Vanguard

Expert Perspective

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Latin America Quarterly Overview & Outlook

Commentary by:
Ignacio Saralegui, Senior Investment Strategist, Vanguard Latin America
Bárbara Grande, Investment Strategist Analyst, Vanguard Latin America

Introduction

The uncertainty surrounding the consequences of the pandemic and the war in Eastern Europe, the economic environment in the United States and high levels of global inflation have all contributed to the deterioration of the outlook for global growth and an aggressive Monetary Policy around the world particularly in Latin America.

Latin America

Growth

For emerging markets, we remain below consensus on full-year 2022 economic growth with an estimate of about 3%; for Latin America the consensus is 3% growth in the year. The primary headwinds faced by emerging economies are widespread central bank tightening and the simultaneous slowing of growth in the United States, the euro area, and China.

In Mexico, we continue to forecast 2% growth for the year—a call that was well below consensus and to which the consensus has converged over the course of this year. We believe Mexico will continue its post-pandemic recovery this year at a more moderate pace, mainly because of the US slowdown.

The main risks ahead for Mexico are: (1) Lower global growth particularly from the US -main trading partner- join by a risk of lower external demand, historical Mexican economy driver. (2) The prolongation of inflationary pressures and therefore the tightening of financial conditions in the US. (3) With winter approaching, the risk of more than expected effects of geopolitical tensions or the global pandemic that could intensify the effects on trade and supply chain problems.

For Brazil, the extraordinary fiscal stimulus and tax cuts can be seen as forces supporting a consensus growth 1.7% for 2022 despite tightening financial conditions in the country. Risks to the downside for growth are centered on the lagged effects of the steeped rate hikes and the expiration of some of the fiscal stimulus by the end of the year.

Inflation

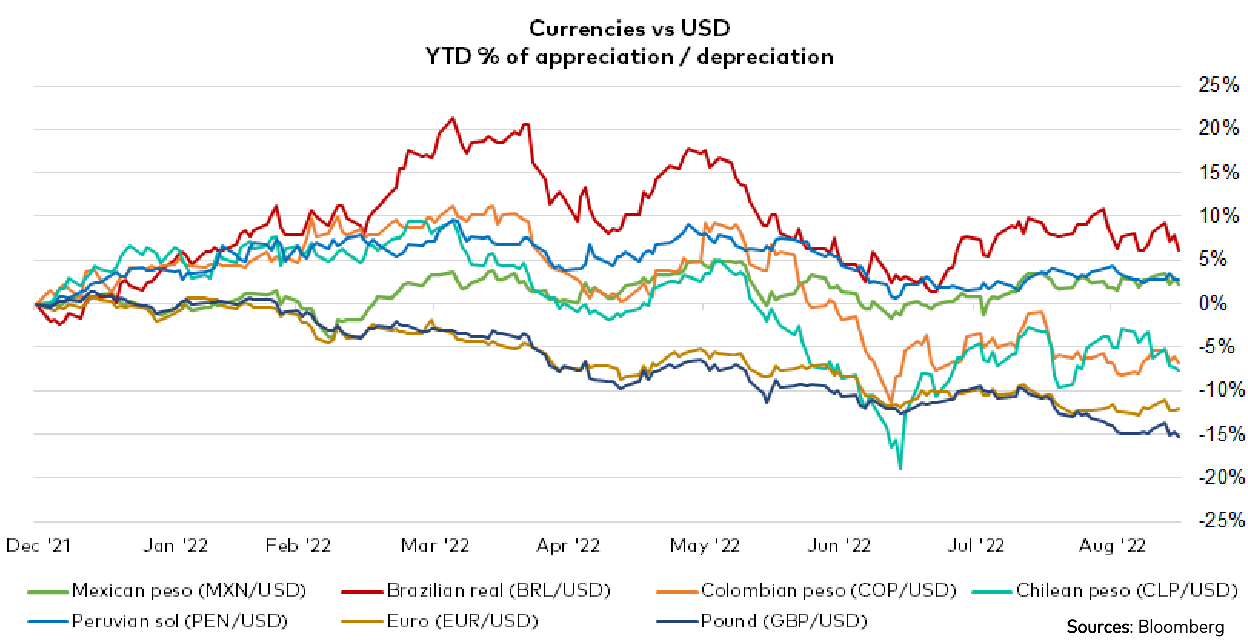
Inflation in Latin America and globally continues to face a complex environment with deeper than expected shocks reaching levels not seen in more than two decades. This situation is mainly an imbalance between supply and demand, in which supply has not been able to adjust quickly to demand. Going forward, there are signs that inflation has peaked across emerging markets with core measures falling for two consecutive months across regional averages.

Inflation in Mexico continued to rise during the third quarter with inflation in the first half of September at 8.76%, slightly higher than market expectations and following the uptrend core inflation. In Brazil inflation peaked at 12.1% in April this year and by the end of August, the level dropped to 8.7%. A high policy interest rate driven by unanchored inflation expectations in the country might pose a challenge to achieve the 3.5% target inflation by the central bank in the near future.

Currencies

Despite a strengthening of the dollar against many advanced and emerging market currencies, the Mexican peso remained stable mainly because of appropriate monetary policy helped by flows driven by (1) tourism and (2) the open economy during COVID lockdown.

The Mexican Peso closed the third quarter of 2022 at 20.1 MXN/USD, fluctuating between 20.9 MXN/USD and 19.8 MXN/USD. For Vanguard, Mexican peso looks overvalued versus its peers, we continue to expect the currency to depreciate by 4% in 2022, ending the year at 21.5 MXN/USD. The Brazilian Real closed the third quarter at 5.4 BRL/USD, after starting the year at 5.6 and hitting a low of 4.6 by April. Consensus forecast a level of 5.3 by the end of the year.

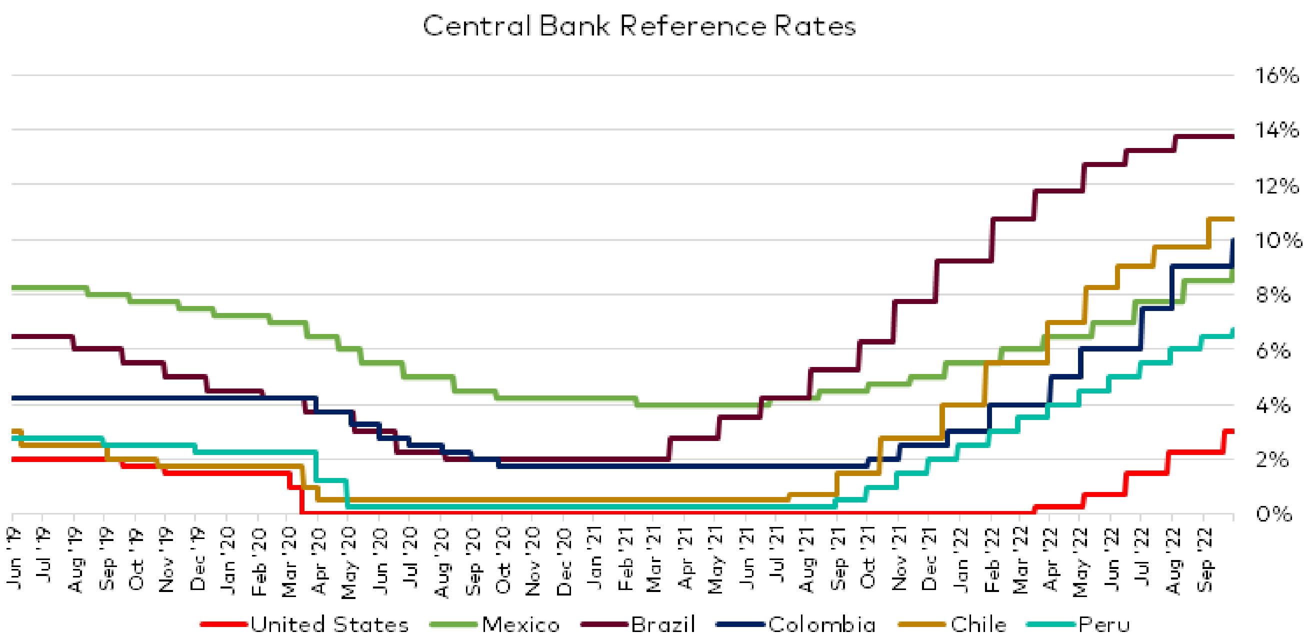


Monetary Policy

Central banks in several emerging markets have raised their rates, some of them more aggressively than expected in the face of the very complex situation. Banco de México was no exception, so far in 2022 it raised its interest rate six times, reaching +375 basis points to a target rate of 9.25%, up from 5.5% at the beginning of the year.

In the two monetary policy announcements remaining in 2022, Banco de México is likely to continue increasing interest rates matching the Federal Reserve's interest-rate path (1) to anchor inflation expectations, which remain under pressure from high inflation and (2) to maintain its spread with US rates while competing in attracting flows with other emerging economies. Going forward, it is probable that the change in the rate uptrend will be driven by a clear downtrend in consumer prices and not before.

The Central Bank of Brazil decided to hold the policy rate at 13.75% in September ending the most aggressive tightening cycle among major economies after a 11.75% increase since March 2021. The central bank signaled to additional rate hikes going forward if the disinflationary path does not proceed as expected.



Rest of the World

United States

Growth activity has stabilized through Q3; given the policy backdrop and purchasing power gap we expect the economy to grow no better than trend (1.8%) through the remainder of the 2022. We expect full-year 2022 U.S. economic growth in the 0.25%–0.50% range. Recession looks unlikely this year given the strength of the labor market. Our expectations for recession are essentially the same, with a 25% chance of a recession in 2022 and a 65% chance in 2023.

The exceptionally strong labor market recovery is on track for an unemployment rate slightly above 3% by year-end. Wage pressures are moderating but year-over-year wage growth remains on a 5% pace for the remainder of 2022. We expect average monthly job growth of 250,000 through the remainder of 2022.

We are more hawkish than consensus when it comes to U.S. monetary policy. We expect the Fed to continue ratcheting up rates until it reaches a range of 3.25% to 3.75% by the end of the year, and 4.25% by the second quarter of 2023. Rate cuts in 2023 are unlikely, given that wage inflation concerns, and energy prices are key risk factors. Persistent oil prices in the $130–$150 range would present significant cycle risks.

Euro Area

Vanguard still expects 2022 growth to be in the 2%–3% range, we have lowered our 2023 forecast to a range between –0.5% and 0.5%. In our case, Vanguard sees a 50% chance of euro area recession in the next 12 months, growing to 60% over the next 24 months. The impact of Russia cutting off the flow of natural gas through Nord Stream 1, which provides more than one-third of this commodity to Europe, will be uneven among countries.

China

We downgraded China's full-year GDP growth forecast to a range of 2.5%–3.5% (from our previous estimate of 3%–4%) based on data indicating a flagging economic recovery. Consumer spending was much lower than expected, indicating the adverse impact of zero-COVID policies, and falling property prices will continue to weigh on consumer confidence. Our full-year 2022 inflation forecast for China is 2.2%.

China has been a relative anomaly among economies, unscathed by spiking inflation. The trend will likely continue with inflationary pressure muted given two factors: Chinese economic activity that is slightly depressed and lower energy prices because China did not impose sanctions on Russian energy imports.

Investment Outlook

Our equity returns projections favor developed markets ex-US exposure in general for investors. We forecast that over the next 10 years, Mexican equities will return in the range of 6.7%–8.7% per year in MXN, with higher volatility than U.S. and global equities. Mexican sovereign bonds, meanwhile, are expected to offer a substantial return on average per annum over the next 10 years.

Future Expected Returns

Our 10-year annualized nominal return projections are as follows. Please note that the figures are based on a 1-point range around the 50th percentile of the distribution of return outcomes for equities and a 0.5-point range around the 50th percentile for fixed income.

MEXICAN PESO INVESTORS (in MXN)	RETURN PROJECTION	MEDIAN VOLATILITY
Mexican equities	**6.7%–8.7%**	29.3%
U.S. equities (unhedged)	**8.3%–10.3%**	24.9%
Global ex-U.S. developed market equities (unhedged)	**10.7%–12.7%**	24.8%
Mexican sovereign bonds	**10.4%–11.4%**	12.4%
Global bonds (MXN-hedged)	**9.2%–10.2%**	7.3%
BRAZILIAN REAL INVESTORS (in BRL)	**RETURN PROJECTION**	**MEDIAN VOLATILITY**
Brazil equities	**11.4%–13.4%**	36.6%
Global Equity ex-Brazil (unhedged)	**11.6%–13.6%**	35.2%
Brazil aggregate bonds	**11.8%–12.8%**	9.2%
Global bonds (BRL-hedged)	**12.8%–13.8%**	5.3%

U.S. DOLLAR INVESTORS (in USD)	RETURN PROJECTION	MEDIAN VOLATILITY
U.S. equities	**4.1%–6.1%**	17.2%
Global ex-U.S. developed markets equities (unhedged)	**6.5%–8.5%**	16.7%
Emerging markets equities (unhedged)	**5.9%–7.9%**	26.5%
U.S. aggregate bonds	**3.1%–4.1%**	5.1%
Global bonds ex-U.S. (USD-hedged)	**3.0%–4.0%**	4.1%
Emerging market sovereign bonds (USD-hedged)	**5.4%–6.4%**	11.9%

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