

Latin America Weekly Outlook



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- **High-yield debt markets extend rally despite moderation in exchange rate gains**
- **Brazil prepares to elect a new president in the context of a robust economic recovery**
- **Mexico benefits from external financial market developments; improved growth outlook**
- **Interest rate normalization continues in Chile amidst a strong economic recovery**
- **Colombian central bank leaves monetary conditions unchanged; new fiscal measures**

High-yield debt markets extend rally despite moderation in exchange rate gains

Global fixed-income investors continue to be attracted to emerging-market debt instruments pushing Latin American bond yields to record low levels. The benchmark EMBIG (yield) closed the week at a level of 280 bps (over equivalent US Treasury bonds). Brazil, Chile, Colombia, Mexico and Peru are all sovereign credits trading in the low 100 bps. Fears of overvaluation may be building up in the near term. Commodity markets seems to be facing signs of technical resistance and modest correction, a development that led the regional currencies to lose some value over the past week. Expectations of prolonged conventional and unconventional monetary stimulus may pave the way for further US dollar (USD) weakness before the end of the year.

Brazil prepares to elect a new president in the context of a robust economic recovery

The major factors shaping investors sentiment in Brazil include a mix of positive exogenous and endogenous. The external financial environment remains extremely favourable for high-yielding assets of emerging-market economies. The relentless pursuit of conventional and unconventional monetary stimulus by the US Federal Reserve is a primary driver of capital flows to Brazilian fixed-income assets. The Brazilian government-administered short term interest rate is the highest with the G10 economies: at 10.75%, the SELIC rate contrasts sharply with the near-zero Fed funds rate in the US. Futures markets also anticipate further tightening in the first quarter of 2011, reinforcing the attractiveness of Brazilian local-currency securities. We maintain a bearish view for the USD, despite the recent stabilization phase. As a result, high-yielding currencies such as the BRL will regain an appreciating bias in the near term. The Brazilian authorities are sending a clear sign of no complacency with the existing currency momentum: the consecutive increases in the financial transaction tax applicable to foreign holdings of Brazilian debt assets highlight the government's uneasiness with the exchange rate environment. Nevertheless, according to some observers, it was a politically motivated decision during election time. The final round of presidential elections will take place on Sunday and Dilma Rousseff is positioned to be elected as the new president for a four-year period; if so, she would assume the presidency in January 2011. Policy continuity is amply discounted.

Mexico benefits from external financial market developments; improved growth outlook

The external financial and economic environment continues to influence market sentiment in Mexico. The MXN is aligned to the stable-to-appreciating momentum enjoyed by the other core currencies in Latin America. The US business and monetary cycle remains a primary determinant of capital flows to Mexico. The Mexican economy is not – and will not be – immune to the current softness in US economic conditions characterized by persistently high unemployment, household finance deleveraging, prolonged weakness in housing markets and deteriorated fiscal conditions. Nevertheless, recent data has confirmed a pickup in local economic activity; indeed, the central

bank has unveiled an improved macroeconomic outlook stressing that inflation will continue to decline and that growth will accelerate in the coming months; indeed, real GDP growth will approach a 5% rate in 2010 before decelerating to a near-4% rate in 2011. Meanwhile, consumer price inflation will range, according to the monetary authorities, between 3.75% and 4.25% during the first quarter of the year. The central bank does not see, at present, price pressures of relevance. Interest rate differentials continue to be another primary factor shaping capital flows to peso-denominated assets. The Mexico-US 10-year sovereign debt yield spread closed the week at 340 basis points, reflecting a perception of improved credit risk in place since early July. However, the current spread level coupled with supportive crude oil prices continues to attract foreign portfolio investors to Mexican local-currency bonds.

Interest rate normalization continues in Chile amidst a strong economic recovery

The Chilean economy offers a promising outlook. Recovery dynamics from the dual shock of the external financial crisis and the earthquake/tsunami of the first quarter of the year have been stronger than previously anticipated. The Chilean economy may average an expansion of 6% (if not higher) over the next two years. The central bank, sensitive to potential build-up in inflationary expectations has been, on a pre-emptive basis, embarked on a process of interest rate normalization. In five consecutive moves, the monetary policy interest rate has been raised from 0.5% to 2.75%. The most recent official communiqué stressed that further tightening is in prospect, yet it seems that price pressures remain well contained for now. The headline inflation rate declined to 1.9% in September (y/y) from 2.6% the previous month. Within the context of a low-inflation strong-growth scenario, the government authorities have increased their sensitivity to the steady appreciation of the Chilean peso with the potential to intervene, if necessary. We have revised

our currency outlook to reflect a more favourable trend for the Chilean peso, which should close the year at 490 per USD. The Chilean currency is benefiting from supporting terms of trade; indeed, copper prices have been in ascendancy since early June trading as high as US\$387 per pound before reaching a stabilization phase of the past week. As in the case of other core Latin American currencies, the CLP has benefitted from the concerted move against the USD.

Colombian central bank leaves monetary conditions unchanged; new fiscal measures

Colombia is well positioned to reach a sustainable growth rate of 4.5% for this year and next with relatively low inflation. The country will be receiving massive capital flows directed to both the energy and mining sectors in the coming years. Besides growth and interest rate differentials with other economies, the COP is quite sensitive to the direction of crude oil prices; indeed, the light-crude oil WTI, which has averaged US\$76 per barrel over the past six months, closed the week at 82. The central bank estimates that the headline inflation rate will be near the bottom of the official 2-4% target range. As a result, the monetary authorities opted to keep the administered interest rate unchanged at 3% on October 29th in line with investors' expectations. The official estimates include an improvement in confidence indicators, favourable terms of trade and a steady expansion of domestic credit. Moreover, the central bank remains committed to intervene in the local currency market as a means of moderating the pace of currency appreciation. The monetary board announced that it will keep the strategy of foreign exchange reserve accumulation through daily purchases of US\$20 million until mid-March 2011. The Colombian peso, which has been subject to corrective forces recently, closed the week at a rate of 1,838 per USD. By the end of the week, the government was ready to unveil tax and fiscal measures to complement the central bank's approach to moderate the peso rally.

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