

Latin America Weekly Outlook



Pablo Bréard
1 (416) 862-3876
pablo_breard@scotiacapital.com

- **Latin America well positioned to withstand a new wave of global financial volatility**
- **Presidential elections might trigger a short pause in monetary tightening in Brazil**
- **Mexico influenced by oil price adjustments and softening US economic conditions**
- **Sizable capital flows and stable policy environment supports Colombia's outlook**
- **Chile benefits from robust economic performance and interest rate normalization**

Latin America well positioned to withstand a new wave of global financial volatility

Intensifying global financial market volatility is causing a temporary increase in global risk aversion, directly affecting the value of emerging-market assets. The core group of Latin American economies are not immune to this new phase of risk-repricing activity under way in multiple asset classes. Latin American sovereign debt instruments continue to trade at a better value than Southern European credits such as Spain, Portugal, Ireland and, of course, Greece. Brazil remains a key engine of growth and foreign capital flows to the region, yet local-currency markets appear to be trading in consolidation mode. Renewed weakness in US equity securities markets has also been felt throughout the Americas, however, a change in trend is not yet in place. Commodity markets present a mixed behaviour: while crude oil prices adopted a defensive tone, the price of copper has not suffered major value adjustment, still reflecting strong growth prospects to the major importers of base metals in the developing world. The constant re-assessment of global economic conditions to incorporate softer activity in the US has led to moderate depreciation of NAFTA zone currencies, including the Mexican peso, which depreciated in relative terms more than other Latin American currencies in the current phase of asset price adjustments. Looking ahead, the longer than originally discounted monetary stimulus and ongoing purchase of US treasury securities by the US central bank will continue to fuel demand for high yielding fixed income securities issued by government in the developing Americas.

Presidential elections might trigger a short pause in monetary tightening in Brazil

Brazilian financial markets remain relatively immune to the political developments linked to the approaching presidential elections. Market participants continue to discount policy continuity irrespective of the electoral outcome. The Brazilian real (BRL), a gauge of emerging-market sentiment in the Americas, is well entrenched in a consolidation phase despite intensifying volatility in NAFTA zone currency markets. Interest rate differentials also remain a highly supportive factor for local-currency securities. Indeed, the monetary policy rate spread of 1,050 basis points (bps) between Brazil and the US coupled with a 10-year UST bond yield of 2.66% is a major incentive for Brazilians to keep their funds at home. From a purist macroeconomic perspective, Brazil offers a promising growth outlook; the latest survey of economic projections conducted by the central bank points to a real GDP expansion of 7.1% in 2010 while inflationary pressures remain relatively well contained. Consumer price inflation, which reached 4.6% y/y in July, will remain below the 5% threshold over the next 12 months. The combined effect of stable price conditions and decelerating growth dynamics for 2011 has led to adjustments in the expected monetary policy adjustments, in fact, market participants now discount that the authorities may increase the credit-sensitive SELIC rate by only 25 bps by the end of the year to 11% and thereafter resume a tightening cycle once the electoral process is completed.



Mexico influenced by oil price adjustments and softening US economic conditions

Investor sentiment in Mexico is strongly influenced by economic and monetary developments north of the border. The mid-term congressional elections in the US will be conducted in the midst of persistently weak conditions in labour and housing markets. The already discounted deferral of interest rate normalization by the US Federal (Fed) Reserve may redirect flows away from US dollar (USD) assets. US stocks have been subject to downward adjustments since early August. As a result of a downshifting in economic growth expectations in the US, the other NAFTA zone currencies, the Canadian dollar and the Mexican peso (MXN), seem to be receiving the effect of asset reallocation shifts. Indeed, the MXN is now more influenced by directional swings in the USD rather than by developments in the Latin American leading currency, the Brazilian real. The MXN has adopted a defensive bias on the back of softening economic conditions in the US, declining crude oil prices and intensifying global risk aversion expressed in depreciating equity securities. Energy commodity price adjustments linked to a re-assessment of global growth conditions are also exerting negative pressure on the value of the MXN: the market-benchmark WTI price edged the US\$70 per barrel mark this past week, a sharp descent from the US\$83 level earlier in the month. Local Treasury bond markets have also suffered from risk-repricing dynamics in Mexico with the Mexico-US spread widening to 375 bps by the close of the week.

Sizable capital flows and stable policy environment supports Colombia's outlook

The Colombian peso (COP) continues to enjoy a bright momentum. Improved political conditions (President Juan Manuel Santos assumed the presidency on August 7th), major foreign capital investment plans (particularly in the energy and mining sectors), strengthening economic growth prospects (approaching a 4% rate of expansion in 2010 as a whole), a stable inflationary context (within the 2-4% official target range) and a sound domestic financial sector are all key issues driving a steady appreciation of the COP, which has gained 11.5% against the USD since early July. The Colombian currency performance has been second to none in the Americas,

followed at a distance by the Chilean and Brazilian currencies. The global perception of sovereign credit risk has also received a major boost so far this year; in fact, the cost of insurance of government bonds measured through the credit default swaps (CDS) has also diminished markedly trading at 132 bps by the close of the week. The country's creditworthiness continues to improve; indeed, Standard & Poor's upgraded the outlook of Colombia's BBB- rating to "positive" last month. On the inflation front, there are timid signs of increasing price pressures, yet the rate of consumer price inflation at 2.2% in July remains very manageable. The central bank has maintained its policy-setting interest rate unchanged at 3% since April 2010; however, we cannot rule out mild tightening before the beginning of 2011 if growth conditions improve markedly.

Chile benefits from robust economic performance and interest rate normalization

Chile enjoys a promising outlook. The South American economy has barely felt the transition to a new administration following the election of Sebastian Pinera as the new president. The swift policy response to the dual shock of a decelerating global economy and devastating earthquake/tsunami earlier in the year is paying off. Following a well coordinated fiscal and monetary impulse executed by the new government, real GDP is rapidly recovering as reflected in the 6.5% expansion during the second quarter of the year. The local consensus points now towards a growth rate of 5% and 5.8% for 2010 and 2011, respectively. In response to intensifying economic activity, the country's monetary authorities are decisively embarked on a process of interest rate normalization: the central bank unanimously decided to lift the monetary policy rate by 50 bps to 2% on August 12th. The authorities sent a clear message that further tightening of monetary conditions is in sight until the process of interest rate normalization is completed. Widening growth and interest rate differentials in the context of persistently high metal prices have been key factors supporting a stable to appreciating environment for the Chilean peso which has strengthened from 550 to 500 per USD over the past two months. Copper prices seem to be in consolidation mode at the current level of 335 US cents per pound, a sharp increase from 272 in early June.

INTERNATIONAL RESEARCH GROUP

Pablo F.G. Bréard, Head

1 (416) 862-3876

pablo_breard@scotiacapital.com

Tuuli McCully

1 (416) 863-2859

tuuli_mccully@scotiacapital.com

Estela Ramírez

1 (416) 862-3199

estela_ramirez@scotiacapital.com

Oscar Sánchez

1 (416) 862-3174

oscar_sanchez@scotiacapital.com

Scotia Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia_economics@scotiacapital.com

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