

Latin America Weekly Outlook



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- **Sovereign debt (un)sustainability within G7 countries heightens crowding out risk**
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Sovereign debt (un)sustainability within G7 countries heightens crowding out risk

The world's largest debtor nations belong to the so-called developed-country group. The United States, the United Kingdom and Japan continue to suffer from widening fiscal deficits equivalent to roughly 10% of GDP. International credit rating agencies, institutionally weakened by their inability to anticipate the financial systemic crisis, are intensifying their sovereign-credit analytical rigour (and hawkish rhetoric) in an effort to rebuild their battered credibility. The global media highlighted Moody's concerns about the sustainability of the US top ratings, prompting the Treasury Department to defend its fiscal consolidation plan. In his most recent address to Congress (please see <http://www.ustreas.gov>), Treasury Secretary Geithner stressed that the deficit would reach 10.6% of GDP in the current fiscal year, targeting a more manageable level of 4.2% and 3.9% of GDP for 2013 and 2014, respectively. Massive US debt issuance is in prospect: the Treasury announced (please see <http://www.ustreas.gov>) that the US government plans to issue as much as US\$660 billion (€482 billion) during the first six months of 2010, of which US\$81 billion will be offered to investors on February 15th. The substantial increase in the supply of US treasury debt securities may eventually impair (crowding out risk) the ability of other sovereign borrowers (i.e., Greece) to access funding through global fixed-income markets.

Asset price adjustment phase activated in high-yield securities: China in focus

The global economy is indisputably in (fragile) recovery mode; economic activity is accelerating at an uneven pace in the world's major countries. Vestiges of the global financial distress of late 2008 and early 2009 are still present: Dubai (debt restructuring), Greece (fiscal & debt sustainability), Venezuela (massive devaluation), and Argentina (central bank crisis) are a few examples of the ripple effects of the still-present global systemic shocks. Following an impressive rally in equity securities and commodity market prices, the potential development of new asset bubbles in select emerging-market jurisdictions has placed market participants on alert. In this regard, China is at the center of global investors' attention. The Chinese authorities and the media dedicated to global finance continue to highlight the growing risk of potential bubble-development activity. The official drive to tighten lending standards (followed perhaps by an increase in interest rates) to avert an unsustainable property market boom in China has been an influential factor in the correction phase under way. Indeed, the CSI 300 equity market index has lost 14% since December 2009, placing other emerging-market bourses on the defensive. The correlation between China and other emerging-market stock markets is material; within the Western Hemisphere, Brazil (and other South American nations) will remain subject to contagion risk from Chinese market gyrations. Credit markets have also been adversely impacted by the increase in global risk aversion caused by credit stress in Greece and deteriorating fiscal conditions in Portugal, Spain and Ireland.

Commodity price weakness intensifies regional currency & equity market volatility

A new wave of global financial market volatility has emerged. The euro (EUR) has adopted a clearly defined weakening stance. Sovereign debt sustainability concerns connected with a deteriorating fiscal position in Greece, Spain, Portugal and Ireland are at the core of this synchronized move away from

the EUR, which depreciated by 10% against the US dollar (USD) and 8% against the Japanese yen (JPY) since November 25th, 2009. Both the JPY and the USD (in this order) emerged as perceived safe-haven currencies in this latest round of global currency adjustments. Other riskier investment assets such as commodities and equity securities also came under stress, exacerbating downward pressures in the core group of Latin American currencies. Of utmost relevance to the developing Americas, the Brazilian real also followed the EUR trend and lost 8% against the USD; however, the BRL may encounter near-term support at around 1.90 per USD. Declining crude oil prices (the light-crude price closed the week at US\$71 per barrel, down from US\$84 in mid-November 2009) and heightened global risk aversion also had an impact on the value of the Mexican peso which traded at 13.20 per USD at the end of the week. While the Peruvian sol maintained a stable pattern, the Chilean peso was subject to further weakness on the back of depreciating precious and base metal prices; indeed, the spot copper price has declined by 19% over the past month.

More interventionist central banks get ready for pre-emptive monetary tightening

The tense debate leading to the reconfirmation of Ben Bernanke as Chairman of the US Federal Reserve Board (Fed) is a vivid reminder of the process of institutional reform taking place within the developed world as a result of the systemic failure of the global financial architecture. The perceived potential loss of central bank autonomy is a matter of discussion in developed and developing countries alike. Undoubtedly, the unprecedented collaboration amongst developed nation-states and between the central bank and the finance ministry within each country proved to be effective in stabilizing short-term credit markets at the peak of the crisis. It is worth highlighting that the decisive and collective action adopted by the world's most relevant central banks was also a critical success factor in addressing short-term funding needs (and liquidity constraints) and in containing the economic damage of the global credit distress. At present, monetary authorities in key developing countries are keenly following institutional developments in the most advanced nations in an effort to adjust to the new global monetary and credit cycle which is about to unfold.

Beyond China's decision to increase reserve requirements to tighten credit flows, Brazil reintroduced a tax on financial transactions to curb speculative foreign

capital inflows and is preparing investors for a sharp increase in short-term administered interest rates in 2010 (as much as 250 basis points according to the central bank survey). Chile announced a 90-day period to comply with new currency hedging rules governing foreign portfolio investments by local pension funds. A more active and interventionist central bank in currency (and securities) markets is, for now, the natural outcome of the global systemic financial crisis that originated in the most mature and advanced economies. Following the replacement of the central bank president, Argentina is now embarked on using a portion of the international reserves to meet this year's treasury debt obligations. The untidy interference of the Argentine administration in monetary affairs is seen, by many local observers, as a precursor to currency market distress and a lack of credibility of central bank data (including the level of foreign currency reserves) in the year ahead.

Increasing, yet manageable, political risk in countries facing presidential elections

Chile, Colombia and Brazil are facing leadership succession issues in the developing Americas. The election of Sebastian Piñera as the new president of Chile implies continuity of a prudent macroeconomic framework in the context of an accelerating economic recovery phase. Nevertheless, the need for swift institutional reform to labour market legislation and changes to rules governing state-owned firms (such as Codelco) may inject, at times, periods of manageable social unrest and political volatility. In Colombia, the political uncertainties are focused on the re-election and/or succession of President Alvaro Uribe on May 30th. It remains unclear whether the country will be able to organize a referendum on the re-election prior to the vote; a Constitutional Court will rule on this issue in the coming month. Political parties need to register their presidential candidates by March 12th. Finally, Brazil, the largest and most influential country in the developing Americas, will elect a new president in October (and November if there is a second voting round) this year. At present, market metrics indicate a stable election-related political process. There is broad-based consensus amongst local analysts that, irrespective of the electoral outcome, government policy direction will not be subject to material changes. However, as the elections will take place amidst a period of synchronized global monetary tightening, it would be prudent to anticipate that financial market volatility (and official intervention) may escalate during the second half of the year.

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