

Brazil

- **A combination of reform progress (in which we think the TJLP changes are particularly relevant—even if we expect a gradual impact), the Brazilian Central Bank’s revamped credibility, and a stabilization in public finances has allowed rates to drop quite substantially. This in turn is giving the highly indebted economy some relief, and is boosting consumer spending by freeing up disposable income. However, there are still some risks to this rates compression, which are to a large degree linked to politics.**
- **On the political front, there are two main sources of uncertainty: the 2018 Presidential elections, and whether the government will be able to approve the key reforms. In our view, the most important reform will be pensions, which is highly relevant for the country’s fiscal sustainability, but it may also play an important part in next year’s presidential elections because given its unpopularity, approving pensions reform could open the way for the PT to defeat the reformers.**

There are many important questions about Brazil as we head into the close of 2017, and most of them come down to politics. However, there is also some uncertainty over when the economy will start posting a more sustained recovery, as well as what will drive it. Regarding the growth rebound, we see some scope for base effects and a recovery in confidence to drive an improvement, but those two factors alone are unlikely to support a sustained recovery. Household spending has been heavily burdened by high indebtedness (see chart 1), but some relief is coming in the form of lower interest rates, which should continue helping alleviate the debt service burden families face. Are lower interest rates sustainable? Our take is there are many moving parts. The BCB has successfully brought inflation back under control, which is allowing it to cut interest rates quite aggressively (the SELIC rate has been cut from 14.25% to 8.25% since October 2016). We and markets expect further cuts, but there is the risk that if reforms are not passed, we could see investor disappointment put the currency (BRL) under depreciating pressures, and push inflation higher.

On a more structural trend, we see room for the reform of the TJLP rate allowing Brazil’s market clearing rates to decline. The reason is that it should help de-segment local lending markets, by bringing tier-1 borrowers back into the pool (BNDES had essentially taken tier-1 borrowers out of the market), thus lowering clearing rates. This positive factor should play out gradually. Finally, there is a fiscal aspect to lower rates. Over recent years, the rapid deterioration of Brazil’s fiscal position drove the loss of its investment grade rating, and put upward pressure on rates. However, even though the deficit is still wide (we could see a public deficit of around 6% of GDP this year) and the overall debt load is high (gross public debt is rapidly converging to 90% of GDP), the pace of the deterioration is improving, and markets are giving the current government the benefit of the doubt, driving a compression in credit premiums (5yr CDS have tightened 300bps since their highs a couple of years ago, trading around 200bps at the moment).

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Chart 1

Brazil: Household debt service as % of disposable income



Sources: Scotiabank Economics, BCB.

Chart 2

Brazil: Retail Sales (y/y %)



Sources: Scotiabank Economics, IBGE.

Regarding monetary policy, the DI curve shows markets look for 125bps of additional rate cuts. Our take is that although neutral rates have likely fallen somewhat with the changes that the government has implemented and those that are expected (including TJLP reform), they are still relatively high. We would not be surprised if real neutral monetary policy rates are still somewhere around 4%, from around 5% prior to reforms. This means that the additional rate cuts that markets expect from here could be reversed as the economy comes back on track but, for now, we tend to agree that more cuts are likely in the pipeline. However, this view is not without risks. The biggest risk in our opinion is the BRL. Our take is that the real's nominal depreciation has more than been eaten away by inflation, and in our view, the real is now on the "expensive side" (hence our FX call). If the reforms, particularly pensions (for which debate keeps getting pushed back) fall through, we should see market disappointment translate into depreciating pressures on the BRL, which could in turn derail the BCB's easing cycle as Brazil's FX-inflation pass-through is relatively high. Hence, what happens on both the reform and election front next year is key for Brazilian assets, and also for how low local rates can get, and how long they can stay there.

On the political front, there are two major risks worth tracking, and they are both related — and highly relevant to the macro outlook. The first is the reform approval process which is moving forward much more slowly than markets anticipated, and we think it's partly due to the PT now being back on its feet, after seemingly being brought to its knees by President Rousseff's impeachment. A risk is that with Presidential elections looming in November 2018, and the pension reform (arguably the most important) having about a 70% rejection rate, politicians will be unable to get the bill approved before it trips up with the electoral period. The bill has already been materially watered down, but even in its watered-down state, the vote has been repeatedly delayed. Failure to get the bill approved before the end of 18-Q1 would likely trigger some pressure on Brazilian assets. A second risk related to this is how the approval of the pension bill would impact the outlook for next year's elections if it were to materialize. Our take is that markets would see a return of the PT as negative for Brazilian assets, given the poor fiscal performance of the country during its last administration. At the moment, given the judicial process against him, it's unclear whether President Lula will be a contender next year. However, even if he does contend, the path to victory does not look easy despite Lula being the most popular politician in the country. Despite Lula's high popularity (he continues to come out at the top of nearly all polls), he also has a high rejection rate (between 40% and 50% in recent polls), which means winning in a second round run-off would likely be tough, as he has a very low ceiling which should hurt him in a run-off vote. Where the pension bill comes in, is that if approved, it could increase rejection towards reformist candidates, and could tip the electoral balance in favor of the PT, or Lula. Hence, there is both a lot at stake on the political front, but there is also a lot of uncertainty.

Mexico

MIXED SIGNS WITH A POSITIVE BALANCE

- Mexico is grieving the losses suffered as a consequence of two terrible earthquakes in September. It is still too early to determine the likely effects on the macroeconomic landscape, but we think they will be relatively small.
- Some of the recent economic indicators present conflicting results that could imply the Mexican economy is slowing down; while others point the other way. We see the positive balance prevailing, and thus we are once again raising our GDP forecasts.
- Contrasting with the market's view that monetary policy will be rapidly eased in 2018, we still expect Banco de Mexico to increase its reference interest rate a couple more times.

September was a disastrous month for Mexico. Two strong earthquakes produced terrible human losses and severe damage, mainly in the center-south region, affecting Mexico City, Puebla, State of Mexico, Oaxaca, Chiapas and Morelos. There is not yet a final assessment of the devastation, but the death toll across the country is more than 330. In Mexico City alone, over 3,000 buildings were damaged and 40 buildings collapsed. Most of productive infrastructure was not seriously affected, even though some sections of the highway between Mexico City and Acapulco were destroyed and the Salina Cruz refinery in Oaxaca was shut down for some weeks.

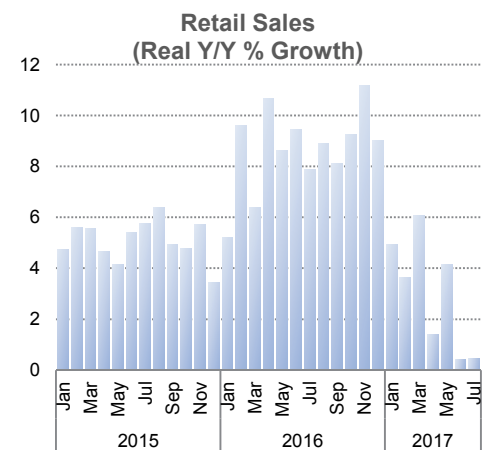
It is difficult to assess the impact on the macroeconomic variables, but in our view, effects on economic growth and inflation will be barely observable and transitory. Our preliminary estimate of the impact on third quarter GDP growth is less than 0.2 percentage points, not affecting the growth forecast for the whole year. Inflation could reveal some pressures as the unusual demand for several products increased and business inventories fell. Some other price increases could be observed during the reconstruction phase, especially in construction materials such as cement, steel, glass, etc. In any case, these pressures will be temporary and are not expected to have a material impact on inflation.

Turning to the economy, there are currently some mixed signals that are difficult to interpret. Retail sales are showing a significant slowdown (see chart 1), barely growing in real terms on a y/y basis in June and July. Much of this slower pace is explained by the weakness in auto sales (-4.8% y/y in June and -4.3% y/y in July), and departmental stores and supermarkets (-0.9% y/y in June and -0.1% y/y in July). There are, however, strong increases in health care items (+7.4% y/y), paper and leisure products (+8.0% y/y), home appliances and computers (+11.0% y/y) and TV and e-commerce (+10.3% y/y), all of them in July. Worth noting is that some of the slowdown is explained by the unexpected acceleration in inflation.

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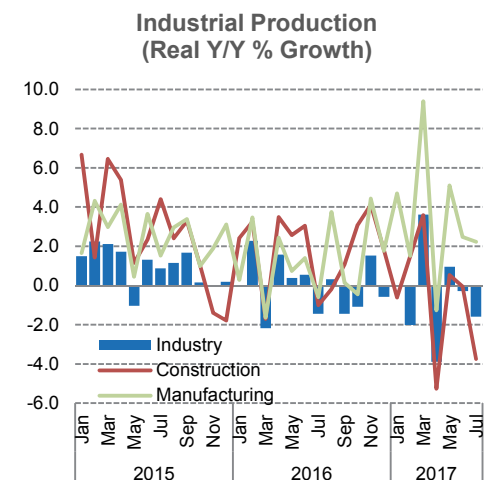
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Chart 1



Source: INEGI

Chart 2



Source: INEGI

Industrial activity also performed poorly, falling 1.6% real y/y in July, showing contractions in mining (-8.6%), utilities (-2.7%) and construction (-3.7%), from which the housing and commercial construction fell 4.4% real, an unusual development for this sector. On the other hand, manufacturing industry grew 2.2% real y/y in July, with some unusual contrasts among some of its components, which suggest there could be some specific unidentified factors affecting the numbers: while oil and carbon derivatives fell 22.7% real y/y, production of machinery and equipment grew 32.0% real y/y (!).

On the positive side, job creation, as measured by the number of workers insured at the Mexican Social Security Institute, reached 676 thousand year to date in August, averaging 4.3% y/y growth, while the unemployment rate reached 3.53%, the lowest for such a month since 2002.

Remittances from abroad reached an accumulated figure of US\$ 16.4 billion in January–August, growing 6.4% y/y and representing MXN 314.7 billion. This influx is a relevant component of many households' spending within the country.

Private consumption grew 3.4% real y/y in July, which represents a healthy pace. On the aggregate supply and demand figures recently released, total demand presented a significant slowdown in Q2, heavily influenced by the “Semana Santa” (Easter Week) seasonality (see chart 3). Private consumption keeps accelerating despite this effect, growing 3.4% real y/y, which reveals some strength in the internal market. Investment, on the other hand, fell 2.4% real y/y, affected by a confluence of factors, including the “Semana Santa” effect, the public investment cuts to strengthen the fiscal stance, and the likely increase in uncertainty levels due to the new government in the USA and the coming change of government in Mexico next year.

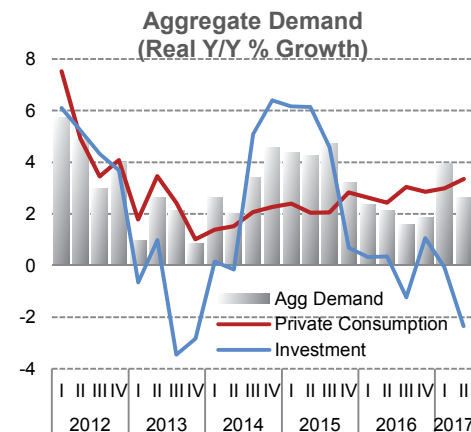
A very positive performance on external trade has been observed during the year. Non-oil exports reached US\$ 376.6 billion in the 12 month accumulated sum in August, growing 7.0% y/y, while imports reached US\$ 369.6 billion and expanded by 3.8% y/y. Chart 4 shows the positive reaction of trade during the last year. Most of this result is explained by the relative strength showed recently in the US economy.

On balance, we still perceive the Mexican economy to be on a positive track, and as a consequence, we are once again revising our macroeconomic scenario toward a faster pace of growth. GDP growth for 2017 is revised to 2.4% from 2.0% in the previous quarterly report. For the coming two years we still expect a gradual additional improvement, with a 2.7% GDP growth forecast for 2018 and 3.1% for 2019.

A special comment should be made about our interest rate forecast. Most analysts expect that Banco de Mexico will cut interest rates in 2018. However, inflation has been on the rise, and even though we share the view that inflation will begin a rapid decline during 2018 once the shocks observed during 2017 fade away, we anticipate that inflation will be higher than expected in 2017 and then will not fall below 4% during 2018. There are some concerning signs that could be interpreted as demand-side pressures, for instance, tuition fees keep accelerating, reaching 4.74% in the first half of September. Since inflationary risk keeps rising, we still believe Banco de Mexico will need to make a couple more hikes to the reference interest rate, one this year and another early next year.

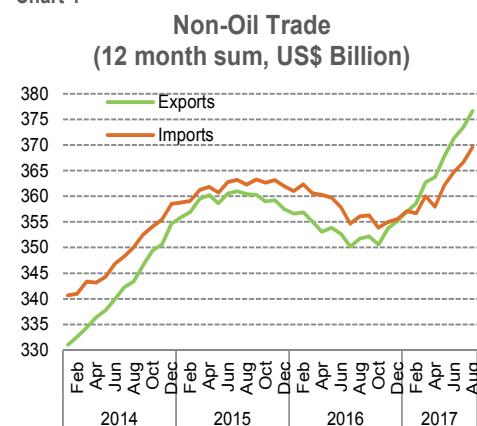
A final comment should be made about the political landscape in Mexico, now that the electoral process has formally begun. In the coming months, no later than February 22nd, candidates should be appointed, and a fierce struggle within most parties is expected. Banco de Mexico will have a new Governor, and one likely candidate is the current Minister of Finance, José Antonio Meade, who could also become the PRI presidential candidate. There will be a lot of changes and uncertainty in the coming months, and depending on the final outcome, expect some financial market volatility.

Chart 3



Source: INEGI

Chart 4



Source: INEGI

Colombia

- **Colombia's economic performance continues to suggest a gradual recovery, consistent with looser policy settings, and a strengthening in confidence, as well as acceleration in the execution of government infrastructure spending which we expect to gain traction over coming months.**
- **Even though we tend to agree with consensus that BanRep will continue to cut rates, we see risks to this view, primarily coming from possible depreciation pressure on the Colombian peso. These pressures could come from worse-than-expected fiscal results, or the upcoming Presidential elections.**

News on Colombia's outlook has been mixed, but remains consistent with an economy that is gradually gaining traction, accelerating as we near year-end. The sectors of the economy that are still serving as a drag are the mining industry and construction. On the construction front, we expect more dynamic performance heading into 2018. Furthermore, it is worth noting that retail sales are posting better performance as the year turns into the second half (+3.0% in the latest release), but they are still being hurt by relatively high unemployment. Hence, we expect GDP to continue strengthening over coming quarters, and sector performance to become more balanced. We expect growth of +1.9% this year (Bloomberg consensus +1.7%), to be followed by a more robust +2.5% in 2018 (Bloomberg consensus +2.6%), and a closer to potential +3.1% in 2019 (Bloomberg consensus +3.0%). The gradual strengthening of the economy is consistent with our view that both the 4G infra program, and the peace process will bring accelerated growth with them, but the benefits will slowly gain momentum.

The main concern among market players in our view is whether the rebound will be strong enough to match the macro assumptions that the government is using for its fiscal plan. Markets, and Scotiabank Economics, are still skeptical that the economy can recover enough to match the [official projections](#) (we're not sure that growth will top 4.0% in 2019–2025 as the government projects) which feed into the country's fiscal rule. This concern about whether the public finances have been properly anchored is one of the reasons why local rates have come under pressure (upwards), and one of the reasons the country's credit ratings still have some downgrade risk (we assign a 30% probability to a downgrade).

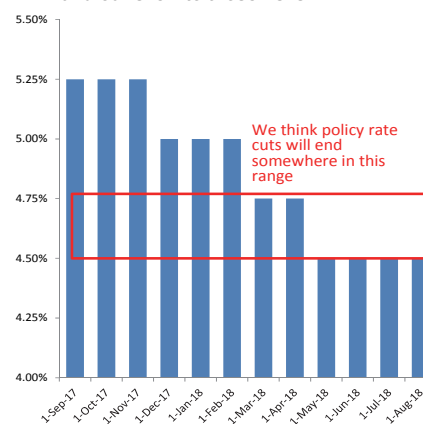
On the rates front, the latest minutes from BanRep are consistent with continued cuts in interest rates, given the board sees inflation still converging towards the mid-point of the inflation target, even if there is some upward pressure from food prices that will generate some noise heading into year-end (similar to elsewhere in LATAM). The latest decision was split, with 4 members voting for a 25bps cut, and 2 members voting for a 50bps cut. There was also one member who voted for a pause. Our take is that acceleration in the pace of rate cuts is unlikely, given the majority of the board believes that—with the cut delivered last time—rate settings are already in neutral. The board believes the economy has

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Chart 1

Market consensus on BanRep's policy rate, and our skew to those risks



Sources: Scotiabank Economics, BanRep.

already touched bottom and is starting a gradual rebound—hence we see no rush on the easing front, particularly as food continues to pressure inflation upwards.

Regarding the outlook for interest rates, we are roughly in line [with consensus in the latest BanRep survey](#), although we are relatively hawkish in our skew of risks. The first reason for caution we see is that in the most recent survey of expectations, we saw that economists broadly expect inflation to rise to slightly above BanRep's target as we head to year-end (consensus looks for 4.2% inflation by December). Given the inflation spike is driven by likely temporary pressures coming from food prices, we don't see this shock on its own as serious. However, if the shock were to be accompanied by a material depreciation of the Colombian peso, the risks become higher, given Colombia still has relatively high FX-inflation pass-through (20%–30%).

What can trigger a sell-off in the Colombian peso? Barring an external shock (the Fed?), we believe there are two primary sources of domestic risk: the first is the Presidential elections in May 2018, which could make investors nervous if an anti-establishment candidate were to emerge as a strong contender. Our take is that there will be two main camps within the establishment, primarily representing supporters of President Santos and of former President Uribe. The main difference between the two is approaches to the peace process, and we see little differences on the macro front. However, there is also the possibility that a third camp, to the left of the political spectrum, could emerge (former Mayor of Bogota Gustavo Petro has been strong in recent polls, and we have heard some, still small, degree of concern among investors). The second domestic risk we see is related to public finances, and the potential for credit rating downgrades. If the situation does not improve, we could see downgrades materialize, which would leave Colombia at the threshold of investment grade, which could spook some investors. However, we note we see a loss of investment grade as a low probability risk.

Peru

CONGRESS WINS AGAIN

- **A new cabinet, the same economic policy.**
- **Politics continues to dominate in Peru, even as the economy shows signs of rebounding from the El Niño downturn.**
- **Government reconstruction spending starts to kick in.**
- **High metal prices improve macro accounts.**

Congress, not content with taking down cabinet members one by one, decided to do away with the whole lot by way of a political “censura” on September 15. The head of the cabinet (here popularly called Prime Minister), Fernando Zavala, has been replaced by the current Vice-President and member of Congress, Mercedes Aráoz. Zavala was also Minister of Finance, and has been replaced in that role by Claudia Cooper, who was acting as Vice-Minister of Economy. Other cabinet changes include: Minister of Justice, of Education, of Health, and of Housing. Six cabinet members in all were changed, while twelve were ratified. We do not expect any major disruption in policy, outside of moderate adjustments. The six new members may signify policy shifts within their jurisdictions; however, these shifts will remain within a generally market-friendly and business-friendly framework. This includes Cooper at Finance, who is known to be orthodox and mainstream in her economic views. In general, Peru’s new cabinet is similar to the past in that its members are predominantly independent, with a technical (apolitical) profile.

Congress seems to have accepted the new cabinet, at least for now. However, there is no real guarantee that the PPK regime and opposition Congress will get along much better. The replacement of the former Minister of Justice (Marisol Perez Tello), by Enrique Mendoza has reopened the discussion of the pardon (“indulto”) and freedom of Alberto Fujimori. An event such as this would have political consequences that are not easy to predict.

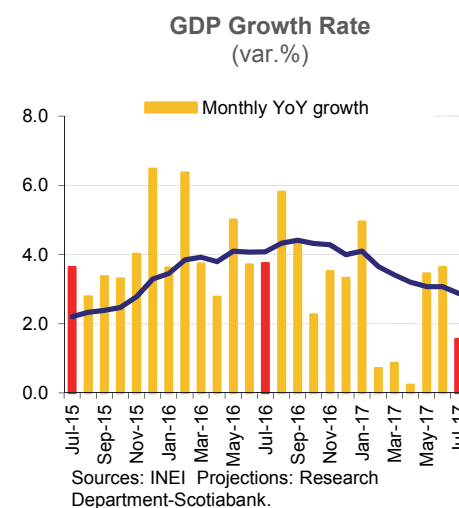
Markets have reacted with calm to the change in cabinet and events that led to it. In part, perhaps, because everything occurred so quickly and over the weekend, but also I believe it reflects the confidence that neither Congress nor the government is interested in changing economic policy significantly.

Meanwhile, economic news is not strong, but in general points to an economy that is rebounding after El Niño. GDP grew 1.6% in July, YoY, and 2.2% during the first seven months of the year. The softer growth figures compared to 3.6% in June and 3.4% in May, reflecting the fact that resource sectors (mining and fishmeal) are no longer driving growth. This was expected. Growth figures from now on will reflect non-resource sectors, more linked to domestic demand, which fell to 1% levels during the El Niño months, and has since rebounded closer to 2%.

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Chart 1



The growth outlook is set to improve as we approach the end of the year, as government investment is, finally, rising in earnest and starting to drive the economy. After declining nearly every month from September 2016 to April 2017, government investment has risen at an increasing pace since May, with a 24% YoY increase in August.

Government spending should only get stronger. The government announced details for investment in post-Niño reconstruction and the Panamerican Games, which includes a 10% spending increase in its 2018 budget. Public investment will rise 18%. This is in line with our expectations of GDP growth rising from 2.5% in 2017 to 3.7% in 2018.

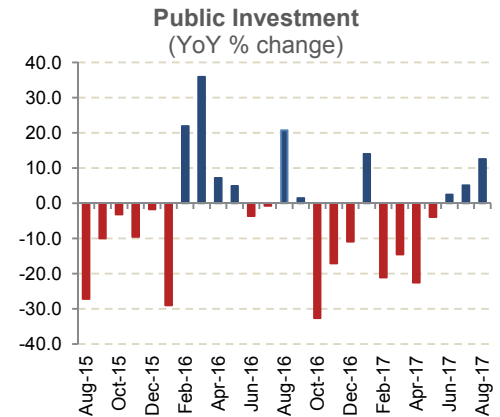
Another source driving growth expectations is the performance of metal prices. Even with the recent retracement, most metal prices that are important to Peru are still way ahead of expectations. This is feeding into improving external accounts, a strengthening FX rate (held back by significant Central Bank intervention), less concern over deteriorating fiscal accounts, and rising business confidence. All in all, macro accounts are improving and expectations are rising, despite political events. This seems largely to be what was behind the decision both by Moody's and Fitch to maintain Peru's credit rating and "stable" outlook.

The Central Bank has continued to do its part as well. The CB lowered its reference rate in September to 3.50%, the third 25bps decline in the year. The CB was clear in signaling that it would reduce the rate in September, and has stated its intention to continue giving clear guidance on what it will do from one month to the next. For October, it has signaled a pause. After that is anyone's guess, but we would not be surprised to see one more 25bps decrease before the CB ends its expansionary policy.

The CB continues to be more concerned about growth than inflation. Twelve-month inflation to August came in at 3.2%. This was above the CB target range, but the CB seems convinced that this reflects temporary supply shocks, and that inflation will fall well below its 3.0% target ceiling before the year ends.

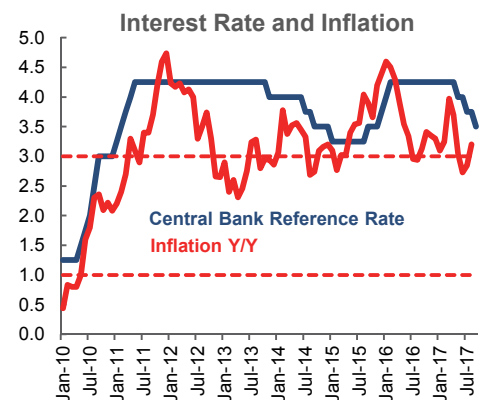
Peru is slowly transitioning to more robust, investment-driven growth. It would be helpful if politics could also transition to a state of less conflict and uncertainty.

Chart 2



Sources: BCR
Elaboration: Research Department-Scotiabank Peru.

Chart 3



Sources: BCR, INEI, EE - Scotiabank.

Chile

RISING OPTIMISM, BUT RISKS REMAIN

- The situation for the Chilean economy remains very similar to that described one month ago. The economy is stabilizing, and 2018 growth is expected to reach its highest level since 2013 as the political situation improves.
- Though risks for 2018 growth are tilted to the upside, worsening terms of trade and some potential political challenges represent possible downside risks to the forecast.

MACRO UPDATE: SMALL BUT MEANINGFUL CHANGES

No significant data changes have taken place since our last report. We continue to forecast growth of 1.4% for the current year and 2.8% for 2018, which is more conservative than the Central Bank's forecast. In September the Central Bank increased the average of its forecast range for economic growth from 1.375% to 1.5% for the current year and kept the forecast at 3% for 2018. Though the upward revision was modest, it ended the recent string of negative revisions to the growth outlook. On the inflation side, the forecast for the current year was revised down (from 2.6% to 2.4%) and upward for 2018 (3% vs. previous 2.9%). In the same report, the potential growth for the Chilean economy was cut to the range 2.5%–3%.

All in all, although monetary policy rate (MPR) cuts were not ruled out, no change to the MPR (currently at 2.5%) is the most likely scenario for the coming months. Aligned with that, we maintain our expectation of no change in MPR up to mid-2018. Were stronger-than-expected growth to materialize, this could lead to a re-assessment of this view. In the very short term, the Central Bank should not be too uncomfortable with a twelve-month accumulated inflation temporarily in the low half of its reference range (2%–4%). Along with the reduction in inflation, the exchange spot rate (CLP/USD) started to recover, though there was likely a much more powerful reason for it: a pullback of the copper price and the strengthening of the US dollar in the international markets. We continue to expect a year-end value around 640, which would be consistent with forecast values for most of the variables that historically condition the exchange rate.

POLITICAL PANORAMA: SHARPER PICTURE... STILL BLURRY

In the political arena, the changes have not been very dramatic either. Surveys show that relative position for presidential election remains almost the same, led by former President Sebastián Piñera (center-right) with 43%, followed far behind by Alejandro Guillier (center-left, pro current Government) with 19%, and Beatriz Sánchez (left) with 13%. Just to Piñera's left and right there are two candidates (Goic and Kast, respectively) with 4% each. That picture means the November 19th election will be followed by a ballottage on December 17th, for which Mr. Piñera keeps the first option. Though this is the most likely scenario, there are two additional political risks: first, the parliamentary election (half senate and whole Deputies Chamber) where results are far from being clear and, second, the ability

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Chart 1

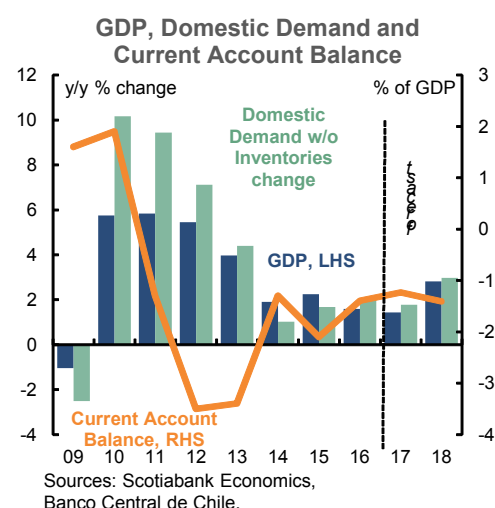
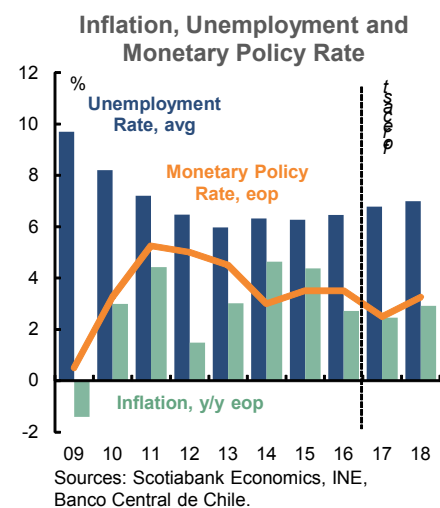


Chart 2



of the new Administration to accomplish both short- and long-term improvements (tax reform, labor reform, environmental institutions, among many other). Some surveys show that this political uncertainty, though lower than in other Latin American countries, in addition to the implementation of damaging reforms in the previous three years and the deterioration of the terms of trade, has reduced the flow of investment, with investors adopting a wait-and-see attitude.

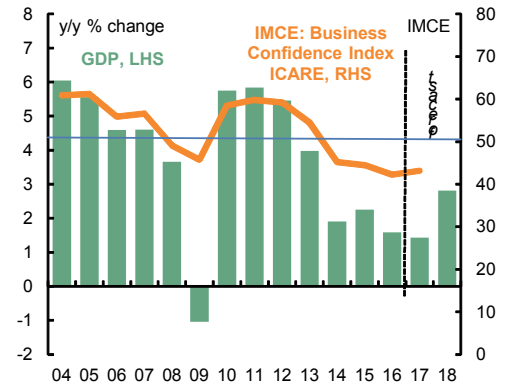
The resignation of the core of the economic team (on August 31st) highlighted the cracks in the ruling coalition, but is unlikely to mean dramatic changes in the current economic policy of the government. Its tenure ends within six months (on March 11th, 2018), which is a limited timespan to make changes, especially when the government's popularity, though improving, is still low and there is a widening rejection of previous reforms or, at least, skepticism about them. The new economic team (which is headed by the same people as in Mr. Lagos' center-left administration in 2000–2006) is apparently focused on continuing with the previous line, to capitalize on improvement in expectations or growth that could come from better terms of trade and the perspective of a new political environment (as in other countries in the region). In that context, the design of a 2018 balanced budget seems the first priority.

MAIN RISKS

These conditions for investment imply a two-fold short-term risk: a) decisions could be on hold before knowing the result of the election and the performance under the new political scenario, and/or b) a growing pent-up demand for investment that might burst in 2018. Of course, consequences of the first would be more concerning than those of the second, but either of them might cause large impacts in activity, demand, prices, rates, etc.

Chart 3

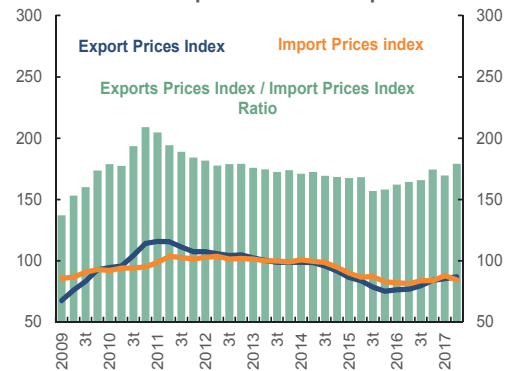
GDP - Business Confidence



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

Chart 4

Prices Exports / Prices Imports



Sources: Scotiabank Economics, Banco Central de Chile.

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