

EM Alpha

Brazil tames the beast, Colombia lets it roam – Long BRL/COP

The trade: Long BRL/COP

We initiate a long BRL/COP trade (entry: 724, target: 775, stop: 700). The trade has three-month annualized carry of 4.5%, with historical volatility at 12.8%. We expect BRL to outperform given its exceptionally high carry, attractive valuation, and the potential for improved Brazil-US trade ties. In contrast, we expect COP to underperform due to fiscal slippage, flow reversals, and concerns around foreign policy. Risks are higher public spending in Brazil, potential rate hikes in Colombia, and large dollar sales by Colombia's treasury.

Large interest rate differentials

Both BRL and COP rank among the highest-yielding currencies globally, but Brazil's 15% Selic rate is well above Colombia's 9.25% policy rate. The real rate differential – 5.6% based on one-year ahead inflation expectations of 4.2% in Brazil and 4.1% in Colombia – is significantly above the 3% average real rate spread observed since 2010.

Inflation declines in Brazil, rises in Colombia

Brazil's monetary policy appears *appropriately* tight, in our view, helping to push expected inflation down by nearly 170bp since February. In contrast, Colombia's policy stance seems *insufficient* to counterbalance fiscal slippage, with expected inflation stuck at around 4% and showing signs of renewed acceleration.

BRL around 15% undervalued relative to COP

Brazil's real exchange rate remains significantly undervalued relative to Colombia's, with BRL nearly 15% cheaper based on historical trade-weighted metrics. This valuation gap is impacting trade dynamics: Brazil continues to run solid trade surpluses despite coming off record highs, while Colombia is experiencing growing trade deficits.

Colombian rate cuts coming in 2026

We expect Colombia to cut rates next year, with the easing cycle being significantly deeper than what is currently priced by the market. In our view, the terminal rate in Colombia will be 7%, but the market is pricing only 9%. This should put some pressure on the Colombian peso, particularly should we get any dovish surprise this year.

Colombian treasury running out of dollars to sell

Colombian authorities reported two weeks ago that the government had about \$6.8bn in foreign currency liquidity. However, local press has since then reported that the government may have already sold about \$3.4bn. Moreover, implicit in the 2026 Financial Plan is the objective to keep about \$2bn in foreign currency liquidity by 2025-end. In our view, this suggests that the government has now much more limited room to sell dollars.

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The trade: Long BRL/COP

We initiate a long BRL/COP recommendation (entry: 724, target: 775, stop: 700). The trade offers a 3-month annualized carry of 4.5%, with historical volatility at 12.8%. We expect the BRL to outperform given its exceptionally high carry, attractive valuation, and the potential for improved Brazil-US trade ties. In contrast, we expect COP to underperform due to fiscal slippage, flow reversals, and concerns around foreign policy. Risks are higher public spending in Brazil ahead of next year's election, potential rate hikes in Colombia, and large dollar sales by Colombia's treasury.

Large valuation gap to rate differentials

Both BRL and COP rank among the highest-yielding currencies globally, but Brazil's 15% Selic rate stands well above Colombia's 9.25% policy rate. The real rate differential – 5.6% based on one-year ahead inflation expectations of 4.2% in Brazil and 4.1% in Colombia – is significantly above the 3% average real rate spread observed since 2010.

Real interest rate differentials are typically a key driver of exchange rates (see Exhibit 1). Yet, despite Brazil's substantial tightening relative to Colombia this year, BRL has only modestly outperformed COP. We see three factors behind this. First, Colombia's growth has reaccelerated in 2025. Second, according to polls from EcoAnalitica, markets increasingly expect a pro-market candidate to win Colombia's 2026 election. And third, Colombia's treasury has conducted sizable dollar sales.

Inflation expectations decline in Brazil, rises in Colombia.

Brazil's monetary policy appears *appropriately* tight, helping to push expected inflation down by nearly 170bp since February. In contrast, Colombia's policy stance seems *insufficient* to counterbalance fiscal slippage, with expected inflation stuck at around 4% and showing signs of renewed acceleration (see Exhibit 2).

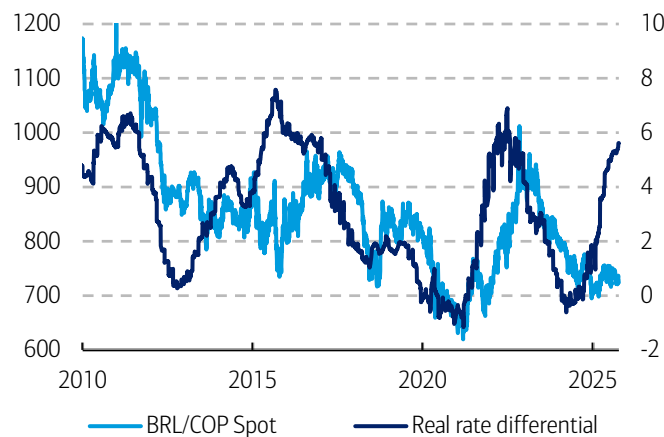
As a result, we expect Brazil to begin easing in December with a 50bp cut, lowering rates to 11.25% by end-2026. In Colombia, we have postponed our expectation of the next rate cut to March 2026, with the policy rate now forecast at 7.5% by end-2026 and 7% by mid-2027.

BRL is almost 15% undervalued relative to COP

Brazil's real exchange rate remains around 10% cheaper than in early 2024. In contrast, Colombia's real exchange rate has returned to early-2024 levels. Based on historical real trade-weighted exchange rates, we estimate that BRL is nearly 15% undervalued relative to the Colombian peso.

Exhibit 1: Large real rate differential suggests undervalued BRL/COP

Spot BRL/COP (left axis) and real ex-ante policy rate differential (right axis)



Source: Bloomberg, Haver Analytics

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Exhibit 2: Inflation expectations decline in Brazil but rise in Colombia

One-year-ahead CPI expectations based on surveys in Brazil and Colombia



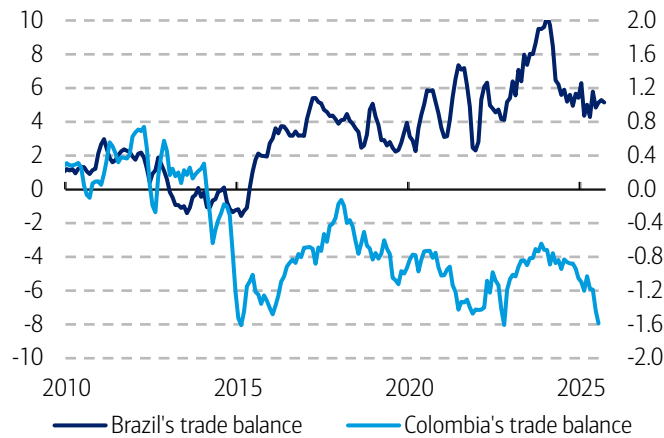
Source: Bloomberg, Haver Analytics

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Exhibit 3: COP overvaluation driving larger trade deficits in Colombia

Brazil (left) and Colombia (right) trade balance (US\$bn, 3m ma)

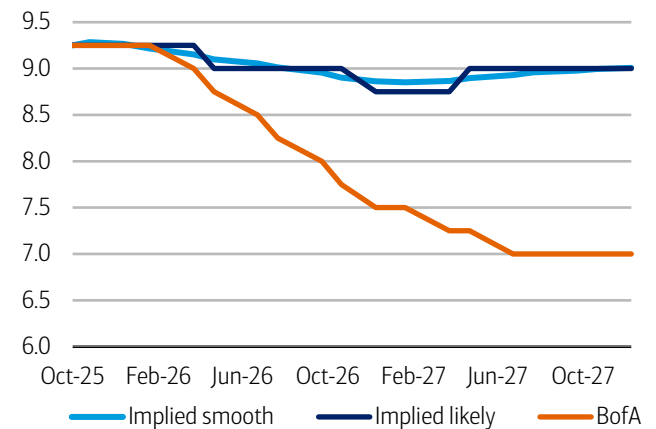


Source: Haver Analytics

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Exhibit 4: We expect a deeper-than-priced easing cycle in Colombia

Market-implied policy rate vs. BofA forecast (%)



Source: BofA Global Research, Bloomberg

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This valuation gap is already influencing trade flows. Brazil's trade surpluses, while off their record-highs from a stellar agricultural season, remain well above multi-year averages. Colombia, on the other hand, is running record trade deficits (see Exhibit 3). Moreover, Brazil's economic slowdown should support trade surpluses, while Colombia's reacceleration is likely to exacerbate deficits. We see this as strong evidence of an overvalued Colombian peso.

Hawkish BanRep for now... but not forever

Strong growth and fiscal slippage have both pushed BanRep (the central bank of Colombia) to remain on hold over the past 3 meetings. We don't disagree with the hawkish shift, as we see potential risks to the short-term inflation outlook. Specifically, a potentially higher-than-expected minimum wage hike may add some pressure on inflation and justifies maintaining a tight monetary policy for longer. This is particularly the case given that economic activity has surprised to the upside. The labor market remains tight, with unemployment at historical lows. Not only that, but economic activity, industrial production, manufacturing production, and retail sales have all surprised to the upside in the most recent print.

However, we have been arguing that the drivers of growth seem fragile and unsustainable. Expansionary fiscal policy, large minimum wage hikes, and remittances, have been supporting domestic demand but seem to be temporary boosts (see the report, *Waiting for bold fiscal action from the next president*). Therefore, we expect the central bank to cut rates next year, with the easing cycle being significantly deeper than what is currently priced by the market (see Exhibit 4). In our view, the terminal rate in Colombia will be 7.00%, but the market is pricing only 9.00%. This should put some pressure on the Colombian peso, particularly should we get any dovish surprise this year.

A distorted market that warrants risk premium

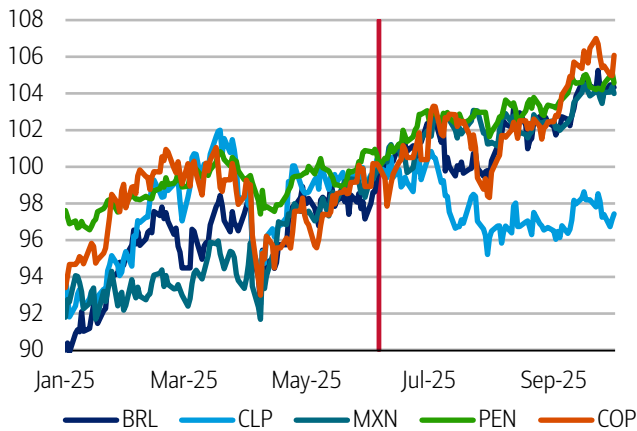
We believe that the Colombian peso has rallied well beyond fundamentals. Granted, the high carry and the weak dollar narrative could be providing some support to COP, as has been the case with the rest of LatAm. However, we believe that it is mostly stronger on the back of Colombia's unconventional liability management operation.

We believe that COP should have *underperformed* LatAm FX, as it should have priced some fiscal risks. Instead, it has *outperformed* the rest of LatAm FX (see Exhibit 5). We believe this should correct as the market gains more confidence that the government's room to sell dollars has significantly narrowed.



Exhibit 5: COP has outperformed LatAm FX since fiscal rule suspension

Evolution of the Colombian peso and LatAm FX (Jun 2025 = 100)



Source: BofA Global Research, Bloomberg

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About two weeks ago, Public Debt Director Javier Cuellar reported that the government had about USD 6.8bn in foreign currency liquidity. However, local press has since then reported that the government may have already sold about USD 3.4bn. Moreover, implicit in the 2026 Financial Plan is the objective to keep about USD 2bn in foreign currency liquidity by 2025-end. In our view, this suggests that the government has now much more limited room to sell dollars.

With less room for additional FX market distortion, we believe that fundamentals will take over price action. Fundamentally, we believe that Colombia's fiscal position is weaker than it was before. The key risk with Colombia's fiscal stance is, in reality, the persistence of wide fiscal deficits. We believe that this higher risk is still yet to be priced in the Colombian peso.

Policy risks ahead may impact the Colombian peso

We also see some significant policy risks ahead that could act as a trigger for a weaker Colombian peso. Among these are the Historical Pact's primary elections to be held on October 26. A strong turnout may provide a signal to the market that the election could be more uncertain than initially expected. Other relevant domestic risks are the potential approval of a competence law that clears the way for the decentralization law, approval of health reform, as well as a rejection of a fiscal reform, all of which would increase the already high fiscal risks.

Escalation of tensions between Colombia and the US could also put pressure on the currency. Unlike Brazil, which is a relatively closed economy with stronger ties to the Chinese market, Colombia's economic ties with the US are relevant. A further deterioration in the relationship may increase the risk of a more significant impact on external accounts. In our view, this would put pressure on the currency.



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