Expert Perspective

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Latin America market perspectives

Quarterly economic and market update – 2Q 2023

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Introduction

High inflation has led to a marked slowing in global economic activity. The rapid monetary tightening aimed at bringing inflation down will ultimately succeed, but at a cost of a recession in many economies. Financial markets have begun to price in our somber economic forecast and tensions in the banking sector are symptomatic of this stage of a hiking cycle.

Overall key risks for the region include slowing global growth, liquidity tightening by developed countries central banks, and geopolitical tensions escalating.

Economic Outlook

Growth

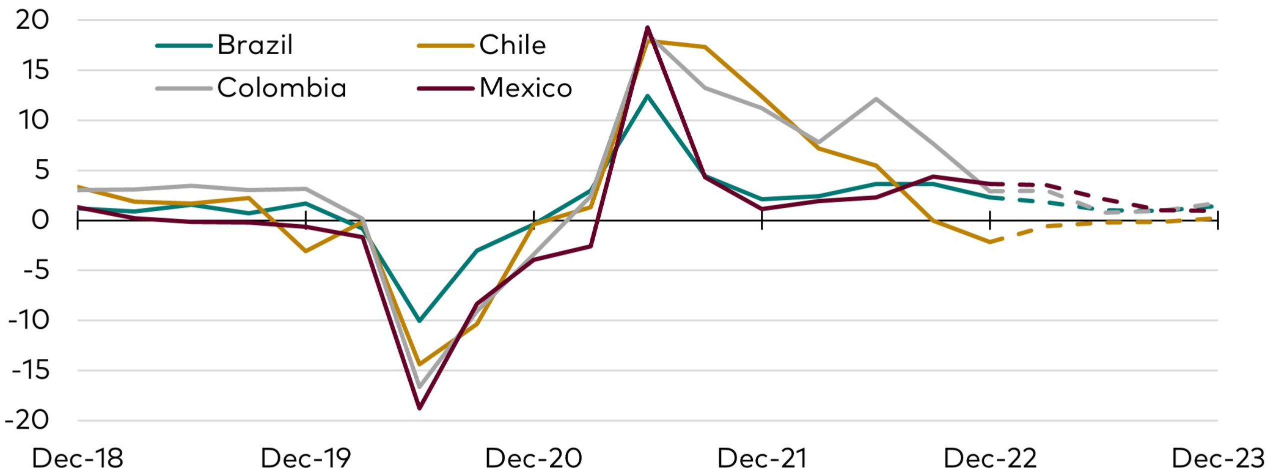
Latin-American markets has a consensus projected GDP growth rate of 1.6% for 2023. The primary headwinds faced by emerging economies, and especially for Latin America, are the probability of recession in the United States in the second half of the year and the high central bank rates.

For the Mexican economy, the second largest in Latin America and among the most open in the world, we continue to expect growth at 1.8%-1.9% for 2023 as we see resilience in the composition of Mexican growth; although, several factors will challenge economic growth:

- Our base-case for a recession in the United States during the second half of this year. Mexico is highly integrated with the US economy, leaving it vulnerable to shifts in the US business cycle.
- Reduced external demand. Seventy percent of Mexican exports go to the U.S., and Mexican exports are highly correlated with the U.S. inventory cycle (excluding autos). We expect inventory growth to slow along with the slowing U.S. economy.
- Interest rates in Mexico are higher than inflation. With inflation falling overall, rates will be even more restrictive at current levels, further slowing economic growth.

On the other hand, robust consumer spending has led growth recently and given our outlook for resilient growth and moderating inflation, we expect real wage growth to continue to accelerate, boosting consumption spending. Additionally, we see the accelerating near-shoring activity as a positive contributor to growth in the midterm.

Real GDP (% YoY change)



Source: Refinitiv Datastream, Vanguard calculations
Note: Vanguard forecast starting Q1 2023

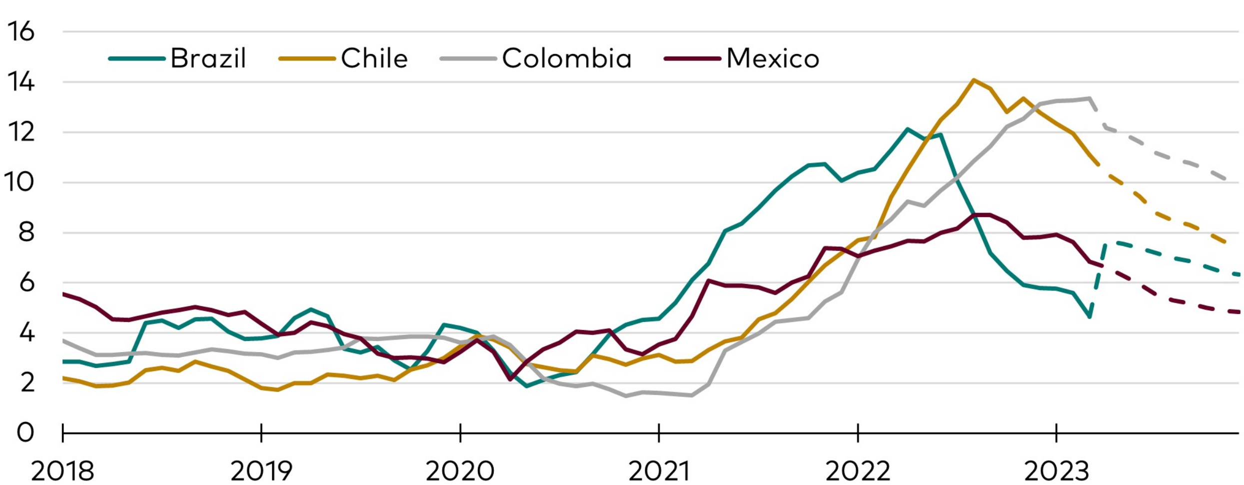
Brazil´s economic growth will decelerate from a 2.9% rate in 2022 to a consensus of around 1.0%-1.2% for 2023. A high domestic interest rate and high inflation appears to outweigh demand for commodities from China.

Inflation

Overall inflationary pressures in Latin America are receding as result of the aggressive monetary policy from local central banks as well as lower commodity and energy prices.

In Mexico, headline inflation slowed to 6.25% in April compared with a year earlier. It was the slowest annual rate of inflation since a 6.24% reading in October 2021, when the pace of inflation was accelerating. Core inflation, however, is coming down much more slowly. It was 7.67% in April, down from 8.09% in March and a peak of 8.51% in November 2022. Given the broad-based nature of Mexican inflation and our expectation of relatively anemic Mexican growth, expect headline CPI to fall to around 5% (consensus 5.1%) and core CPI to fall just below 6% by year-end 2023.

Consumer prices (% YoY change)



Source: Refinitiv Datastream, Vanguard calculations
Note: Vanguard forecast starting Q1 2023

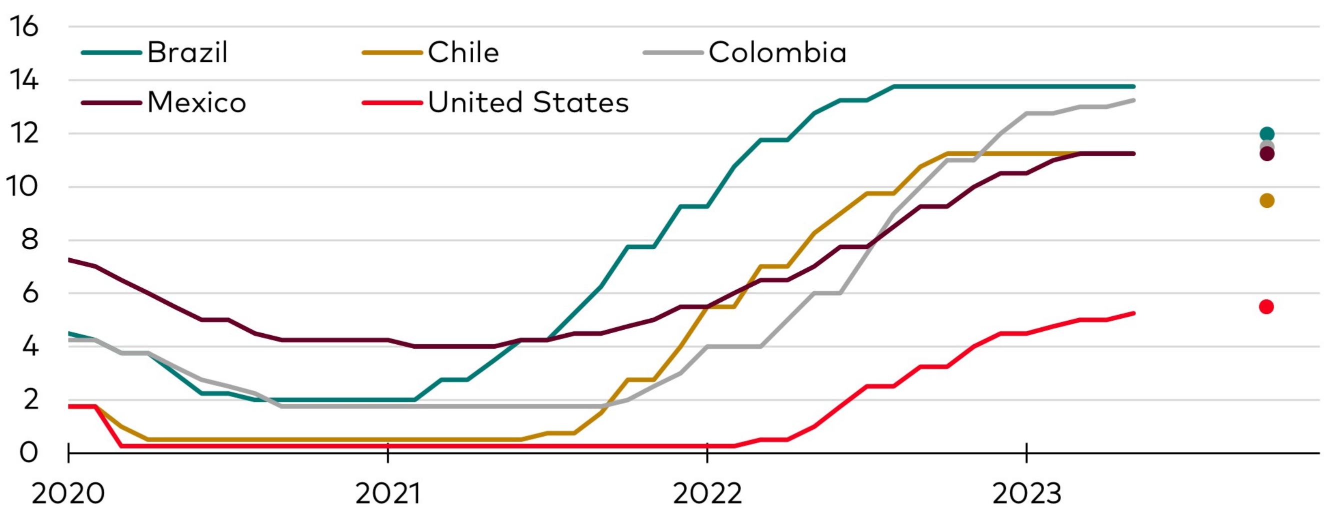
For Brazil, inflation slowed to 4.18% in April compared with a year earlier as higher commodity prices and supply constraints eased. It was the slowest annual rate of inflation since a 12.13% reading in April 2022, when the pace of inflation peaked. We expect CPI to push higher this year and end the year in 6.2%-6.3% range slightly above consensus of 6.0% driven by demand generated from fiscal stimulus. Core inflation continues to run higher at around 7%. We expect core CPI to continue a slow decrease to 6% by the end of the year. Brazil´s central bank inflation target sits at 3.25% for 2023 with a range of +/- 1.50%.

Monetary Policy

After tightening their monetary policy stance through the last few years most central banks have moderated the pace of hikes in 2023 while some kept their rates steady as consequence of recent slowing inflation data. Emerging-market central banks were quicker to raise interest rates in this hiking cycle than their developed-market counterparts and may lead the way in pausing rate hikes and eventually in cutting rates.

At the end of March, Banco de Mexico (Banxico) raised the reference rate by 25bps to a level of 11.25% creating a 625bps gap with the US Federal Reserve. Easing inflation might point towards the end of Banxico´s tightening cycle; therefore, we do not expect rate hikes this year and the highest policy rate of 11.25% since 2006 should remain unchanged before Banxico starts cutting it next year.

Policy interest rate and projected terminal level (%)



Source: Refinitiv Datastream, Vanguard calculations
Note: Vanguard forecast starting Q1 2023

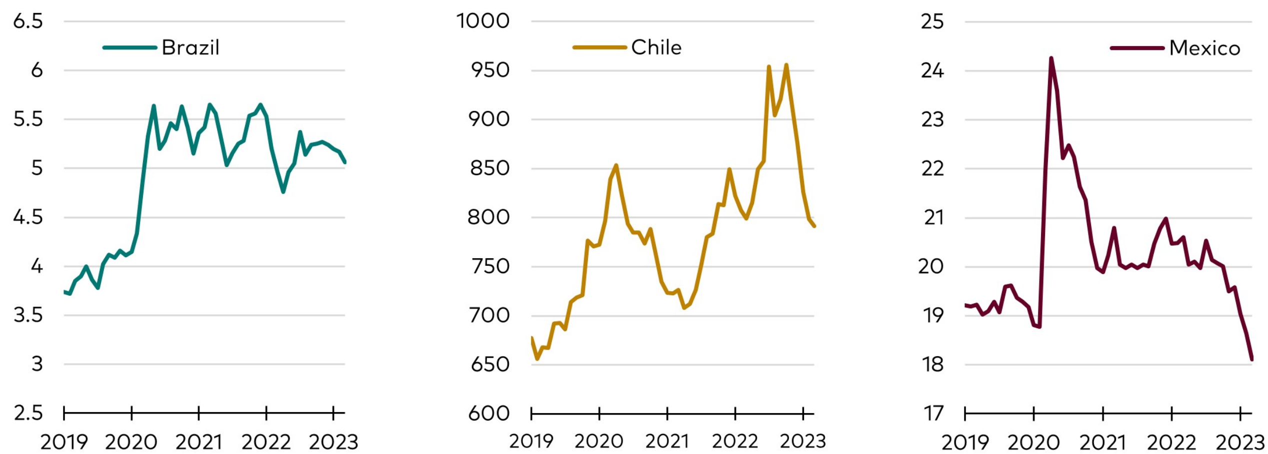
Banco Central do Brasil (BCB) has kept its Selic rate at 13.75% as the deceleration of inflation has stalled and amid rising concerns about the government´s fiscal policy going forward. Consensus continues to expect monetary policy normalization over the next years to a Selic rate of around 10.50%.

Exchange Rates

The Mexican Peso (MXN) closed the first quarter of 2023 at 18.07 MXN/USD, fluctuating between 19.49 MXN/USD and 17.97 MXN/USD. It has been one of the strongest emerging-market currencies so far this year. We believe the strength of the Mexican peso is based on macroeconomic stability, Banxico's credibility in tightening monetary policy, the nearshoring opportunity and Mexico's real interest rate differential with the US amid higher investment in local securities through the carry trade.

However, we visualized some risk ahead for the currency. As we expect Banxico to end its rate increases and decouple with the US Fed rate cycle, this will increase depreciation pressure on the peso. We continue to expect the Mexican peso to close 2023 between a range of 19.50-20.50 MXN/USD.

Currency rate (local per US$ 1.00)



Source: Economist Intelligence Unit

The US Dollar strength appears to fade as the US Fed nears the end of its tightening cycle, boosting the value of other currencies. For the Brazilian real, its support form the carry trade will also fade as the Brazilian Selic rate declines. The real currently trades at BRL 4.92 per USD and the consensus forecast has it ending the year at BRL 5.11 per USD.

Market Outlook

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

Equity: 10 years average returns and volatility projections (in MXN)

	5th percentile	25th percentile	50th percentile	75th percentile	95th percentile	Median volatility
Mexican equities	-1.3%	4.1%	8.0%	12.0%	17.8%	29.1%
U.S. equities unhedged peso	-2.8%	3.8%	8.8%	14.8%	26.0%	24.1%
Developed ex-U.S. unhedged peso	0.0%	6.1%	10.9%	16.7%	27.5%	23.6%
Emerging markets unhedged peso	-2.9%	5.1%	10.9%	17.0%	28.3%	31.7%

Notes: The forecast corresponds to the distribution of 10,000 VCMM simulations for 10-year annualized nominal returns in MXN for asset classes highlighted here. Median volatility is the 50th percentile of an asset class's distribution of annualized standard deviation of returns. Asset class returns do not take into account management fees and expenses, nor do they reflect the effect of taxes. Returns do reflect reinvestment of dividends and capital gains. Indexes are unmanaged; therefore, direct investment is not possible. Source: Vanguard calculations, as of December 31, 2022.

Equity returns projections have improved across the board as compared to last year given improvement in market valuations. Mexican equities return projections over the next decade have increased to (7.5%-8.5%) compared to (6.0%- 7.0%) last year. Similarly return projections over the next decade for U.S. equities and Developed ex-U.S. have risen to (8.3%-9.3%) and (10.4%-11.4%) respectively, an average increase of 150bp.

Fixed Income: 10 years average returns and volatility projections (in MXN)

	5th percentile	25th percentile	50th percentile	75th percentile	95th percentile	Median volatility
Mexican sovereign bonds	**8.4%**	**9.8%**	**10.9%**	**11.8%**	**13.4%**	12.8%
U.S. bonds hedged peso	**5.9%**	**8.2%**	**9.7%**	**11.2%**	**13.6%**	6.3%
Global bonds hedged peso	**5.3%**	**8.0%**	**9.8%**	**11.7%**	**14.6%**	7.5%
Cash	**6.2%**	**7.9%**	**9.1%**	**10.2%**	**11.9%**	2.6%

Notes: Forecast corresponds to distribution of 10,000 VCMM simulations for ten-year annualized nominal returns in peso for asset classes highlighted here. Median volatility is the 50th percentile of an asset class's distribution of annualized standard deviation of returns. Sources: Vanguard calculations as of December 31, 2022.

Rising global interest rates have also improved return projections across fixed income. Compared to last year return projections over the decade on Mexico sovereign bonds have improved by 230 bps to (10.4%-11.4%). U.S. aggregate bond (hedged) and Global aggregate bond (hedged) returns have also improved compared to last year to (9.2%-10.2%) and (9.3%-10.3%) respectively. Return projections also assume an inflation expectation of 3.2% for the reported period.

U.S. DOLLAR INVESTORS (in USD)	RETURN PROJECTION	MEDIAN VOLATILITY
U.S. equities	**4.4%–6.4%**	17.2%
Global ex-U.S. developed markets equities (unhedged)	**6.5%-8.5%**	16.7%
Emerging markets equities (unhedged)	**6.3%–8.3%**	26.3%
U.S. aggregate bonds	**4.0%–%5.0%**	5.5%
Global bonds ex-U.S. (USD-hedged)	**3.9%–4.9%**	4.4%
Emerging market sovereign bonds (USD-hedged)	**5.6%–6.6%**	10.6%
BRAZILIAN REAL INVESTORS (in BRL)	**RETURN PROJECTION**	**MEDIAN VOLATILITY**
Brazil equities	**12.3%–14.3%**	37.6%
Global Equity ex-Brazil (unhedged)	**11.3%–13.3%**	33.5%
Brazil aggregate bonds	**11.5%–12.5%**	9.2%
Global bonds (BRL-hedged)	**12.6%–13.6%**	5.5%

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