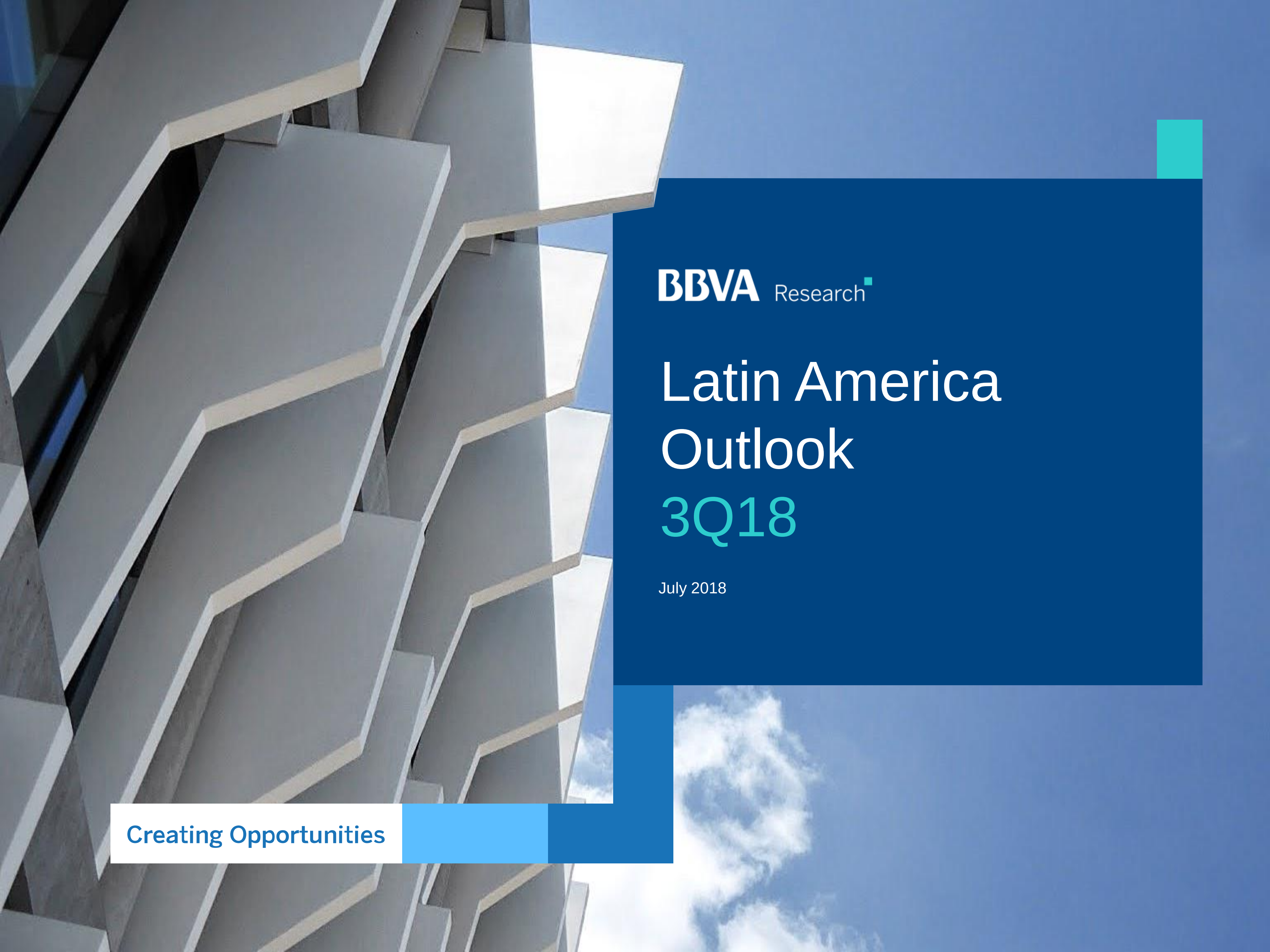

BBVA Research

Latin America Outlook 3Q18

July 2018

Creating Opportunities

Key messages

- Global growth remains robust, but risks also increase. Robust growth in the US on the back of fiscal stimulus. Growth stable in China, but coming down in Europe. Global risks increase due to chances of a trade war and tighter international financing conditions
- Growth in Latin America recovers, but heterogeneously. Growth will move from 1.2% in 2017 to 1.3% in 2018 and 2.1% in 2019. We revise down growth in Argentina and Brazil, affected by financial volatility and idiosyncratic factors. Conversely, we revise growth upwards in Mexico, Colombia and Peru, on the back of strong growth data at the beginning of 2018
- Central Banks in South America (except Argentina) will start raising interest rates in 2019, given controlled inflation and the recovery of domestic demand. Argentina and Mexico will resume rate cuts in the short run, when inflationary risks subside
- Increasing risks associated with protectionism and tighter international financial conditions. On the internal front, the main risks are political noise in Brazil, an increase of social tensions in Argentina and possible delays in public and private investment in several countries

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Global outlook: Global growth continues, but risks also intensify

Global growth continues, but risks are intensifying

01

The pace of global expansion is being maintained, but is less synchronised

Growth is robust in the US due to the fiscal stimulus and stable in China, but it has been reduced in Europe

02

Increased protectionism

At the moment, its impact on growth is limited, but it could be greater if the measures under discussion were to be implemented

03

Increase in the price of oil

Higher inflation and drag on growth in oil-importing countries

04

Different pace of monetary normalisation in Europe and the United States

Strengthening of the dollar and tightening of global financial conditions

05

More volatility in emerging markets

Increased financial tensions due to increased financing costs and protectionist threats

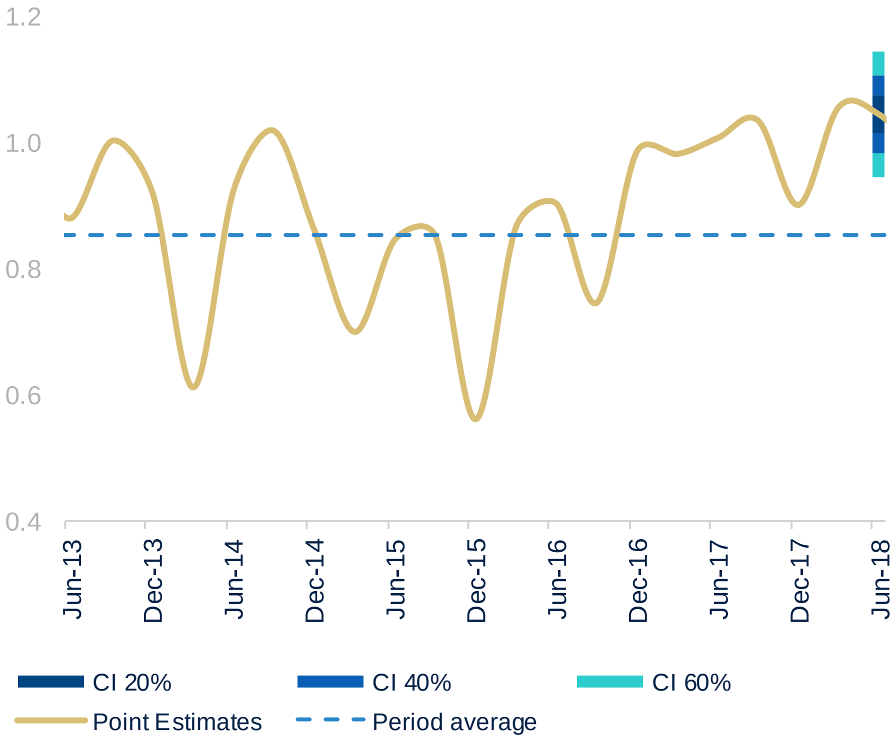
06

Global risks are intensifying

The possibility of a trade war comes together with greater risks in emerging economies and in Europe

Robust global economy despite growing uncertainty

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

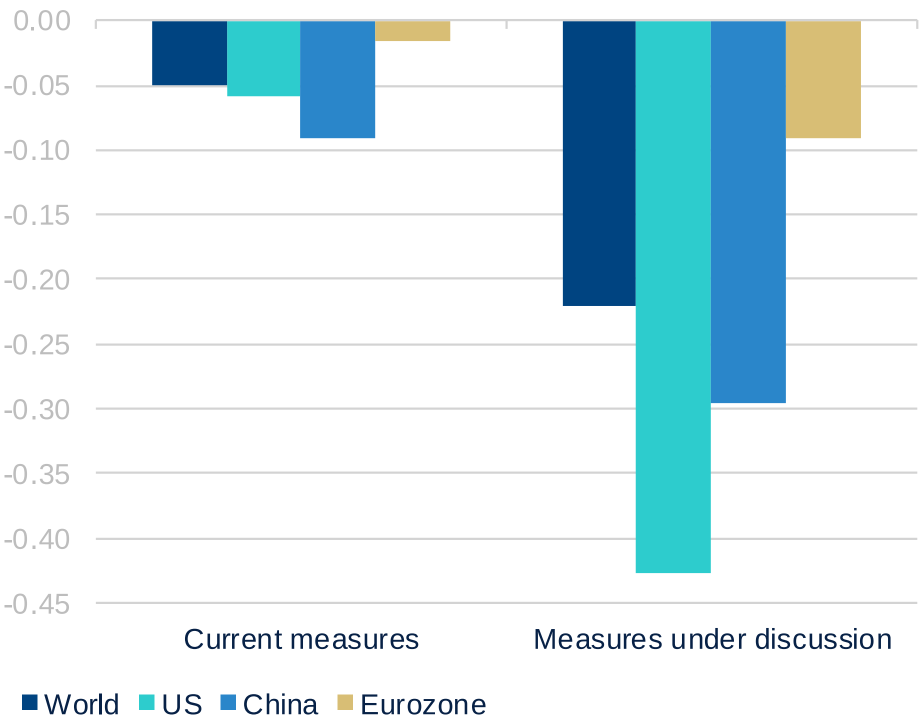


- Global growth continues, supported by private consumption and investment, but with growing differences by region
- World trade continues to show a positive trend, although it is losing momentum and still does not reflect the protectionist escalation
- Confidence indicators show some moderation, but remain at high levels

Source: BBVA Research

Limited effect of approved tariff increases, but significant if those being discussed are implemented

Effect on GDP growth of US tariff increases and the response by other countries
(2018-19, pp)



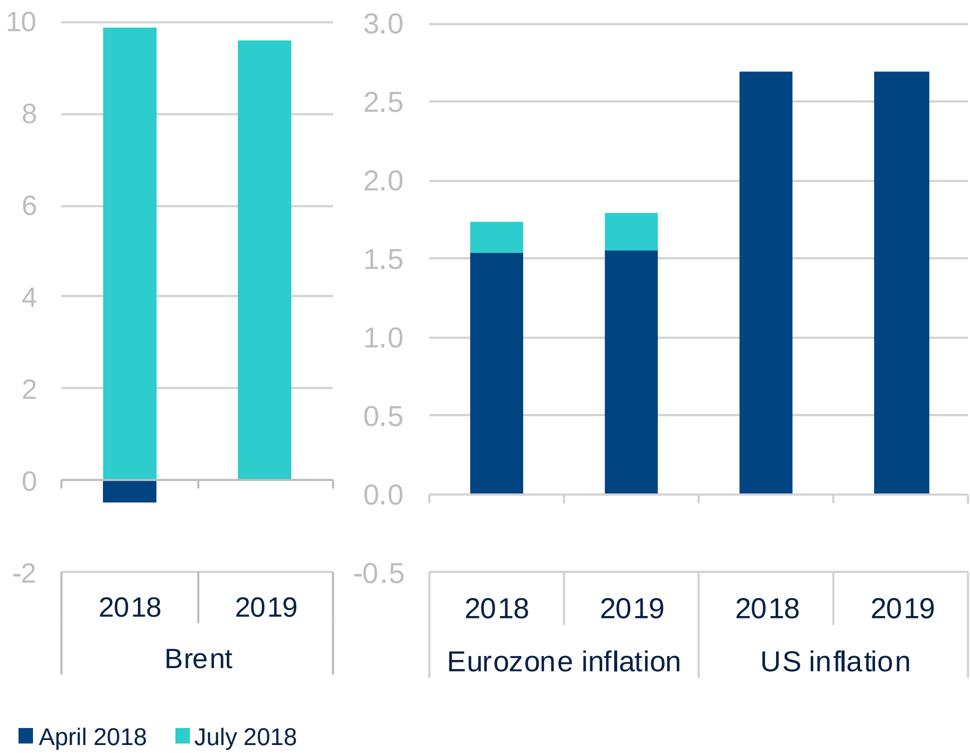
Measures announced: tariff increase to 25% on steel, 10% on aluminium and 25% on Chinese imports for a value of US$50 billion.
Measures under discussion: Tariff increases up to 20% on cars and Chinese imports for a value of US$200 billion.
Source: BBVA Research

- The tariff increases approved by the US would have a limited direct impact. Indirect effects, via economic confidence and financial channel, could be felt in 2H18
- With a protectionist escalation, the negative effect on growth would also be significant in the US
- The effect, smaller in Europe, would differ by country and would, above all, affect Germany and the countries in Eastern Europe
- The growth of global GDP could be reduced by around 0.2 pp just due to the trade channel

The rise in the price of oil will push inflation upwards and could weigh down growth

Upward revision of the price of oil and inflation

(%)



- The increase is due to a reduction in supply. The price will remain relatively stable in 2018 and 2019
- Higher inflation in the euro zone, although below the target, while core inflation will increase gradually from very low levels
- In the USA the impact will be lower, but inflation will remain above the target in 2018-19
- The exit strategy of the Fed and the ECB is reinforced

Source: BBVA Research

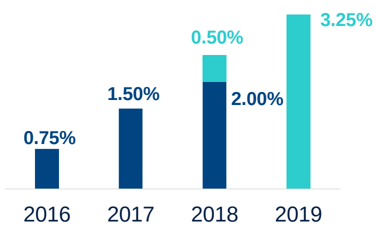
Fed and ECB return to conventional monetary policy each at a different pace

Assessment

Interest rates

- **Reduction** of US$450 billion in 2018

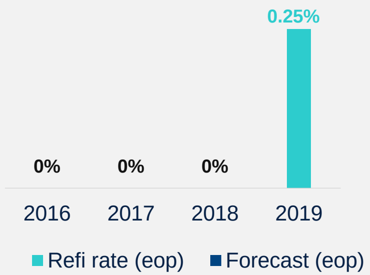
- The pace of **rate hikes accelerates in 2018**



EUROPEAN CENTRAL BANK
EUROSYSTEM

- **Gradual ending of QE between September and December 2018**

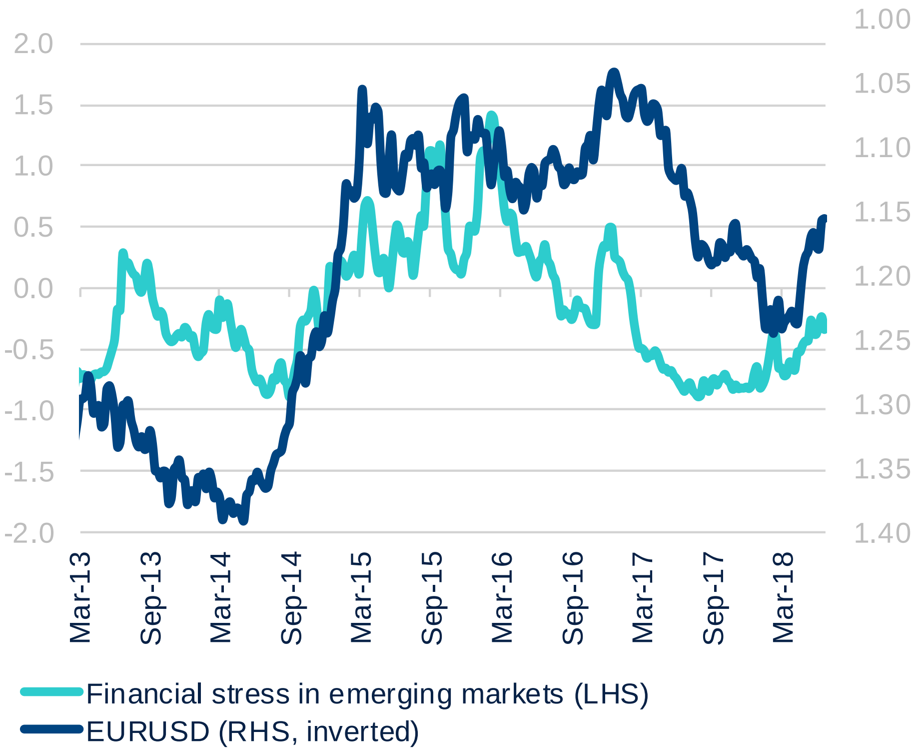
- **Delay** in **rate hikes** until **September 2019**



Source: BBVA Research

The strength of the US dollar and higher interest rates are causing an adjustment in emerging markets

EUR-USD exchange rate and BBVA index of financial tensions in emerging markets



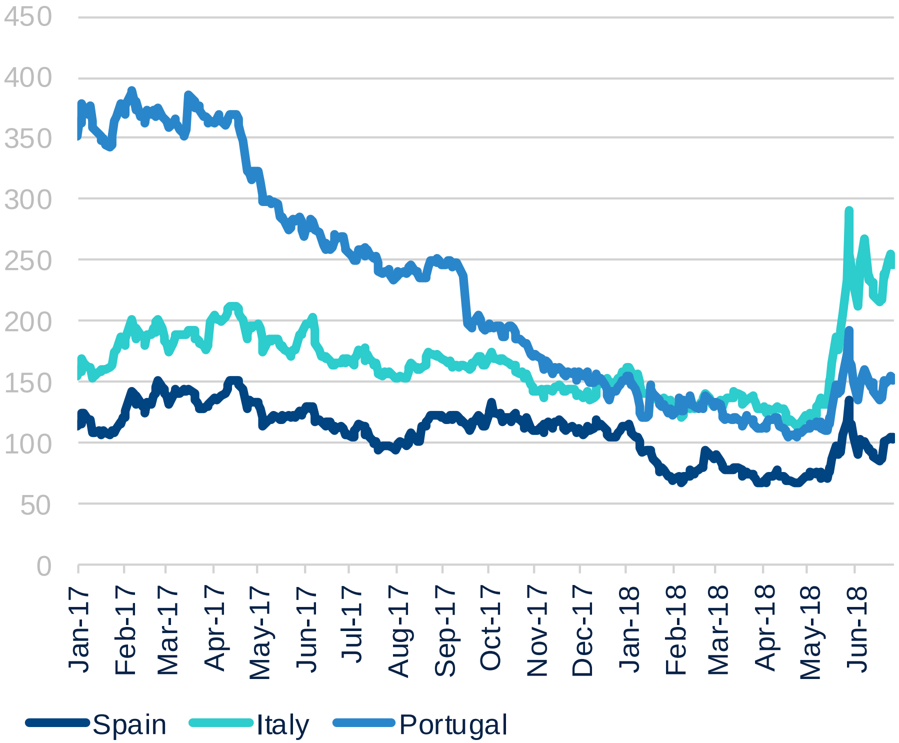
Source: BBVA Research based on Bloomberg

- The most vulnerable countries are those with the greatest trade deficit and the greatest need for external financing
- Shift towards a tightening of monetary policy in emerging countries (except China) to avoid further depreciation of their currencies
- The increase in financial tensions also reflects the intensification of the trade dispute

Political uncertainty in Italy and Germany weakens the euro and raises peripheral risk premiums

Prima de riesgo Italia, España y Portugal

(pb)

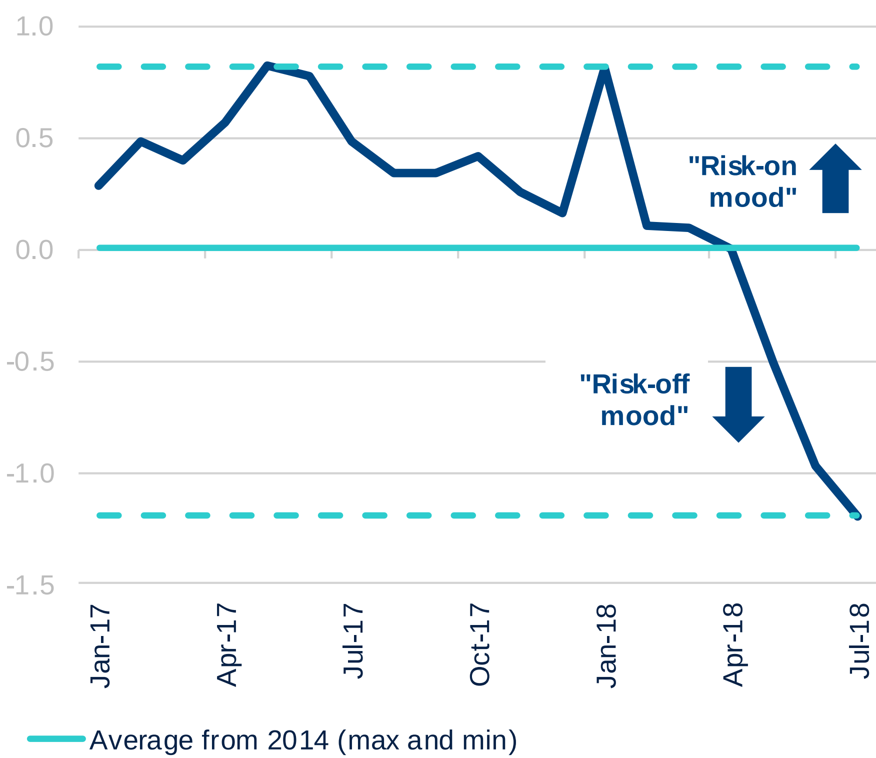


- The reappearance of risk in the periphery is linked, above all, to the political uncertainty in Italy, which is slowing the progress towards European integration
- Although the Italian risk premium was raised significantly, the contagion to the rest of the countries in the periphery was moderate...
- ...which did not prevent a refuge effect on German and US bonds and a sharp depreciation of the euro

Source: BBVA Research based on Bloomberg

Protectionism and political factors lead to a growing risk aversion

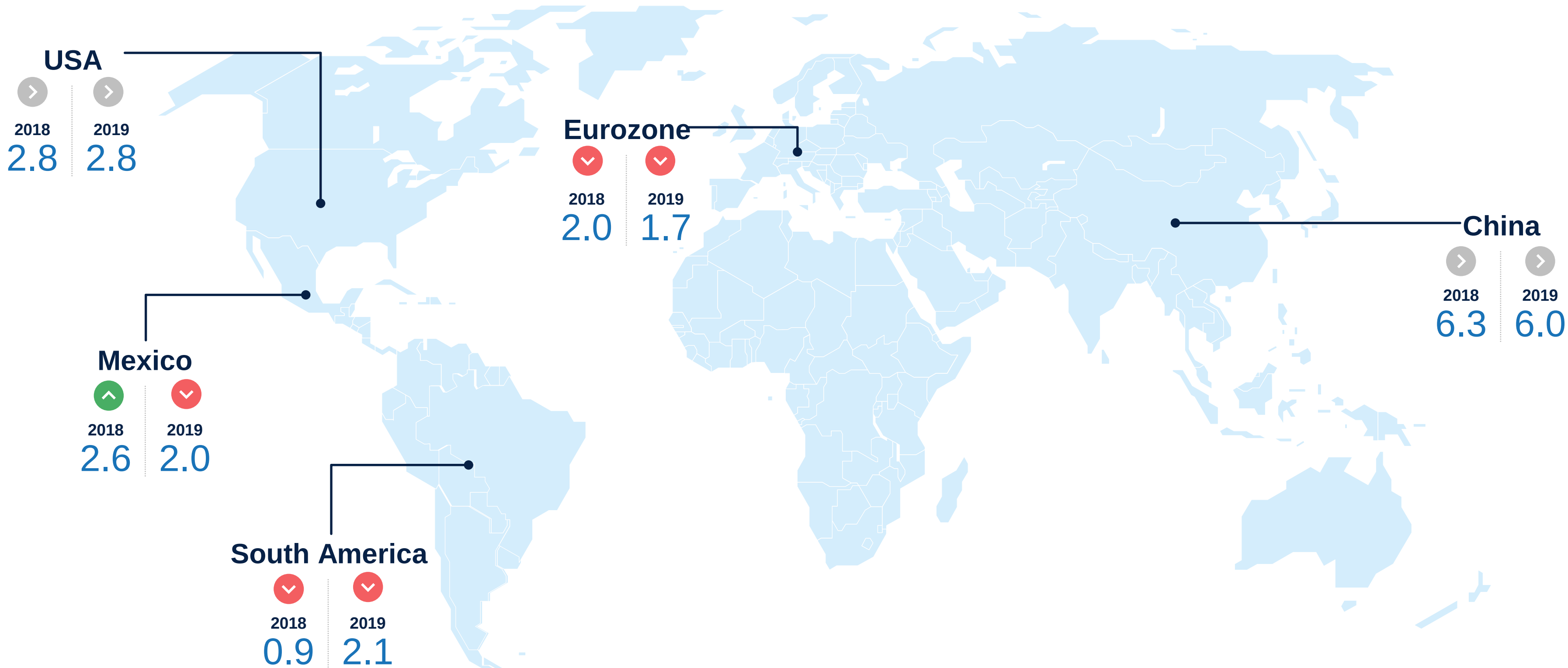
Risk appetite/aversion indicator



- Investor sentiment has shifted from a framework of risk-taking (and even a certain complacency) to one of risk aversion
- The change is causing a rotation of flows between assets: from emerging markets to developed ones, and from equities to bonds
- Trade tensions could lead to an environment of flight towards quality

Source: BBVA Research

Stable growth in the US, but a slowdown in other areas

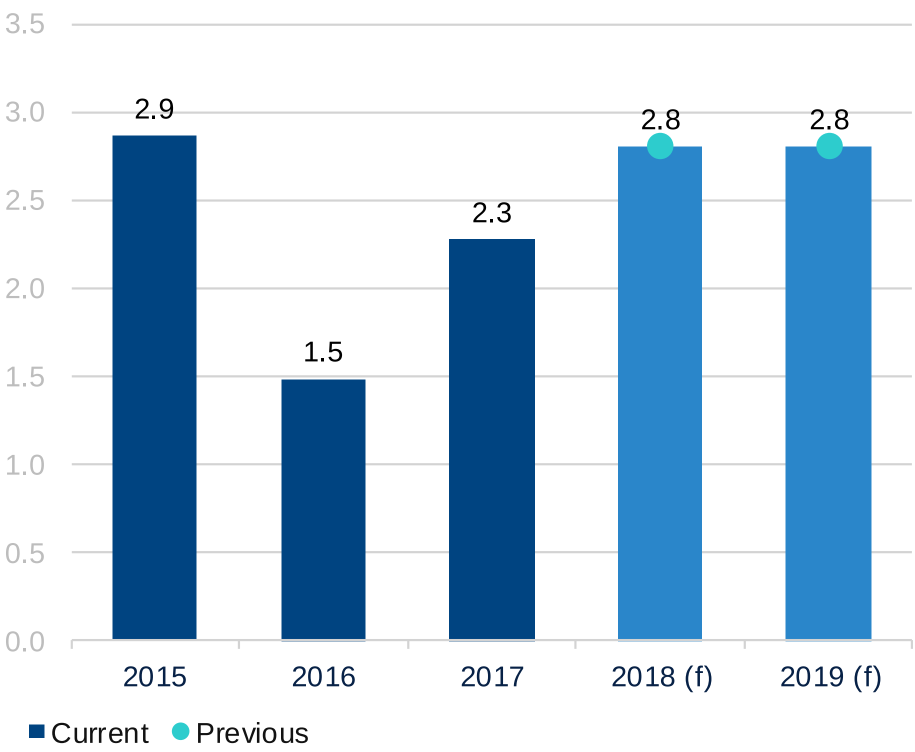


- Up
- Unchanged
- Down

Source: BBVA Research

US: Growth supported by fiscal stimulus, but approaching the end of the expansive phase

USA: GDP growth
(% YoY)

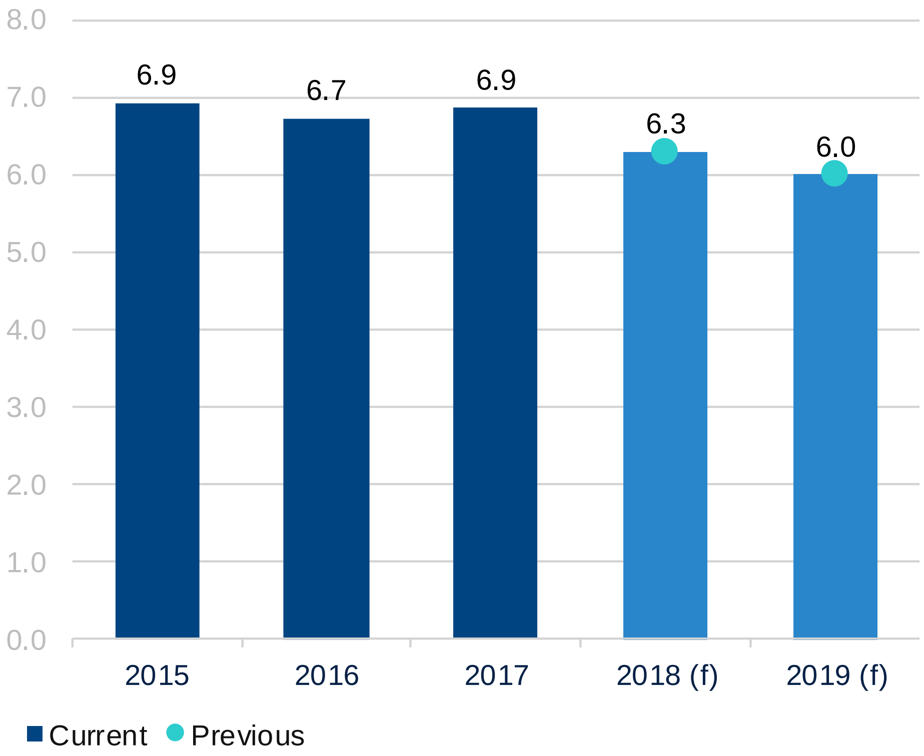


- Growth has accelerated in the first half of the year, boosted by the fiscal stimulus and the improvement in the labour market
- Trade tensions could weigh down on production and global demand
- The absorption of the idle capacity of the economy foreshadows the end of the expansive phase of the cycle
- Inflation will temporarily exceed the Fed's target for higher energy prices, but inflation expectations remain anchored

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

China: Mild moderation of growth thanks to greater stimuli

China: GDP growth
(% YoY)

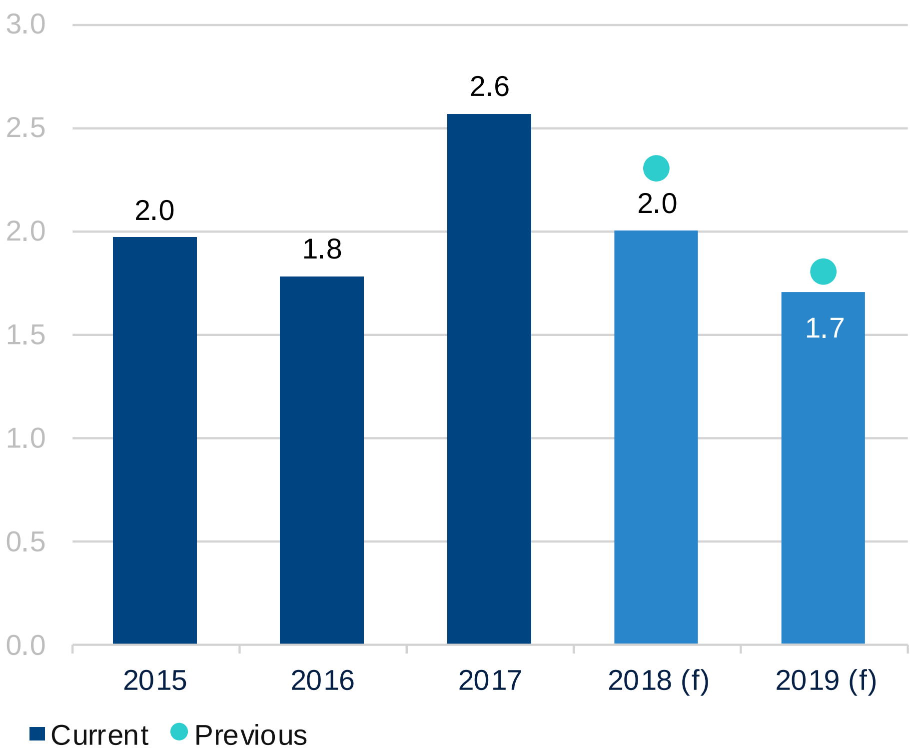


- The slowdown in growth will continue in the second half of the year, although the data so far is somewhat more positive than expected
- Policies to tackle financial vulnerabilities continue, but are softened by fiscal and monetary stimulus measures to sustain growth
- Protectionism threatens the sustainability of exports, as well as the restructuring of the economy

Source: BBVA Research based on CEIC data

Eurozone: Rapid transition towards more moderate growth rates

Eurozone: GDP growth
(% YoY)

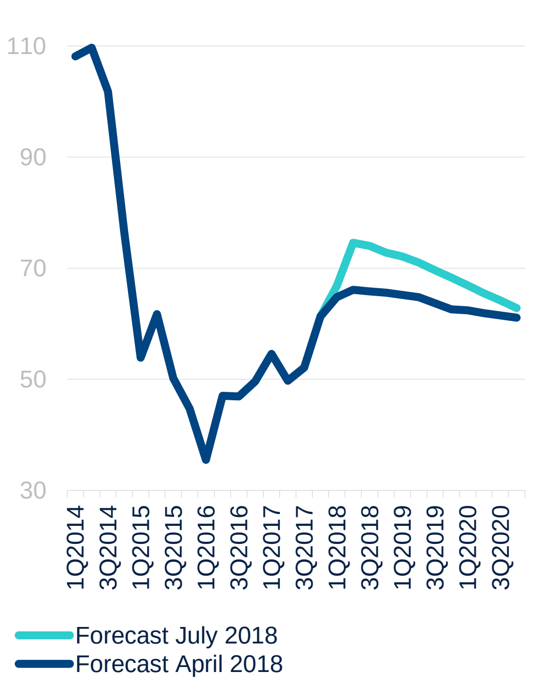


Source: BBVA Research based on Eurostat figures

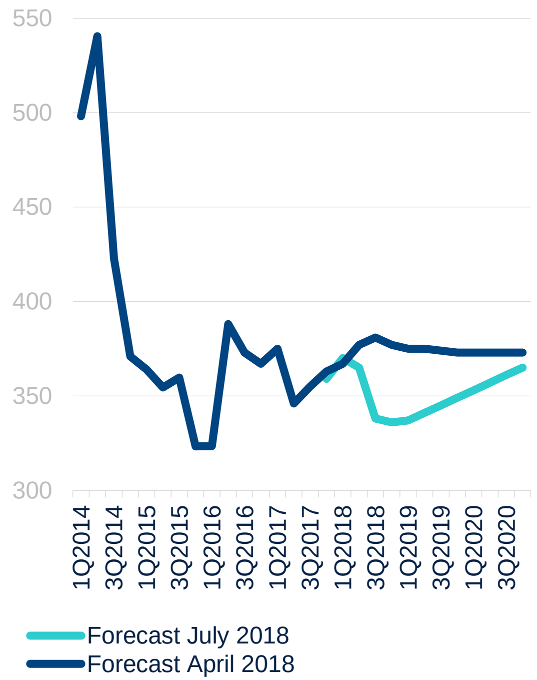
- The increase in uncertainty and higher oil prices are having an impact on activity, but domestic demand remains solid
- The depreciation of the euro and global demand will continue to support exports
- Economic policies will be somewhat more accommodative: lower rates for longer periods and fiscal relaxation in some countries
- Despite the rebound of inflation in the short term, the underlying rate will only increase gradually, especially in 2019

Oil price increases on geopolitical factors. Copper is on track for a gradual easing of prices

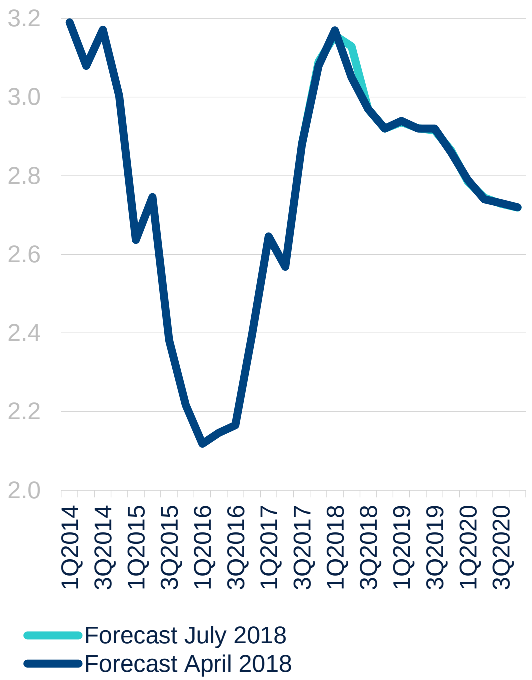
Brent Crude
(US$ per barrel)



Soybeans
(US$ per metric tonne)



Copper
(US$ per lb.)

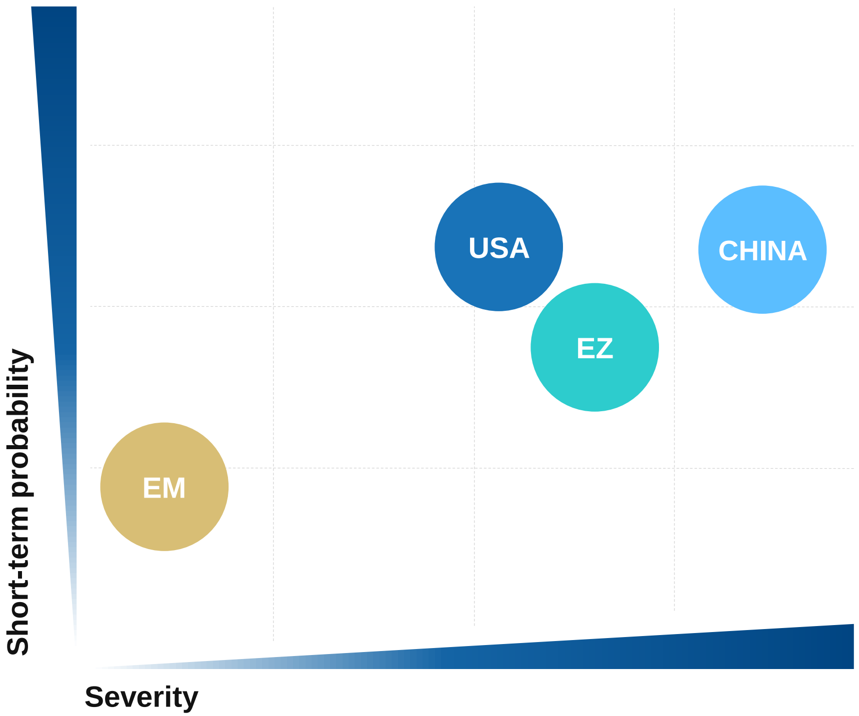


Source: BBVA Research and Bloomberg

Oli prices revised up on geopolitical factors (Iran, Venezuela). Prices will start to moderate as US oil export capacity increases and demand stabilizes

We continue to anticipate a gradual price correction for copper as speculative positions are reduced and Chinese growth also moderates. The price of soybeans drops significantly on a good US harvest and US-China trade war

Global risks: The main one is a trade war, but also those associated with emerging economies and Europe are increasing



CHINA

- High indebtedness: more contained but still high
- Protectionism: upwards (retaliation) with possible impact on domestic policies (financial stability, reforms)

USA

- Protectionism: upwards
- The Fed exit strategy: high.Aggressive rate hikes in the face of a temporary increase in inflation
- Signs of over-valuation of certain financial assets

EUROZONE

- Political uncertainty: on the upswing, led by Italy. Brexit: risk of a rough departure
- Protectionism: on the upside with a focus on the auto sector
- Exit strategy by the ECB: on the downside (delay of rate hikes)

EMERGING ECONOMIES

- Upward. Global risks and domestic vulnerabilities in some countries are raising the risk of a systemic crisis

Source: BBVA Research

02

Latin America:
A heterogeneous recovery

Heterogeneous response of Latin American financial markets to rising US interest rates and dollar appreciation

Financial asset prices: percent change over the past three months to 11 July

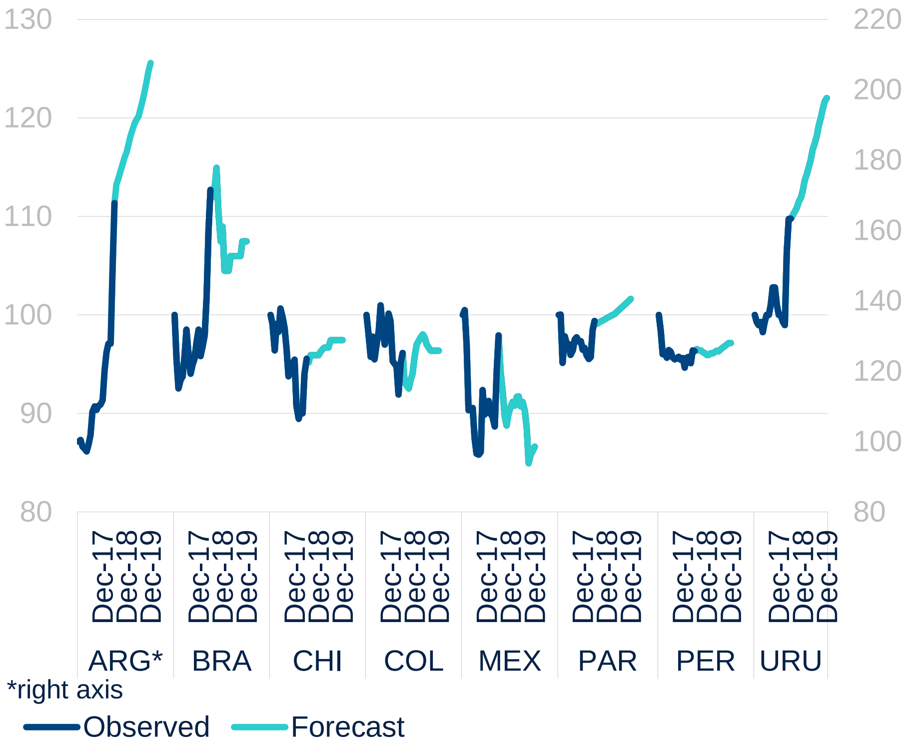
*Changes between 1 April and 12 July. Exchange rate: domestic currency / dollar. In this case, increases indicate depreciation. Country risk premium: EMBI.
Source: BBVA Research, Haver Analytics and DataStream

- Global financial market volatility affected especially Argentina and Brazil with strong FX depreciation and asset price corrections
- Mexican financial markets were more influenced by prospects of renegotiation of NAFTA
- Other countries in Latam weathered global volatility relatively well
  - Growth recovery
  - Higher commodity prices

Going forward, gradual depreciation of exchange rates in 2018 and 2019 in most countries, with the main exception of Brazil and Mexico, where appreciation is possible in 2019

Exchange rates against the dollar

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



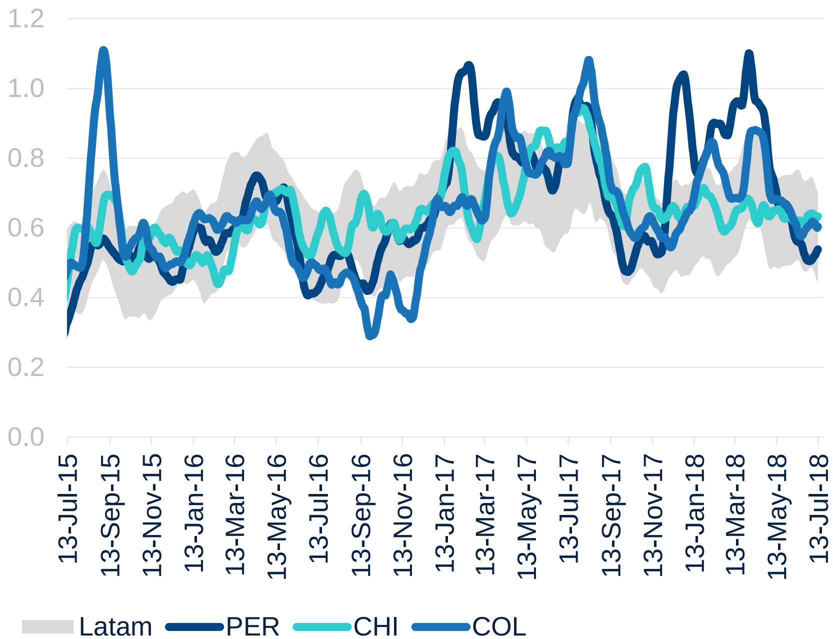
- Moderate depreciation of exchange rates going forward, driven by:
  - Fed raising interest rates in contrast to cuts in Latin America
  - Lower commodity prices
- The exception is Argentina, where we foresee nominal depreciation more in line with inflation, so that recent gains in competitiveness are not reduced excessively.
- The Mexican peso could appreciate in 2019 if the risks regarding NAFTA negotiations do not materialise, and in line with lower political noise

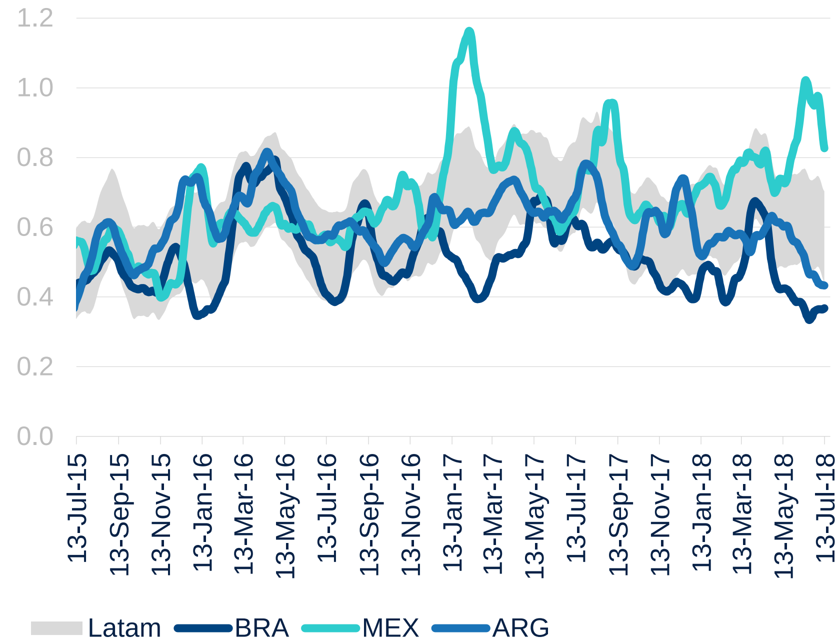
Source: BBVA Research, Haver Analytics and DataStream

Political stress has abated in most countries after elections or change in government. Risk of an increase in Argentina and Brazil

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

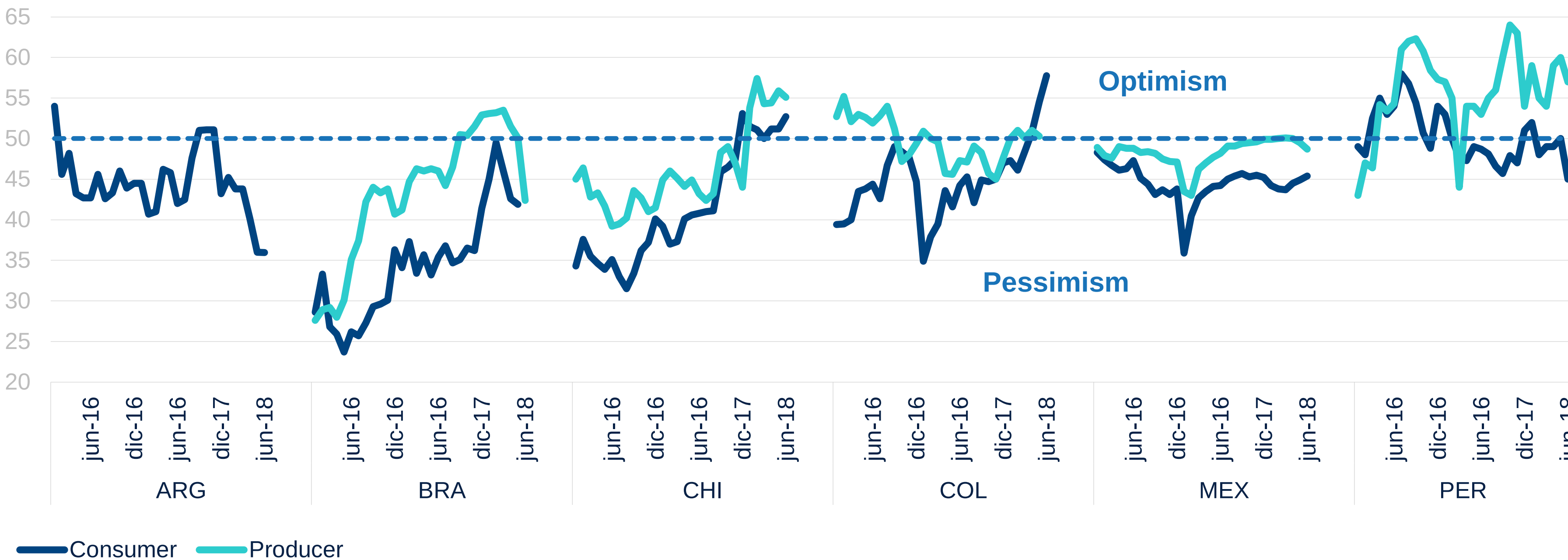
Political tension abated in Chile and Peru after change in government, and in Colombia after the elections. Political stress in Mexico is also starting to be reduced after the election

Political stress in Argentina and Brazil remain low in the last weeks. But the risk of an increase in Brazil is high, before the elections. In addition, social tensions could increase in Argentina

Confidence indicators in the region continue to improve. The main exception is Argentina and Brazil, due to market volatility and protests

Latin America: home and business confidence indicators

(values over 50 pts indicate optimism)



Source: BBVA Research and Haver

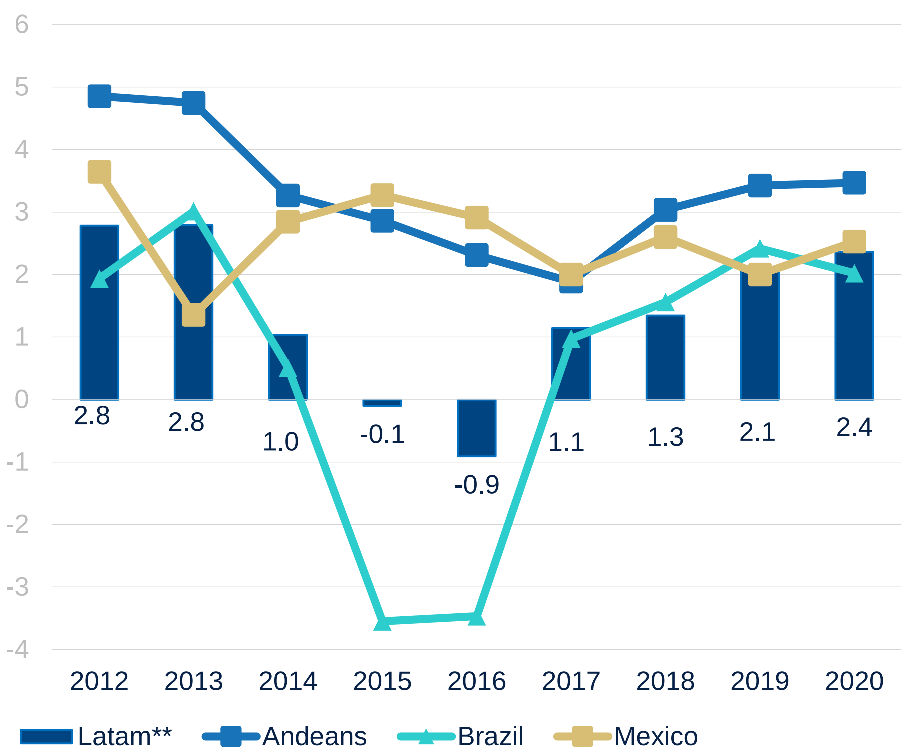
Confidence is reduced sharply in Argentina and Brazil. In Argentina, due to FX depreciation and utility price hikes. In Brazil, due to political noise, market volatility and trucker's strike

In Andeans countries, confidence recovers amid higher commodity prices, increasing growth, lower inflation and lower political stress

Heterogeneous growth in Latin America. Growth close to potential in 2020

Latin America: GDP growth

(% YoY)



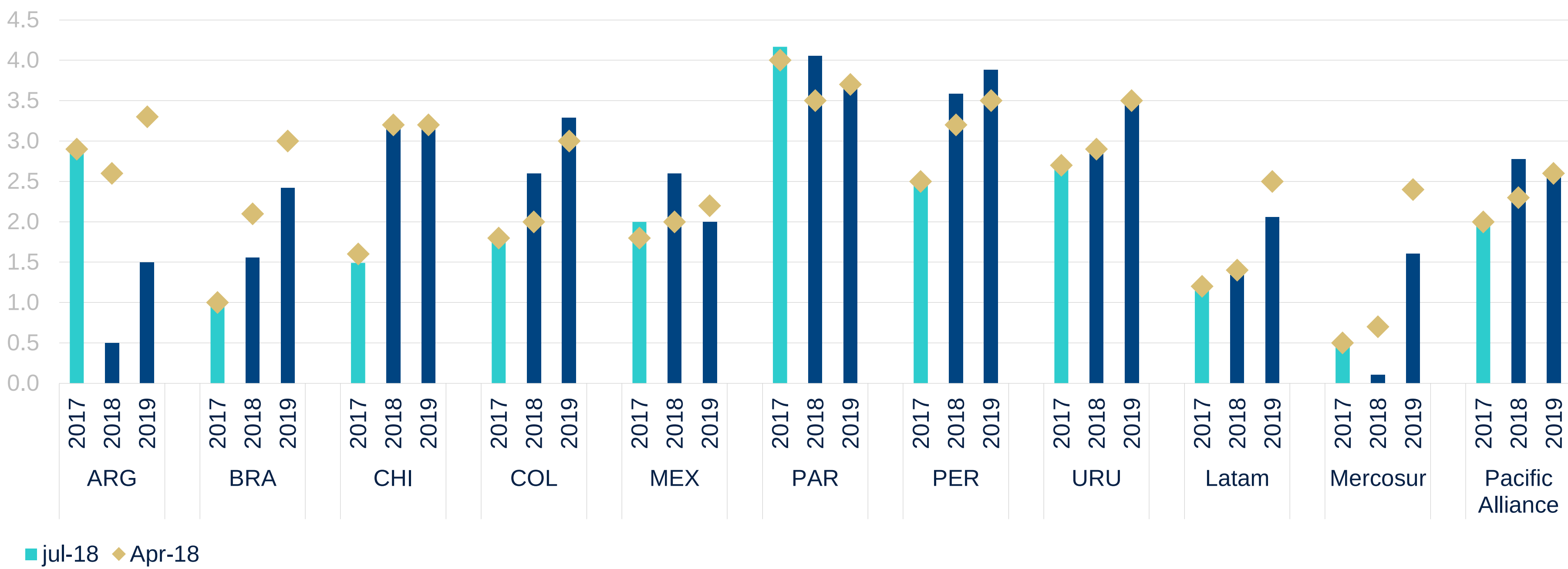
- Growth has continued to increase in recent months, especially in Andeans. in line with a recovery in confidence and a favourable foreign environment
- Growth in 2018 and 2019 will be driven by two factors:
  - The external sector: increased growth levels worldwide and higher commodity prices.
  - A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

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

Growth forecasts revised down in Argentina and Brazil, due to financial volatility and local factors. Growth in Mexico, Colombia and Peru revised up on positive outturns

Latin America countries: GDP growth

(%)



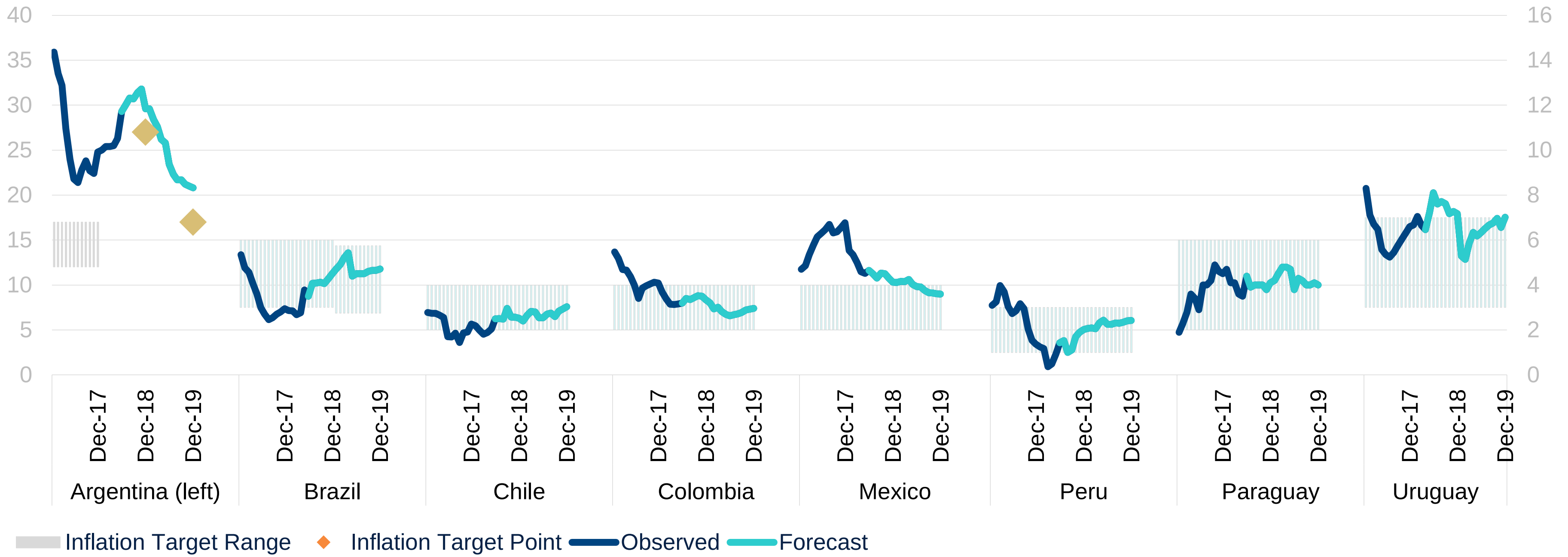
Source: BBVA Research and Haver

Growth forecasts revised down in Argentina (FX crisis and tighter fiscal and monetary policies) and Brazil (trucker's strike, a weaker government and political uncertainty

Growth forecasts revised up in Mexico, Colombia and Peru, given positive surprises in activity in first half of 2018. In addition higher oil prices are a positive for Colombia. In Peru, new mining projects will also support growth

Lower inflationary pressure, except in Argentina. Inflation in Mexico comes down more slowly than anticipated

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



Source: BBVA Research

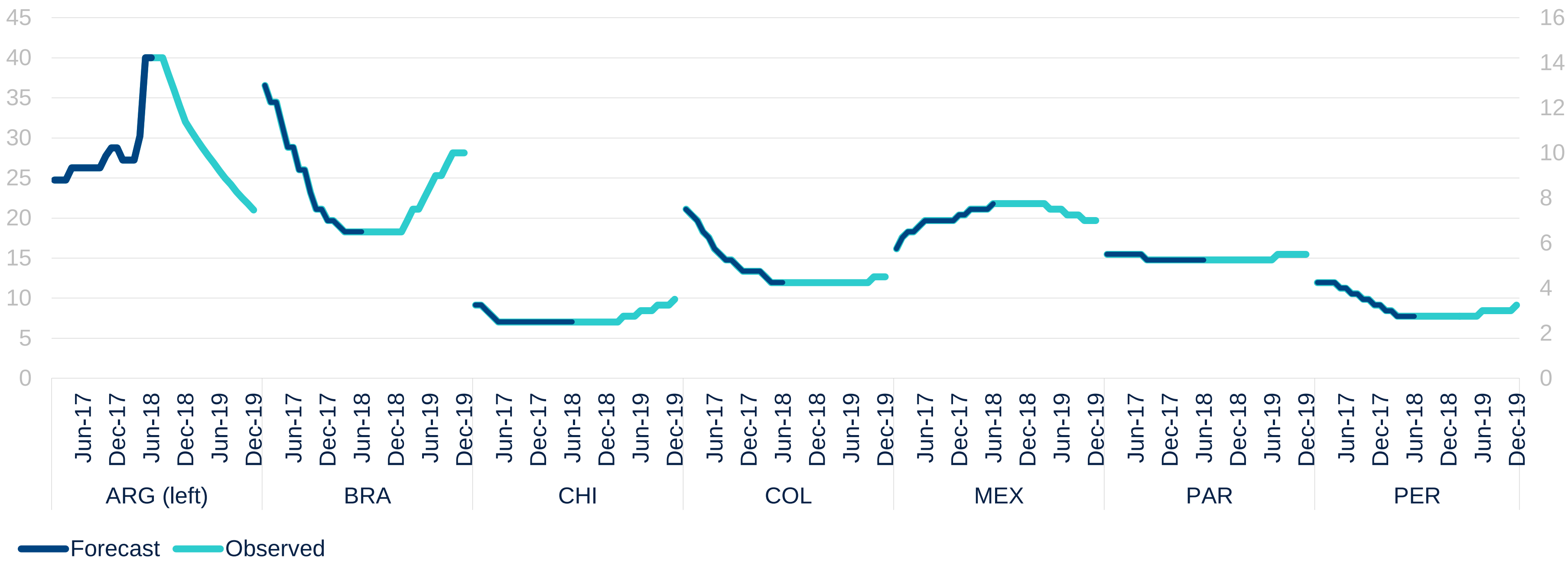
Lower inflationary pressure in the Andeans, despite depreciation of local currencies and some recovery of domestic demand

On the other hand, inflation in Argentina increases sharply, due to depreciation of the peso.
Inflation in Mexico will continue to come down, but more slowly than anticipated three months ago.

Central Banks in South America will start tightening cycle in 2019 (except Argentina)

Latin America: official interest rates

(%)



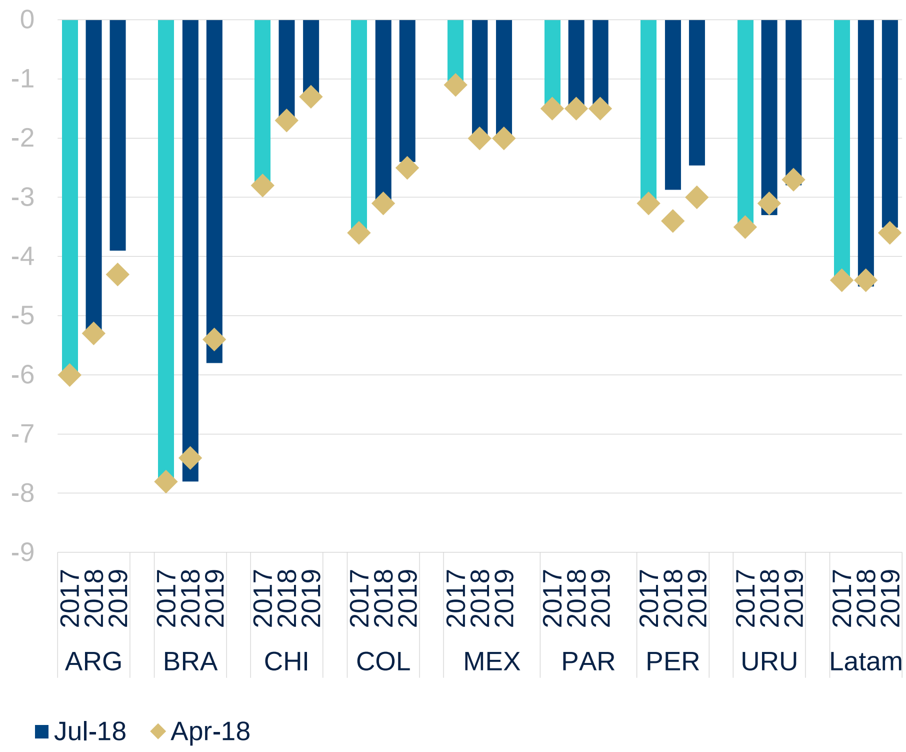
Source: BBVA Research and Haver

With inflation close to targets, growth recovering and an increase in US interest rates, Central Banks will start increasing interest rates in 2019

The exceptions to this scenario are Argentina and Mexico. In Argentina, interest rates will begin falling again at the end of 2018 as inflation and exchange rate risks are reduced.
Mexico will start cutting interest rates at the beginning of 2019

Higher growth and higher commodity prices drive lower public deficits. Faster fiscal adjustment in Argentina and Peru, and less ambitious in Brazil

Latin America: Fiscal balances
(% GDP)

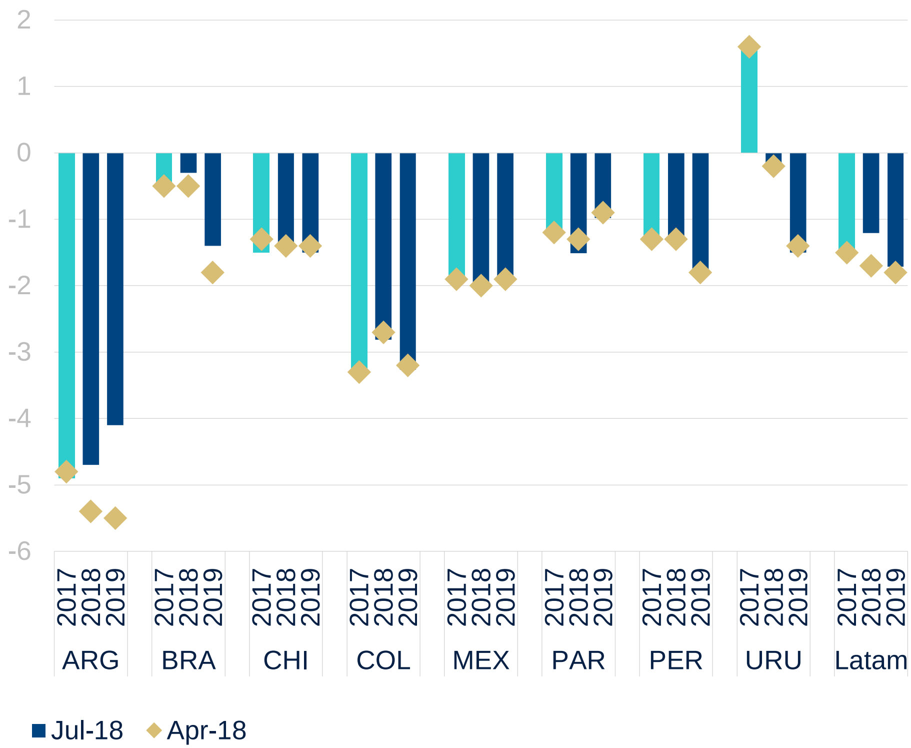


Source: BBVA Research and Haver

- Fiscal outlook in Brazil deteriorates, on lower expected growth and scant room for spending cuts without ambitious reforms (which are now less likely).
- Faster reduction of primary fiscal deficit in Argentina, in line with IMF programme. However, nominal deficit will not be reduced much, due to higher debt service.
- Lower deficit than expected in Peru, due to higher growth and recent increase in excise taxes. In Colombia, public accounts will be under stress in 2019, due to lower tax revenues and base effects on spending

Higher growth and imports will weigh on external balances. Tighter monetary and fiscal policies will reduce external deficit in Argentina

Latam: saldos por cuenta corriente
(% PIB)



- Foreign deficits to increase in 2018 in many countries. Higher exports will not compensate for stronger imports coming from brisk internal demand
- External deficit in Argentina will shrink going forward due to a more competitive exchange rate and import reduction
- In Colombia, external deficit would increase in 2019 due to stronger growth and lower oil prices, but it will still be wholly financed by FDI

Source: BBVA Research and Haver

Increasing external risks, except from China…

01
Protectionism and impact on global trade flows

02
Tightening international financial conditions

03
Leveraging and a hard landing in China

…while domestic risks remains, with differences across countries

04
Political noise: increased risk in Brazil, lower risk in Colombia Chile and Mexico

05
Delays in private and public investment

06
Failure to push ahead with reforms and boost productivity

Key messages

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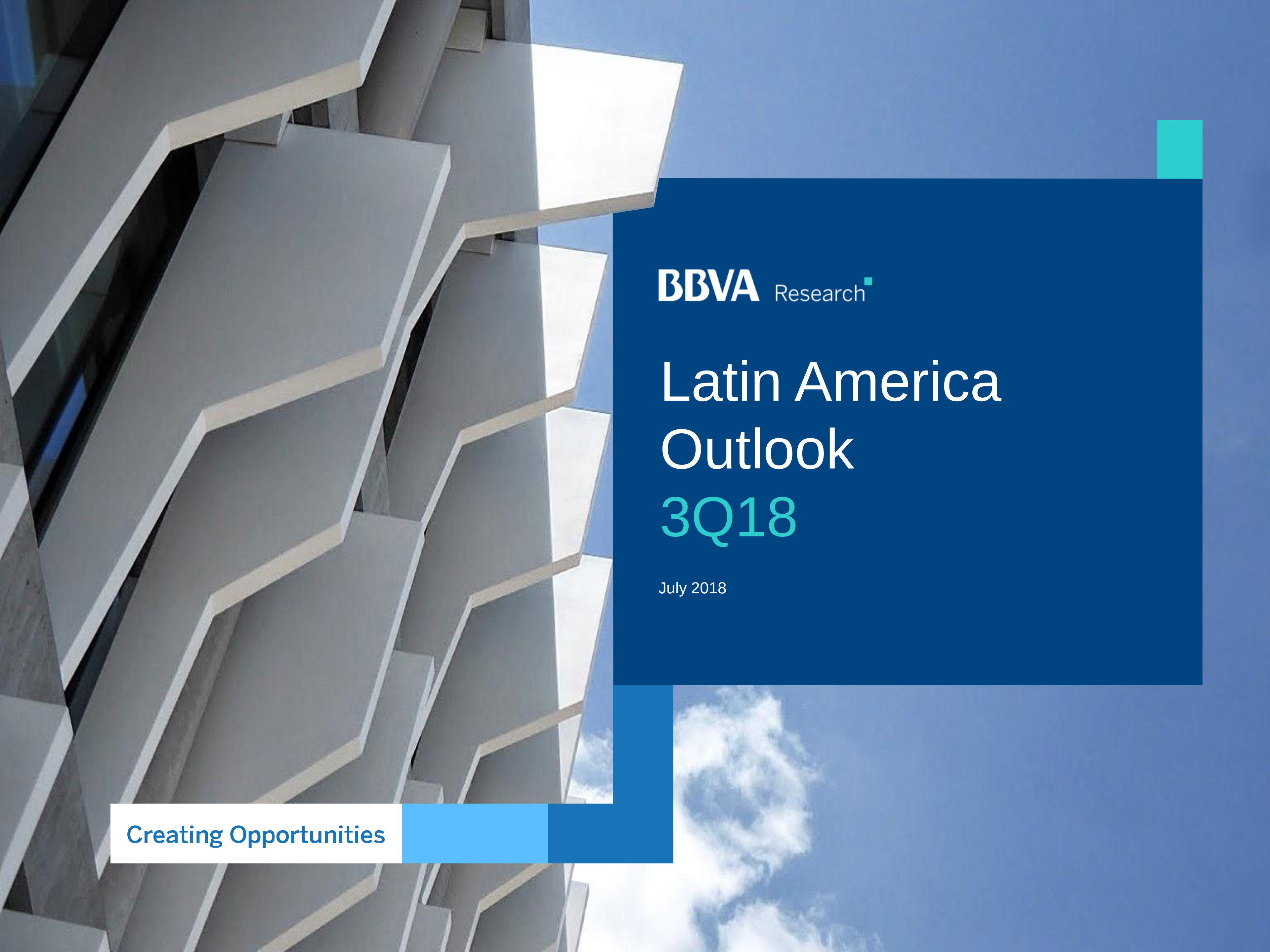
Previsiones de crecimiento en América Latina

GDP (% YoY)	2015	2016	2017	2018 (f)	2019 (f)
Argentina	2.7	-1.8	2.9	0.5	1.5
Brazil	-3.5	-3.5	1.0	1.6	2.4
Chile	2.3	1.3	1.5	3.2	3.2
Colombia	3.0	2.0	1.8	2.6	3.3
Mexico	3.3	2.9	2.0	2.6	2.0
Paraguay	3.0	4.0	4.2	4.1	3.7
Peru	3.3	4.0	2.5	3.6	3.9
Uruguay	0.4	1.7	2.7	2.9	3.5
Mercosur	-2.6	-3.9	0.5	0.1	1.6
Pacific Alliance	3.1	2.7	2.0	2.8	2.6
Latin America	-0.1	-0.9	1.1	1.3	2.1

(f) Forecast.



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Latin America Outlook

3Q18

July 2018

Creating Opportunities