Galapagos Capital Monthly

November 2022

Keeping up with Jay

As we have noted in recent pieces the main concern of investors has shifted to the possibility of recession in developed economies and in some cases -mostly from central bank officials- to potential problems of financial stability associated the rapid pace of central bank tightening after the events in the UK. Markets continue to bank on the supposition that the FED will pivot and reduce the pace of hikes aided by the perception that some officials weigh more financial stability or are more concerned about overtightening than controlling inflation. To be sure, the perceived dovishness propelled stock markets in the US to one of the best monthly returns on record in October, bear market or not. The FED's November decision hopefully disabused markets of those notions by emphasizing that the pace of hikes is secondary to the more relevant issues like the terminal rate and how long it will need to stay at that level. To be sure, Jay Powell clearly indicated in his press conference that the terminal rate would be higher than they anticipated. The FED is going full steam ahead with little concern about the impact on the real economy; the path for a soft landing has narrowed and we continue to expect a mild recession in the latter half of 2023. After almost 15 years of cheap money, the bill is arriving. The world partied hard, and the hangover will be brutal for some. If anything, the FED kept the punchbowl going for far too long.

The IMF meetings early in the month reflected a bearish sentiment about growth globally but also highlighted the favorable potential for emerging market investors -particularly in Latin America- in countries that got ahead of the inflation problem and made timely monetary policy adjustments. Central banks acted early, and the pace of adjustment was absorbed well by their economies over a long period allowing for a gradual adjustment of relative prices and minimizing financial stability risks or sharp downturns in economic activity. The stance of regional central banks is now much closer to where they should be, recognizing that a restrictive stance is required to bring inflation back to target whereas for instance in Europe that discussion is a no-no. In the presence of continuous adverse shocks, emerging market policy makers understand that the next battle starting in 2023 will be to restore proper fiscal anchors and preserve debt sustainability; these and other structural reforms are the only appropriate policies to shield countries from the convoluted global environment. Investors will undoubtedly reward those who take these challenges seriously.

Markets are actively looking for a pivot from the FED since late spring and have been disappointed including with the November decision. Yes, hiking interest rates is unpopular, painful, and politically "inappropriate" but it is the right thing to do to control inflation that has so many adverse effects on all the population, not only on some. Ending tightening cycles prematurely also carries significant risks, too many to list here. We believe it is preferable to overdo it a bit if necessary -we agree with Chairman Powell-, rather than under doing it: excessive tightening can be unwound quickly while underdelivering adds to uncertainty and damage can be extended over a much longer period. Risks to financial stability issues in the US like those in the UK emanating from a solid tightening cycle, are unlikely, as former NY FED chief Bill Dudley noted in a recent Bloomberg

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article. The issues related to low liquidity in the treasury market can be addressed with the expansion of existing repo facilities and potential treasury swaps (buybacks is a misleading term) which are already being considered actively. That said, the FED has already warned and appears to be willing to pay the painful cost of a recession to solve the inflation challenge.

We recently changed our call on the FED to a higher terminal rate of between 5.25 and 5.5% arguing that inflation, inflation expectations and the labor market are taking much longer to correct, and an additional dose of rate hikes is in order. As opposed to market pricing and market views, we disagree with an unconditional pivot. When the FED decides to "stepdown" the pace to, say 50bp, -according to Powell es soon as December or as late as February of '23- it will have to be complemented by a clear indication that the cycle will be longer and the terminal rate higher -5.25% to 5.5% seems right- and once at that level, the FED will keep it long enough for inflation to slow meaningfully to levels consistent with the target. In his press conference Powell agreed with our script. We believe the December meeting will be the appropriate place for that "pivot" when the FED provides a fresh assessment and forecasts for inflation. Between here and there, there will be plenty of data and Fedspeak to argue back and forth about how far the FED should go. Our guiding principle comes from the latest FED projections where it seemed to be targeting a 1.5% real policy rate. Even after the November hike the policy rate is still in negative territory and not even at neutral. There is progress but more is needed.

Central banks in Mexico, Colombia and particularly Chile may have to rethink their policy paths. Some of Banxico's board members were getting ready to decouple from the FED but the latest developments will force them to reconsider. A terminal rate above 11.0% seems appropriate. Chile chose to close its cycle at 11.25% but they based their scenarios on the old FF path and a much different level of the currency. We have been skeptical that such a decision was timely, and it now seems that the cycle may have ended prematurely. Restarting the cycle will be difficult but adding another 50 to 75 bp to their current target also seems warranted to us. Banrep is facing serious policy challenges only amplified by the presidential rhetoric that undermines its independence. Here we see that they would need an extra 50 to 75 bp of extra effort to get the job done. Brazil is at a different stage of its cycle. We believe that the current level of policy rates of 13.75% will need to stay through mid-2023 to allow for a proper disinflationary trend to set in.

What will be the implications for markets in general and emerging markets in particular of a FED decision that reduces the pace of tightening but elevates the terminal rate?

We believe that an extended FED hiking cycle will continue to support a strong dollar, at least through spring; other central banks are already in the process of slowing the pace of tightening, while others have stopped. Norway and Canada hiked by less than expected, the ECB already noted that they would not match the FED's pace and terminal rate, and the Bank of England pushed against the market pricing of a terminal rate above 5%. Some will likely end prematurely. We see no central bank globally that is likely or willing to overdo their tightening. A strong dollar also will be a headwind for stocks and many commodities' prices perhaps with the exception of energy which will continue to be affected by geopolitical developments related to the war in Europe, decisions by OPEC+ to protect their market, and fundamentally to a lack of investment in the sector. Unclear regulation and ambitious government programs for energy transition lacking the proper consideration of the significant hurdles that a serious assessment of the

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time required to adopt new technologies are unhelpful. The sector requires pragmatic and realistic targets not just wishful thinking. There is no secret that the bumper profits of oil companies worldwide will not likely flow into new investment but rather be given back to investors in the form of dividends. Rather than demonizing oil companies and threatening to tax "excessive profits" the US government should find a way to balance the urgent need to invest in fossil fuels while promoting a realistic energy transition. Consumers are certainly paying the price for such a controversial approach to energy security. That said, the midterm elections in the US and the potential Republican wave to take both houses of congress may provide some regulatory relief in many areas but particularly in energy.

Emerging markets will, yet again, face another shock in the form of tighter financial conditions and potentially adverse terms of trade shocks and wider external funding gaps. Currencies could potentially come under pressure. As emerging market experts know after decades of dealing with these problems, countries need to do the proper fiscal adjustments in conjunction with an appropriate monetary policy stance to weather the storm. There is simply no good substitute for a strong fiscal anchor. This will be the topic for 2023 in our view. Investors will reward countries with strong fiscal programs focusing not only on implementing tax reforms but also in streamlining expenditures especially those related to the pandemic, phasing out programs that are no longer justified and avoid making them permanent. Fiscal rules are necessary, but they need to be credible and easily traceable; too many exceptions or loopholes undermine their purpose.

During the month we had two important events for our markets, China's 20th Party Congress and presidential elections in Brazil. The economic message coming out of China's quinquennial meeting is that the country will seek "sustainable development", the modernization of its economy and a more balanced growth path. The stark emphasis on the security of its supply chain, as well as on its food and energy needs is noteworthy. Their inward emphasis of the engines of growth can reinforce the deglobalization trend we are already witnessing. There was no guidance whatsoever regarding their COVID policy, but we believe that March 2023 is the earliest date they will consider reopening the economy. Militarily, the message was clear: although a peaceful unification process with Taiwan is preferable, they wouldn't hesitate to use force. This will be crucial for markets going forward adding a potentially significant tail risk. Finally, on the political front, we saw President Xi being renominated for a third term in a process that can only be described as a show of force. The new members of the Politburo Standing Committee are all Xi's allies, thus giving him even more power. The second in command and the person responsible for overseeing economic policy, Li Quiang, seems less prone to market reforms than Li Keqiang, his predecessor. In sum, we believe the outlook for the Chinese economy remains uncertain, if anything the results of the 20th Party congress left observers more concerned about the direction of the country. China is becoming more of a wildcard rather than the stabilizing force of years past.

The elections in Brazil resulted in a political configuration predominantly of center-right. In 2023, 73% of congress and 84% of the senate will be members of centrist or right-wing parties; 20 of the 27 states will be governed by center-right politicians. All the indications are that the winning leftist coalition for President (PT and PSB) will have to negotiate with centrist parties to broaden their coalition to be able to implement their reform agenda. The fiscal challenges in Brazil will be significant in 2023, and as we argued at the beginning of this letter, markets will be

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particularly sensitive to the new government's fiscal plans. A favorable scenario will include a proper proposal for a new fiscal framework and other reforms, especially a set of objectives that can be traced by investors once the spending cap has been essentially abandoned. In the next couple of months, investors will be following closely the approval of the 2023 budget including identifying resources to fund the Auxilio Brasil program, transfers to support children under the age of 6 and the formation of new ministries. The new government will take office on January 1, 2023.

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