Highly volatile Latin American markets on the back of doubts about growth in China

Prices of the main commodities suffer the impact of doubts about growth in China, on top of the adjustment to supply shocks in the second quarter of the year.

The prices of raw materials continued to fall over the last three months, with the exception of some agricultural commodities, gold and iron ore, where prices remained constant. The fall in prices was sharper on the natural gas, zinc, soya, tin and oil markets and less pronounced in copper and coal (Figure 3.1). In all cases considered, prices at the close of October were significantly down against just over two years ago, when the speech by Ben Bernanke, then the Chairman of the American Federal Reserve, led markets to reflect on the start of tapering and the normalisation of monetary policy in the USA.

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**Figure 3.1**

**Commodity prices (% var.)**

Source: Bloomberg

The main factor behind moderating commodity prices is the fall in China’s growth rate and the re-orientation of its economy towards consumption, becoming less intensive in commodities (mainly metals and energy) at the expense of investment. Although commodity markets have been watching the Chinese economy and its impact on demand for years, concern has increased in recent months, mainly in July and August, as a consequence of the turmoil mentioned in the previous section, which has helped decisively to drive the downside corrections observed recently.

Slowing demand also appears to be the main justification in the face of increased supply to explain the fall in oil prices from USD60 per barrel halfway through the year to around USD45 in November. The dynamics of oil are similar to those of other raw materials, mainly metals such as copper and iron ore, which is consistent with the existence of a factor common to all of them, linked to the constraint of demand. In the case of soya, a very important product for countries like Argentina, Brazil, Paraguay and Uruguay, apart from global factors the good US crop has had an influence. In general terms, the adjustment to supply in the face of significant price falls is starting to show, but this has been unable to offset the effects of weaker demand.
Falling commodity prices and volatile markets weighed on the main regional assets

Problems in China have had a direct impact, not only on commodity markets but also on the financial markets of the region, because of the importance of the Chinese economy – and of primary products – for practically every economy in the region. Although the US Federal Reserve delayed the first interest rate hike, markets remained nervous, reflecting the uncertainty about the next steps that the American monetary authority will take.

Apart from the unfavourable external environment, the domestic situation in most countries of the region also had a negative effect on the price of Latin American financial assets, mainly due to a generalised moderation in economic activity. The internal factors of the region included a strong fiscal deterioration and the consequent downgrading of Brazilian debt from investment grade by S&P in September. In practice, the deterioration of the Brazilian economy is another negative element weighing on Latin American financial markets, although its impact is limited, and most probably less than the slowdown in China and the normalisation of monetary policy in USA.¹

![Figure 3.2](image)

Latam: stock market prices, sovereign spreads and exchange rates (index 23 May 2013=100)*

* Exchange rate: average of the countries of the region. Stock market indicator: MSCI. Sovereign risk: EMBI Latam. In the case of the exchange rate, an increase in the index indicates a depreciation

Source: Haver Analytics, Datastream and BBVA Research

In this context, the prices of the main financial assets were revised down even further over the last three months, mainly due to the corrections observed up to the beginning of September. From the close of July to the end of October, the EMBI Latam rose approximately 20 basis points, the MSCI stock market index contracted almost 10% and exchange rates depreciated by around 8% on average (Figure 3.2). These are significant losses, greater than those seen during the taper tantrum of summer 2013, after Ben Bernanke’s famous speech.

The corrections observed in the approximately 45 days between mid-July and the end of August, when there was turmoil on Chinese financial markets and concerns about the Chinese economy intensified, also assumed unusual proportions. The case of the currency markets is illustrative: in the 45 days that financial tensions lasted in China, the exchange rate of the main Latin American countries depreciated by an average of 10.1%. Over the last 10 years, the region had only seen such a sharp depreciation in its currencies at the

¹: For further details about the loss of investment grade in Brazil and the eventual consequences for the region, see our report “Economic Watch: Brazil, back to high-yield”
start of the Lehman Brothers crisis in 2008. In the other cases, accounting for 99% of the period between 2005 and now, currency depreciation has never been more significant than recently (Figure 3.3).

Another consequence of the current economic context was a moderation in capital flows into the region, although they remain at positive levels. Foreign currency issues of both sovereign bonds and corporate shares have also slowed down significantly this year, compared to the last three years (Figure 3.4). Specifically, issues to October 2015 are down 34% year on year. The most significant slowdowns have been in the corporate sector (down 54%) and issues made by Brazil (down 83%).

Financial losses in recent months have been wide-spread, both in terms of countries and assets. The only clear exceptions were the Argentine sovereign spread and stock market, which stayed in positive territory over the last three months, probably due to the economic prospects for the country after the presidential elections in November.

In all the countries analysed, except Argentina, the sovereign spread widened over the last three months, albeit less so in Uruguay, possibly related to the movements observed in Argentina, and in Mexico, where the economic dynamics are different from the other countries of the region as Mexico benefits more directly from a recovery of economic activity in USA and it has less exposure to the Chinese economy. Increases in country risk were more pronounced in Brazil, due to the impact of the aforementioned fiscal deterioration and political instability (Figure 3.5).
The losses seen on the stock markets over the last three months were as important, if not more so, in Colombia and Peru as in Brazil. Apart from their higher starting points, Peruvian and Colombian stock market prices fell on the recent slowdown of their economies, with the political noise in the former case and with the strong fall in oil prices in the latter. On the other hand, stock markets managed to remain relatively stable in Chile and Mexico, despite the complex international environment (Figure 3.6).

Finally, in the exchange markets, all the currencies, without exception, have weakened since the close of July. As in previous cases, the strongest adjustment occurred in Brazil, which, together with the strong correction to soya prices and downside pressure on the currency, could have contributed to even stronger depreciatory pressures in Argentina, Paraguay and Uruguay than in the other countries of the region (Figure 3.7).

It is worth highlighting that although both the slowdown in the Chinese economy and the uncertainty regarding the normalisation of monetary policy in USA have a negative impact on the financial assets of all the countries of the region, the former weigh heavier on the Andean countries than on Brazil and Mexico, as Chile, Peru and Colombia depend to a larger extent on the sale of primary products to China. The impact of the turmoil triggered by the Federal Reserve raising interest rates is significantly greater in Mexico and Brazil, due to the greater depth of their financial markets (Figure 3.8).
Volatility will continue, due to the Fed’s actions and doubts surrounding the slowdown in China

As the Chinese economy continues to adjust and the Fed reveals its interest rate hike strategy, Latam financial markets will continue to react, very probably with one shock following another, given the importance and the high levels of uncertainty that surround both processes. Against this backdrop, it is difficult to imagine that the financial markets of the region will rapidly recover the losses accumulated in recent times.

Another factor that points in the same direction is Brazil’s likely downgrade below investment grade by a second risk-rating agency in the coming months (possibly in mid-2016), which will trigger an automatic adjustment to the portfolio of certain kinds of investors, which could have an impact, albeit limited, on the region beyond Brazil.

All in all, regional financial markets should benefit from a recovery in the prices of some key raw materials such as oil and copper against the current depressed levels, which would drive some strongly associated markets such as Colombia, Peru and Chile (Figure 3.9).

In the case of oil, we expect prices to exceed USD50 per barrel by the end of the year, converging towards something closer to USD60 in the course of next year. Similarly, we expect the price of copper to rise gradually over 2016, after hitting rock bottom around USD2 per pound, to approximately USD2.14. Although these forecasts are more negative than three months ago on greater concern about China, they both continue to factor in the expected impact of further adjustments to supply on prices. On the other hand, we think it more likely that soya prices remain relatively stable within the timeline of the forecast.

Finally, after recent corrections, we forecast that the price of at least some financial assets of the region may currently be below their “equilibrium” price according to their fundamentals. This is the case of CDS Latam, for instance, illustrated in Figure 3.10. In our opinion, this should limit downside pressure in the coming months.
Figure 3.9
Main commodity price forecasts (average index 2010 = 100)

Source: BBVA Research

Figure 3.10
Risk premium in Latam: CDS observed and equilibrium (basis points)*

* Shaded area: average of four alternative models + 0.5 standard deviation. For further details about calculating the equilibrium, see our report “Flows & Assets Report 3Q15”.
Source: BBVA Research
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