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Latin America Outlook

2nd QUARTER 2017

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Main messages

1. **Global growth keeps increasing**, and uncertainty about US policies starts to fade. Nevertheless, global risks remain.

2. **The end of GDP deceleration for Latin America.** Regional growth will increase from -1.4% in 2016 to 1.1% in 2017 and 1.8% in 2018. Yet, it will remain below potential growth, which is closer to 3%.

3. **Inflation will continue to decrease in South America, but will rise in Mexico, though less than expected 3 months ago.** We anticipate further interest rate cuts in South America (deeper in Brazil), and they will also be implemented in Argentina and Peru. On the other hand, Mexico will continue hiking rates, but less aggressively than expected.

4. **Risks for Latam are tilted to the downside.** Short-term risks coming from China and US diminish, though structural, long-term risks in China increase. Domestic risks in the region continue to stem from political noise and delays in infrastructure projects.

GLOBAL

Stronger growth,
but still with significant risks

Positive global momentum

Main trends continue …

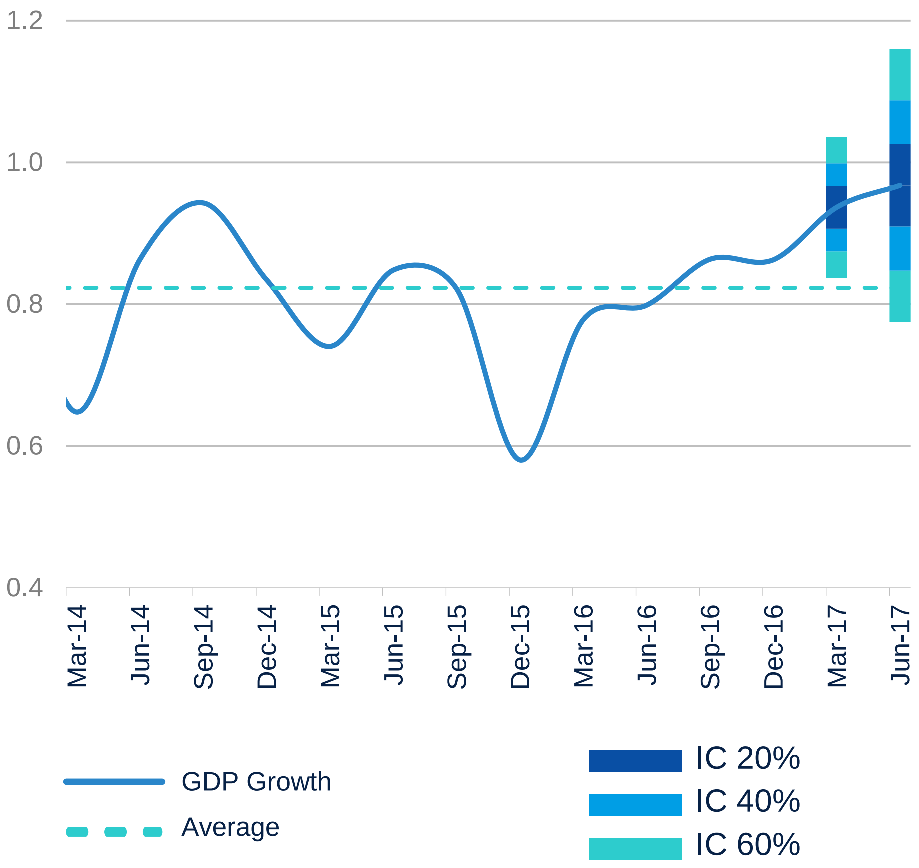
- Recovery of industrial production and trade still underway
- Low volatility in financial markets
- Headline inflation continues to rise in advanced economies, but core inflation remains stable

… and central scenarios become more likely

- A strong stimulus to US economy looks less likely…
- …but so does scenarios with strong protectionism
- Central banks in developed countries lean towards policy normalization

Global growth continues to increase at beginning of 2017

Global GDP growth
Forecasts based on BBVA-GAIN model (%, qoq)

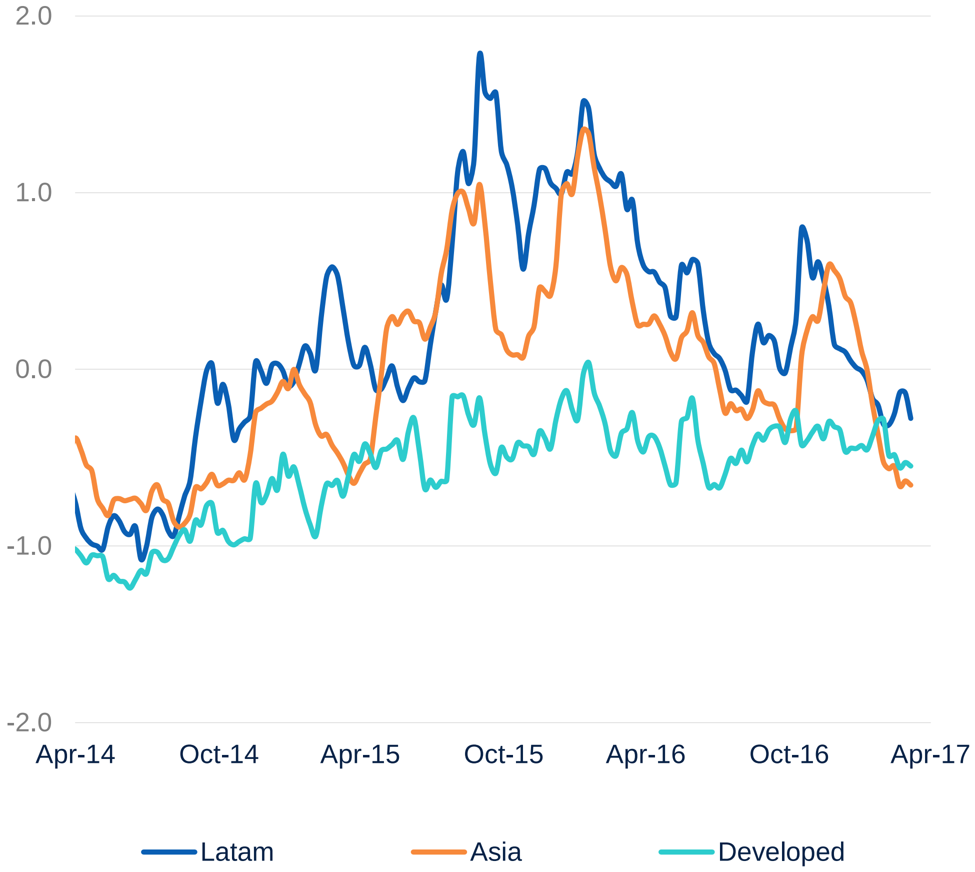


Source: BBVA Research

- Confidence indicators remain very high, although hard data still do not capture all the improvement in sentiment
- China and developed economies show sign of strong growth. However, other emerging economies show mixed signals

Financial stress remains low

BBVA Financial Stress Index
(normalized)



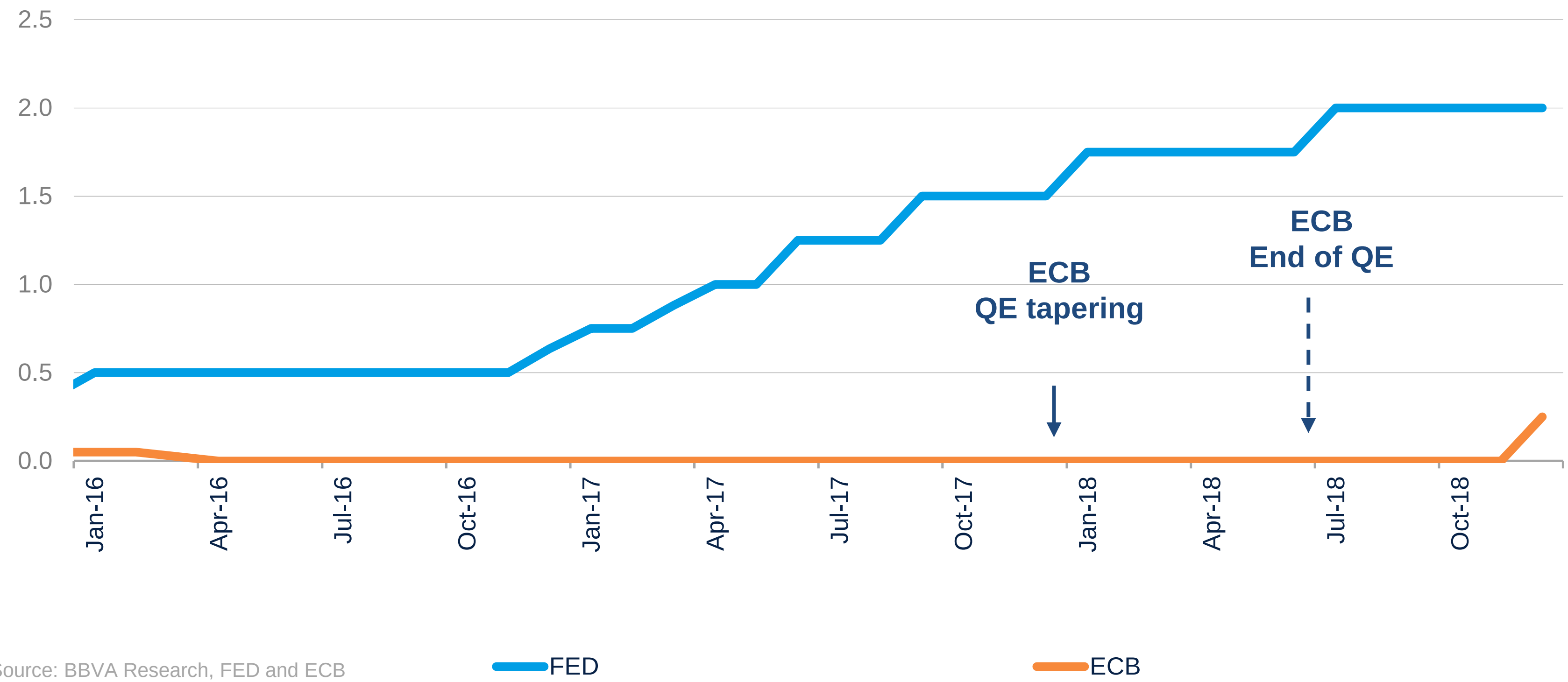
Source: BBVA Research

- Volatility has decreased despite uncertainty about economic policies
- Monetary and fiscal stimulus mask some underlying weakness
- Europe has been the exception, with some increase in sovereign spreads, linked to elections in France and the political outlook for the region as a whole

Central banks on the way to policy normalization

Official interest rates in the US (Fed) and Eurozone (ECB)

(pp)

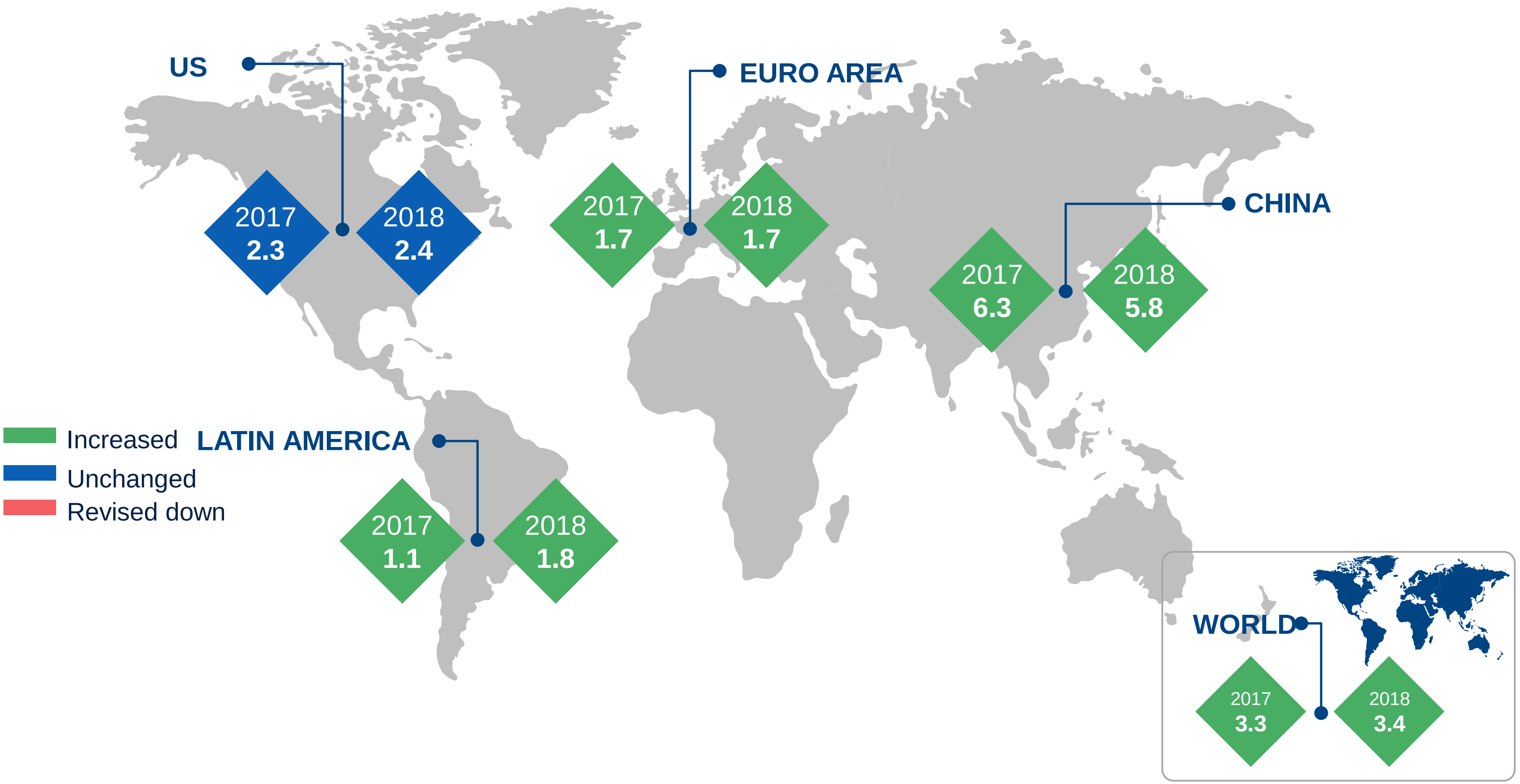


Source: BBVA Research, FED and ECB

Fed continues to increase interest rates, though is still cautious about the economic outlook.

The ECB is to start discussing its exit strategy, but very cautiously.

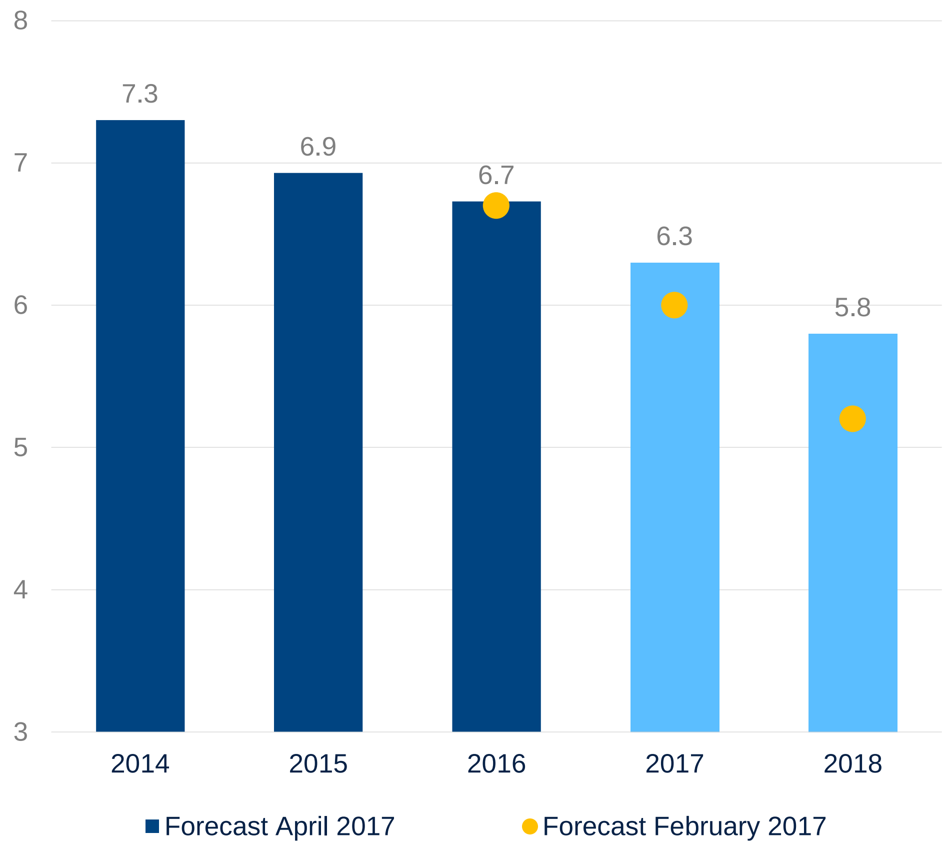
Global growth revised up



Source: BBVA Research. Latin America includes: Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

China: renewed recovery with old engines

China: GDP growth
(%)



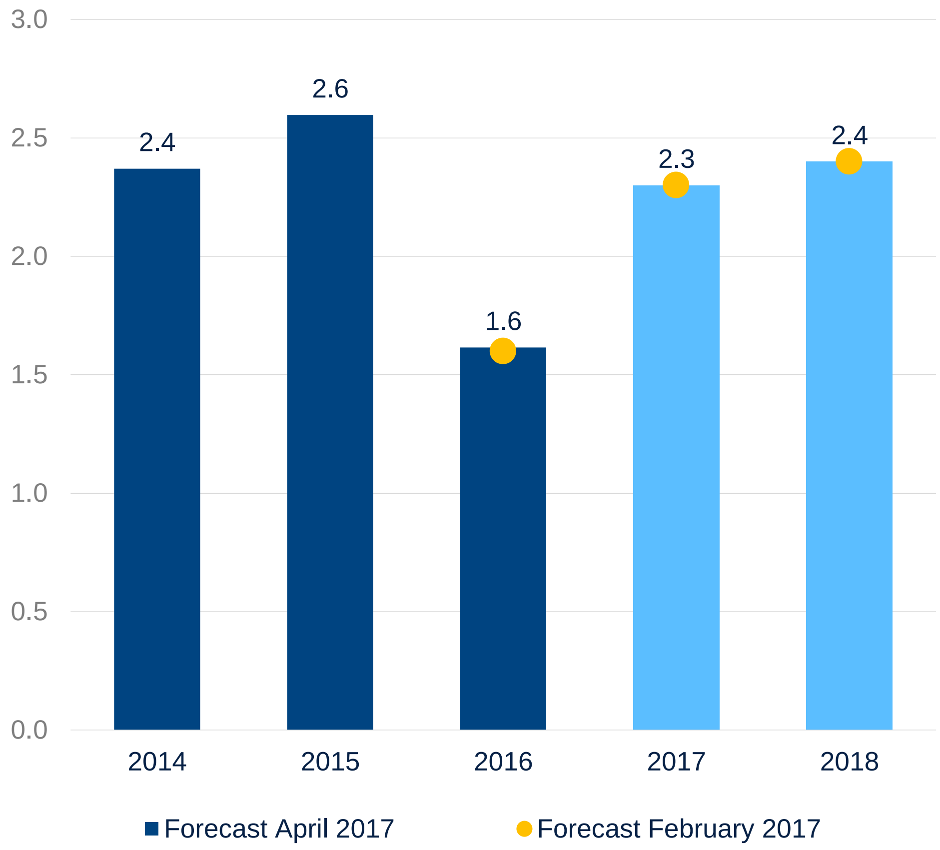
Source: BBVA Research and CEIC

- We revised up our growth forecasts for 2017-18, due to incoming data and a fiscal impulse. Gradual deceleration underway

- But medium-term risks are still significant:
  - Rebalancing of growth towards services and consumption has stalled
  - Policy missteps could lead to a disorderly deleveraging

US: diminished prospects of a pro-growth fiscal impulse

US: GDP growth
(%)

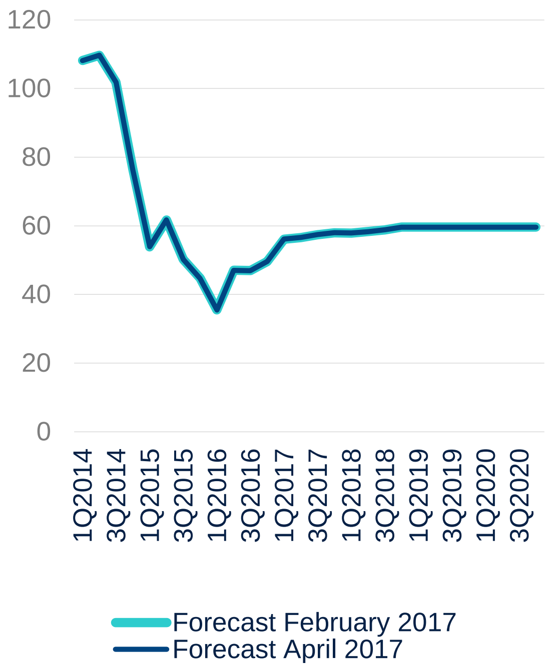


Source: BBVA Research and BEA

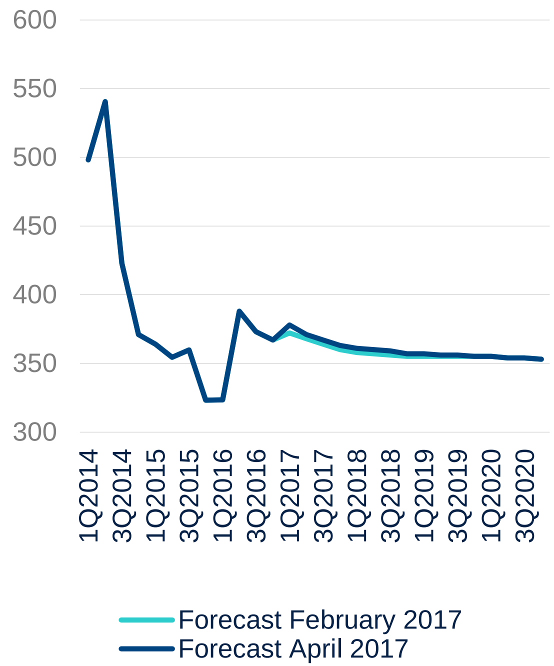
- Growth increases in 2017 given pick up in investment. However, private consumption is expected to slow down
- Risks stemming from economic policy continue despite a softer tone in the last months

We maintain our view of gradual convergence of commodity prices to their long-run equilibrium levels

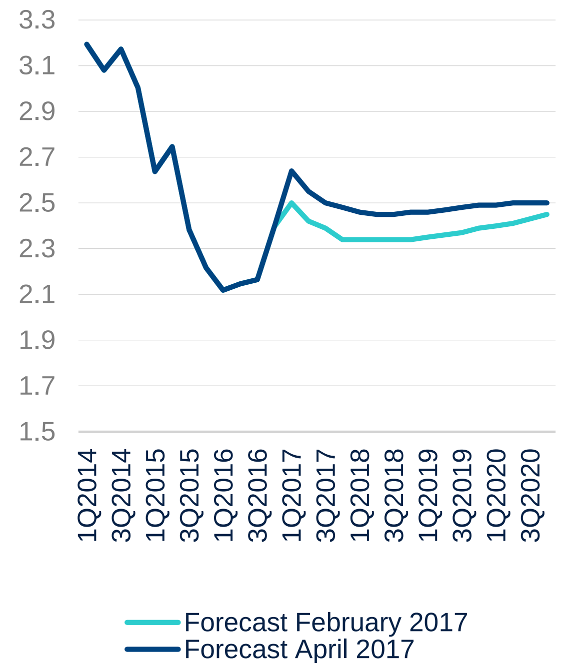
BRENT OIL
(USD/B)



SOYBEANS
(USD/mT)



COPPER
(USD/lb)



Source: BBVA Research and Bloomberg

Oil prices will continue to get support from OPEC production agreement, as well as increase in demand. Copper prices will benefit from stronger demand and also supply disruptions.

No significant changes in our view for long-term commodity prices. Forecasts mostly unchanged for oil and soybeans relative to February.

Global risks most relevant for Latin America are related to US policies and rebalancing in China

1

Lingering **uncertainty about economic policies** to be implemented in US, especially trade policies

2

Policy stimulus in China to support investment could delay and slow down reforms to reduce structural imbalances

3

Elections in France and Italy in (the unlikely) case that Eurosceptic platforms prevail

4

Risks stemming from **monetary policy normalization**, especially in the US

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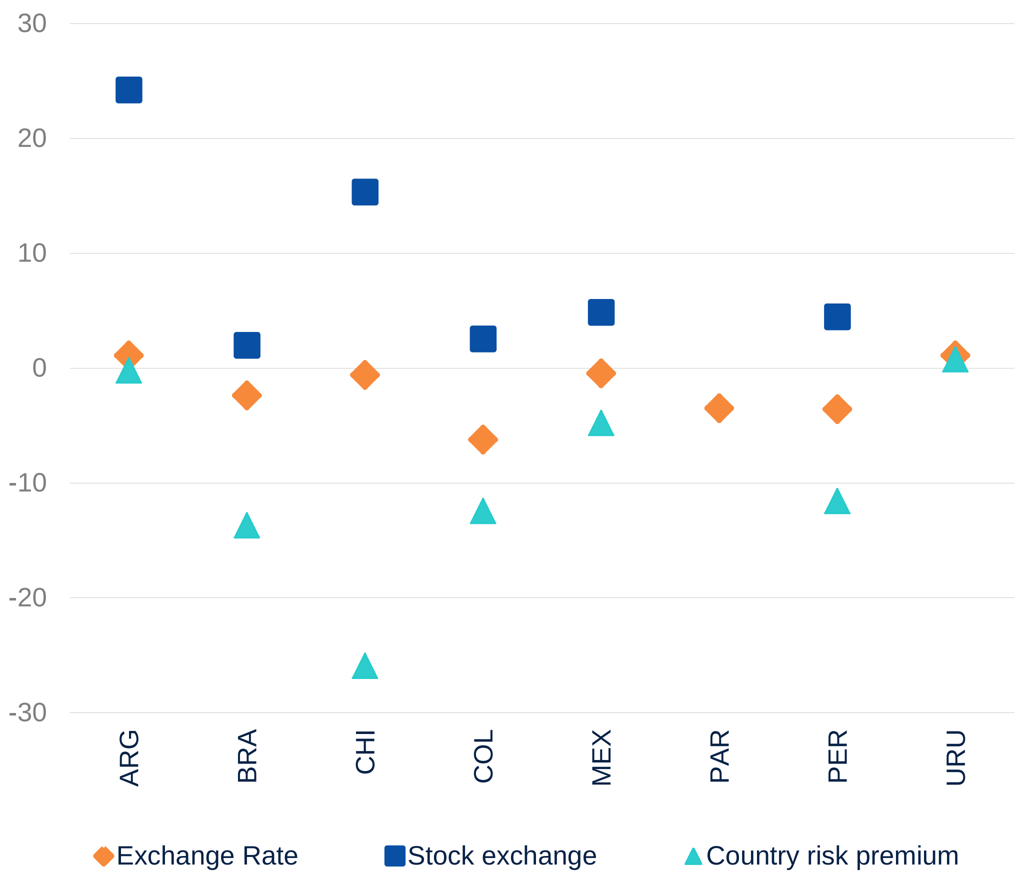
LATAM

A heterogeneous recovery

Financial markets continue to recover in Latam, including in Mexico

- Asset prices and exchange rates continued to see significant year-to-date gains, driven by:
  - Diminished worries about US policies
  - A gradual approach to Fed rate hikes
  - Stronger global growth
  - Increased commodity prices
  - Recovery of growth in some countries

Latam asset prices: percent change since the US election *



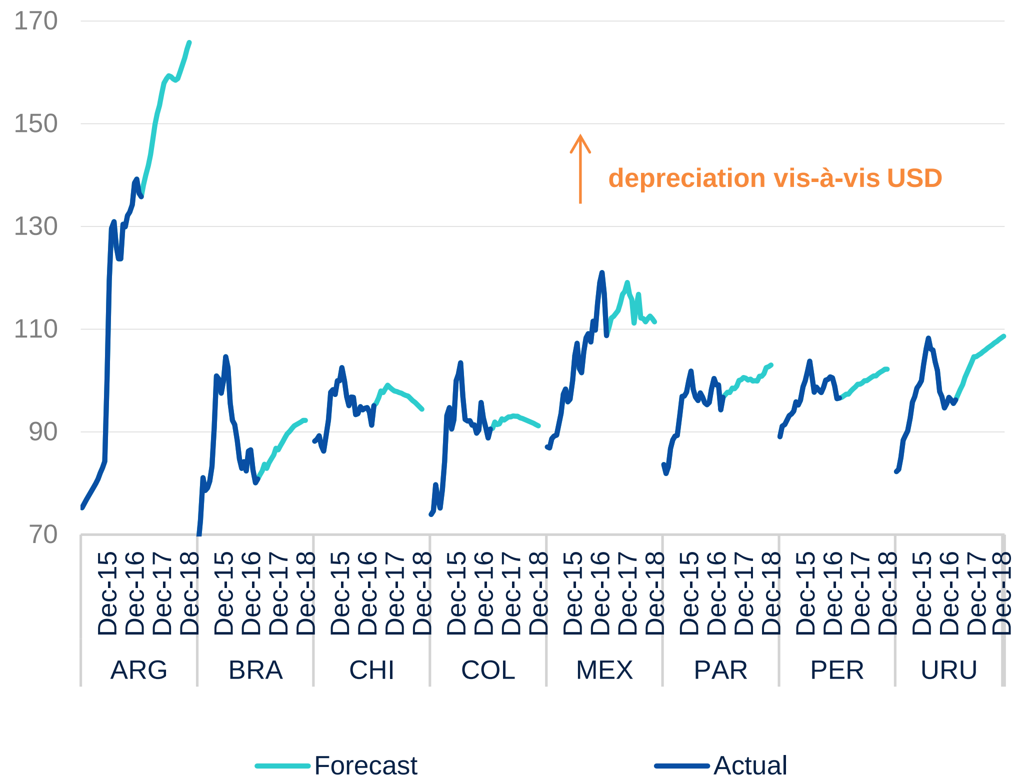
Source: BBVA Research, Haver Analytics and DataStream
* Change between November 7 and April 14. Exchange rate: local currency per USD. In this case, an increase signals a depreciation. Country risk premium: EMBI.

Stable or mildly depreciating exchange rates, going forward

- Exchange rates appreciated in most countries since beginning of 2017. Strong recovery in Mexico
- We expect a mild depreciation of exchange rates going forward given easier monetary policy in South America, diverging from Fed's tightening
- Some room for further appreciation in Mexico in the short run. Chile and Colombia may also see appreciation in 2018

Exchange rates to the USD

(Index Dec 2015=100)

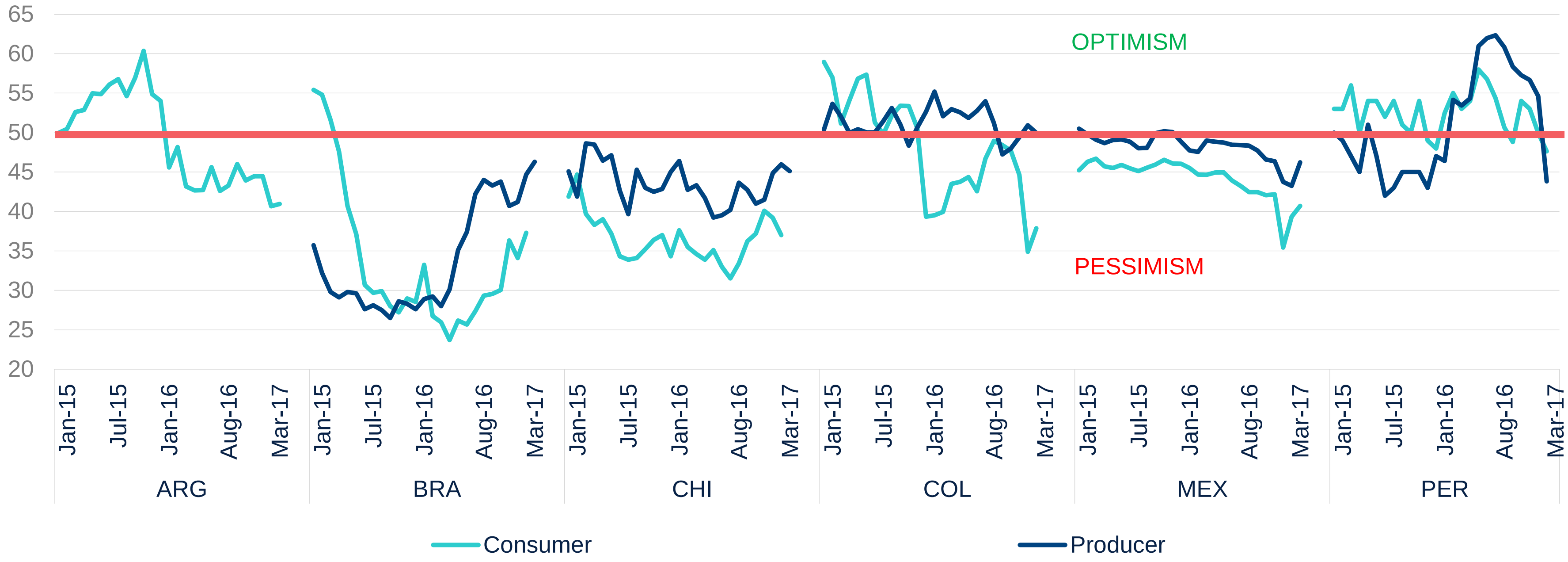


Source: BBVA Research and Haver

Confidence indicators recover in Brazil and Mexico, but remain pessimistic throughout the region

Latam: Confidence indicators for households and firms

(values above 50 pts indicate optimism)



Fuente: BBVA Research y Haver

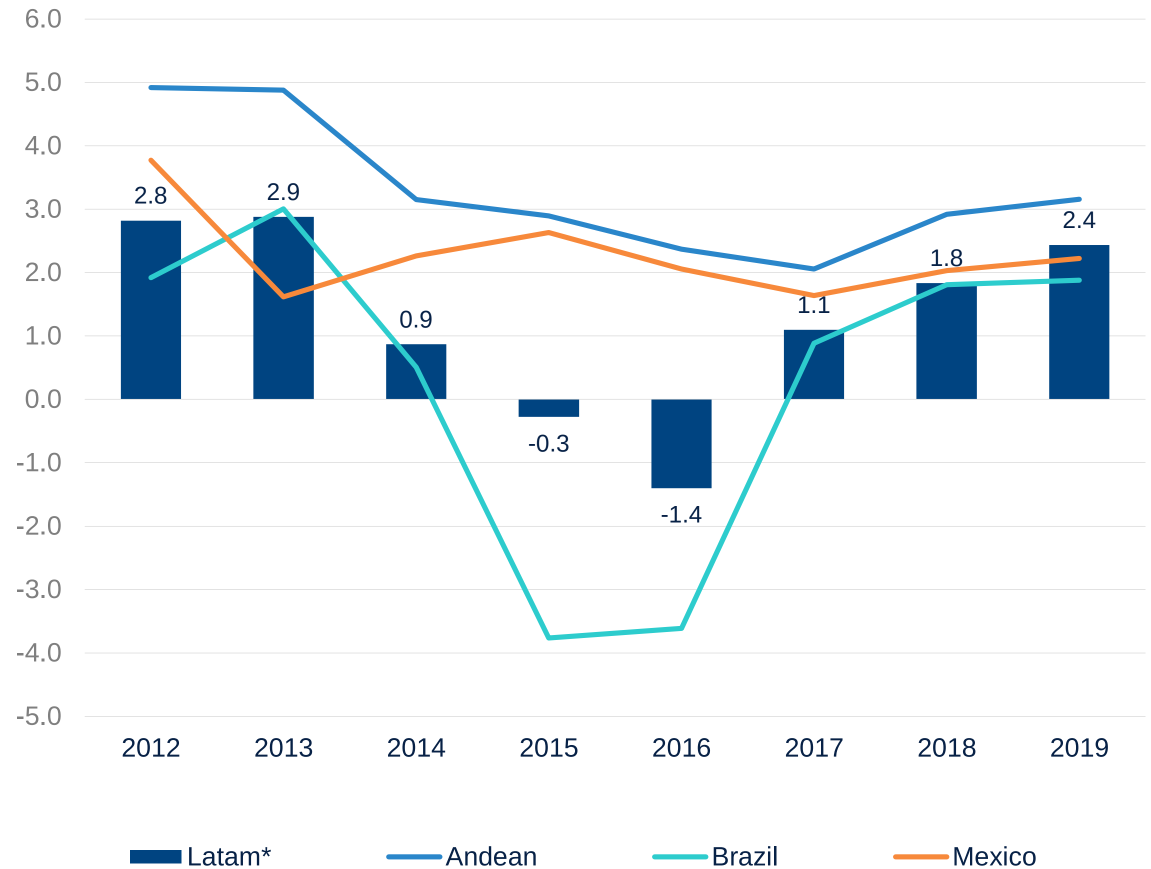
Drop in household confidence in Colombia, after VAT and income tax hikes. Significant confidence fall in Peru after corruption cases linked to Odebrecht case and the negative impact of the “coastal El Niño”

In Mexico, confidence recovers after softer US tone towards trade. Private sector confidence in Brazil recovers after fiscal reform and a significant fall in inflation.

End of GDP deceleration in Latam, but growth remains below potential

- Latin America leaves 4-year deceleration behind it
- Stronger growth in 2017-18 driven by:
  - External sector, supported by more favorable terms of trade and stronger global growth
  - Investment, especially in places like Argentina and Colombia
- Growth in 2017-19 still below potential, which is closer to 3%

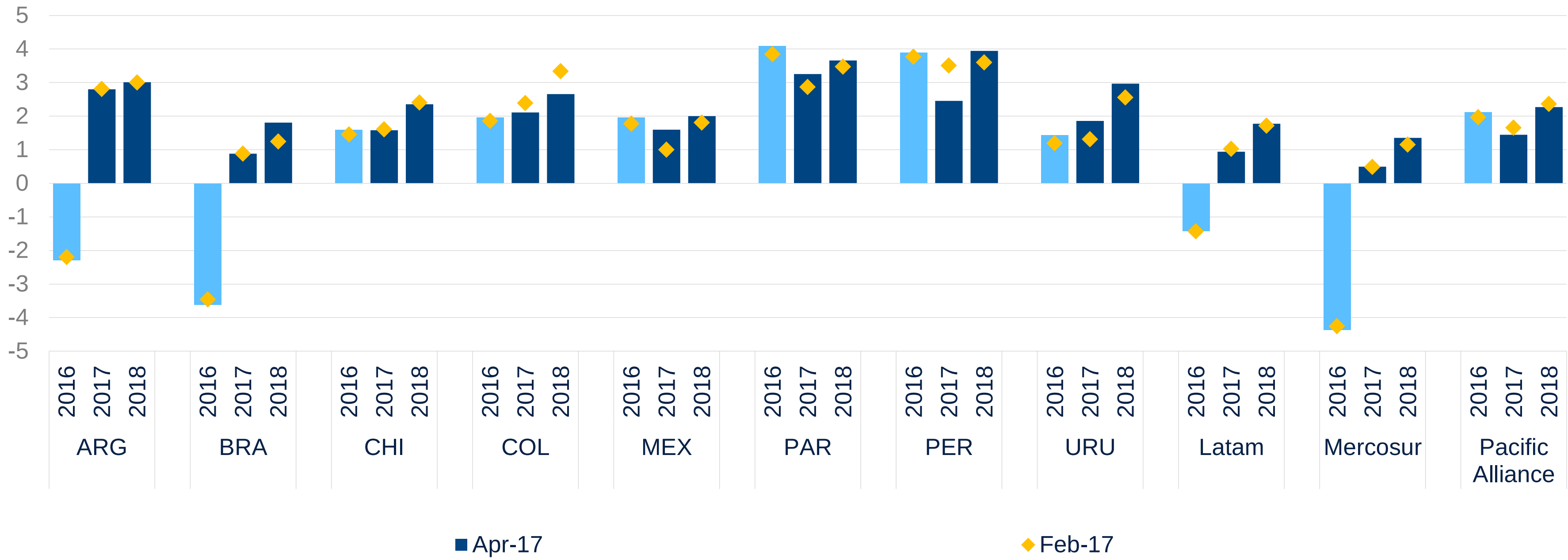
Latam: GDP growth
(%)



Source: BBVA Research
* Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Mexico, Uruguay and Venezuela

Recovery under way in Argentina. Brazil leaves recession behind. Mexico will decelerate less than anticipated.

Latam countries: GDP growth
(%)



Source: BBVA Research

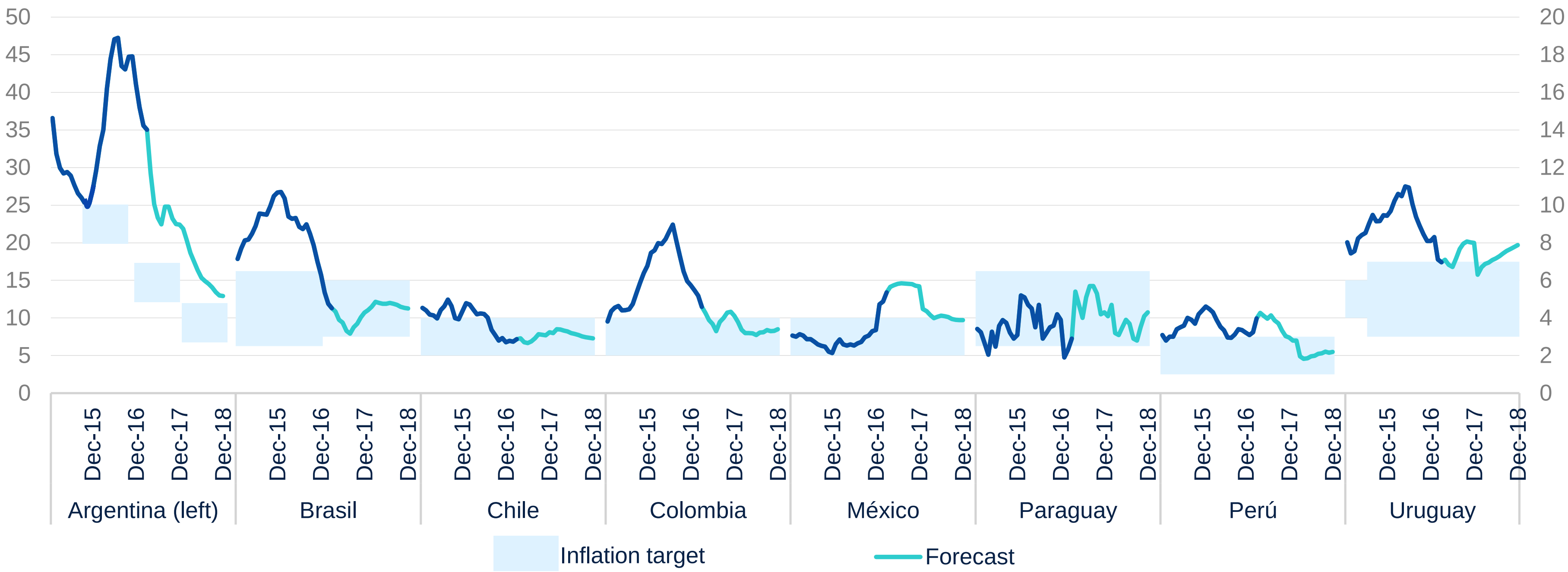
Recent data show the recovery is already under way in Argentina and activity is bottoming out in Brazil.

Economic outlook is less challenging for Mexico, as the new US administration seems to be softening its stance on trade.

Downward revision to growth in Colombia and Peru, due to weak incoming data and infrastructure delays. In addition, Peru suffers the effects of the “coastal El Niño”

Inflation continues to abate in South America and will increase less than anticipated in Mexico

Latam: inflation and central bank target ranges
(%, yoy)



Source: BBVA Research

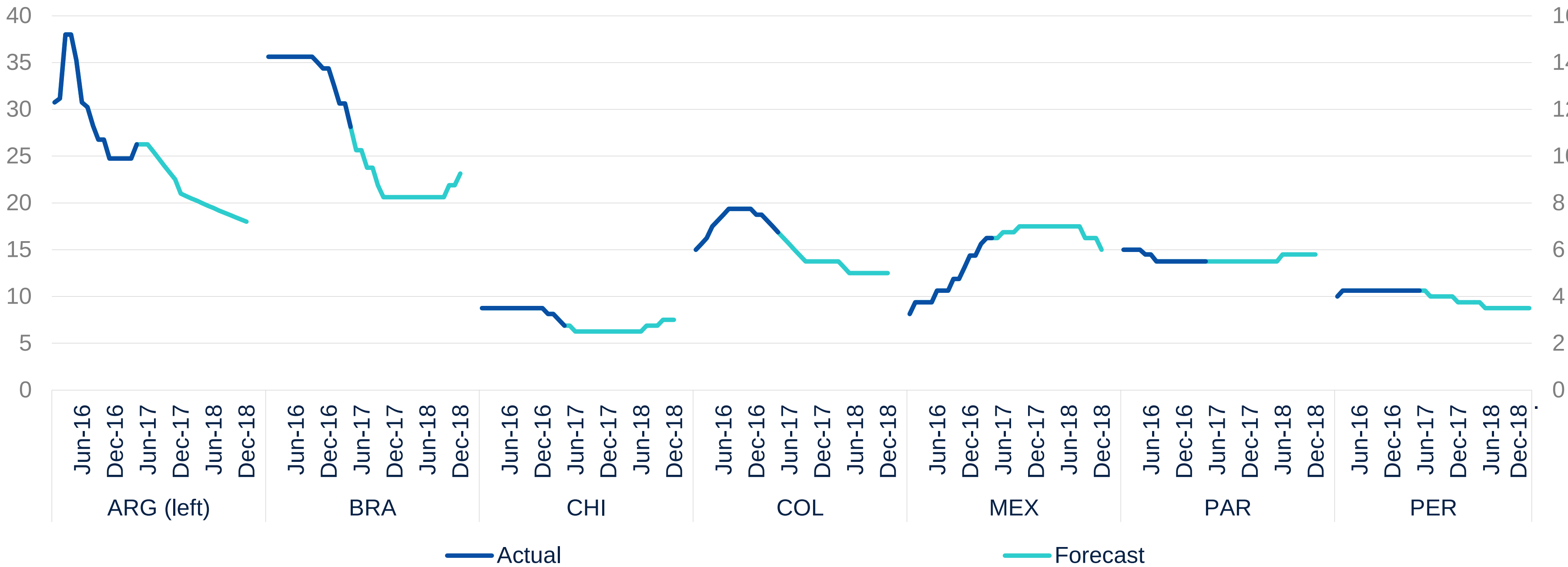
Recent exchange rate appreciation and weak demand effected a lower inflation in South America, except (temporarily) in Argentina and Peru. Inflation will continue to come down going forward.

In Mexico, inflation continued to increase, given past depreciation and fuel price hikes. But recent appreciation will moderate future inflation increases.

Reduction of interest rates in South America will mark decoupling with Federal Reserve

Latam: official interest rates

(%)



Source: BBVA Research and Haver

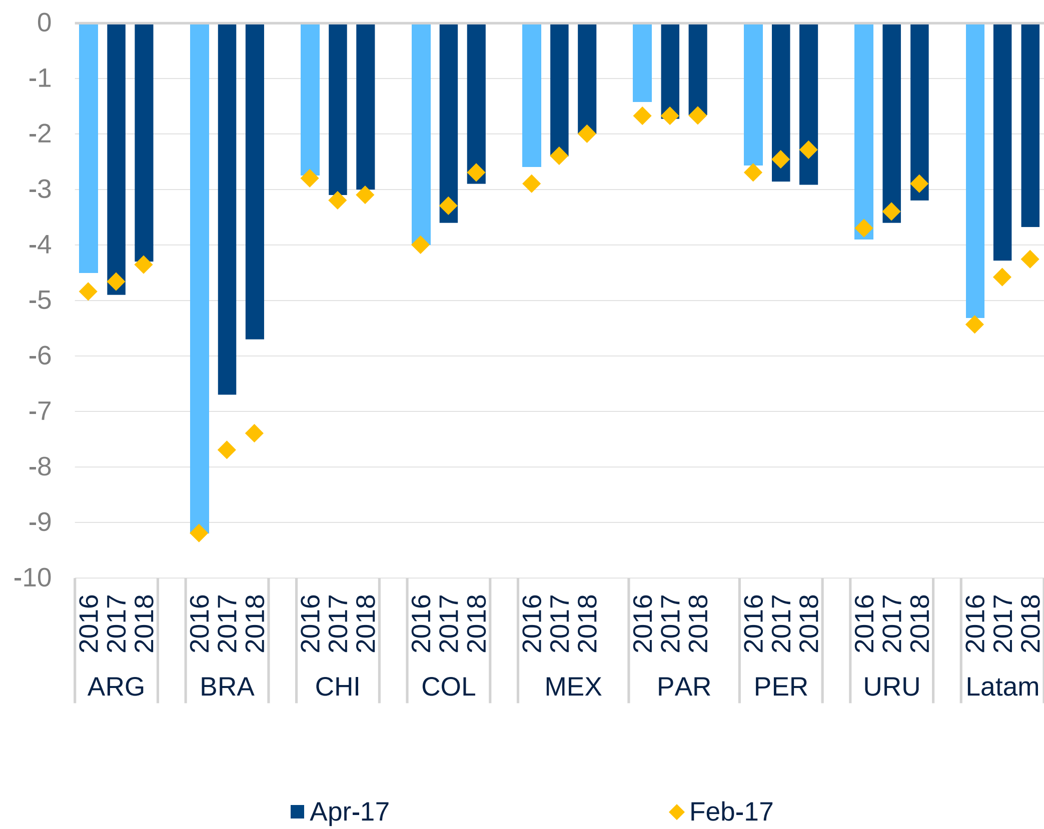
Interest rate cuts will continue in coming months in South America. Argentina and Peru will also cut rates as inflation eventually comes down later in 2017.

Mexican central bank will likely hike rates going forward, in line with the Fed. But policy tightening will be less severe than anticipated three months ago.

Fiscal deficits will continue to shrink, except (temporarily) in Peru

- We continue to expect Brazil and Argentina to meet their primary deficit targets. Fast reduction in interest rates in Brazil induce a downward revision to our forecasts for headline fiscal deficit
- Fiscal deficit in Colombia and Peru to increase above expectations.
    - In Colombia, fiscal council allows for more fiscal space as current account risks diminish
    - In Peru, fiscal deficit would be higher than anticipated, to address emergency and reconstruction expenditure (deviation allowed by the fiscal rule)

Latam: fiscal balance
(%, GDP)

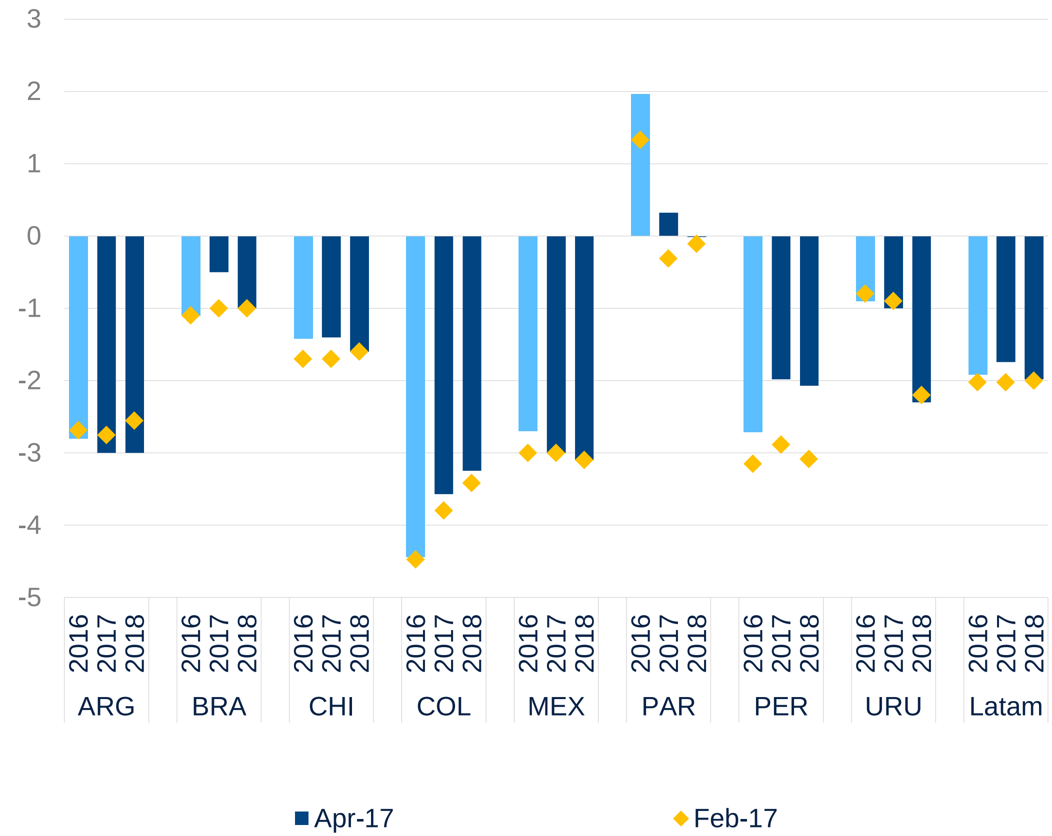


Source: BBVA Research and Haver

Current account vulnerability continues to abate in most countries

- External deficits continue to shrink in countries with the widest gap, like Colombia
- Gaps shrink driven by past exchange rate depreciation, increasing terms of trade and global growth
- Nevertheless, stronger growth in 2017 will slow down external adjustment as imports recover

Latam: current account balance
(%, GDP)



Source: BBVA Research and Haver

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ANNEX

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Latin America GDP growth forecasts

GDP (%yoy)	2014	2015	2016	2017f	2018f
Argentina	-2.5	2.6	-2.3	2.8	3.0
Brazil	0.5	-3.8	-3.6	0.9	1.8
Chile	1.9	2.3	1.6	1.6	2.4
Colombia	4.4	3.1	2.0	2.1	2.7
Mexico	2.3	2.6	2.1	1.6	2.0
Paraguay	4.7	3.0	4.1	3.3	3.7
Peru	2.4	3.3	3.9	2.5	3.9
Uruguay	3.2	0.4	1.4	1.9	3.0
Mercosur	-0.4	-2.6	-4.4	0.5	1.4
Pacific Alliance	2.6	2.7	2.2	1.8	2.4
Latin America	0.4	-1.3	-2.7	0.9	1.8

f = forecast