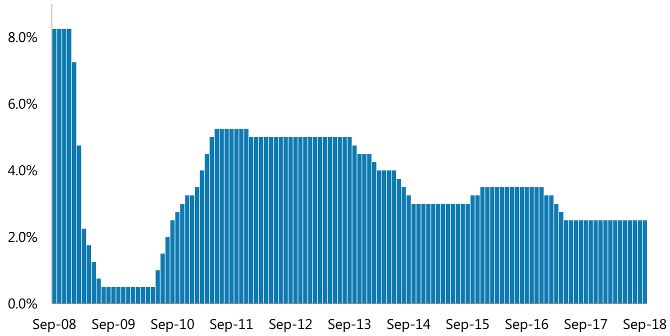
Source: BCB, Morgan Stanley Latam Economics

Brazil's August Current Account Balance
Morgan Stanley Forecast: -$1.7 billion; Consensus: n/a

- In August, the 12-month-sum Current Account Deficit should widen to 0.8% of GDP. However, this negative print would come as a consequence of a less favorable trade balance, which was impacted by oil platforms imports. On the following months, we believe the weaker currency will reverse this trend.

- FDI should increase in the last 12 months to close to $69 billion (from $64 billion), which is more than enough to finance the small current account deficit. In fact, the external sector does not represent sources of concern, at this point.

Exhibit 11: Chile: Central Bank Target Rate (annual rate)



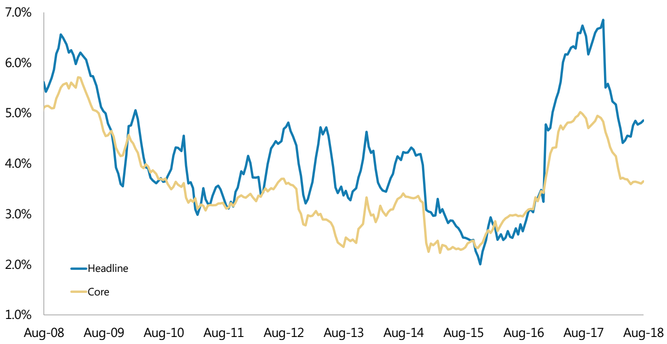
Source: BCCh

Chile's Monetary Policy Minutes
Morgan Stanley Forecast: n/a; Consensus: n/a

- The statement of the early September meeting, and the subsequent Monetary Policy Report (IPoM), showed a hawkish shift in policymakers' assessment of the economy and inflation, indicating that there seem to be conditions for rate hikes to start "in coming months." That contrasts with the previous, more open-ended tone that stressed the need for more information before considering tightening.

- The minutes will be important to gauge the degree of confidence with the new guidance and if "in coming months" involves a potential move in October or, as in the previous guidance, a December hike – swap markets are now pricing in quarter-point adjustments in October and December. Part of policymakers' more hawkish guidance, we suspect, was in response to external uncertainty and the peso's sell-off; accordingly, unless external funding conditions deteriorate further, we think that swaps pricing is overly aggressive as the minutes may show that an October hike is far from certain.

Exhibit 12: Mexico: Headline and Core Inflation (% change y-o-y, semi-monthly index)



Source: INEGI

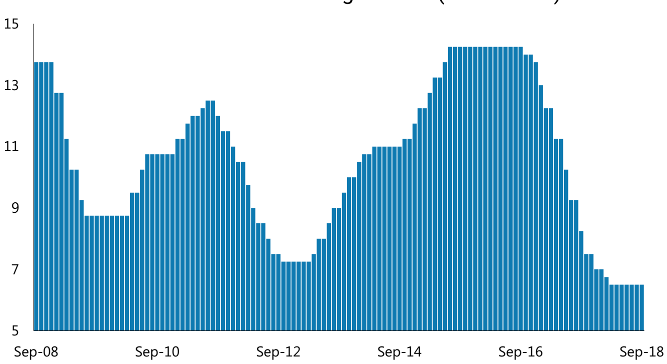
Mexico's 1H September CPI
Morgan Stanley Forecast: 0.32% 1H/2H; Consensus: 0.35% 1H/2H

- Inflation has surprised to the upside since May led by energy prices – which jumped 5.6% in the past three months – pushing the annual rate of headline inflation up to 4.90% in August, a trend that we expect to continue into September when the index should move slightly above the 5.0% mark for the first time since March.

- Absent renewed pressure from either energy costs or volatile produce prices, September should mark the peak for headline inflation, after which it seems poised to gradually shift lower into yearend.

Tuesday, Sep 25

Exhibit 13: Brazil: Central Bank Target Rates (annual rate)



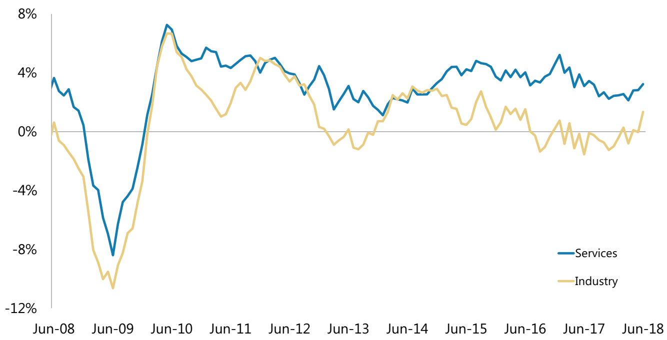
Source: BCB

Brazil's Monetary Policy Minutes
Morgan Stanley Forecast: n/a; Consensus: n/a

- We believe the minutes will keep the tone from the central bank statement, which was a hawkish tilt by the BCB. Policymakers should continue to highlight that if the currency stays at weak levels, following the election results, and this moves inflation expectations for 2019, they would be ready to hike rates.

- They should also signal a gradual removal, which is historically associated with small hikes, as they do not foresee an inflationary outlook that would require an aggressive hike. But depending on the degree of weakens on the currency we believe they could hike as much as 75 basis points on the next meeting.

Exhibit 14: Mexico: Services and Industry GDP (% change y-o-y)



Source: INEGI

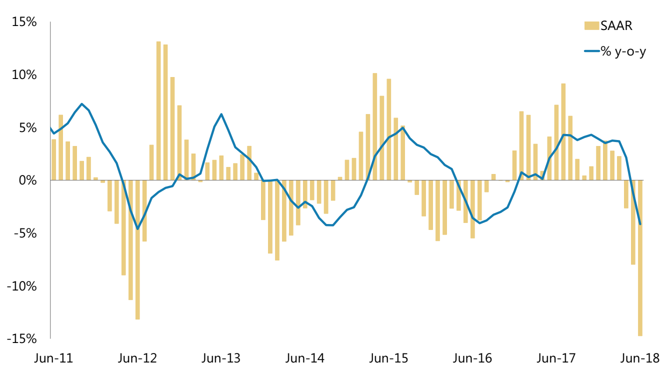
Mexico's July IGAE
Morgan Stanley Forecast: 2.6% y-o-y; Consensus: n/a

- After a strong start to the year, economic activity hit a speed bump in the second quarter contracting at a -0.2% sequential pace. Was the recent weakness just a temporary dip or the start of a more prolonged downshift? We suspect the former and activity seems poised to normalize in the third quarter.

- July's IGAE is likely to post a solid sequential gain, paving the way for a stronger third quarter. For example, industrial output rose 0.2% sequential in July led by a jump in construction, a sector whose weakness played an important role in the second-quarter GDP drop (see "Mexico: Soft Patch or Inflection Point?" in *Week Ahead in Latin America*, August 24, 2018).

Wednesday, Sep 26

Exhibit 15: Argentina: Economic Activity Index (% change)



Source: INDEC

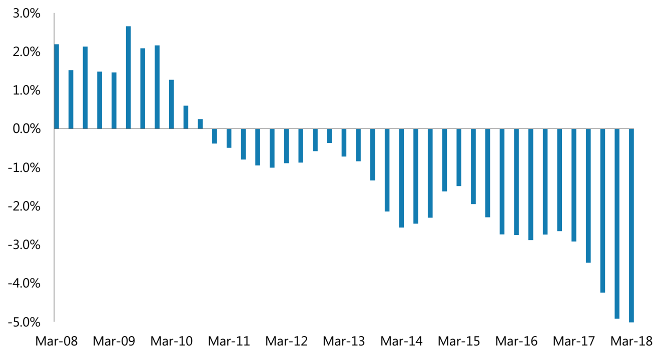
Argentina's July Economic Activity Index (EMAE)
Morgan Stanley Forecast: n/a; Consensus: n/a

- We expect activity to post a meaningful sequential bounce at the margin as, similar to the past two droughts in the country, the impact of the drought wears off in seasonally adjusted figures (see: "Argentina 2.0: Upside and Risks," August 1, 2018)

- Nevertheless, growth should remain subdued into this year and next given the confidence crisis, a very tight monetary policy stance and the swift fiscal adjustment proposed for next year. The economy should only exit the recessionary territory in 2Q2019 on the back of normalization in the upcoming agricultural harvest coupled with prospects for a more stable macro backdrop (see: "Argentina: What You Need to Know Ahead of the Adjustment," September 6, 2018).

Thursday, Sep 27

Exhibit 16: Argentina: Current Account Balance (4Q rolling, as % of GDP)



Source: INDEC

Argentina's 2Q Balance of Payments

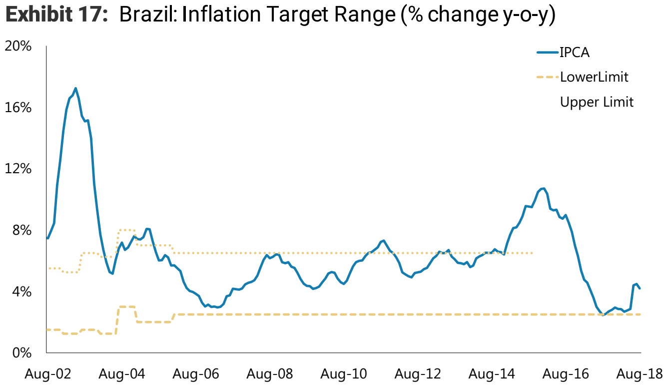
Morgan Stanley Forecast: -8.9 billion (C/A); Consensus: n/a

- The second quarter Balance of Payments report is likely to keep portraying a widening current account deficit, as the external adjustment only began towards the end of the reference period. Goods trade figures were hurt by the drought while high frequency data suggests that services narrowed mildly and the income account kept widening on the back of rising interest payments.

- Going forward, we expect a swift adjustment on the current account given the much weaker REER – back to levels last seen in 2011 – which should trim goods imports and services outflows materially as well as upside from exports into next year as agricultural output normalizes and industrial exports benefit from a gradual recovery in Brazil. Indeed, we have already begun seeing signs of adjusting external accounts, such as the tourism balance into July and falling imports of goods at the margin.

- We see the current account deficit closing next year close to the US$10 billion handle (2.6%GDP), a meaningful adjustment from the US$31 billion level (5.0%GDP) seen in 2017. The current account correction and stabilization of the macro backdrop should mean that financial account inflows, even if reduced, should suffice to keep the currency from depreciating much further and stop the ongoing drainage of reserves.

Exhibit 17: Brazil: Inflation Target Range (% change y-o-y)



Source: IBGE, BCB

Brazil's 3Q Inflation Report

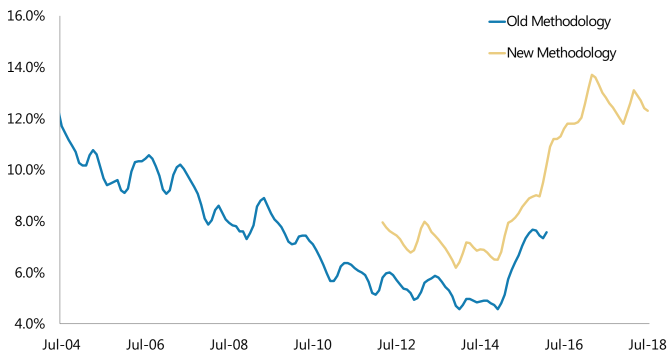
Morgan Stanley Forecast: n/a; Consensus: n/a

- The central bank should show its inflation forecasts, given the new FX level and 2019 inflation expectation should stay above the 4.25% target. In case the expectations move far beyond the target, depending on how the currency behaves after the elections, this could trigger a rate hike.

- In our recent report we explore different scenarios for FX and rates on different policy choices by the future president (see here), where we believe that if the currency breaches 4.70 a 75 bps hikes could be needed.

Friday, Sep 28

Exhibit 18: Brazil: National Unemployment Rate (%)

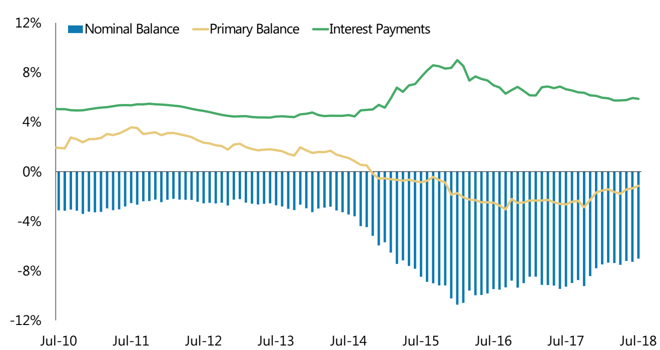


Source: IBGE

Brazil's August National Unemployment Rate
Morgan Stanley Forecast: 12.2%; Consensus: n/a

- Compared to same quarter of 2017, we believe unemployment rate will be 0.4 p.p. lower decreasing to 12.2%. Once seasonally adjusted, we expect unemployment to remain roughly stable around 12.2%. The bulk of this better number is due to informal jobs. Formal job creation should continue to post positive numbers, but admissions have decreased over the past months. Regarding real wages, they should grow as a consequence of the payback seen on August inflation from the trucker's strike.
- Additionally, uncertainty regarding the elections have been hitting consumer and business sentiment, hence possibly impacting the labor market.

Exhibit 19: Brazil: Fiscal Balance (12-month sum, as % of GDP)

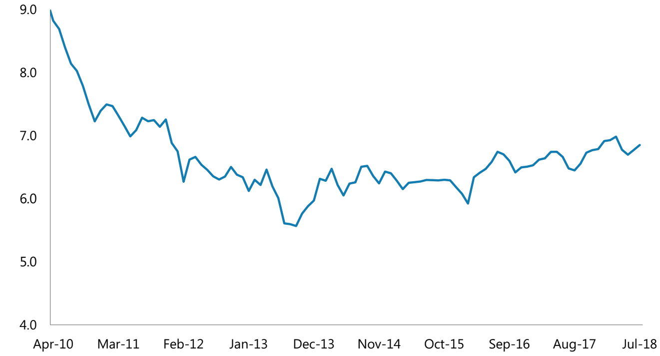


**Excludes Petrobras Capitalization*
Source: BCB, Morgan Stanley Latam Economics

Brazil's August Primary Budget Balance
Morgan Stanley Forecast: -R$ 25.6 billion; Consensus: n/a

- Primary Balance should post yet another deficit in August, mainly as a result of pressures on the expenditure side, as salary bonuses and social security spending are likely to increase in the central government, highlighting Brazil's main fiscal issue. Despite that, we expect regional governments and SOEs to deliver a surplus.
- For the remainder of the year, we believe the government will be able to deliver its target of R$ 159 billion deficit for 2018 with ease. However, the need of a deeper fiscal adjustment is becoming ever more pressing, and will certainly be one of the next administration's main challenges (see "Brazil: Beyond the Elections", in *Looking Back to Look Ahead: A Defining Vote*, September 4, 2018).

Exhibit 20: Chile: Unemployment Rate (seasonally adjusted, 3mma, % of labor force)



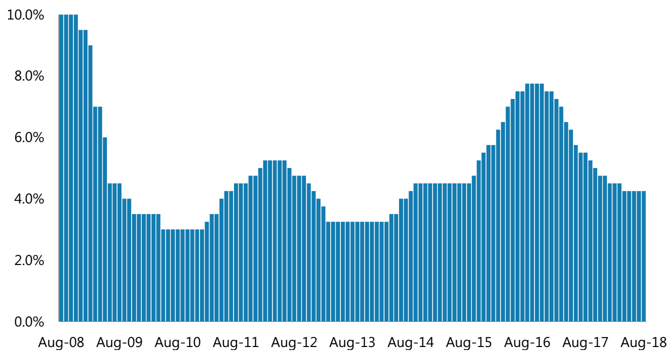
Source: INE, Morgan Stanley Latam Economics

Chile's August Unemployment Rate

Morgan Stanley Forecast: 7.1%; Consensus: n/a

- Job markets have been lagging the strong performance of the broader economy: the July release put unemployment at the highest in five months (6.9%) and job creation running at the slowest annual pace in nearly a year and a half (1.4%).
- Aggregate numbers, however, mask some positive news: salaried workers are outperforming (up 2.3%) and though the public sector job growth is still leading, private hiring is gaining ground as well.

Exhibit 21: Colombia: Central Bank Target Rate (annual rate)



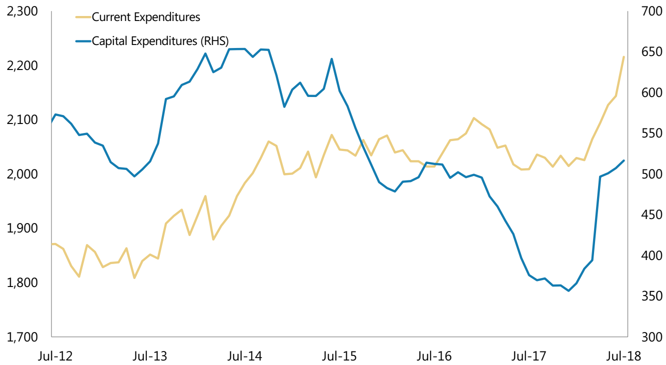
Source: BanRep

Colombia's Monetary Policy Meeting

Morgan Stanley Forecast: 4.25%; Consensus: 4.25%

- We expect BanRep to remain on-hold for a prolonged period. While domestic inflation remains well-behaved – signs of pass-through from the weaker FX thus far have been scant – and activity continues running below potential, a more adverse backdrop for emerging markets does not favor easing, particularly in countries with relatively elevated external exposure such as Colombia (see: "EM Strategy: EM Technical Watch: A Tricky Set-up into September," August 28, 2018).
- Looking ahead, we expect policymakers to begin tightening policy – it is currently in slightly expansionary territory – and bring the policy stance back to neutral as activity gains traction into 2019: our call is for rate hikes to begin in the second half of next year and rise by 75bps to the 5.00% level by the end of the year.

Exhibit 22: Mexico: Real Public Sector Expenditures (6mma, seasonally adjusted, M$ billion)



Source: SHCP, Morgan Stanley Latam Economics

Mexico's August Tax Revenues (Real) Morgan Stanley Forecast: n/a; Consensus: n/a

- Above-budget revenues so far this year, which are running nearly 1.8% of GDP above estimates thanks to higher oil prices and non-oil receipts as well, make fiscal targets – a primary surplus of 0.8% of GDP – quite achievable.

- While the 2019 budget could be submitted to congress as late as mid-December, comments by members of the incoming administration point to a largely inertial package that will closely resemble the preliminary version – that included a primary surplus of 0.9% of GDP and overall deficit of -2.5% of GDP, both very close to the 2018 targets – unveiled in March of this year by the current administration.

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