Research @ Citi Episode 92: Latin America — Room to Run, Risks to Watch

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Host: Rob Rowe, Head of Global Strategy and Macro Group, Citi

Guests: Ernesto Revilla, Head of Latin America Economics, Citi

Luis Costa, Head of Emerging Markets Strategy, Citi

Rob Rowe (00:02)

Hi, everyone, and welcome to the Research @ Citi podcast. I'm Rob Rowe. I'm the head of the Global Strategy and Macro Group, and I'm really pleased to have on the podcast today Ernesto Revilla, who is the head of our LatAm Economics team, and Luis Costa, who is the head of our Emerging Markets Strategy team.

The topic is Latin America. And one of the reasons why we have this topic today is because we also published a really extensive top-of-the-line publication, which we call Must C, on the LatAm economies and the LatAm markets.

Welcome, Ernesto. And welcome, Luis.

Luis Costa (00:34)

Good to be here.

Ernesto Revilla (00:35)

Thank you very much, Rob.

Rob Rowe (00:36)

Fantastic. Maybe we can start, Ernesto, with you, and maybe we can talk a little bit about the Must C report. Why we felt compelled to write it, and also give us context: What's going on in the Latin American economies, and what are the potential opportunities there?

I think also you're relatively optimistic about the region, and that's good to hear. We have some latent developments that we'll also discuss in terms of elections, etc., but maybe we can start off there.

Ernesto Revilla (01:02)

Of course. We titled the report *Latin America Poised for Growth* and that's because we are seeing a combination of positive factors aligning for Latin America that we haven't seen probably in decades, Rob.

So let me start with the observation that Latin America traditionally has suffered from low growth. If you look at a long series — for example, even 100 years of data — you see that Latin America's GDP per capita has been stuck at around 30% of the U.S. GDP per capita level. There hasn't been really convergence in terms of Latin America getting closer to the U.S. But now we are constructive on the region, we are optimistic, because we are seeing a set of factors that are very positive for the region.

Let me give you some of them.

First, Latin America is far away, fortunately, from geopolitical hotspots. It's far away from Russia and Ukraine, it's far away from the Middle East, and that means that investors see Latin America as a good place to diversify from geopolitical conflict.

In second place, Latin America is very well-placed for the reconfiguration in global trades. As the U.S. tries to decouple in the margin from Asia, China, from Europe, Latin America is very well-placed to satisfy the demands from the U.S., both on commodities and light, medium-value manufacturing, but also from the rest of the world. And some of our research has shown Latin America has kept its market share with the U.S. and has marginally increased its market share with China.

Then we have had a political cycle that some people call the super-cycle of politics in Latin America, where many countries in the region have moved from left to right. And that means that we have new administrations that are generally more market- and business-friendly. Of course, Brazil is now the biggest exception, and I'm sure we will discuss it at length in the podcast. But there was a big trend on politics moving to the right, and investors are constructive about that.

And finally, at this point, we have high commodity prices. We have a relatively weak dollar compared to 2025. And that's always a tailwind for emerging markets in general, but for Latin America in particular.

So that's our thesis. We are very constructive, it's a nice window of opportunity. But as we stressed in the report, it's not a guarantee for growth. Reforms have to be made. The new administration has to implement and execute. And now we are seeing some headwinds in the global economy, from the oil price to the increasing long-term rates. And domestically, we have El Niño weather phenomenon, which we can discuss. And of course, Brazil, the biggest economy in the region, re-elected President Lula for his fourth time.

So there are some headwinds for the very positive, this optimistic story, but we still think that Latin America is still well-placed for growth.

Rob Rowe (04:01)

Fantastic. And let me just hop to you, Luis, for a second: Talk about what the market implications of the potentially higher growth in Latin America are. I know we're going to

talk a little bit about high yields, which is a phenomenon globally, but let's talk a little bit about how you position Latin America relative to other emerging markets and other emerging-market strategies.

Luis Costa (04:20)

I think that one important differential here is the fact that many jurisdictions in Latin America have been running asynchronous monetary-policy cycles. What does that mean? It means that coming out of COVID, the likes of Brazil, the likes of Colombia — I mean, it happened the same in Chile – for several reasons, including the fiscal and inflation uptrends, they had to hike. But they have to hike a lot more than the other EMs if compared to CEEMEA jurisdictions, especially if you compare to the Asian counterparts.

And that allows the same jurisdictions two, three, four years down the road, most of them — probably not necessarily the case of Brazil — to enjoy sizable easing cycles, right? I mean, longer easing cycles, allowing more directionality of the trade here.

One important point as well, going back to the growth, to what Ernesto pointed out — which I think is very important, right? It's one important component of carry. For investors out there, looking for selective carry, it's not only the nominal carry behind that, but also, How is this carry protected by the terms-of-trade story?

This is something very important. And I know that many quants, many portfolio managers out there, they are looking into this type of stuff. And that helps quite a lot. I mean, for example, Chile, given the copper run. Brazil, very diversified and a very good bias when it comes to agri-commodities. Colombia, for the past year, given the oil shock, absorbing that in a positive way. So this is all helping the carry trade.

And it's very interesting, right, Rob? Because we have seen this in terms of flows as well. Over the past six months, especially after the oil shock, the beginning of the Iran conflict, we have seen macro flows moving out of Asia, out of CEEMEA, into LatAm assets. LatAm continues to be a little bit of a magnet to this type of investment.

Rob Rowe (06:17)

And what do you think in regard to what Ernesto is mentioning? Do you think that the major macro flow is due to the fact that it's isolated in a way? It's not really, but it's sort of isolated from geopolitical events. Or is it the potential growth and some of the positive things you mentioned about some of the countries?

Luis Costa (06:32)

Absolutely. I do think that this component of being far away from Russia, Ukraine, from Middle East risk, even though obviously we know that some of these economies in one way, not the other, they will be affected by higher energy levels. But if you take into account those first two, three months of normalization of prices after the beginning of the Iran conflict — probably April, May, June — that was a very important factor. And

investors were looking for places to hide, right? We're still benefiting from the carry opportunities and looking into the terms-of-trade alternatives out there.

Rob Rowe (07:11)

And Ernesto, we've had some recent developments. One is the election of Lula in Brazil. And I would ask also about the status of Venezuela, given what's happened there and the U.S. influence.

How are these two things impacting the region? You mentioned that you had seen a more conservative wave take place in Latin America, but obviously that's a turn. That's a change. Was that expected? And how does that affect the region? And how is the U.S. influence in Venezuela affecting the region?

Ernesto Revilla (07:39)

The election in Brazil was very surprising for the market. There are two rounds in the presidential election in Brazil. In the first round, candidate Flávio Bolsonaro, who is the son of former President Jair Bolsonaro, was ahead. So most people expected him to win easily in the second round of the presidency. Prediction markets had his probability at three quarters. Polls showed him ahead in the weeks after the first round. But it turns out that President Lula in the second round won by a very important margin against predictions, against the polls, against forecast prediction markets.

So let me give you this data point: No president in Brazil has won the presidency after having lost the first round. And that was the case of Lula. And he broke the tendency of Latin American countries moving from left to right: Brazil stayed on the left with President Lula, at 81 years old, going to start his fourth administration.

Now, markets reacted very badly. The Brazilian real fell more than 10 percent at some point in the first day of trading after the election. The equity market fell by double digits. Interest rates increased by up to 250 basis points in the initial knee-jerk reactions. So it was a huge surprise for the market, explained in part by positioning, and explained in part by the difference that the market interpreted Bolsonaro probably going to do — if he had won — very important reforms, particularly on the fiscal side. And President Lula more on the left side, more populist — not as strong on fiscal, which is really what Brazil needs.

The way I see it — and I'm sure Luis is going to have comments — is that we know Lula for a long time. This is going to be his fourth administration. It's not that he's surprising us. He will try to do something on the fiscal. And I think probably the market overreacted a little bit.

But it changes the dynamics of politics in the region. It will change how the U.S. relates to Brazil because, of course, the Trump administration would have preferred a closer ally in Flávio Bolsonaro.

And this leads me to Venezuela. Venezuela is extremely interesting. The stages that the U.S. set for Venezuela was, first, stabilization of the economy and politics, and I think that has been done. A much more stable country with the U.S. involved. The U.S. chose the vice president, now president, Delcy Rodríguez. So things look relatively more stable on the economic and political front.

We move to the second stage, which is recovery. An important part of the recovery is predicated on the oil industry. So the laws have been changed by the government down there. There's much more interest, increasing investment in Venezuela.

And now the big question in the eyes of the public and of the market is the third phase, which is transition — namely political transition towards democracy and towards election. And there's no visibility on how that can come. Local political analysts think it won't happen in the next 12 months, for example, maybe in a 24-month window. But that's the next stage that people want to see.

Let me finish, Rob, by saying that today we have elections in the U.S. Let's see what happens in the outcome. But that can change the relationship between the U.S. and Latin America in the margin, because if it's a Democratic Congress, they will put more oversight on Venezuela dealings — how the oil is flowing, how the money is going back to Venezuela. So that's going to be important to watch for sure.

Rob Rowe (11:00)

Do you think that's a positive outcome or a negative outcome in terms of how it'd be perceived?

Luis Costa (11:05)

I think it won't change much in terms of the broader Donroe doctrine — what people are calling the way the U.S. now relates to Latin America — because the Trump administration will continue to be very involved in Latin America regardless. And many of those interactions have been done without Congress through executive actions, and that will continue. But the additional checks and balances and Democrats controlling the Congress potentially can increase the oversight, particularly on the Venezuela dealings, many of which we don't have a lot of clarity so far.

Rob Rowe (11:36)

And Luis, Ernesto mentioned fiscal, and mentioned that yields flew up 250 basis points and that maybe the markets overreacted. Are the markets in general going to drive higher yields in Latin America as a result of fiscal concerns going forward? Will they also drive yields higher as a result of inflation?

Luis Costa (11:56)

Fiscal dominance, and that's what I tell clients all the time, right? Fiscal is nonlinear, right? And obviously very difficult to trade. But I think that if you take Brazil, if you single

Brazil out, it's going to be very difficult for investors not to differentiate the situation in Brazil now, given the political outcome, compared to what at least we are starting to see in other jurisdictions in LatAm.

Colombia, for example, and we know that [President Abelardo] de la Espriella got a very tough fiscal inheritance, right? I mean, he's got a mountain to climb in terms of fiscal consolidation. But I do get the sense that investors are giving the change of political vane, and political bias — and it's very initial innings — but I do get the feeling that investors are giving this a little bit more tolerance, right?

For Lula — and Ernesto made a very important point — we know what Lula's policy is about. It's not like this brand new left-leaning candidate just came. I mean, what is his policy going to be like? We know the story.

It's about social grants, but I mean, also Lula responds to markets' reactions. I mean, it happened since 2001, 2002, the beginning of his first mandate, and we had several occasions over the past years that he responded this way.

But I mean, it's interesting. After eight big shifts to the right in Latin America — it all started with Panama, El Salvador, so on and so forth, finishing with Colombia at the beginning of the year — it was a little bit of a disappointment from the bond-holder perspective to see a continuation of another Lula government.

It's going to be a very interesting litmus test, the beginning of the Lula government in 2027. Because yes, as I said, there will be less tolerance. The economy is starting to decelerate. I mean, that's very interesting because we have seen — to Ernesto's point as well — Brazilian growth has been reasonably exceptional to Brazilian standards over the past maybe two, three years. And we have finally seen some cracks in the wall, some responses to the very high nominal and real yields in Brazil. It's finally materializing in terms of creditworthiness, household economy, and so on and so forth.

So it's going to be very interesting. Should that give the central bank the window to cut rates in an environment where if you believe that slowdown in the output generation will transfer to disinflation, or will investors and analysts be so scared because nominal growth is coming down and yields should be higher because of the risks of fiscal dominance?

I think this is a very interesting discussion to have. And I do believe that at the beginning, central bank will be more cautious. And markets, there will be a lot more scrutiny in terms of what can be done by the new Lula government at the beginning of next year, after an inauguration, in terms of fiscal consolidation.

Rob Rowe (14:51)

So let's throw another wrench in. Ernesto, you mentioned El Niño. When I think about inflation, I would think that that would be positive for commodity-producing countries on the margin. Is El Niño, though, going to be detrimental to Latin America? Will it lead to

even higher rates? Or do you think that it's positive, especially for those countries that are more commodity-driven?

Ernesto Revilla (15:13)

Yeah, that's a great question. It's a question we struggle with, and we do research, and we produce reports around it. Usually, yes, high commodity prices are very beneficial for the region, for sure. And now we have high terms of trade associated with high commodity prices, and that's very positive. But El Niño brings a set of economic impacts that are usually negative on net for Latin America.

Why? Let me go one step back for our listeners. El Niño is this phenomenon of the Pacific Ocean becoming warmer by between 0.5 to 2.5 degrees Celsius. What that creates is extreme weather events that hit Latin America in differentiated ways. In some cases, it means more water and flooding. In some other cases, it means drought. So, it's hard to pinpoint exactly which country is going to be affected in which way.

But usually, these extreme weather events are negative for growth and for economic activity, and they increase prices, particularly of foodstuffs. So high commodity prices are positive for Latin America; high prices of food for the population, not so much. So, this is basically a stagflationary shock: lower economic activity, higher inflation.

And then the big question, how do central banks react? And I think the answer is it depends on the central bank. It depends on local conditions. Let me give you a couple of examples.

In Colombia, the central bank has been very hawkish. inflation has been above target for some time. So, they react to higher inflation from El Niño by hiking rates, and interest rates are quite high in Colombia, the second biggest in Latin America. On the other hand, you have central banks that are choosing to look past the El Niño shocks, like the central bank in Peru, the central bank in Chile. They say, well, yes, inflation is higher than target right now, but we know it's a supply-side shock. We hope it's transitory. We're going to hold and let's hope for the best.

So we now have a bit of a differentiated reaction. But El Niño, the stronger season is the fourth quarter of 2026, the first quarter of 2027, and countries are watching and preparing for a very big El Niño.

Rob Rowe (17:12)

So Luis, I guess that would beg the question: How high can rates go in the region? And aren't higher rates positive for carry?

Luis Costa (17:20)

Absolutely. If you put this all together, all the factors that we are discussing here, yes, it could. It could, in a way, we really like to look into real rate valuation, not only the nominal carry. But I mean, knowing that, of course, U.S. real yields have also been

revised higher over the past six, nine months. But that discussion of LatAm real yields vs. U.S. real yields is still sizable. So we do like the real yield valuation in LatAm.

But obviously, there are some pitfalls along the way, right? What Ernesto mentioned, which I think is very important: If El Niño really hits the Andean countries? For example, Chile, which is a central bank that has been more focused on the output drop, rather than the potential for reflation, something's got to give. And the markets don't like the central-bank response. The escape valve will be the Chilean peso, right?

Rob Rowe (18:16)

I see.

Luis Costa (18:17)

So I think that that's very important. If you put all those variables together, we can find winners and losers. And to Ernesto's point, we will all depend a lot on the central-bank reaction function.

Rob Rowe (18:30)

Got it. And we're coming close to the end of our talk. I wanted to ask two quick things. One is USMCA with Mexico. It seems like there are a lot of admirers of [President Claudia] Sheinbaum in the U.S. How do we think USMCA will go? Some people tell me it isn't really USMCA, everything's really a bilateral discussion. But how is it perceived from the Latin American end in terms of how this would go?

And lastly, which countries other than Brazil and Mexico do you see a really positive growth and future for?

Ernesto Revilla (19:00)

Let me do it very briefly and pass it to Luis. On USMCA, we are very constructive. The trade relationship between the U.S. and Mexico remains very strong. Mexico is now the number one trading partner of the U.S., and the market share of Mexico in U.S. imports continues growing, despite the noise around the trade agreement and the trade negotiations.

And I agree very much with the point you make, Rob, that it's all now bilateral. That's how things are negotiated. That's how the U.S. understands trade. And right now, it continues to be noisy, particularly on autos and tariffs on steel and aluminum. But I think our clients, investors, are understanding that the trade relationship continues regarding if it's a trilateral treaty, if it gets formalized, or if it gets extended year by year until the Trump administration ends. What matters is the trade relationship, but then that continues.

And very quick word on positive stories. We are seeing small countries in Latin America growing very fast, improving their credit quality. And these are Dominican Republic, Guatemala, Costa Rica, Panama. In that report that we were talking about, the Must C,

we call them the hummingbirds because they are small, but they grow fast. So we don't have Asian tigers, of course, in Latin America, but we have the hummingbirds and those are good credit stories.

Rob Rowe (20:15)

Do you agree, Luis? Is that an opportunity within markets?

Luis Costa (20:19)

Absolutely, especially on the credit side. Absolutely. I do think that some of these economies, they still offer very interesting metrics here.

And something that we haven't mentioned. In terms of relationship with the White House, even though knowing that the White House is not necessarily living the best days, but the change of the story over the past couple of years in Argentina has been fundamental. And I think that this is another jurisdiction where investors are still happy. Despite the whole appreciation of the bonds, investors are still very happy to participate.

And we moved. That's a very interesting story. We moved from credit-only interest, from EM credit investors, to local investors, right? Giving some consolidation, some stabilization of local markets without too much peso devaluation.

So it's still a story to be determined. It's a volatile story, but so far, so good. And that continues to attract a lot of client interest there.

Rob Rowe (21:17)

Fantastic. Well, Ernesto, Luis, thank you for your insights. This is exciting. I especially like to visit Latin America. Maybe this will be my opportunity to do so. Thanks very much.

Ernesto Revilla (21:25)

Thank you, Rob.

Luis Costa (21:26)

Thank you.

Rob Rowe (21:27)

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