

## Brazil

- The performance of the Brazilian real (BRL) in 2018 is likely to be dictated by external factors, and internal politics. The key political element to monitor is whether enough reforms will be approved to stabilize the country's rapidly deteriorating fiscal position.
- In terms of specific events, pension bill approval is likely the key event, but not the only one. Lula's appeal process will be relevant to the likelihood of a pro-establishment president keeping power in 2019. Public asset privatizations are another factor facing hurdles—and a relevant one to meeting fiscal targets. In addition, a newly emerging risk is whether restrictions on public borrowing to finance current spending will be relaxed. If the restrictions to public borrowing for non-investment spending are unwound, it is likely to be seen as a sign that the 2018 fiscal targets will be missed. This would pressure BRL.
- Consistent with this fiscally focused outlook for the BRL, S&P is reported to have said on January 4<sup>th</sup> that it might take negative action on the country's credit ratings before the expected pension bill vote in mid-February. All this translates into relatively front-loaded negative risks for Brazil in 2018.
- There is still a window to avoid this negative spiral from becoming reality, by securing enough reform progress before electoral campaigns hijack legislator agendas, but this window is rapidly closing, and we expect it to shut by April–May.

This looks to be a volatile year for BRL, with politics likely to remain the top driver for the real through the year. At the heart of the political risk, is the government's capacity to reverse the country's rapid fiscal deterioration—as well as its negative credit ratings trajectory. Achieving this is highly dependent on the President's ability to gain legislative support for reforms. One of the "bad news" items we've recently received, came on January 4<sup>th</sup>, when S&Ps said it might take credit rating actions on the country even before the anticipated vote on the pension bill in mid-February. This seemed to fly in the face of local consensus that rating agencies would wait for the outcome of the October elections before making credit ratings changes. Among the heavy pipeline of major events to follow, it is important to focus on:

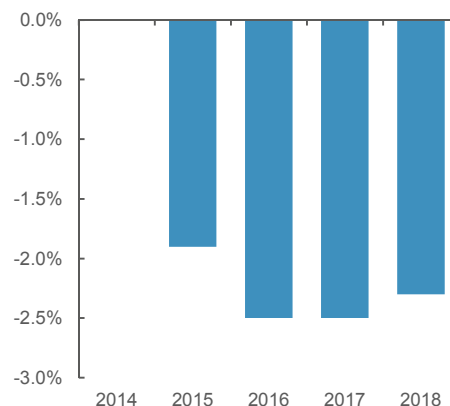
- The court ruling on former President Lula's appeals, which should affect who the players will be in the October Presidential Election. At the moment, Lula continues to lead all other contenders in the polls, but it will be important to watch whether courts allow him to contend for the presidency. The first ruling is expected to come in the final week of this month and, based on comments from local political analysts, it seems like the whole process could be finished by May 2018. At the moment, the contenders that make markets most uneasy seem to be Lula, or whoever represents the PT, and anti-establishment candidate Jair Bolsonaro.

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Chart 1

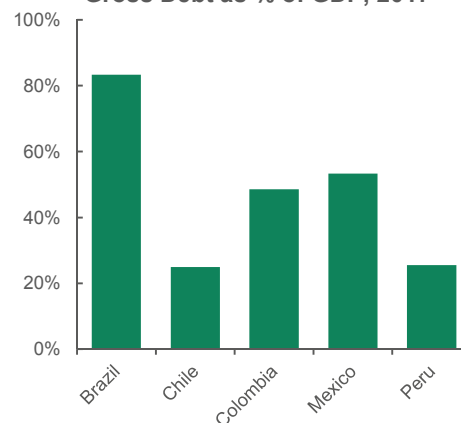
Brazil - Primary Balance (% of GDP)



Sources: Scotiabank Economics, IMF.

Chart 2

Gross Debt as % of GDP, 2017



Sources: Scotiabank Economics, IMF.

- There is also rising uncertainty over whether the so-called “Golden Rule” will be amended, relaxing restrictions on the ability of different levels of government to borrow not only to finance investment (as the rule currently states), but also to fund current spending. Based on comments by key legislators, it seems like a relaxation of these restrictions is a rising probability—which should be seen as a symptom of the unlikelihood that the annual fiscal goals will be achieved.
- Pension reform approval: The past year has been a roller-coaster for pension reform approval expectations. What was initially seen as a likely positive event, now seems increasingly unlikely to materialize before the Presidential elections. There remains some hope that the reform could clear the lower house mid-February and later proceed to the upper house, but the vote math looks tough. The last tally we saw from local media set the pro-reform votes about 50 short of the necessary 308 votes, and the more the negotiation process drags on, the more complex it will become to pass the unpopular bill. Hence, we think the window is rapidly closing—and there is increasing talk that without pension reform, ratings cuts again become a major risk for Brazil.
- Privatizations: One of the previously expected positives for both public finances and BRL (a large part of the acquisitions were expected to be by foreigners), was the government’s fairly ambitious privatization plans (here [is the Federal Government’s list](#)). Our take is that a large share of market players were fairly constructive on the results. However, recent media reports suggest that Legislative support for the privatization agenda is wavering, including that for a stake sale in Eletrobras. According to Government Affairs Minister Marin, legislators will not even discuss the potential privatization until after the pension bill is voted on, which suggests the window for this asset sale may also be shutting for 2018.

Overall, we see the BRL risks for the year as fairly front-loaded, but the second half of the year includes the October Presidential elections, which are also highly relevant—particularly if, as current polls suggest, the front runners are Lula and Bolsonaro—over whom markets seem somewhat uneasy.

## Mexico

### STRONGER GROWTH IN 2018, BUT MANY RISKS

- Mexico is facing a challenging year on the economic and political fronts. The range of possible outcomes is very wide, due to the conjunction of several factors that could tip the balance either way. Our base scenario is still a gradual improvement in the pace of growth. However, the heightened uncertainty will likely be a heavier burden for the economy, so we are moderately adjusting our growth forecast.**

The road ahead for the Mexican economy is somewhat foggy. A number of factors of great relevance could influence the course of the economy, either positively or negatively. These include the NAFTA renegotiations, the potential impact of US tax reform, normalization of monetary policy in the US, inflation dynamics in Mexico, the evolution of the situation in North Korea and, of course, Mexican elections. As a result and now as a habit, there is a high level of uncertainty surrounding the macroeconomic forecasts for the year.

Our base case scenario remains a modest improvement in the pace of growth in 2018, but from a lower starting point in 2017, reflecting historical revisions to the national accounts. The latest data presents mixed signals. On one hand, exports are booming due to the recovery in oil prices and strong US auto sales. Export-related manufacturing industries are also booming, employment numbers continue to show strong job creation coupled with low unemployment rates, private consumption remain relatively strong, and banking credit keeps growing at healthy rates. On the other hand, retail sales are faltering while domestic auto sales are falling, construction is now contracting while mining keeps falling sharply and investment remains severely affected. It seems that households and firms are doing well but are not immune to the many unknowns that the outlook presents, so we anticipate cautious behaviour during 2018.

Under these circumstances, we are reducing our GDP growth forecast for 2017 to 2.1% from 2.4% in the previous *Global Outlook*, and for 2018, to 2.4% from 2.7%. By sectors, the industrial production is expected to grow 1.9% in 2018, mining will fall 2.4% and construction should expand by 1.7%. Manufacturing activity will remain healthy, rising by 3.4%.

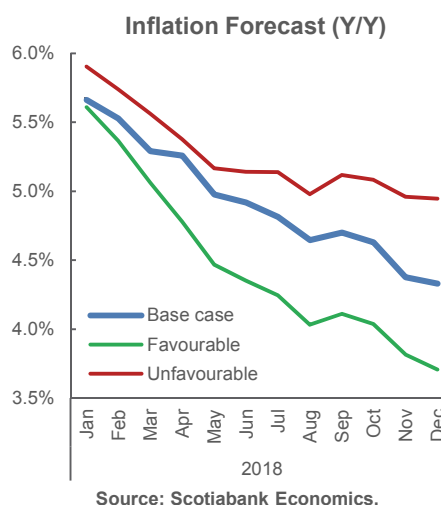
We forecast that private consumption will improve marginally as households have already absorbed the shocks of 2017, such as the higher inflation, interest rates and the natural disasters of September. As is usual in election years, some consumption-inducing spending is anticipated. Investment is expected to recover, although at a modest rate, as public sector capital spending stops falling, and firms digest the adjustments of 2017 and look again towards the positive medium and long term perspectives.

On the monetary policy front, the reference rate is expected to increase another 25 basis in the last quarter of the year, ending at 7.75%. This additional increase is required to keep pace with the Federal Reserve. Also relevant to this view are inflationary pressures that will likely continue through the year: even though we

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Chart 1



are anticipating a rapid descent on the year/year inflation rate, we think inflation will remain above the 4% threshold with upside risks to that view. In the chart, we present the base scenario for the general inflation along with alternatives built on arbitrary assumptions: a favourable scenario in which each month's inflation is the average of the last 7 years less 10% of standard deviation of this period; and an unfavourable scenario in which each month's inflation is the average of the mentioned period plus 40% of the standard deviation recorded. As can be seen, even in the favourable scenario, y/y inflation remains above the 4% threshold most of the year, and in the unfavourable scenario, y/y inflation remains stubbornly close to the 5% threshold. This exercise tells us that inflation will remain as a significant concern for Banco de Mexico most of the year.

The FX forecasts remain basically the same, with the Mexican peso (MXN) ending close to 19.48 per USD, but it should be noted that a high volatility in the currency is expected, reflecting the unusually high uncertainty levels around the economic environment. In this scenario, the MXN could temporarily fall below the 18.0 mark if markets price in a positive outcome of the NAFTA negotiations while disappointing progress on the negotiations could easily see the MXN go beyond 21. Another relevant driver for the MXN will be the expected outcome of the presidential election, adding pressure if a negative outcome is perceived and releasing tension if a positive outcome is anticipated.

There are many different possible outcomes for the Mexican economy in 2018. On the pessimistic side there could be a "perfect storm" if an unfortunate combination of factors occurs, such as a termination of NAFTA and the electoral process in Mexico becomes sour while domestic inflation rises. On the other hand, a more positive outcome would occur if tensions on the NAFTA renegotiation process are eased by a more constructive stance from the US Government, the US tax reform has a positive effect on US economic growth and this favours Mexican exports, inflation in Mexico descends rapidly, the electoral process runs smoothly and a positive outcome is anticipated. We should not forget that the structural reforms achieved should produce a positive additional impulse for the economy as time passes.

## Colombia

- **With growth improving, and inflation abating, market focus is likely to be on the fiscal story, and the upcoming Presidential elections. We think the former will be the more relevant market driver of the two.**
- **Strengthening oil markets should help the Colombian peso (COP), and may also to some extent bail out the government on the fiscal pressures it is facing, but we don't think the government is exactly erring on the side of caution on the fiscal side.**
- **We don't see local markets as particularly cheap, which presents the risk that investors may decide to pull out to position investments elsewhere. Foreign holdings of TES (local government nominal securities) have increased from around 20% to near 30%, and there is some risk we could see repositioning if the risks facing countries in the region, such as Brazil or Mexico, moderate somewhat.**

With growth expected to post a moderate upswing this year, and inflation dropping over the past couple of months (and expected to continue to do so), market focus in 2018 is likely to be on the fiscal story, and the elections. On the fiscal side, we think it still looks unjustified to view the country's investment grade ratings as "at risk", and hence any downgrades by Moody's or Fitch, should be only "catch-ups" to S&P's December cut. However, there are a couple of things we are concerned about related to the fiscal story:

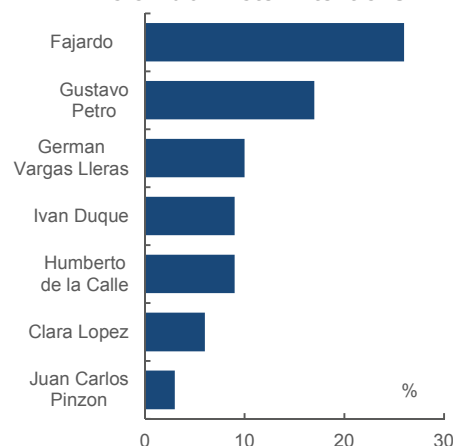
- One of the anchors for Colombia's fiscal position is the fiscal rule ([an overview of Colombia's fiscal rule can be found here](#)). One of its weaknesses is the lack of clear formal enforcement procedures for both spending and the budget balance (in LATAM, Brazil, Peru and Mexico's rules do have formal enforcement mechanisms, while Chile and Colombia don't). In addition, there have recently been questions (in our view justified) on whether the assumptions being made about macro variables to project fiscal performance going forward are realistic. The main points centre on whether Colombia can grow as fast as its fiscal rule assumptions suggest (the pace of growth is projected at over 4% for the forecast horizon). We are skeptical that Colombia's growth potential is as high, we think it's closer to 3%, rather than in the 4.0% to 4.5% range as the government projects. Hence, results may be worse than projected debt trajectories suggest.
- The second issue is related to the government's response to the latest credit rating downgrade (by S&P to "BBB-"). Although the rating's outlook was shifted to "stable" (good news, and justified as we don't think Colombia currently deserves junk status), it was also worth bearing in mind they now sit on the verge of the "junk ratings cliff". Hence, the government's response which suggested they are comfortable with the status quo (i.e., stable ratings), rather than announcing a plan to set public finances on an improving trend is concerning, as the country now has little room to handle potential shocks (an unexpected one could tip the country into junk territory and could

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Chart 1

Colombian Voter Intentions



Sources: Centro Nacional de Consultoría (CNC).

trigger some outflows from the local markets, as some investors could face mandate restrictions due to credit ratings). If a drop to junk becomes a risk, COP would likely suffer a strong shock.

On the election front, we think news will be better. Recent polls have put Sergio Fajardo, Gustavo Petro, and German Vargas Llera as the leaders in voter intentions. Of the three, Petro is the one markets seem most uneasy about. However, we expect that as the pro-establishment candidate list narrows (likely to Fajardo, and someone representing the Santos and Uribe camps), we will likely see the race narrow to one between 3 market favourable players. Hence, we think election risk is not as strong as fiscal risk—but it's worth noting that, around the globe, polls have missed the mark substantially in the past couple of years.

We have not altered our calls for COP's direction, but highlight that there is quite a binary path for the Colombian peso:

- If, as we expect, a “market friendly” candidate is the victor in this summer's election, and the positive appetite for investing in emerging markets (EM) remains in place, alongside strong oil prices (our house call has oil prices in the US\$52/bl–US\$56/bl range), COP should remain supported, and we could see a move towards the 2,700 / USD area.
- However, if oil prices dip further than we anticipate, an unexpected shock puts ratings at risk of “junk status”, or appetite for EM does not remain as strong as we expect it to, then we could see USDCOP move higher than the 3,000–3,100 range we anticipate—potentially to the 3,500 area.

## Peru

### THE DIVERGENT IMPACT OF POLITICS AND TERMS OF TRADE

- In 2018 politics remains a concern, but should be compensated by higher metals prices and healthy economic fundamentals.
- We have adjusted our Central Bank call from one rate cut to two during 2018, in reaction to low inflation.

Politics trumped Economics in Peru in 2017. However, now that the political dust has settled a bit, the future does not look quite as bad as it seemed last month when Congress was seeking to impeach President Kuczynski (PPK), and the presidential pardon awarded Alberto Fujimori sparked a wave of protests.

The impeachment motion was defeated and protests have subsided... so far. Although political noise will not go away in 2018, it may become manageable enough to have less of an impact on the economy. Uncertainties abound on this count. Future political conduct and performance will depend on how the parties restructure internally, and realign with each other and with the government. Lava Jato investigations will continue, potentially affecting both PPK and the opposition.

Although the political divide is so wide that it is difficult to conceive a smooth political path going forward, with metal prices rising and healthy macro balances, the impact on the economy is likely to be much more benign than otherwise. Growth figures in the latter half of 2017 were improving before the period of greatest political turmoil, but there is likely to have been a degree of pause in both public sector and private sector investment since December.

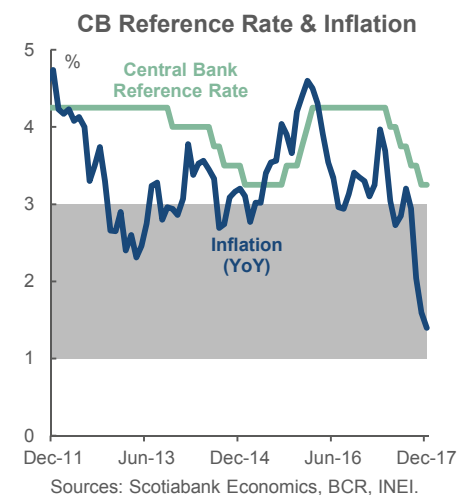
We shall be reviewing our 2018 GDP forecasts once we have a clearer view on how quickly the government is able to put public sector investment back on track. Note, however, that whereas before we saw upside to our 3.7% GDP growth forecast, we now see mild downside. Government spending, in particular, may come in somewhat below our 15.4% estimate. Smaller or less sophisticated investment in reconstruction should continue—such as housing and river bed reinforcement—but large projects are likely to be delayed to some extent. Spending on the Pan-American games and annual budgetary investment should proceed as normal, though.

We've become more bullish on Central Bank policy, due to low inflation, which closed 2017 at 1.4%. The downtrend is strong, and we agree with the CB in expecting inflation to dip below the 1% floor of its target range in early 2018. The combination of low inflation and countering the impact of political turmoil on growth justifies more than one decrease in rates, and we are adjusting our expectations from one rate cut in the year, to two rate cuts, to 2.75%. After dipping early on, inflation should rebound rather quickly, although not significantly. We have lowered our full-year forecast to 2.0%, from 2.8%.

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Chart 1



As for the FX market, political uncertainty does not change the reality of improving terms of trade. Nor does it endanger the country's debt profile. Short-term knee-jerk reactions to political events are likely to continue, with an impact on the FX and the soberano curve, but it's hard to envision a political/economic scenario so dire as to lead to a persistent hemorrhage of financial capital from local markets over a longer term.

Growth in 2019 will depend, in part, on what happens in 2018, but better terms of trade and continued public investment should bolster GDP growth to 4.2%. We are hopeful that political turmoil will ebb, but note that it probably has already had some impact on longer-term growth.



## Chile

### A MODERATE RECOVERY SEEMS MORE LIKELY DAY-BY-DAY

- Two factors will be critical for the Chilean economy in the current year: the copper price trend and the new government's ability to work with the opposition to pass reforms that would enhance investment. These two factors will also be the critical risks.
- Business confidence could improve much more if the new administration moves quickly on key reforms.
- The economy is basically balanced: low inflation trending up, a limited current account deficit, fiscal conditions worsening but still manageable, and a solid financial sector.

### MACRO UPDATE: GOOD CONDITIONS ARE SUPPORTIVE FOR OPTIMISM

Much of the market is expecting a stronger performance in the last quarter of 2017, but we are keeping our annual growth forecast of around 1.4% for 2017. Our forecast for the current year remains at 2.8%, though the upward bias has strengthened significantly due to higher expectations for copper prices, a calmer international outlook and lower domestic political risks. Accordingly, the first half of the year will be critical for the Chilean economy and market forecasts could be revised more than usual, in both size and frequency.

A key variable to track will be the recovery of private expectations which is critical to domestic demand (consumption and, importantly, investment). Monetary and fiscal policies are expansionary, with ample spare capacity to meet demand. We have seen some signs of a recovery in confidence recently, but there are good reasons to expect that further improvement is forthcoming.

Inflation reached 2.3% in 2017, the lowest level since 2012. It is pretty consistent with an economy that has been growing below its potential rate for 4 years, characterized by a drive to efficiency in some sectors reinforced by the lagged impacts of high investments in recent years. For the current year we expect inflation will rise to 2.8%. The rebound in inflation is already underway, since inflation troughed in September. However, that uptrend will be critically linked to a tug of war between an exchange rate that might become weaker—which would impact prices of tradable goods—and the recovery of expectations and activity, whose major influence will be on non-tradable goods and services.

In that context, we continue to expect that the Central Bank will keep the Monetary Policy rate at 2.5% up to mid-year, though the bias could be modified before then. For the second half of the year we expect three hikes (25bp each) to end 2018 at 3.25%. That would be the start of a normalization policy that should continue into 2019. A moderate recovery of long-term rates should start even before that, as soon as the current quarter.

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Chart 1

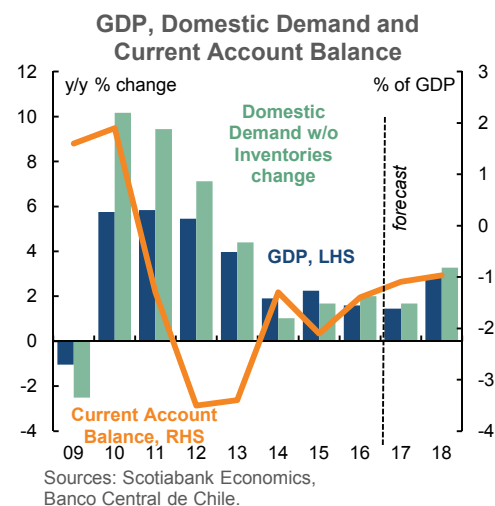
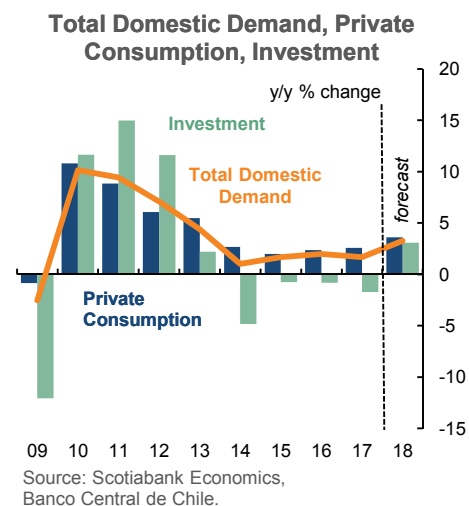


Chart 2



## POLITICAL PANORAMA: RISKY BUT PROMISING

The political panorama seems to be much clearer than before. Parliamentary elections did not result in an absolute majority in Senate or in Chamber of Deputies. However, the decisive win for Mr. Piñera, with the deeply divided and confused opposition, make Mr. Piñera's coalition of parties the strongest force in Parliament. Even so, they will have to strive to reach agreements with other forces to get required majorities. The task is huge and will require great political skills. On the positive side, it appears that Mr. Piñera favors almost everything that markets can dream of for the region: more room for private activity, more fiscal responsibility, more growth, etc., paired with experience and strong political and technical leadership.

The new President is aware of the importance of moving quickly to improve the economic situation (probably the main reason why he was so convincingly elected). In addition to the traditional one-year "honeymoon period" between the new President and the Chilean people, the runoff election result was so categorical that any attempt to hamper the new President's actions will likely be stifled by public opinion. Accordingly, the first months will be critical to begin fixing problems in the economic framework. Financial markets and decision makers in corporations will be tracking the performance of the new political team and the environment.

## MAIN RISKS ARE THE SAME

The main risks for our forecasts are the same issues that allow us to be optimistic. We expect a limited but sustained recovery in the price of copper which, if it is too fast, could cause some troubles with exchange rate and monetary policy. However, the opposite risk (if copper prices fall) would be much more harmful: growth would be lower with implications for the foreign and fiscal accounts. The forecasted trend to a potential growth between 3.5% and 4% in coming years would be considerably harder to reach.

Domestic risks have probably been overestimated, but they remain important. Some abilities of the new government were tested in the first administration of Mr. Piñera who governed Chile from 2010 to 2014, but one should expect some improvements. On the positive side, if political management were excellent and smoother than expected, opportunities for investment would be extraordinary and some variables like unemployment could react accordingly. But the flipside is that the opposition will not be naïve: the real term of a coalition government in Chile is likely not 4 years, but 3. Within that period, municipal elections will take place, which have proved to be a good predictor of the presidential and parliamentary elections the following year.

Chart 3

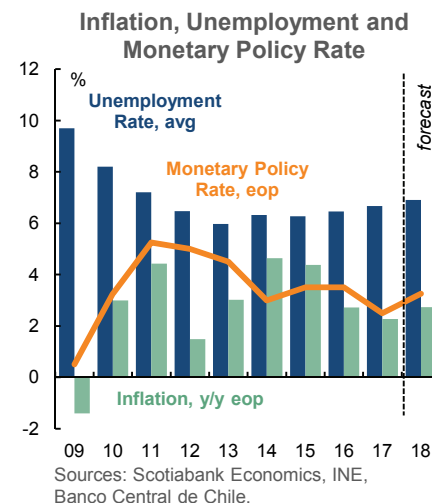
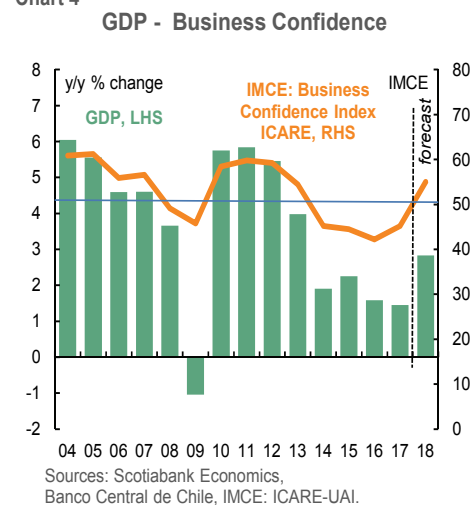


Chart 4



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