3 Volatility continues in LatAm markets as they watch out for the timing of rate hikes in the United States

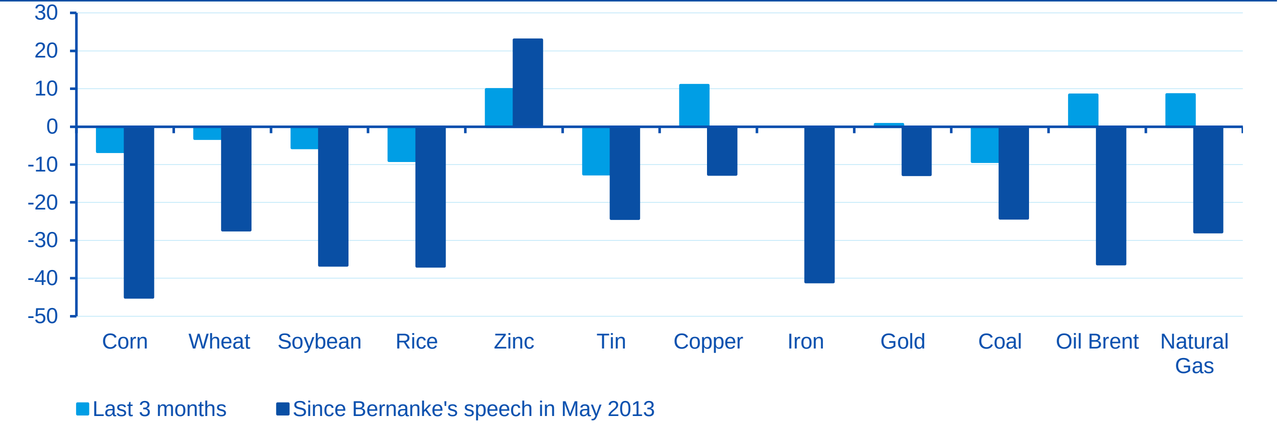
Commodity prices are still flat, as expected three months ago.

Commodity prices have not performed evenly in the past three months. Whereas the oil price and that of some metals such as copper have risen by around 10%, agricultural commodity prices have shifted downwards over this period and those of gold and iron ore have remained practically unchanged (Figure 3.1).

The oil price rise, which is a little less than we were expecting three months ago, was associated with the fall-off in crude inventories (which are nonetheless still at high levels) and movements in world financial markets, especially the depreciation of the USD and the lower volatility seen since March.

The loss in value of the USD in world markets and the toning down of financial upheavals, which partly reversed the movements in the opposite direction which had been observed at the beginning of the year, also provided support for another of the most important commodities for LatAm countries, namely copper. The rally in the price of this metal was in line with our forecasts of three months ago.

Figure 3.1
Commodity prices (% var.)

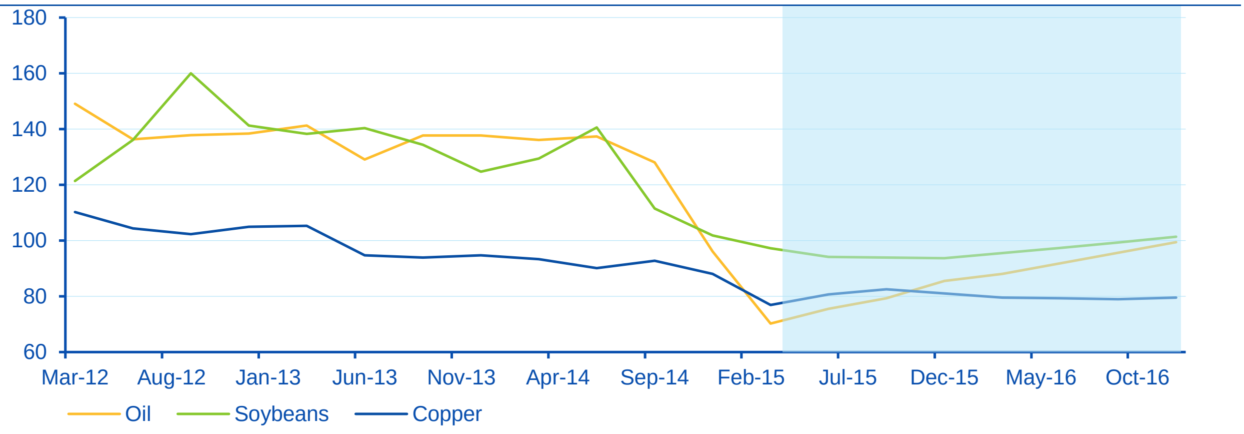


Source: Bloomberg

In spite of the boost which financial factors also gave to agricultural commodity prices, within this group of commodities it was effects relating to their fundamentals which predominated. Specifically, the additional fall in the soybean price in recent months reflects the impact on supply of the bumper harvests in the United States, as well as Argentina and Brazil. The downward correction in the soybean price contrasts with our predictions of three months ago that prices would remain stable.

Whatever the case, prices are still low, far below those of two years ago when markets started to price in the beginning of tapering and monetary policy normalisation in the United States after the speech made by the former chair of the Federal Reserve (Fed), Ben Bernanke. At the same time, the gradual slowdown of the Chinese economy on top of the absence of a stronger pull from demand from the developed countries has helped to keep commodity prices depressed in recent years.

Figure 3.2
Prices of the major commodities (average index value, 2010=100)



Source: BBVA Research

Bearing in mind movements in commodity markets over the past three months and the downward revision of our forecasts for world growth in 2015, we have revised our forecasts for the short-term prices of oil, copper and soybeans down a little. Meanwhile, we are still waiting for prices to converge gradually until the close of 2016 towards their long term equilibrium levels. In other words, we expect the oil price to continue to adjust upwards, moving towards USD70/bbl (Brent) at the end of 2015 and USD80/bbl at the close of 2016 as world demand picks up and the supply responds to the relatively low prices observed in the last few months. With regard to soybeans and copper, we estimate that current prices are not significantly far from their long-term levels (Figure 3.2).

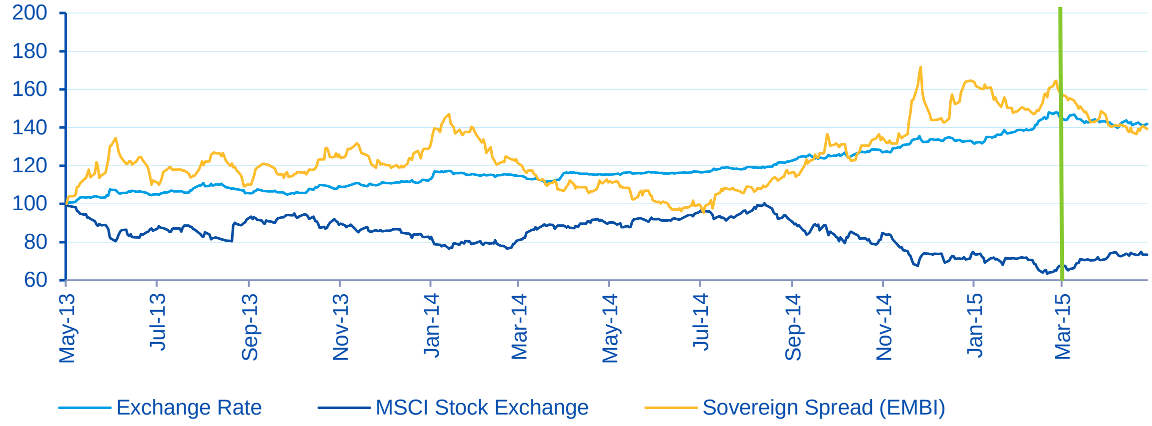
The shift in views on the start date and pace of the Fed rate hikes has moved LatAm markets.

As with the commodity markets, prices of Latin American financial assets have also reacted over the past three months to the outlook for the normalisation of monetary policy in the United States. In fact, Latin American markets fell back up to mid-March and began to rally again from then onwards as the idea took hold that the Fed's rate adjustment would be slower in coming and take longer than was expected at the outset of the year and, as a result, the USD backtracked on its strengthening trend.

As can be seen in Figure 3.3, the sovereign spread (the LatAm EMBI), the MSCI stock market index and the average LatAm exchange rate stopped declining and began to improve again from mid-March. This rally has allowed the region's sovereign spread to narrow by 31 points in the past three months and both the MSCI stock market index and the region's average exchange rate to regain all the ground they have recently lost.

Meanwhile, the slowdown in the region and the weakening of commodity prices continued to weigh on LatAm asset prices, which has stopped there being a more marked upturn since March.

Figure 3.3
LatAm: stock market prices, spreads and exchange rates (23 May 2013=100)

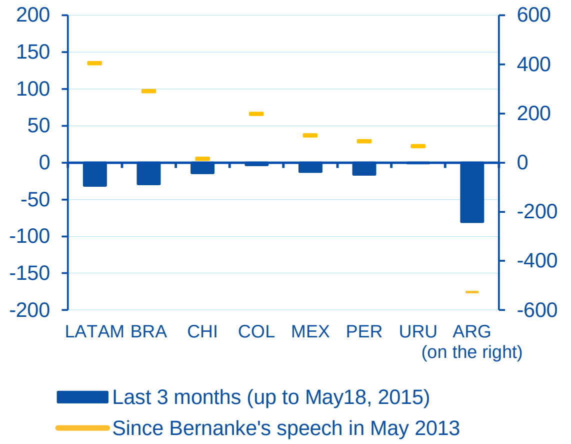


Sources: BBVA Research

With few exceptions, recent regional trends have repeated themselves relatively uniformly across the financial markets of each country, suggesting that global factors have been more influential on local markets than idiosyncratic aspects.

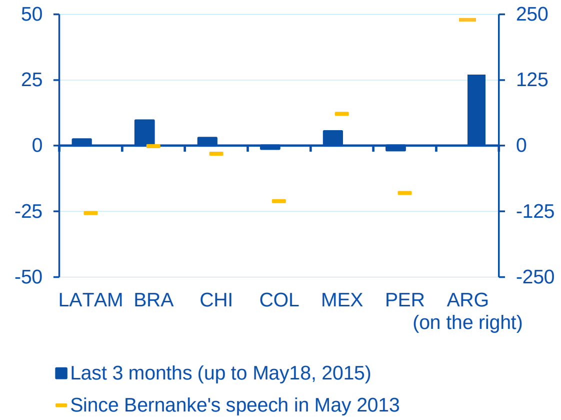
The sovereign spread has corrected itself in a pattern of reduction over the last three months in all the countries under review (Figure 3.4), more sharply so in Argentina (-80bp) and Brazil (-29bp). In the case of Argentina, one of the factors which have helped narrow the sovereign spread has been optimism about the outlook for the country after the October elections. On the other hand, with Brazil we should bear in mind that the earlier decline was worse there than for the rest of the region, as events in the Petrobras crisis and expectations over the economic adjustment underway amplified global movements (i.e. there was a deterioration up to March, followed by a mild improvement from then onwards).

Figure 3.4
Trends in sovereign spreads in Latin America (EMBI, bp)*



* Data on Argentina on the RH axis.
Source: Haver Analytics and BBVA Research

Figure 3.5
Stock market performances in Latin America (%, in local currency)*



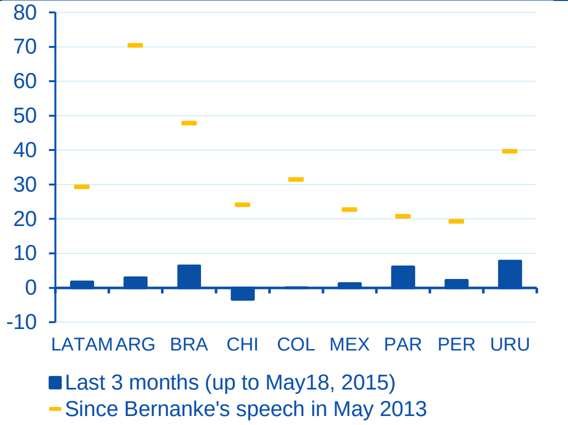
* Data on Argentina on the RH axis.
Source: Haver Analytics and BBVA Research

Although stock markets have been more weighed down by the slowdown in activity and other local factors, in the last three months there have generally been rises, especially in Argentina and Brazil, for the reasons cited earlier (Figure 3.5).

Turning to the FX markets, despite the reversal of the depreciating trend from March, exchange rates in mid-May were still somewhat weaker than they had been three months earlier (Figure 3.6). This phenomenon was more pronounced in the Mercosur countries, where inflation is higher (and requires a more swingeing currency depreciation to head off a loss of competitiveness), and the major commodity markets (agricultural products) have proved a bigger handicap to these countries than to the Andean economies or Mexico in recent months (Figure 3.1). On top of this there might have been some degree of spill-over into the other countries within the block of countries from the depreciation in Brazil (see Box 1). On the other hand, in the Pacific Alliance countries the depreciation was very minor (2% in Peru and 1% in Mexico), or even non-existent (0% in Colombia and -3% in Chile), partly due to the rally of roughly 10% in the copper price and oil over the period, added to which currency market intervention was a factor in Peru's case.

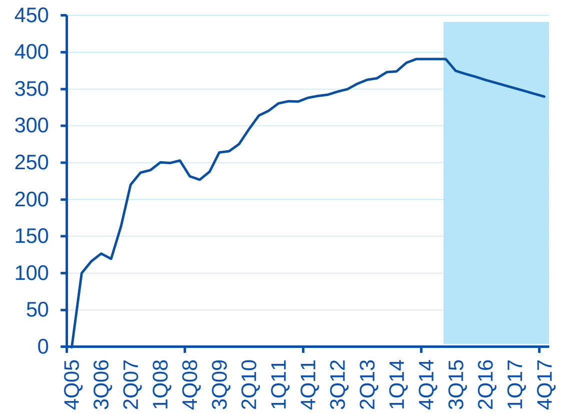
Thus, with the notable exception of Argentine sovereign risk and the stock markets in Mexico and Argentina, prices of the region's financial assets have remained significantly below the levels of two years ago, when the tightening of monetary liquidity in the United States had not yet been discounted, and commodity markets admitted far higher levels of economic activity than there are now.

Figure 3.6
Exchange-rate movements in Latin America (% var.)



Source: Haver Analytics and BBVA Research

Figure 3.7
Capital inflows to LatAm (portfolio flows, USD mn)



Source: IFS and BBVA Research

Volatility will continue further ahead, to the extent that any hiking of the Fed rate hike will US data-dependent

Given that the decision on the timing and scale of the rate hike in the United States basically hinges on the country's economic activity data, it is highly likely that any positive or negative surprises in these indicators will give rise to fresh adjustments in expectations, and therefore an upturn in volatility in global and Latin American financial markets further down the line.

The central banks of LatAm countries may add to this volatility (especially as regards the exchange rate) if there is any uncoupling (albeit only partial) from the Fed rate hike in the course of addressing local conditions marked by weak growth.

Thus, even though the gradual recovery of growth in activity in the region's countries ought to lend support to LatAm asset prices, the most likely scenario is that global conditions will not be as helpful as they have been. Looking at this more closely, we predict that capital inflows into the region will fall off in the coming years. In our baseline scenario, which features world growth of the order of 3.5% in 2015 and 3.9% in 2016, with the United States embarking on its monetary normalisation process in 3Q this year and global risk aversion gradually wearing off, a net outflow of capital of non-residents should arise, which should build up to an amount equalling 2% of regional GDP in the next two years (Figure 3.7), which is a bit less than we were forecasting before (see Box 2 of our LatAm Outlook, 1Q15). This would then imply a continuation of the easing of flows into the region that we have observed since mid-2014.

DISCLAIMER

This report has been produced by the LatAm Co-ordination unit.

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