BBVA Research

Latin America Outlook 2Q18

April 2018

Creating Opportunities

Key messages

- Global growth remains robust., although uncertainty is increasing.
  US fiscal stimulus may underpin progress in other areas too, but protectionist measures pose a risk

- Latin America maintains its recovery amidst external turbulence.
  Global growth will increase from 1.2% in 2017, to 1.4% in 2018 and 2.5% in 2019. We have revised our growth forecast for 2018 downward in Argentina, Paraguay and Uruguay due to the drought, and in Peru as a result of political noise. We have revised expectations for Chile upward due to higher copper prices and increased business confidence

- The cycle of interest rate cuts will come to an end in South America in the second quarter.
  The exception is Argentina, where they will fall again as inflation continues to slow. In Mexico, interest rates will remain stable to late 2018, when cuts will begin

- The main external risks center on protectionism (increased) and on China (lesser than three months ago). On the domestic front, political noise and the possible delay in public and private investment is an upside risk in a number of countries

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Global environment

Global growth remains but risks intensify

01

Steady global momentum remains

Supported by the recovery of trade and investment

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Economic policies underpin the cyclical recovery

The US fiscal stimulus can support other areas

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Greater financial volatility

The unusual low-volatility environment is now past

04

Normalization of central banks' monetary policy

Somewhat faster than expected in the Fed, while the ECB has already taken its first steps

05

Uncertain effect of US protectionist measures

The direct effect of approved measures is not very large, but it may presage more aggressive measures

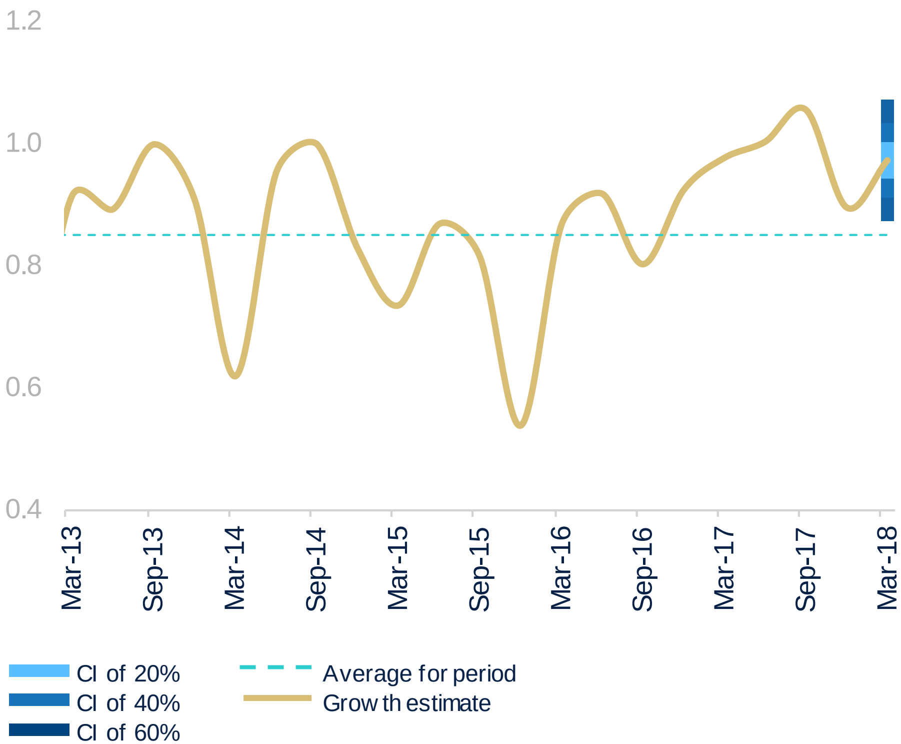
06

Global risks

Increasing in the short-run by a possible escalation of protectionist measures

The global economy is expected to grow firmly in 1Q18, at rates similar to those of most of last year (1% quarterly)

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

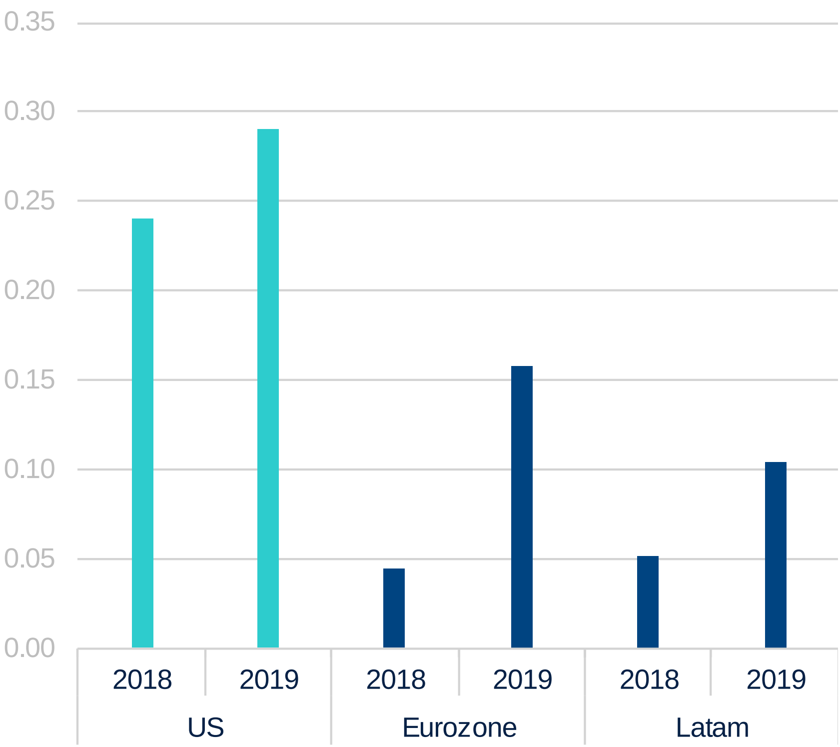


- Global growth is continuing, buoyed by the recovery in investment and trade
- Private consumption is softening, but remains a positive factor for the advanced economies and is gaining momentum in emerging economies
- Confidence indicators remain at high levels, but show signs of dampening

Source: BBVA Research

The upward revision of US growth forecasts, due to fiscal stimulus, could add further support to the recovery in other areas

Impact of the fiscal stimulus in the US on growth
(pp)



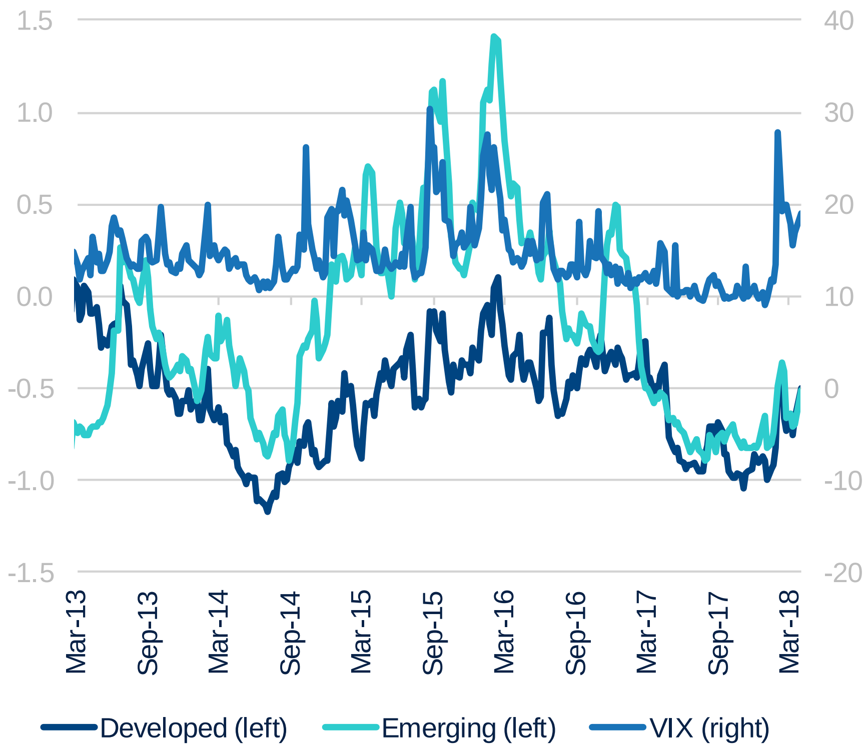
Source: BBVA Research

- The larger effect would be in 2019, especially in the eurozone
- This support could offset some headwinds in other areas (political uncertainty in Latam or higher global volatility)
- The weakness of the dollar could mitigate the positive impact of higher US demand

Financial tensions are beginning to reflect a less accommodating environment

VIX and BBVA Research financial tension

(%)



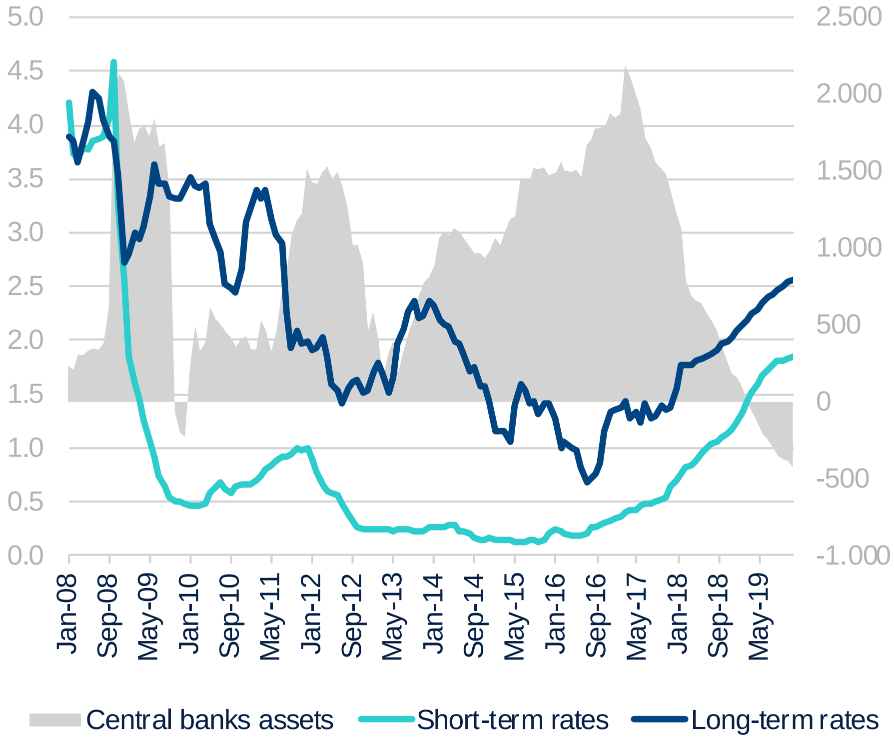
Source: BBVA Research based on Bloomberg

- Concerns about inflation (US) and protectionism have led to higher volatility and stock market correction
- The contagion effect is limited, but it will depend on the persistence of the current shock
- Markets are unlikely to be as complacent with uncertainty as in 2017

Financial conditions will be less accommodating

Global financial conditions*

(% and change in billion dollars)

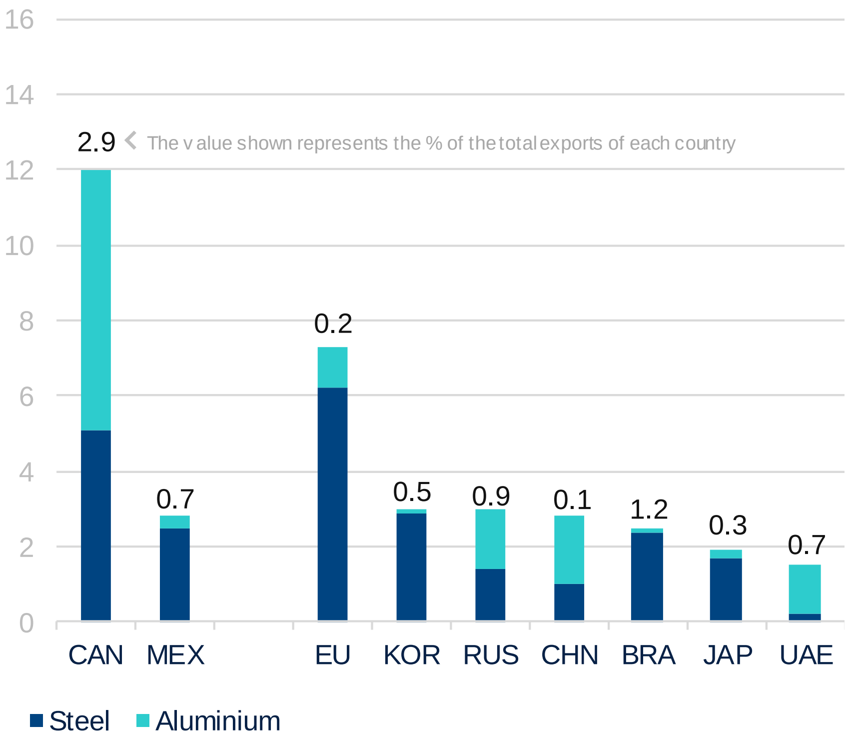


- As central banks will reduce their balance sheets and interest rates gradually increase…
- … volatility shocks could be more frequent and persistent
- More cautious investor mood

(*) Short and long term interest rates, average yield of German and US bonds over 3 months and 10 years. Includes assets on the balance sheets of the Fed, ECB, BoE and the BoJ
Source: BBVA Research based on Fed, ECB, BoE and BoJ

The risk of protectionist escalation creates uncertainty about the global economic outlook

US imports of steel and aluminium and export share by country
(billion USD, % of total exports)

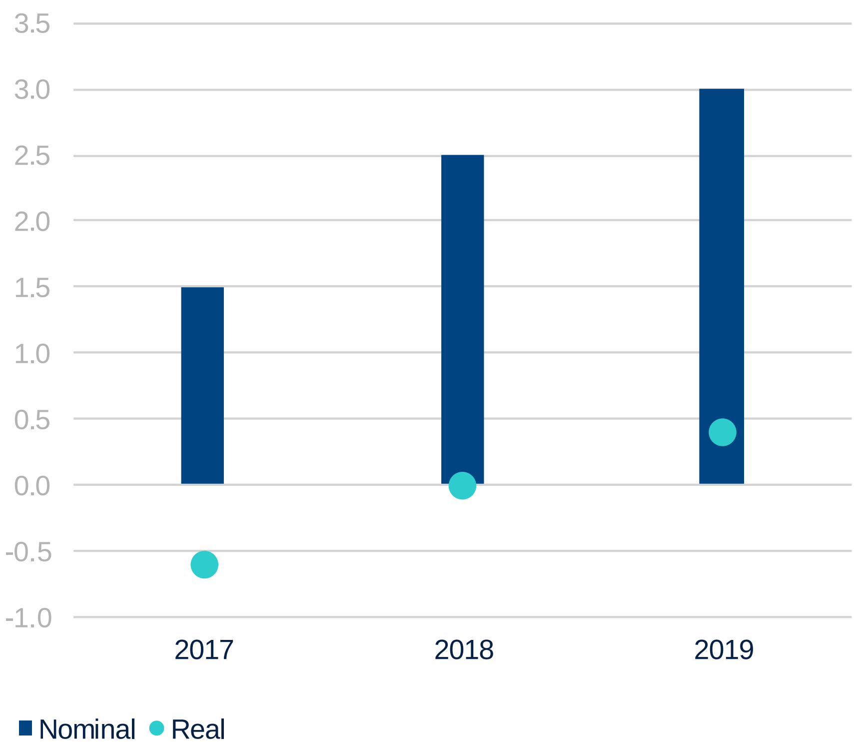


Source: BBVA Research

- US tariffs on steel and aluminum have a small direct impact on activity:
  - They represent only a small share of total exports
  - Exemption for many countries until May
  - The greatest negative impact may come from indirect effects and possible reaction of the countries concerned
- The mutual tariff increase between the US and China (25%, 50bn USD in 2017):
  - Larger effect: 38% exports to China (3% of the total US exports) and 11% of exports to the US (2% of the total chinese exports)
  - They can only be the beginning of a major escalation

Further Fed rate hikes due to better economic outlook

USA: Intervention rate
(%)



Source: BBVA Research, based on FED and BEA

- Fed is likely to increase rates by further 75bp this year and 50bp in 2019
- Monetary conditions will remain accommodative, with real interest rates close to zero

ECB is making progress to QE without causing any strain

QE

The QE will end in 2018

Monthly purchases of assets (30bn EUR) up to September

Purchases withdrawal between September and December

Interest Rates

As we approach the end of QE, the **focus shifts** to the rate hikes: when and at what pace

But the **ECB will remain in debt markets:** reinvestment of maturities

The **challenge** for the ECB is to **manage the interest rate expectations** *(forward guidance)*

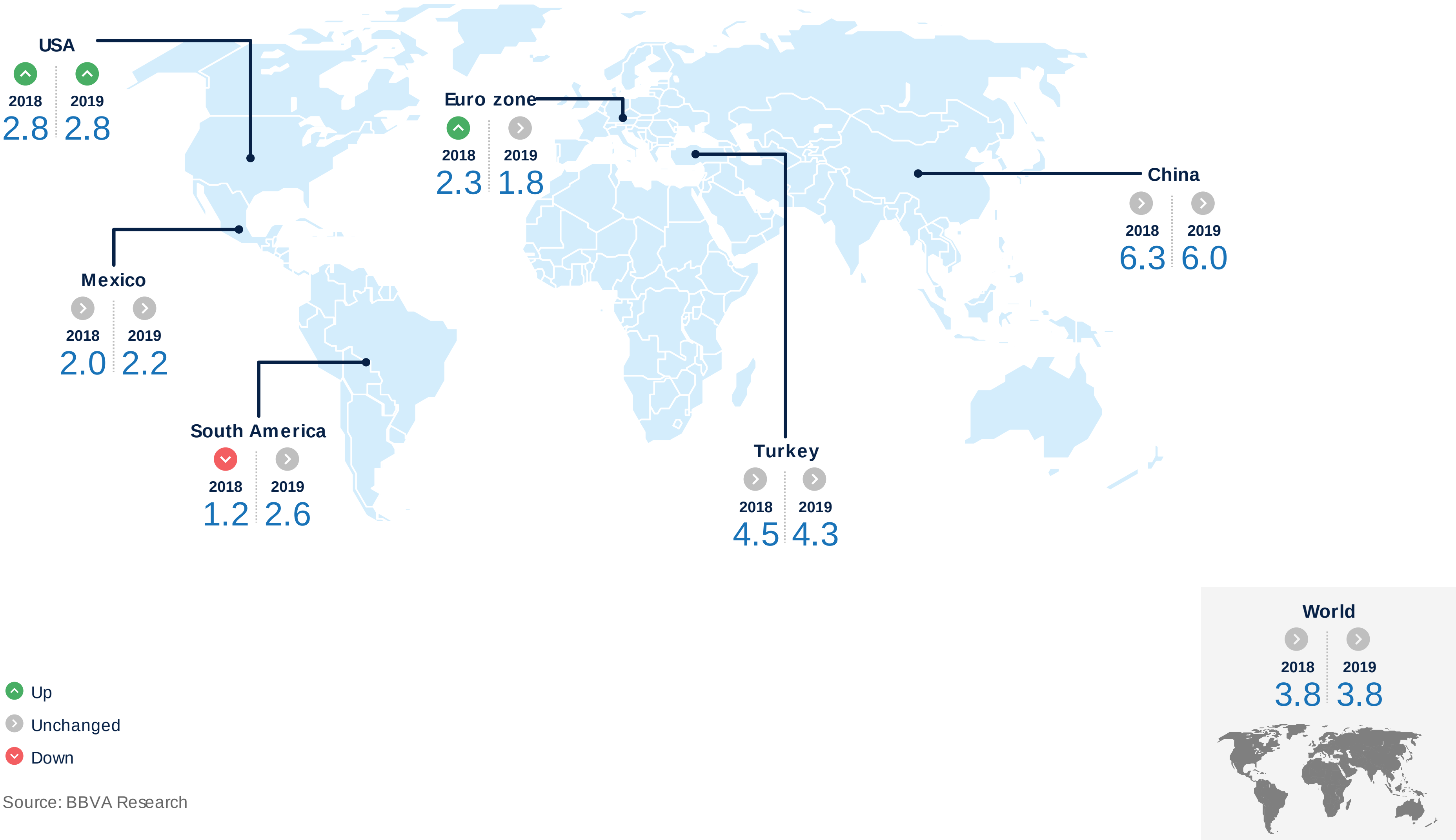
Key points in crisis exit:

Long rates and risk premiums

Exchange rate (EUR)

Rate hike expectations

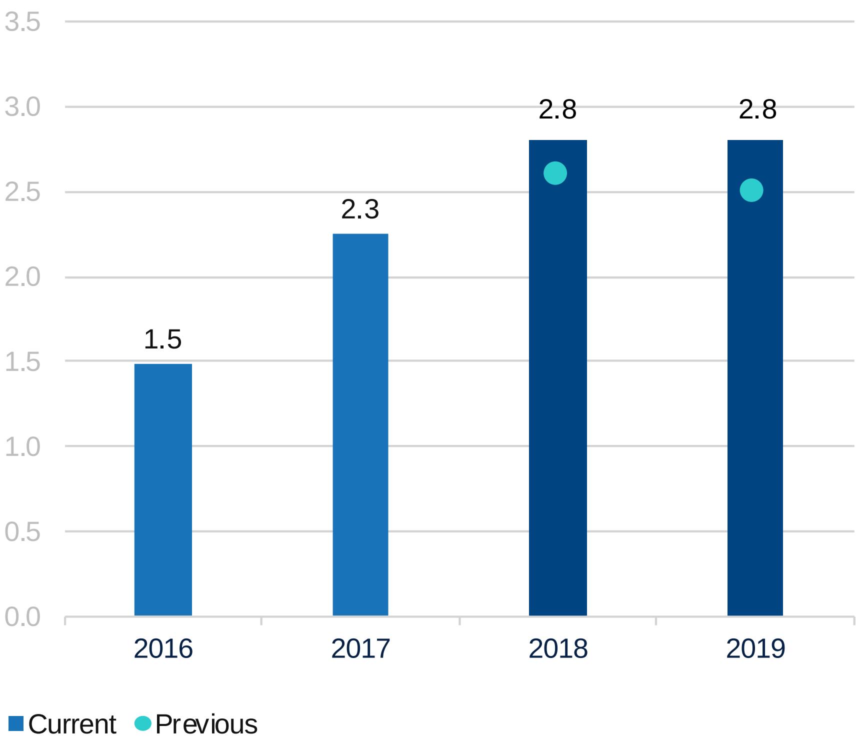
Revised upwards in the USA and downwards in South America



Source: BBVA Research

USA: Higher growth on new budget deal

USA: GDP growth
(% YoY)

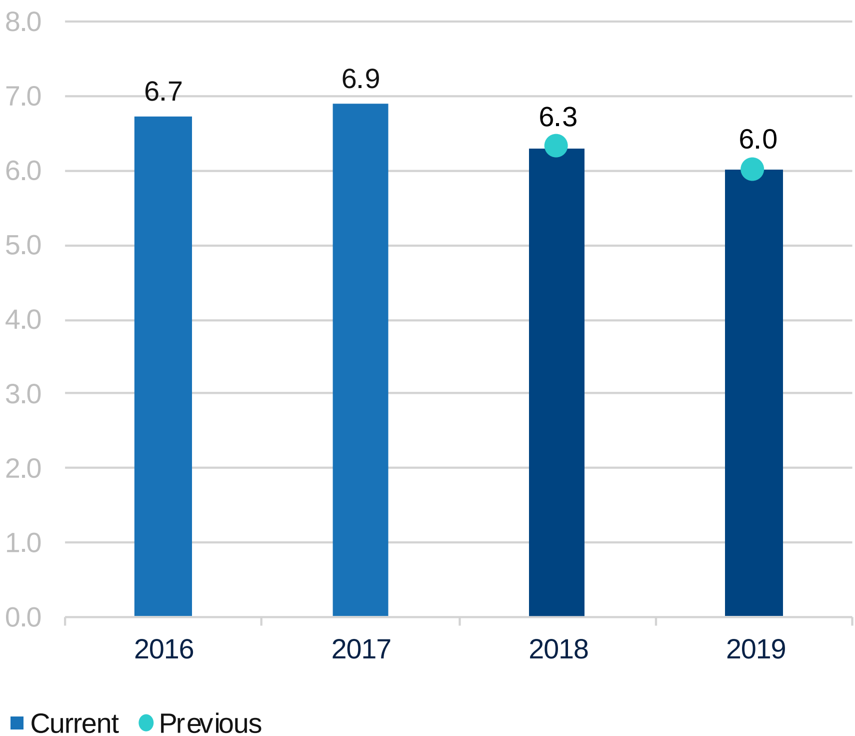


- Moderate impact of the new fiscal stimulus in the short term as the economy approached full employment without measures to support a significant increase in potential growth
- The favourable global environment and strong domestic demand complement the positive impact of higher public spending (upward revision 0.2 and 0.3pp in 2018-19)
- Inflation is likely to temporarily exceed the Fed's target, but will remain contained

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

China: Growth holds well while policy uncertainty abates

China: GDP growth
(% YoY)

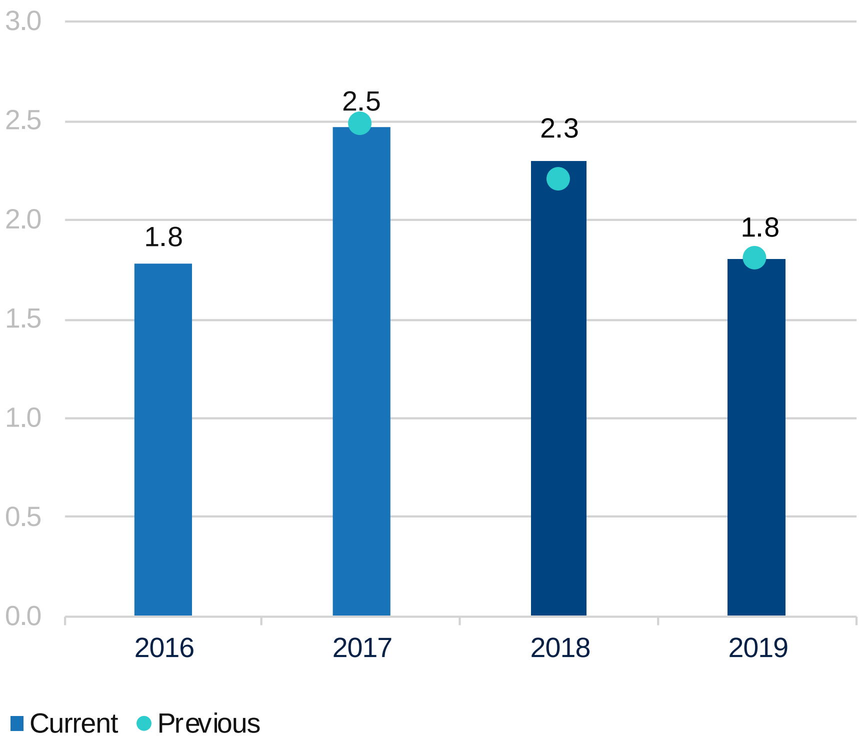


- The strength of credit and exports allowed the economy to stabilize in 1Q18
- Forecast unchanged: growth moderation in 2018 due to more prudent economic policy
- Increasing probability of implementing structural reforms in the medium term and addressing financial vulnerabilities
- Increasing protectionism threatens the sustainability of exports

(f) Forecast
Source: BBVA Research based on CEIC

Eurozone: Small upward revision for 2018 despite recent softer data

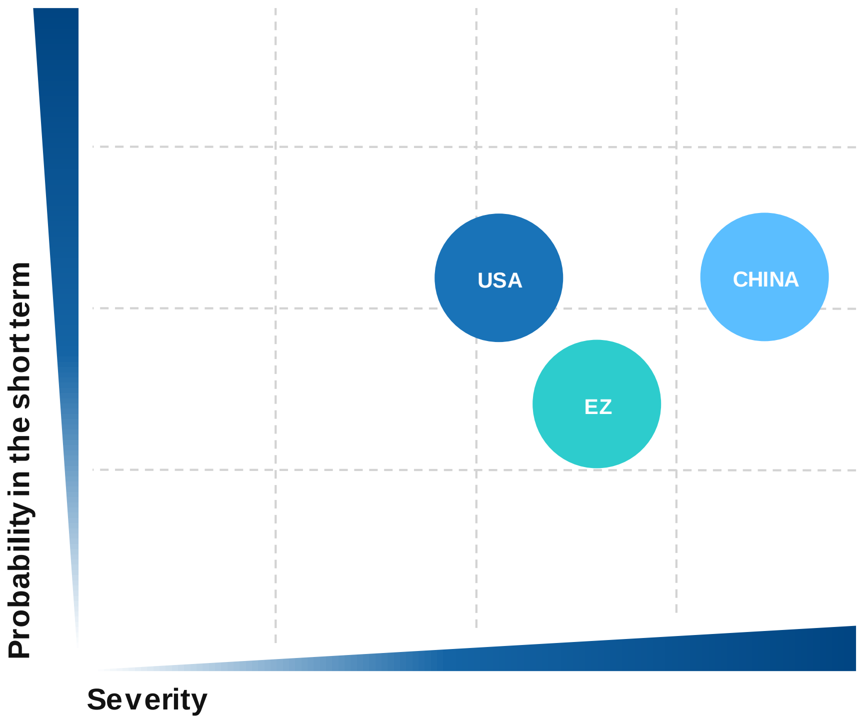
Eurozone: GDP growth
(% YoY)



(f) Forecast
Source: BBVA Research based on Eurostat

- Stronger exports, supported by increased global demand, help maintain momentum in 2018
- Lower domestic demand contribution, although domestic fundamentals remain strong
- Core inflation will continue to rise gradually, but clearly below 2%.
- Recovery is widespread in most countries, but the problem of low potential growth persists

Global risks: Turning again towards the US. The protectionism threat (with potential global range) joins to the Fed's exit risk



CHINA

- Deleveraging risk more contained in the short term, coexisting with a slower than expected GDP moderation
- Potential negative outcome derived from increased protectionist rhetoric

USA

- Protectionism risk increases after recent measures
- Political controversy risk despite fiscal stimulus
- Signs of overvaluation in certain assets
- Fed exit risks: tighter monetary policy in response to a transitory spike in inflation (without demand support). Risk of sell-off in bonds

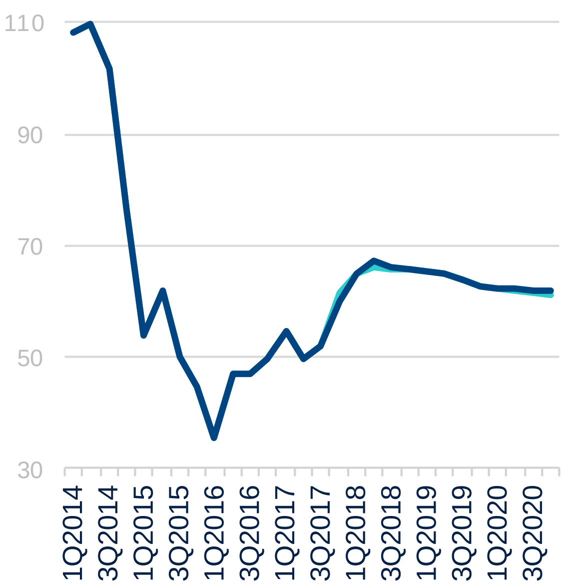
EUROZONE

- Political concerns increase following Italian elections outcome
  - Italy: uncertainty on the Government formation , and risk of a populist / heterodox government contrarian to European project
  - *Brexit:* uncertainty on negotiations outcome
- ECB's exit risk is low, but will require monitoring the risk of a faster normalization

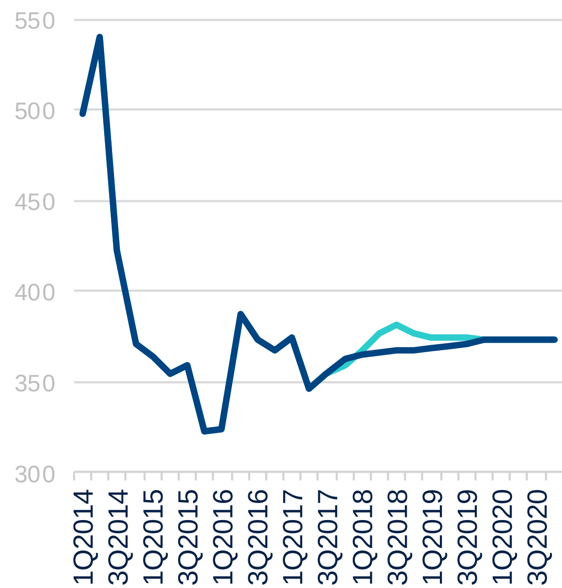
Source: BBVA Research

The increase in commodity prices continues, driven mainly by demand

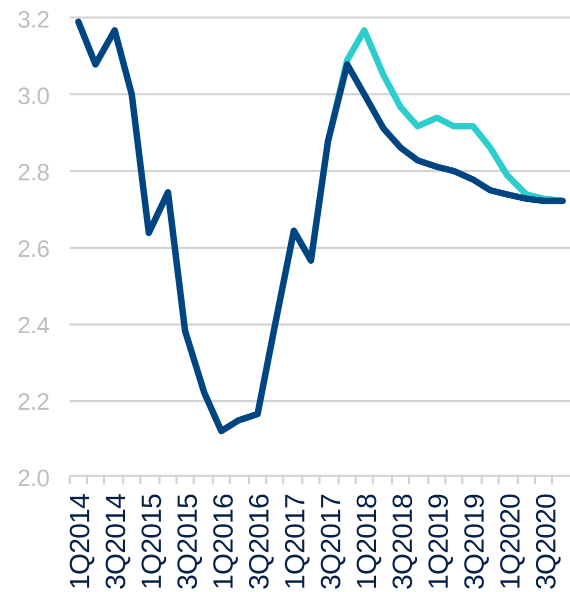
Brent Crude
(US$ per barrel)



Soybeans
(US$ per metric tonne)



Copper
(US$ per lb.)



Forecasts - April 2018   Forecast January 2018

Source: BBVA Research and Bloomberg

The price of oil settled at between US$60 and US$65 a barrel. Global growth will support crude oil prices, but the expected increase in output will cause the price to move towards US$60 a barrel in the medium term

We continue to anticipate a price correction for copper as speculative positions are reduced. The price of soybeans will continue to rise in view of the effects of the drought in producer areas of South America

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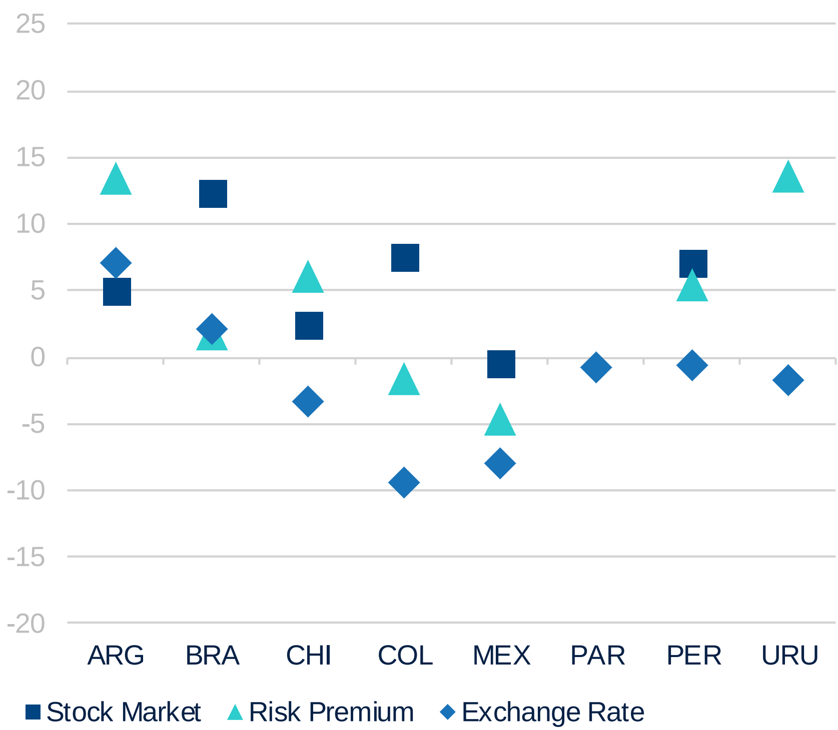
02

Latin America

Latin American financial markets resilient to rising volatility in developed markets

The price of financial assets: percentage change over the past three months to 18 April*



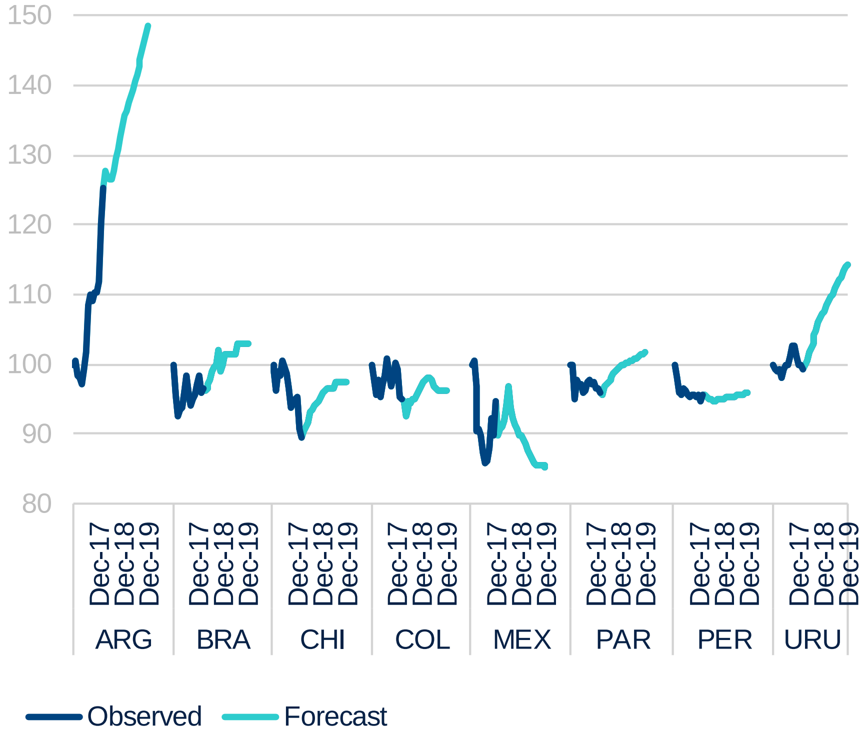
- The prices of the main financial assets have not been overly affected despite international tension, political noise in the region and NAFTA negotiations
- Factors behind the resilience
  - Growth recovery
  - Higher raw material prices

Source: BBVA Research, Haver Analytics and DataStream
*Changes between 31 December of 2017 and 18 April of 2018. Exchange rate: domestic currency / dollar. In this case, increases indicate depreciation. Country risk premium: EMBI.

Gradual depreciation of exchange rates in 2018 and 2019 in most countries

Exchange rates against the dollar

(Dec 2016 index = 100. Increase indicates depreciation against the dollar)



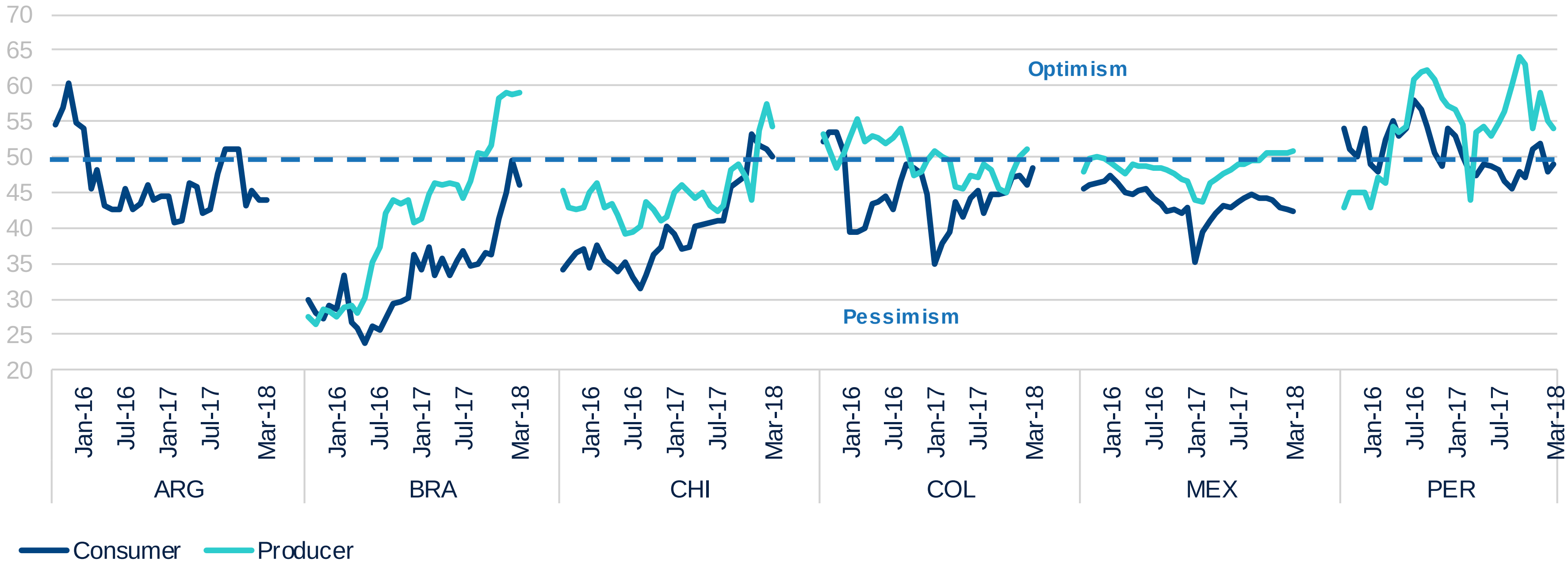
- Moderate depreciation of exchange rates looking forward, within a context of:
  - Fed raising interest rates in contrast to cuts in Latin America
  - Lower raw material prices
- The exception is Argentina, where greater inflationary presence will drive depreciation at a faster rate than in the rest of the region
- The Mexican peso could appreciate in 2018 if the risks regarding NAFTA negotiations and the elections do not materialise

Source: BBVA Research, Haver Analytics and DataStream
*Changes between 31 December and 5 April. Exchange rate: domestic currency / dollar. In this case, increases indicate depreciation. Country risk premium: EMBI.

Confidence indicators in the region continue to improve…

Latin America: home and business confidence indicators

(values over 50 pts indicate optimism)



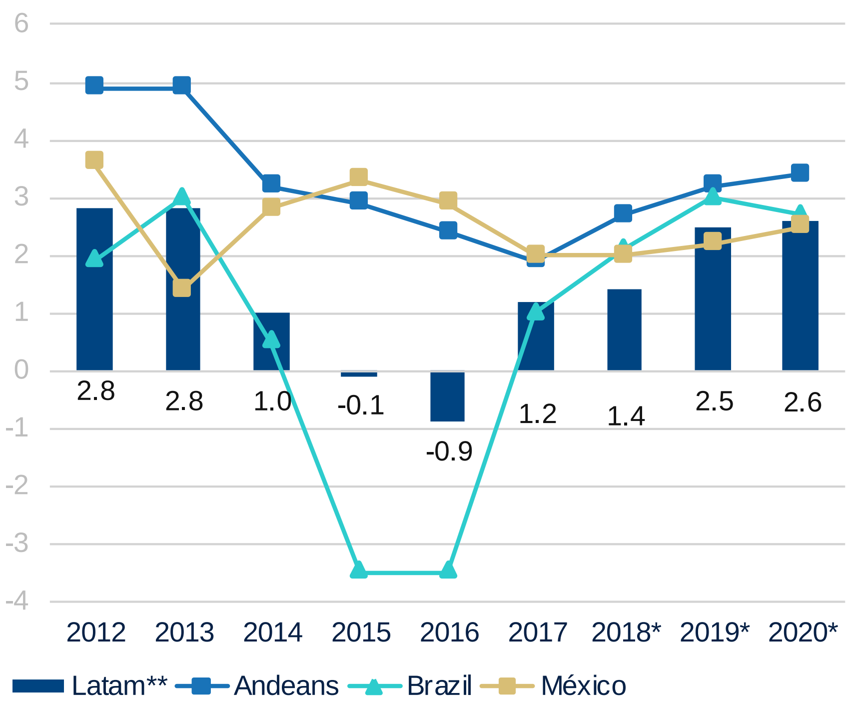
Source: BBVA Research and Haver

Along with the upturn in business confidence, higher raw material prices. Concurrently, the reduced political noise in Chile favoured greater levels of confidence, although increased tension has been a drag on the economy of other countries (Peru)

In the case of families, lower inflation continues to favour an upturn in confidence (with the exception of Argentina), while the deterioration of labour markets seems to have bottomed out in many countries

…continuing to point to growth recovery in Latin America, despite occasional temporary negative shocks

Latin America: GDP growth
(% YoY)

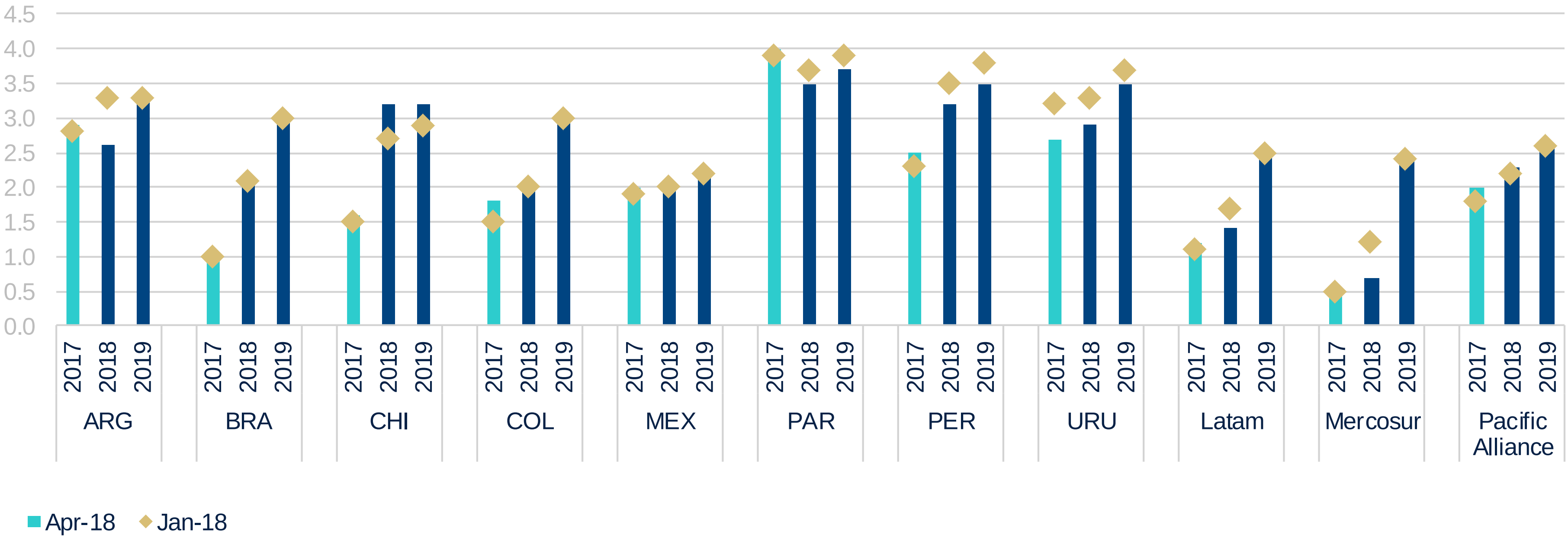


- Growth has continued to increase over recent months, in line with a recovery in confidence and a favourable foreign environment
- The rise in growth in 2018 and 2019 will continue to rest on two factors:
  - The foreign sector: increased growth levels worldwide and higher raw material prices.
  - A boost from private and public investment
- Growth will be lower than in other emerging regions such as Asia or eastern Europe

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

A downward revision of growth forecasts in Argentina, Paraguay and Uruguay due to the drought, and in Peru as a result of political noise. Improved panorama in Chile

Latin America countries: GDP growth
(%)



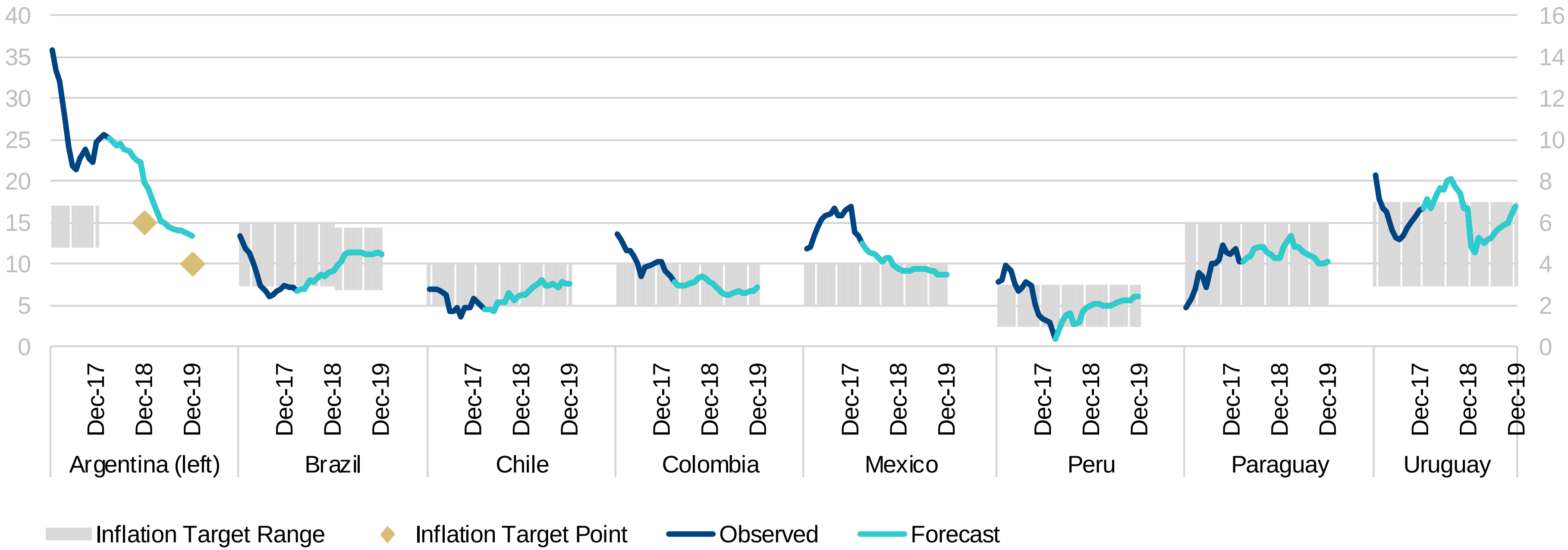
Source: BBVA Research and Haver

The improved foreign environment (increased growth levels worldwide and higher raw material prices) is not sufficient to fully compensate for the impact of the drought in Argentina, Paraguay and Uruguay, nor that of the of political noise in Q1 in Peru

An upward revision of growth forecasts for Chile, thanks to higher than expected copper prices and a significant upturn in business confidence

Lower inflationary pressure, although higher in Argentina and Mexico

Latin America: central bank inflation and target ranges
(%)



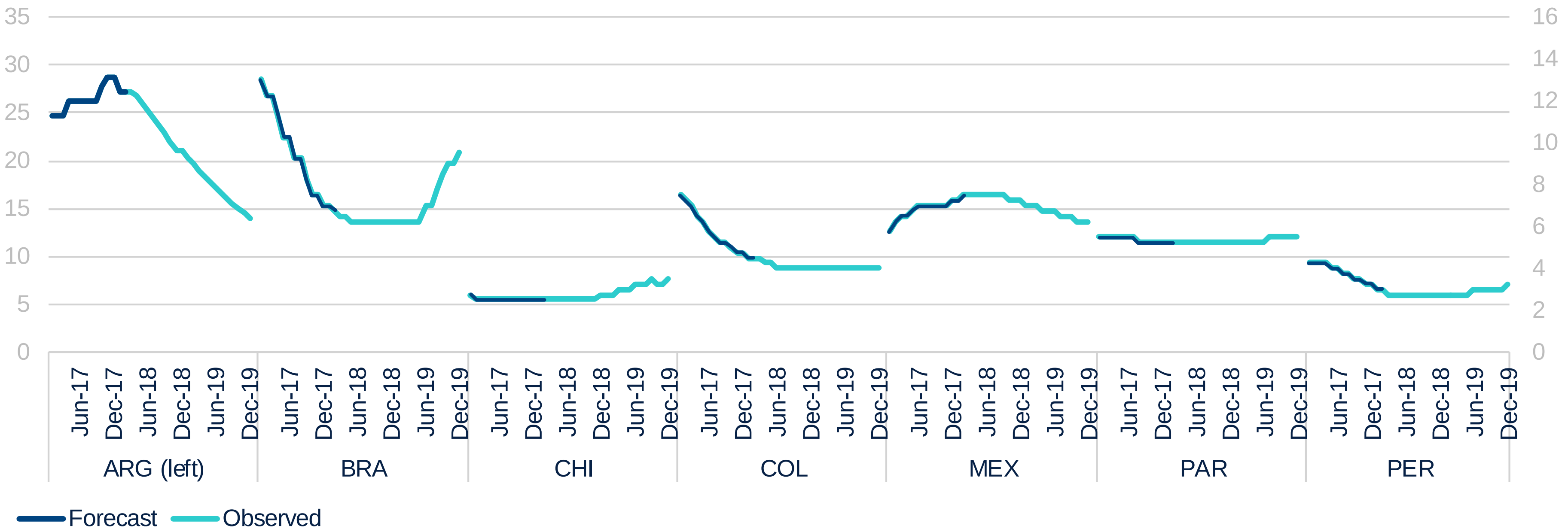
Source: BBVA Research

Lower inflationary pressure in the region, within a panorama of (i) stable exchange rates or showing some appreciation over recent months and (ii) domestic demand that is still weak. The exception here is Argentina and Mexico, with inflation still high, although falling

Inflation will converge toward the targets set by central banks, although in the case of Argentina, this will be a slower process than we forecast three months ago

The cycle of interest rate cuts in South America during Q2 2018 (except Argentina)

Latin America: official interest rates
(%)



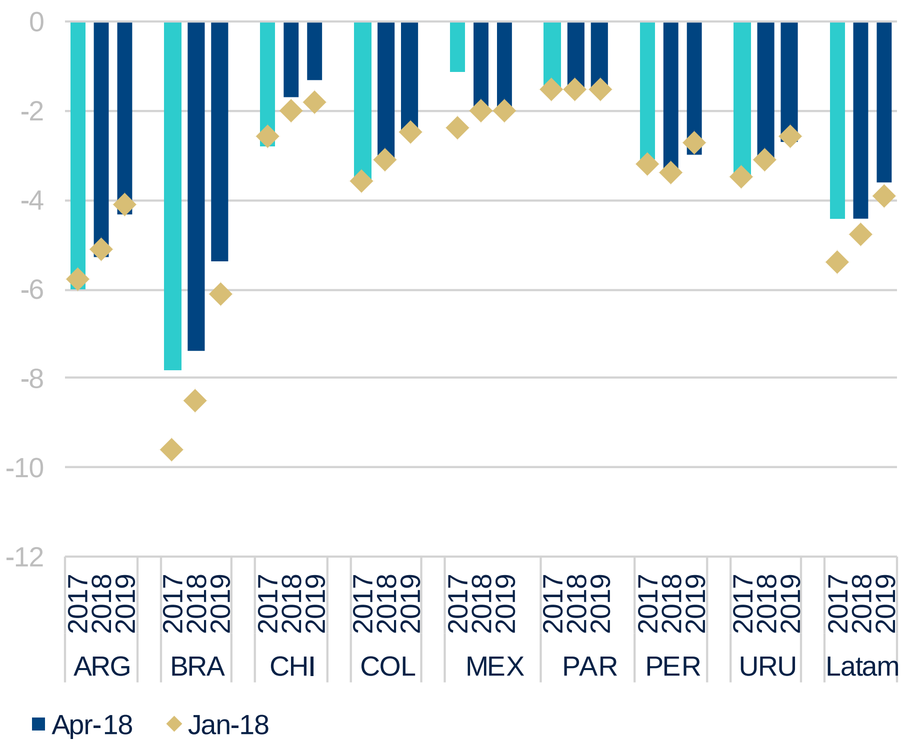
Source: BBVA Research and Haver

With inflation among the priorities of central banks and amidst a context of a convergence of targets, as well as recovery in terms of growth, the cycle of interest rate cuts in South America is coming to an end. There will be few further cuts in Colombia and Brazil

The exceptions to this scenario are Argentina and Mexico. In Argentina, interest rates began falling again, mirroring the drop in inflation, although real rates remain positive. In Mexico, rates will remain stable throughout 2018, with cuts commencing toward the end of the year

Improved growth figures and higher raw material prices suggest a reduction in public deficits

Latin America: fiscal balances
(% GDP)

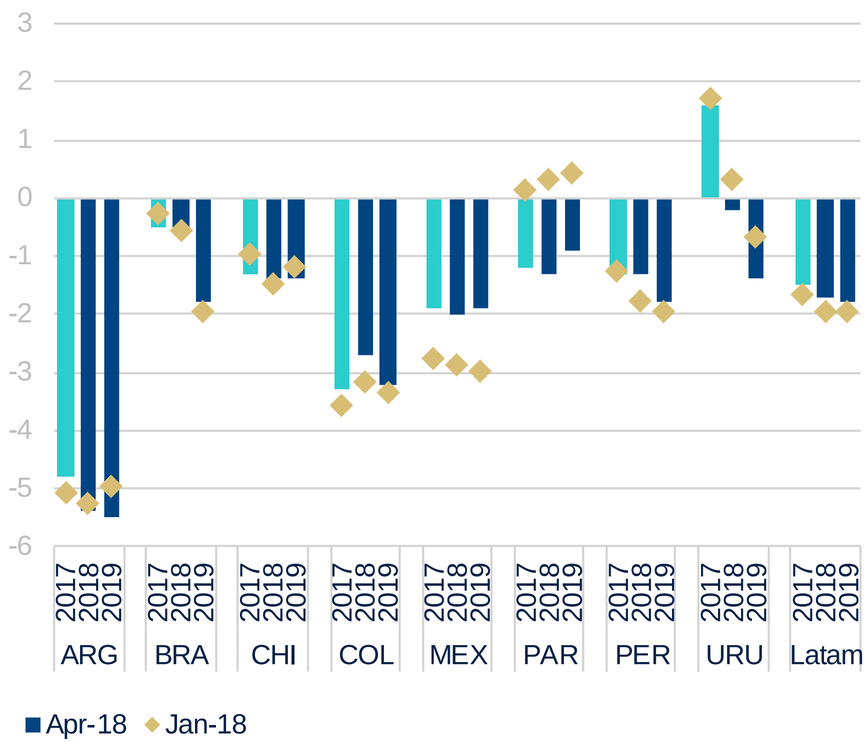


Source: BBVA Research and Haver

- Improved fiscal outlook in Brazil. 2017 results were surprisingly positive thanks to controlled spending and increased growth. However, there is still a risk that reforms to the social security system will not be passed
- Gradual fiscal tightening as forecast in Argentina. Deficit reduction targets will be met in 2018
- Lower deficit than expected in Peru in 2018, attributable to a lower execution of public investment and higher copper prices. Nevertheless, a special effort will be needed to ensure fiscal consolidation from 2019 onward

The pressure from imports on increased growth has dragged foreign balances down

Latin America: current account balances
(% GDP)



- **Foreign deficits to be extended in 2018 in various countries,** despite a more favourable foreign panorama. Increased exports will not compensate for the momentum of imports in 2018, due to higher growth in internal demand
- **Significant foreign deficits in Argentina and Colombia.** In the case of Colombia the trend toward a lower deficit will continue, helped by energy prices

Source: BBVA Research and Haver

Greater foreign risk, except in the case of China…

01

Protectionism and impact on global trade flows

02

A good pace in terms of the Fed's stimulus programme (aggressive rate increases in response to temporary inflationary pressure)

03

Leveraging and a sharp slowdown in China

…while domestic risk remains, uniformly across the countries concerned

04

Political noise: increased risk in Peru, Brazil, Colombia and Mexico, lower risk in Chile and Argentina

05

Delays in private and public investment
Increased risk in Peru, lower risk in Chile

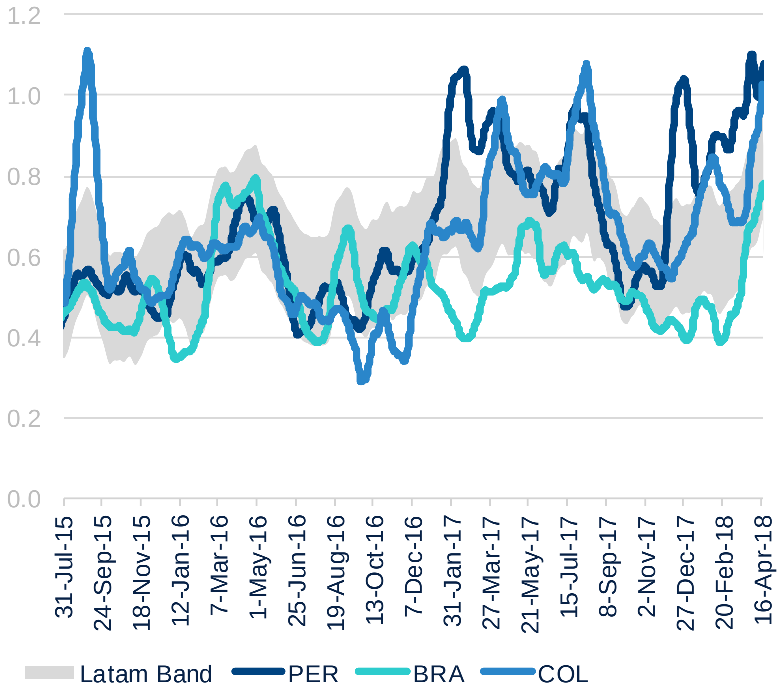
06

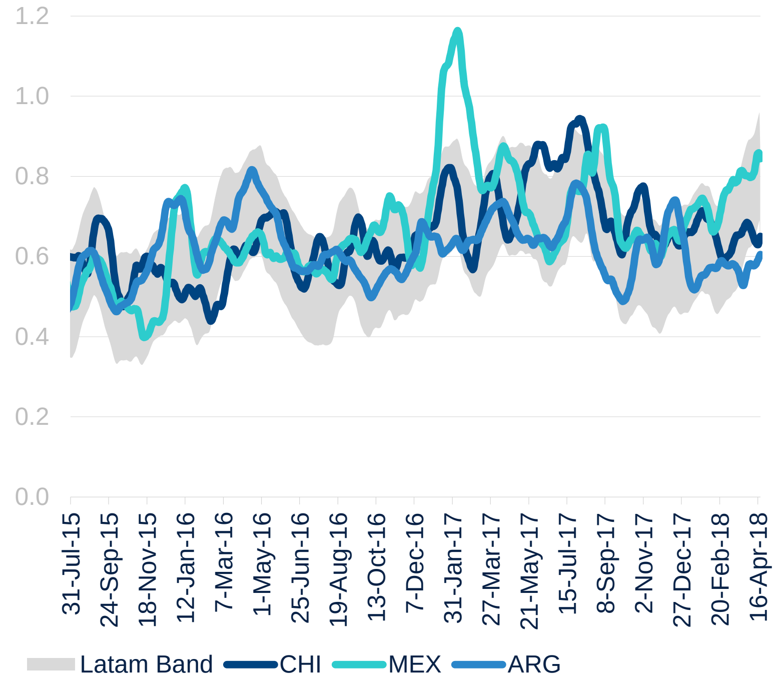
Failure to push ahead with reforms and boost productivity

Political risk: tension increasing with the pre-electoral scenario and corruption scandals

Latin America: Political stress indicator

(Media tone on politics weighted by media coverage. 30-day moving average)





The political tension index measures the tone of political reporting in the media, weighted by media coverage of political matters

Source: BBVA Research and Gdelt

Political tension increased over recent months, especially in Peru, as a result of corruption accusations made against former President Kuczynski. It also increased in Colombia and Brazil, in the middle of election campaigns

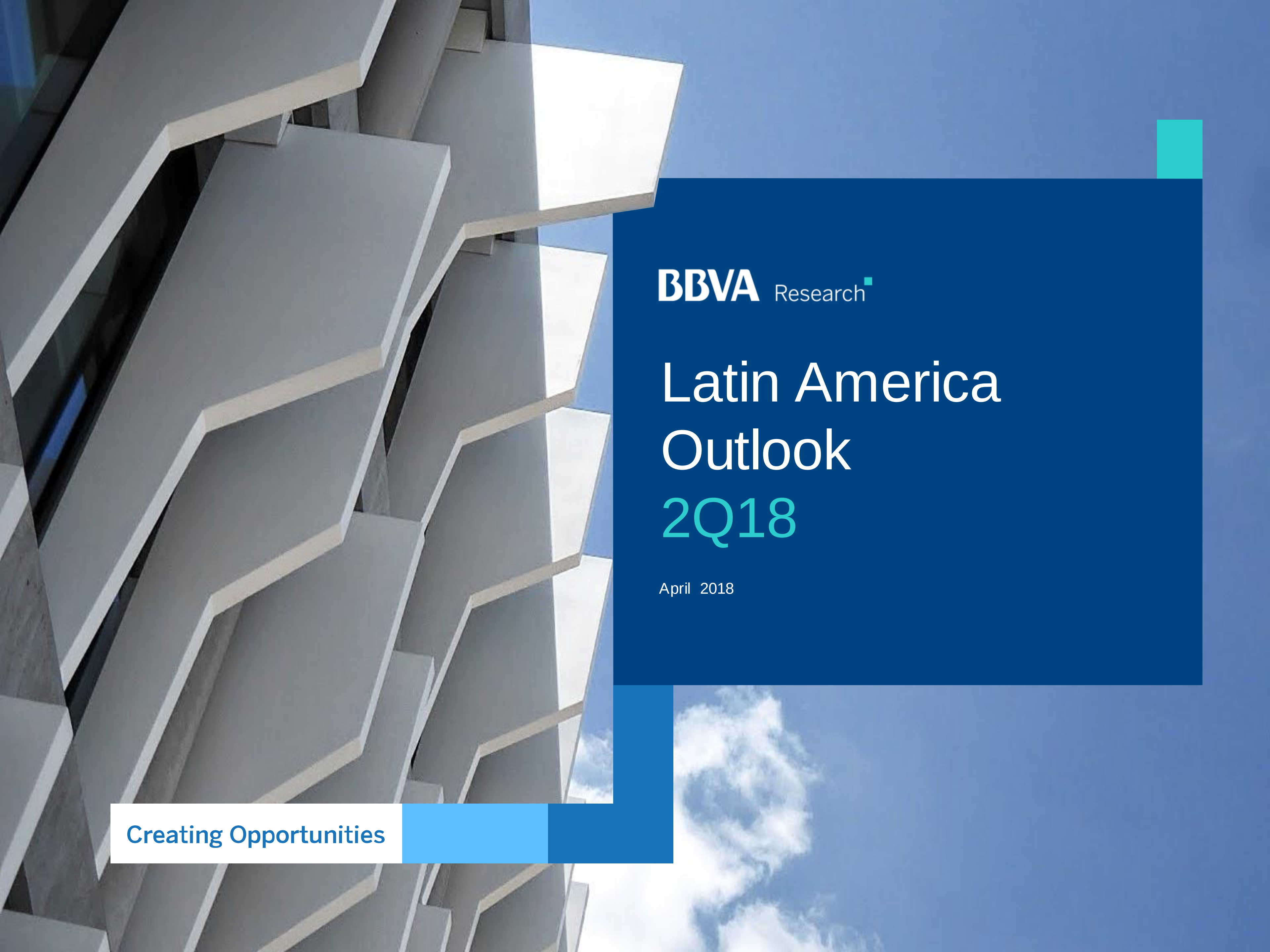
In Mexico, political tension was influenced by the renegotation of the NAFTA. In contrast, tension in Chile and Argentina fell after elections were held in recent months

Key messages

- Global growth remains robust., although uncertainty is increasing. US fiscal stimulus may underpin progress in other areas too, but protectionist measures pose a risk
- Latin America maintains its recovery amidst external turbulence. Global growth will increase from 1.2% in 2017, to 1.4% in 2018 and 2.5% in 2019. We have revised our growth forecast for 2018 downward in Argentina, Paraguay and Uruguay due to the drought, and in Peru as a result of political noise. We have revised expectations for Chile upward due to higher copper prices and increased business confidence
- The cycle of interest rate cuts will come to an end in South America in the second quarter. The exception is Argentina, where they will fall again as inflation continues to slow. In Mexico, interest rates will remain stable to late 2018, when cuts will begin
- The main external risks center on protectionism (increased) and on China (lesser than three months ago). On the domestic front, political noise and the possible delay in public and private investment is an upside risk in a number of countries

Growth forecasts for Latin America

GDP (% YoY)	2015	2016	2017	2018 (p)	2019 (p)
Argentina	2.7	-1.8	2.9	2.6	3.3
Brazil	-3.5	-3.5	1.0	2.1	3.0
Chile	2.3	1.6	1.6	3.2	3.2
Colombia	3.1	2.0	1.8	2.0	3.0
Mexico	3.3	2.9	2.0	2.0	2.2
Paraguay	3.0	4.0	4.0	3.5	3.7
Peru	3.3	4.0	2.5	3.2	3.5
Uruguay	0.4	1.7	2.7	2.9	3.5
Mercosur	-2.6	-4.0	0.5	0.7	2.4
Pacific Alliance	3.1	2.7	2.0	2.3	2.6
Latin America:	-0.1	-0.9	1.2	1.4	2.5



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