Latin America Weekly Outlook

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- **Global risk appetite swings and US dollar strength support emerging-market assets**
- **Currency stability, elections and monetary tightening shape Brazilian markets**
- **Monetary status quo in Mexico; pension fund reform improves debt outlook**
- **Commodity price swings trigger currency adjustments in metal- & oil-rich countries**

Global risk appetite swings and US dollar strength support emerging-market assets

The external environment for emerging-market currencies and securities remain quite benign despite the recent wave of financial market volatility caused primarily by persistent euro (EUR) weakness, the euro zone's deteriorating fiscal and debt profile and renewed US dollar (USD) strength. The EUR depreciated by 10.6% against the USD over the past three months. It is worth noting that the renewed strength of the USD does not necessarily reflect an improvement in the US fiscal profile; in fact, massive debt issuance (US$660 billion) scheduled by the US Treasury (UST) for the first half of the year still portrays an extremely fragile US sovereign debt position. The risk of the US crowding market access by other investment-grade sovereign borrowers has exacerbated the negative market environment present in Southern European debt markets (please review our document published last week on European Debt Sustainability). Nevertheless, the stability in the UST bond market has not been interrupted; indeed, 10-year UST bonds yielding 3.8% reflect a still healthy interest rate environment. Moreover, both Japan and China (and now the US central bank) continue to be key market stabilizers through their vast holdings of UST assets.

Although the core group of Latin American economies maintain a manageable sovereign debt profile and healthy access to local sources of finance, credit differentiation trends are consolidating within the developing Americas. Credit default swap (CDS) market metrics indicate that Chile, Brazil, Mexico and Peru are perceived to have a manageable risk profile, similar to that of Spain. Others, such as Venezuela and Argentina, remain in the distressed-credit category -with CDS levels over 1,000 basis points (bps). Potential adjustments to the valuation of emerging-market assets may materialize should the world's major central banks begin to unwind in a disorderly way the substantial fiscal and monetary stimuli in place; indeed, the US Federal Reserve (Fed) has recently announced adjustments to its credit-easing programme which has been interpreted by market participants as the initial phase of its exit strategy.

Currency stability, elections and monetary tightening shape Brazilian markets

Global investors' demand for Brazilian assets remains strong. The Brazilian real (BRL) has regained an appreciating bias against the USD; after reaching technical support at 1.90, the BRL was approaching the 1.80 mark by the end of the trading week. An improving growth scenario and firm expectations of aggressive monetary tightening in the coming months are boosting demand for Brazilian financial assets. We expect the Brazilian economy to expand by 5% this year and thereafter moderate to a more sustainable rate of 4-4.5% during the 2011-13 period; recent data showed an improved outlook for domestic employment. However, demand-driven price pressures are intensifying and we believe that the monetary authorities will not tolerate a spike in currency market volatility in a presidential election year.

Economic and market analysts expect a sharp increase in government-administered interest rates this year. Futures markets discount a 175 bps increase in the credit-sensitive SELIC rate by the end of this year whereas the local-market consensus (indicated in the latest survey conducted by the central bank) points towards a 250 bps rate hike. We believe that a SELIC rate of at least 11% by year end is feasible. The next monetary policy announcement is scheduled to take place on March 17th. Meanwhile, Brazilian debt and equity securities remain sensitive to changes in global risk appetite caused by the European fiscal concerns and potential adjustments in Chinese stock markets. By the close of the week, the five-year Brazilian CDS was valued at 134 bps (similar to Spain - 129 bps - but much lower than Ireland, Portugal and Greece).

Monetary status quo in Mexico; pension fund reform improves debt outlook

Mexico enjoys a favourable market environment. Recently announced changes to rules governing portfolio investments by the domestic pension funds coupled with a persistently low global interest rate environment continue to fuel demand for long-term peso-denominated Mexican fixed-income securities. Indeed, the yield on the 10-year Mexican government bond has declined to 7.6% from 8% since the beginning of the year. On a yield spread basis versus equivalent UST securities, the Mexican improvement has been more pronounced, closing the week at UST + 374 bps (114 bps narrowing over the past six months). As in Brazil, the five-year Mexican CDS is trading at 134 bps. On February 17th, the Finance Secretariat issued a brief statement increasing the official 2010 GDP growth projection to 3.9% from 3% (please see http://www.shcp.gob.mx/). On the currency front, the Mexican peso (MXN) regained an appreciating tone versus the USD supported by favourable conditions in energy markets, increased foreign demand for Mexican debt assets and expectations of monetary tightening in the months to come. On the external finance front, the authorities have indicated that the reciprocal currency arrangement (valued at US$30 billion) with the US Federal (Fed) Reserve System will be terminated next month suggesting that there is no longer the need for emergency financing to deal with short-term USD liquidity needs.

On the monetary front, Banco de Mexico opted to keep its target monetary policy rate unchanged at 4.5% today (please see http://www.banxico.org.mx/), stressing that the domestic economy continues to show signs of steady recovery and that inflationary pressures were clearly present in January 2010 due to the effect of recent tax hikes and government-administered price adjustments. The official statement also highlighted that inflationary expectations for 2010 also remain anchored above the 3% target. At present, interest rate futures markets discount a 75-100 bps rate hike by the end of the year; the next monetary policy setting meeting is scheduled for March 19th.

Commodity price swings trigger currency adjustments in metal- & oil-rich countries

Global commodity markets remain very sensitive to news and developments linked to the timing and shape of removal of stimulus measures by the US Fed and other major central banks around the world. The bullish market sentiment in favour of the USD has also triggered the unwinding of investment positions in gold-linked assets. In fact, gold prices which have been in downward adjustment mode since last December, seem to have consolidated a trading range with a technical bias towards further weakening. Both the Chilean peso (CLP) and the Peruvian sol (PEN) may receive the negative impact from declining prices in the months to come. Particularly, gold prices may approach the US$1,000 per troy ounce level in the coming months before finding technical support. The CLP, which remains very sensitive to copper prices, has experienced a new phase of volatility in the past month, closing the week at 532 per USD, recently supported by recovering copper prices. The PEN, however, has been quite stable so far, supported by favourable energy-linked foreign exchange receipts as well as by increasing foreign investment inflows. At the same time, energy-linked currencies such as the MXN and the Colombian peso have also received a boost from recovering crude oil prices which approached the US$70 per barrel mark (WTI) this week.

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