BBVA Research

Latin America Economic Outlook 1Q19

February 2019

Creating Opportunities

Main messages

- The global slowdown will limit the recovery in Latin America. A weaker growth in developed countries, an increase in global financial volatility and worse prospects for commodity prices, on top of idiosyncratic factors, will negatively affect the region

- After growing 1.6% in 2018, the region will expand 2.1% in 2019 and 2.4% in 2020, respectively 0.3 pp and 0.2 pp lower than previously expected. Growth will remain higher, around 3.5%, in Peru, Chile, Colombia and Paraguay, and will be close to 2% in Mexico, Brazil and Uruguay. In Argentina, GDP will fall again in 2019 as a whole, although positive quarterly growth will begin to be seen, and possibly 2020 will recover

- In an environment where there is scarce room for expansionary fiscal policies, most of the region will continue to benefit from lax monetary policies. Likewise, the strengthening of domestic demand and/or the exchange rate pass-through depreciation will gradually eliminate monetary stimuli in the coming years. In contrast, in Mexico and Argentina monetary policy will gradually become less restrictive once inflation moderates after the recent rebound

- The main risks hovering around the region are those related to political and the fiscal issues, as well as the possible delays in investment projects, which add to those linked to the evolution of the global environment

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01

Global Environment: moving towards a soft-landing of global growth, amid high uncertainty

Moving towards a soft-landing of global growth, amid high uncertainty

Slowdown in global growth, but still robust

Strong adjustment of trade and the industrial sector, while investment and consumption resist the deterioration of confidence

Lower inflation after the fall in oil prices

Less pressure for central banks and more support for oil-importing economies

Increased financial tensions in developed countries

Strong adjustment in capital outflows in developed markets, but not in emerging economies

More cautious and patient central banks

The normalization of monetary policy will depend on the evolution of the economy and is key to containing market concerns

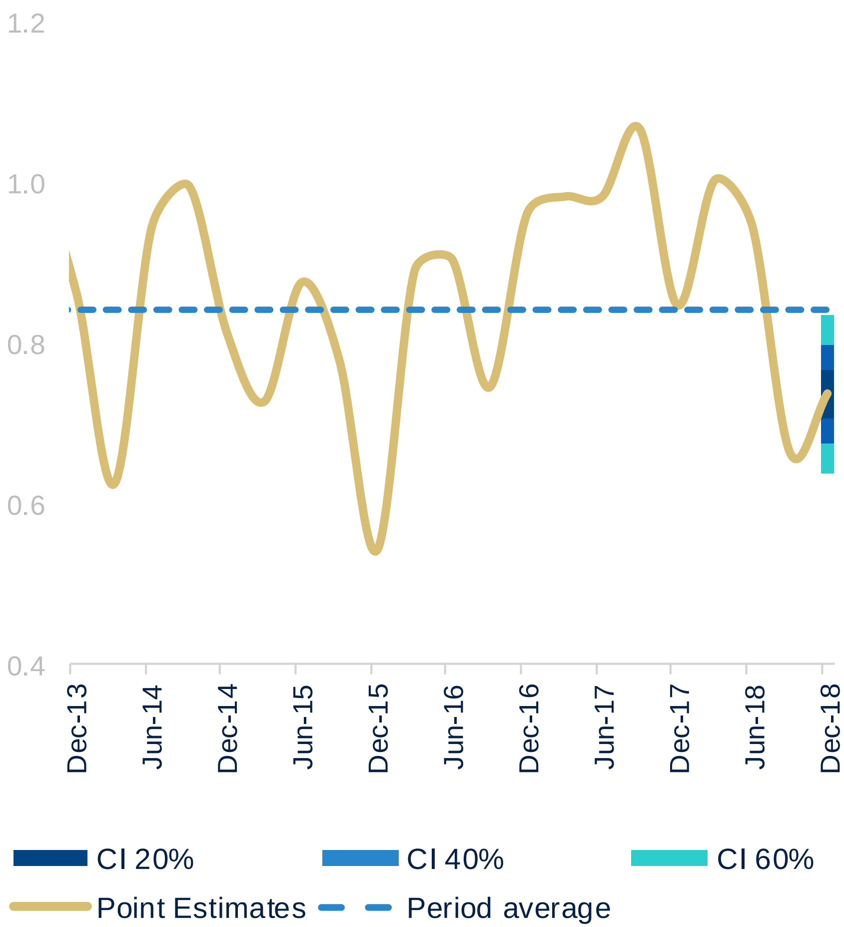
Global risks Intensify

The normalization of monetary policy will depend on the evolution of the economy and is key to containing markets concerns

Clear downward trend in world growth, but with signs of some stabilization

World GDP growth

(Forecast based on BBVA-GAIN, % QoQ)



Source: National sources and BBVA Research

- Global growth has entered the deceleration phase, but is still strong
- The widespread deterioration of industrial production and trade suggests a more evident impact of protectionism
- Strong moderation in industrial confidence extends to other sectors, but growth in private spending remains
- High uncertainty continues at the beginning of the year and will continue to hinder growth

Global trade: more evident effect of higher tariffs and uncertainty on trade negotiations

BBVA-Goods Exports

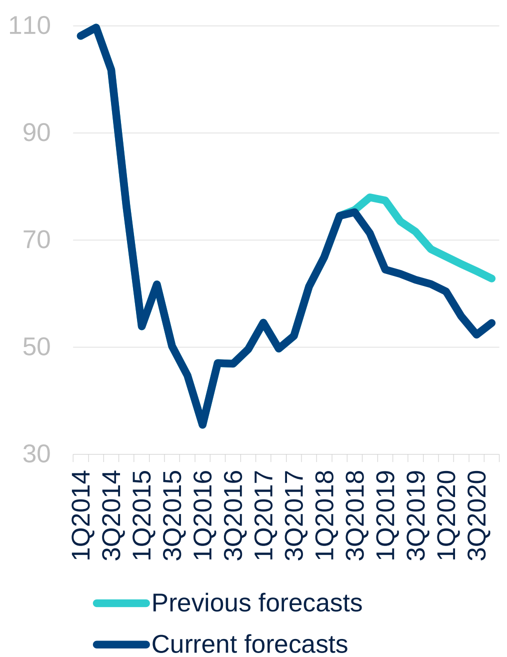
(% YoY, 3-period moving average)

Source: National sources and BBVA Research

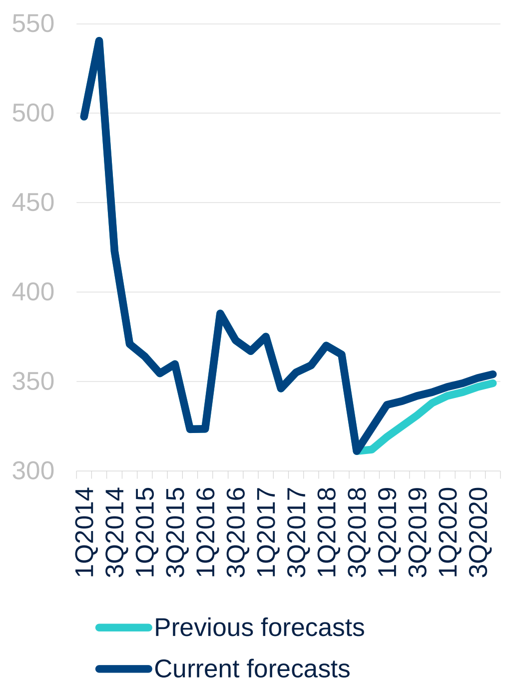
- World trade has shown strong volatility due to uncertainty about trade disputes
- China's recent poor export performance is partly due to the upturn in trade related to the possibility of further tariff increases, but its downward trend is a cause for concern
- The worst export performance has also been observed in the rest of Asia and Germany

Heterogeneous outlook for commodities: downward revisions in oil and copper, upward revisions in soybeans

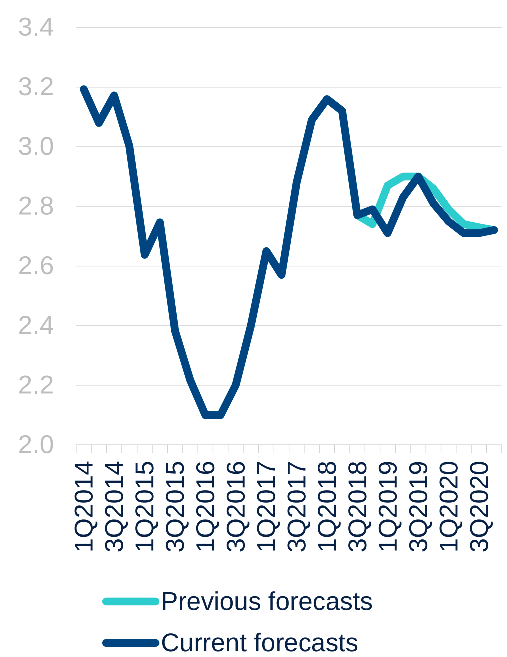
Brent Crude
(USD$ per barrel)



Soybeans
(USD$ per metric tonne)



Copper
(USD$ per lb.)

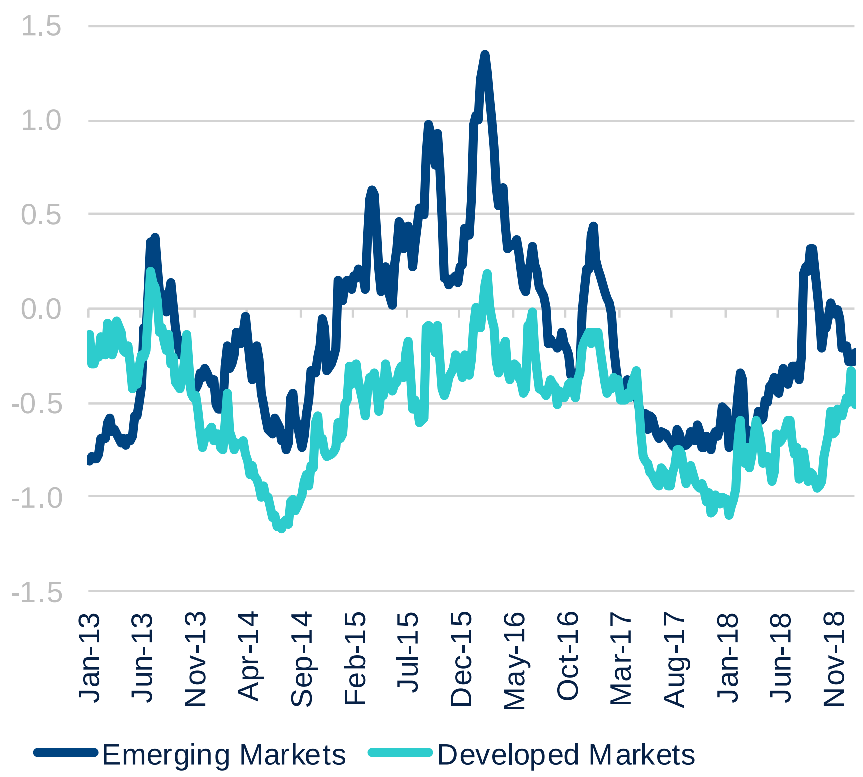


Source: National sources and BBVA Research

- Oil prices may recover in the short term due the announced production cuts
- However, the growing production in the US and lower global demand will push prices downwards more than expected throughout 2019-20
- The fall in prices will benefit world growth, but the effect on some Latam countries will be negative
- Copper forecasts were revised downwards, due to lower world growth, while soybean forecasts were adjusted upwards, due to the prospects for relaxation in the China - US trade relationship

Recent turmoil in the financial markets due to a risk of a sudden adjustment of global growth

BBVA's Financial Tensions Index
(Index)



01

Developed markets (US) are at the center of the episode

02

EM remained relatively resilient despite the global mood and the fall in oil prices

03

Investors have withdrawn **sizeable outflows from DM**, but EMs have failed to attract new flows

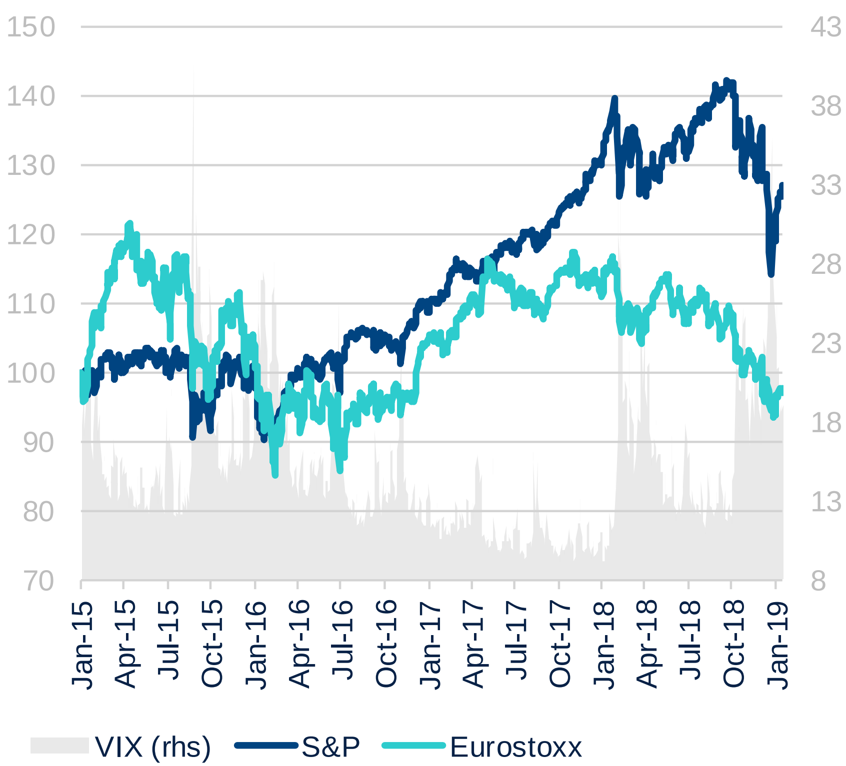
04

The response of central banks, particularly the Fed, has been key to halt tensions

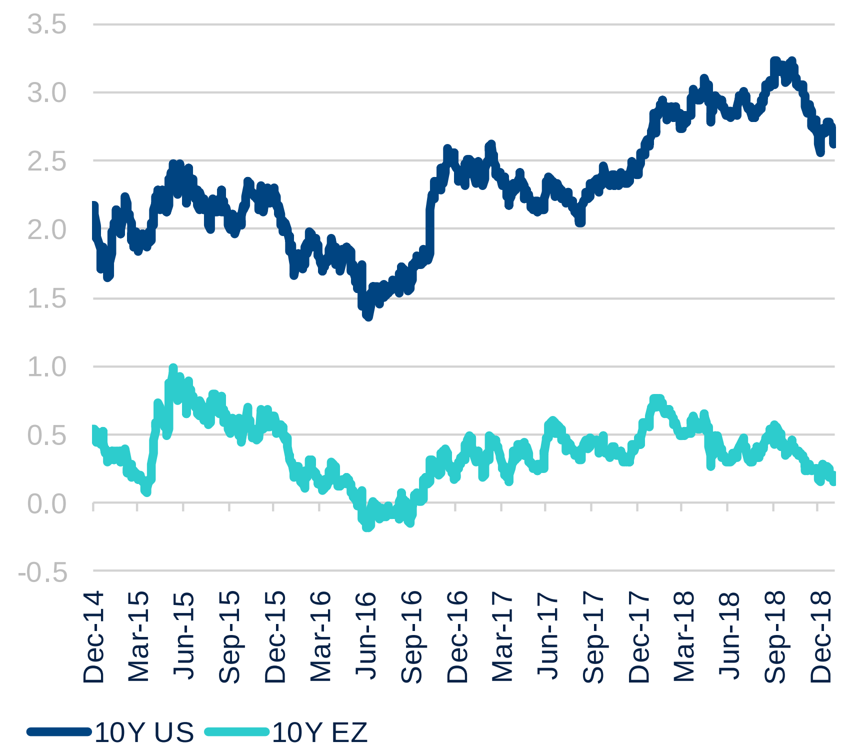
Source: BBVA Research

Financial tensions hit mainly developed markets; interest rates return to very low levels

Developed equity indexes and VIX
(Base 100: January 2015 and %)



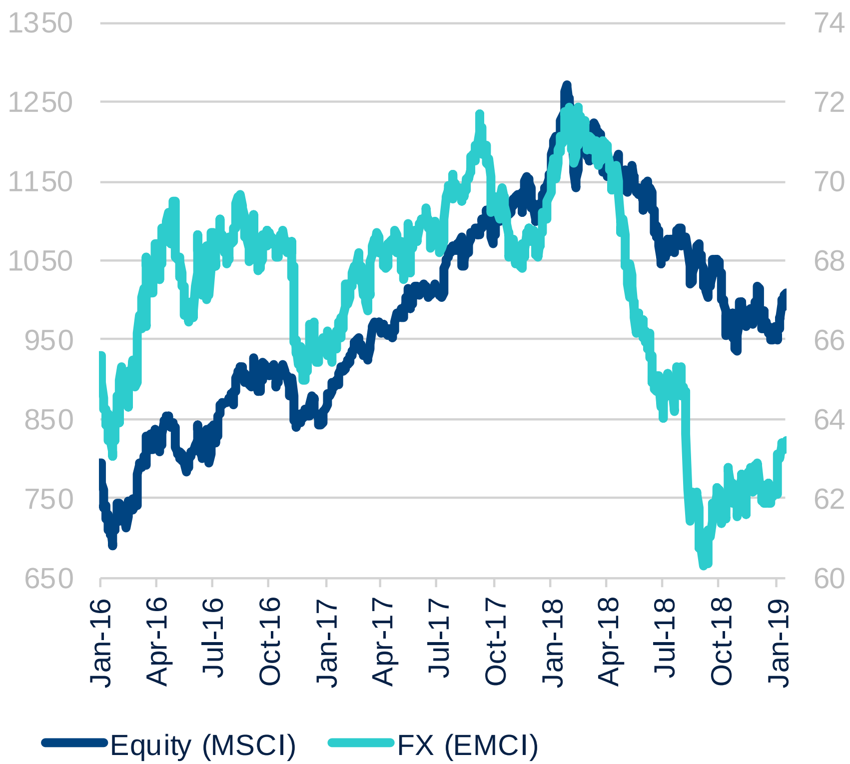
Sovereign debt yields
(%)



Source: BBVA Research

Emerging markets, after a strong adjustment in 2018, stay out of the most-recent volatility episode

Emerging markets FX and equity
(indices)



Source: BBVA Research a partir de EPFR

Economic policy reaction at more vulnerable countries (Argentina, Turkey)

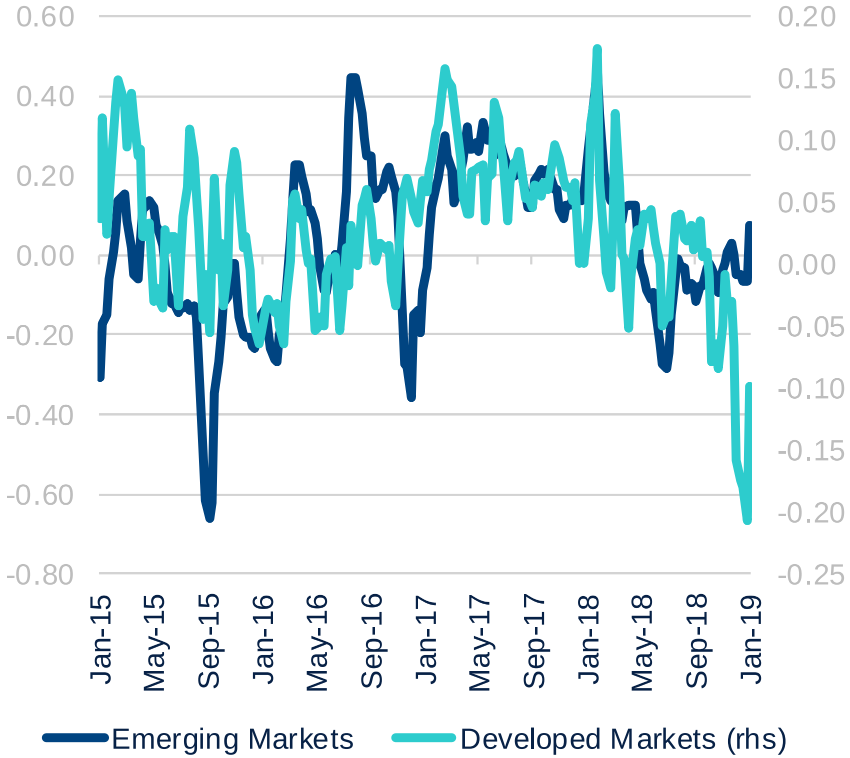
Economic stimuli (China)

Asymmetric effects of the fall in oil prices (exporters vs importers)

The risk aversion environment is being seen in the recomposition of capital flows, refuge in debt and liquidity

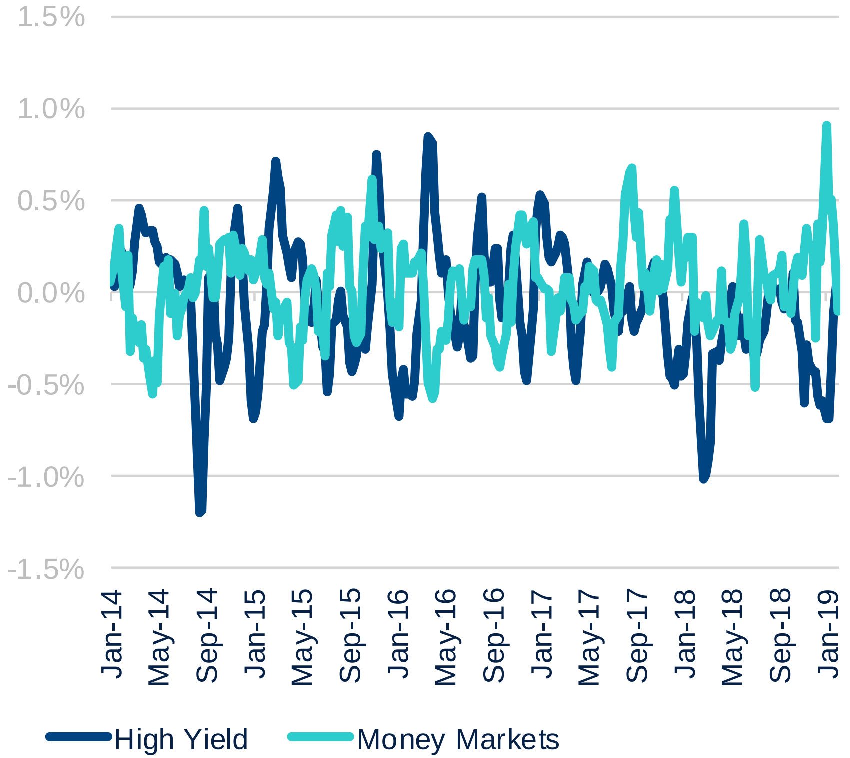
Portfolio flows: regions

(%, assets under management, 4 weeks moving average)



Portfolio flows: assets

(%, assets under management, 4 weeks moving average)



Source: BBVA Research

Central banks are sensitive to growing risk scenarios, and the process of monetary normalization is slowing down

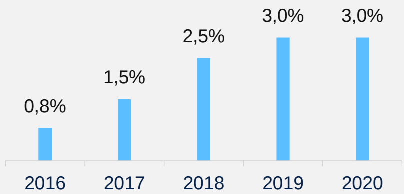
Balance

Interest rates

Federal Reserve System

- **Ongoing reduction of the size of the balance sheet** (USD500bn in 2019)

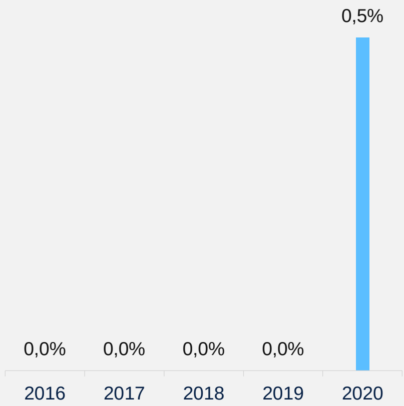
- **The end of the hiking cycle is near** (two 25pbs in 2019)



European Central Bank – Eurosystem

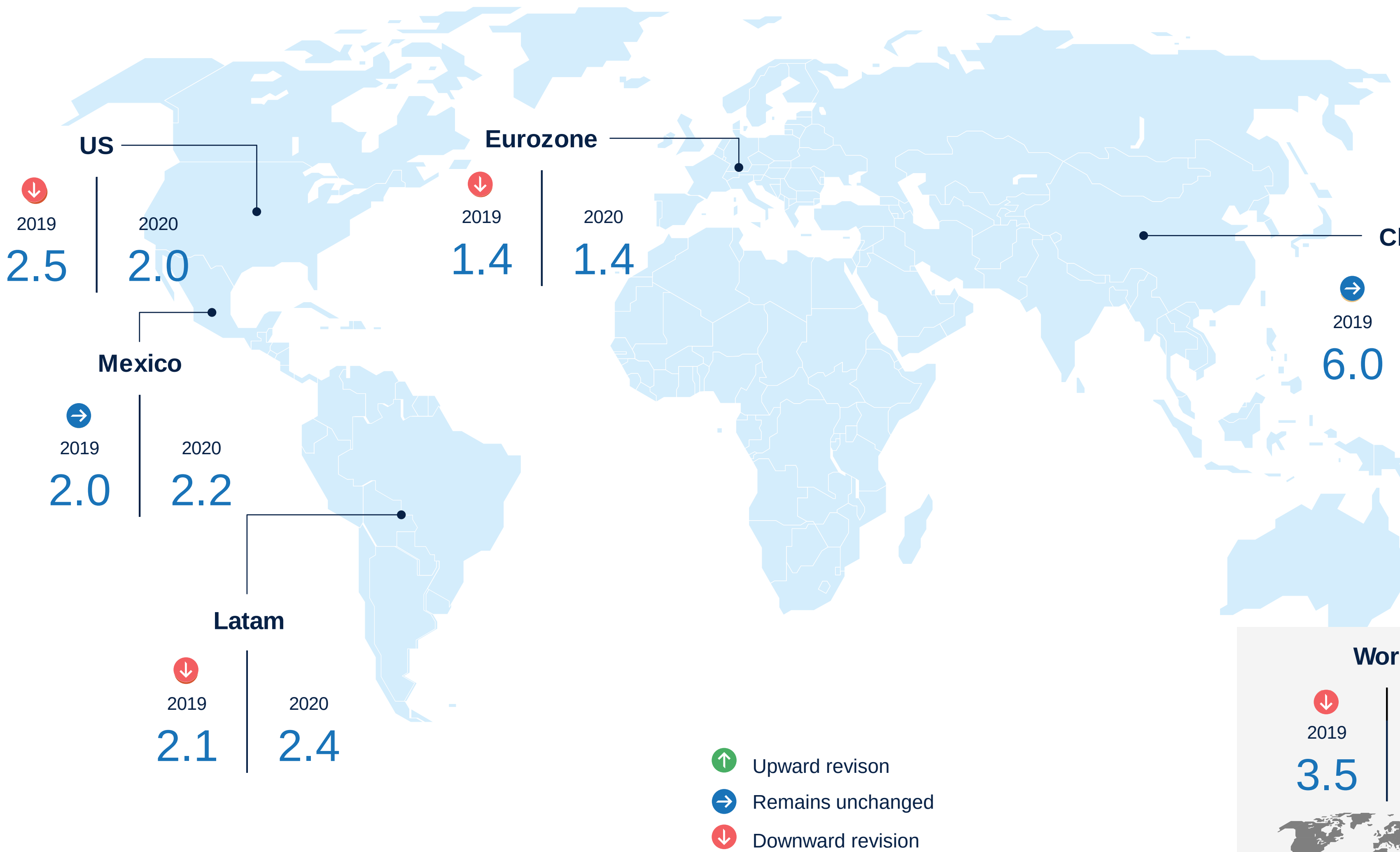
- **The QE ended** (December 2018)
- **QE total reinvestment** to continue well beyond the start of interest rate hikes
- **Another TLTRO** before June 2019 is very likely

- **Delay in the rate hike path** due to a less supportive global outlook and higher risks. **Not expected before June 2020**



Source: BBVA Research

A general downward revision of growth, with a more evident moderation in developed countries and in emerging Asia



World

2019 3.5

2020 3.4

Source: BBVA Research

Still soft landing, but more uncertain due to dependence on politics and policies

Worse macro outcomes

Faster slowdown than expected
(Protectionism+China)

Evidence that impact from **US fiscal stimulus** will fade earlier than expected

Higher financial stress

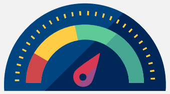
Risks of **global growth hard landing**

Tougher financial conditions

Three key assumptions in our projections:

01
Easing US-China trade tensions: Unchanged tariffs, but structural issues remain

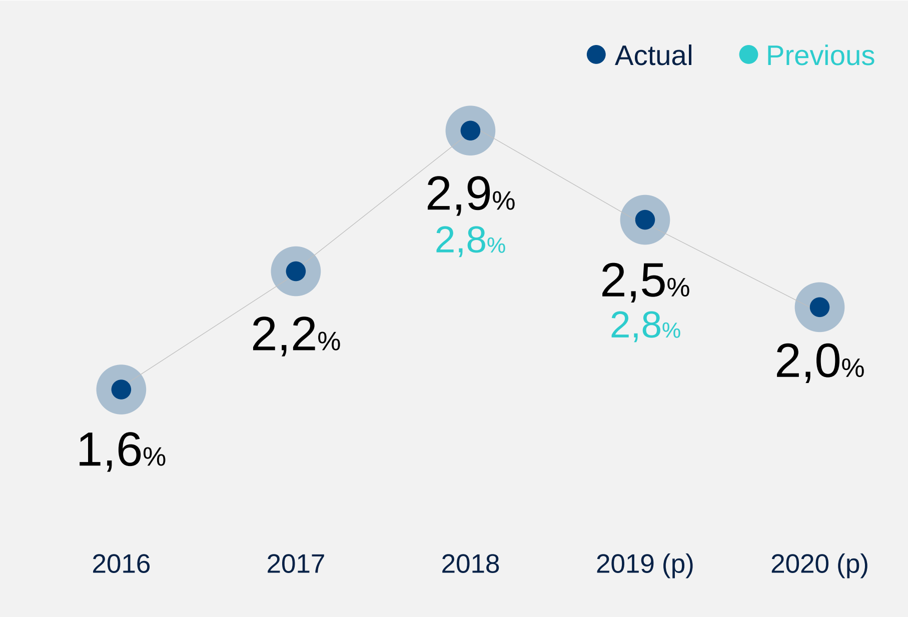
02
Tail risks in Europe are eventually resolved (orderly Brexit)



03
More dovish Fed and ECB, further room for EM central banks

U.S. U.S.: further slowdown in growth due to the fading of fiscal stimulus and financial volatility

USA.: GDP growth
(% y/y)

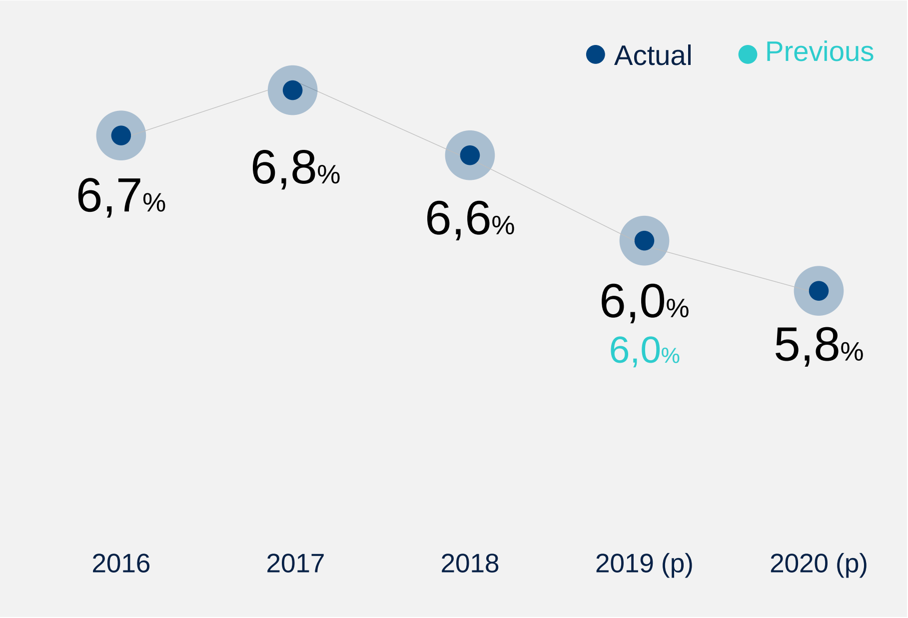


- GDP downward revision due to less optimistic outlook for private investment and public expenditure
- Private consumption will moderate as the impulse of the tax cut disappears, despite the strength of the labor market
- Inflation remains above target, but will be gradually reduced to somewhat below target in 2020
- Downward risks have increased due to the deterioration of the global environment, but there is also a greater risk of recession over the two-year horizon

(p) Forecast.
Source: BBVA Research and BEA

China: authorities' priority is to avoid abrupt adjustment of growth

China: GDP growth
(% y/y)

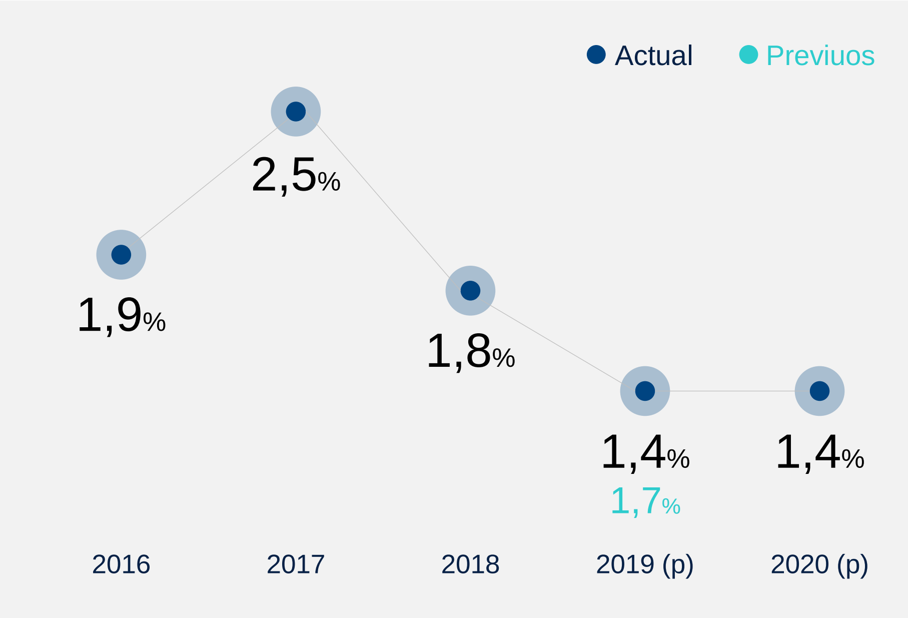


- Growth forecasts remain unchanged, due to the implementation of greater incentives to halt the intensification of the slowdown
- Support measures, both fiscal and monetary, are spreading, but attempts are being made not to worsen existing financial vulnerabilities
- Protectionism remains the main risk. If it has to be compensated with more stimuli, the necessary deleveraging is stopped and can lead to a sharp depreciation of the exchange rate

(p) Forecast.
Source: BBVA Research and CEIC

Eurozone: rapid deceleration towards potential growth due to less support from the global environment

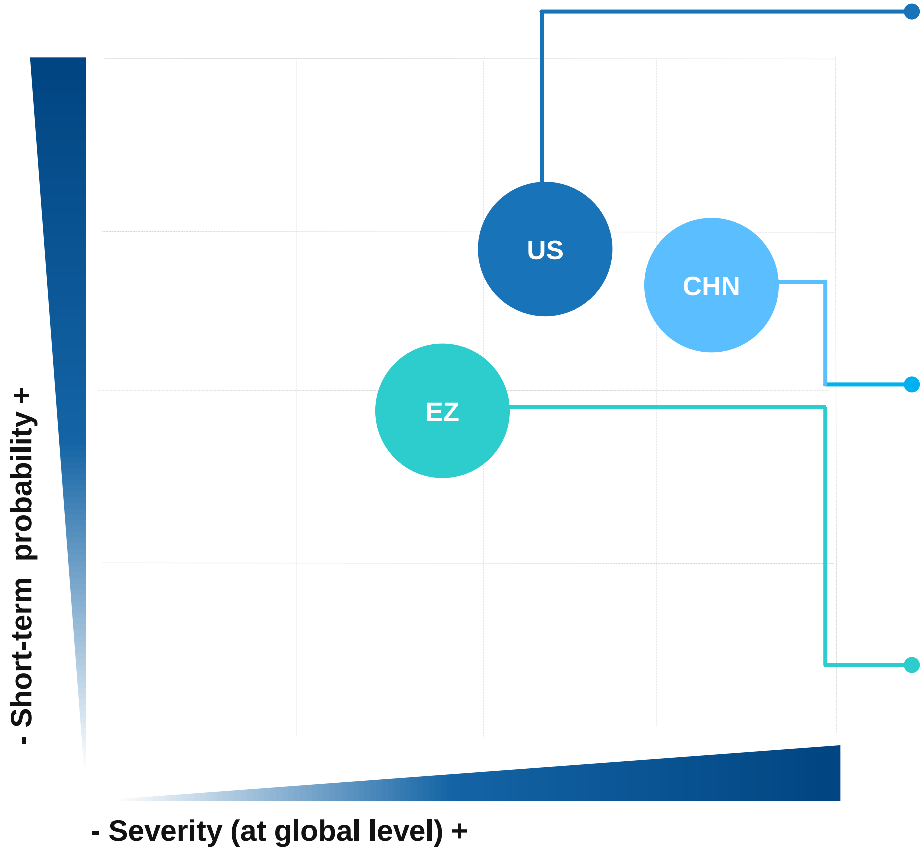
Eurozona: GDP growth
(% y/y)



- The fall in oil prices reinforces the strength of domestic factors, but not enough to compensate for lower global demand.
- A somewhat more accommodative monetary and fiscal policy could offset the effect of worsening confidence on private spending.
- Rapid fall in inflation, but core inflation should gradually rise
- Political risk has increased (Brexit, and more uncertainty in several countries)

(p) Forecast.
Source: BBVA Research a partir and Eurostat

Global risks tilted to the downside: US recession fears, China's debt as key concerns and trade war



- **Economic recession: increasing** (trade concerns, political controversy -shutdown-, geopolitical issues, credit risk / corporate leverage)
- **Protectionism: high.** Negative spillovers on growth (investment, impact on certain sectors / states) and cost pressures
- **Fed's exit: falling**. Lower risk of overshooting (rates above neutral levels)

- **Disorderly deleveraging: relatively higher**. Growing debt overhang amidst further stimulus and flagging growth (also visible in household expenditure). Monitoring: RMB, corporate defaults, local government debt
- **Protectionism: high**. Big differences remain despite a potential trade deal in March19. Lack of advances in structural issues (intellectual property, FDI, WTO reform)

- **Political concerns: relatively higher**. Lack of advances in integration process on the eve of European Parliament elections
  - ***Brexit***: risk of a cliff-edge Brexit in March19
  - **Italy:** political and policy uncertainty remains. Banking concerns rising
  - **Spain:** growing political instability. Parliament fragmentation, deficit deviations, structural reforms and Catalonia tensions
- **Proteccionism:** contained but it could be not discarded (autos)
- **ECB's exit risk:** low. Pending on changes in the Board

Source: BBVA Research

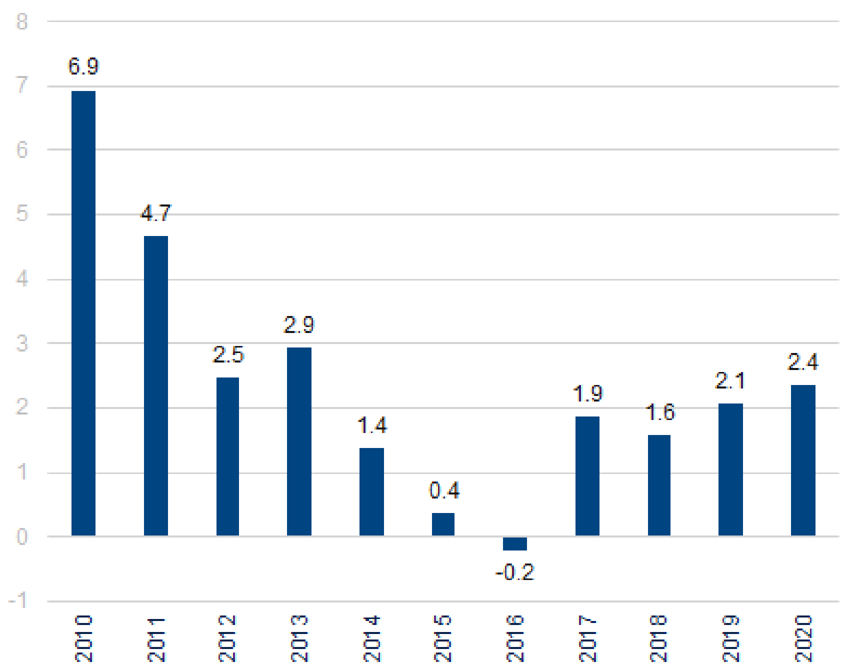
02

Latin America: the global slowdown will limit the regional recovery

Latin America will grow 2.1% in 2019 and 2.4% in 2020, respectively 0.3 pp and 0.2 pp lower than previously expected

Latam: GDP growth (*)

(%)

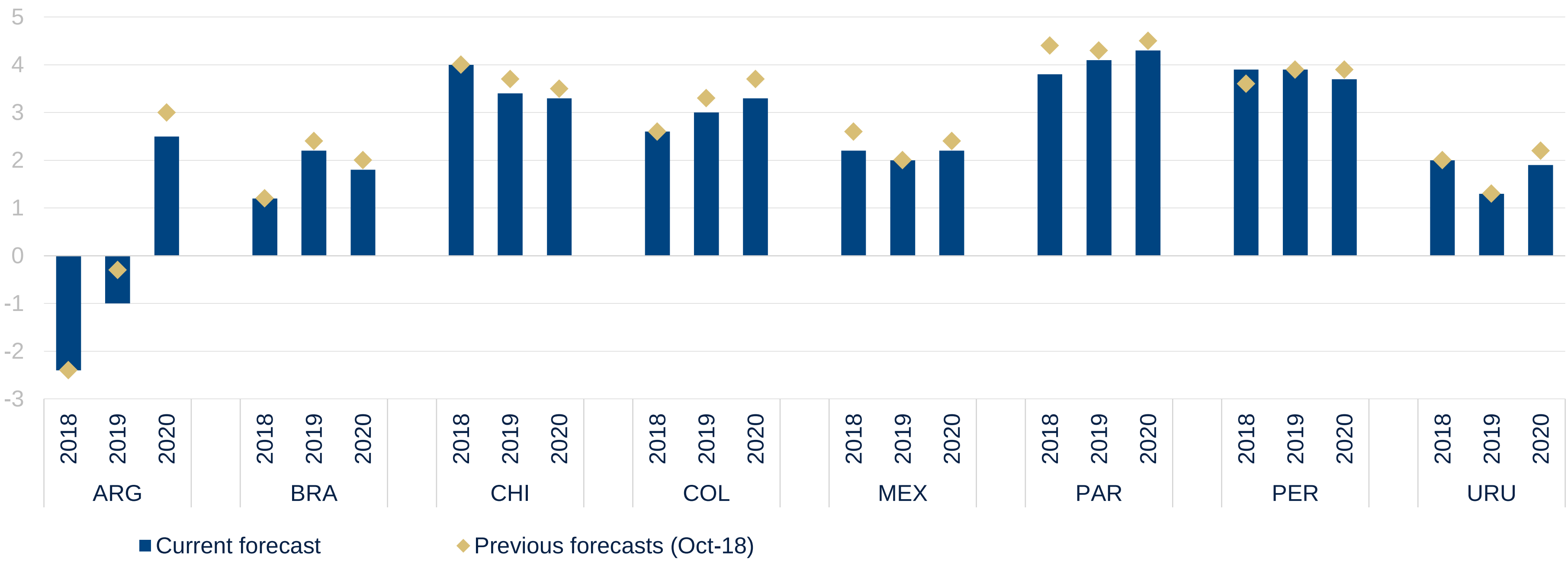


- Growth in Latin America will continue to recover, although more gradually than expected
- The region will have to face a less favorable global environment, marked by lower growth, greater volatility (at least in the short term) and lower prices of commodities, as well as some idiosyncratic factors
- Despite the recovery, the region will not exhibit in the near future growth rates as robust as those recorded few years ago: reforms to stimulate productivity have been relatively scarce and insufficient to counteract the effects of lower commodity prices

(*) Weighted average of Argentina, Brasil, Chile, Colombia, Mexico, Paraguay, Peru and Uruguay.
Source: BBVA Research

The growth forecasts of all the countries in the region have been revised downwards

Latam: GDP growth
(%)

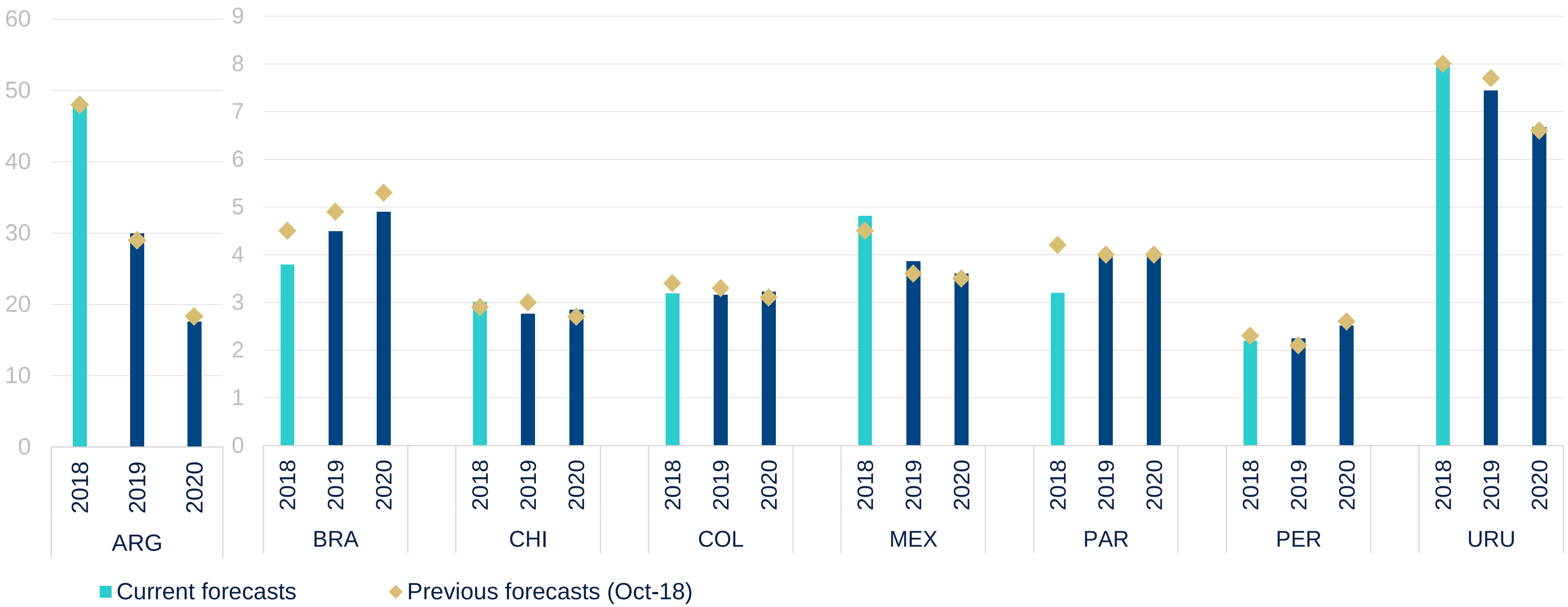


Source: BBVA Research

- Beyond global drivers, some local factors contribute to less optimism with respect to growth: worse-than-expected incoming data (ARG, CHI, COL, PAR), a more costly adjustment after the currency crisis (ARG) and lower investment and fiscal noise (COL)
- Growth will be higher, around 3.5%, in Paraguay, Peru, Chile and Colombia, and will be close to 2% in Brazil, Mexico and Uruguay. In Argentina the GDP will fall again in 2019 and will recover in 2020 (for more on the prospects for each country, see Session 3)

Inflation: under control in most of the region and still high in Argentina, Mexico and Uruguay, where there are already signs of moderation

Latam: inflation
(y/y %; end of period)



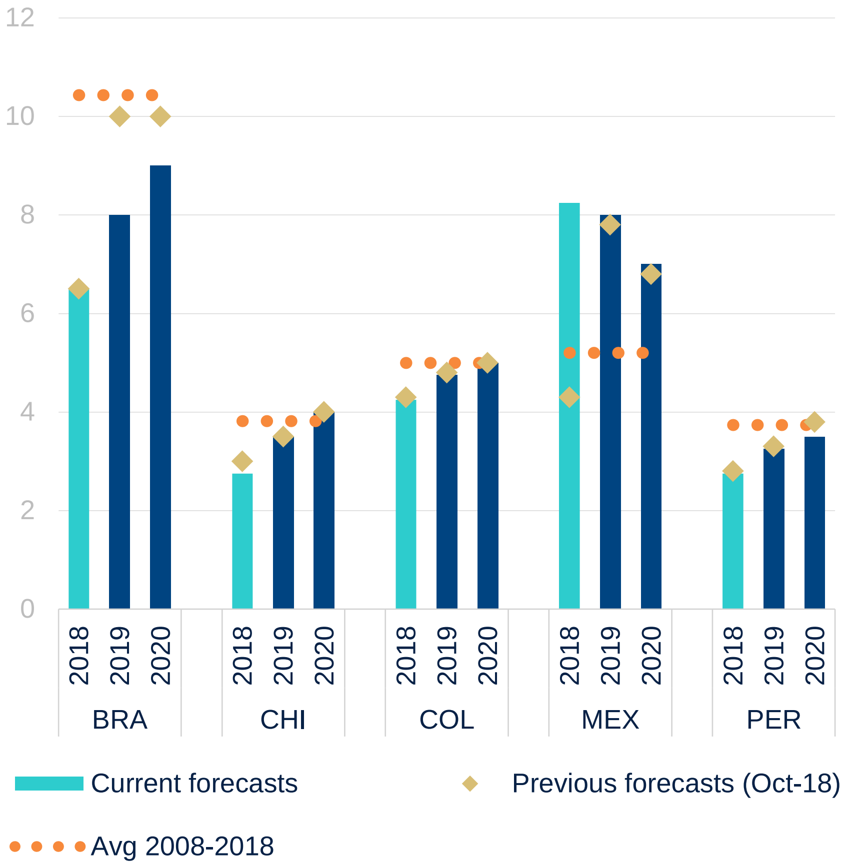
Source: BBVA Research

- In most countries, inflation will tend to rise, but will remain contained, close to inflation targets. In Mexico and Argentina, there are already signs of moderation after the recent strong rebounds, which supports the vision of lower inflationary pressures in the coming years
- In general, the adjustments in the forecasts reflect, on the one hand, more depreciated currencies, and on the other hand, the lower oil prices and the smaller demand pressures

The monetary stimulus will gradually be withdrawn in most of the region, with the exceptions of Argentina and Mexico

Latam: monetary-policy interest rates

(y/y %; end of period)

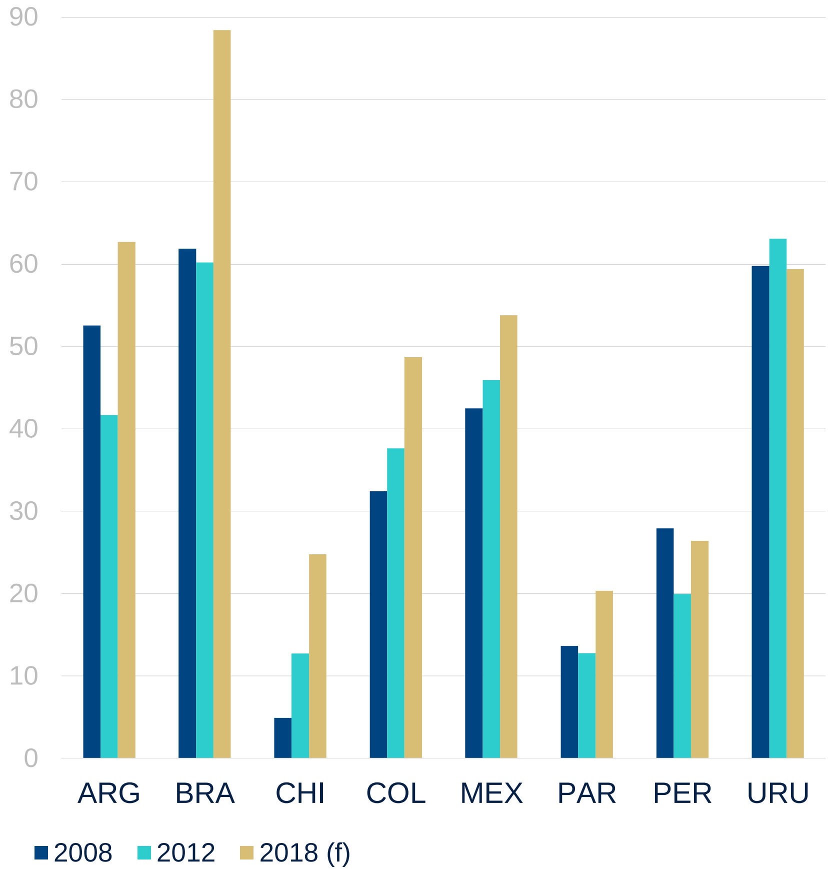


Source: BBVA Research

- The recovery of activity and the gradual increase in inflation will determine a reduction in monetary stimuli
- The monetary normalization in the US will also contribute to the increase in interest rates in the region, although less than previously expected since we now expect two instead of three increases in interest rates by the Fed
- The lower inflation in Chile, where the upward adjustment of interest rates has already begun, and in Brazil and Peru will result in a more tightening of monetary conditions
- We maintain the outlook for adjustment in Colombia and Paraguay
- In Mexico and Argentina the restrictive tone will be maintained for longer: in the first case, we expect interest rate stability until 4Q19, and in the second, growth of 0% m/m of the monetary base in the first half of the year and of 1% m/m in the second

There exists scarce room for expansive fiscal policies in the region

Latam: gross public debt
(% of GDP)



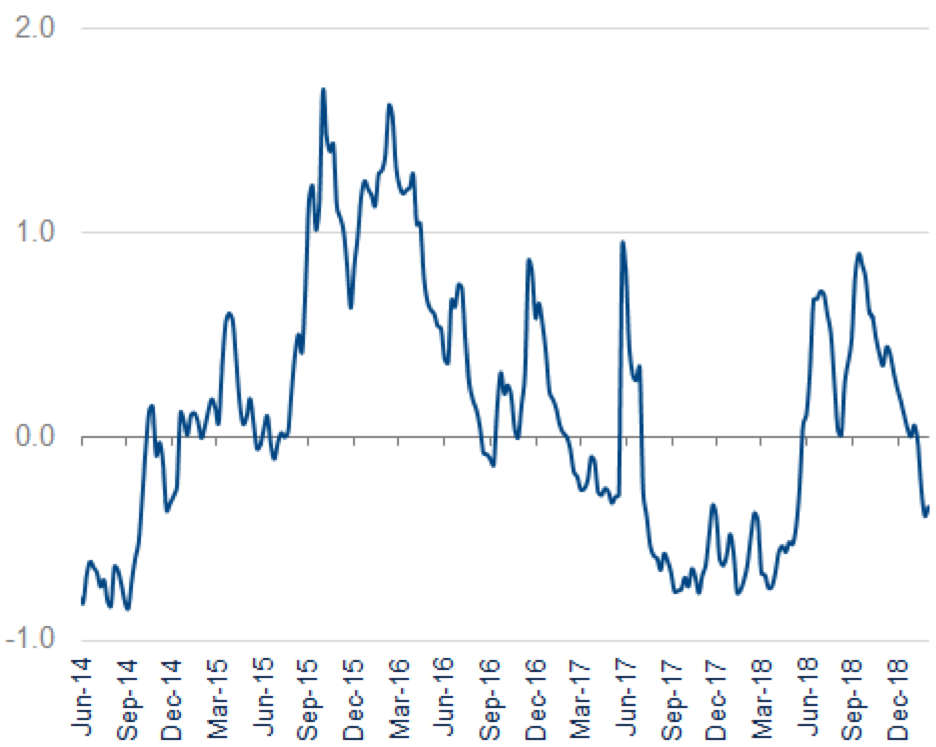
(f) = forecast
Source: FMI

- In a context of increasing public debt and taking into account the need that many countries have to comply with certain fiscal rules and objectives, we foresee that they will continue taking measures to reduce fiscal deficits (see forecasts in Session 4)
- In the case of Argentina, the primary deficit will possibly be cut to zero, in line with what was agreed with the IMF
- In Brazil, public spending will continue to be contained and a social security reform is likely to be approved (at least a non-ambitious one), but high public debt will continue to be a source of concerns
- In Colombia, compliance with the fiscal rule will require cuts and additional measures, mainly in 2020
- In Mexico, the new government has presented a relatively conservative budget for 2019, we expect stability in public debt

Local assets will continue to reflect global financial volatility, as well as local factors

Latam: BBVA's Financial Tensions Index

(Average since January 2006 = 0)

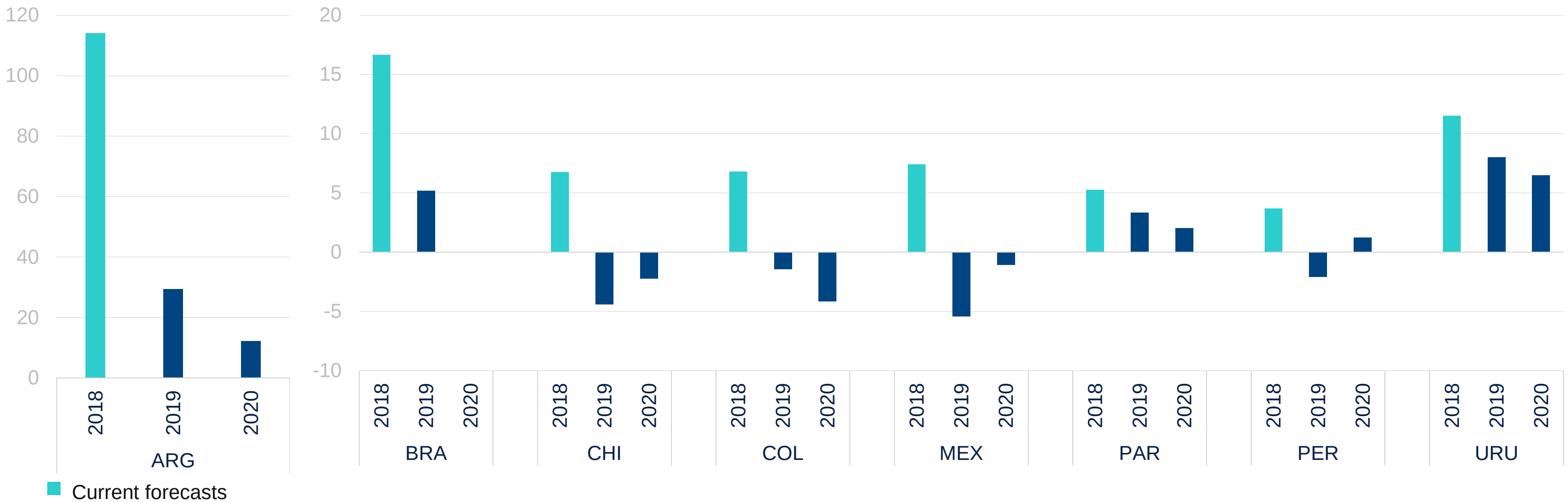


- After rebounding significantly in the middle of 2018, financial tensions in Latin America have moderated despite the global markets volatility
- The reduction of financial tensions has been especially important in Argentina, where the measures announced after the new agreement with the IMF ended up easing markets' fears
- Also in Brazil, the other country in the region where tensions had risen strongly before, the mood of financial markets has improved, due to greater optimism with the new government
- In Mexico, tensions also went down, partly due to the approval of a conservative budget for 2019
- In the last three months tensions increased somewhat in Colombia and declined further in Peru

Source: BBVA Research

After depreciating in 2018, there is room for currencies to appreciate somewhat moving forward, at least in real terms

Latam: nominal exchange rates (*)
(%; local currency / US dollar)



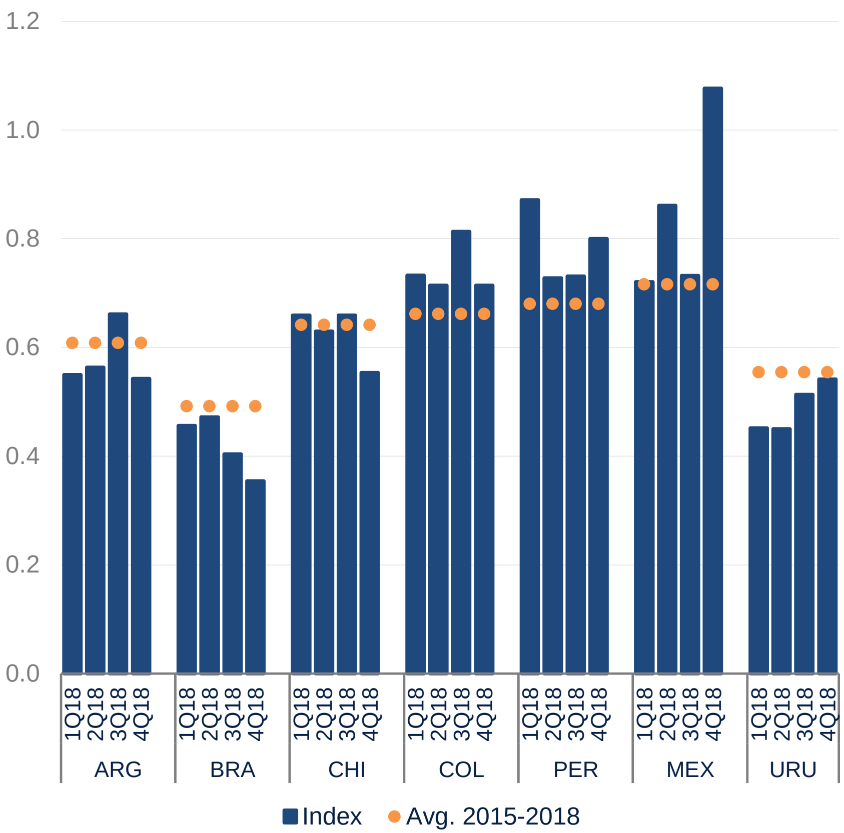
(*) Positive values indicate depreciations and negative ones indicate appreciations.
Source: BBVA Research

- Global financial volatility will continue to pressure foreign exchange markets in the coming months, but there is room for currencies to recover part of their recent losses throughout 2019 and in 2020, at least in Chile, Colombia, Mexico and Peru
- In Argentina, the peso will continue to depreciate, but at a lower rate than inflation. In Brazil, the real could depreciate if the (high) expectations of the markets with respect to the new administration are not met

The balance of risks to our base scenario for Latin America has increased due to external and local risks

Latam: BBVA's Political Tensions Index

(Media tone on politics weighted by media coverage)



Source: GDELT, BBVA Research

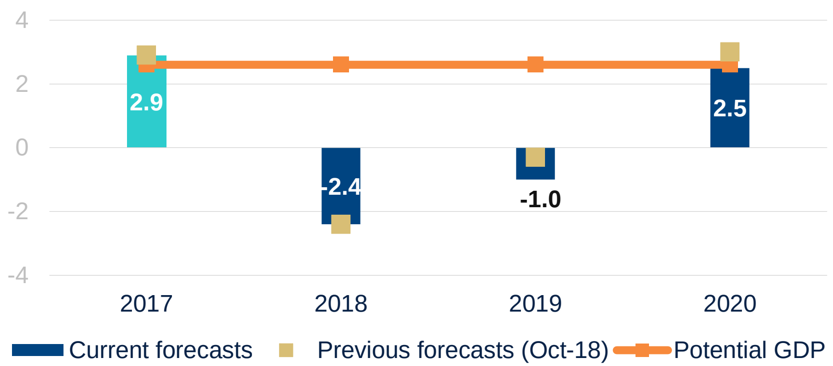
- External and local risks are now higher than before
- Political risk remains an issue in virtually all countries, but mainly in Brazil and Mexico, where there is still uncertainty regarding the policies of the new governments, and in Argentina and Uruguay where there will be presidential elections this year
- Fiscal risk is relevant mainly in Brazil and Argentina, but also in Colombia and Mexico
- The risk of delay in investment projects hovers around Peru, Paraguay and Uruguay

03

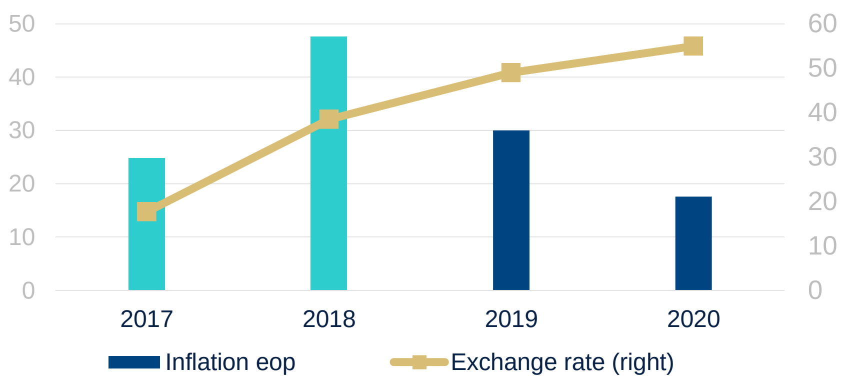
Latin America: outlook by country

Argentina: more contractive policies and higher global and local volatility leads to downward revisions in GDP growth forecasts

Argentina: GDP and potential GDP growth
(%)



Argentina: inflation and exchange rate
(%, end of period)



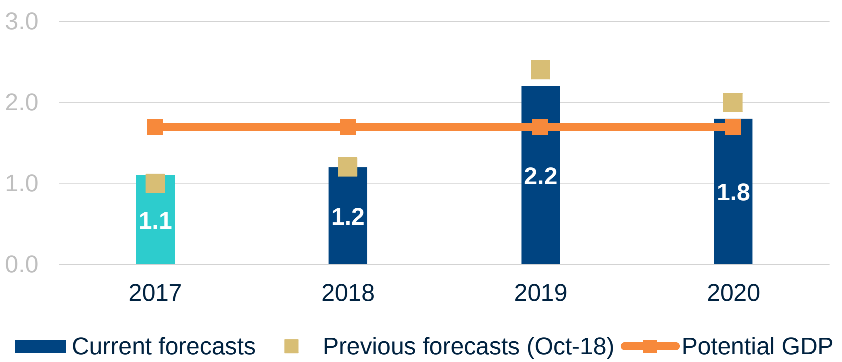
Source: BBVA Research

- More contractive fiscal and monetary policy in 2019
- Internal demand will be a drag on growth, it will be partly offset by external demand. We expect to see positive quarterly growth beginning in 1Q19
- Sharp depreciation shapes high inflation. Some FX and inflation has already been achieved. Disinflationary path is expected next year
- Financial needs for 2019 are covered; primary fiscal equilibrium should underpin debt sustainability
- Local risks: political uncertainty on elections next year; protracted scarcity of capital flows preventing the return to global capital markets in 2020

Brazil: we maintain our view on domestic issues, but revise growth slightly down on a less supportive global environment

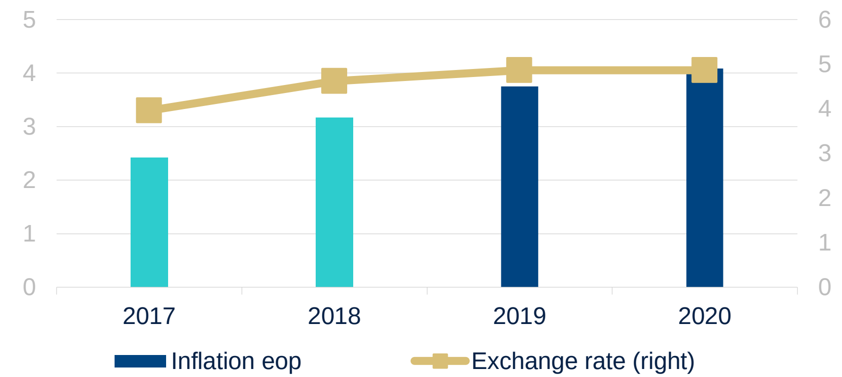
Brazil: GDP and potential GDP growth

(%)



Brazil: inflation and exchange rate

(%, end of period)

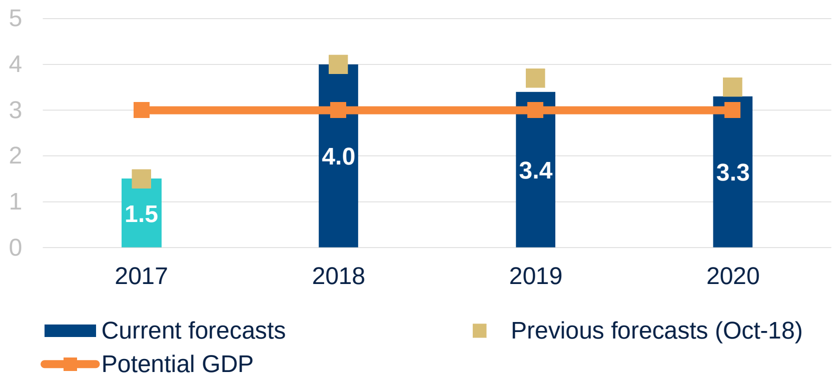


Source: BBVA Research

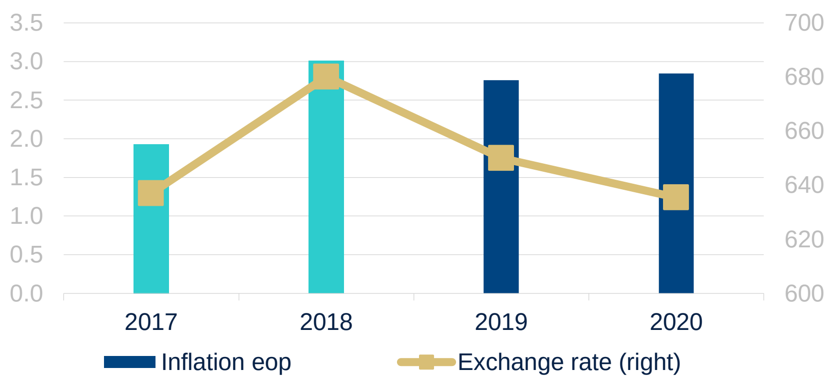
- Recent data support the outlook for a gradual recovery in growth, in line with expectations, but a less favorable global environment will result in lower growth ahead.
- Preliminary economic announcements by the new government are positive, but doubts remain about the ability to implement major reforms, including social security.
- Local risks: failure to pass social security reform and lack of significant fiscal adjustment

Chile: downward revision in GDP forecasts due to lower-than-anticipated incoming data and less buoyant external demand

Chile: GDP and potential GDP growth
(%)



Chile: inflation and exchange rate
(%, end of period)

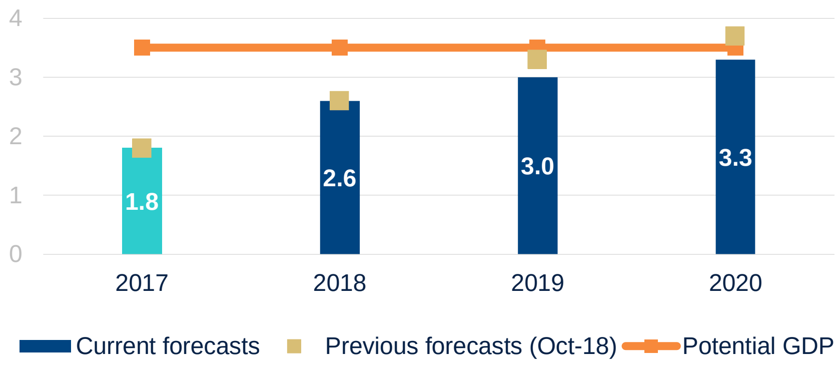


Source: BBVA Research

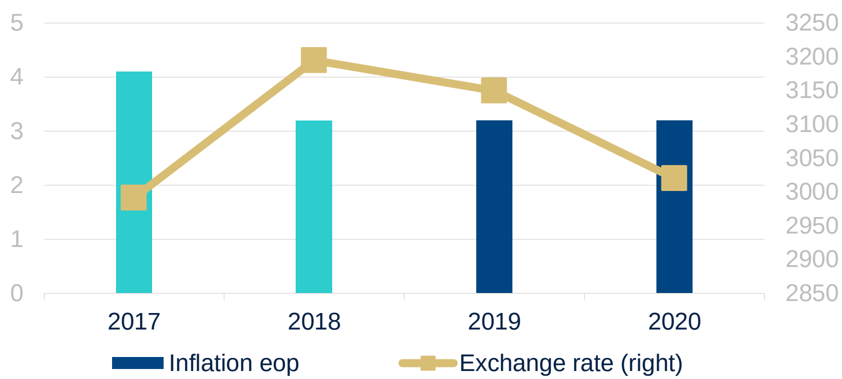
- Both downward surprises in the mining and manufacturing sectors at Q3 and a less supportive global environment determine a downward revision in 2019 and 2020 growth estimates
- Main drivers of growth will be public and private investment, and private consumption
- The expected expansion in investment will be mainly due to mining projects while consumption growth is in line with upward-revised wage mass figures
- Local risks: better performance of investment; private consumption ends up being weaker than expected

Colombia: downward GDP growth forecast revision explained by lower investment and exports

Colombia: GDP and potential GDP growth
(%)



Colombia: inflation and exchange rate
(%, end of period)



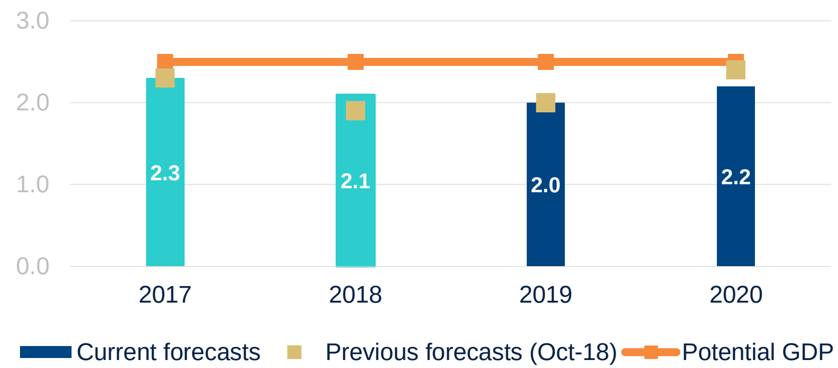
Source: BBVA Research

- Investment will recover more slowly due to lower oil prices, lower investment in exporting industries and the concentration of buildings in housing with lower added value
- With respect to 2018 domestic demand will continue to lead the expansion, but now with a greater contribution from investment and private consumption, and a lower dynamism of public consumption
- Current account deficit widens in 2019 because of lower oil prices and higher imports.
- FDI flows will need to be complemented by other sources to finance this level of deficit
- Local risks: compliance with the fiscal rule lower effect of tax incentives on investment

Mexico: 2019 GDP forecast unchanged; moderate downward revision to GDP from 2020 onwards based on less optimistic US outlook

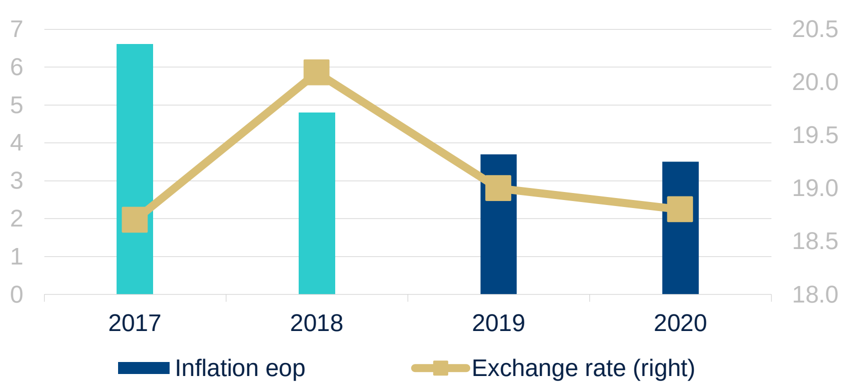
Mexico: GDP and potential GDP growth

(%)



Mexico: inflation and exchange rate

(%, end of period)



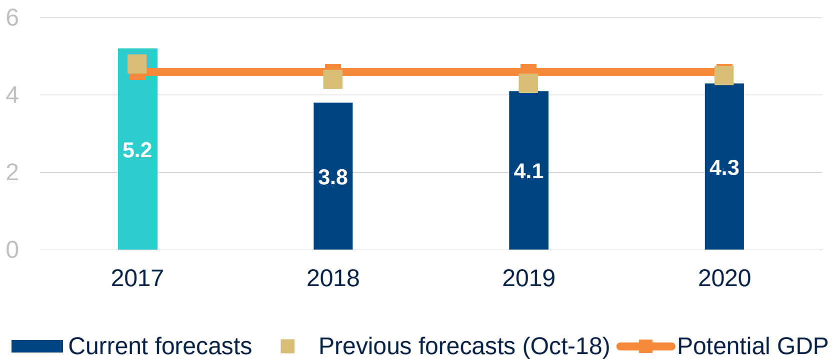
Source: BBVA Research

- Strong exports but a tad less than in 2018, partially offset by somewhat stronger internal demand
- Lower inflation as supply shocks fade and core inflation declines somewhat
- Restrictive monetary policy stance but start of an easing cycle in late 2019 on lower inflation and risks; more stable MXN
- Stable public debt as % of GDP; 2.0% of GDP CA deficit, no financing problems
- Local risks: concerns for the PEMEX business model and the probability that fiscal objectives are not met may trigger a perception of a possible deterioration in the fiscal position

Paraguay: still among fastest growing economies in the region, in spite of some downward revision of GDP growth forecasts

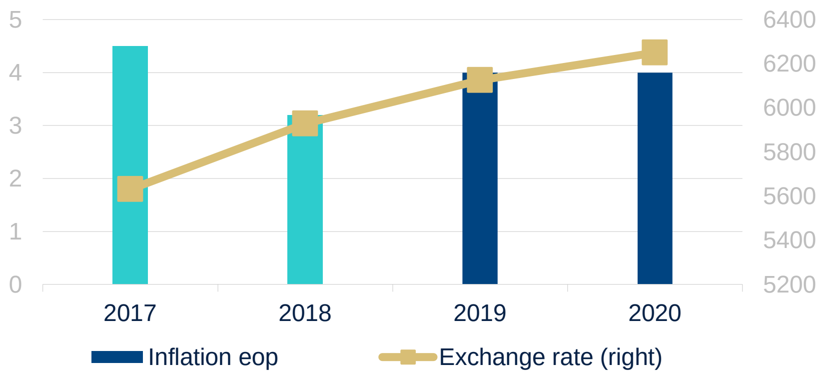
Paraguay: GDP and potential GDP growth

(%)



Paraguay: inflation and exchange rate

(%, end of period)

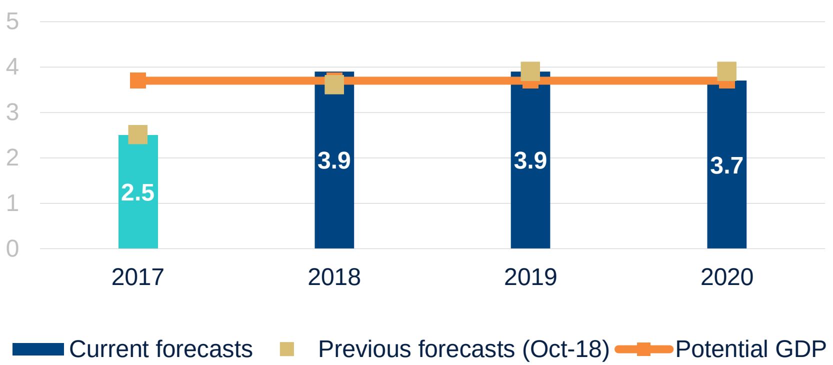


Source: BBVA Research

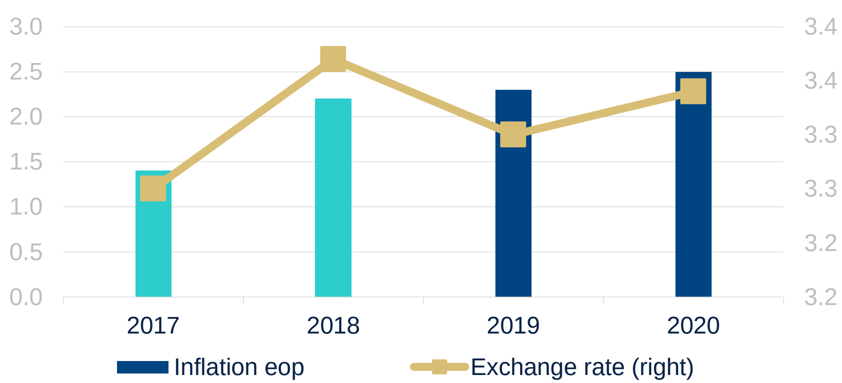
- During Q4, economic activity would have recovered some dynamism as a result of the better performance of some services. With this, the Paraguayan economy would have registered an expansion close to 3.8% year-on-year in 2018
- In the coming years, GDP will grow at a rate of between 4.0% and 4.5%, stimulated mainly by domestic demand and, in particular, investment
- GDP forecasts have been revised downwards, due to a less favorable external environment, including worse growth prospects for Argentina and Brazil
- Local risks: additional delay in infrastructure construction

Peru: economy will maintain a solid economic growth due to a strong investment performance

Peru: GDP and potential GDP growth
(%)



Peru: inflation and exchange rate
(%, end of period)

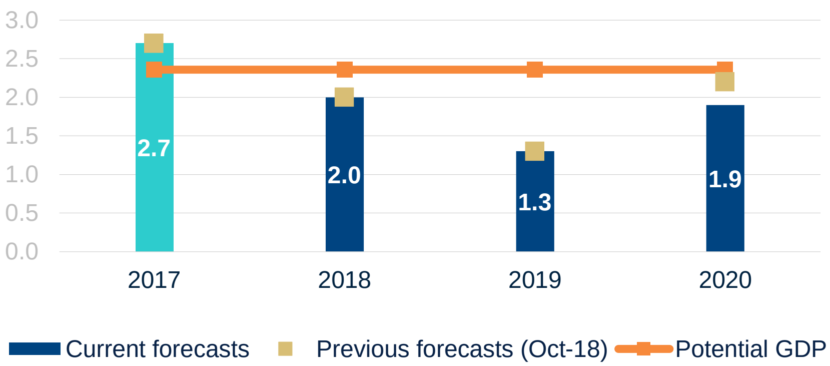


Source: BBVA Research

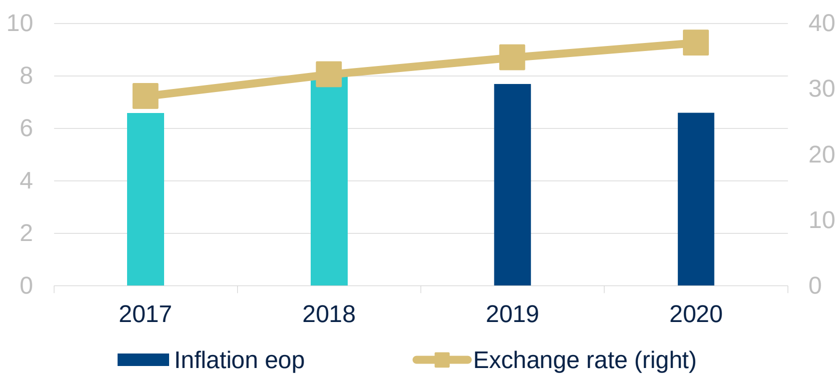
- Estimated rebound of economic growth in 4Q18 on the back of both private and public demand
- As a result, GDP would have accelerated in 2018 as a whole due to a natural post-El Niño rebound but also to the improvement of both private and public investment
- We expect output to grow in 2019 once again above potential. The main driver would be new mining investment, offsetting weaker external tailwinds and a less supportive monetary and especially fiscal policies
- Local risks: eventual delays in the construction of public infrastructure and an El Niño weather phenomenon of moderate or greater intensity need to be watched

Uruguay: we maintain our 1.3% growth forecast for 2019 and adjust our 2020 figure down to 1.9%

Uruguay: GDP and potential GDP growth (%)



Uruguay: inflation and exchange rate (%, end of period)



Source: BBVA Research

- We maintain our forecast of GDP for 2019 which implies deceleration in private consumption and a negative contribution of external demand (tourism)
- Due to global factors and higher uncertainty about the date of beginning of construction of the third pulp mill we revise our 2020 GDP forecast down by 0.3 pp
- Fiscal consolidation will take longer than expected.
- Local risks: low and related to the Oct-19 presidential election

04

Latin America: forecast tables

Forecasts: GDP, inflation, exchange and interest rates

	GDP (% yoy)					Inflation (% yoy. eop)				
	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
Argentina	-1.8	2.9	-2.4	-1.0	2.5	39.3	24.8	47.6	30.0	17.6
Brazil	-3.3	1.1	1.2	2.2	1.8	6.3	2.9	3.8	4.5	4.9
Chile	1.3	1.5	4.0	3.4	3.3	2.8	1.9	3.0	2.8	2.8
Colombia	2.0	1.8	2.6	3.0	3.3	5.7	4.1	3.2	3.2	3.2
Mexico	2.7	2.3	2.1	2.0	2.2	3.2	6.6	4.8	3.7	3.5
Paraguay	4.3	5.2	3.8	4.1	4.3	3.9	4.5	3.2	4.0	4.0
Peru	4.0	2.5	3.9	3.9	3.7	3.3	1.4	2.2	2.3	2.5
Uruguay	1.7	2.7	2.0	1.3	1.9	8.2	6.3	8.0	7.4	6.7

	Exchange rate (vs. USD. eop)					Interest rate (%. eop)				
	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
Argentina	15.8	17.7	37.9	49.0	55.0	24.80	28.80	59.30	35.00	20.00
Brasil	3.35	3.30	3.85	4.05	4.05	13.75	7.00	6.50	8.00	9.00
Chile	667	637	680	650	635	3.50	2.50	2.75	3.50	4.00
Colombia	3010	2991	3195	3150	3020	7.50	4.75	4.25	4.75	5.00
México	20.7	18.7	20.1	19.0	18.8	5.75	7.25	8.25	8.00	7.00
Paraguay	5787	5631	5928	6125	6250	5.50	5.25	5.25	5.50	5.50
Perú	3.40	3.25	3.37	3.30	3.34	4.37	3.26	2.75	3.25	3.50
Uruguay	28.8	28.9	32.2	34.8	37.1	**	**	**	**	**

** Monetary Policy in both Argentina and Uruguay is carried out according to monetary aggregates and not using a reference interest rate.
Source: BBVA Research

Forecasts: fiscal balance, current account and commodities

	Current Account (% of GDP)					Fiscal Balance (% of GDP)				
	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
Argentina	-2.7	-4.9	-5.2	-3.3	-2.3	-5.8	-6.0	-5.6	-3.3	-2.3
Brazil	-1.3	-0.3	-0.3	-0.8	-1.5	-9.0	-7.8	-5.6	-5.3	-6.4
Chile	-1.4	-1.5	-2.2	-2.6	-1.5	-2.7	-2.8	-1.7	-1.3	-1.3
Colombia	-4.3	-3.3	-3.5	-4.1	-3.8	-4.0	-3.6	-3.1	-2.4	-2.2
Mexico	-2.2	-1.6	-2.0	-2.0	-1.9	-2.5	-1.1	-2.0	-2.0	-2.0
Paraguay	3.5	3.1	0.3	1.2	1.8	-1.1	-1.1	-1.3	-1.5	-1.5
Peru	-2.7	-1.1	-2.2	-2.2	-2.2	-2.5	-3.1	-2.7	-2.3	-2.2
Uruguay	0.6	0.7	-0.5	-2.3	-2.2	-3.8	-3.5	-2.9	-3.1	-2.5

	Commodities (yearly average)				
	2016	2017	2018	2019	2020
Brent Crude (USD$ /Barrel)	44.75	54.43	71.95	63.15	55.75
Soybeans (USD$/ton)	362.88	358.75	342.50	340.50	350.50
Copper (USD$/lb)	2.20	2.80	2.96	2.81	2.72

Source: BBVA Research