RESEARCH

2nd QUARTER

2016

Outlook
Latin America

Main Messages

The global outlook has improved. but global growth will continue to be low. Financial stress has been reduced significantly in the last three months. especially in emerging markets. and commodity prices have recovered. Global growth will increase, but moderately and will remain fragile.

Latam GDP will shrink -1.1% in 2016 and recover to 1.7% in 2017. The fall in 2016 will be dragged by the sharp recession in Brazil. whereas the Pacific Alliance will grow 2.3%. Recovery in 2017 will be driven by the external sector (stronger global growth and better terms of trade) and higher investment in places like Argentina, Peru and Colombia.

The positive effect of the recent recovery of commodity prices will be offset by lower public expenditure. Public expenditure will be adjusted in most countries given lower tax receipts and to preserve fiscal rules and sovereign ratings. The main exception will be Brazil, where the necessary fiscal consolidation is likely to continue to be postponed.

Inflation abates slightly in most countries, helped by the recent appreciation of commodity prices. Lower inflation and weak domestic demand will allow central banks to wait and see, with stable interest rates likely for the remainder of this year with the exception of Colombia, where further hikes are likely. In turn, Mexico will continue to synchronize interest rate hikes with the Fed’s.

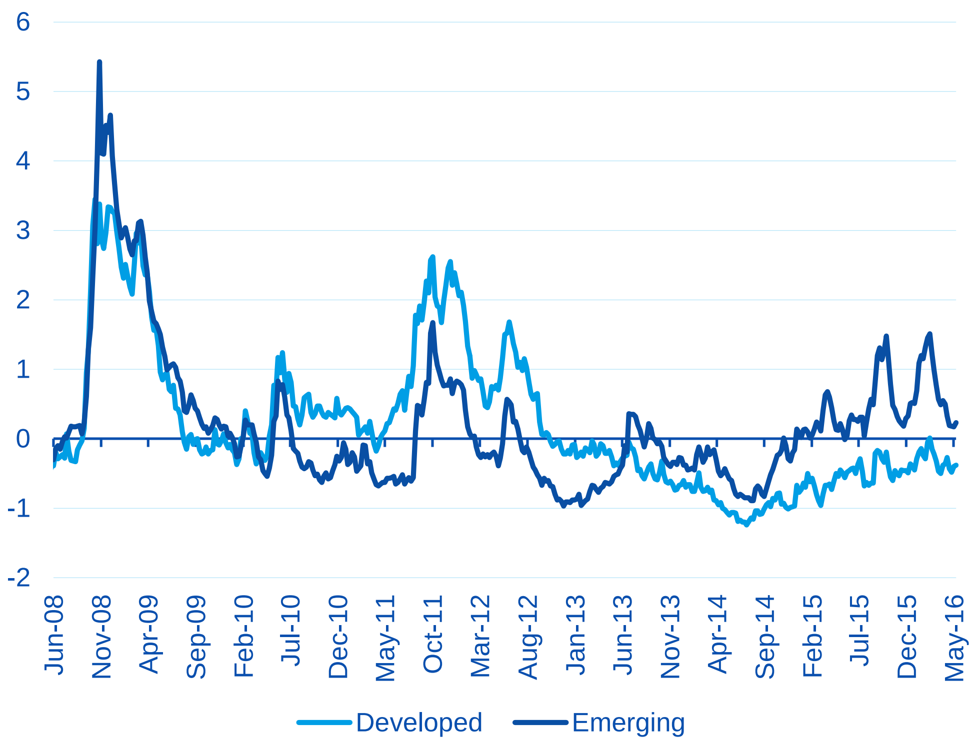
BBVA | RESEARCH

External environment

Global scenario improves, but growth will continue to be subdued

Global financial markets calm down in the last three months

Financial stress in financial markets
BBVA Research Financial stress index



Source: BBVA Research

Financial stress abates since high reached in January, especially in emerging markets…

… driven by:

1. Improved macro indicators in China and lower FX depreciation pressures
2. Recovery of commodity prices (especially oil)
3. More gradual expected path of Fed's rate hikes

Global economic scenario was quite negative three months ago…

-6%
Concerns on China
(fall in reserves)

-25%
Fall in oil prices
(Brent)

-12%
Stock markets
(MSCI Global stock market index)

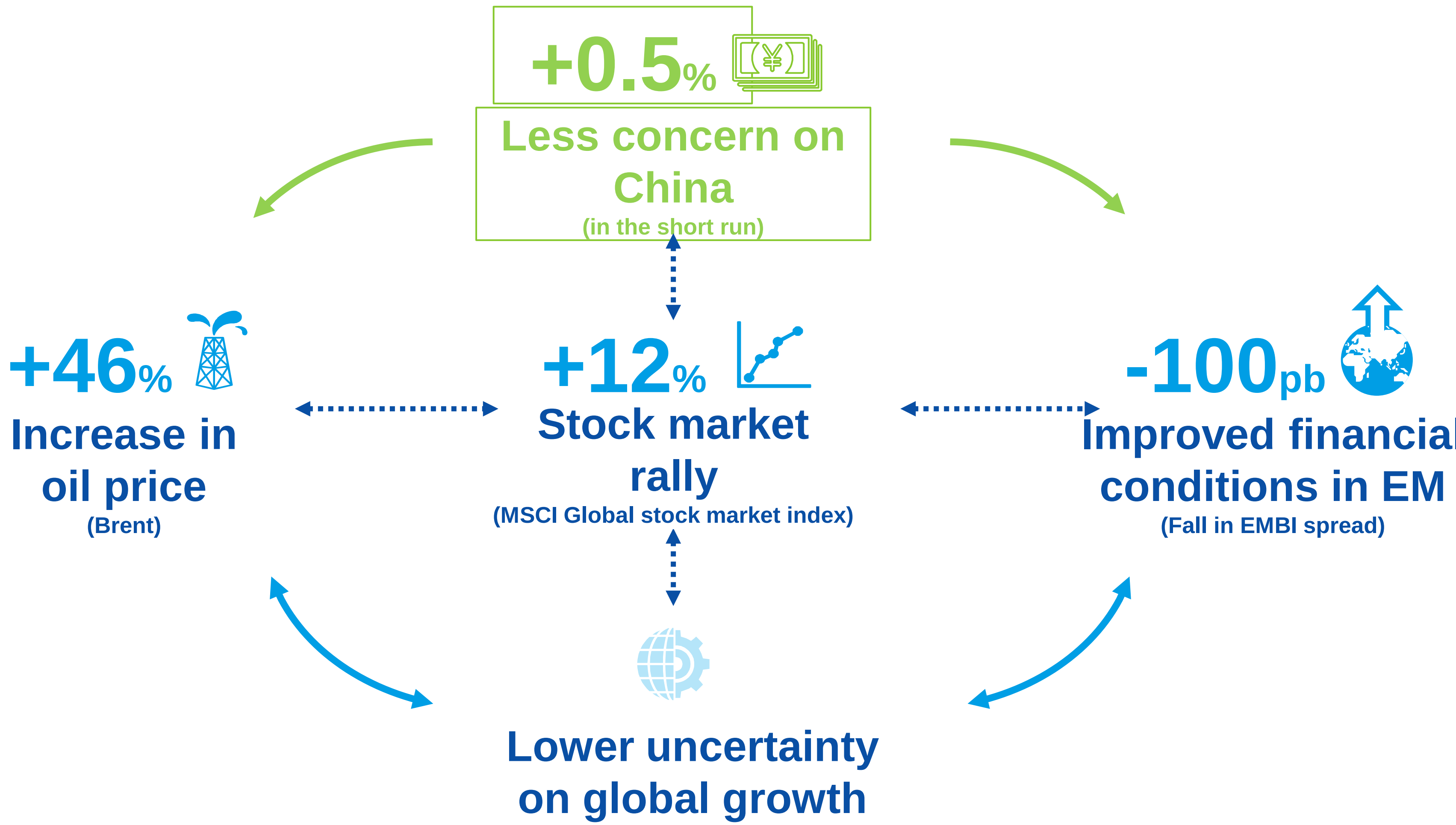
+100bp
Correction in Emerging Markets
(Increase in EMBI spread)

More uncertain global growth

Source: BBVA Research. Evolution from 11 Nov 2015 to 10 Feb 2016

BBVA RESEARCH

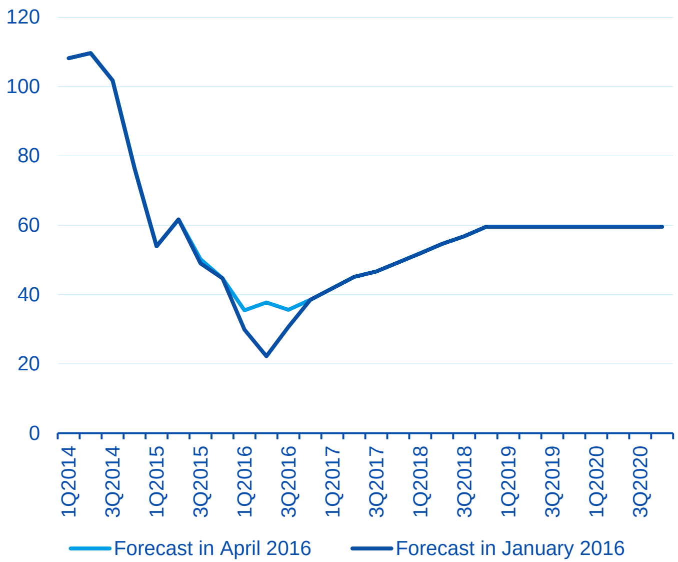
… but many of those factors have reversed in the last three months



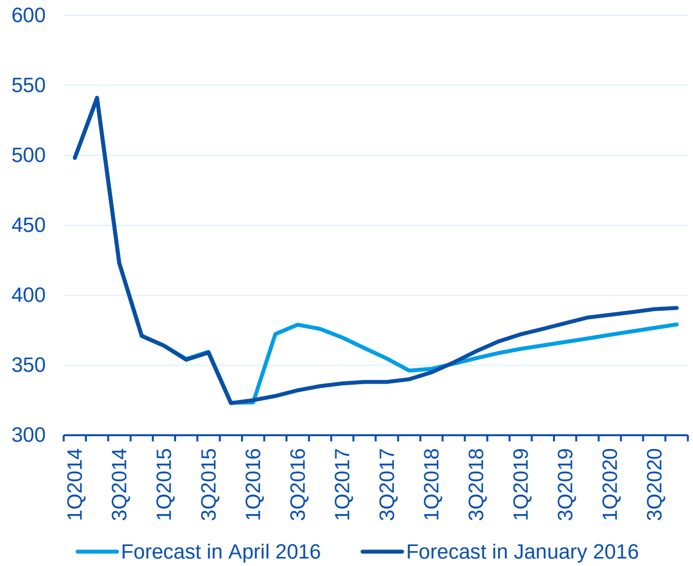
Source: BBVA Research. Evolution from 10 Feb 2016 to 10 May 2016

Commodity prices also benefitted from lower global volatility

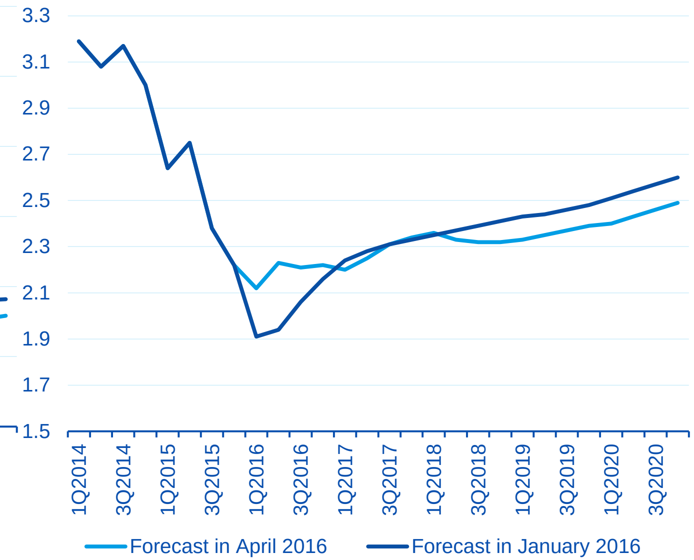
Brent oil: (USD/b)
Source: BBVA Research and Bloomberg



Soybeans: (USD/mt)
Source: BBVA Research and Bloomberg



Copper: (USD/lb)
Source: BBVA Research and Bloomberg

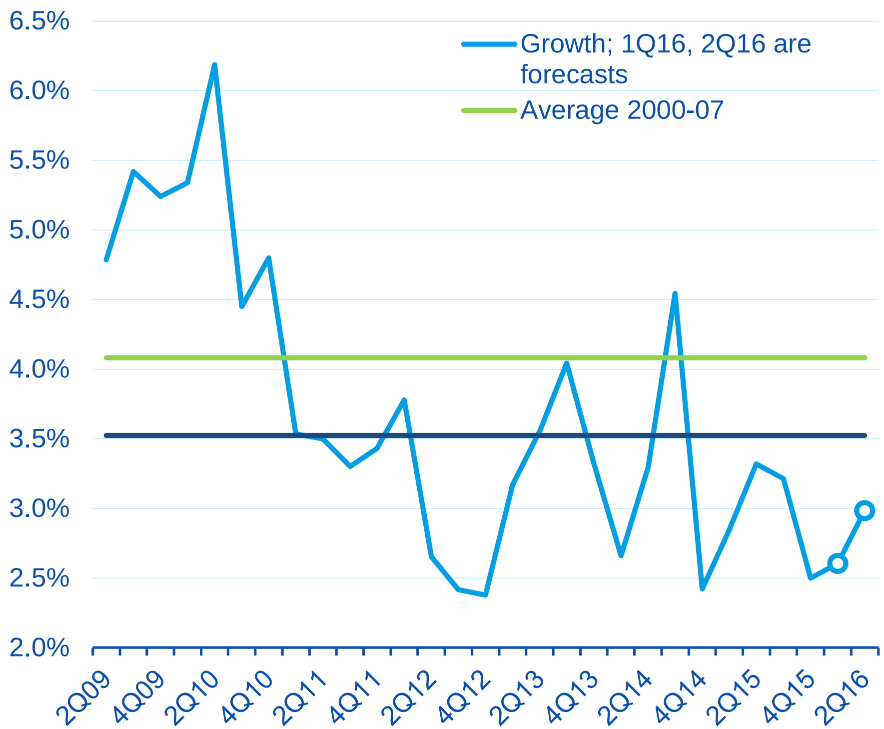


Oil and copper prices recovered driven in part by less concerns about policy support for growth in China …

… but long-term perspectives for commodity prices suffer given doubts about the pace of structural reforms in China

Nevertheless, global growth continues to be subdued, and with warning signs

Global growth (% qoq at annual rate) (Forecasts based on BBVA-GAIN model)
Source: BBVA Research



Global growth around 3% (annual rate) in the last quarter has been accelerating, but still far from previous years

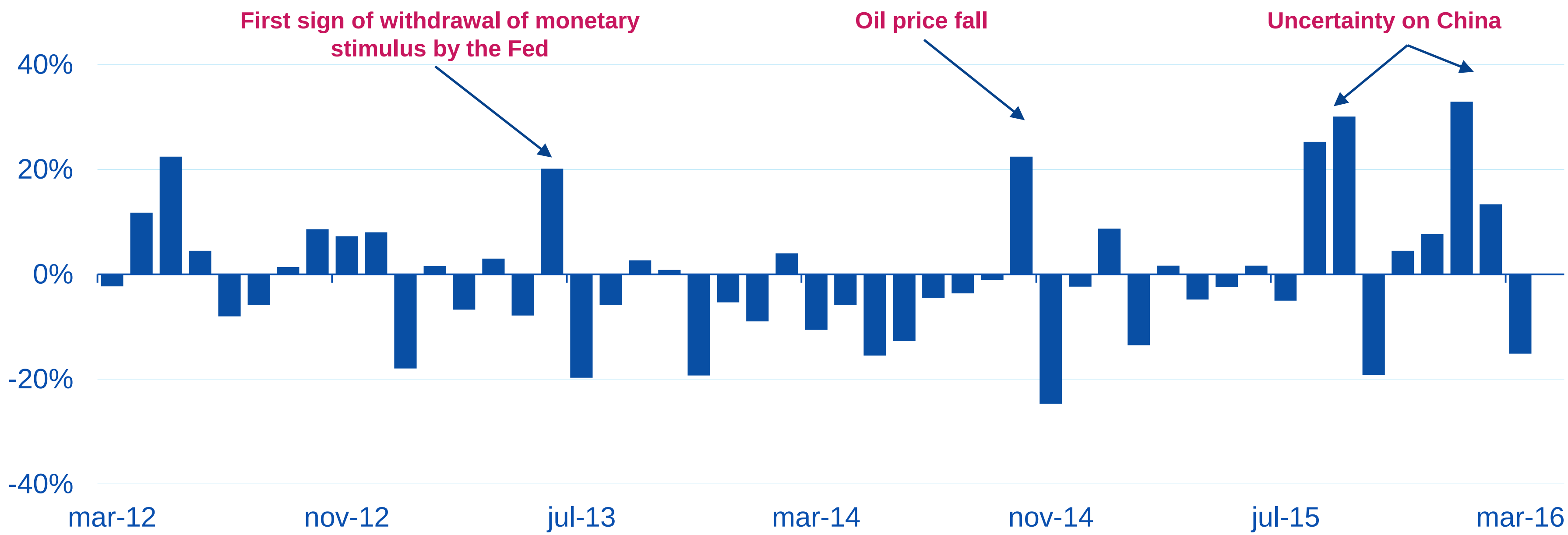
Global growth to increase to 3.4% in 2017 but it will still be subdued:

- Given adjustment in emerging economies
- Developed economies not growing beyond its potential
- Global investment still weak

Global trade growth still decreasing since 2014. Warning: traditional sources of global growth are not working, as well as in previous recoveries.

Additional warning sign: global uncertainty shocks are now more frequent …

Immediate effect of uncertainty shocks on financial volatility*
Source: BBVA Research



*** Effect on VIX (implied volatility of S&P 500) from a model of volatility and global growth. See global outlook for 2Q16 for details.**
Source: BBVA Research

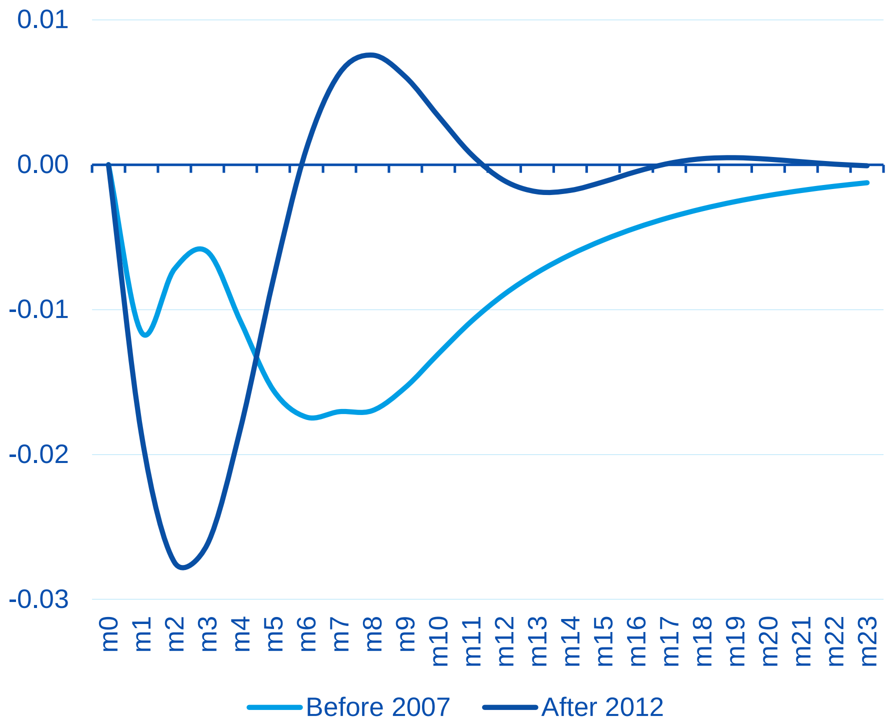
More frequent uncertainty shocks that generate high volatility (frequency has doubled)

Given fragile growth. uncertainty shocks tend to be amplified

… but their impact on growth, though stronger, is also shorter-lived

Effect on growth of a temporary increase in volatility (percentage points)*

Source: BBVA Research



*** Impact on growth of an increase in volatility caused by and increase in uncertainty. Details in Global Outlook 2Q16.**
Source: BBVA Research

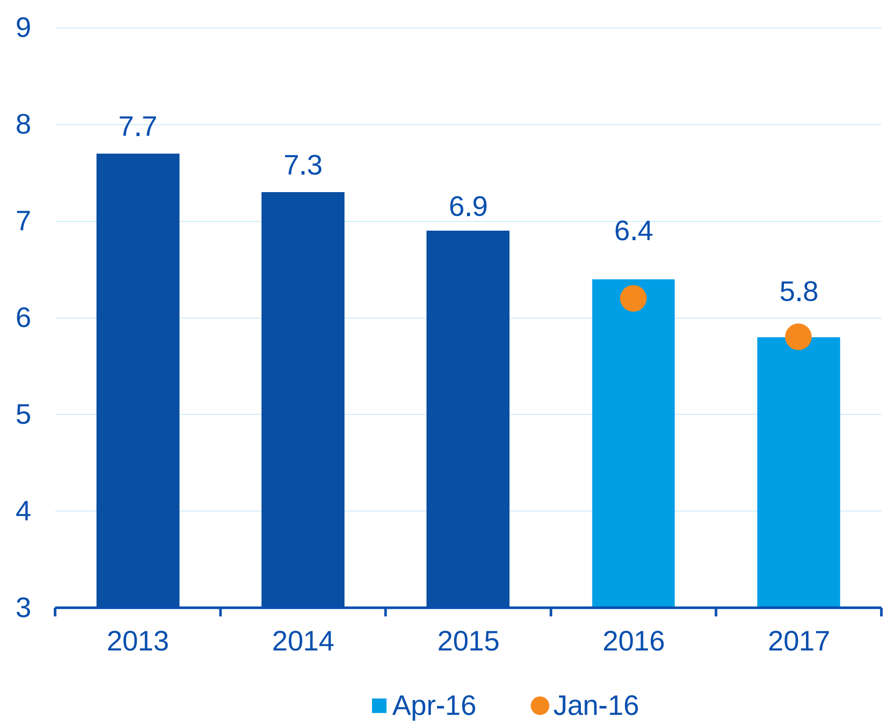
Good news is that even though negative shocks are more frequent, their impact on growth seems now less persistent

This could be in part the result of very accommodative monetary policy in developed economies, which buffer uncertainty shocks …

… but, what will happen when those accommodative monetary policies are withdrawn?

China: gradual adjustment to continue

China: GDP growth (%)
Source: BBVA Research

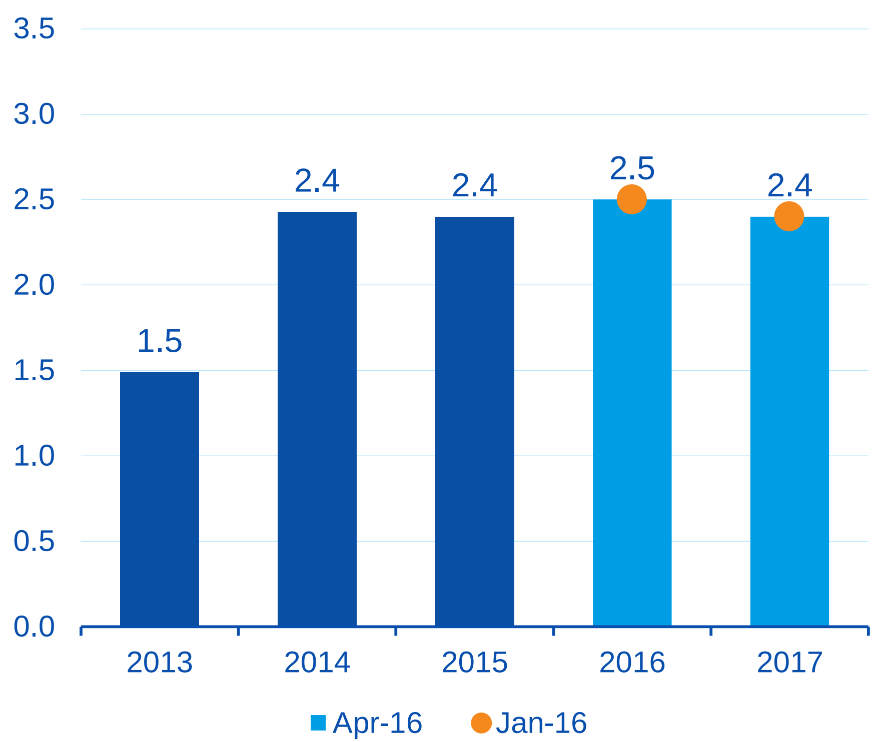


Monetary and fiscal stimuli will continue to support growth in the short run. A soft landing continues to be the central scenario

State-owned enterprises: sustained by increasing debt and carrying excess capacity. Without reforms, they will drag medium-term growth by hampering an efficient allocation of resources.

US: growth to increase during 2016

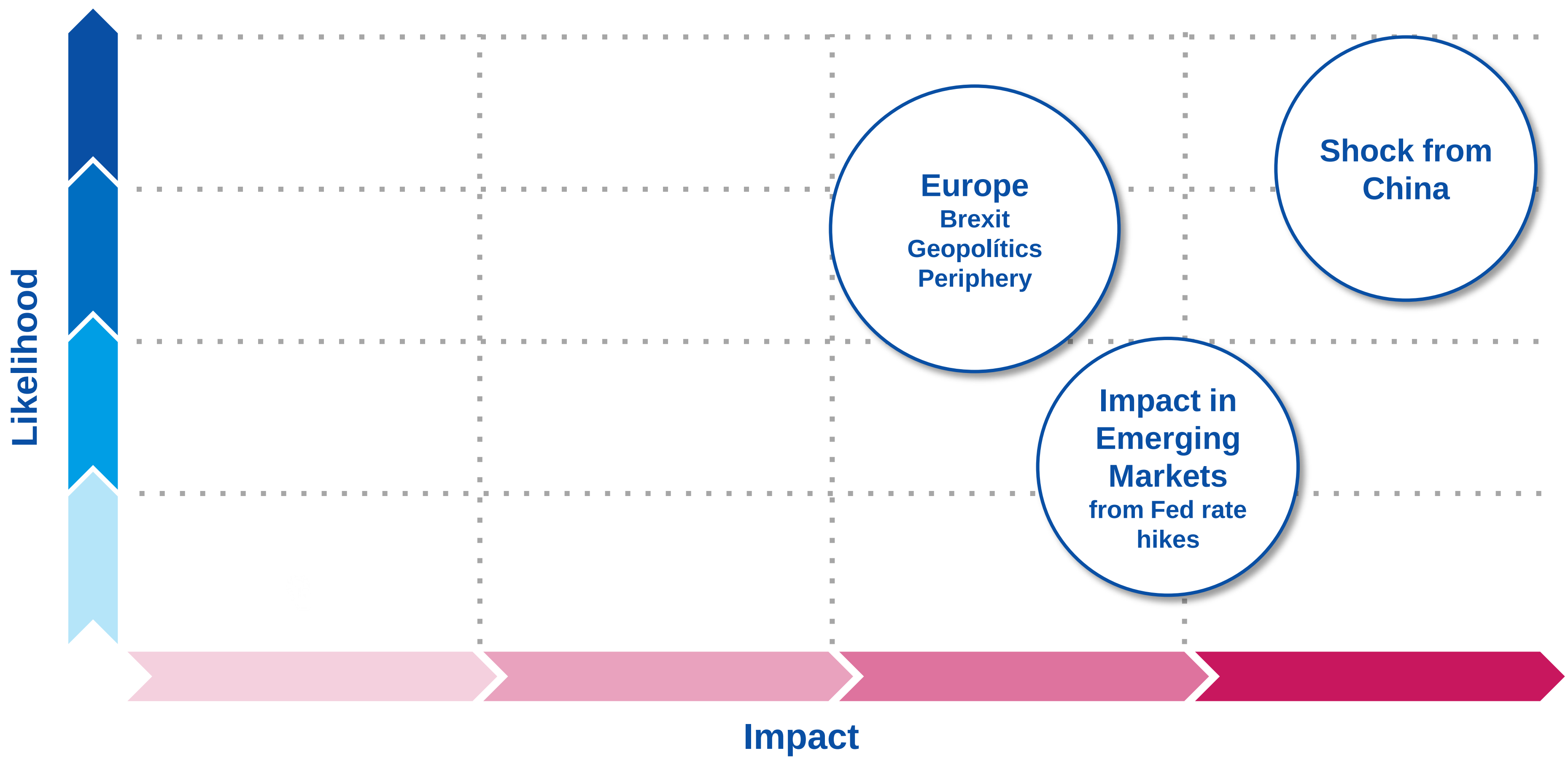
US: GDP growth (%)
Source: BBVA Research



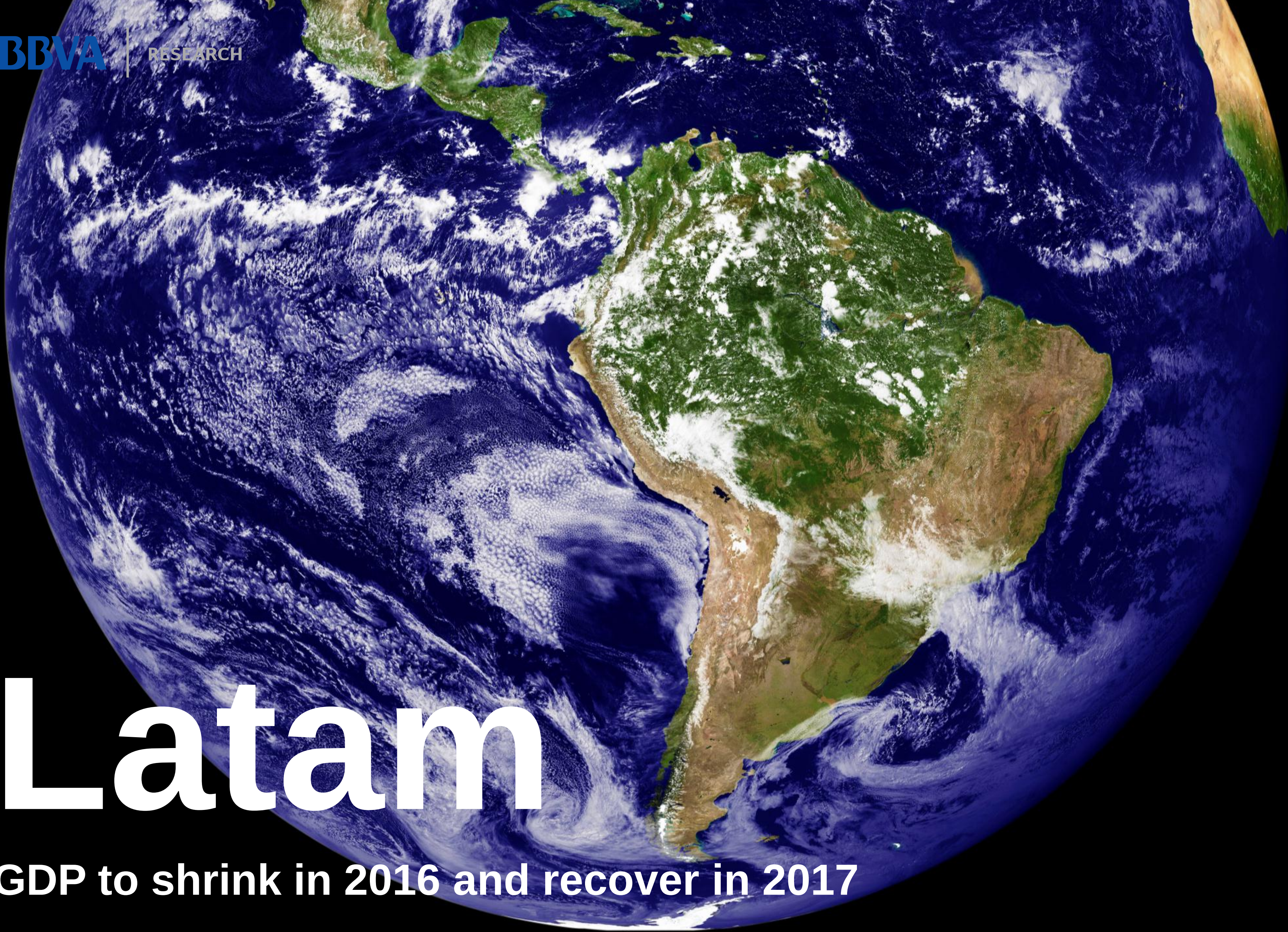
After a soft Q1, growth will increase during 2016, with a stronger employment growth

Fed will take into account stronger domestic growth and the drag from the external sector to decide on the timing and speed of further rate hikes.
We anticipate 2 more hikes in 2016, but with a downward bias.

China is currently the main global risk



Source: BBVA Research



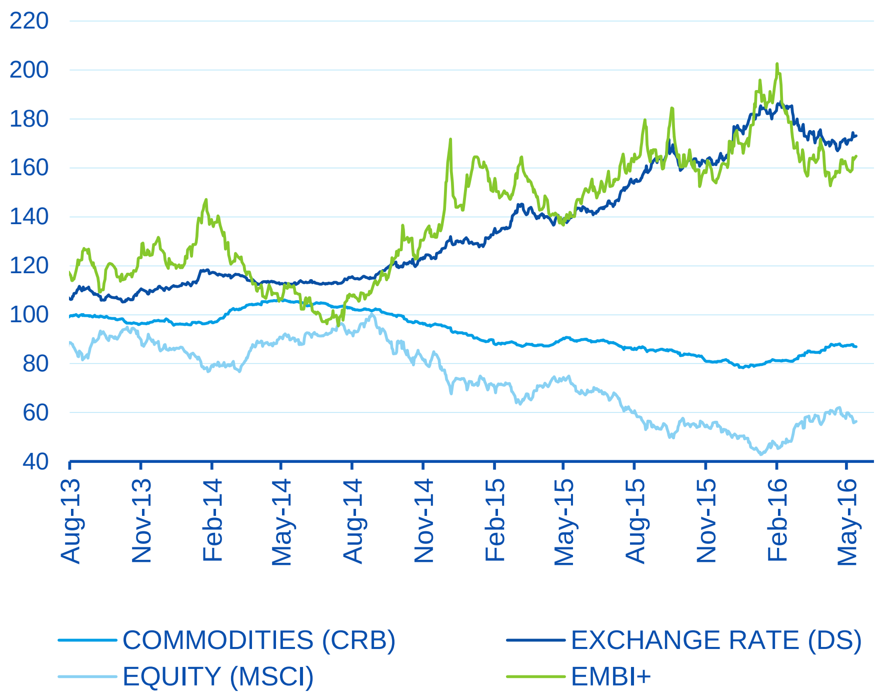
BBVA RESEARCH

Latam

GDP to shrink in 2016 and recover in 2017

Lower global risk aversion and an increase in commodity prices lifted Latam financial markets

Latam main asset prices
(Index May 2013=100)



Source: BBVA Research y Haver

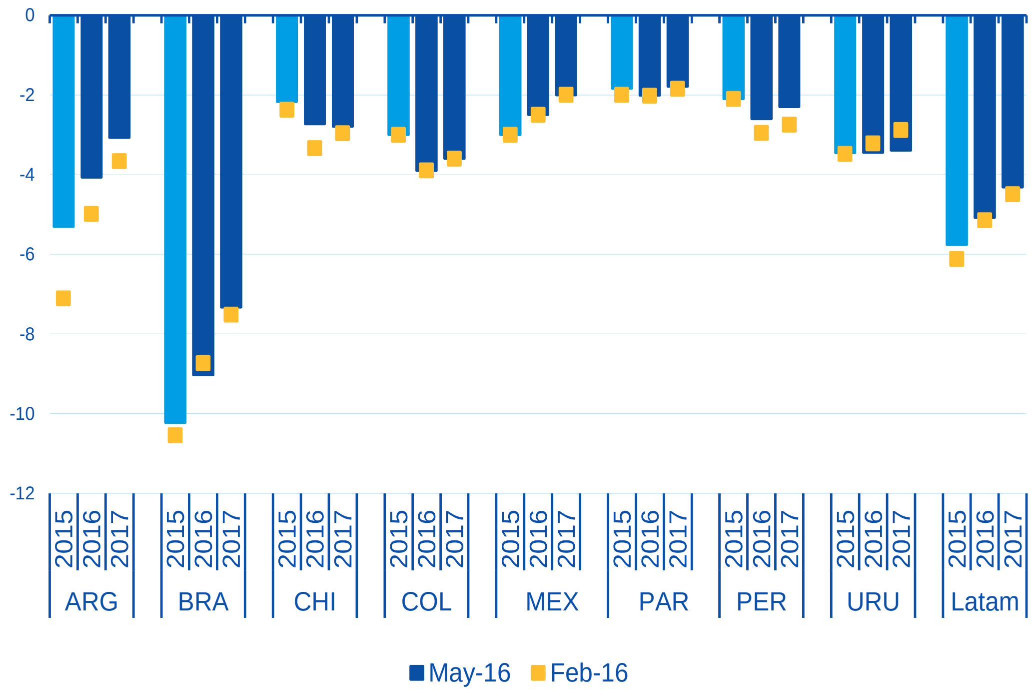
Main asset prices and exchange rates in the region showed significant gains since February…

… driven by lower volatility in global financial markets and the ensuing impulse on commodity prices

Going forward, volatility and corrections in financial markets may return, as long as risks on Chinese growth and exchange rates persist, in addition to unexpected changes in Fed's plans for rate hikes.

Public expenditure will be marked down or decelerate sharply in Latam, with the main exception of Brazil

Latam: Fiscal balance (%GDP)



Source: BBVA Research and Haver

Public expenditure will be less expansionary than previously anticipated, especially in Argentina, Chile, Peru and México.

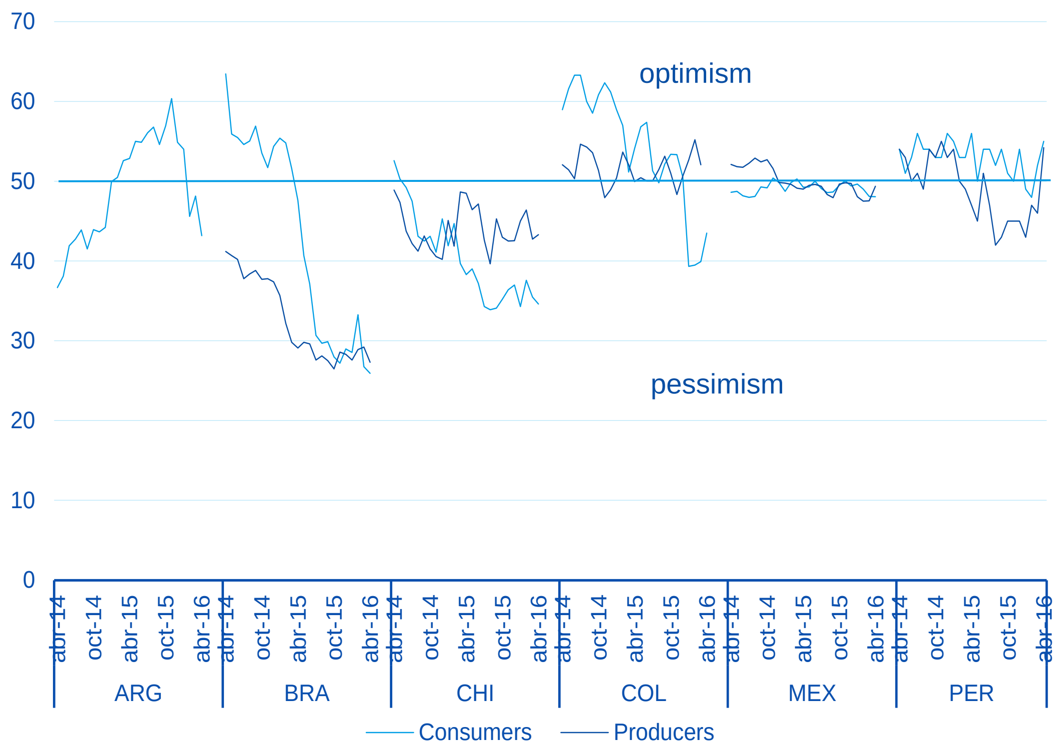
Main exception is Brazil, where we expect a less ambitious adjustment of public expenditure due to still-high political uncertainty

Correction of public expenditure seems unavoidable in countries with very low (or even non-existent) fiscal space, in the context of a significant negative shock to tax revenues from subdued commodity prices.

Confidence indicators remain weak, dragging consumption and investment

Latam: Confidence indexes (households and firms)

(values over 50 indicate optimism)



Source: BBVA Research and Haver

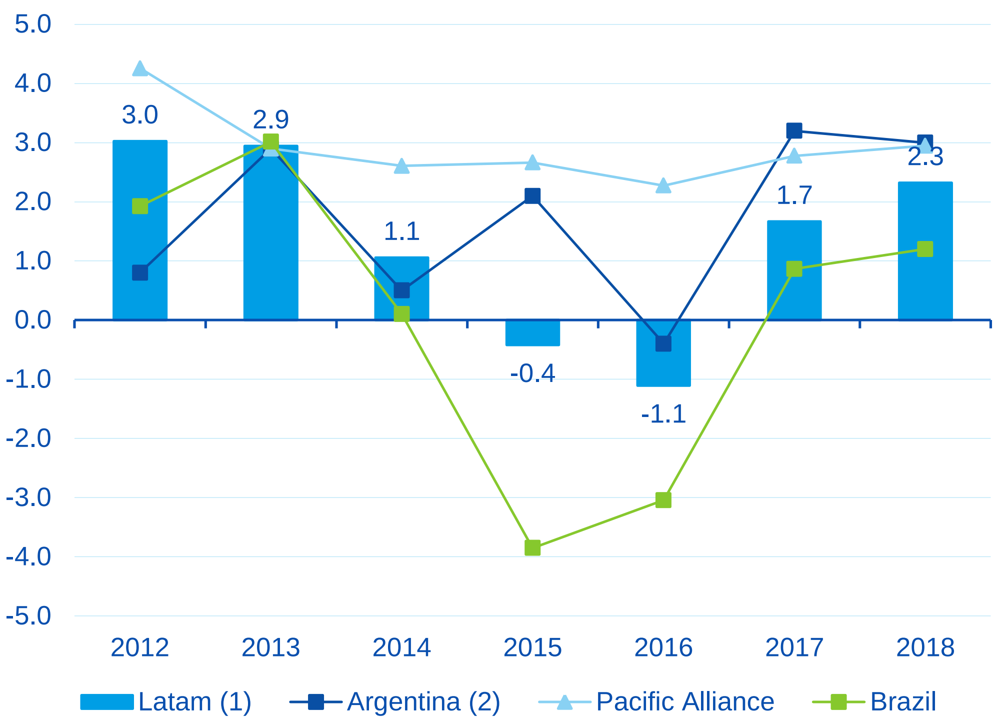
Sharp recent fall in household confidence in Argentina (due to rise in utility prices as part of fiscal consolidation) and Colombia. Confidence improves in Peru after the elections

Firms: low confidence on the weak external environment, political noise and uncertainty about economic policies in some countries

Households: pessimism on weak labor markets and still-high inflation

Latam GDP to fall in 2016 (-1.1%) and recover gradually starting in 2017 (1.7%)

Latam*: GDP growth (%yoy)



Growth forecasts revised down despite recovery of commodity prices in 2016 …

… as lower public expenditure in many economies weigh down on growth

Stronger 2017 growth in Latam driven by:

1. **The external sector**, due to higher global growth, depreciated exchange rates and improved terms of trade
2. **Investment**, especially by the private sector in Argentina and infrastructure investment in Peru and Colombia

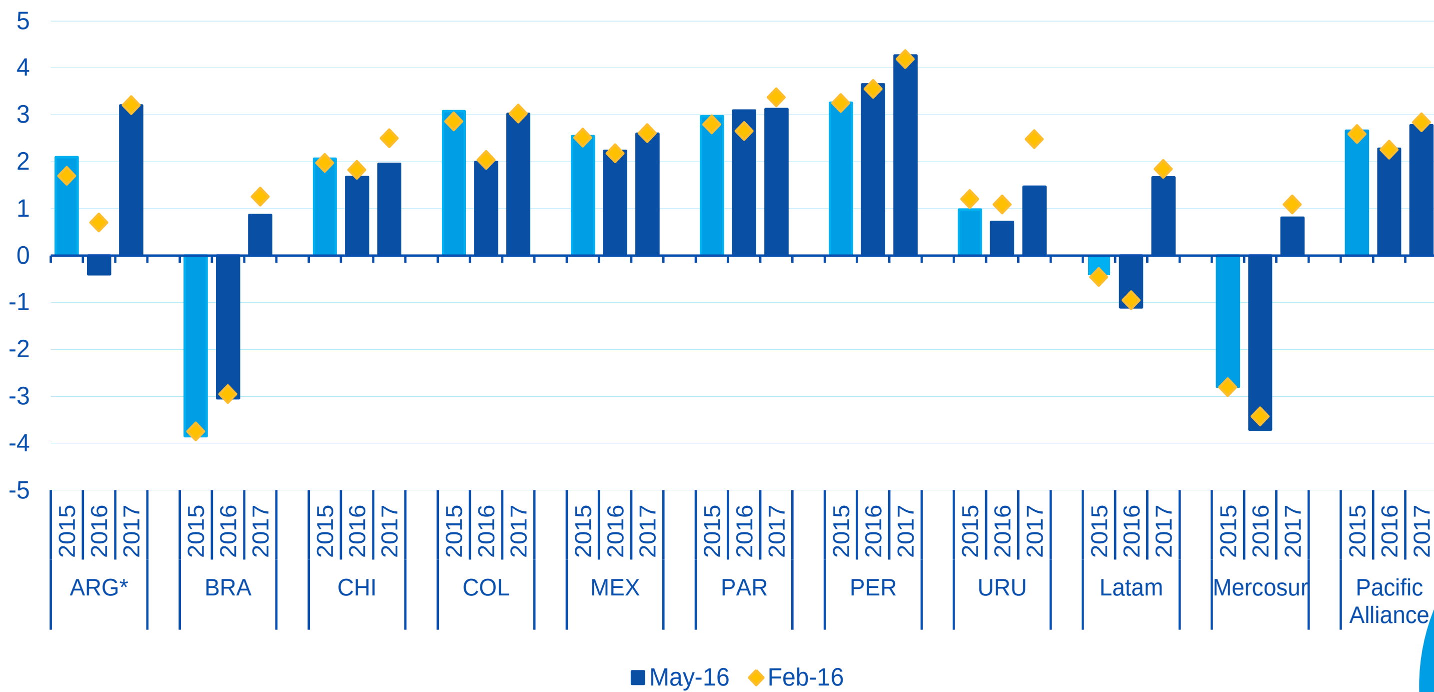
Source: BBVA Research

(1) Weighted average of Argentina. Brazil. Chile. Colombia. Mexico. Paraguay. Peru. Mexico. Uruguay and Venezuela

(2) For Argentina. private estimates of GDP are used while official statistics are released

Peru, Colombia, Mexico and Paraguay, the most dynamic economies in 2016

Latam countries: GDP growth (%)



Source: BBVA Research

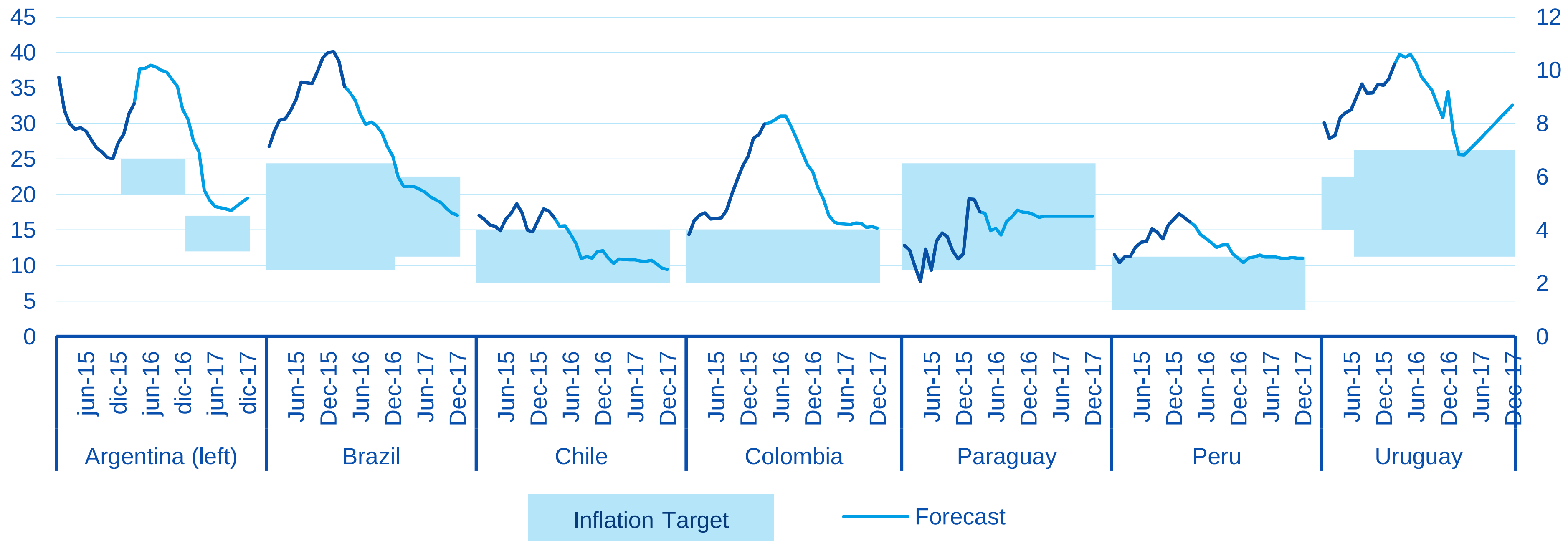
Growth revised down in Argentina (monetary policy) and Uruguay (lower consumption). Growth marked down in 2017 in Brazil, Uruguay and Chile in 2017

Pacific Alliance will grow 2.3% in 2016 and 2.8% in 2017, towards its potential (3.8%)

Latin America maintains strong heterogeneity in growth momentum and forecasts

Inflationary pressures abate somewhat, given recent exchange-rate appreciation

Latam: inflation (%yoy) in inflation-targeting countries



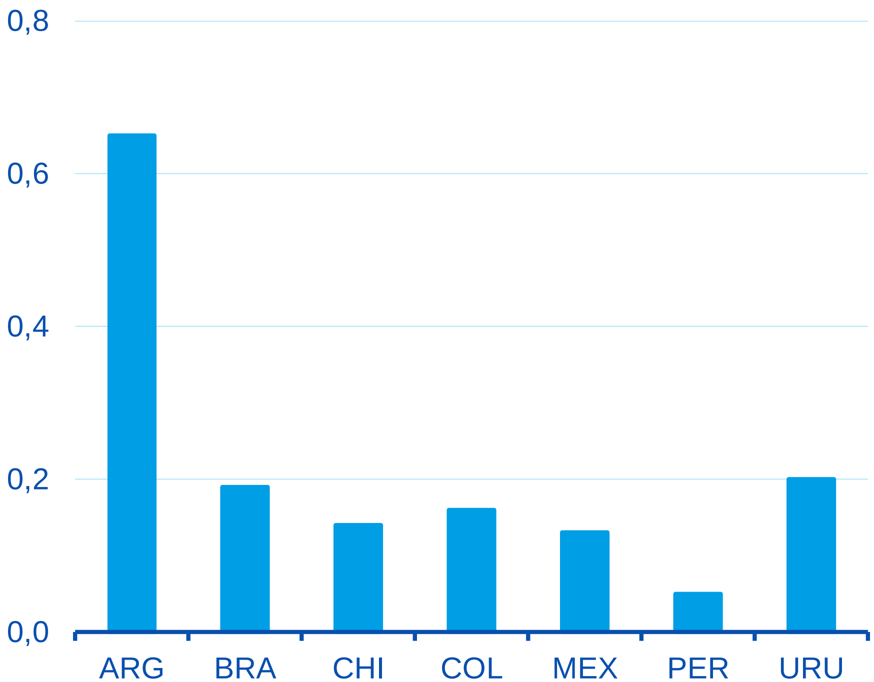
Source: BBVA Research and Haver

Inflation starts to flex down (except Colombia and Uruguay, but remains above Central Bank targets (bar Mexico and Paraguay)

Inflation will converge to Central Bank's targets at the end of 2016 or in 2017, given less pressure from FX depreciation and from domestic demand.

Persistence of inflation in some countries could delay convergence to inflation targets

Latam: persistence of core inflation*



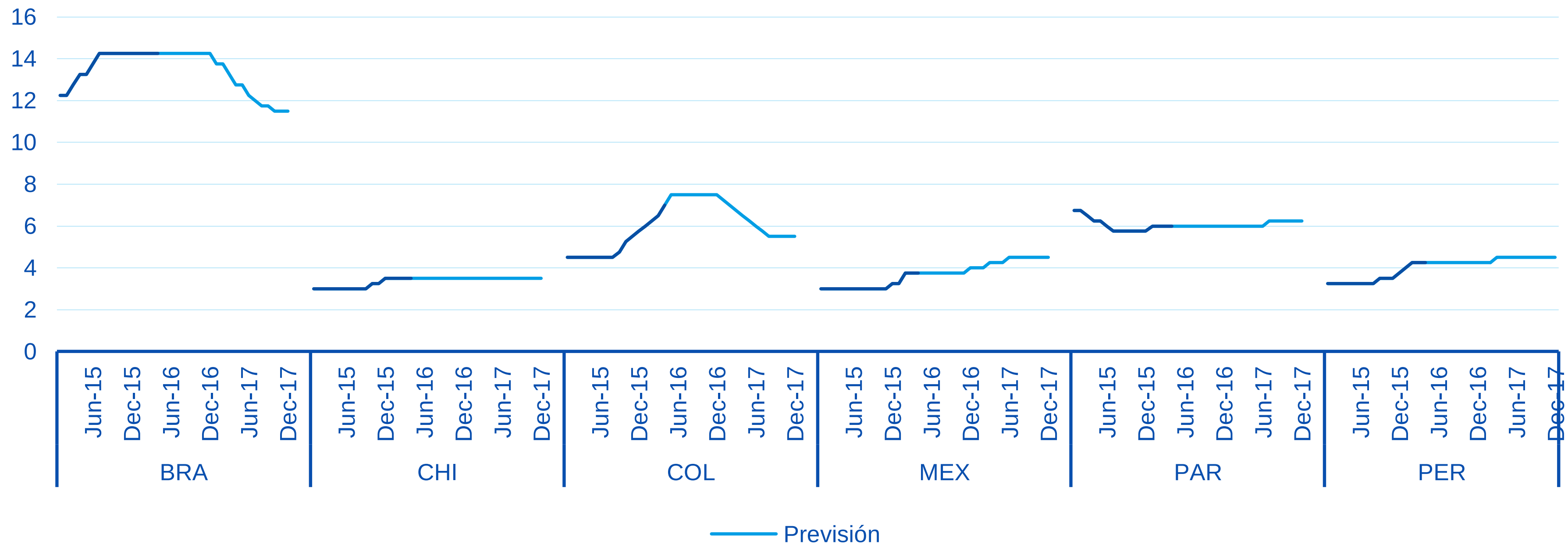
* Degree of influence of past core inflation on current core inflation. Based on the estimation of a Phillips curve where current inflation depends on the output gap, past inflation, inflation expectations, exchange rate and commodity prices
Source: BBVA Research and Haver

Persistence of inflation is strongest in Argentina and, to a lesser extent, in Brazil, Colombia and Uruguay. This could delay convergence back to central banks' inflation targets

Nevertheless, persistence can diminish drastically if there is a significant change in the conduct of monetary policy (as in Argentina) or in indexation mechanisms.

Monetary policy in wait-and-see mode, except in Argentina and Colombia

Official interest rates in inflation-targeting countries (%)



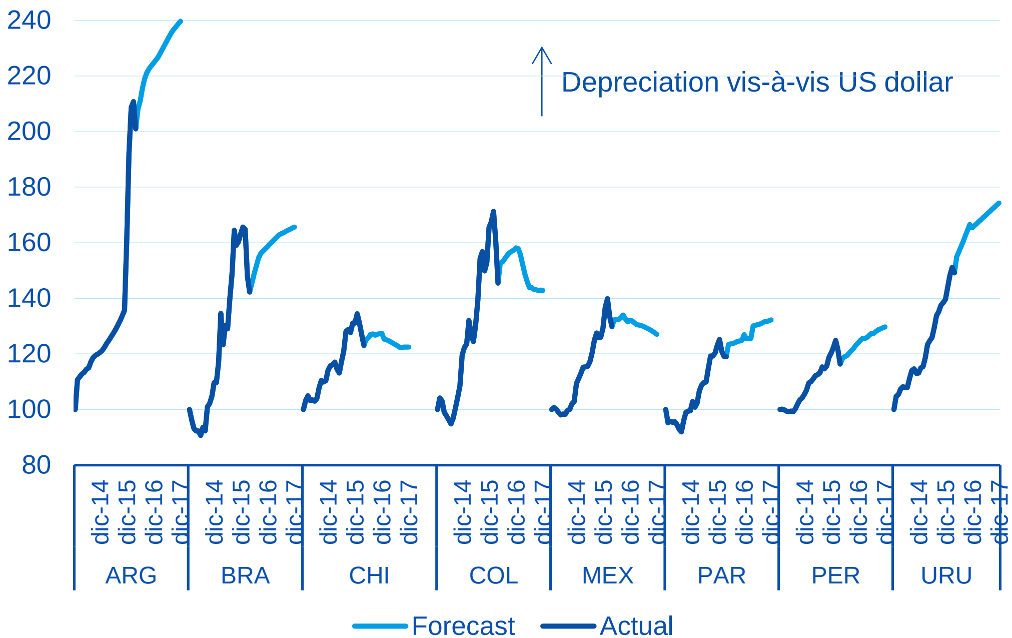
Source: BBVA Research and Haver

Lower pressure on inflation will allow Central Banks in the region to wait and see, keeping rates stable during 2016 (except Colombia)

Mexico will keep its official interest rate synchronized with the Fed

Exchange rates will depreciate going forward, but from a stronger starting point than 3 months ago

Exchange rate to the US dollar (Index Dec 2014=100)



Source: BBVA Research and Haver

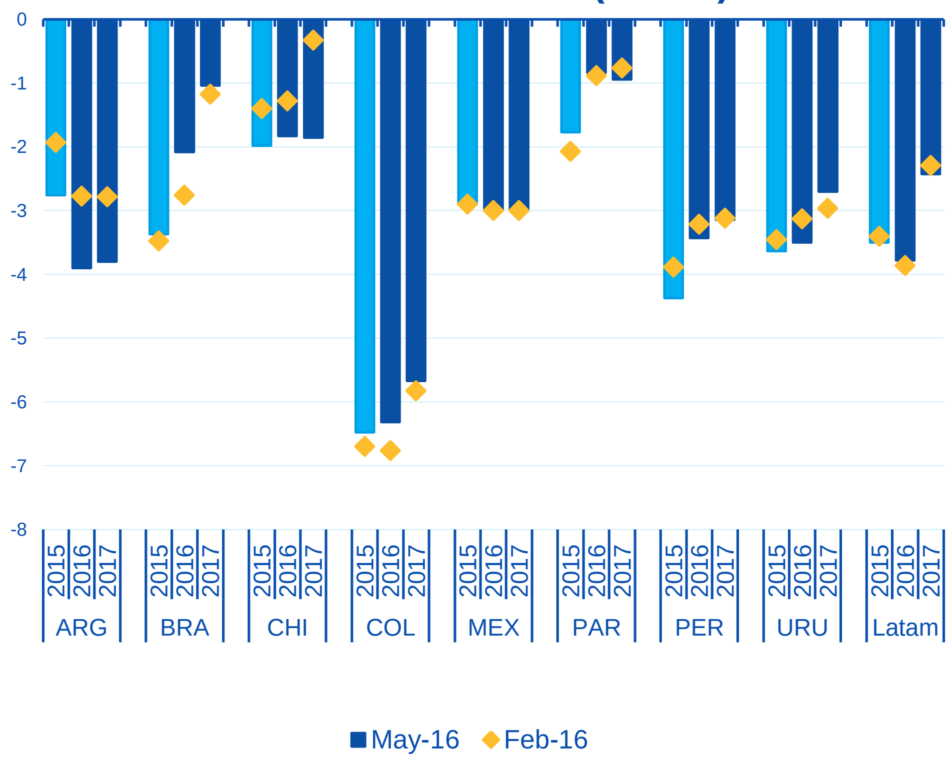
FX appreciation in February-April driven by lower global risk aversion and return of capital inflows

Going forward, markets will follow closely Fed's decision on interest rates and any signs of weaker growth in China or a weaker Renminbi.

In Mexico, Colombia and Chile there is some room for appreciation during 2016-17 given improving fundamentals and an expected rise in oil and copper prices.

External deficits continue to correct in most countries, in part due to deceleration of domestic demand

Latam: Current account balance (%GDP)



Source: BBVA Research and Haver

External deficits (small in Chile and Paraguay) continue to shrink in most countries …

… driven by the depreciation of exchange rates in previous quarters, a weak domestic demand and a gradual improvement of terms of trade

FDI is weakening due to the fall in commodity prices, but still represents a significant share of external financing needs, limiting external vulnerability in the region.

Main Messages

The global outlook has improved. but global growth will continue to be low. Financial stress has been reduced significantly in the last three months, especially in emerging markets, and commodity prices have recovered. Global growth will increase but moderately and will remain fragile.

Latam GDP will shrink -1.1% in 2016 and recover to 1.7% in 2017. The fall in 2016 will be dragged by the sharp recession in Brazil, whereas the Pacific Alliance will grow 2.3%. Recovery in 2017 will be driven by the external sector (stronger global growth and better terms of trade) and higher investment in places like Argentina, Peru and Colombia.

The positive effect of the recent recovery of commodity prices will be offset by lower public expenditure. Public expenditure will be adjusted in most countries given lower tax receipts and to preserve fiscal rules and sovereign ratings. The main exception will be Brazil. where the necessary fiscal consolidation is likely to continue to be postponed.

Inflation abates slightly in most countries, helped by the recent appreciation of commodity prices. Lower inflation and weak domestic demand will allow central banks to wait and see, with stable interest rates likely for the remainder of this year. with the exception of Colombia, where further hikes are likely. In turn, Mexico will continue to synchronize interest rate hikes with the Fed’s.

Annex

Latam GDP growth forecasts

GDP (%yoy)	2013	2014	2015	2016f	2017f
Argentina*	2.9	0.5	2.1	-0.4	3.2
Brazil	3.0	0.1	-3.9	-3.0	0.9
Chile	4.0	1.9	2.1	1.7	2.0
Colombia	4.9	4.4	3.1	2.0	3.0
Mexico	1.6	2.3	2.5	2.2	2.6
Paraguay	14.0	4.7	3.0	3.1	3.1
Peru	5.9	2.4	3.3	3.6	4.3
Uruguay	4.6	3.2	1.0	0.7	1.5
Mercosur	3.0	-0.1	-2.8	-3.7	0.8
Pacific Alliance	2.9	2.6	2.7	2.3	2.8
Latin America	2.9	1.1	-0.4	-1.1	1.7

e = estimate; f = forecast