Brazil

IS THERE REALLY LIGHT AT THE END OF THE TUNNEL?

- **Brazilian markets have rallied strongly over the past 18 months, based on expectations of reforms materializing, and the view that the economy has touched bottom.**
- **However, the political outlook has become cloudier as the Lava-Jato spreads, and the 2018 presidential elections near, which has in turn added uncertainty on the economic front.**
- **If reforms fall through, confidence will suffer, the BRL could sell off, which could in turn derail the BCB's efforts to support growth through rate cuts.**

Markets in Brazil rallied strongly for over 1.5 years, but more recently volatility has returned, alongside a more pessimistic tone. So, is the light at the end of the tunnel the exit from the country's turmoil, or a fast-moving train on a collision course? Our take is that it may be both. After spending the past couple of years in the midst of the deepest recession in the country's history, during which the economy was contracting at a 4%–8% pace, some positive growth signs are starting to emerge. Recent data suggest the economy is starting to move back towards flat (Q1 GDP was -0.4% y/y, and +1.0% q/q). In addition, after seeing inflation peak at 10.8% in 2015, it is back under 4%, giving the Brazilian Central Bank (BCB) room to cut rates, in order to give the economy some support (the SELIC rate has been cut from 14.25% to 10.25% over the past year).

Although manufactured goods industrial production is today sitting at 2004 levels (see chart 2), it is encouragingly now moving sideways, rather than south. On the domestic demand side, the story is similar—although we still have some lingering concerns. Retail sales growth has finally turned positive (+1.9% y/y in April), after two years of negative prints. However, we remain somewhat concerned over household debt burdens, which could derail the recovery if confidence sours (triggered by potential worsening of political scandals or a reversal of rate cuts). As of the end of March (the latest data), Brazilian households were using 22.0% of their disposable income (i.e., after-tax income) to pay debt, which is lower than the 22.7% peak, but remains around the levels that we saw in both Spain and the US before the debt crisis.

On the external front, the news has also been reasonably good. After consistently posting current account surpluses in the 2003–2007 period, Brazil's current account swung into deficits in 2008. More concerning, the deficits widened to over 3% of GDP in 2012, and then stopped being fully funded by Foreign Direct Investment (FDI). The country's current account gap peaked in 2014 (-4.2% of GDP), and has since narrowed to a modest -1.3% of GDP—and is more than fully funded by FDI. As long as the growth rebound does not stall, and consumer confidence continues to improve, we expect the deficit to widen somewhat, but still within the 1%–2% of GDP range.

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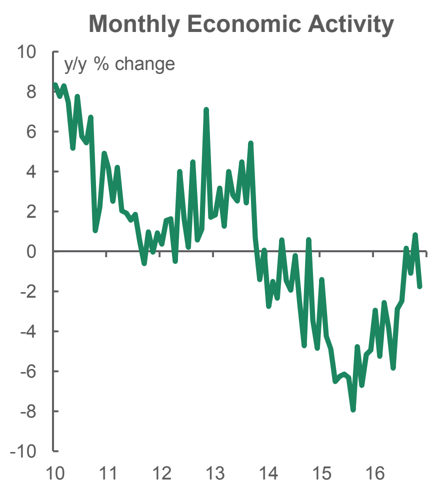
Chart 1



Sources: Scotiabank Economics, Bloomberg.

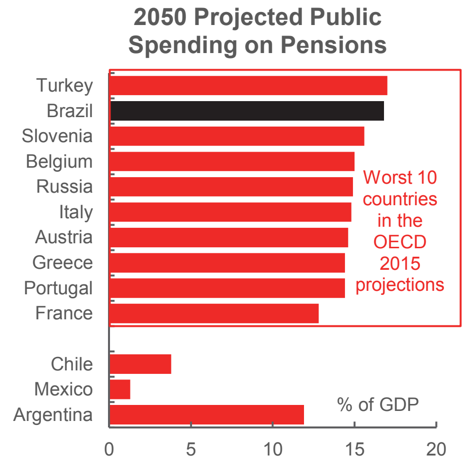
Chart 2

Sources: Scotiabank Economics, Bloomberg.

On the fiscal side, the Brazilian government has been making some progress in stabilizing public finances, cutting the public deficit from 10.2% of GDP in 2015, to an expected 9.1% in 2017—good, but not enough. In addition, gross public debt rose from 62% of GDP in 2008 to an expected 81% of GDP for 2017. Stabilizing the trajectory of public debt has proven a tough challenge, as spending rigidities, and a complicated political environment have combined to make the government's task quite difficult.

To help stabilize public finances, the government's efforts arguably have pension reform at their core. The recent pressure on Brazilian markets comes from the uncertainty over whether President Temer will be allowed to finish his term (following recent accusations and attempts to overturn the Presidential election), as well as whether the upswing in political uncertainty will derail the government's reform efforts. At the very least, it appears that reforms are likely to be delayed—risking overlapping with the presidential elections—which could ultimately derail them.

Chart 3



Sources: Scotiabank Economics, OECD projections.

Why is the Pension Reform so important? Brazil has one of the most challenging pension situations in the world, with annual pension payments forecast to top 15% of GDP on an annual basis by 2050 according to the OECD. We would argue Brazil's pension system is underfunded, and also, too generous. To put it in context, Brazilian men can currently retire at 56, and women at 53. If the reform is approved, the retirement age would be extended to 60 for women, and 65 for men. Even with those changes, the country's pensions would remain among the most generous in the OECD (chart 3). Under the current proposal, a man could retire at age 65—but receiving 96% of pre-retirement earnings!! In the average OECD country, a person can retire at age 65.5, receiving 53% of pre-retirement earnings. Recent polls suggest over 70% of voters disagree with the pension reform.

The current pension reform proposal is expected to save about US$190bn over the next 10 years, but its outlook is uncertain. If the pension bill falls through, there is a risk that investors' newfound confidence in Brazil will dissipate, sending the economy into a negative spiral as, among other factors, it could cause a sell-off in the BRL which could send inflation back higher, further pressuring consumers' already-stretched pockets by adding to their debt service burden—while simultaneously further complicating the fiscal situation.

Mexico

LESS GLOOM AND MORE INFLATION

- **The threat to NAFTA appears to have subsided, lifting the outlook for Mexico's economy and producing a significant upward revision in our growth forecast.**
- **Inflation has been accelerating more than expected and becoming a bigger risk, as the pass-through from the FX depreciation kicked in and fuel price increases affected some other prices.**
- **Monetary policy has been activated rapidly to anchor inflationary expectations, with a 125 basis point increase in the reference interest rate year to date.**
- **Fiscal policy has also been used to restore fiscal discipline.**
- **The political environment will be now dominated by the upcoming electoral process of 2018.**

The outlook for the Mexican economy has been changing significantly in the last quarter. Economic growth expectations are not as grim as at the beginning of the year; however, even though there are some positive signs in certain sectors, they remain lacklustre. It seems that the largest part of the uncertainty surrounding the future of the North American Free Trade Agreement (NAFTA) has been lifted, since the Trump administration refrained from terminating it and decided to start the renegotiation process. This process will take some time and is unlikely to be completed this year. There is, however, a clear incentive for the three countries involved to finalize it as soon as possible, and if an agreement is reached in the next 9 months or so, then it is likely that it will be something better than the current NAFTA.

Now that the threat to terminate NAFTA appears to have dissipated, a heavy burden has been lifted from the Mexican financial indicators. The FX rate has notably appreciated (18%) since the peak reached just before the inauguration day, reaching pre-Trump levels below 18.0 MXN/USD (chart 1).

One of the key assumptions of the previous macroeconomic scenario was that investment was going to be significantly affected by the heightened uncertainty. And there was indeed some very noticeable impact on the investment side, as can be seen in the Non Residential Investment for the first three months of the year (chart 2). Now, anecdotal information gathered in different regions suggests that investment plans are being resumed, and that the actual impact will not be as deep and prolonged as previously assumed.

Another negative consequence can be seen in the inflation rate that, after reaching some of the lowest levels on record a couple of years ago, is now being impacted by a couple of factors: a sharp increase in fuel prices at the beginning of the year (as part of the liberalization process) and the long postponed pass-through effect from the sharp depreciation of the MXN since 2014. Recent evolution of inflation is

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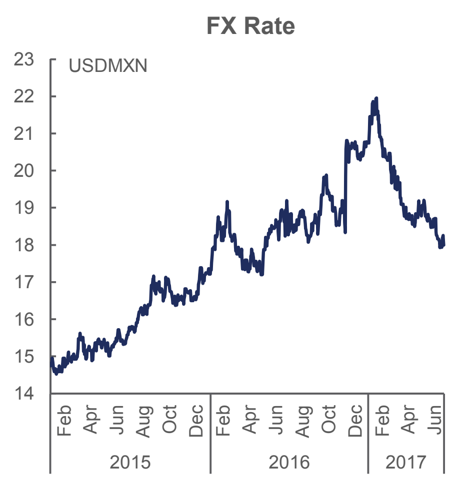
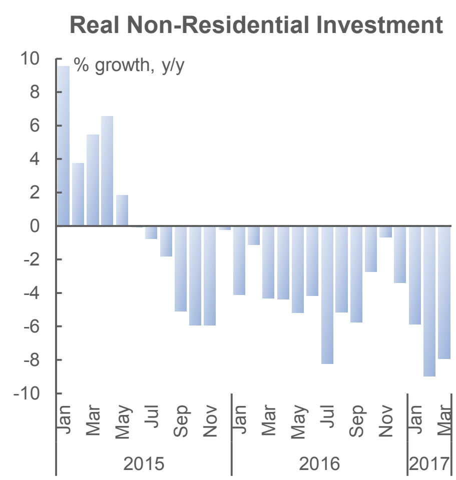
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



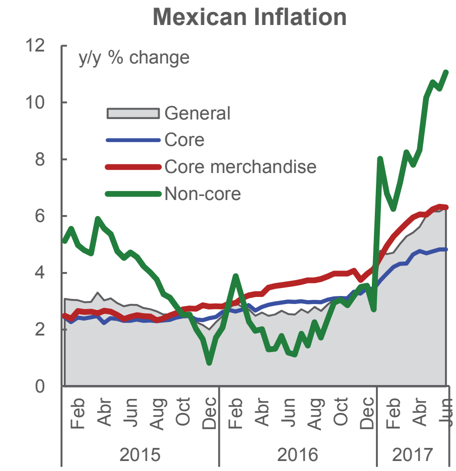
Sources: Scotiabank Economics, INEGI.

shown in chart 3. General inflation reached 6.3% y/y in the first half of June, the highest since 2009. Non-core inflation, which includes the more volatile components such as energy and agricultural prices, reached 11.07%, the highest since 2003! Core components reached 4.82%, well above the higher bound of the acceptable range for Banco de Mexico, and the merchandise part of the core inflation, which is clearly related to the FX, reached 6.31%. Even though this sharp increase in inflation is largely explained by transitory factors and should be absorbed rapidly during 2018, it poses a serious risk for inflationary dynamics. If second round effects appear, then medium- and long-term inflationary expectations could start increasing, and then inflation could easily remain stubbornly above the 4% level for longer than expected. Worth noting is that the number of components within the CPI rising above the 4% threshold is increasing, as can be seen in chart 4, and this represents a serious risk for inflationary expectations.

Monetary policy in Mexico has been reacting in response to this threat and to the changing conditions in global markets due to a more decisive Federal Reserve. The reference interest rate in Mexico has increased by 125 basis points year to date—a much faster pace than the one expected by the markets at the beginning of the year—reaching 7.0% in the last decision taken in June. Financial markets are now "thinking" that Banco de Mexico could be done with the rising cycle of interest rates, since one of the Board members voted to maintain the monetary stance at this meeting and the risk balance perceived by Banxico's Board is now neutral. Coming monetary policy actions will depend on inflation behaviour, and for the time being, we are still expecting one more 25 bp increase before the end of the year and one more in 2018, then stabilizing at 7.50% for many months.

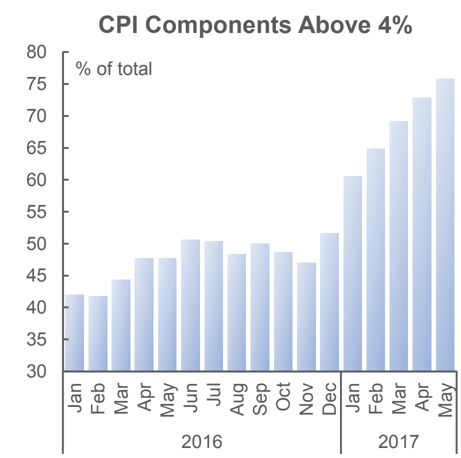
Another significant reaction on the economic policy front is that of the fiscal policy. In the pre-budget document presented to Congress, the government is now aiming at a primary surplus of 0.5% of GDP for 2017 and 1.0% of GDP in 2018, reaching the inflection point of public debt in the present year. This represents a more disciplined state of public finances. Coupled with the extraordinary operation surplus obtained by Banco de Mexico as its foreign reserves appreciated, which amounted to 1.5% of GDP, this significantly reduced the risk of a downgrade in public debt ratings. Moody's already confirmed the current ratings and maintained a negative outlook due to several risks that remain. The other big rating agencies are expected to confirm the current ratings this year.

Chart 3



Sources: Scotiabank Economics, INEGI.

Chart 4



Sources: Scotiabank Economics, INEGI.

Within this less negative framework, we are markedly revising our GDP forecasts upwards, to 2.0% from 1.4% for 2017 in the last *Global Outlook*, and to 2.5% from 2.1% for 2018. Worth noting is that both levels are below the potential and that uncertainty remains high. Another significant change can be found in our FX forecast, which has been reduced along with the recent appreciation of the MXN. We are currently expecting the MXN to end the year at 19.63, and 20.01 MXN/USD for the end of 2018. Both levels are well above the current level due to the less favourable conditions expected in global financial markets as the Fed continues the normalization process of its monetary policy, the noise produced by Brexit and some geo-political tensions, and the approaching electoral process of 2018.

A special note should be made about the political environment. The race for the 2018 presidential elections is now the main issue, with a lot of internal struggle within the political parties and with the electoral logic prevailing on most government decisions. The only clear candidate who will be a contender is Andrés Manuel López Obrador (AMLO), whose populist speech generates anxiety within the business community as the polls mark him as the current leader of the contest. Of course, that is at least partially explained by the fact that the other candidates are not yet defined. There are visible divisions within the main political parties in determining the right candidate who would have a good chance to win, and the remainder of the year will be heavily charged with politics. Since there is a good chance that AMLO could become the next President and he could try to implement market-unfriendly policies, such as taking back the energy reform, there could be some extra uncertainty affecting investments and preventing stronger growth.

Colombia

POLICY STIMULUS ACCELERATES, AS ECONOMY STALLS

- **Colombia's economy started the year flat-footed, with Q1 growth printing at a disappointing 1.1% y/y.**
- **With inflation rapidly converging to BanRep's target, the central bank is expected to continue easing policy to support growth.**
- **On the political front, even through May 2018 Presidential elections are likely to add some measure of uncertainty, near-term political clouds have cleared, as the spillover from the Lava-Jato scandals in Brazil seems to be contained in Colombia.**

The Colombian economy had a somewhat weaker-than-expected Q1, expanding at a meagre 1.1% y/y (the Colombia Central Bank, BanRep, had expected 1.3% y/y). Behind the weak print, was soft activity in mining, construction, and commercial activity (-9.4% y/y, -1.4% y/y, and -0.5% y/y, respectively). The latest industrial production print echoed the weakness we've seen in mining and construction, with the headline industrial production number for April coming in at -6.8% y/y. Industrial production has contracted in three of the four latest monthly releases, and it seems likely that the combination of steady, but lower, oil prices, alongside the shock to construction activity that the Lava-Jato presented is weighing on investment.

At the same time as output slows, we are seeing a softening in domestic demand, with retail sales recently going into somewhat of a nosedive (-2.0% y/y in April). The good news is that recent data on public spending seems more growth-supportive, while investment seems to have found a bottom (gross fixed capital formation was +0.1% y/y in Q1, after five quarters of contracting). On the flip side, exports continue to contract, posting their third quarterly decline (-3.6% y/y in Q1). The bottom line is that the economy remains weak, and our base case is that growth will print just under 2% for 2017 as a whole.

On a more positive note, as the economy slows, previously stubborn inflation is finally coming down, which is giving BanRep some room to cut interest rates in order to support the economy. After peaking at almost 9.0% in the summer of 2016, inflation is back at 4.4% (i.e., almost back within the target range). Consistent with rapidly falling inflation, and soft growth, BanRep's General Director, Juan Jose Echavarria, signaled his views are in line with the markets which look for 100bps of rate cuts over the next year. This dovish tone has been supported by at least two other members of BanRep's board—Ocampo and Cardenas. We agree with the view that the central bank will cut rates four times in the next 12 months (25bps each), and expect the cuts to be front-loaded, with our base case being that the overnight lending rate will be cut four times by year-end (to 5.25%), beginning with a cut on June 30th. Our take is that the main potential threat to the view of additional easing by BanRep is the Colombian peso (COP), which no longer looks clearly cheap (it's just over 1 standard deviation cheap), and could be vulnerable to a drop in oil prices. If the peso does weaken, it could tie the hands of the central bank, but that is not our base case.

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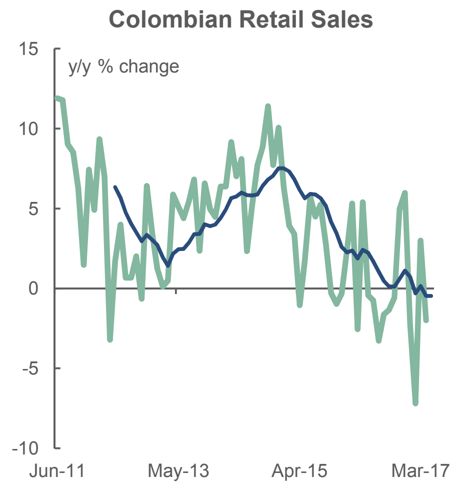

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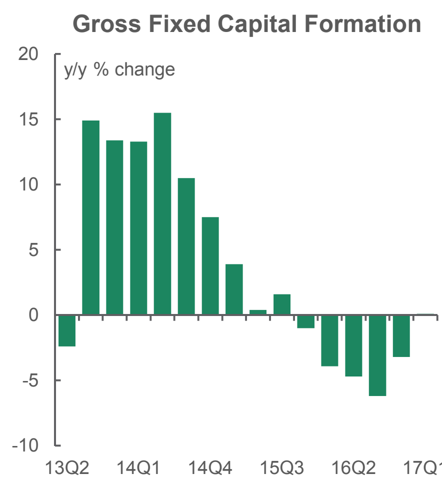
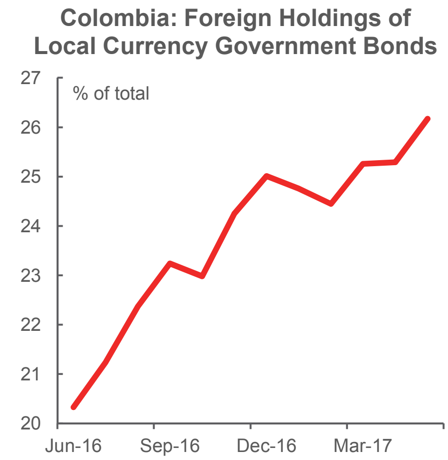
Chart 2



Sources: Scotiabank Economics, BanRep.

On the external front, the combination of slowing domestic demand, alongside a rebound in oil prices has helped compress the country's current account deficit, which now looks much healthier. After posting a very wide -6.4% of GDP deficit in 2015, we saw a narrowing of the deficit to -4.3% of GDP in 2016. Our main concern on the external accounts comes from capital flows. We have seen a very strong run for Colombian assets over the past 18 months, and TES local currency Colombian bonds are now trading 25bps –60bps tight to corresponding maturity m-bonos, which are both rated higher-rated and more liquid, and also have a larger "captive investor base" due to the m-bonos' inclusion in core market benchmarks. A potential issue is that if we were to have a shock that triggered a bout of risk aversion in global markets, Colombia could see outflows from local markets.

Chart 3



Sources: Scotiabank Economics, FinMin of Colombia.

On the political front, a potentially strong shock to the country's infrastructure building program seems to have been avoided, at least for now. In the initial stages of the Lava-Jato investigation in Colombia, it seemed that the Ruta del Sol II Highway project (one of the main infra projects in the country), could have been paralyzed for up to five years due to Lava-Jato related controversy. Thankfully, the risk of delays seems substantially less now, as the road appears to be in the process of being prepared for a new auction, without Odebrecht. This new turn could help restore confidence in infrastructure investment. In addition, initial reports that Lava-Jato could entangle President Santos, following allegations that Lava-Jato related money could have ended up financing his campaign, seem to have fallen through, reducing the risk that we could see the political scandal escalate into something more serious, as it did in Brazil and Peru. The next key date for the political calendar looks likely to be the 2018 presidential elections, which are scheduled for late May 2018.

Peru

AN ECONOMY DOMINATED BY POLITICS

- **Multiple shocks and politics have beset the economy.**
- **Future growth will hinge on public sector spending.**
- **No sign of an upturn in private investment (yet).**

Peru's economy has gone through three shocks in the last three quarters: 1) a contractionary fiscal policy at the end of 2016, the effects of which have lingered into this year, 2) the temporary but significant impact of the El Niño floods, and 3) the more prolonged effect of the Lava Jato events on infrastructure projects. This has all occurred during a period of extraordinary political tension between the government and opposition Congress which has brought three prominent cabinet members down since the Kuczynski regime began in July 2016.

So far, the markets seem fairly sanguine about political risks. However, within the country, economic concerns have taken a decidedly back seat to political issues. Although the political confrontation between Congress and the PPK administration supersedes Lava Jato, the noise created by Lava Jato has put all large infrastructure projects under political scrutiny. Two cabinet members: the Minister of Transportation, Martin Vizcarra, and the Minister of Finance, Alfredo Thorne, were pressured into resigning due to the political controversy surrounding the Chinchero (Cusco) airport project, even though the project is not linked to Lava Jato. Thorne was replaced as Finance Minister by the head of the cabinet, Fernando Zavala, who will have a dual responsibility. This may only be a temporary arrangement, even though Zavala has suggested otherwise. There is some likelihood that the government will change a number of cabinet members, probably around the end of July when President Kuczyinski is due to give the presidential yearly address to the nation. However, the key issue for the government is not economic policy but politics. Namely, will the cabinet be able to establish a working relationship with Congress, reform the convoluted institutional framework, and effectively advance a much needed infrastructure investment program.

To complicate the political scene further, the decision regarding the release of ex-president Alberto Fujimori—a defining element in the relationship between the PPK regime and Congress—has again come to the forefront. Recent statements by spokespeople in both the government and Congress do not bode well.

Three shocks amidst political turbulence is a lot for an economy to endure. The immediate result is that GDP growth has been a paltry 1.6% y/y in the year-to-April. We expect a natural post-Niño rebound henceforth, however, the strength of the rebound will depend largely on government spending, which has been disappointing so far. Central Government investment has fallen over 20% in the year to May, despite resources and initial plans for a sharp increase. El Niño disruptions may be partially to blame, as well as political distractions, but difficulty in getting the government institutional spending apparatus to perform adequately

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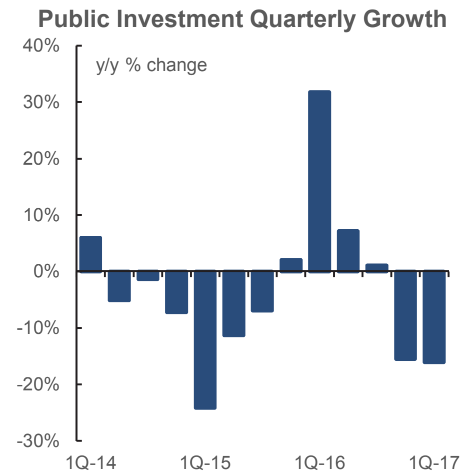
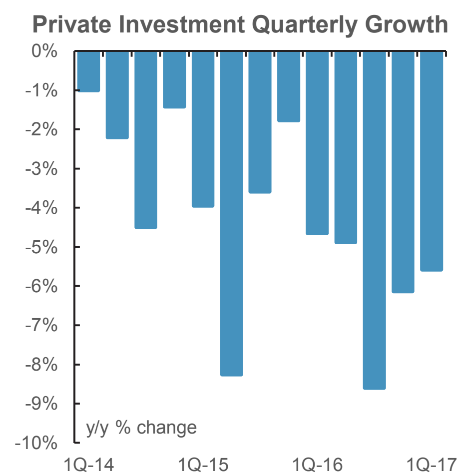
Chart 1



Sources: Scotiabank Economics, BCR.

Chart 2



Sources: Scotiabank Economics, BCR.

also appears to be playing a part. Nonetheless, we expect an increase in spending, especially in post-Niño reconstruction, to commence late in the year, and gather force in 2018.

The private sector is another matter. Consumption growth has slowed to 3% or less, after growing consistently at 3.5% in the previous two years. There have been some positive signs for consumption in May, but a sustained turnaround will depend on investment starting to improve.

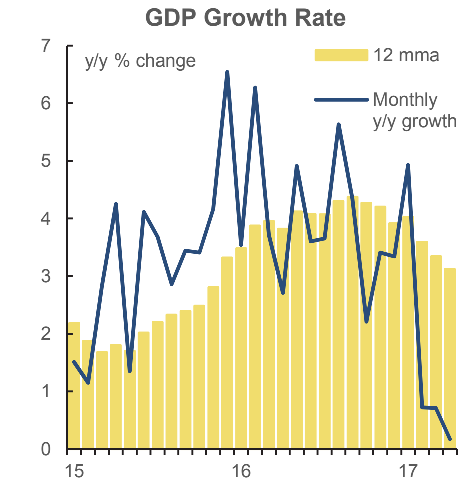
Private investment is well into its fourth year of negative growth with no indication of having reached an inflexion point. While the political environment is not helping business confidence, more fundamental factors are also at play, including excess capacity in industries that cater to domestic demand, and persistent overregulation.

As a result of weak domestic demand, GDP growth has been more linked to natural resources: metals, fishing and agro-industrial output. Except for the smaller agro-industrial sector, in which robust growth is expected to continue, natural resource growth will taper going forward and, in the second half of the year, growth will depend on a pick-up in domestic demand. Thus, the next two quarters will be telling. The third quarter will tell us how resilient growth is without the contribution of natural resource production. The fourth quarter will tell us how aggressive the government will be in its public investment plans.

The Central Bank has signaled that monetary policy will continue to be moderately supportive of growth, which means that further decreases in its reference rate, currently at 4.0% (the CB did not reduce the rate in June) are possible, as well as lower reserve requirements. Inflation, at 3.0%, annual, has declined sharply in the last two months, as food distribution normalized after El Niño. We agree with the Central Bank in expecting inflation to continue falling well within the CB target range (1%–3%), giving the CB room for further monetary loosening. This will be moderate, however, because the Central Bank, with an eye on the FX rate, doesn't seem comfortable reducing rates aggressively when the Federal Reserve is raising its rates.

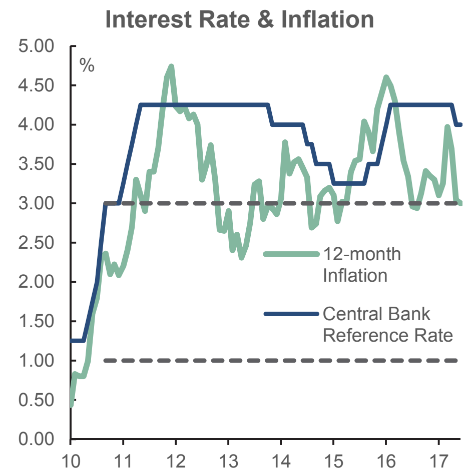
Price stability includes the FX market. With external accounts strengthening more than expected, we ratify our year-end FX forecast of S/ 3.25.

Chart 3



Sources: Scotiabank Economics, INEI.

Chart 4



Sources: Scotiabank Economics, BCR, INEI.

Chile

ANOTHER DOWNGRADE TO OUR FORECAST

The negative risk to our forecast for the first half of the year unfortunately materialized. The slow trend of growth was hit by a set of adverse conditions, the most important of which being the strike in a major copper mine. Even accounting for this, the recovery was weaker than expected and forces us to trim our forecast for the year to 1.6%, with downside risks remaining. Considering the meagre growth so far, achieving this forecast requires a strong recovery in the second half of the year. Support from monetary policy should contribute to stronger growth of 2.6% in 2018. It should be noted this growth would be just a tad below the potential estimated (not higher than 3%).

DOMESTIC DEMAND STAYS FEEBLE

Construction investment is much weaker than we had thought, though investment in machinery and equipment is recovering slowly. As said many times, at the current stage of the cycle, the anticipated recovery in investment is more closely related to business confidence than to the cost of financing. Accordingly, our forecast for investment was revised to -0.3% for the current year, though the recovery for 2018 is estimated at 2.2%. Inventories are rising, as anticipated, and this is expected to continue, since inventory levels remain below levels from four years ago. On the positive side, indices of expectations, both business and consumer, though still in the pessimistic zone, have been showing a moderate recovery. Likely, this improvement should continue because some critical factors in the confidence functions are expected to support them: tamed inflation and lower domestic and foreign risks.

LABOUR MARKET, FISCAL POLICY AND FOREIGN SECTOR

The unemployment rate has been rising and it should continue to do so given that it lags the cycle, some moderation in the rapid pace of growth in self-employment is expected, and the labour law reform deters companies from hiring (some of them declare to be increasing investment in equipment to avoid labour troubles). Though fiscal spending grew at a very fast rate in the first quarter, it is likely to be capped for the rest of the year. The severe warning coming from two rating agencies now seems a foregone fact: the low rate of growth of fiscal income due to the paltry growth of the economy, and despite the huge tax reform, will force a downgrade of the risk rating, though the investment grade will be retained. Likely, this negative event is already priced in the sovereign risk premium. Fortunately, foreign accounts look in order and perspectives remain relatively solid. For example, the current account deficit is expected to reach 1.5% of GDP in 2017.

EXCHANGE RATE, INFLATION AND MONETARY POLICY ALL RATHER STABLE

As expected, and it has been the case since mid-2016, the domestic exchange rate (USDCLP) has been trading within a relatively narrow range, between 640 and 680. Inflation remains below the long term target, but should rise going forward. We forecast inflation of 2.8% in 2017, rising to 3.1% in 2018. The Central

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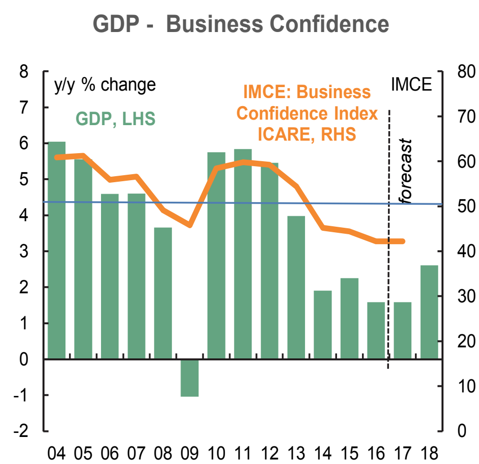
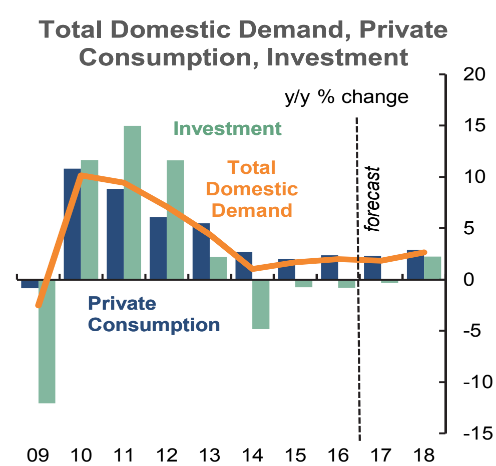
Chart 1



Sources: Scotiabank Economics, Banco Central de Chile, IMCE: ICARE-UAI.

Chart 2



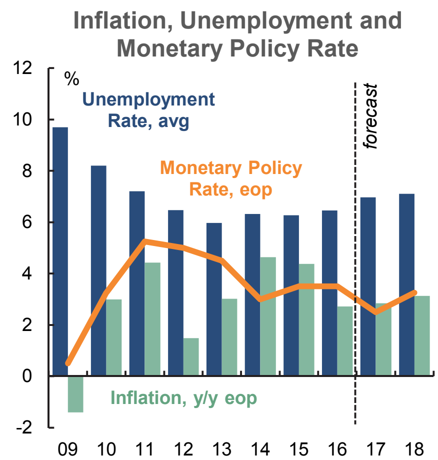
Source: Scotiabank Economics, Banco Central de Chile.

Bank accelerated cuts to the policy rate, leaving the rate at 2.5% last May with a neutral bias. We anticipate the rate will remain there for the rest of the year. In general, interest rates are at historically low levels, but the expansion of credit remains very limited. As inflation rises in 2018, monetary policy will need to tighten, likely around the middle of 2018.

ELECTORAL OUTCOMES REMAIN KEY

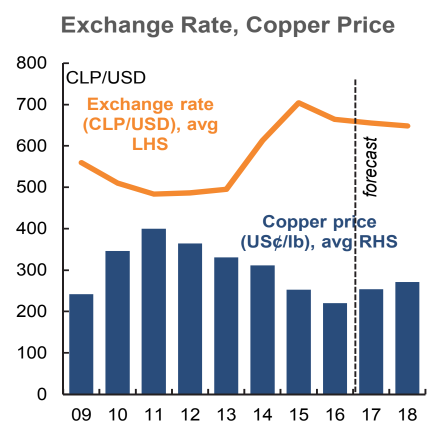
The next general election, for which the first presidential round will take place on November 19th will be faced by a divided centre-left ruling coalition. So far, the favourites for the very likely second ballot (on December 17th) continue to be the former President Sebastián Piñera (opposition, rather pro-growth) and the Senator Alejandro Guillier (somewhat aligned with the ending Government). Considering the current conditions, the probability seems higher for Mr. Piñera, but there are many factors that may have a bearing on the final result, abstention levels being the most notable (in the municipal election last year it was 65%). Though Chile has not faced the same scandals as other Latin American countries, most Chileans feel political disaffection (especially towards Congress and parties, which bear a very low support). The winner will likely have to look for support in both chambers to accomplish his program. Financial markets are probably considering this scenario to some extent, but most surveys suggest that investors in the real sector still remain on the sidelines, preferring "to pay to see" how the candidates will face the challenge in the final track. The outlook might be clearer following the primary elections (July 2nd) onwards, but even then will be far from being a risk-free political outlook.

Chart 3



Sources: Scotiabank Economics, INE, Banco Central de Chile.

Chart 4



Sources: Scotiabank Economics, Reuters Eikon