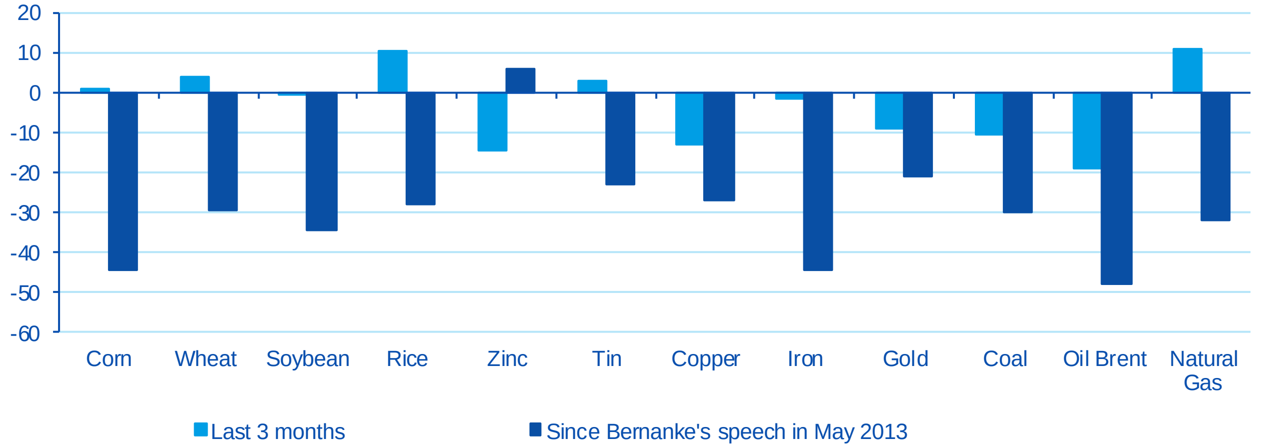
3 The Fed, China and cyclical weakness are depressing Latin American markets

Key commodity prices are enduring the impact of financial market upheaval in China, although the correction has mainly been from supply shocks

In the past three months, the prices of most commodities have drifted (Figure 3.1). This is partly due to the economic slowdown and the recent financial turmoil in China, but above all to supply shocks in certain specific markets and renewed dollar strength (which has an impact on prices via a denomination effect).

Among the goods most affected by the downward corrections of the past few months, copper (-13%) and oil (-19%) are conspicuous. These two markets have been afflicted (as have others) by both the Chinese economy's situation, given the country's substantial share of global demand, and the financial impact of the dollar's appreciation. Even so, the prime factors which have had a bearing on the recent plunge in the oil price have originated from the supply side with, first, the increase in OPEC production (especially in Saudi Arabia and Iraq), second, shale oil's maintained production and productivity gains in the United States and, finally, the nuclear deal between the latter and Iran, which could increase the oil supply in an already overflowing crude market. The oil price has additionally factored in the increase in inventories among the OECD countries and a weaker appetite for investing in the crude market on the part of pension funds.

Figure 3.1
Commodity prices (% var.)



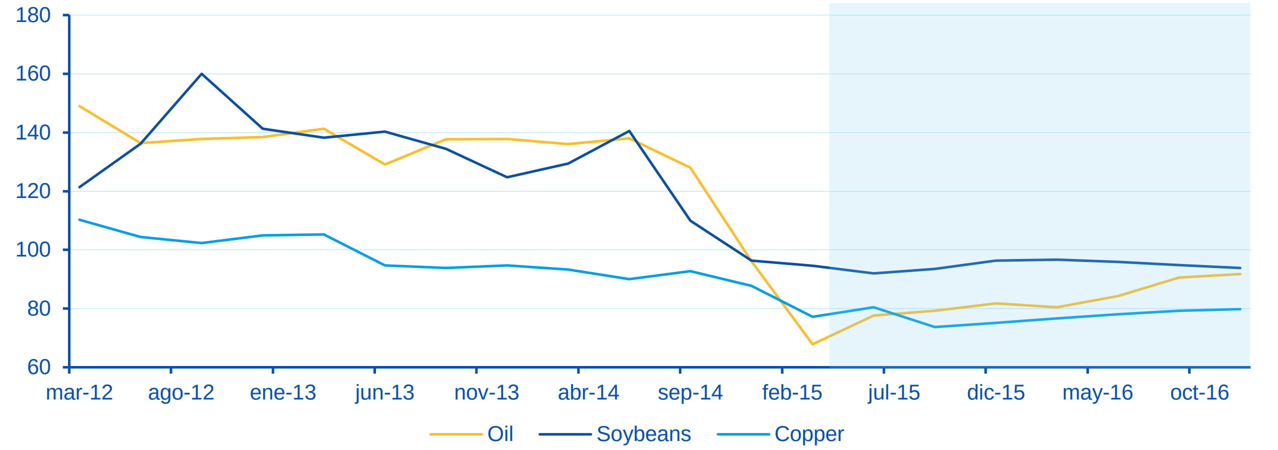
Source: Bloomberg

In our opinion, the factors which have affected the oil price in the last few months, particularly those of a more structural nature, such as shale oil productivity gains, will also dampen the rally in the crude price over the forecast horizon. We have therefore revised down our forecasts for the Brent price and expect this to average USD61/bbl and USD69/bbl respectively in 2015 and 2016, compared to the estimates of USD62/bbl and USD75/bbl which we ventured three months ago (Figure 3.2).

We have likewise moved down our forecasts for the average price of copper, to USD2.62/lb and USD2.68/lb respectively for 2015 and 2016, from USD2.71/lb for both years three months ago. The principal determining factor behind this revision has been the poorer outlook for growth in China. In any event, we still expect the copper price to revive, given expectations of a fall in inventories arising from reduced supply.

Movements in the soybean price, as well as those of other agricultural commodities, have been different from those above. This is, on the one hand, because it is less responsive than metals and oil to financial impacts and the slowdown of China's economy (among other reasons, because the deceleration of China's growth is taking place at the same time as a reorientation towards consumption (more agricultural commodity intensive) to the detriment of investment (more metals and oil intensive). On the other hand, the soybean price has benefited from the dulling effect of excess rainfall on output prospects in the United States. We expect these factors to go on pushing up the soybean price over the rest of the year and that a normalisation of supply, with a promising outlook for production in the southern hemisphere, will drag prices gently down in 2016.

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



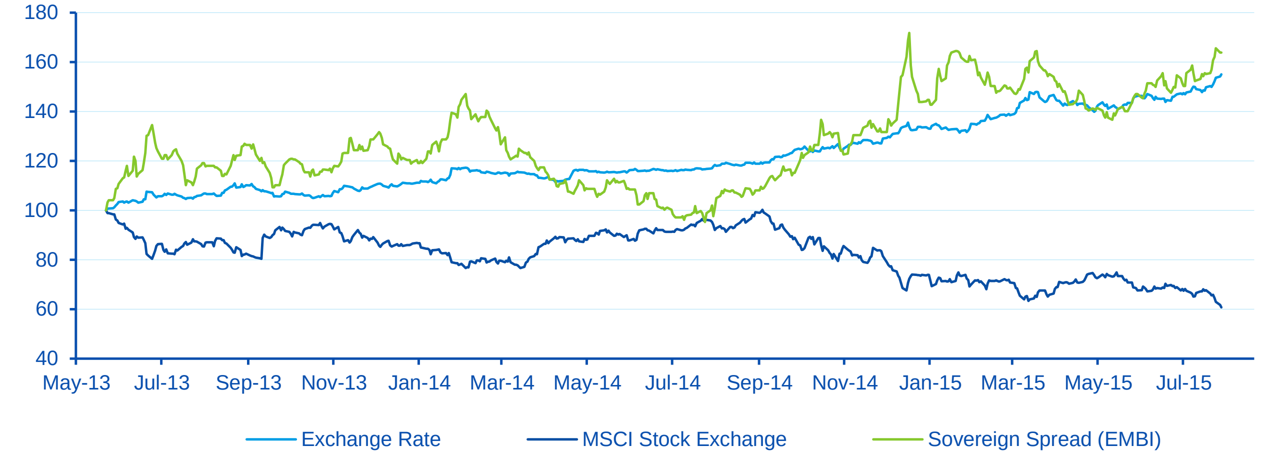
Source: BBVA Research

Significant downward corrections to LatAm financial asset prices in recent months

After a mild upturn in part of March and April, prices of LatAm financial assets have displayed a downward trend again over the past three months (Figure 3.3). As we have been pointing out in our reports, a large part of the weakness and volatility of late is associated with the prospect of monetary policy normalisation by the Fed. Since the decision-making process as regards the timing and magnitude of the rate rise in the United States essentially depends on the country's activity figures, positive or negative surprises in connection with these indicators give rise to shifts in expectations and, consequently, increased volatility in financial markets both globally and in the region. By the same token, the resurrection of the perception that the Fed will hike rates in Q3 is one of the factors that explains the recent falls in Latin American financial markets.

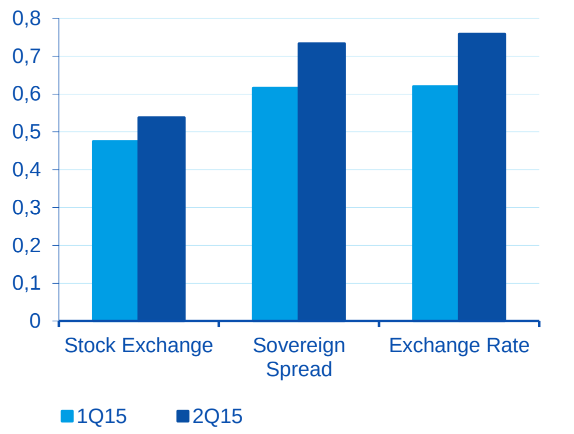
Whatever the case, growing concern over China's economy, and the subsidence in commodity markets which ensued, have also hit financial asset markets in Latin America. Indeed, the significance of these factors for the region's financial markets is likely to have been greater in the past three months than at the beginning of the year, not only with the escalation of concern over China and heftier corrections to commodity prices, but also because of the closer correlation between the price trends for the principal primary products exported by the region's countries and the performance of their financial assets (Figure 3.4).

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



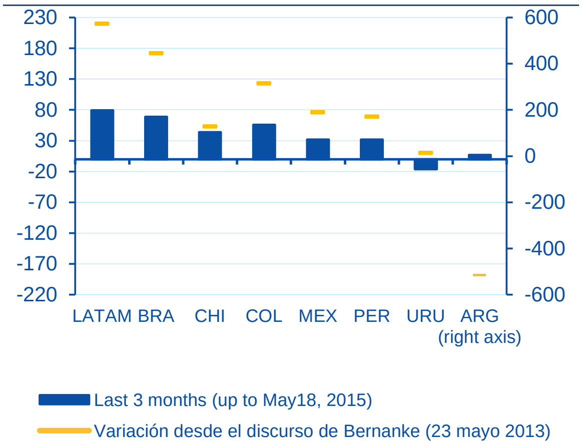
Source: BBVA Research

Figure 3.4
Correlation between the commodities index and the stock market, the sovereign spread and the exchange rate in LatAm*



* Absolute value of the correlation in each quarter between the various indexes. Commodity index: CRB, Stock market: MSCI, Sovereign spread: EMBI Latam; Exchange rate: average exchange rate for the region's principal countries.
Source: CRB, Haver Analytics and BBVA Research

Figure 3.5
Sovereign spread trends in Latin America (EMBI, basis points)*



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

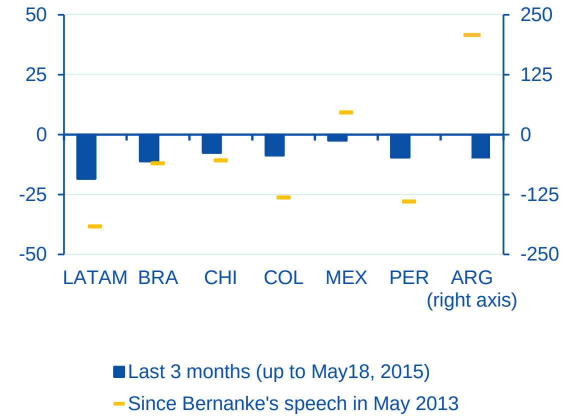
Finally, another of the chief factors behind the falls in Latin American markets has been the cyclical weakness of the region's economies: generally, growth has eased up, inflation pressure has not intensified and, in at least some cases, external and fiscal balances have deteriorated (see the sections which follow for further details on macroeconomic developments in Latin America). One example of the significance of idiosyncratic factors for financial markets is Brazil, where the recent downturn (more accentuated than in other countries) has prompted mounting concern over a potential loss of investment grade status for its sovereign debt, mainly after S&P, which maintains the country's rating as borderline investment grade, revised the outlook in its appraisal for the country in July from "stable" to "negative".

Within this environment, recent evidence points to a slowdown of capital inflows to the region's countries. In some of these, such as Colombia and Brazil, portfolio flows turned negative in June. This phenomenon was to some extent predictable, given the impending normalisation of monetary policy by the Fed, and is a process which is expected to continue into the future. Our forecast is that net capital outflows will amount to approximately 2% of regional GDP in the next two years.

Turning to sovereign spreads, the EMBI Latam aggregate indicator has shown an 80bp upturn over the past three months. Within this market, the sharpest corrections have been felt in Brazil and Colombia, although also in Chile, Peru, Mexico and Argentina. The exception has been Uruguay, where the sovereign spread has narrowed slightly in the last three months (Figure 3.5).

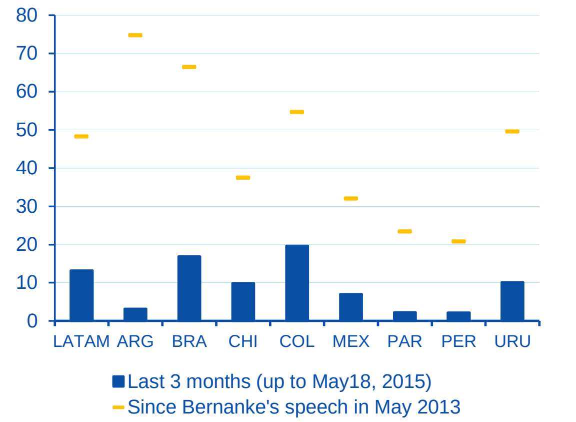
Lost ground has also been observed in stock and currency markets. In these two cases, there have been no exceptions to the widespread downward trend. As with sovereign spreads, Brazil and Colombia are the countries which have experienced the most substantial corrections. In Brazil this has been due to the more marked economic decline (leaving aside the greater liquidity in its financial markets), and in Colombia this owed itself to its dependence on oil, a commodity which has suffered the heaviest downward price corrections in the past three months (Figure 3.1).

Figure 3.6
Stock market performances in Latin America (% var. in local currency)*



* Data for Argentina on the RH axis
source: Haver Analytics and BBVA Research

Figure 3.7
Exchange rate movements in Latin America (% var.)



Source: Haver Analytics and BBVA Research

Volatility is set to linger as the opening Fed rate hike draws near

After the recent corrections, financial markets have notably magnified their cumulative falls since May 2013, when former Fed Chair Ben Bernanke gave the markets cause to start factoring in the beginning of tapering and the monetary policy normalisation process in the United States (Figures 3.5 to 3.7).

Looking ahead, we predict that volatility in Latin American financial markets will persist and intensify as we approach the possible date of the commencement of rate hikes by the Fed, and South America’s central banks disengage still more from US monetary policy, which is something that could particularly affect currency markets (see Section 6). Expectations that China’s economy will continue to slow down over the coming years also lend weight to this perception of a bleak setting for the region’s assets (see Section 2).

In spite of this, we also predict a rally in the prices of certain key commodities, such as oil and copper, from current depressed levels, which should provide support for markets that are strongly bound in with them, such as Colombia, Peru and Chile. Added to this, the gradual recovery of economic activity should steadily bring greater relief from the downward pressures assailing Latin America’s financial markets.

DISCLAIMER

This report has been produced by the LatAm Unit

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