Latin America Outlook

1st QUARTER 2018

Main messages

1. **Strong global growth continues**. Forecasts revised up in 2018 in most areas. Growth stabilizing in 2019.

2. **Growth recovers in Latin America, reaching close to potential in 2019.** Growth will increase from 1,1% in 2017 to 1,7% in 2018 and 2,5% in 2019. Growth revised up in most countries in 2018, except Colombia and Mexico (stable) and Peru (revised down). Growth will increase in 2018-19 driven by the external sector and investment.

3. **Inflationary pressures remain contained, except in Argentina and Mexico.** Therefore, interest rate cuts in South America would end at the beginning of 2018 (except Argentina, where interest rates will fall in line with inflation, and Mexico, where they will stay put after an additional hike)

4. **Exchange rates will depreciate gradually,** given Fed's rate hikes and some downward correction in commodity prices. Appreciation is possible in Mexico if risks associated to NAFTA renegotiation and upcoming elections do not materialize. In Colombia, slight appreciation expected when growth resumes.

GLOBAL

Positive global momentum gets reinforced, but still with downside risks

Sustained Global growth

01

Improved forecasts for the US, China and the Eurozone
There is less short-term uncertainty

02

More positive perspectives for emerging countries
Greater global demand and increase in commodity prices

03

More caution in the financial markets
Expectations of lower liquidity may reduce flows to emerging markets

04

Contained core inflation
Although the downward pressure factors are disappearing

05

Central banks continue their paths towards normalization
The reasons for withdrawing stimuli are materializing

06

Global risks
Lesser in the short term; no changes in the medium and long term

Reasons for optimism in large areas, although with caution

UNITED STATES

Growth revised upwards

Improvement in the labor market

Approval of the tax reform

Continuistic changes in the Fed

CHINA

Moderate deceleration

Some reforms already underway

Positive conclusions at

the XIX Congress of the CPC

Greater potential growth

EUROZONE

Greater growth than expected

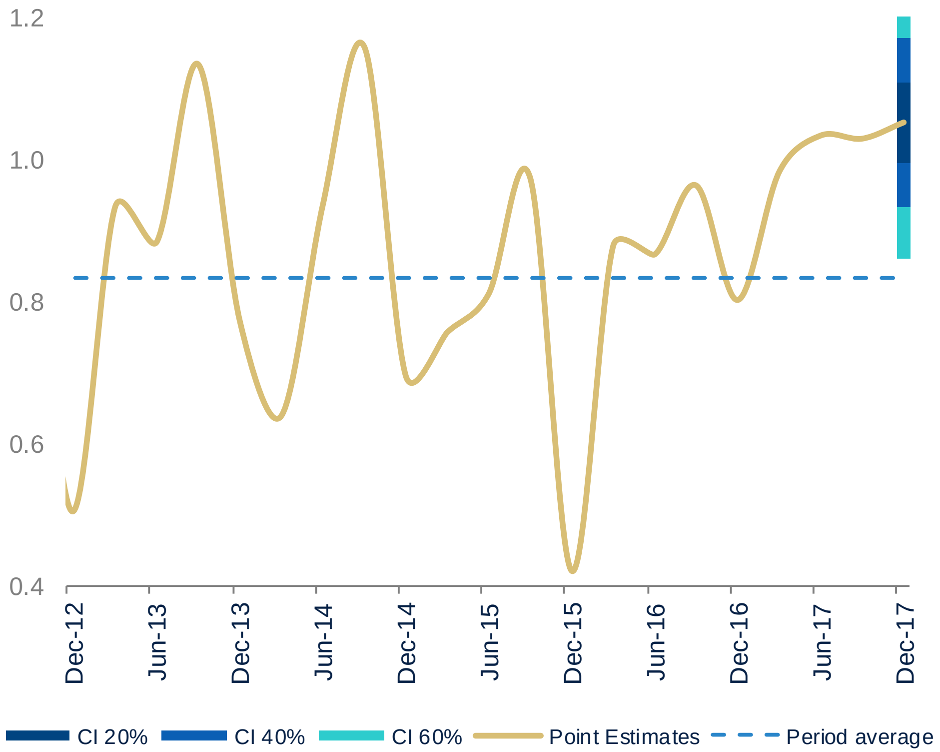
More robust domestic demand

Lower political uncertainty

Plans for greater integration

Robust and sustained global growth

World GDP growth
(Forecasts based on BBVA-GAIN, % QoQ)

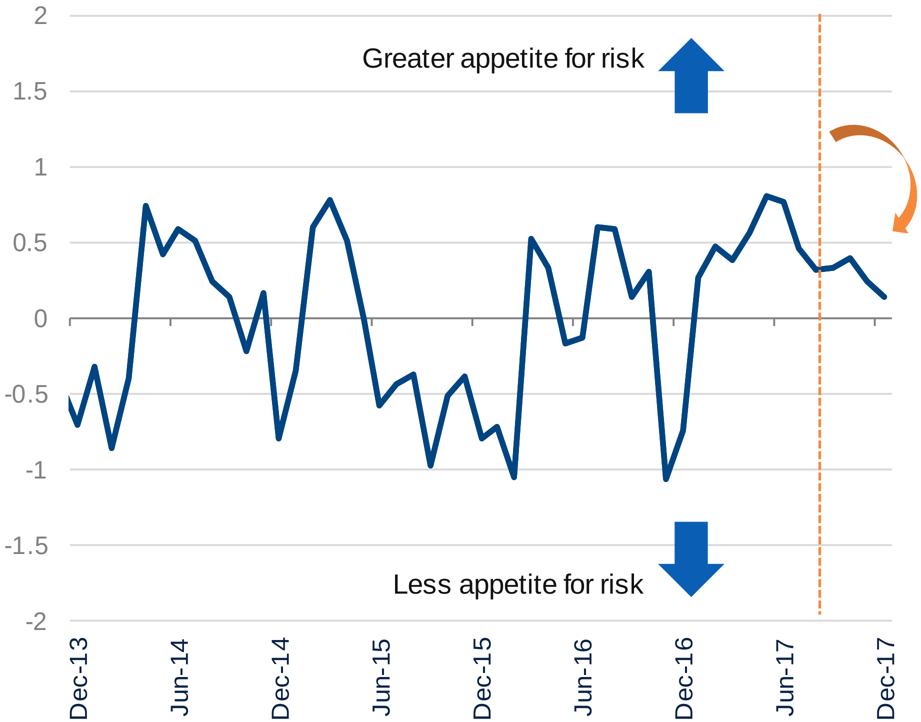


- The global economy continues to grow, supported by the recovery of the industrial sector
- Confidence indicators continue to improve, and anticipate that the outlook will continue to be positive
- Private consumption continues to sustain growth in advanced economies and gains momentum in emerging economies

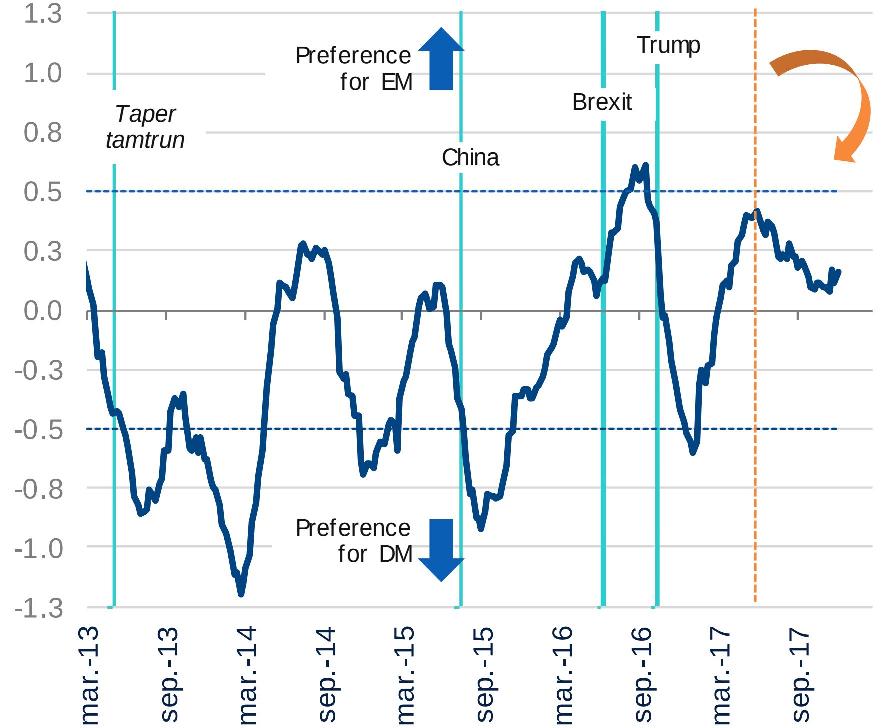
Source: BBVA Research

Caution in financial markets, with moderation of flows to emerging markets

Risk appetite indicator
(Factor 1 (global), EPFR flow analysis)



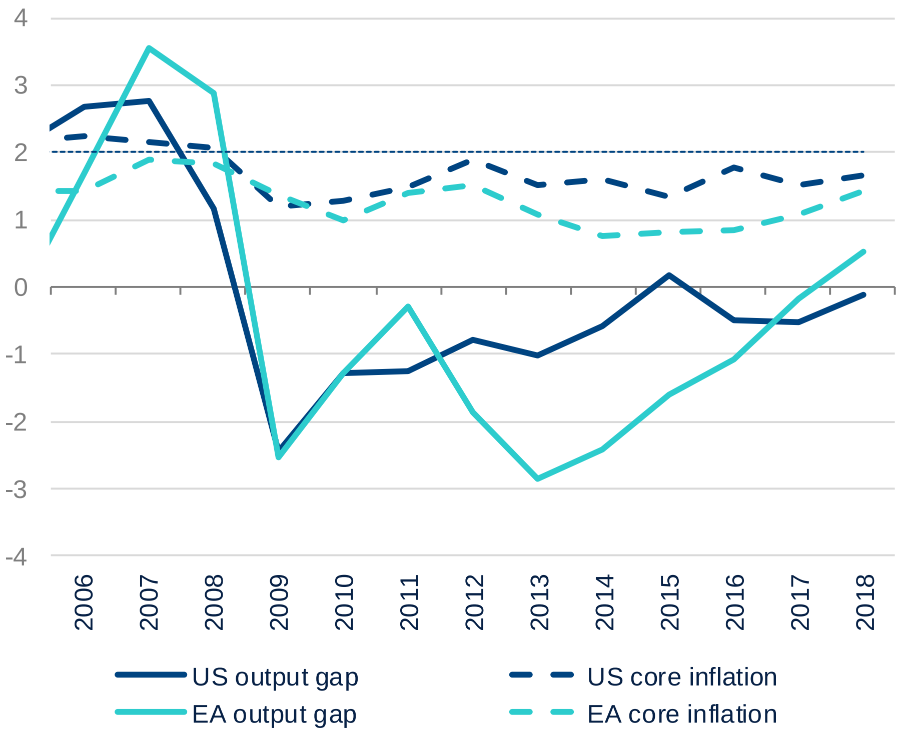
Investors appetite for emerging (EM) vs developed (DM)
(Inflows in EM vs. DM in % of assets under management)



Source: BBVA Research, EPFR

Contained core inflation

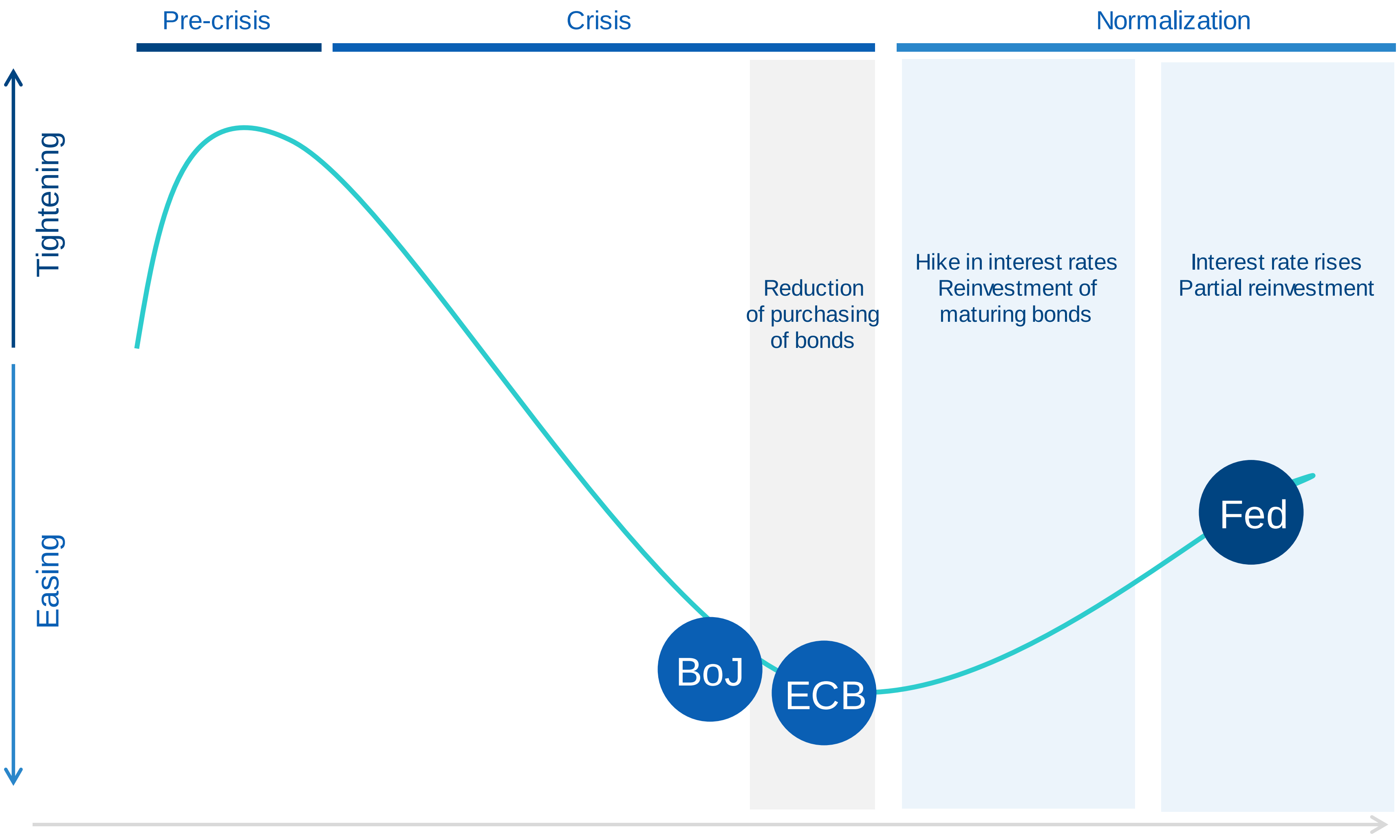
Output gap and core inflation
(% GDP potential, % YoY)



- Reduction of the idle capacity of the economy, but with room to grow without strong inflationary pressures
- Less reaction of prices to the increase in activity, for several reasons:
  - Globalization
  - Increased flexibility of the labor market
  - Low inflationary expectations
  - Reduced productivity growth
- The increase in the price of oil will push up inflation in the short term, facilitating the normalization of central banks in developed economies

Source: BBVA Research and the OCDE

Withdrawal of non-conventional monetary policy measures



Monetary policy normalization: accelerated in the case of the Fed, gradual in the case of the ECB

FED

Tightening cycle and reduction of the balance in progress

Estimated rise of 75pbs in 2018 to 2.25% and reduction of its balance sheet by 420bn USD

ECB

QE reduction, but extension until September 2018

No rate hikes are expected until 2019

Focus: gain room for manoeuvre

Focus: avoid sudden acceleration of long-term rates

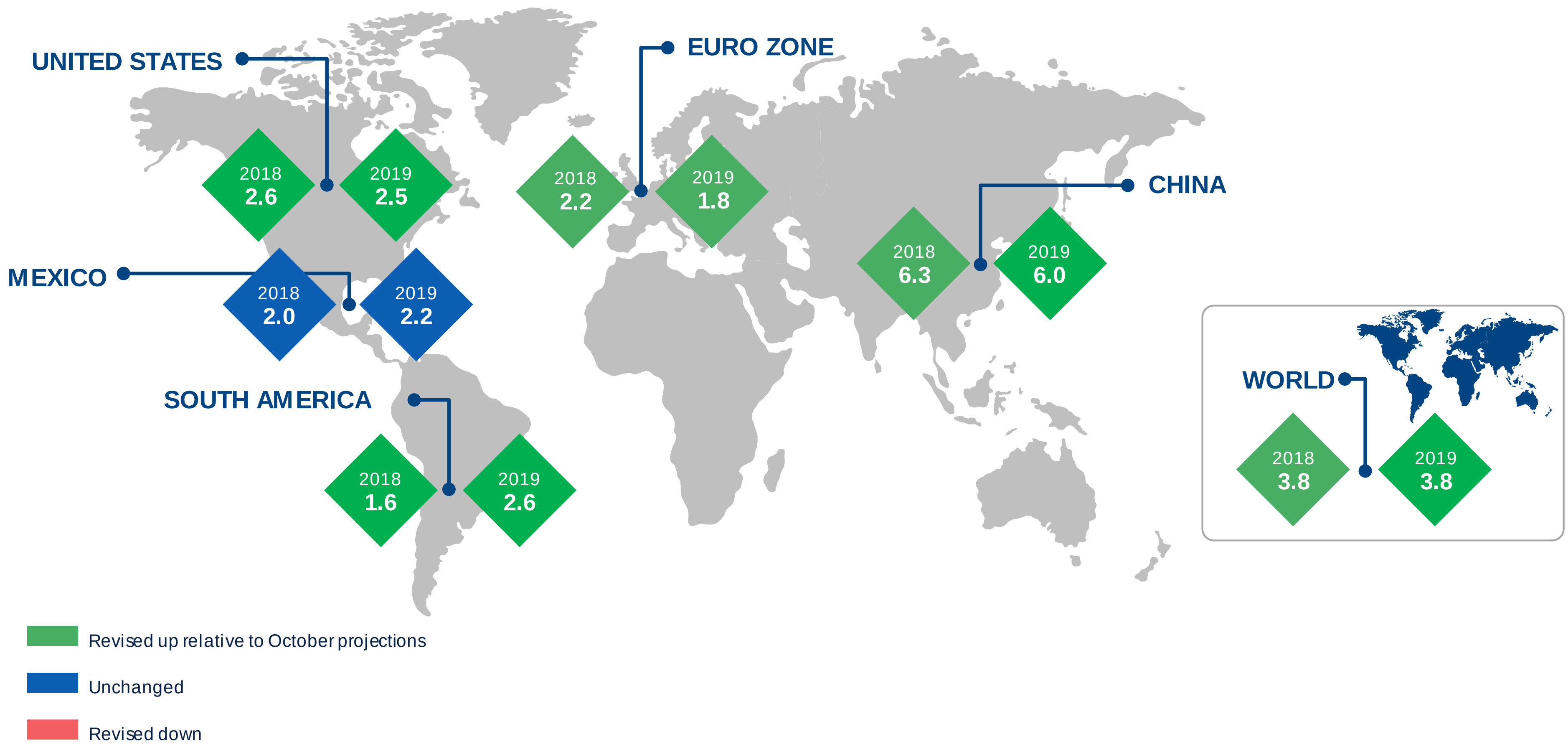
Elements of uncertainty:

Politics: changes in government ministries (Fed, ECB)

Macro : possible surprises in inflation

Markets: Long-term rates and slope of the curve

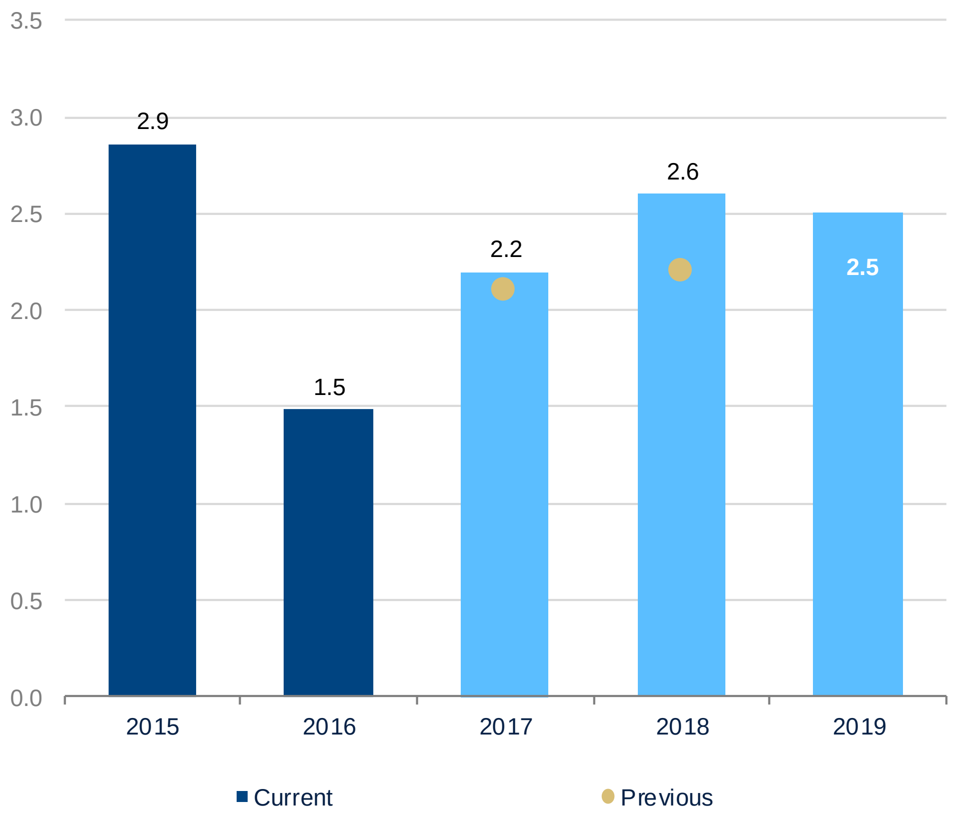
Generalized upward revision of growth forecasts



Source: BBVA Research

US: stronger economic growth in the short term

US: GDP growth
(YoY, %)

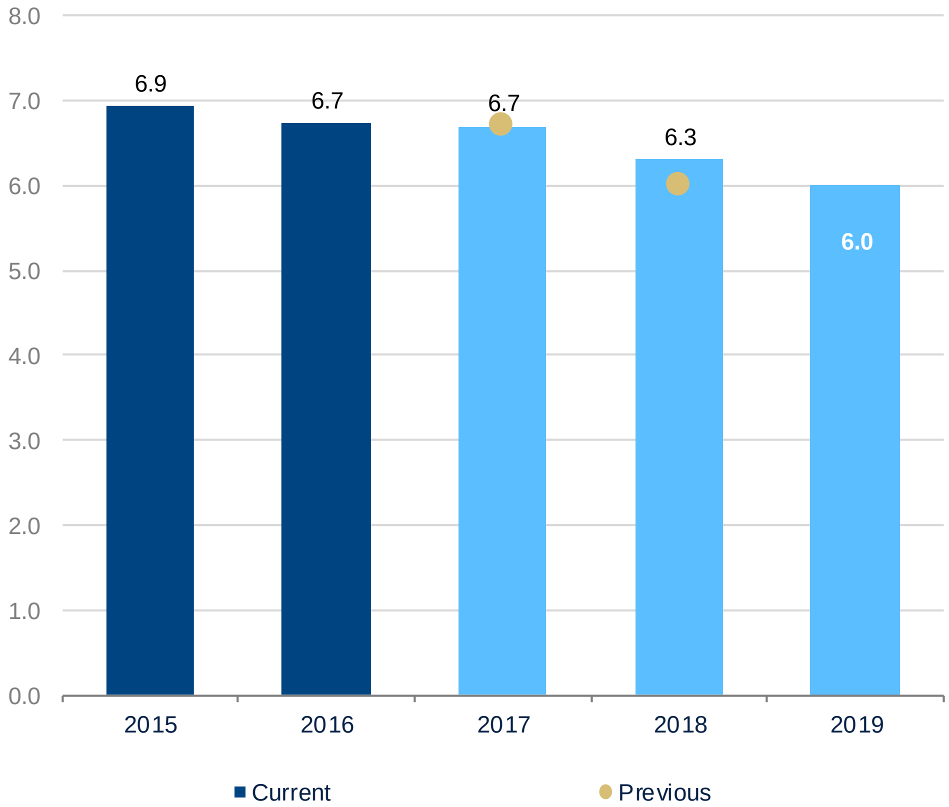


- Positive impact of the oil price increase, global demand and the weakness of the dollar on investment and exports
- Positive but limited effect of the tax reform (around 0.2% in 2018), mainly due to changes in corporate taxation. Doubts about the long-term effect
- Monetary policy will remain accommodative, despite normalisation

Source: BBVA Research based on BEA (Bureau of Economic Analysis) figures

China: More moderate slowdown in growth

China: GDP growth
(YoY, %)

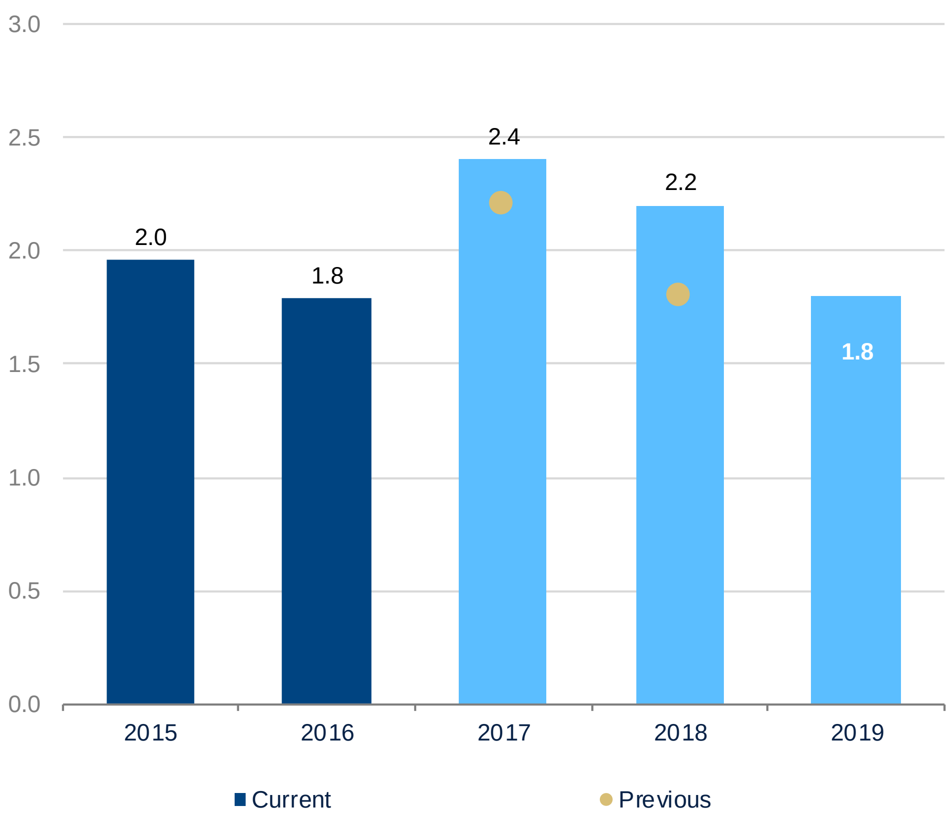


Source: BBVA Research based on CEIC data

- More moderate slowdown due to ongoing structural reforms and less support from economic policy
- Despite this, the good economic performance reduces the risk of a sudden adjustment in the short term
- Eliminating the growth objective limits imbalances
- The measures aimed at opening up the economy, together with more qualitative objectives, will drive structural reforms and potential GDP

Eurozone: Stronger and more balanced growth

Eurozone: GDP growth
(YoY, %)

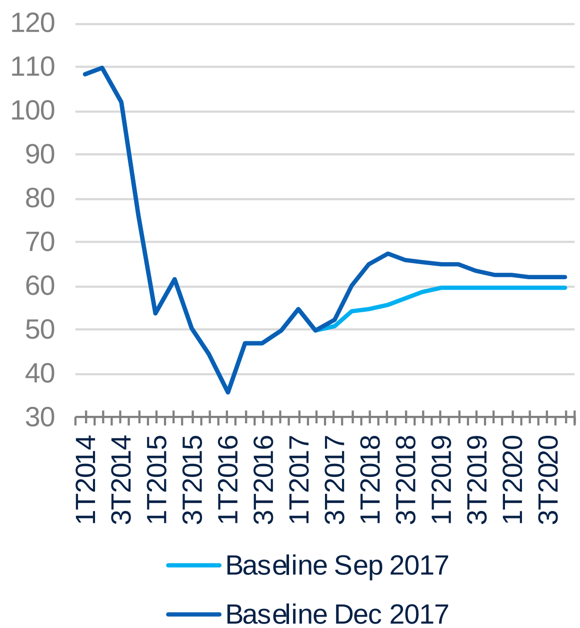


Source: BBVA Research based on Eurostat figures

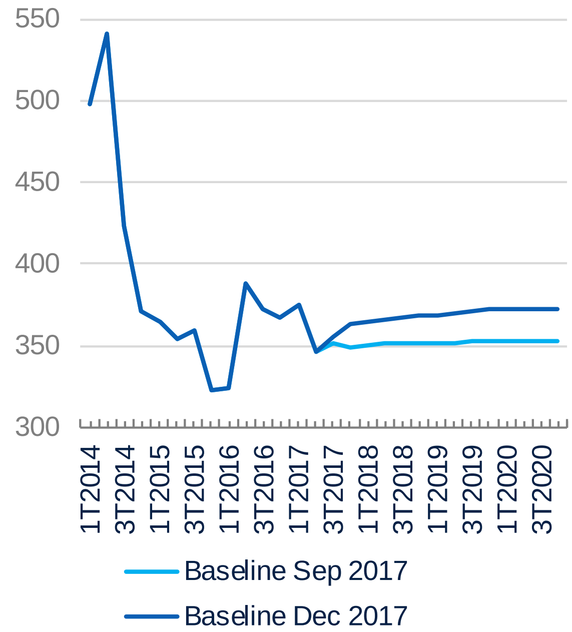
- The increase in disposable income continues to support solid private consumption
- Greater support from global demand, with limited impact from the euro's appreciation
- Easing uncertainty and increased earnings will underpin the recovery in investment
- Monetary policy will contribute to favourable financial conditions and a relatively stable euro
- The cyclical improvement will allow the deficit to be reduced by means of a somewhat expansive fiscal policy

Higher forecasts for commodity prices reflect mostly stronger global demand

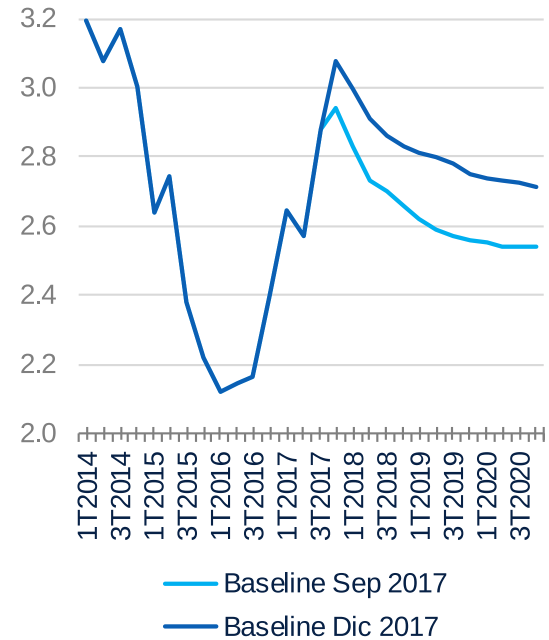
BRENT OIL
(USD/B)



SOYBEANS
(USD/mT)



COPPER
(USD/lb)

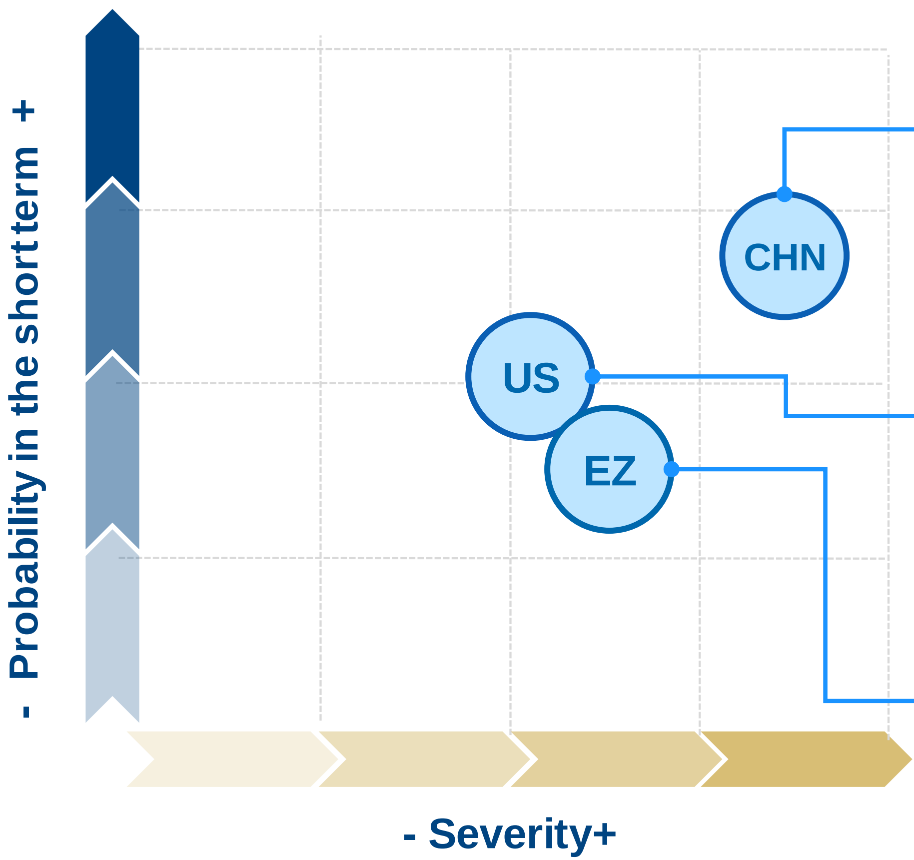


Source: BBVA Research and Bloomberg

Oil prices increased in higher global demand but also supply effects, geopolitical risks and lower inventories. But we continue to forecast a long-run price of 60 dollars per barrel due to competition from shale oil producers.

Copper prices increased significantly due to higher demand and financial flows. The latter should abate gradually going forward.

Global risks: lower in the short term



- Containment of risks associated with high leverage in the short term
- Potential negative effect of increased protectionism

- Political tensions still high, but more contained
- Negotiation of trade agreements (NAFTA)
- Signs of over-valuation of certain assets
- Reduced risk of rapid normalization by the Fed, but uncertainty persists

- Reduced political uncertainty, but significant question marks remain in several countries (Brexit, Germany, Italy)
- Managing monetary policy normalization

* US: United States; EX: Eurozone; CHN: China. Source. BBVA Research

BBVA Research

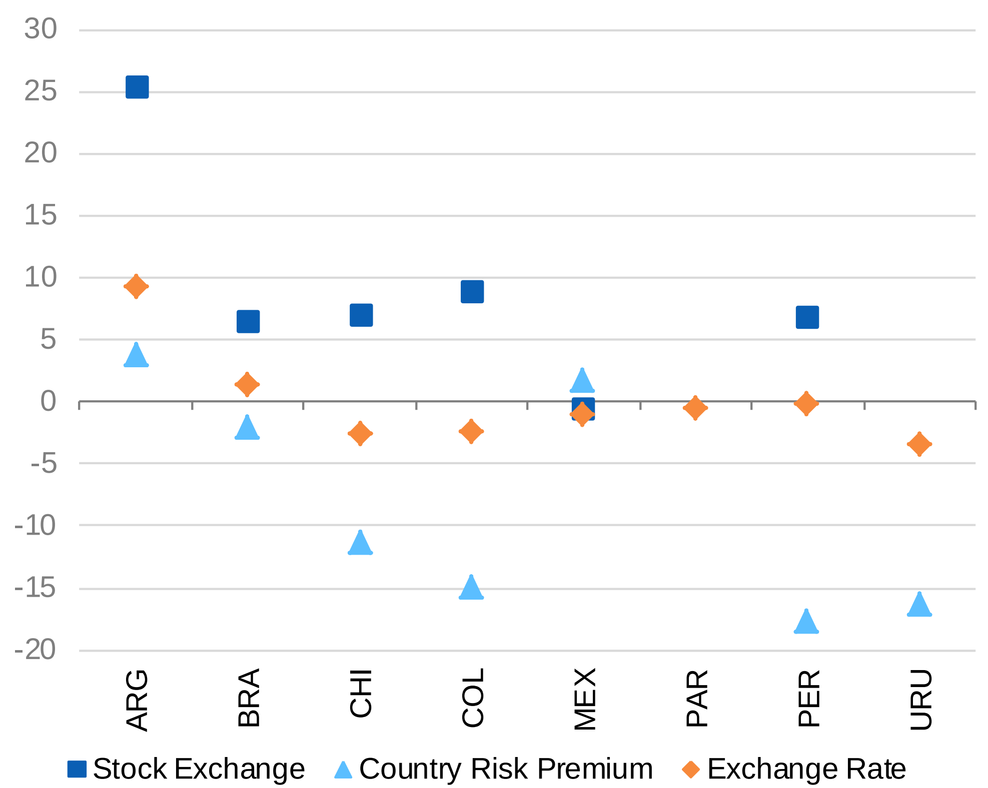
LATAM

Growth increases, reaching new potential in 2019-20

Positive mood in financial markets in Latam

- Asset prices continued to see gains in the last months, extending the trend since the beginning of 2017. Main drivers:
  - Weak dollar
  - Increase in global growth
  - More bullish view on China
  - Higher commodity prices
- More moderate gains in Mexico, given stumbling blocks to renegotiating NAFTA
- In addition, growth prospects increase in Latam

Latam asset prices: percent change in the last 3 months to January 19*

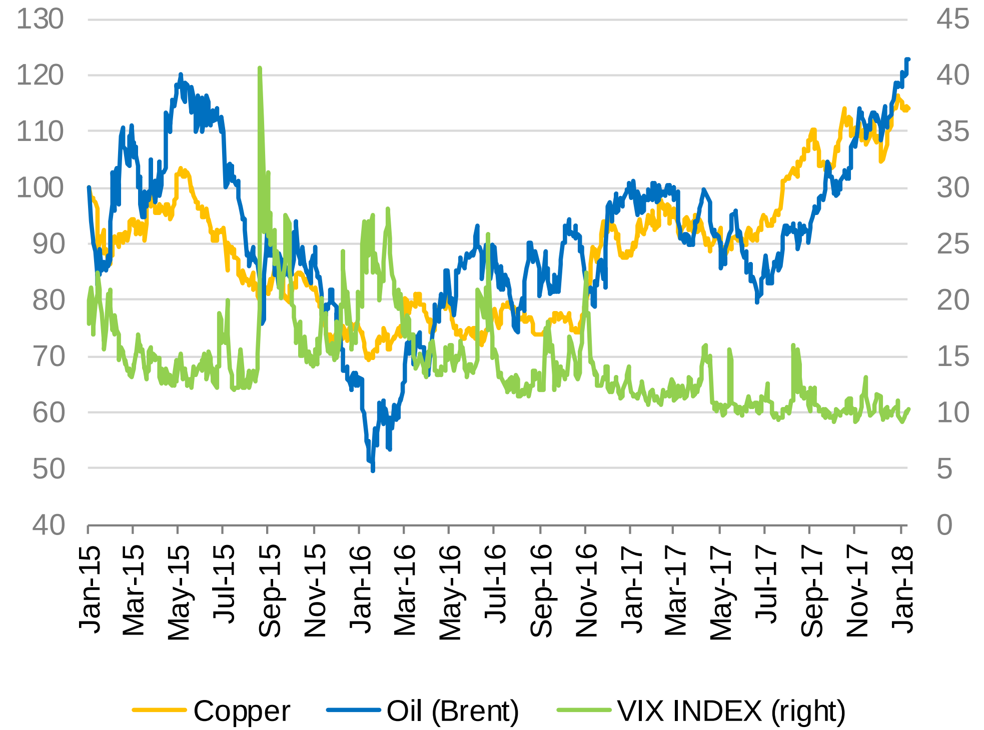


Source: BBVA Research and DataStream * Changes between October 19 and January 19. Exchange rate: local currency per USD. In this case, an increase signals a depreciation. Country risk premium: EMBI.

Latam financial markets benefitted also from low global volatility and higher commodity prices

- Volatility at historical lows keep supporting risky assets, including emerging markets assets
- Commodity prices also increase pushed by demand factors, but also include a financial component (copper) and a geopolitical risk premium (oil)
- Risk of complacency by markets, at a time of increasing rates by the Fed and lower monetary stimulus from other central banks.

Volatility in developed markets and commodity prices (index)

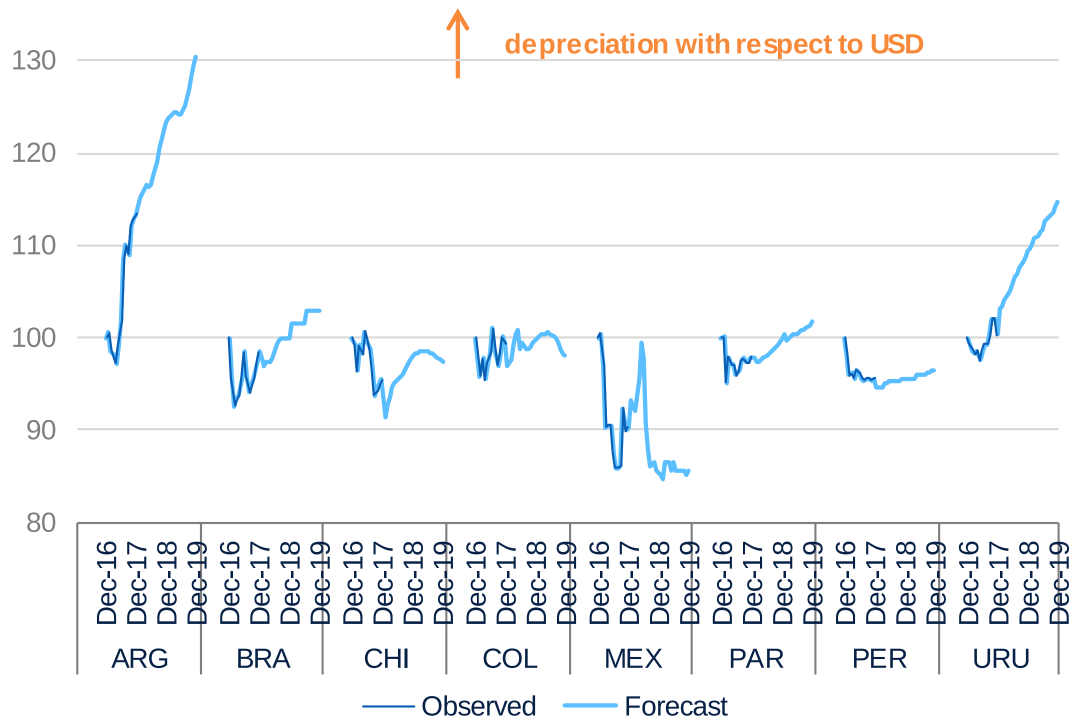


Source: BBVA Research, DataStream and Bloomberg

Gradual exchange rate depreciation in 2018-19 in most countries

- Stable or appreciating exchange rates in the last 3 months due to favorable global financial conditions.
- We expect a mild depreciation of exchange rates going forward, given:
  - Increasing US interest rates (versus stability in Latam)
  - Lower global liquidity
  - Moderating commodity prices
- Mexican and Colombian peso would be the exception. Mexican peso could appreciate if risks related to NAFTA renegotiations and the election do not materialize. Colombian peso could appreciate as growth recovers.

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

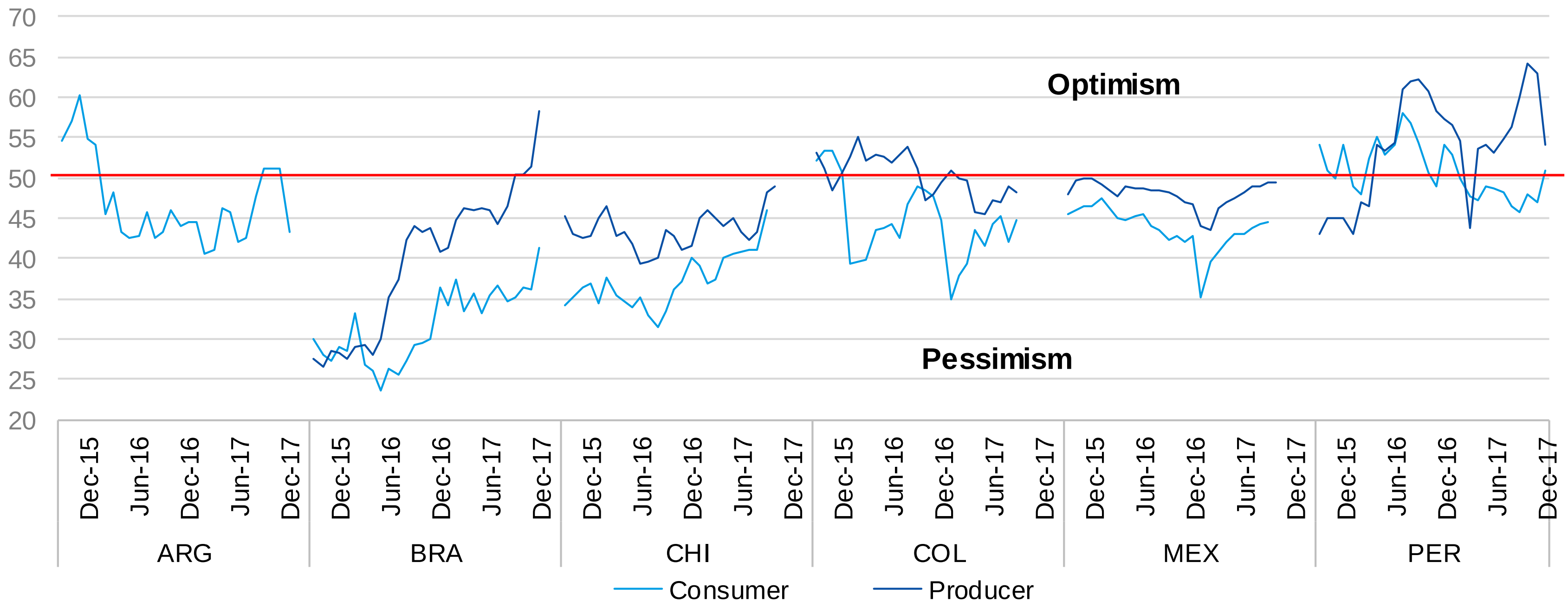


Source: BBVA Research and Haver

Confidence indicators continue to recover gradually, but still remain weak

Latam: Confidence indicators for households and firms

(values above 50 pts indicate optimism)



Source: BBVA Research and Haver

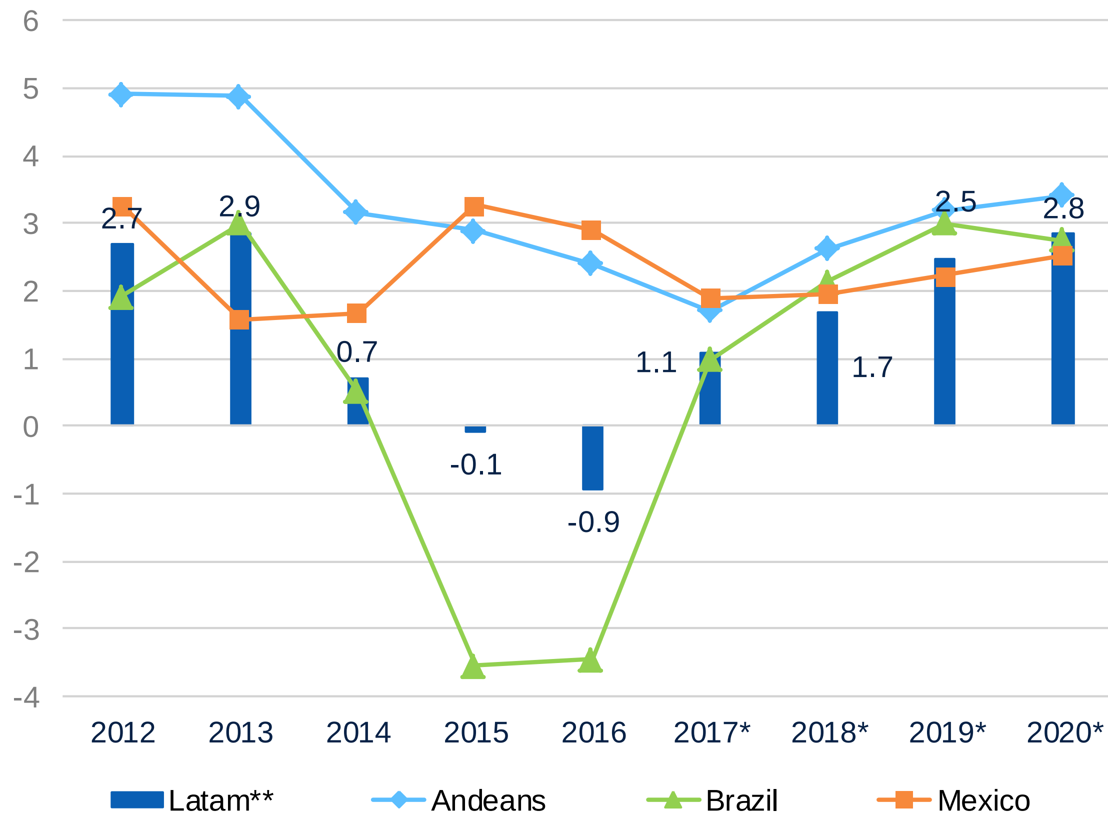
Recovery of producer confidence, supported by low volatility in financial markets, higher commodity prices and somewhat lower political noise and uncertainty in some countries (Chile).

For households, lower inflation continue to improve sentiment. Also, labor market adjustment seems to be coming to an end in many countries.

Latin America on track to an upward growth trend in 2018 (1.7%) and 2019 (2.5%)

- Growth recovers in the last months in line with stronger expectations
- Stronger growth in 2018 and 2019 driven by 2 factors:
  - External sector, supported by stronger and widespread global growth and higher commodity prices
  - Public and private investment
- Growth in 2019-20 around the new potential for Latam, below that of the commodity boom years (2004-2013).

Latam: GDP growth
(%)

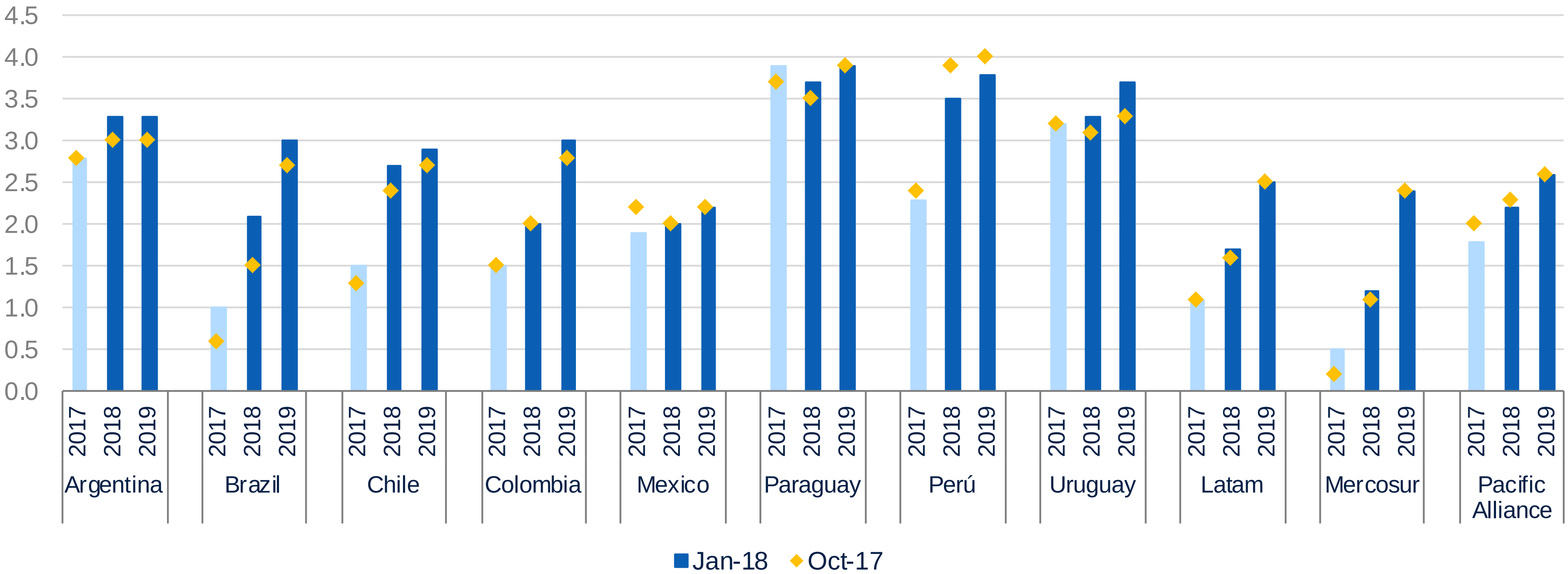


Source: BBVA Research
* Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

Growth forecasts for 2018 revised up in most countries, except México, Colombia (both unchanged) and Peru (revised down)

Latam countries: GDP growth

(%)



Source: BBVA Research

Recent data confirm growth consolidating in Argentina and continuing to recover in Brazil, Chile and Peru.

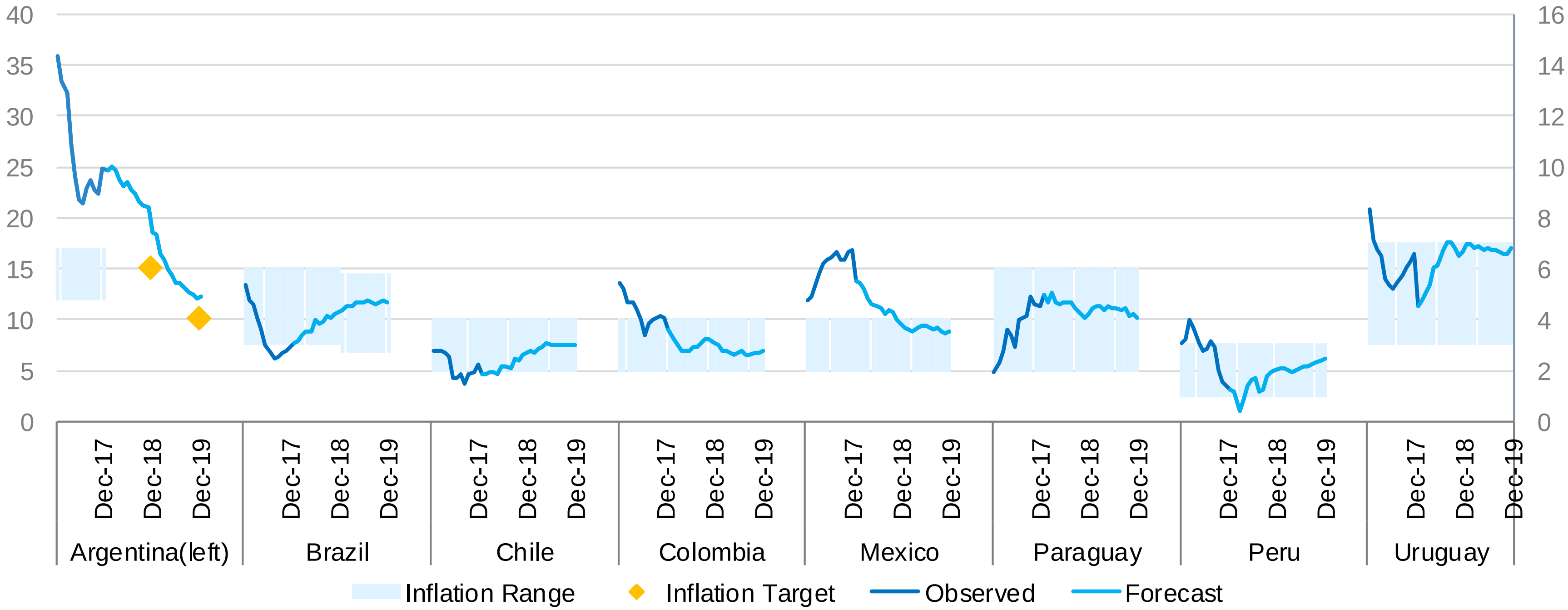
Economic activity remained weak in Colombia and fell (temporarily) in Mexico

Growth forecasts revised up on better incoming data and a more favorable external outlook

Inflationary pressures remain contained, except in Argentina and Mexico

Latam: inflation and central bank target ranges

(%, yoy)



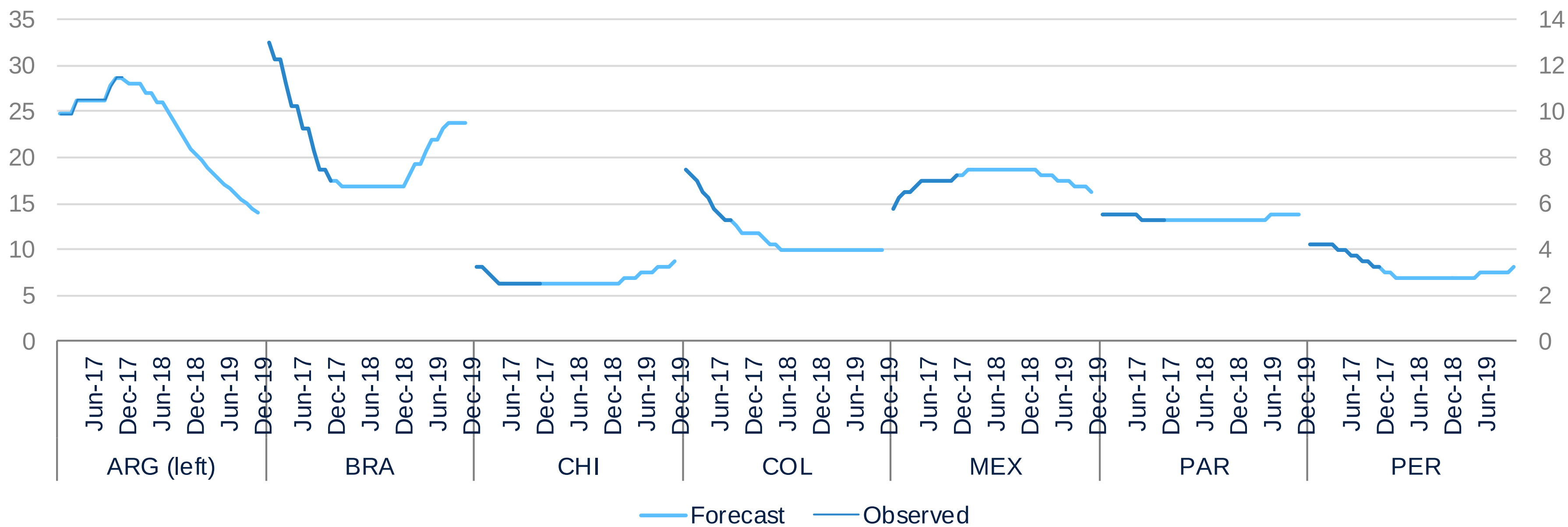
Source: BBVA Research

Inflation in South America ended 2017 at low levels, unseen in almost 3 years, due to exchange rate stability, weak domestic demand and, in many cases, lower food prices.

Inflation will remain contained, within central bank targets, except Argentina and Mexico, but in both cases inflation will fall throughout 2018 and 2019

Cycle of interest rate cuts close to end in most countries in South America. Stability expected in Mexico after February

Latam: official interest rates
(%)



Source: BBVA Research and Haver

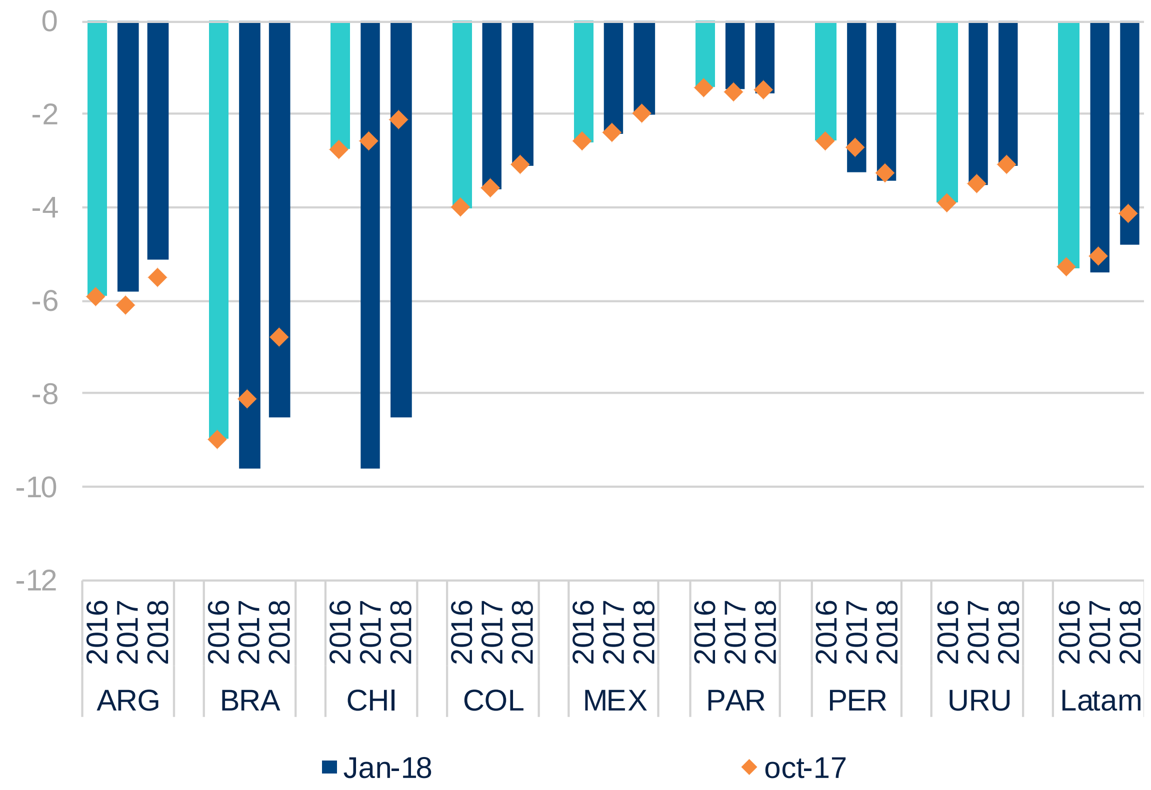
Interest rate cuts in South America to end at the beginning of 2018 (except in Argentina) given inflation around Central Bank targets or increasing in some cases. In Argentina, interest rates set to fall in line with inflation.

In Mexico, after a possible additional rate hike, Banxico will keep interest rates stable for the remainder of 2018, with rate cuts only on 2019.

Fiscal deficits will continue to fall. Higher fiscal risks in Brazil.

- Fiscal deficit in Argentina fall beyond targets in 2017, which will help meet 2018 target.
- Some progress regarding fiscal consolidation in Brazil, but fiscal risks remain high.

Latam: fiscal balance
(%, GDP)



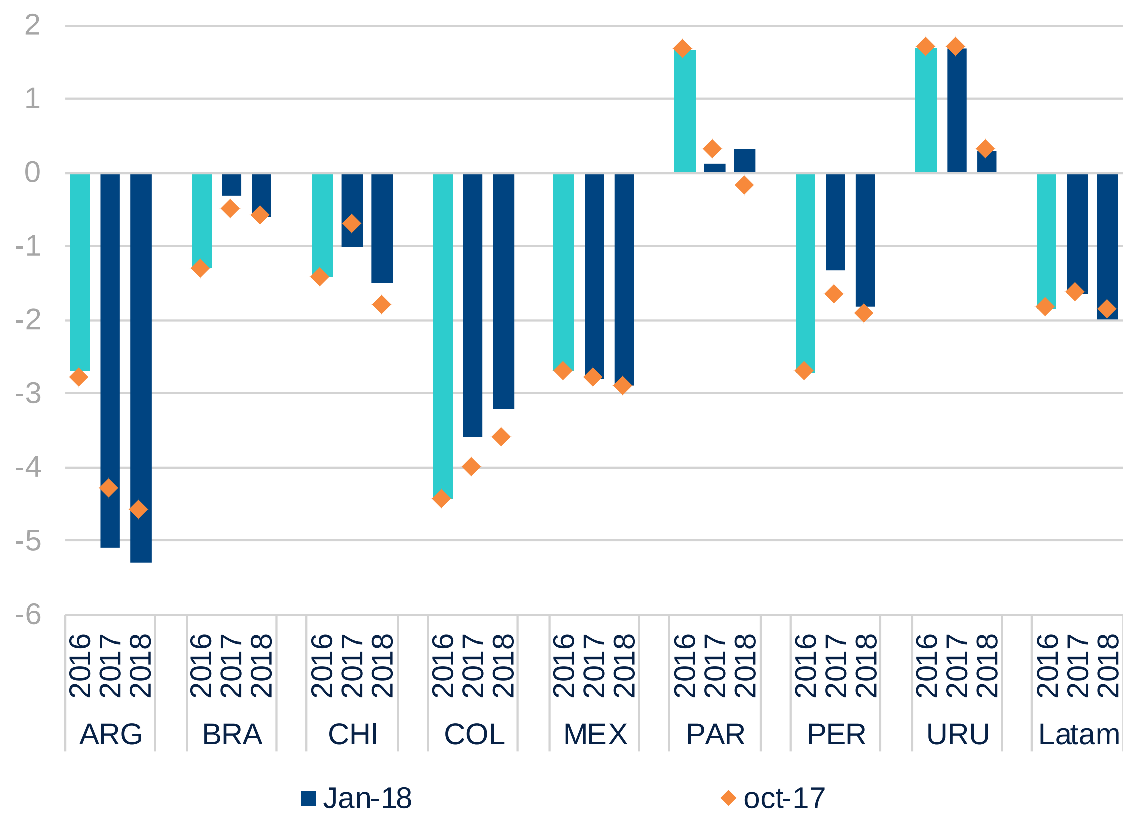
Source: BBVA Research and Haver

Higher growth will put pressure on external deficits in Latin America in 2019

- External deficits would start to widen in many countries given an expected increase in imports
- External deficits expected for Argentina revised up in 2018 and 2019, precisely due to strong expected imports.
- Higher commodity prices would compensate for increasing imports, in countries such as Colombia, Chile and Peru

Latam: current account balance

(%, GDP)



Source: BBVA Research and Haver

Main messages

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ANNEX

Latin America GDP growth forecasts

GDP (%)	2015	2016	2017e	2018f	2019f
Argentina	2.6	-2.2	2.8	3.3	3.3
Brasil	-3.5	-3.4	1.0	2.1	3.0
Chile	2.3	1.6	1.5	2.7	2.9
Colombia	3.1	2.0	1.5	2.0	3.0
Mexico	3.3	2.9	1.9	2.0	2.2
Paraguay	3.0	4.0	3.9	3.7	3.9
Peru	3.3	4.0	2.3	3.5	3.8
Uruguay	0.4	1.4	3.2	3.3	3.7
Mercosur	-2.6	-4.0	0.5	1.2	2.4
Pacific Alliance	3.1	2.7	1.8	2.2	2.6
Latin America	-0.1	-0.9	1.1	1.7	2.5

e= estimates; f = forecast