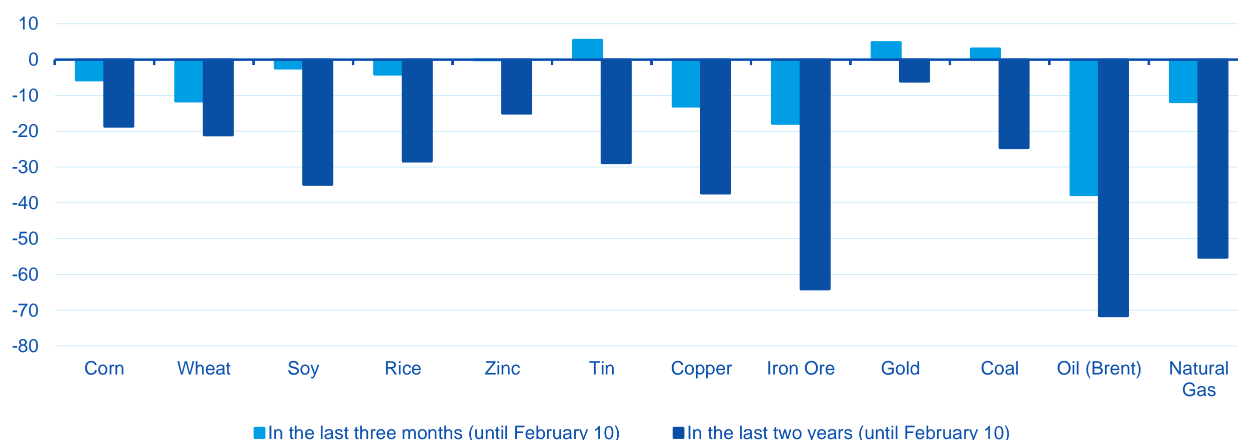
3 Volatility still the order of the day in Latin American financial markets

Fresh falls in commodity prices, prompted by doubts about growth in emerging markets, and, in some cases, supply resistance

The downturn in commodity prices, which began in mid-2014 amid heightened concern about slowing growth in China and in other geographic areas, has continued over the last three months (Charts 3.1 and 3.2). Indeed, from the end of October to early February, prices of most primary products had been adjusted downward, except for tin, coal and gold (the latter because of its status as a safe haven in times of turmoil). The adjustment in oil prices has been even greater, prompted by uncertainty regarding the slowdown in the Chinese economy, in particular, and about emerging markets, in general, and also by the fact that supply has held up relatively firmly: output and profitability on shale oil, Iran's return to the global oil markets and the persistent high supply by OPEC member countries. The price of crude oil has dropped by almost 40% since the end of October (for further details of the recent pattern on the oil market, refer to Box 1 below).

Chart 3.1
Commodity prices (% chg.)



Source: Bloomberg

Corrections have not been so acute in other markets, although they are also significant. Turning to metal commodities, the price of copper - which is so important for Peru and mainly for Chile - has fallen by around 13% over the last three months. This adjustment brings the copper price below the average cost of production. Despite the fact that global growth estimates have been lowered, that there are more fears about the future of the Chinese economy and that the dollar's rise in value on global markets is putting downward pressure on prices (not only on copper, but on all commodities in general), the recent fall in the copper price cannot fully be explained by fundamental variables. The current pattern in prices has also been shaped by non-commercial agents acting on the derivatives market, largely of a speculative nature.

Meanwhile, the sharpest fall in agricultural commodities, which are more isolated from the impact of the slowdown in China - as the adjustment is above all in investment, which is less intensive in foodstuffs - has been in wheat (approx. 12%), though soy, corn and rice prices also fell recently. In certain cases, the abundant recent harvests play some part in the downward corrections in recent months.

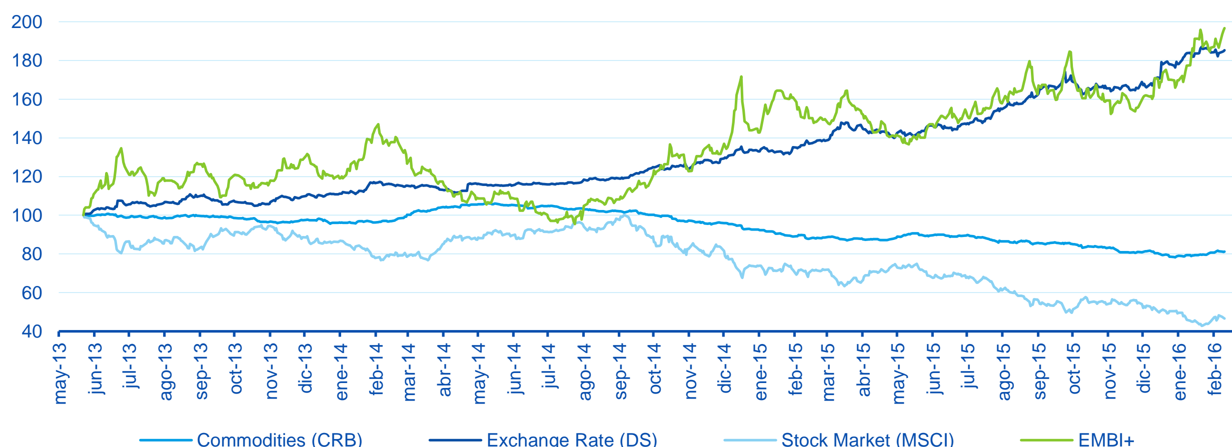
After these recent adjustments, commodity prices now stand at levels much lower than they were not that long ago. Oil, copper and wheat prices, for example, are now at levels 72%, 37% and 35% respectively, lower than those observed two years ago, in early 2014, when the slowing growth in the Chinese economy began to have a stronger impact on the commodities markets (Chart 3.1).

Volatility on financial markets has depressed main assets in the region

As noted in section 2, we have not only observed sharp correction in commodity prices, but also a slump in global markets and a spike in financial tensions in recent months. The most probable conclusion to be drawn is that the recent volatility is the result, as it was in mid-2015, of underlying doubts about the reshaping of the Chinese economy and fears that the Chinese authorities might be unable to achieve a “soft landing”. Part of this has to do with the fact that markets appear to be concerned about the impact that cheaper oil may have on the macroeconomic balance of exporter countries and on the corporate sector most exposed to commodities.

Although the Fed’s raising of interest rates and the slowdown in the global economy are not conducive to stability on the global markets, they do not appear to be the main reasons for the recent turmoil. On the one hand, the launching of the monetary normalisation process in the US was not only widely discounted by the market, but, in addition, at the same time as the stock market corrections, the expectations for interest rate hikes by the Fed are being revised downward, and this does is not calming the markets’ jitters either. On the other hand, financial tensions do not appear to be springing from the slowdown in global growth. In the second half of 2015, business indicators were basically in line with expectations, and even higher than expected in certain developed economies. Furthermore, although global growth is relatively low and improvement is proving to be too sluggish, it is certainly not an unfamiliar scenario and thus cannot justify recent market corrections.

Chart 3.2
Latam: Stock market prices, sovereign spreads and exchange rates (index 23 May 2013=100)*



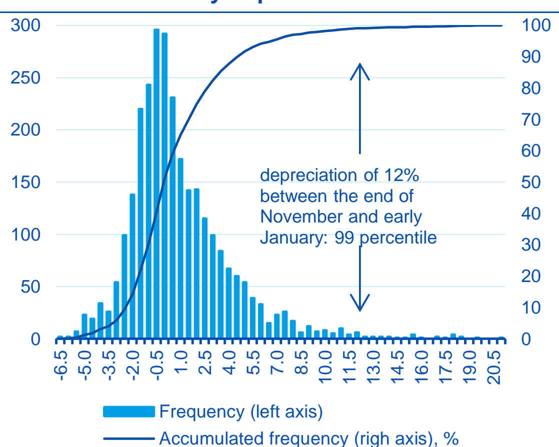
* Exchange rate: average for Latin American countries. Stock market indicator: MSCI. Sovereign risk: EMBI Latam. For exchange rates, an increase in the index indicates depreciation.
Source: Haver Analytics, Datastream and BBVA Research

In any event, global financial turmoil is depressing Latin American financial asset prices. Over the last three months, from the end of October to early February, the exchange rate depreciated by approximately 12% on average, the main Latin American stock markets shed 14% and the EMBI Latam, which measures sovereign risk in the region, rose by around 24% (Charts 3.2, 3.4, 3.5 and 3.6).

The recent corrections in local financial asset prices are reminiscent of those observed in the summer of 2015, due to their causes and also their magnitude. The adjustment on the currency markets is a good

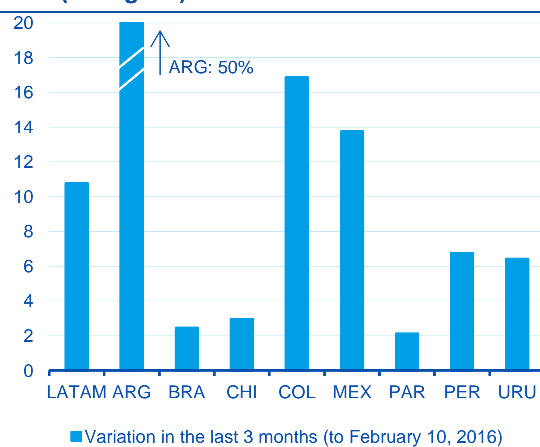
reflection of what has happened in other financial markets in the region: in the first two weeks of January, average 45-day cumulative depreciation was 12%. Since 2005, the only time the Latin American currencies had depreciated on such a scale was during the start of the Lehman Brothers crisis in 2008. In 99% of cases, currency adjustments in Latin America have been less pronounced than those observed in early 2016 (Chart 3.3). In particular, recent corrections are slightly higher than those observed in the previous bout of turbulence, between June and August 2015. At that time, the main regional currencies devalued by an average of 10%.

Chart 3.3
Frequency distribution of average 45-day cumulative currency depreciation in Latam*



* Cumulative 45-day currency variation calculated daily between January 2005 and February 2016. The positive (or negative) numbers on the horizontal axis show currency depreciation (appreciation). Simple averages of the currencies of Argentina, Brazil, Chile, Colombia, Mexico and Peru.
Source: Datastream and BBVA Research

Chart 3.4
Latin American exchange rates: change over time* (change %)



* Positive variations represent currency depreciations.
Source: Datastream and BBVA Research

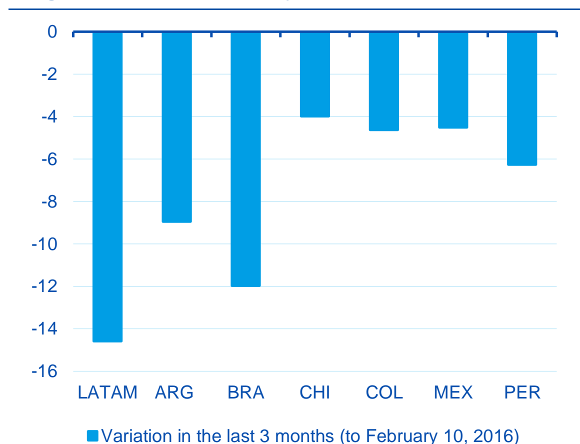
It is also important to bear in mind that certain idiosyncratic factors also contributed to recent volatility. In the currencies market, for example, it is important to bear in mind that the Argentinian peso depreciated by around 45% after the new economic authorities removed the “dollar clamp”. In fact, if we strip out Argentina from the analysis, Latin American currencies would have depreciated an average of 5% in early 2016, even higher than 98% of the period of time between 2005 to now, but lower than the 10% depreciation observed in the summer of 2015.

Apart from the adjustment in the Argentinian peso, the strongest corrections in recent weeks have been in Colombia and Mexico, economies which have greater exposure to falls in oil prices (Chart 3.4).

On the stock markets (Chart 3.5), the greatest losses were in Brazil, hardly surprising in view of the macroeconomic decline, political problems and the fact that the country recently lost its investment grade rating (Fitch downgraded it in December, three months after S&P had done so).

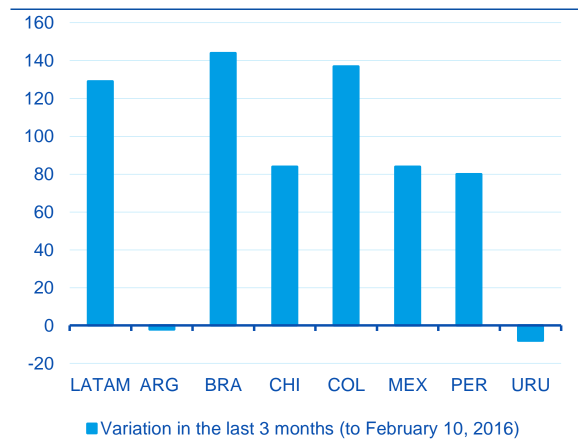
Argentina and Uruguay were the only countries which did not report a significant decline in their sovereign spreads over the last three months. The sharpest adjustments to sovereign spread were in Brazil and Colombia. In Brazil's case, this was due to the sharp decline in the economic and political situation; and in Colombia's, due to the slump in the oil price. After these latest corrections, Argentina's sovereign spread is now lower than Brazil’s.

Chart 3.5
Latin American stock markets: change over time (chg. %, in local currency)



Source: Haver Analytics and BBVA Research

Chart 3.6
Sovereign spreads in Latin America: change over time (EMBI, basis points)



Source: Haver Analytics and BBVA Research

Lastly, it is important to note that the Fed's increase in interest rates and the greater aversion to global risk, helped by the slowdown in Latin American economies, is prompting a slowdown of capital flows towards the region and even, in some cases, such as Brazil, an outflow of capital. Corporate and sovereign issues to foreign investors also fell by 33% in 2015, largely due to the slowdown in the former, especially in Brazil.

Looking forward, volatility will persist, but losses should be offset by recovery in commodities

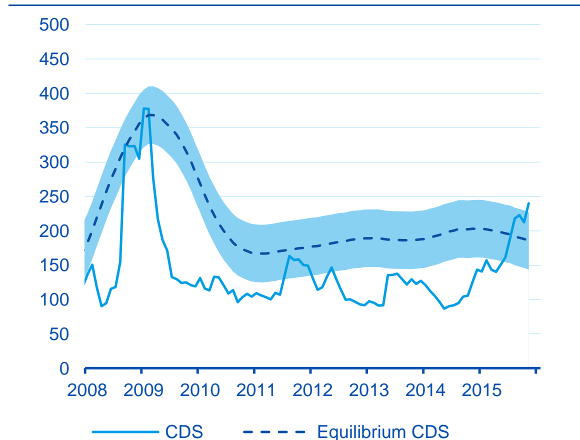
As we have repeatedly warned in recent reports, the pattern of global economic activity and the performance of the financial markets will continue to be shaped by the process of recovery in the US economy, which marks the pace at which the Fed normalises monetary conditions, and the reshaping of the Chinese economy towards lower rates of growth which are less dependent on investment and more on domestic demand. Even if the US economy manages to steadily regain strength and the Chinese economy is able to avert a "hard landing", further turmoil - such as that observed in early 2016 and between June-August 2015 - is very likely because of the complex nature of these two processes and the fact that the market closely follows short-term indicators in these two geographical regions.

Judging by these perspectives for the international setting, taking into account that the slowdown process in at least certain Latin American economies is not over yet, and that, in certain cases, political problems and uncertainties will play a significant role in how events unfold, we cannot state categorically that Latin American financial markets will recover quickly and significantly.

Future losses should be limited, however, taking into account that in some cases, the prices of financial assets, such as exchange rates (see section 6) and CDS (Chart 3.7) are below the value determined by fundamentals.

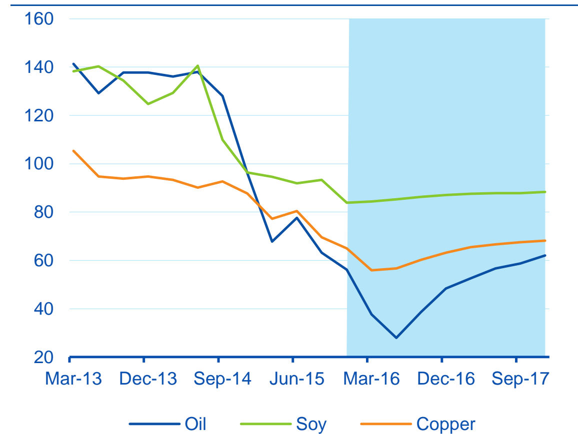
Commodity prices are another factor that should bolster regional assets to some extent. Current market conditions should lead supply to be reduced, albeit gradually, allowing prices of products such as oil and cooper to converge at relatively stronger levels at the end of 2017 of around 10% higher than the end of 2015, in the case of oil, and of 5% in the two other cases (for further details refer to Chart 3.8, and for the case of oil, Box 1). Although this recovery in commodity prices is limited, it should play a role in driving higher economic activity over the next two years.

Chart 3.7
Risk premium in Latam: Observed and equilibrium CDS (basis points)*



* Shaded area: average of four alternative models + 0.5 standard deviation. For more details on the equilibrium calculation, refer to our "Flows & Assets Report 3Q15" report.
Source: BBVA Research

Chart 3.8
Estimated prices of staple commodities (average index 2010 = 100)



Source: BBVA Research

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