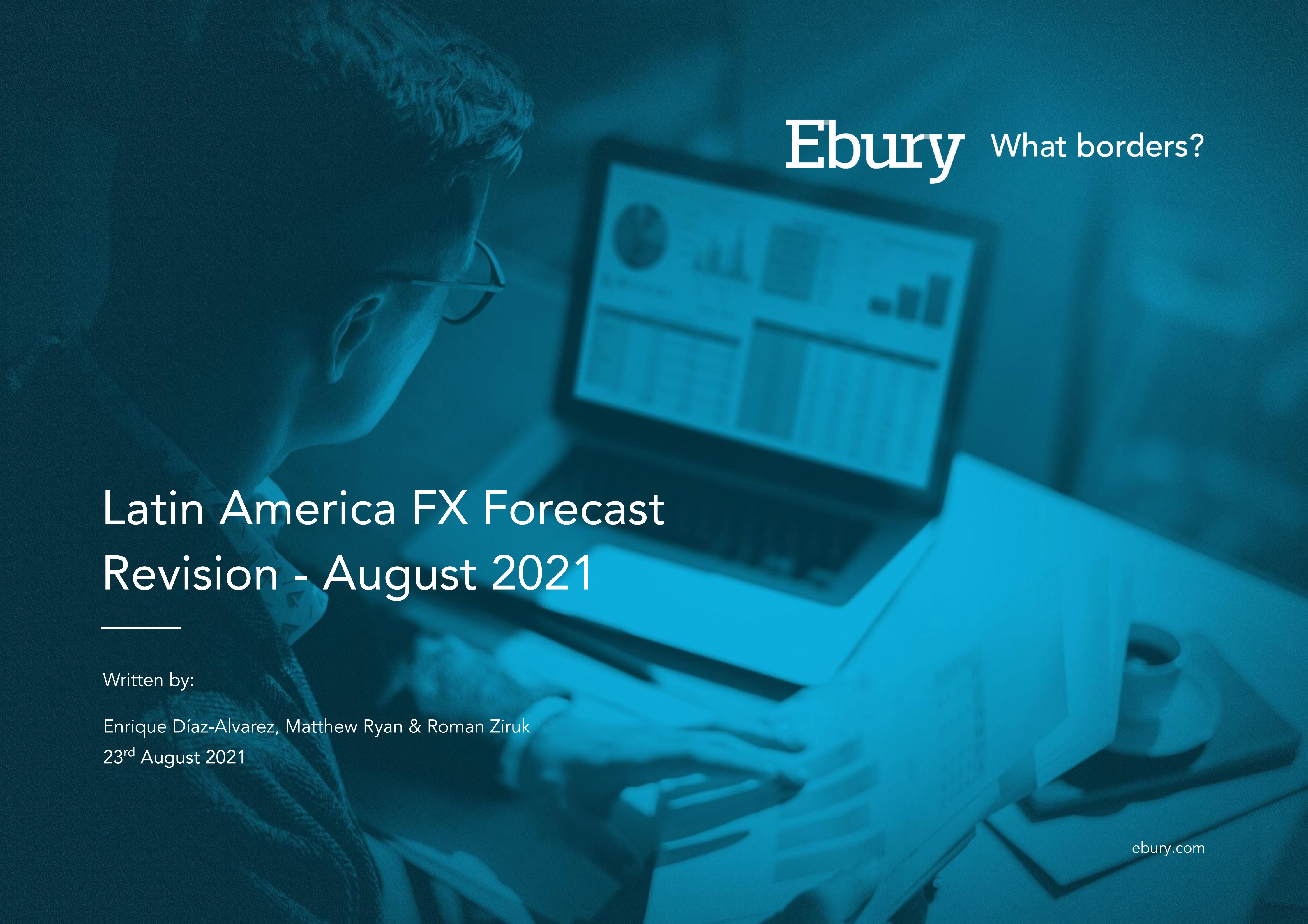

Ebury What borders?

Latin America FX Forecast Revision - August 2021

Written by:

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23rd August 2021

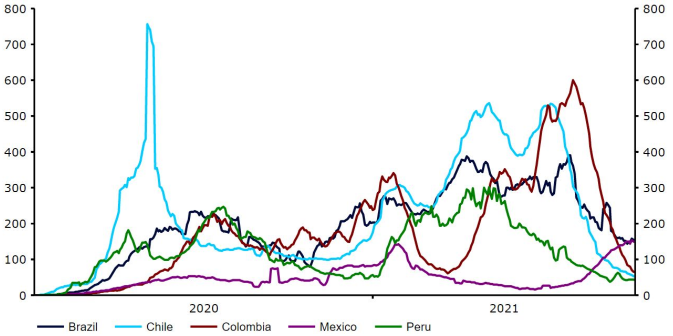
Currencies

Introduction

The currencies of the Latin American region have been among some of the worst performers of all the emerging markets we cover so far in 2021.

The COVID-19 pandemic has continued to hit the region particularly hard. Authorities in most countries in Latin America have managed to rein in rates of infection in the past two or three months (Figure 1), partly due to the mass rollout of the various vaccines. That being said, all five of the LatAm nations that we feature in this report still rank among the top 24 countries with the highest number of total reported COVID-19 cases in the world (according to Worldometer), despite relatively limited levels of testing.

Figure 1: New COVID-19 Cases [per 1M people] [LatAm] (2020 - 2021)

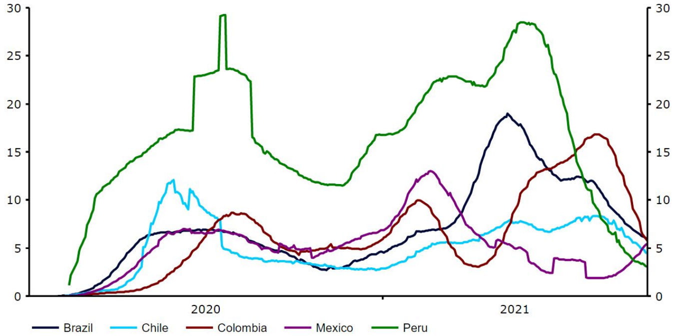


Source: Refinitv Datastream Date: 20/08/2021

COVID-19 deaths as a percentage of the population, which tends to provide a more accurate representation of the severity of the virus' spread in counties with inadequate levels of testing, also suggests that the region has been one of the worst affected areas in the world.

Peru (1st), Brazil (8th) and Colombia (11th) have suffered the highest number of deaths as a share of the population of the five. At the time of writing, Peru has registered almost twice as many deaths on a per capita basis (5,900 per 1 million people) than any other country in the world.

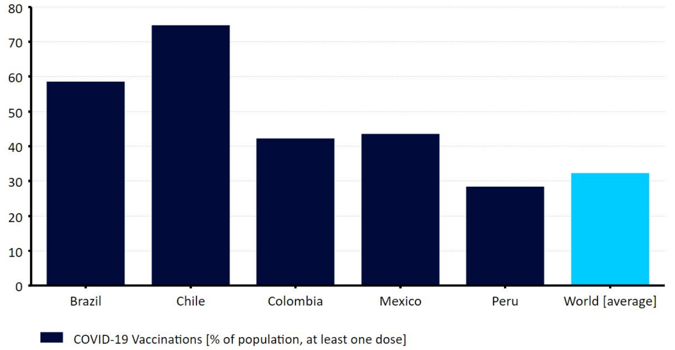
Figure 2: LatAm COVID-19 Deaths [per 1M] [4WMA] (March '20 - August '21)



Source: Refinitv Datastream Date: 20/08/2021

Since the worst of the economic downturn, the economies in the region have, on the whole, bounced back rather well, albeit to varying extents. In our view, the speed at which authorities are able to roll out the various COVID-19 vaccines to the populations remains key as to the timing of a full reopening and the return to economic near-normality. With the notable exception of Chile, progress on that front was rather sluggish in the first half of the year, although the pace of vaccinations has picked up relatively sharply in most instances since then.

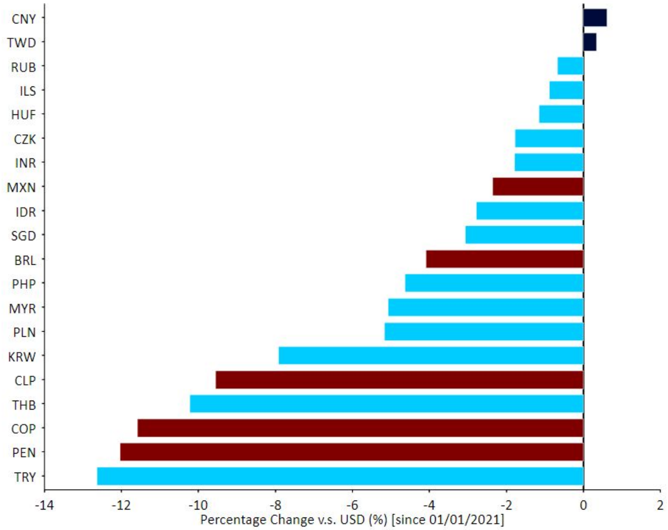
Figure 3: COVID-19 Vaccinations Administered [% of population] (as of 23/08/21)



Source: Refinitv Datastream Date: 23/08/2021

The severity of the spread of the virus, combined with heightened political uncertainty in the region, have been among the main contributing factors to the general underperformance in the LatAm currencies so far in 2021. Of the five, the Brazilian real has experienced the largest sell-off since the start of 2020, albeit the currency has managed to mostly hold its own since the peak of the downturn. The Chilean peso has been the best performer since the start of last year, although alongside the Colombian peso and Peruvian new sol, it has sold-off rather aggressively of late, with all three down around 10% versus the USD since the turn of the year (Figure 4).

Figure 4: EM FX Performance [select vs. USD] (YTD)



Source: Refinitv Datastream Date: 23/08/2021

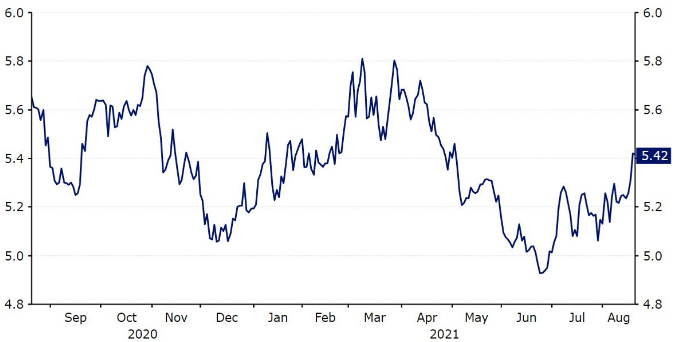
We think that the sell-offs in the LatAm currencies mentioned in this report have perhaps been overdone, and believe that a recovery in these currencies is on the cards once developing nations vaccinate a greater share of their populations. In our view, the extent of the rebounds will be highly dependent on how the respective central banks respond to rising inflationary pressures. As has been the case elsewhere, we think that we are already beginning to see a shift in investors' focus away from the pandemic and back towards monetary policy. Those EM currencies whose country's central banks are already engaging in a tightening cycle will, in our view, likely be among the better performers during the remainder of 2021.

Brazilian Real BRL

The Brazilian real (BRL) was among the worst performing currencies in the world in the first year of the COVID-19 pandemic.

The currency lost almost one-third of its value versus the US dollar at one stage, as investors flocked to low risk assets during the first half of 2020. This sell-off sent the currency to its lowest ever level at just shy of 6 to the USD in May last year. Since then, however, the real has rebounded in line with our forecasts and rallied below the 5 level to the dollar for the first time in over a year in June (Figure 5).

Figure 5: USD/BRL (August '20 - August '21)



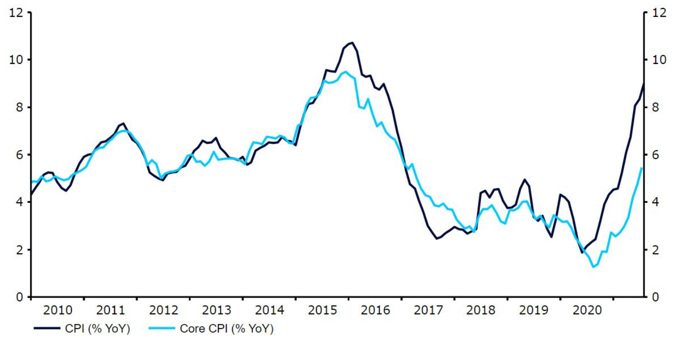
Source: Refinitv Datastream Date: 20/08/2021

We think that the recovery in the real in the second quarter of the year was driven by the hawkish policy stance adopted by the Central Bank of Brazil, which has raised rates more aggressively than just about every other central bank in the world in 2021. Rates were hikes by a larger-than-expected 75 basis points to 2.75% in March, the first in six years. This was followed up with another two hikes of the same magnitude in May and June, with an additional 100 basis point rate increase coming at the August meeting, taking the main rate up to 5.25%.

The bank's accompanying communications were again hawkish, with policymakers noting that another 100 basis point hike was likely on the way at the September meeting - indeed, this is already largely priced in by the market.

The decision to engage in a tightening cycle is a bold one, in our view, given the current challenges to growth, but Brazil's economy has bounced back strongly following last year's recession. Output expanded by another 1.2% on a quarter previous in Q1, and yearly growth entered back into positive territory (+1%) for the first time since the final quarter of 2019. Policymakers have also cited the recent increase in domestic inflation as a justification for hiking rates ahead of almost every other central bank in the world. Headline inflation has continued to trend higher, rising to 9% in July, its highest level since March 2016 (Figure 6).

Figure 6: Brazil Inflation Rate (2010 - 2021)



Source: Refinitv Datastream Date: 20/08/2021

Despite pressure on the government to enforce tougher virus restrictions, far-right President Jair Bolsonaro has rebuffed calls for a nationwide lockdown, leading to mass protests and a sharp downturn in his approval rating. Bolsonaro has adopted a troublesome approach to dealing with the pandemic thus far, which we think contributed to the extent of the sell-off in BRL earlier in the year.

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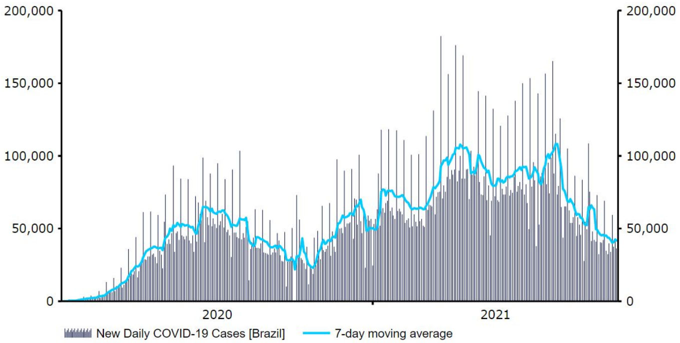
Bolsonaro's government has actively encouraged people to defy social distancing, ignore regional lockdown and partake in large gatherings. As a consequence, Brazil has been one of the worst affected countries in the world by the virus, racking up the second highest number of COVID-related deaths, behind only the far more populous US. Brazil now accounts for 13% of the world's COVID-19 death toll, despite only making up just 2.75% of the population.

The aggressive spread of the virus in Brazil since the beginning of the year has been in large part due to the gamma variant of the virus that was first identified in January. This variant is said to not only be twice as contagious as the original strain, but also more than 60% likely to reinfect people than other versions of the COVID-19 virus. Pressure on hospitals peaked in April, with many intensive care units at full capacity and hundreds experiencing severe medical supply shortages. Bolsonaro has, however, continued to criticise regional state governors for enforcing lockdowns, with the president instead prioritising the health of the economy. The rollout of vaccines has, at least, eased some of this pressure on the healthcare system and contributed to a decline in daily deaths. At the time of writing, Brazil has administered at least one vaccine dose to 59% of the population - considerably above the world average (32%).

Figure 7: New Daily COVID-19 Cases [Brazil] (2020 - 2021)



Source: Refinitv Datastream Date: 20/08/2021

Despite the clearly concerning pandemic situation in the country, we remain encouraged by Brazil's strong macroeconomic fundamentals. These should, in our view, allow BRL to continue recovering its recent losses once the pandemic is brought under control:

1) Still high, albeit declining, FX reserves that equate to around 20 months' worth of import cover. This remains an ample level of ammunition for the Central Bank of Brazil to successfully intervene in the market in order to reverse the currency's sell-off. The central bank has been increasingly active in the FX market in recent months, selling around $5.6 billion in the spot FX market and $6 billion in the FX swaps market in the first two-and-a-half months of the year alone. We expect this proactivity to continue in the near-term.
2) A manageable current account deficit that is comfortably financed by foreign direct investment (FDI). This deficit decreased to 0.7% in 2020 from 2.7% in 2019.
3) A near 7 p.p increase in Brazil's external debt since the start of the COVID-19 pandemic is a slight cause for concern, although as a percentage of GDP debt remains low compared to its peers at 37.2% of GDP. The recent appreciation in BRL also decreases the real value of the debt payments.
4) High and rising nominal interest rates of 5.25%, ensuring that the real offers among the highest carry of all the major EM currencies.
5) A high terms of trade ratio that has increased from 96.25 in early-2016 to 125.6 in April 2021. This represents a country's export prices relative to its import prices.

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Figure 8: Brazil Terms of Trade (2010 - 2021)

Source: Refinitv Datastream Date: 20/08/2021

Given the above supportive factors, and our view that the currency is very cheap at current levels, we do not think that a continued sell-off in the real at the rate witnessed at the onset of the crisis is likely in the long-term. We are instead continuing to pencil in a recovery for the currency against the dollar through to the end of 2022, and think that Brazil's solid macroeconomic fundamentals should allow the currency to successfully bounce back once the worst of the crisis is over. This view is reinforced by the hawkish policy stance adopted by the Central Bank of Brazil, which looks likely to continue raising rates in 2021.

	USD/BRL	EUR/BRL	GBP/BRL
Q3-2021	5.20	6.15	7.35
E-2021	5.00	5.95	7.10
Q1-2022	4.80	5.80	6.85
Q2-2022	4.65	5.65	6.70
E-2022	4.50	5.60	6.55

Chilean Peso CLP

Up until relatively recently, the Chilean peso (CLP) had continued to trade in line with our expectations since our last Latin America update, and Ebury was named by Bloomberg as the number one forecaster for the USD/CLP cross in Q2 2021.

CLP has been one of the more resilient emerging market currencies during the pandemic period. The currency rallied to a near two-year high just above the 690 level to the dollar in May, albeit it has since sold-off and is now trading back at its lowest level since October. Regardless, the peso is still trading 10% higher against the dollar than its all-time low from March last year, and has been the third best performer in Latin America in the past year, behind the Mexican peso and Brazilian real.

Figure 9: USD/CLP (August '20 - August '21)

Source: Refinitv Datastream Date: 20/08/2021

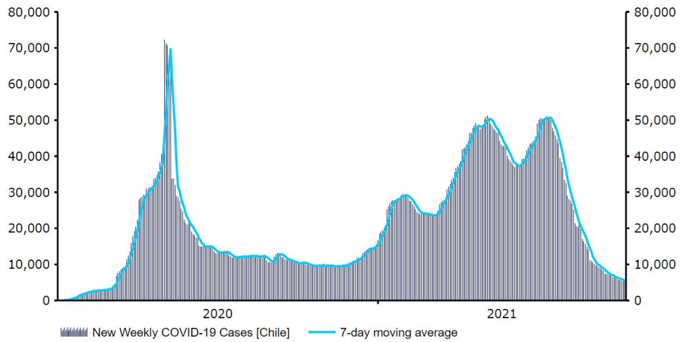
We attribute the outperformance to the country's large-scale fiscal response, rapid vaccination rollout and the recovery in copper prices, to which the peso has historically been closely linked. London Metal Exchange (LME) copper prices have risen sharply since the peak of the crisis in late-March 2020, as investors turn bullish on commodities.

Prices have more than doubled from $4,625 per tonne at the peak of the market panic in March 2020 to around the $10,000 per tonne level in July this year. Growth forecasts for the world's top copper producer have subsequently been increased by the Chilean government, which now expects its economy to grow by 7.5% in 2021 versus the previous 6% projection.

We have also been encouraged by the success of Chile's vaccination programme. To date, Chile has administered at least one vaccine dose to a greater percentage of its population than almost every other country in the world (75%). The country has, however, primarily used the Sinovac vaccine that is said to be less effective in preventing infection and fending off serious illness, particularly against the more contagious variants of COVID-19. This explains why new cases and deaths caused by the virus have not fallen by as much as one would hope in recent months.

Chile remains one of the worst affected countries by the virus in the region, with reported cases now above the 1.6 million mark (85,000 cases per 1M people), although we have at last witnessed a drop in contagion levels since mid-June. High levels of infection are almost certainly a consequence of the less strict containment measures imposed by the Chilean government at the beginning of the crisis, as the country did not impose a national lockdown. Regional lockdowns have instead been implemented, notably across parts of the capital Santiago, along with a nationwide nighttime curfew.

Figure 10: Chile New Weekly COVID-19 Cases (2020 - 2021)



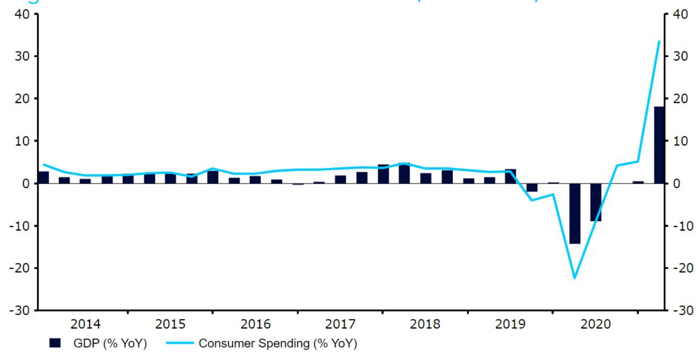
Source: Refinitv Datastream Date: 20/08/2021

Similarly to its neighbor Peru, the Chilean government has had plenty of fiscal wriggle room to provide financial support to the domestic economy. The government has unveiled more than $30 billion in stimulus measures (greater than 12% of GDP), which place a heavy focus on income support and worker subsidies. This impressive financial response appears to have calmed some of the political unrest surrounding rising costs of living and high inequality that was triggered following the subway fare hike in October last year. The delayed referendum held at the end of October yielded an overwhelming majority in favour of rewriting Chile's constitution. This, we believe, is an encouraging step in the right direction towards ending the political unrest that had placed a significant risk premium on the peso.

The recent hawkish monetary policy shift from the Central Bank of Chile also presents an upside risk to CLP, in our view. The CNC raised interest rates for the first time since 2018 in July, hiking its benchmark rate by 25 basis points to 0.75% in light of rising inflationary pressures and a moderately weaker peso. Headline inflation jumped to 4.5% year-on-year in July and is now above the upper end of the bank's 2-4% target range. Recent weakness in the peso and the sharp increase in commodity prices suggests that a further increase in inflation may be on the cards in the coming months.

The strong rebound in domestic economic activity post-vaccination rollout can also partly explain the Central Bank of Chile's hawkish turn. Growth has continued to exceed expectations in recent months, with the 3.2% quarter-on-quarter rebound in activity in Q1 returning GDP to pre-pandemic levels. We have been particularly encouraged by the rapid recovery in consumer spending - retail sales rose by 33.9% in May, a staggering 72.1% higher than a year previous. While we remain optimistic on growth over our forecast horizon, the reintroduction of lockdown measures in June, notably in the capital Santiago, presents a downside risk to the outlook, albeit this is yet to be reflected in recent macroeconomic data.

Figure 11: Chile GDP Annual Growth Rate (2014 - 2021)



Source: Refinitv Datastream Date: 20/08/2021

We continue to hold an upbeat view on the Chilean peso. The country's rapid vaccination programme should allow authorities to remove lockdown measures and return to near-normal sooner than most other EM nations. The government's large-scale fiscal response, rising domestic rates and the sharp rebound in copper prices should also continue to support the currency, in our view. This, we believe, should allow the peso to post solid gains against the US dollar from current levels through to the end of next year. We are, however, revising our CLP forecasts in light of the currency's recent move lower.

	USD/CLP	EUR/CLP	GBP/CLP
Q3-2021	760	895	1070
E-2021	740	880	1050
Q1-2022	720	870	1030
Q2-2022	710	865	1020
E-2022	700	870	1015

Colombian Peso COP

The Colombian peso (COP) has underperformed all of its regional peers covered in this report so far in 2021.

So far this year the peso has sold-off at a steady rate versus the US dollar and is currently trading around the 3,850 level - just shy of its weakest position since April 2020. The currency has been particularly susceptible to recent dollar strength, extending its losses to more than 10% year-to-date (Figure 12). This makes COP the second worst performing currency in the emerging market universe so far this year, behind the Turkish lira.

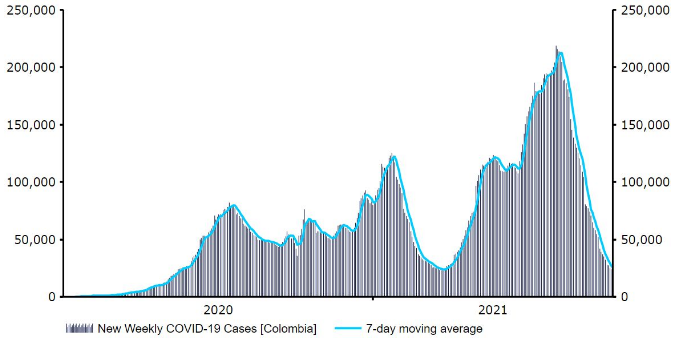
Figure 12: USD/COP (August '20 - August '21)

Source: Refinitv Datastream Date: 20/08/2021

We think that the extent of the move lower in the peso can be attributed to both the worrisome virus situation and recent social unrest in Colombia. New cases increased sharply in the second quarter during Colombia's third wave of infection. The seven day moving average of daily reported cases increased almost tenfold between mid-March and late-June.

This led to surges in hospitalisations and the near collapse of the country's healthcare system, albeit the situation has improved rather dramatically since then. Over the course of the pandemic, approximately 124,000 COVID-related deaths have been reported in Colombia, around half during the third wave alone. Colombia now has the 11th highest total number of deaths due to the virus in the world, and one of the highest number of reported cases per capita, despite limited testing (460 per 1,000 people versus 1,690 in the US).

Figure 13: Colombia New Weekly COVID-19 Cases (March '20 - August '21)



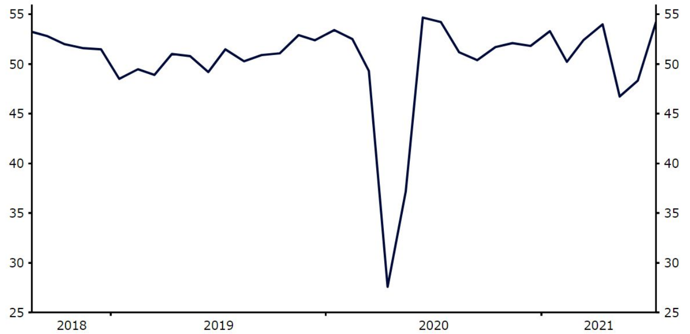
Source: Refinitv Datastream Date: 20/08/2021

To make matters worse, a wave of protests have swept through the country since the end of April following the proposition of a new tax reform, which was hastily withdrawn by the government following the fierce backlash. The protests have centred around the country's high levels of inequality that many feared the proposed reforms, which would lower the threshold at which salaries are taxed, would exacerbate. The rallies have escalated in recent months, leading to more than 2,000 injuries and 59 deaths at the time of writing, while souring sentiment towards the peso. The Colombian government partly softened its stance in July, announcing revised proposals to raise an equivalent of $4 billion in taxes, around two-thirds the size of the initial package. This proposition has so far been greeted positively by opposition parties and is expected to pass by the end of August.

Colombia's economy has, at least, rebounded from the worst of the downturn. The strict social distancing measures and national lockdown imposed at the start of the crisis triggered a record 14.8% quarter-on-quarter contraction in the Colombian economy in the second quarter of 2020. Since then, however, the economy has posted three consecutive quarters of solidly positive growth, with the 2.9% expansion recorded in Q1 lifting annual growth back into positive territory for the first time in a year (+1.1%).

The reimposition of strict lockdown measures during the third wave of infection in April and May has, however, worsened the near-term outlook and triggered a deterioration in economic indicators. The manufacturing PMI collapsed to a one-year low 46.7 in May, and remained in contraction territory in June (48.3). Consumer spending has also slowed, with retail sales dropping by around one-fifth in the two-months from April. An easing in restrictions should help in this regard, as should the continued rebound in global oil prices, to which the Colombian economy has historically been closely linked. Brent Crude oil prices crashed to record lows at the start of the pandemic, although have since recovered to around $65 a barrel. This is now comfortably above Colombia's projected breakeven oil price of $45 a barrel. Colombia's terms of trade index has also increased back up to pre-pandemic levels (132.3 in June), which should be supportive of the peso.

Figure 14: Colombia Manufacturing PMI (2018 - 2021)



Source: Refinitv Datastream Date: 20/08/2021

We remain optimistic regarding the Colombian peso, despite the ongoing political unrest. The country continues to boast solid macroeconomic fundamentals, notably high FX reserves equivalent to more than 13 months of import cover and manageable and rising terms of trade, albeit rather high external debt (57% of GDP). The recent spike in domestic inflation has also raised expectations for central bank hikes. The Central Bank of Colombia held rates steady in June, although bank chief Leonardo Villar warned over rising inflation, suggesting to us that a hike may be on the cards in the not too distant future, perhaps at the September meeting. The current account deficit has also continued to narrow and remains almost completely financed by high quality FDI flows. We therefore forecast continued mild gains for the peso against the US dollar over our forecast horizon.

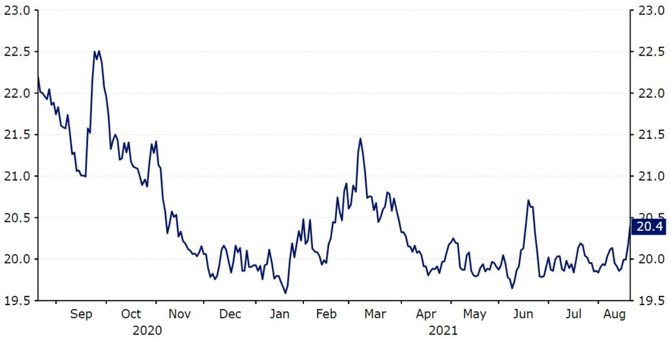
	USD/COP	EUR/COP	GBP/COP
Q3-2021	3700	4365	5215
E-2021	3600	4285	5110
Q1-2022	3500	4235	5005
Q2-2022	3450	4210	4970
E-2022	3400	4215	4930

Mexican Peso MXN

The Mexican peso (MXN) has traded within a relatively narrow band around the 20 level to the US dollar in the past few months.

MXN was one of the worst-performing currencies in the world at the beginning of the COVID-19 pandemic. A sharp reversal in carry trades during the intense risk off period sent the currency to an all-time low north of 25 to the dollar, although it rallied back sharply to a 10-month high in late-January this year as broad market sentiment improved. Since then, volatility in the peso has been relatively low, with the currency holding its value much better than most of its emerging market peers, particularly those in Latin America.

Figure 15: USD/MXN (August '20 - August '21)



Source: Refinitv Datastream Date: 20/08/2021

One of the main reasons for the violent swings experienced in MXN during periods of uncertainty throughout the pandemic has been the peso's attractiveness from a carry trade perspective. Such currencies tend to experience larger sell-offs during intense 'risk off' modes, as investors unwind long positions and exit these carry trades en masse, and rally sharply during 'risk on' periods.

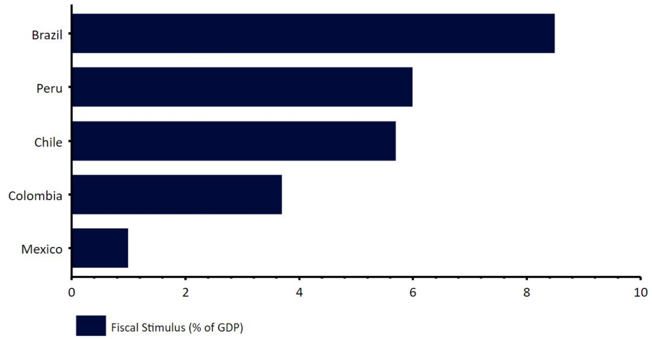
This is the reason why MXN has been among the best performers in the EM universe in the past twelve months (up over 10% versus the US dollar).

The hawkish stance adopted by Baxico at recent monetary policy meetings has further improved the appeal of the currency to investors. Banxico cut interest rates aggressively at the start of the crisis, lowering its main rate by a total of 325 basis points to 4%. Policymakers did, however, surprise investors in June by unexpectedly raising its main base rate by 25 basis points, the first rate increase since December 2018, and followed this up with another hike of the same magnitude in August. Neither of the two decisions were unanimous, with two of the five members voting to keep rates unchanged, but ultimately the consensus deemed that higher rates are required in order to anchor inflation expectations. As has been the case globally, headline inflation in Mexico has risen sharply in annual terms, rising to 6.1% YoY in April and remaining close to that level ever since (5.8% in July), although this appears to be largely due to the base effect.

So far, investors have largely overlooked the recent deterioration in the COVID situation in Mexico that has seen a sharp increase in infection levels, at a time when the dominant delta variant has spread aggressively around the world. Caseloads have risen back up to January levels, which has so far translated into a modest increase in new deaths. Mexico's ratio of virus deaths per 1,000 people is comparable to that in the US (1.9), despite the country only conducting levels of testing that equate to around 4% of that undertaken in America. Restrictions have been unwound to a fairly significant extent since the start of February, which may partly be responsible for the resilience in MXN. We think that the country's so far sluggish vaccination rollout does, however, present a risk to a full reopening of the economy and the peso. So far, vaccines have been administered to only 43% of the population, just above the world average (32%).

A further cause for concern among currency traders has been the Mexican government's unwillingness to spend money to protect the economy. President Obrador has been strongly opposed to taking on additional debt during the pandemic, with the government's stimulus plan equivalent to just 1.1% of GDP - less than a quarter of the average in the Latin America region. Mexico's debt-to-GDP ratio is expected to remain relatively stable at around 65% this year, although there are fears that this unwillingness to spend could hold back the economic recovery.

Figure 16: LatAm Fiscal Spending during COVID-19 Pandemic [% of GDP]

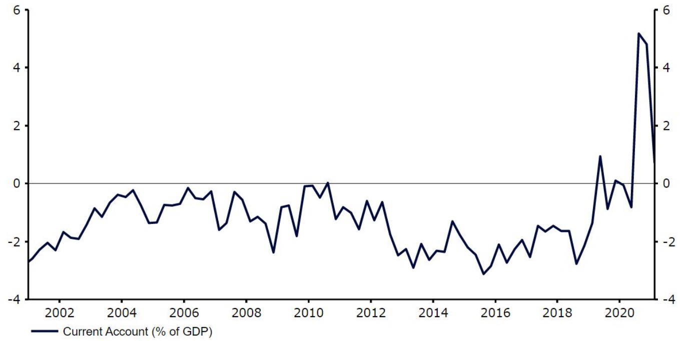


Source: Refinitv Datastream Date: 20/08/2021

Even prior to the current crisis, the country's economy had been under pressure, contracting in six of the eight quarters leading up to the pandemic. The 16.9% QoQ plunge in activity in the second quarter of 2020 was one the deepest downturns in the region, although the country did, at least, post four consecutive quarters of positive economic growth through to Q2 this year. The recovery has, however, not been quite as rapid as many of Mexico's peers. We think this is partly a consequence of the government's unwillingness to increase fiscal spending.

Despite the aforementioned downside risks to the currency, we think that the peso will continue to be well supported over our forecast horizon by Mexico's solid macroeconomic fundamentals. Mexico's external position has improved dramatically, with the current account balance increasing into positive territory (+2.4% of GDP) for the first time since the 1980s in 2020. The country's external debt level is relatively low compared to some of its regional peers at little over 40% of GDP. Real interest rates have fallen into negative territory for the first time since late-2014, although we think that this may prove temporary given the likelihood of additional rate hikes from Banxico.

Figure 17: Mexico Current Account [as % of GDP] (2000 - 2021)



Source: Refinitv Datastream Date: 20/08/2021

We think that there are enough supportive factors to ensure that the peso should be able to post decent gains against what we think will be a broadly weaker US dollar in the next twelve months or so. The unwillingness of the Mexican government to support the economy through fiscal spending does, however, ensure that we think these gains may be slightly less pronounced than they otherwise would have been.

We think that there are enough supportive factors to ensure that the peso should be able to continue to post decent gains against what we think will be a broadly weaker US dollar over our forecast horizon. We are, therefore, revising our USD/MXN forecasts lower in order to reflect the recent improvement in sentiment towards the peso. In our view, Mexico's rather slow vaccination rollout may, however, limit gains for the currency.

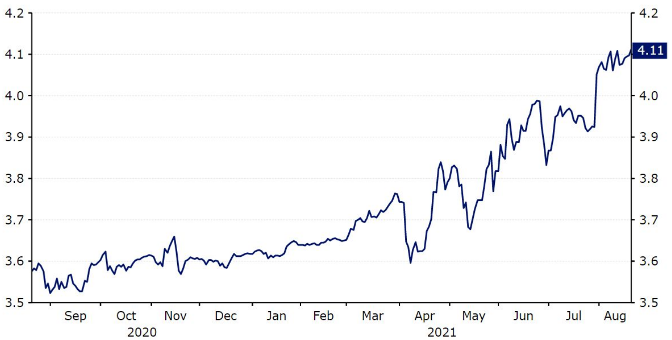
	USD/MXN	EUR/MXN	GBP/MXN
Q3-2021	20.00	23.60	28.20
E-2021	19.80	23.55	28.10
Q1-2022	19.70	23.85	28.15
Q2-2022	19.60	23.90	28.20
E-2022	19.50	24.20	28.30

Peruvian New Sol PEN

The historically low volatile Peruvian new sol (PEN) has suffered one of its worst sell-offs in recent years versus the US dollar so far in 2021.

The new sol fell to a nineteen-year low at the height of the market panic in March 2020, before erasing most of its losses amid an aggressive stimulus injection from the Peruvian government. In the second half of last year, the currency sold-off again at a time when most other emerging market currencies rallied amid 'risk on' trading. It has continued to fall aggressively so far this year (Figure 18), down over 11% year to date to a record low north of 4 to the US dollar. The currency is now trading 19% lower since the start of 2020, despite ongoing intervention from the Central Reserve Bank of Peru.

Figure 18: USD/PEN (August '20 - August '21)

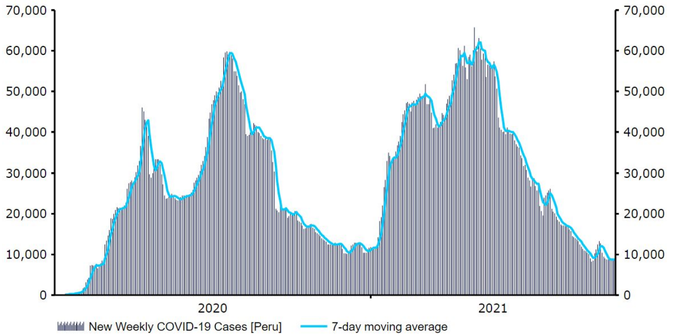


Source: Refinitv Datastream Date: 20/08/2021

The extent of the sell-off in the new sol can, in our view, be largely attributed to both recent political developments and the aggressive spread of the COVID-19 virus in Peru, which has significantly soured sentiment towards the currency. Peru has been one of the worst affected countries in the world by the pandemic, so far reporting more than 2.1M cases and 197k deaths at the time of writing.

This is comfortably the highest number of COVID-related fatalities in the world on a per capita basis according to worldometers (5,900 per 1 million people) - almost double Hungary in the number two spot. The third wave of infection has, at least, passed since the peak of new cases in April and the pace of daily vaccinations has finally begun to pick up pace (0.7 per 100 people per day in mid-August). So far, however, only around 28% of the population have received at least one vaccine dose, so a removal of all restrictions still appears a little way off.

Figure 19: New Weekly COVID-19 Cases [Peru] (March '20 - August '21)



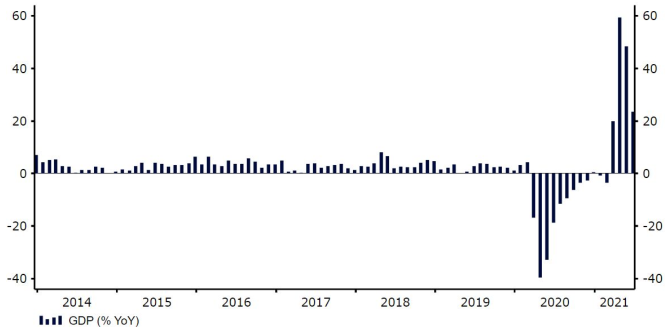
Source: Refinitv Datastream Date: 20/08/2021

An inadequate health system, including unequal access to health care and a shortage of medical supplies, has left some regions ill-equipped to deal with the pandemic. Corruption has also reportedly left many of the most vulnerable without financial assistance, causing large numbers to flaunt the strict lockdown measures. A raft of inquiries have been opened up since the beginning of the first national lockdown, with most looking into whether officials have embezzled funds designed to pay for aid or protective equipment. More recently, a vaccine queue-jumping scandal involving the now-former president Martin Vizcarra sparked further outrage at the authorities' handling of the crisis.

A loss of confidence in the government led to the impeachment of Vizcarra in November. A new leftwing leader, Pedro Castillo, was sworn in as president in July, following April's election and subsequent runoff vote in June. The market has generally greeted Castillo's appointment negatively - the new sol suffered its worst daily sell-off in seven years following his surprise first-round victory back in April. Castillo has proposed a number of drastic changes, notably to redraft the constitution in order to nationalise the country's mining, energy and telecoms industries and strengthen the role of the state. In our view, these proposed policies and Castillo's leadership present the biggest downside risk to the new sol over our forecast horizon.

Despite the political risk premium currently attached to the new sol, we believe that there are a number of supportive factors that could allow the currency to reverse some of its losses in the medium-term. Low government debt (still only 35.4% of GDP in 2020), has allowed the Peruvian government to pump a huge amount of stimulus into the economy since the onset of the crisis, indeed the largest in the region. The sell-off in PEN during the crisis period has also created a sharp divergence in the currency with that of global copper prices, to which the Peruvian economy is heavily linked. London Metal Exchange (LME) copper prices have continued to rise at a steady pace throughout most of the year so far, albeit are now back trading around the US$9,200 per tonne level. We think that this is a clear positive for the Peruvian economy, and could provide a tailwind for the new sol during the remainder of the year.

Figure 20: Peru GDP Growth Rate (2014 - 2021)



Source: Refinitv Datastream Date: 20/08/2021

During the period of new sol weakness, the Central Reserve Bank of Peru has continued to intervene in the market in order to protect the currency and should have additional room to do so again in the near future. Peru's FX reserves have dropped by around 10% since March amid continued intervention, although remain more than sufficient at around 18 months' worth of import cover. We think that the central bank should have plenty of room to continue intervening in order to limit currency fluctuations. Peru's current account also moved into positive territory in 2020 for the first time since 2007 (+0.7% of GDP), with exports recovering to above pre-pandemic levels in recent months. Aggressive interest rate cuts at the start of the crisis, and a recent move higher in domestic inflation do, however, mean that real rates are deeply negative in Peru (-3%). This, in our view, presents another fairly significant downside risk to the new sol.

Given the ample room available for continued central bank intervention, and the significant undervaluation of the new sol relative to global copper prices, we still continue to forecast gains for PEN versus the dollar over our forecast horizon. The commencement of an apparent interest rate hike cycle by the Central Reserve Bank of Peru in August should also be supportive of the currency. That being said, we think that the election victory for leftwing leader Pedro Castillo places a sizable political risk premium on the currency and we are, therefore, revising our forecasts for the new sol lower across the board.

	USD/PEN	EUR/PEN	GBP/PEN
Q3-2021	3.80	4.50	5.35
E-2021	3.70	4.40	5.25
Q1-2022	3.60	4.35	5.15
Q2-2022	3.60	4.40	5.20
E-2022	3.60	4.45	5.20

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