BBVA Research

Latin America Outlook

3rd QUARTER 2017

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Main messages

1. **Global growth continues increasing**. This is driven especially advanced economies and China (the latter with fiscal impulses). However, global risks remain.

2. **Slow growth in Latin America.** Growth will increase from -1.2% in 2016 to 0.8% in 2017 and 1.7% in 2018, a slow recovery from deceleration in the previous years. Recovery will be driven by Brazil and Argentina’s exit from recession. Other countries will decelerate in 2017 compared to 2016.

3. **Inflation will keep decreasing in South America and will stop rising in Mexico,** driven by stable exchange rates, weak demand and lower oil and food prices. Consequently, central banks in most countries in South America will continue cutting interest rates, whereas in Mexico will remain stable for some time.

4. **Risks for Latam increase on the internal front, but diminish externally.** Political noise and delays in investment are the most important domestic risks. On the other hand, risks stemming from vulnerabilities in China and the normalization of US monetary policy are the main external risks.

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GLOBAL

Stable growth, with risks still tilted to the downside

Positive global momentum

Global growth driven by China

Signals of stabilization of global growth

Some rebalancing from US towards Europe

Both in the macro as well as policy fronts

Low inflation in developed countries

Wage moderation as well as some correction in commodity prices

Central banks in developed countries lean towards policy normalization

Moping up liquidity and increasing policy rates

Complacent financial markets

Low volatility supports lower risk aversion

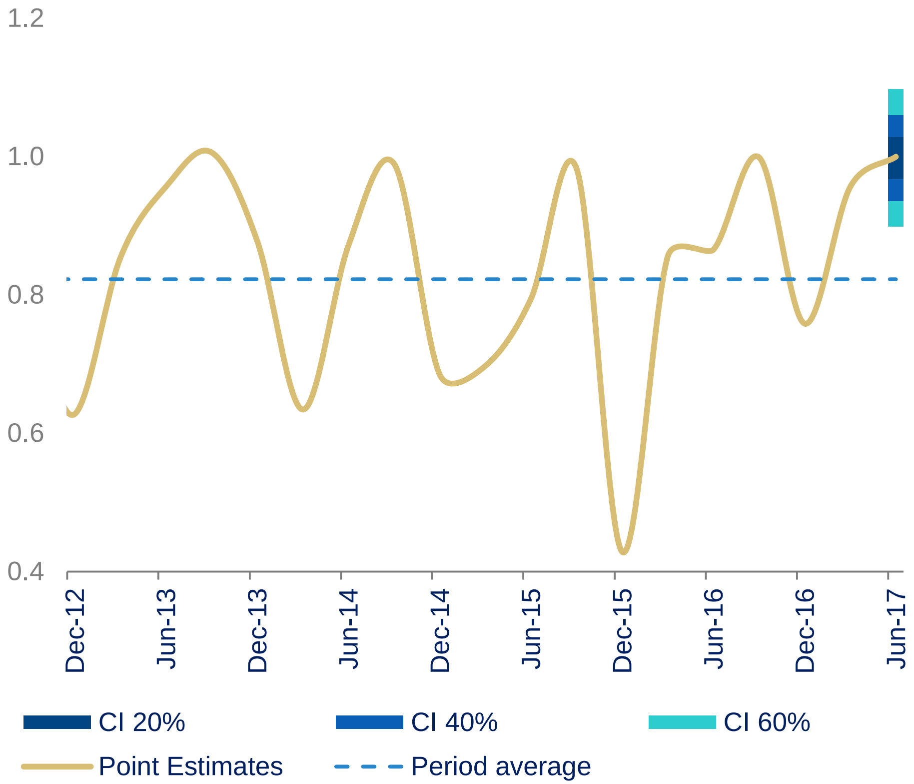
Risks

Decreased in Europe, but scaling up in China

Global growth tends to stabilize

Global GDP growth

Forecasts based on BBVA-GAIN model (%, qoq)

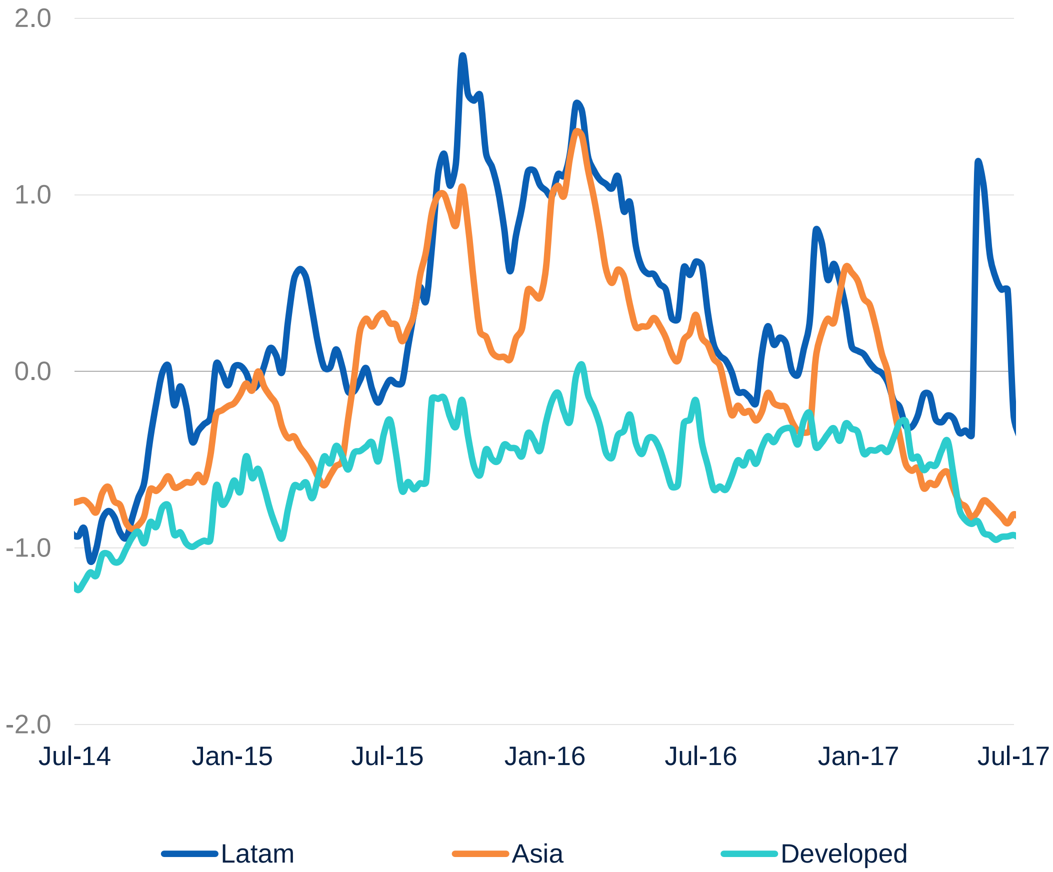


- Confidence indicators remain very high, stronger than actual hard data
- China and emerging Asia show strong growth, pushed by expansionary policies…
- … have supported stronger trade and investment in the last quarters

Source: BBVA Research

Financial stress remains low

BBVA Financial Stress Index
(normalized)



Source: BBVA Research

- Volatility has decreased to very low levels despite uncertainty about economic policies
- Brazil is the exception in Latam, due to high political noise
- Reversal of expectations of reflation in US have maintained low long-term interest rates
- Capital flows to emerging economies have continued
- Risk of complacency in financial markets

Central Banks lean towards policy normalization

Global

- Communication towards tightening from central banks, point more clearly towards normalization (except Japan)
- Besides inflation, Central Banks are increasingly worried about the side-effect of abundant liquidity (especially high asset prices)

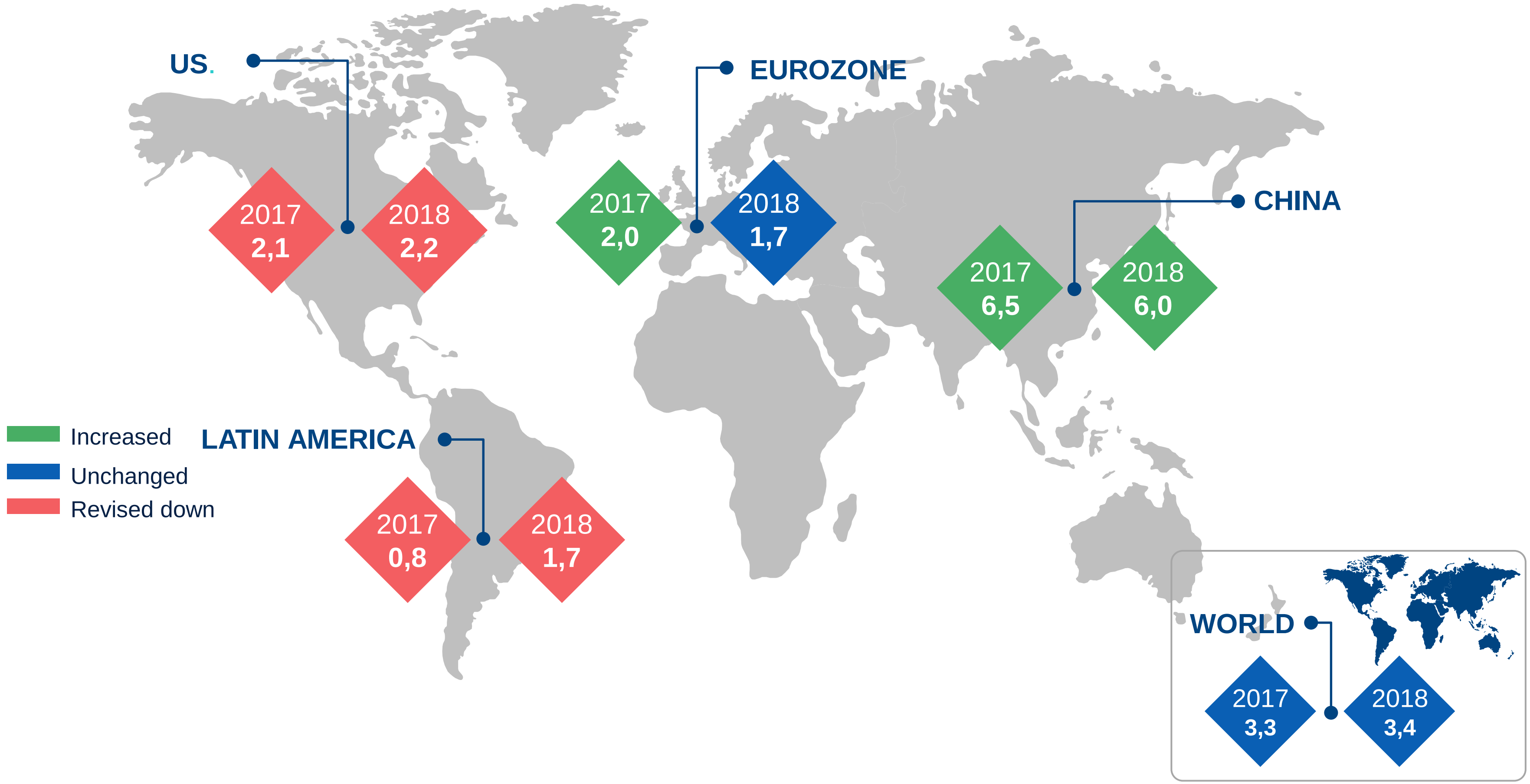
Fed

- Fed expects to hike interest rates an additional 25 bp in 2017 and begin to reduce its balance sheet before the end of the year…
- … but financial markets discount a slower policy normalization

ECB

- Has taken initial steps towards normalization, changing communication, but very cautiously..
- Reduction of bond purchases would be announced after the summer. Interest rate hikes around end-2018

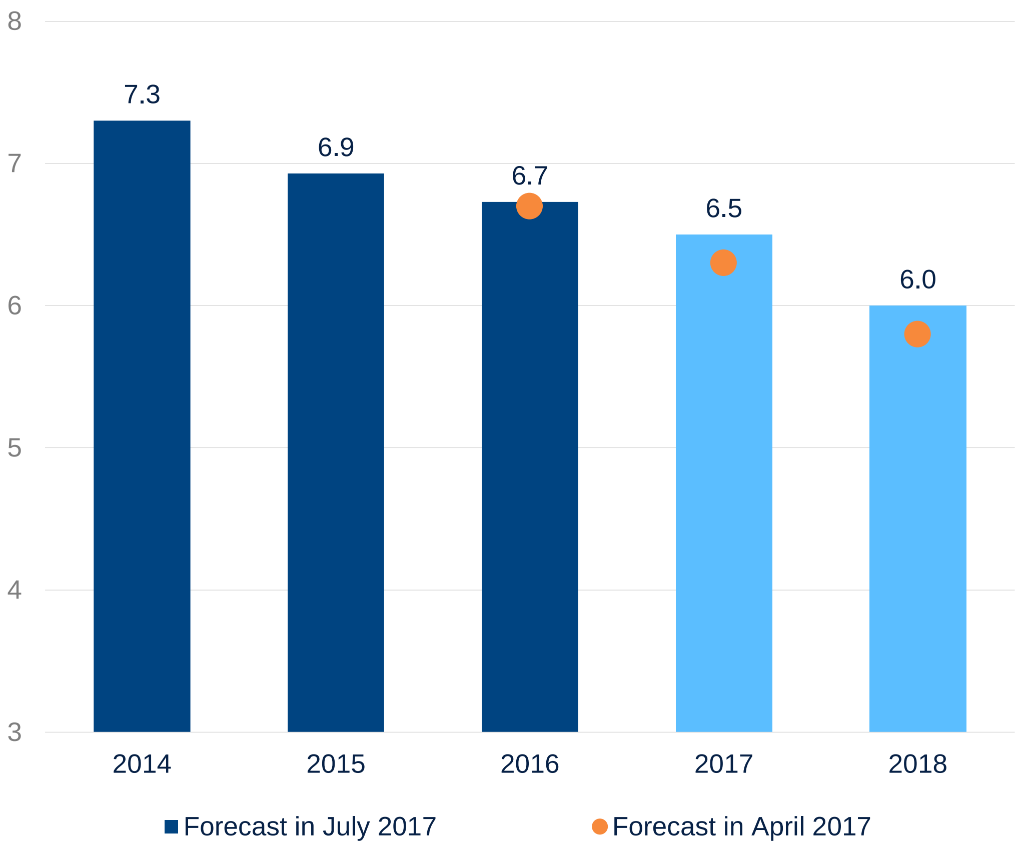
Growth revised up in Europe and China, down in US and Latin America



Source: BBVA Research. Latin America includes: Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

China: (fiscal) policy impulses effective in the short run

China: GDP growth
(%)

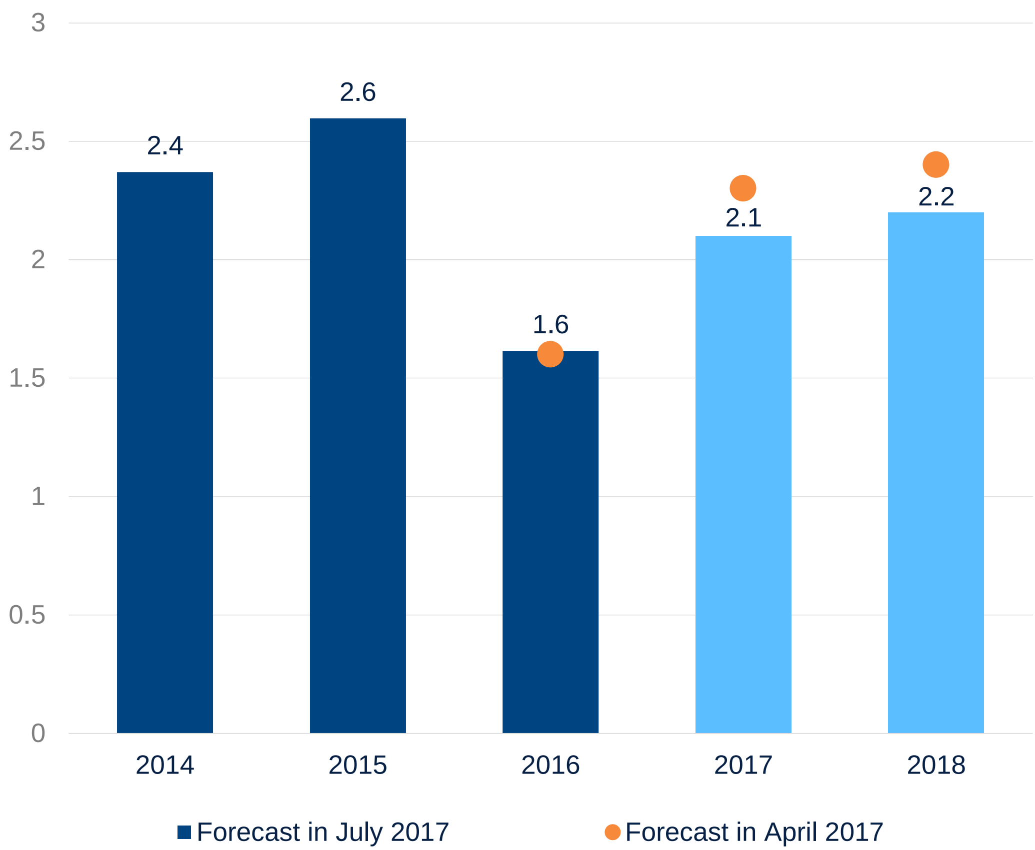


Source: BBVA Research and CEIC

- We revised up our growth forecasts for 2017-18, due to incoming data and the fiscal impulse. Gradual deceleration underway, slower than anticipated
- Prudent monetary policy. Fiscal policy continues to support growth
- Risks in the medium run continue to increase
  - Slow rebalancing of growth towards services and consumption
  - Financial fragilities continue to accumulate due to growth still based on debt and favoring shadow banking system.

US: fiscal impulse hard to materialize

US: GDP growth
(%)

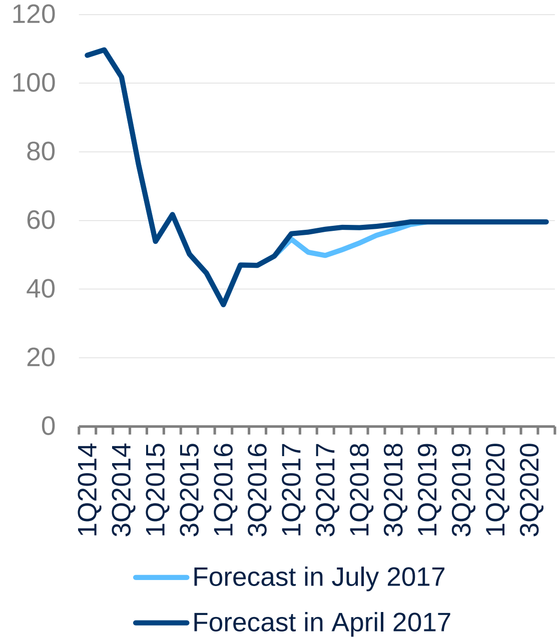


- Growth revised down in 2017-18 Stimulus measures will probably not be implemented in the short-run
- Fed: strong labor market and convergence of inflation to 2% justify policy normalization
- Risks stemming from protectionism diminish but uncertainty about economic policies remain

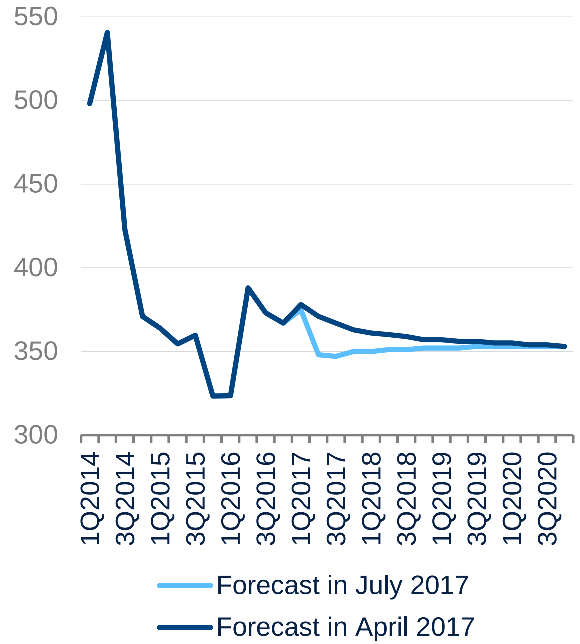
Source: BBVA Research and BEA

Commodity prices adjusted down in the short run, on concerns about strong supply

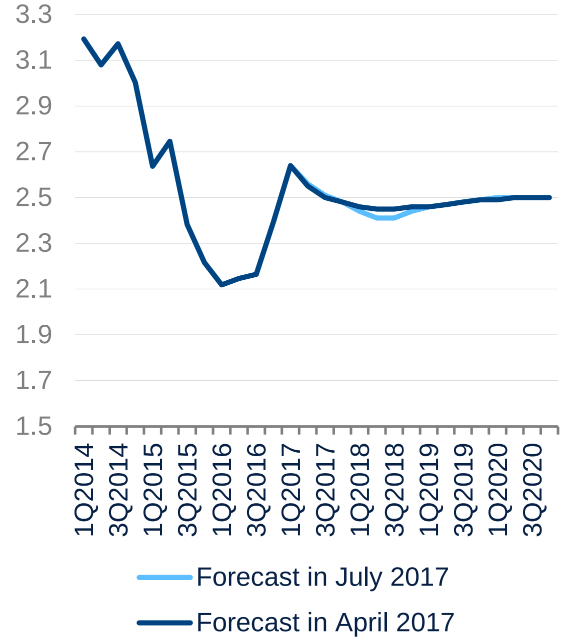
BRENT OIL
(USD/B)



SOYBEANS
(USD/mT)



COPPER
(USD/lb)



Source: BBVA Research and Bloomberg

Oil prices will continue to be dragged by strong supply and high inventories. We maintain expectations of 60USD/b in the long run, given lower capital expenditures in exploration.

Strong supply also affects soybean and copper prices in the short run. No significant changes in long-run view for commodity prices.

Global risks most relevant for Latin America are related to US policies and rebalancing in China

1

Lingering **uncertainty about economic policies** to be implemented in US, though the risk of protectionism is reduced

2

Policy stimulus in China to support investment continues to accumulate financial vulnerabilities

3

Political risks in Europe diminish but remain around Brexit negotiations, banking problems in some countries and elections in Italy.

4

Risks stemming from **monetary policy normalization**, especially in the US, given divergence with market expectations

LATAM

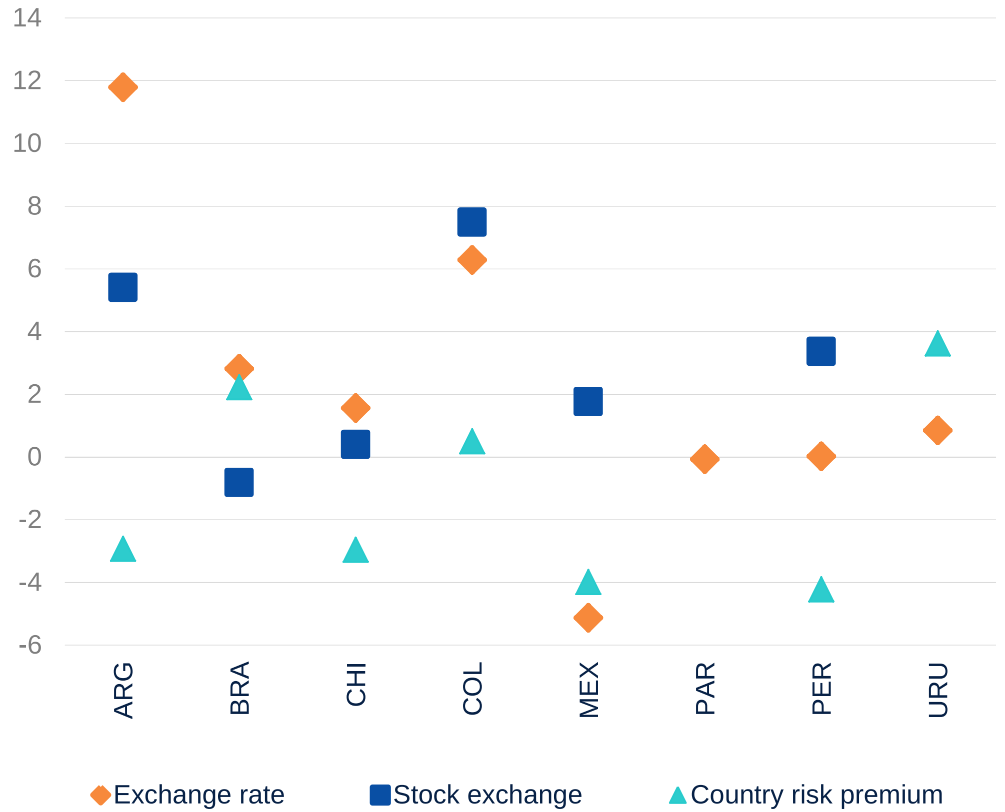
Slow growth

Financial markets continue to recover in Latam…

- Asset prices and exchange rates continued to see significant year-to-date gains, driven by global factors:
  - Diminished worries about US policies
  - A gradual approach to Fed rate hikes
  - Stronger global growth

- Despite some correction in commodity prices

Latam asset prices: percent change in the last 3 months to July*



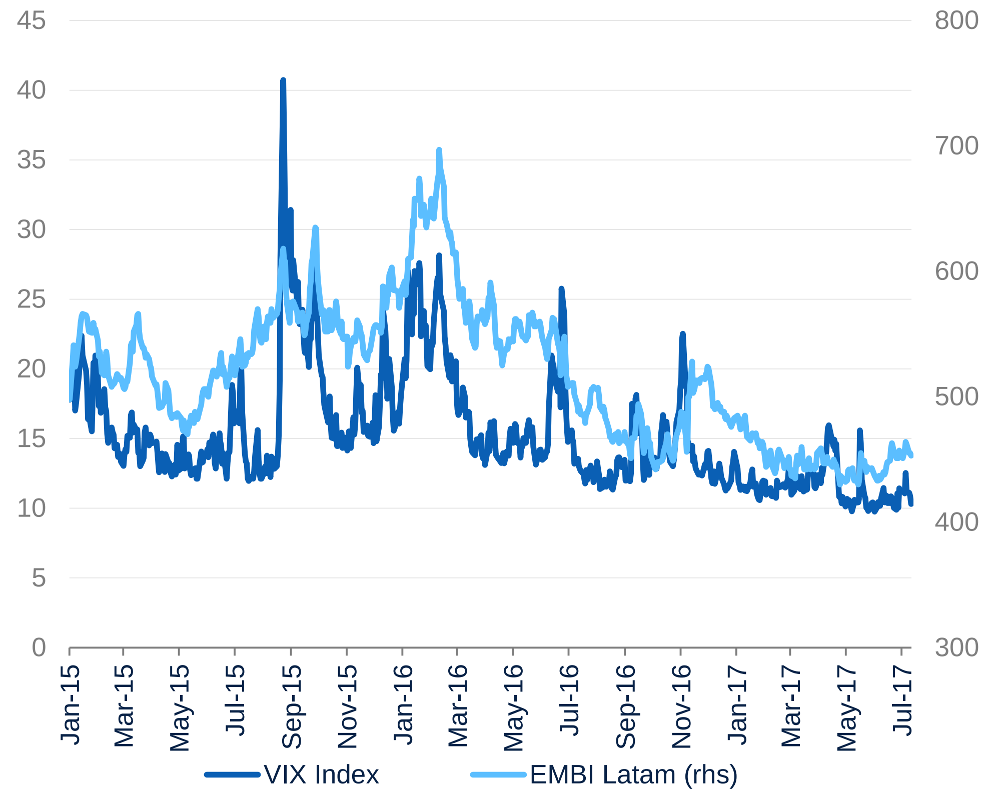
Source: BBVA Research and DataStream * Change between April 12 and July 12. Exchange rate: local currency per USD. In this case, an increase signals a depreciation. Country risk premium: EMBI.

… with the background of very low volatility in global financial markets, which could revert quickly

- Positive tone in financial markets with volatility at historical lows despite increasing economic, political and geopolitical uncertainty

- An important question is whether markets are too complacent, especially given that main central banks are starting to withdraw their monetary stimulus

Volatility in developed markets and country risk premium in Latam

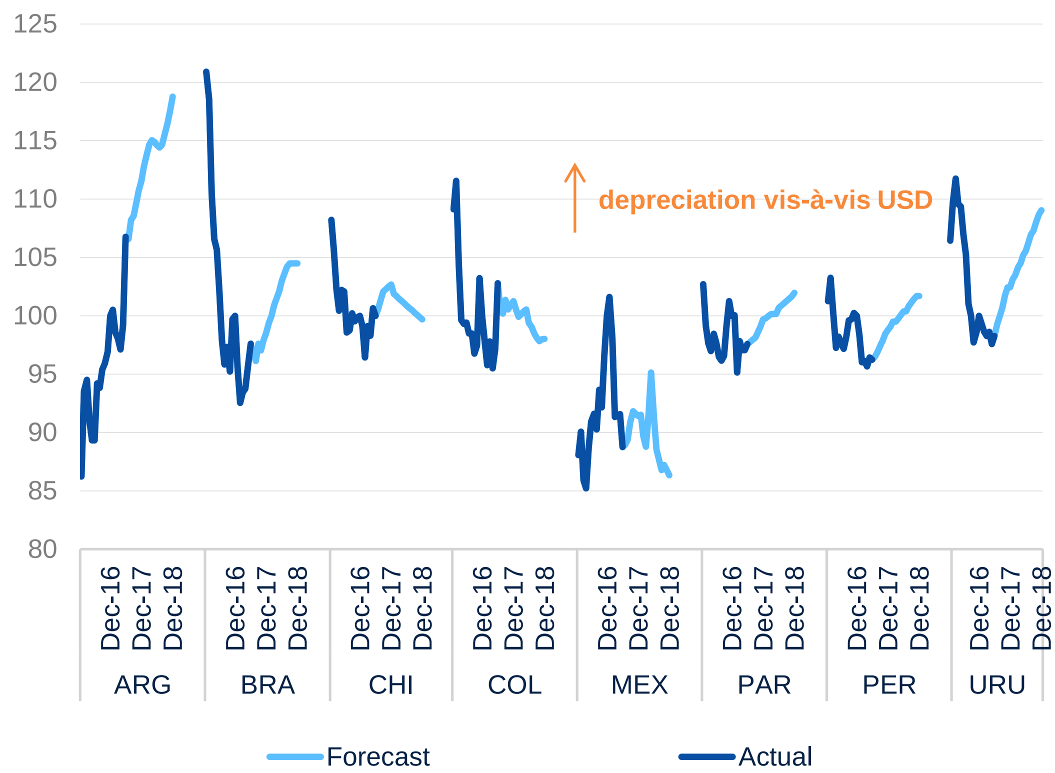


Source: BBVA Research, DataStream and Bloomberg

Mildly depreciating exchange rates going forward in most countries

- Relatively stable exchange rates in the last 3 months. Recovery of Mexican peso continues, aided by softer tone from US on trade policy
- We continue to expect a mild depreciation of exchange rates going forward given easier monetary policy in South America, diverging from Fed's tightening
- Some room for further appreciation in Mexico in the short run. Chile and Colombia may also see appreciation in 2018

Exchange rates to the USD
(Index Dec 2016=100)

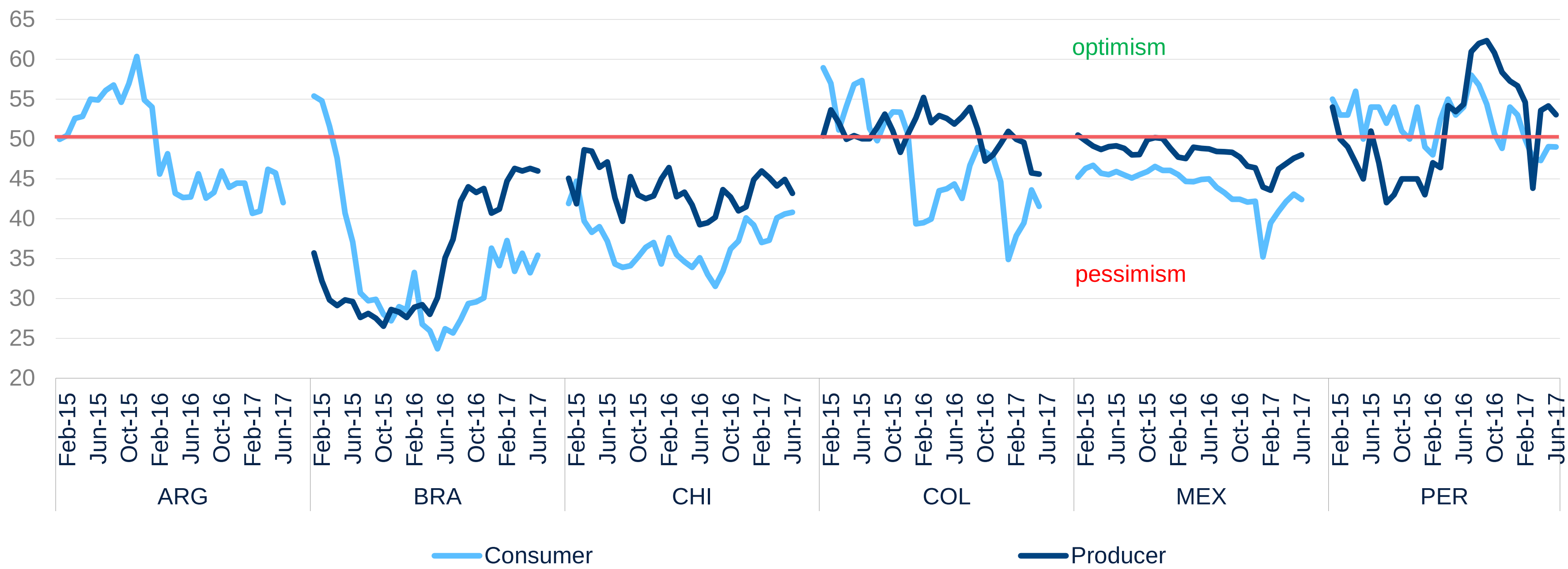


Source: BBVA Research and Haver

Confidence indicators remain pessimistic throughout the region, dragged by political noise

Latam: Confidence indicators for households and firms

(values above 50 pts indicate optimism)



Source: BBVA Research and Haver

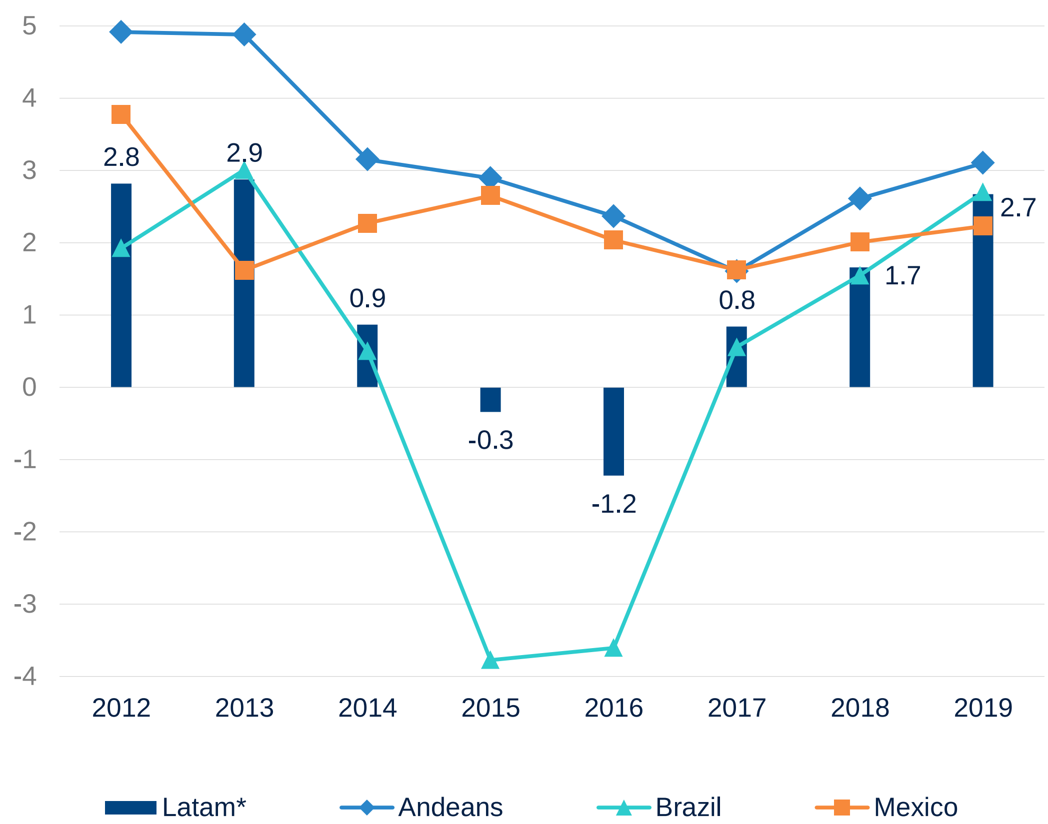
Some recent recovery of confidence in Mexico (driven by a softer tone on trade policy by US) and on Brazil (though there is a high risk of relapse given high recent political turmoil).

For households, pessimism remains due to weak labor markets, but there has been some recent recovery of confidence driven to some extent part by lower inflation.

Still low growth in Latam in 2017 and 2018

- Recovery after contraction in 2015 and 2016, supported by Brazil and Argentina coming out of recession
- Stronger growth in 2017-18 driven by:
  - External sector, supported by more favorable terms of trade and stronger global growth
  - Investment, especially in places like Argentina and Colombia
- Growth still low in the next two years, still below potential, and below developed economies

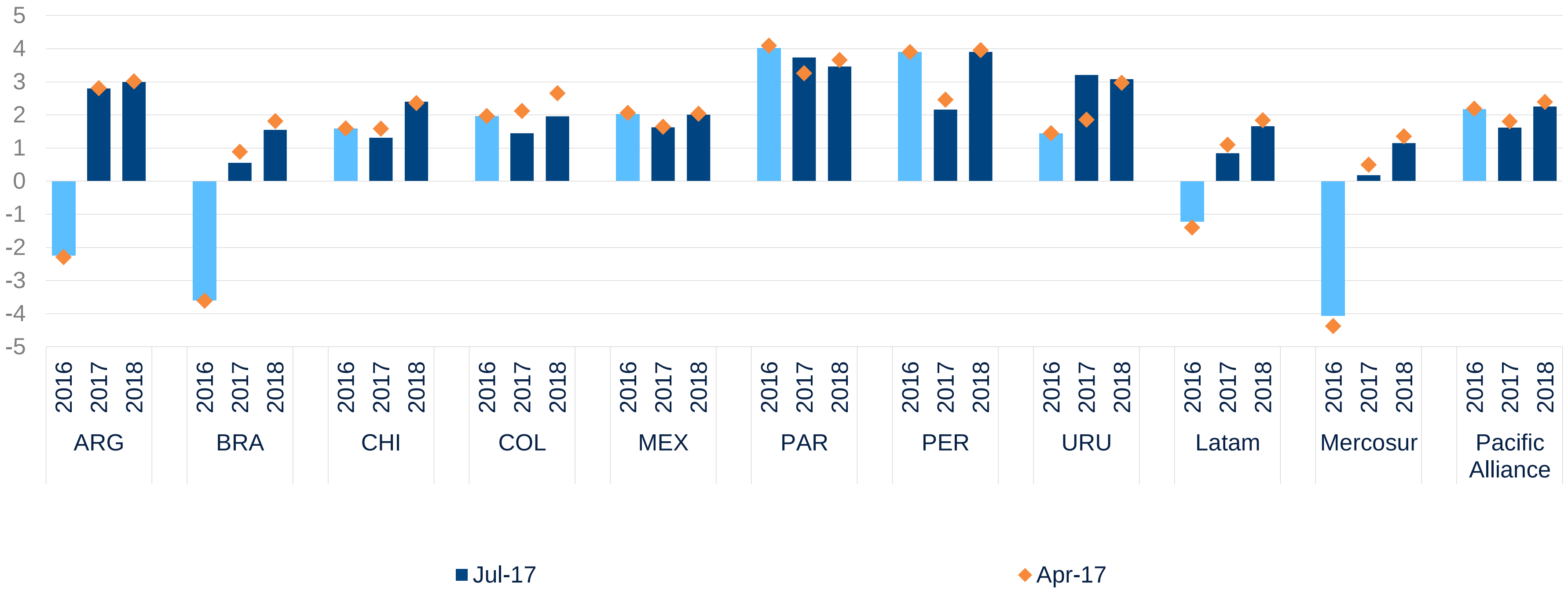
Latam: GDP growth
(%)



Source: BBVA Research
* Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Mexico, Uruguay and Venezuela

Recovery gets stronger in Argentina, but stabilization in Brazil still carries high political risks

Latam countries: GDP growth
(%)



Source: BBVA Research

Recent data show the recovery is already under way in Argentina and recession finished in Brazil, but with high political risks in the second case.

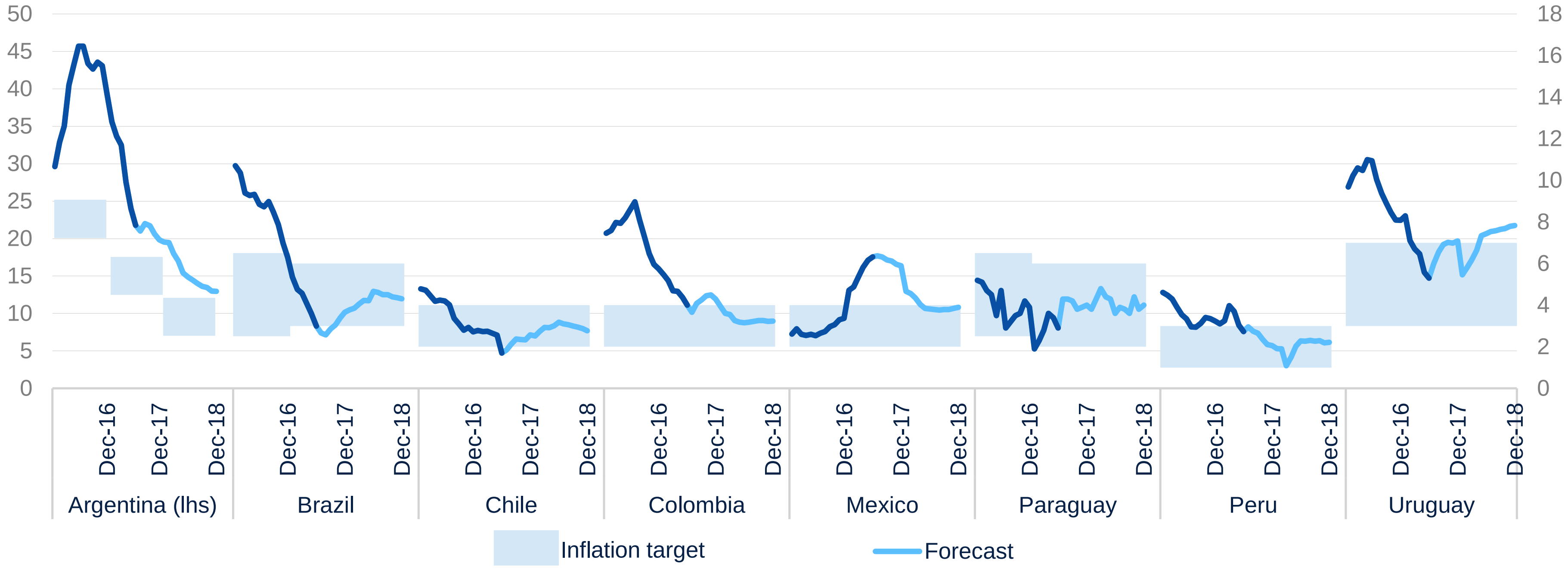
In most of the rest of the countries, activity will decelerate in 2017 relative to 2016, dragged by external shocks and weak domestic demand.

Main downward revision in Colombia, given a lower oil price and delay in some infrastructure projects.

Inflation continues to diminish in South America and has peaked in Mexico

Latam: inflation and central bank target ranges

(%, yoy)



Source: BBVA Research

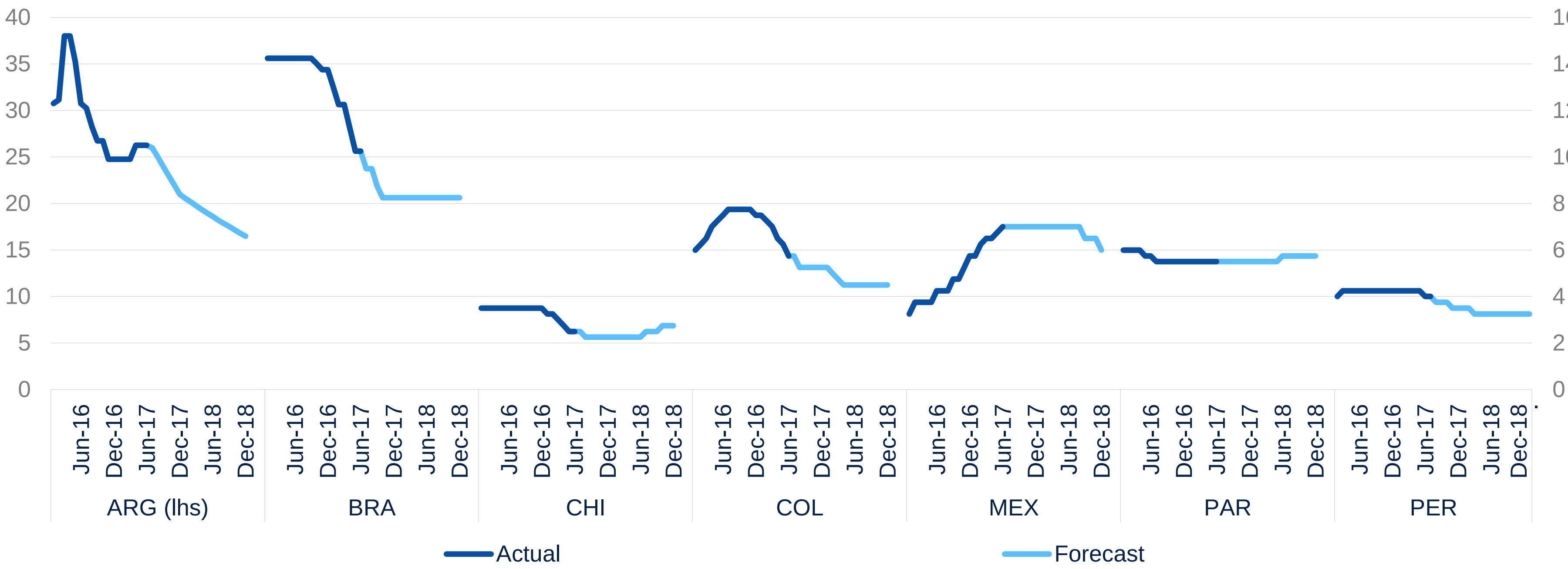
Lower inflation in South America due to a stable exchange rate, weak demand and lower oil and food prices. Inflation will remain within target ranges in most countries going forward.

In Mexico, inflation continued to increase, given past depreciation and fuel price hikes. But recent appreciation has moderated inflation increases, which would have peaked this July.

More dovish monetary policies in South America, and the end of rate hikes in Mexico

Latam: official interest rates

(%)



Source: BBVA Research and Haver

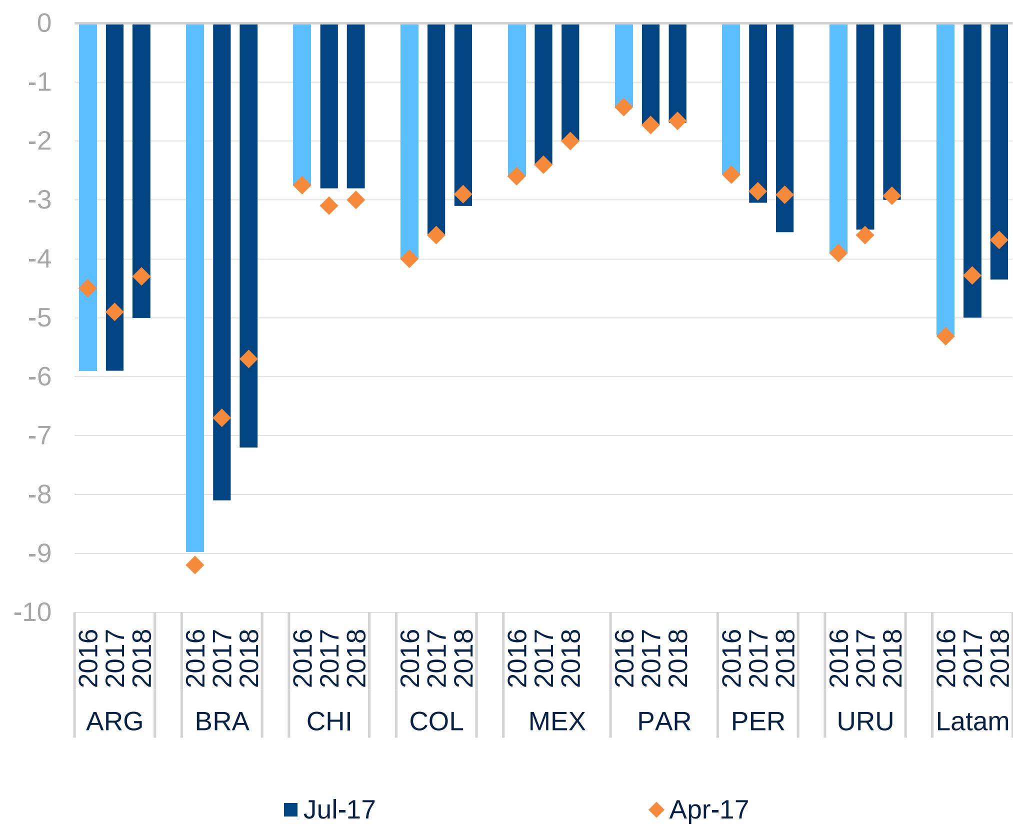
Interest rate cuts will continue in coming months in South America, on the back of lower inflation and weak demand.

Rate hikes have probably ended in Mexico, and interest rates would remain stable until mid-2018, while inflation comes back to Banxico's target range.

Fiscal deficits will continue to shrink, except (temporarily) in Peru

- No changes in fiscal scenario in Argentina, though current forecasts count Central Bank financing as part of the deficit
- A slower fiscal consolidation path in Brazil, in line with a slower growth than expected 3 months ago
- Expected fiscal deficit revised up in Peru in 2018, to finance reconstruction works. This revision complies with the fiscal rule

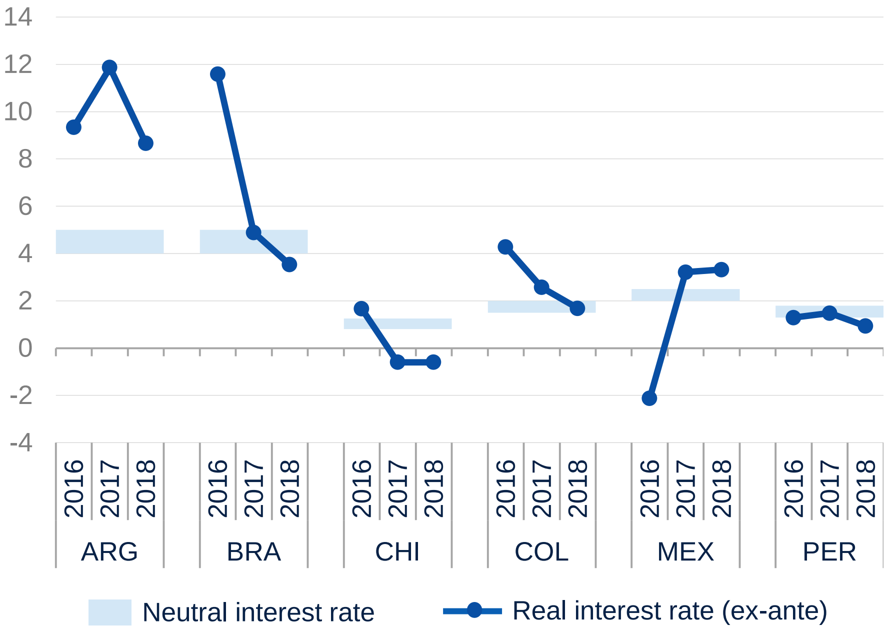
Latam: fiscal balance
(%, GDP)



Source: BBVA Research and Haver

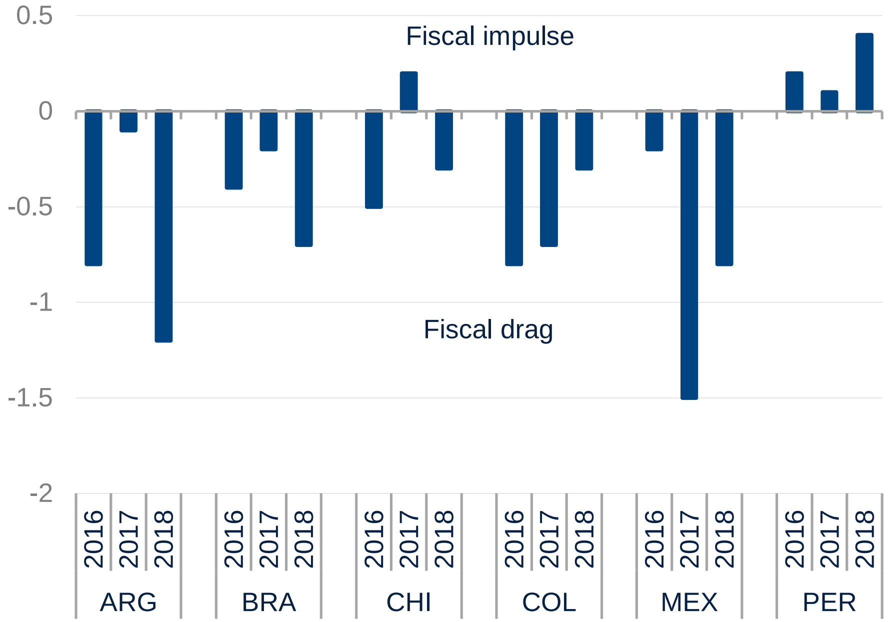
Monetary policy will continue to bear most of the countercyclical adjustment in South America, given lack of fiscal space

Latam: Real interest rates*
(%)



Source: BBVA Research and IMF * Inflation and interest rate data refer to July for each year. Ex-ante real interest rate is computed using yoy inflation rates expected 12 months ahead.

Latam: fiscal impulse
(Change in the structural primary deficit, % GDP)



Source: BBVA Research

Only Mexico and Argentina will have contractionary ex-ante real interest rates, reflecting inflation rates above central bank’s target ranges.

Fiscal policy will not be able to support economic activity, given lack of policy space. Exception will be Peru, where the fiscal rule allows for extraordinary spending for reconstruction, in the wake of “el Niño costero” of 2017.

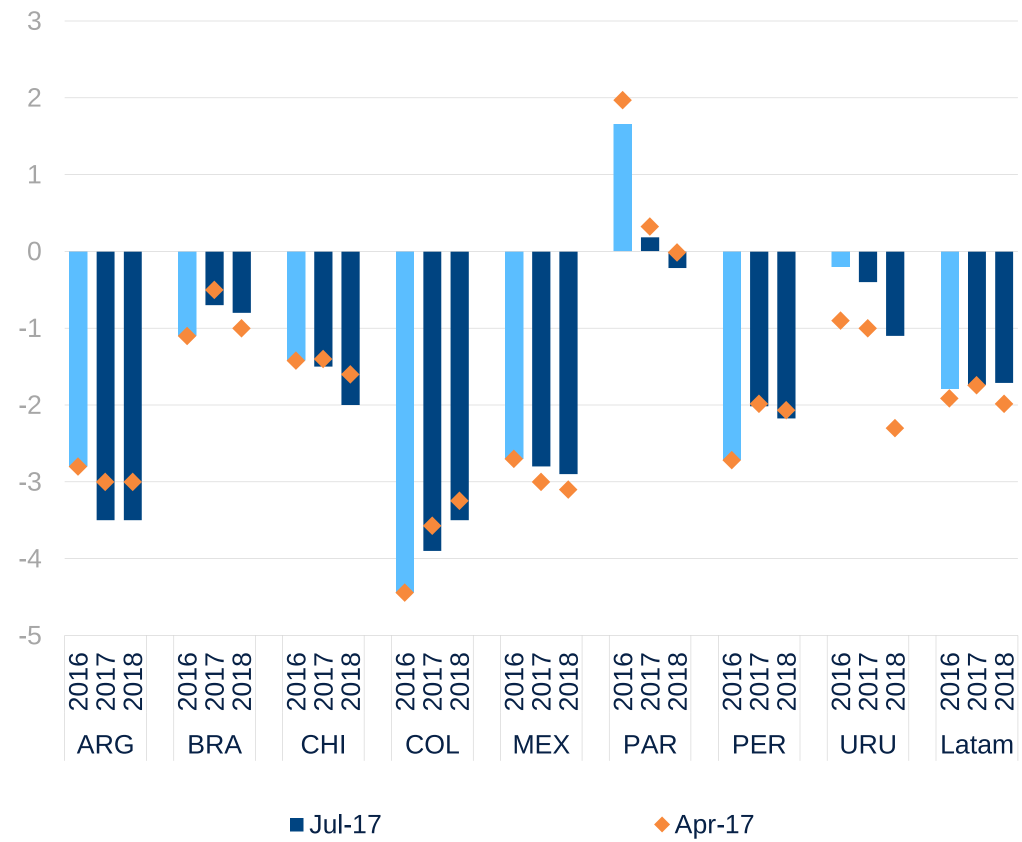
Current account vulnerability continues to abate in most countries

- External deficits continue to shrink in countries with the widest gap, like Colombia, although at a slower pace than anticipated

- Recent drop in commodity prices and weak demand from intraregional trade partners has weighed down on exports

Latam: current account balance

(%, GDP)



Source: BBVA Research and Haver

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Main messages

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ANNEX

Latin America GDP growth forecasts

GDP (%yoy)	2014	2015	2016	2017f	2018f
Argentina	-2.5	2.6	-2.2	2.8	3.0
Brazil	0.5	-3.8	-3.6	0.6	1.5
Chile	1.9	2.3	1.6	1.3	2.4
Colombia	4.4	3.1	2.0	1.5	2.0
Mexico	2.3	2.7	2.0	1.6	2.0
Paraguay	4.7	3.0	4.0	3.7	3.5
Peru	2.4	3.3	3.9	2.2	3.9
Uruguay	3.2	0.4	1.4	3.2	3.1
Mercosur	-0.4	-2.8	-4.1	0.2	1.2
Pacific Alliance	2.6	2.7	2.2	1.6	2.3
Latin America	0.9	-0.3	-1.2	0.8	1.7

f = forecast