

## Credit Conditions Latin America:

# Domestic politics and increasing U.S. protectionism undermine favorable conditions

June 28, 2018

### Key Takeaways

- **Overall:** Credit conditions in Latin America remain broadly favorable, but downside risks are increasing. On the bright side, credit conditions in the region still benefit from GDP growth, which we expect to be higher this year than in 2017, although a bit lower than we previously forecasted. A combination of external and domestic factors has resulted in falling currencies and tighter financing conditions. Pressure on the region's currencies could begin weighing on inflation levels and result in monetary tightening over the next few months.
- **What's changed:** Investor sentiment towards emerging markets has turned over the past few months. In our view, this has been due to the dollar strengthening as result of strong U.S. economic performance and global portfolio rebalancing. Furthermore, rising interest rates in the U.S., along with the expectation of the U.S. Federal Reserve's tighter monetary policy have resulted in portfolio outflows from emerging markets. Investors are also concerned about increasing protectionist policies from the U.S. and the potential for a full blown trade war. Other global risks related to geopolitical tensions could bring additional episodes of volatility for emerging market currencies. Regional political risks prevail given looming elections in the largest economies in Latin America. Furthermore, Argentina's fiscal rigidities and tougher external conditions will test the government over the next few quarters.
- **Risks and imbalances:** In our view, regional risks are increasing as a result of changing external conditions and domestic challenges. We still view political risk on the rise especially in Argentina, Brazil, and Mexico. Meanwhile, external conditions are becoming less favorable, despite sound GDP growth in advanced economies, still very high liquidity sustained by central bank balance sheets, and largely accommodative monetary policies. Investor sentiment towards emerging markets has faltered over the past few months as a result of the dollar's strength, increasing U.S. rates, and trade disputes.
- **Financing conditions:** Funding conditions remain neutral to slightly favorable in Latin America, but will likely face headwinds in the second half of 2018, especially among nonperforming loans. As interest rates rise, countries with higher exposure to international funding may face additional capital flow constraints, as investors may allocate capital to higher yielding securities in developed markets, instead of emerging markets.
- **Macroeconomic conditions:** Although we still expect mildly stronger real GDP growth in 2018 than in 2017 for most major economies in Latin America, macroeconomic conditions have become more challenging. The external conditions that encouraged capital inflows into the region over the last couple of years have taken a hit in recent months, particularly regarding the greenback's trajectory. Flexible exchange rate regimes will help cushion the repricing in risk premiums which has occurred in recent months given increasing competitiveness via weaker currencies. We do note, however, that if exchange rates continue to weaken versus the dollar, central banks could decide to tighten monetary policies earlier than anticipated, which could in turn soften real GDP growth in Latin America.
- **Sector themes:** The negative bias in most sectors has decreased over the past months. However, credit quality is worse and is reflected in lower ratings across all sectors. Less favorable external conditions and their effect on variables such as interest rates and weaker currencies, might pressure issues rated in the lower rating categories.

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(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Latin America, North America, and Europe, the Middle East, and Africa). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the Latin America committee on June 25, 2018.)

Table 1

## Top Latin America Risks

## Volatile capital flows that restrict market access

<b>Risk level*</b>	Very low	Moderate	<b>Elevated</b>	High	Very high	<b>Risk trend**</b>	Improving	Unchanged	<b>Worsening</b>
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A combination of domestic and external factors has undermined investor sentiment towards Latin America over the recent months. We expect volatility to continue over the coming months as the U.S. increases its rates and continues implementing protectionist measures. Political uncertainty in countries such as Brazil and Mexico will continue weighing on investor decisions. In other countries, fiscal and monetary flexibility will be crucial in dealing with more challenging external conditions.

## Uncertainty about further changes in U.S. policies

<b>Risk level*</b>	Very low	Moderate	<b>Elevated</b>	High	Very high	<b>Risk trend**</b>	Improving	Unchanged	<b>Worsening</b>
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Trade tensions between the U.S. and China continue escalating, through the recent tit-for-tat exchange of 25% tariff imposition. A breakdown in negotiations or policy missteps could lead to a full-blown trade dispute, which would impair global business and consumer confidence, investment prospects, and growth. Within the region, the North American Free Trade (NAFTA) renegotiations have not been finalized and tensions rose after the U.S. imposed tariffs on steel and aluminum imports from Mexico and Canada that prompted Mexico's retaliation. Recently, parties expressed their intention to resume negotiations after Mexico's elections in July. However, we don't expect them to be finalized in 2018 in light of midterm election in the U.S. and congress renewal in Mexico.

## Political uncertainty due to upcoming elections

<b>Risk level*</b>	Very low	<b>Moderate</b>	Elevated	High	Very high	<b>Risk trend**</b>	Improving	Unchanged	<b>Worsening</b>
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With major elections in Brazil and Mexico still to come during the year, investors maintain a wait-and-see mode. Election results could drag down investors' sentiment, especially if winning candidates oppose to promote important reforms or if they reverse recent changes. For Brazil, such reforms are crucial to tackle its fiscal challenges and rising debt. In other countries in the region, such as Chile and Colombia, political risk is fading because elections had already passed and investor confidence is improving.

## Potential for future commodity price shocks

<b>Risk level*</b>	Very low	<b>Moderate</b>	Elevated	High	Very high	<b>Risk trend**</b>	Improving	<b>Unchanged</b>	Worsening
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Commodity prices have stabilized recently, bringing relief for many key economic variables in the region; a reversal of this trend could reintroduce currency and inflationary pressures to Latin America if capital flows reverse, resulting in pressure on currencies in the region.

Sources: S&P Global Ratings.

\* **Risk levels** may be classified as very low, moderate, elevated, high, or very high, are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically these risks are not factored into our base case rating assumptions unless the risk level is very high.

\*\* **Risk trend** reflects our current view on whether the risk level could increase or decrease over the next twelve-months

## Regional Credit Conditions

### What's changed?

Favorable credit conditions in Latin America are diminishing as downside risks are increasing. On the bright side, credit conditions in the region are still supported by GDP growth, which we expect to be higher in 2018 than in 2017, although a bit lower than we previously forecast. In addition, despite uncertainty about trade and U.S. policies, healthy growth in that country continues supporting remittances and exports from Latin American partners. Nevertheless, we expect credit conditions to continue weakening over the next quarter. A combination of external and domestic factors has resulted in falling currencies and tighter financing conditions. The region's weakening currencies could begin pressuring inflation levels and result in monetary tightening over the next few months.

Investor sentiment towards emerging markets has turned sour over the past few months. In our view, this was due to the dollar strengthening as a result of strong U.S. economic performance and global portfolio rebalancing. Furthermore, the rising reference interest rates in the U.S., along with the expectation of the Federal Reserve's tighter monetary policy has prompted portfolio outflows from emerging markets. In many cases, investors are also concerned about increasing protectionist policies from the U.S. and the potential for a full-blown trade war. Finally, other global risks related to geopolitical tensions could bring additional episodes of volatility for emerging market currencies.

Political risk prevails in the two largest economies in the region, Brazil and Mexico. Brazil remains a big question mark because of an absence of a clear front runner for president, while the country's currently sour mood is favoring anti-systemic candidates. The recent transportation strike exposed the fragility of the current lame-duck administration, and highlighted the risks inherent in national elections. In Mexico, polls continue showing the leftist candidate Lopez Obrador with a large lead. This has brought some volatility on the domestic side given high uncertainty about his plans to manage Mexico's economy. In our view, it's too early to tell, but we believe that if Mr. Obrador wins, he will largely maintain fiscal discipline and the independence of the central bank.

Yet there are bright spots. We expect business confidence and economic activity in Colombia to pick up following the recent presidential election. Chile and Peru are also showing favorable prospects amid rising commodity prices and diminishing political issues.

### Assessment of key risks

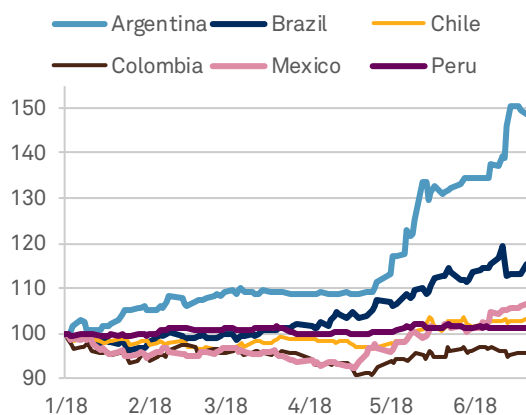
In our view, regional risks are increasing as a result of changing external conditions and the prevalence of some domestic challenges. We still view political risk on the rise especially in Argentina, Brazil, and Mexico. Argentina currently faces difficult policy trade-offs in implementing its recently revised economic plan, which requires tighter economic policies. The combination of additional fiscal austerity and monetary tightening may help stabilize the exchange rate and contain inflation, but it will hurt GDP growth, in our view. Deteriorating economic conditions could, in turn, weaken the government's political standing ahead of national elections late next year.

The results for the upcoming elections in Brazil and Mexico are highly uncertain and disconcerting for investors, because some candidates are promoting higher expenditures and favor either the reversal of major reforms or the absence of important economic changes. Mexico's new administration will face several challenges, like the need to tackle rising insecurity and fight corruption, which has been the populace's key demand during the election campaign. At the same time, the new president will have to maintain fiscal discipline, monetary independence, and successfully renegotiate NAFTA in order to keep investors' confidence on track. Brazil also faces significant challenges, including fiscal rigidities, and the next administration will have to deal with a pension reform to get government finances back on track.

Meanwhile, external conditions are beginning to sour, despite sound GDP growth in advanced economies, still very high liquidity sustained by central bank balance sheets, and largely accommodative monetary policies. Investor sentiment towards emerging markets has faltered over the past few months. These factors are raising volatility in the region, resulting in portfolio outflows and weakening currencies across the board. In our view, these factors heighten risks for the region.

Chart 1

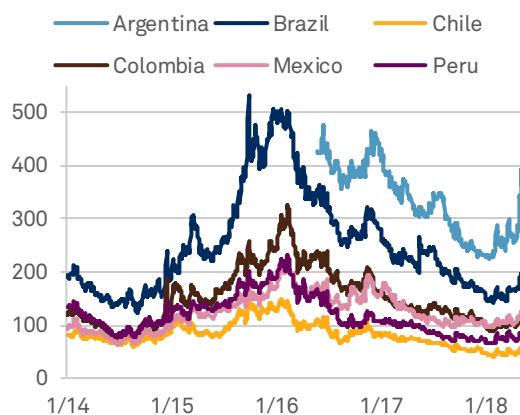
**Latin America Exchange Rate Performance**  
(Jan. 2, 2018=100)



Source: S&P Global Ratings

Chart 2

**5 year CDS Spreads**



Source: S&P Global Ratings

## Financing conditions

Funding conditions remain neutral to slightly favorable in Latin America, but will likely face headwinds in the second half of 2018, especially among nonperforming loans. As interest rates rise, entities with higher exposure to international funding may see additional constraints with respect to capital flows, given that investors may allocate capital to higher yielding securities in developed markets, instead of emerging markets.

**Neutral/stable conditions.** Despite softening in loan demand and the rise in nonperforming loans, financing conditions in Latin America remain stable and neutral. However, we expect deterioration in the second half of 2018. The Institute of International Finance's (IIF's) composite index of bank lending conditions in Latin America for the first quarter of 2018 dropped two points to 51 since the fourth quarter of 2017. This reading implies that financing remains on the edge of expansive territory (i.e., index above 50).

**Maturing debt.** S&P Global Fixed Income Research expects \$225 billion of rated financial and nonfinancial corporate debt in Latin America (including the Caribbean region) to mature through 2022. Of this total, a manageable \$38.8 billion is due 2018, and scheduled maturities rise to a peak of \$50.4 billion in 2021. About 71% of the rated corporate debt maturing through 2022 is among nonfinancial companies, and about \$88 billion (39%) of the total maturing debt is speculative grade (rated 'BB+' or lower). We believe issuers of this speculative-grade debt are more susceptible to refinancing risk, increased funding costs, and tighter credit availability during market volatility. However, we expect refinancing demand to remain largely manageable, especially because corporate issuers have a multiyear window for refinancing before the largest sums come due.

**New issuance.** Latin America has recently experienced modest issuance growth alongside economic recovery in the region. However, a number of potential risks remains this year, mostly related to **geopolitics**. Any delayed agreement over the future of NAFTA, or any breakdown in negotiations, could have deleterious effects on Mexico. Brazil and Mexico also have upcoming elections, **and though conditions are subdued for now**, another political upheaval in Brazil would certainly impede the economy and financial markets. Finally, if the Federal Reserve raises interest rates at a faster-than-expected pace, this could hamper capital inflows to the region.

Corporate bond issuance in Latin America steadily grew in 2017 after declines in previous years. This momentum--particularly in Brazil--has continued into 2018 with \$47.6 billion, compared with \$35.8 billion for the same period last year. Brazil currently accounts for 48% of the region's total bond issuance this year and Mexico accounts for 34%.

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# Macroeconomic developments and assumptions

*(Editor's Note: The views expressed in this section are those of S&P Global Ratings' economics team. While these views can help to inform the rating process, sovereign and other ratings are based on the decisions of ratings committees, exercising their analytical judgment in accordance with publicly available ratings criteria.)*

Although we still expect slightly higher real GDP growth in 2018 than in 2017 for most major economies in Latin America, macroeconomic conditions have, on balance, become more challenging for the region since our previous quarterly update.

The favorable external conditions that encouraged an uptick in capital inflows into the region over the last couple of years—stemming from an improvement in expectations for global growth, low long-term interest rates in advanced economies, and a softer dollar—have been tested in recent months, particularly regarding the trajectory of the greenback. A bout of the dollar strength triggered a deterioration in investor sentiment towards emerging markets, which took a toll on Latin American assets. Unsurprisingly, the biggest impact was in countries with large fiscal and external imbalances, such as Argentina. However, we currently don't see major risks of contagion to other economies in the region. Flexible exchange rate regimes can help cushion the repricing in risk premium that has taken place in recent months amid increasing competitiveness via weaker currencies. We do note, however, that if exchange rates continue to weaken versus the dollar, central banks in the region could tighten monetary policy earlier than markets currently anticipate, which could in turn soften real GDP growth.

Furthermore, political dynamics in the region remain difficult, with no meaningful improvements since our last update. There's still a lot of uncertainty regarding the outcome and implications of the upcoming general elections in Mexico in July and Brazil in October, the ongoing NAFTA renegotiations, and most recently, Argentina's ability to re-establish investor confidence in domestic economy. Therefore, volatility is likely to remain elevated throughout most of this year.

## Forecast Changes

- We have lowered our real GDP growth forecast for **Argentina** to 1.0% in 2018 and 2.0% in 2019 from previous 2.8% and 3.0%, respectively. The sharp sell-off of the currency will spike inflation, and the implementation of higher interest rates to contain inflation will lower domestic demand.
- We have also lowered our real GDP growth projections for **Brazil** to 1.8% in 2018 and 2.4% in 2019 from previous 2.4% and 2.6%, respectively. Sluggish first-quarter growth and the impact of the truckers' strike on several economic sectors will result in lower GDP growth than we previously expected. The outlook for the October election and its implications on key pending pension reform remains highly uncertain, which is likely to dent fixed investment.
- We have increased our real GDP growth forecast for **Chile** to 4.0% in 2018 and 3.3% in 2019 from previous 3.3% and 3.1%, respectively, due to robust economic growth in the first quarter, which we expect to continue in the subsequent quarters.
- We have also increased our real GDP growth forecast for **Peru** to 3.7% for 2018 from 3.5% previously, following stronger-than-expected growth so far this year.

## Key assumptions

The U.S. monetary policy normalization will be gradual and accompanied by strong economic growth, which will keep global financial conditions generally favorable for Latin America, despite episodes of heightened volatility. We don't assume that the current bout of broad dollar strength that started in February, which picked up pace in April, marks the beginning of long-lasting appreciatory trend of the greenback. Our base-case scenario incorporates an eventual NAFTA deal that broadly preserves investment and trade linkages between the U.S., Canada, and Mexico. Our current GDP forecast for Mexico doesn't assume major long-lasting disruptions to investment as a result of the outcome of the July 1 general elections.

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Table 2

**Latin America GDP growth**

(%)	2016	2017	Baseline scenario				Downside scenario			
			2018f	2019f	2020f	2021f	2018f	2019f	2020f	2021f
Argentina	-1.8	2.9	1.0	2.0	2.5	3.0	-0.5	1.0	1.5	1.5
Brazil	-3.5	1.0	1.8	2.4	2.6	2.6	0.8	1.2	1.2	1.2
Chile	1.2	1.6	4.0	3.3	3.0	3.0	3.0	2.5	2.3	2.3
Colombia	2.0	1.8	2.5	2.6	2.7	2.8	1.8	2.0	2.0	2.0
Mexico	2.6	2.3	2.4	2.5	2.5	2.5	1.6	1.8	2.0	2.0
Panama	5.0	5.4	4.5	5.5	5.5	5.5	3.0	4.5	5.0	5.0
Peru	4.1	2.5	3.7	3.8	3.8	3.8	2.8	3.0	3.0	3.0
Uruguay	1.7	2.7	2.7	3.0	3.2	3.2	2.2	2.7	2.8	2.8
Venezuela	-12.0	-10.0	-8.0	-4.0	2.0	2.5	-15.0	-8.0	-2.0	-2.0
<b>Latin America</b>	<b>-1.1</b>	<b>1.1</b>	<b>1.6</b>	<b>2.2</b>	<b>2.6</b>	<b>2.7</b>	<b>0.2</b>	<b>1.0</b>	<b>1.5</b>	<b>1.5</b>
<b>Latin America ex Venezuela</b>	<b>-0.4</b>	<b>1.8</b>	<b>2.2</b>	<b>2.6</b>	<b>2.7</b>	<b>2.8</b>	<b>1.2</b>	<b>1.6</b>	<b>1.7</b>	<b>1.7</b>

Source: S&P Global Economics. Note the Latin America GDP aggregate forecasts are based on three-year average (2014-2016) PPP GDP weights. Our GDP numbers are based on seasonally-adjusted series when available.

Table 3

**Changes in Baseline GDP growth forecast from First Quarter 2018 Credit Conditions Report**

(%)	2018	2019
Argentina	-1.8	-1.0
Brazil	-0.6	-0.2
Chile	0.7	0.2
Colombia	0.0	0.1
Mexico	0.0	0.0
Panama	-1.4	-0.5
Peru	0.2	0.0
Uruguay	-0.3	-0.1
Venezuela	-4.0	-4.0
<b>Latin America</b>	<b>-0.6</b>	<b>-0.4</b>
<b>Latin America ex Venezuela</b>	<b>-0.4</b>	<b>-0.2</b>

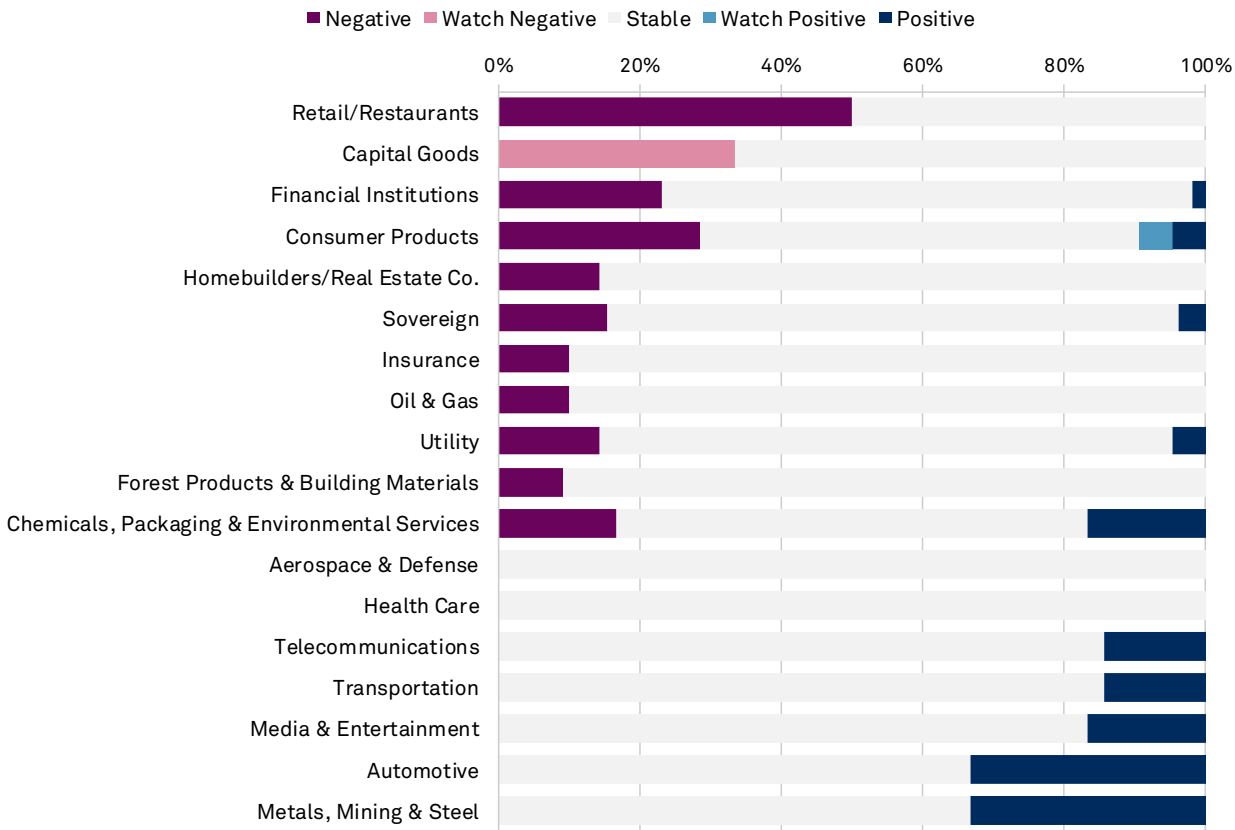
Source: S&P Global Economics

**Risks to our macroeconomic outlook**

An abrupt tightening of global financial conditions could trigger another round of capital outflows from Latin America, especially given the currently high levels of political uncertainty in several economies in the region. The trajectory of the dollar will be an important variable to monitor, following its recent strengthening versus both the euro and emerging market currencies. Episodes of abrupt broad dollar strength tend to heighten investor caution towards Latin America, given the relatively high reliance in some countries on the dollar denominated debt. Furthermore, expectations for weakness of Latin American currencies versus the dollar tend to pressure domestic interest rates higher, given the increase of non-residential holdings of domestic debt in several countries, which can depress domestic demand. A softening in global growth expectations could lower business confidence and hamper the nascent investment recovery that's taking place in most Latin American countries. A significant change in policy direction in Mexico and Brazil after their upcoming elections would likely lead us to revise our GDP projections for those countries. A breakdown of the ongoing NAFTA renegotiations would have negative implications for the Mexican economy, particularly in the short term. Argentina's economy is in a very delicate position, and failure to accelerate its fiscal consolidation would weaken its macroeconomic prospects.

Sector themes

Chart 3  
Outlook Bias Distribution Of Latin America Issuers By Sector, May 2018



Source: S&P Global Fixed Income Research. Data as of May 31, 2018.

## Sovereigns

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- Uncertainty about U.S. trade policy will persist longer than we initially expected.
- Countries that have suffered from recent market volatility (beyond the general depreciation of emerging market currencies) did so mainly for domestic reasons.
- Election results will continue causing uncertainty in Brazil and Mexico over the coming months.

### What's changed?

The uncertainty about U.S. trade policy will persist longer than we initially expected. So far, this hasn't resulted in negative indicators in the region, partly because the U.S. economy is growing robustly and remittances to Latin America remain high. However, the mood is more pessimistic than the recent economic data.

Countries that have suffered from recent market volatility (beyond the general depreciation of emerging market currencies) did so mainly because of domestic factors. The combination of persistent external vulnerability, rising inflation, and large fiscal deficits contributed to a sharp fall in the Argentine peso, leading the central bank to raise its rate to 40% and the government to seek a loan from International Monetary Fund (IMF). Upcoming elections in Mexico have generated growing uncertainty (more among domestic investors than among their foreign counterparts) about future economic policies, but this hasn't undermined economic conditions. A truckers' strike in Brazil led the government to concede to almost all of their demands, including steps to control retail petroleum prices. The strike exposed the fragility of the current lame-duck administration, and highlighted the risks inherent in national elections later this year.

### Key assumptions

- Impact of recent trade tariffs will be moderate because they have only marginal influence on overall trade volumes and GDP growth in Latin America.
- World economy continues to grow well in 2018 due to acceleration in the U.S., satisfactory growth in China, and moderate economic expansion in the EU.

### Key risks

- Rupture in NAFTA trade and investment links.
- Spike in U.S. interest rates well beyond market expectations, leading to substantial currencies depreciation and capital outflows from Latin America.

### What to look for over the next quarter

Polls show that controversial leftist candidate Lopez Obrador enjoys a large lead in Mexican elections and his coalition may gain a majority in Congress. The prospect of his victory could trigger market turbulence in **Mexico**. We will focus on the announcements and actions of the presidential election winner, who takes office in December, to assess their economic impact.

**Argentina** faces a difficult period given that the government will commit to austere fiscal and monetary policies that will hurt economic growth, raise unemployment, and likely bring down rising inflation only after some time. The government faces national elections in late 2019, giving it limited time to show concrete results of its new economic policies. How credible will the government's adjustment program be?

Recent events highlight the depth of public rejection of traditional politicians in **Brazil**. The current government may be forced into more concessions to other interest groups prior to the elections late this year. Considerable uncertainty over upcoming the election results persists. Will the next president be able to implement reforms in a highly divided political arena? Conservative candidate Ivan Duque won the recent presidential election in **Colombia**, easily defeating his leftist opponent. Centrist and conservative parties also dominate Congress, making it easier for Mr. Duque to advance his legislative agenda. We expect broad continuity in economic policy under the Duque administration, including implementation of the recent peace accord with the FARC guerrillas.



## Local and Regional Governments

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- Local and regional governments (LRGs) continue to struggle to balance their budgets and plan capital expenditures to cover short and medium term needs.
- Relatively weak institutional frameworks limits credit quality among regional governments.
- Presidential elections in Brazil and Mexico, as well as at the local level, bring uncertainty on important issues that need to be addressed at local level to ensure fiscal sustainability in the coming years.

### What's changed?

We're observing greater challenges for LRGs to increase own source revenues to finance increasing operating needs, and more importantly, to keep funding capital expenditures. In Mexico, public safety concerns have increased and it is still uncertain how the national and local governments would work in the future to tackle this issue. External financing will remain mostly open for debt refinancing, but country risks are likely to significantly affect financing costs and in some cases availability and the cost of finance. Despite these challenges, we expect creditworthiness of more than 80% of rated LRGs to remain stable this year.

### Key assumptions

- Presidential elections in Mexico and Brazil generate uncertainties on LRGs fiscal and intergovernmental issues that are expected to be addressed once electoral processes pass.
- While fiscal challenges remain of some concern for most Latin American LRGs during 2018, we don't expect significant increases in debt issuances for the rest of the year.
- Borrowing will be limited to subnational governments in Mexico and Brazil, while Argentine provinces keep having the need to close budget gaps with external financing, though most difficult to achieve in the same magnitude that in the past couple of years.

### Key risks

The main risks for LRGs' creditworthiness are related to the relatively weak institutional frameworks in which they operate and to economic growth and investment levels in respective countries. **Political contexts are more challenging to solve fiscal sustainability issues in the medium term.** A credit concern doesn't stem from debt burden among most rated LRGs in the region, but from limited ability to plan finances for the medium and longer term.

### What to look for over the next quarter

Three factors will have a crucial bearing on credit conditions in the third quarter. First, the election outcome for presidency and the nine governorships in Mexico. Second, which presidential candidate will win in Brazil and if the national agenda will turn attention to the states' troubled finances. Third, the impact on investment and economic growth in Mexico's states bordering the U.S. following a NAFTA renegotiation.

# Non-Financial Corporations

- Credit conditions for non-financial corporations are slipping.
- The political landscape in Latin America is still volatile and may increase risk premiums over the reference rate.
- Refinancing risk for Latin American corporations is largely contained, with about 15% of total debt outstanding coming due in the next 12 months.

## What's changed?

Credit conditions for non-financial corporations are tightening, given that market access has stalled and borrowing costs continue rising. In particular, during the first half of 2018, yields have increased across all rating levels by more than 80 basis points (bps).

More stringent market conditions for international bond issuers could open the door for Latin American banks to expand lending, and domestic bond markets would become more attractive as well, especially amid declining reference rates in most markets across the region, with the exception of Argentina and Mexico. However, the political scenario in Latin America is still turbulent and may increase risk premiums over the reference rate. Concerns about the fate of the NAFTA renegotiations, meanwhile, have continued to aggravate tension in Mexico ahead of the July elections.

Refinancing risk for Latin American corporations is largely manageable, with about 15% of total debt outstanding coming due in the next 12 months. Companies took advantage of the easy lending conditions in 2017 and rolled over a substantial portion of short- and medium-term debt maturities, resulting in debt term structures that are comfortable for both investment- and speculative-grade issuers.

Rising borrowing costs and cautious investment decisions in an uncertain and volatile business environment could depress asset values and limit capital allocations to accelerate growth. Therefore, it's highly likely that companies would minimize cash shortfalls by simply cutting capital expenditures.

## Key assumptions

- Reduced market access and higher interest rates: probably 100 bps higher for investment-grade issuers and 150 bps higher for speculative-grade issuers by 2019 than March 2018 levels.
- We don't expect the U.S. tariffs on steel imports to have a sizable impact on global iron ore demand or prices. For oil, our 2018 crude price assumption for Brent is currently at \$65 per barrel (bbl) and at \$60 per bbl for 2019. Our Henry Hub natural gas assumption remains unchanged at \$3 per British thermal unit (Btu).
- Our base-case scenario continues to assume a successful renegotiation of NAFTA because of its importance for many stakeholders in Mexico, U.S., and Canada. However, we don't expect the renegotiation to be finalized during 2018.

## Key risks

- Lower growth in Brazil and Argentina due to multiple factors such as weakening currencies, receding investments and consumer sentiment, along with rising inflation in the latter country.
- Volatile capital flows that exacerbate exchange rate volatility, resulting in inflationary pressures and weak leverage metrics for companies with foreign currency debt exposure.
- A decline in private investments that undermines medium-term growth prospects, either due to political risks, or (in the case of Mexico) uncertainty about trade relationship with the U.S., particularly amid rising interest rates in the international markets.
- A rising impact of populism on Brazilian and/or Argentine elections, deviating from fiscal discipline.

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## **What to look for over the next quarter**

Consumption trends in Latin America have generally underperformed our expectations during the first half of 2018. Soft demand trends in Brazil, Mexico, and Argentina are likely to impair top-line growth and gradually squeeze profits in the coming quarters, particularly amid rising inflationary pressures in some markets. Weak consumption trends are likely to take a toll on the retail and consumer durable product sectors. Argentina's corporate sector is currently facing the highest downside risks, given that economy may be rapidly decelerating due to high policy rates to curb inflationary pressures, and a plummeting consumer confidence that's close to its five-year historical low.

Higher oil prices and a strong dollar will also shape the profitability and growth prospects for various industries during the second half of 2018. The escalation in energy prices could erode margins across the industrial sector. On one hand, if companies opt for a full pass-through of the energy cost to the end-customers, they will further undermine consumer demand, thus slowing growth prospects for the second half of the year. On the other hand, absorbing the energy cost increments will take a bite out of the companies' bottom line. In Brazil, the truckers' strike revealed how difficult it will be to maintain the market parity pricing mechanism for petroleum in times of high oil prices. Similarly, we'll be monitoring the impact of Argentina's removal of petroleum subsidies. On the other hand, companies with exposure to dollar-denominated costs are likely to trigger price increases that would exacerbate inflation, and those with exposure to foreign currency debt will struggle to keep leverage contained.

The Trump administration's decision to impose new tariffs on steel and aluminum imports coming from Mexico has raised concerns about the future of NAFTA. The reciprocal retaliation measures by Mexico on several U.S. products, including steel is not only disruptive to the cost structure of certain regional supply chains, but signals heightened risks for the trade relationship between both countries. The Mexican peso has depreciated more than 10% in the past two months, and we expect private investments to come to a halt during the rest of the year.

# Infrastructure

- Mexico will hold elections in July.
- Negative impact of truckers strike in Brazil
- First round of bids for public-private partnerships (PPPs) occurred in Argentina.
- Peru has recently unveiled a new infrastructure law.

## What's changed?

The leading presidential candidate in Mexico's elections has expressed deep skepticism about the country's recent energy reform and construction of the new Mexico City airport. We continue to view the cancellation of both as unlikely given that the reform is enshrined in the Mexican constitution and that it bolsters investment prospects.

M&A activity in **Brazil** continues for existing utilities and transportation assets, in particular from Chinese and European investors. This was evidenced in the recent announcement that Enel Americas has gained control of Brazil's largest electric distribution company. On the flip side, the performance of many infrastructure assets including toll roads, ports and airports was negatively impacted by the truckers strike in late May. The strike affected not only commercial vehicle traffic, but also light vehicles, ports and airports due to fuel scarcity. Overall, this resulted in a drop of our GDP forecast and should negatively impact our recovery forecast for our rated portfolio in 2018.

The first round of PPP projects in **Argentina** was granted in June 2018. It comprises six highways and **safe roads**. We estimate the investment for these projects to total \$8 billion. This round will likely set a precedent, given that additional projects are set to be launched throughout 2018 and beyond. The likely projects under the same PPP framework include railroads, electrical transmission, hospitals, penitentiaries, water, sanitation, public lighting, bridges, and logistics contracts. Overall, the PPP-based projects are likely to attract investment bids totaling around \$26 billion. We believe that the new framework includes several features that represent significant advances from previous PPP laws enacted in the country.

The **Peruvian** government recently approved the regulations for the Law 30737, which was approved in March 2018. This replaced the 2017 anti-graft decree that imposed financial restrictions on construction companies that acknowledged or have been found guilty of corruption, stemming from a bribery scandal involving Odebrecht. The new law's main objective is to allow existing projects to proceed and release frozen payments to construction workers and suppliers, while providing mechanisms for the payment of civil reparations by companies found guilty of corruption. The intent is to remove uncertainty over civil compensation amounts. The law also provides clarity on how construction companies will pay civil reparations. We believe these developments will help financing flow to construction companies and allow projects to restart.

## Key assumptions

- We continue to expect single-digit GDP growth in the region and continued M&A activity.

## Key risks

- Uncertainty stemming from the regional elections could delay investment decisions by market participants.

## What to look for over the next quarter

The outlook for Latin American utilities and transportation infrastructure is broadly stable, mirroring those on the respective sovereigns. Despite the likely stable-to-improving operating performance among utilities and transportation infrastructure based on our expectation of GDP growth, we don't envision upgrades. This is because ratings on many assets are limited by those on the sovereign due to their highly regulated nature. Statements by Mexico's president-elect regarding infrastructure is something to pay attention to next quarter. In addition to the PPP auctions in Argentina, the results of the Oaxaca and Baja California transmission lines tender in Mexico should be announced next quarter.

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## Financial Services

- Political uncertainties, corruption investigations, and NAFTA renegotiations continue hampering investor confidence.
- Currency depreciation could pressure inflation and interest rates, weakening asset quality.
- Still gradual economic recovery in most countries could offset these burdens.

### What's changed?

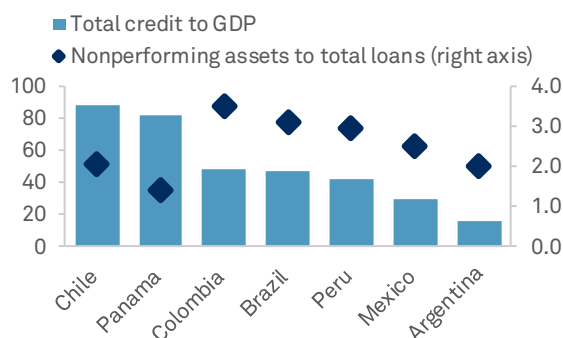
Sharp currency depreciation in **Argentina**, resulting in higher inflation and interest rates and lower economic growth, will likely impair banks' asset quality. Political uncertainty in **Colombia** has diminished following Ivan Duque's election victory; we expect business confidence to pick up during H2 2018, resulting in higher credit demand. The **Peruvian** government has recently approved a new infrastructure regulation law that could lead to recovery in construction and bring relief to the banking system. **Asset quality** has been stabilizing, helping boost operating performance. But **Brazil's** rate cutting cycle appears to have ended, albeit with interest rates at a record low.

### Key assumptions

Credit demand remains subdued in the largest economies (Brazil, Mexico, and Argentina) due to weak investor confidence. Increasing interest rates could bolster banks' net interest margins because deposits provide the overwhelming majority of funding for lenders. We expect mild recovery in most economies, which should support stabilization or improvement in banks' asset quality. Our base-case scenario excludes a breakdown in the NAFTA renegotiations.

Chart 4

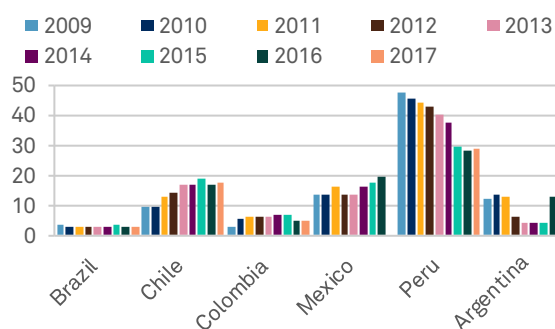
Credit to GDP and Asset Quality, 2018 Forecast



Source: S&amp;P Global Ratings

Chart 5

Dollar denominated loans % of Total Loans



Source: S&amp;P Global Ratings

### Key risks

- Deposit stability is the major risk in Argentina, given the country's still recent history of unstable deposits. So far, total deposits have remained relatively stable.
- Corruption investigations or a breakdown in NAFTA renegotiations could impair certain sectors of the economy in the region.
- Significant changes in economic policies following elections could affect the financial institutions' operating performance.
- Cyber security is an emerging risk, as seen in the recent spate of attacks in Mexico and Chile.

### What to look for over the next quarter

A prolonged period of currency depreciation could pressure inflation and hinder income capacity and increase loan delinquencies. We will monitor the effects of election outcomes in Mexico, Brazil, and Colombia on investor confidence and economic activity. We will continue following the performance of dollar denominated loans given the currency depreciation in most regional economies. The impact of the truck drivers' strike in Brazil is still to unveil, and could stress credit demand and the performance on the SME sector.

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## Structured Finance

- Credit quality across the main asset types will remain adequate; however, less favorable macroeconomic and political conditions could threaten collateral performance of some transactions in Argentina and Brazil.
- Asset diversification will remain for the rest of 2018 despite lower credit origination following tighter monetary policy pressures in the region's main economies, stemming from higher U.S. interest rates and weaker currencies in Latin America.
- After strong first-quarter issuance, political uncertainty is causing slowdown in securitization issuance in Mexico.

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### What's changed?

Recent hikes in Argentine interest rate are crimping credit origination, given that borrowers avoid engaging in higher cost debt, including UVA mortgages linked to inflation. Higher-than-expected inflation and less affordable housing (priced in dollars) are currently postponing long-term financing from banks. Similarly, consumption levels could drop given price increases amid high inflation, hindering the use of securitization among some retailers.

Credit origination continues to rise in Brazil as a result of lower interest rates and inflation, bolstering the use of traditional securitization to fund growth strategies. Brazilian banks are still examining new regulations for the covered bonds, but we expect the new issuances of this product to pick up especially among banks with ratings below those on the sovereign. Performance of all asset types remains stable in Brazil, although the recent truckers' strike could impact some of the small- and mid-size agribusiness companies, which could take a toll on the performance of trade receivables transactions. This is because the latter are mostly dependent upon production, sales, and effective distribution of the agricultural products.

Political uncertainty in Mexico due to elections will delay issuances in the second half of 2018 after a very active first half, during which issuances grew in 35% year over year. The recent U.S. decision to impose tariffs on steel and aluminum imports from Mexico could impact some sectors related to our equipment leasing transactions; however, these are over collateralized, so we don't expect rating movements.

Colombia's structured finance market will continue to focus on residential mortgage-backed securities transactions; however, investor appetite is rising for the recently issued consumer loans transactions. Favorable macroeconomic conditions, together with stable but lower interest rates and targeted inflation, will likely cause the demand for this type of notes to rise; furthermore, the recent presidential election, the closing phase of the peace process, and expected future tax reforms, could increase market stability.

### Key Assumptions

- Asset diversification will remain across the region, although at a slower pace.
- We expect stable collateral performance across asset types and jurisdictions with temporary spikes in delinquency levels of some consumer transactions in Argentina and Brazilian trade receivables.
- Nevertheless, the sector ratings will remain stable.

### Key risks

- Inflationary pressures in Argentina will continue hinder public-sector salary renegotiations, thereby reducing the borrowers' capacity to pay debt obligations, leading to lower disposable income that could weaken the performance of some outstanding transactions in the consumer arena.
- In general, currency depreciation in the region's main economies, inflation, and tighter monetary policies could slow credit origination, and consequently, the use of securitization, as well as borrower's capacity to pay, which we will continue to monitor closely.

### **What to look for over the next quarter**

- Asset diversification: Potential funding sources for PPP contractors in Argentina may come from repackaged securitizations placed in international capital markets, mirroring recent transactions in Peru and Panama.
- A potential spike in delinquencies of trade receivable transactions in Brazil as a result of the truckers' strike.
- Argentinian macroeconomic factors impacting securitization both in origination and performance of existing deals.
- Overall currency depreciation, its effect on inflation and interest rates and subsequent use of securitization as funding source for originators.

**Only a rating committee may determine a rating action and this report does not constitute a rating action.**

## **Related Research**

- Global Trade At A Crossroads: The Risk Of An All-Out China-U.S. Trade War Moves Up A Notch, June 18, 2018
- Argentina Has Secured Support From the IMF, But Challenges Remain, June 12, 2018
- Credit Conditions: Latin America March -2018 – Political Risk May Dampen The Impact of a Global Economic Upswing, March 28, 2018
- Global Trade At A Crossroads: U.S. Steel And Aluminum Tariffs Raise Risk Of Retaliatory Spiral, March 9, 2018

## Appendix 1: Ratings trends and surveys

Table 4

### Latin American Sovereigns and IPF

	Economic conditions	Economic conditions outlook	Budgetary performance	Sector outlook
Brazil	Weak	No change	Same	Negative
Mexico	Weak	No change	Same	Stable
South America (excluding Brazil)	Satisfactory	No change	Same	Stable
Central America & Caribbean	Weak	No change	Same	Stable
Mexico IPF	Satisfactory	No change	Same	Stable
Argentina IPF	Satisfactory	No change	Same	Stable
Brazil IPF	Weak	No change	same	Negative

Source: S&amp;P Global Ratings.

Table 5

### Latin American Corporate and Infrastructure Sector Trends

	Current business conditions	Business conditions outlook	Financial trends outlook	Sector outlook
Aerospace & Defense	Satisfactory	No change	Same	Stable
Auto suppliers	Satisfactory	Somewhat weaker	Same	Stable
Building materials	Satisfactory	No change	Same	Stable to Negative
Chemicals	Satisfactory	No change	Same	Stable
Consumer products A (including protein and bottler)	Satisfactory	No change	Same	Stable
Consumer products B (agro)	Satisfactory	Somewhat weaker	Lower	Stable
Forest products	Strong	No change	Higher	Stable
Merchant power	Satisfactory	No change	Lower	Stable to Negative
Metals and mining	Satisfactory	No change	Same	Stable
Oil and gas	Weak	Somewhat stronger	Higher	Stable to Negative
PPP/Infrastructure project finance	Satisfactory	Somewhat stronger	Same	Stable
Real estate: homebuilders	Weak	No change	Same	Stable
Regulated utilities	Satisfactory	No change	Same	Stable
Retail	Satisfactory	No change	Same	Stable to Negative
Telecom	Satisfactory	No change	Same	Stable
Brazil IPF	Weak	No change	same	Negative

Source: S&amp;P Global Ratings.



Table 6

**Latin American Banking Industry Trends**

Country	BICRA Group	Economic risk factors					Industry risk factors				
		Economic Resilience	Economic imbalances	Credit risk in the economy	Economic risk score	Economic risk trend	Institutional framework	Competitive dynamics	System wide funding	Industry risk score	Industry risk trend
Argentina	8	Very High	Very High	High	8	Stable	High	High	Very High	7	Stable
Brazil	6	Very High	High	High	7	Negative	Intermediate	High	Intermediate	5	Negative
Mexico	4	High	Low	High	5	Stable	Intermediate	Intermediate	Low	3	Stable
Colombia	6	High	High	High	7	Stable	High	Intermediate	Intermediate	5	Stable
Peru	5	High	Very Low	Very High	6	Stable	Low	Intermediate	Intermediate	3	Stable
Chile	3	High	Low	Intermediate	4	Negative	Low	Intermediate	Low	3	Stable

Source: S&amp;P Global Ratings. Data as of June, 2018.

Table 7

**Latin American Insurers and Reinsurers Sector Trends**

	Current business conditions	Business conditions outlook	Sector outlook
Mexico	Satisfactory	No change	Stable
Brazil	Weak	Improving	Stable
Colombia	Satisfactory	No change	Stable

Source: S&amp;P Global Ratings.

Table 8

**Latin American Structured Finance Sector Trends**

	Current collateral performance	Collateral performance outlook	Sector fundamentals	Ratings trends
<b>Argentina</b>				
Consumer assets	Satisfactory	No change	Stable	Stable
<b>Brazil</b>				
Commercial assets	Satisfactory	No change	Stable	Stable
Consumer assets	Satisfactory	No change	Stable	Stable
RMBS	Satisfactory	No change	Stable	Stable
Future flows	Satisfactory	No change	Stable	Stable
<b>Mexico</b>				
Commercial assets	Satisfactory	No change	Stable	Stable
Consumer assets	Satisfactory	No change	Stable	Stable
RMBS	Satisfactory	No change	Stable	Stable
Future flows	Satisfactory	No change	Stable	Stable
<b>Colombia</b>				
RMBS	Satisfactory	No change	Stable	Stable
<b>Cross-Border</b>				
Future flows	Satisfactory	No change	Stable	Stable

Source: S&amp;P Global Ratings.

## Appendix 2: Economic forecasts

Table 9

### Latin America CPI inflation

(%)	2016	2017	2018f	2019f	2020f	2021f
Argentina	43.5	24.8	30.0	20.0	16.0	12.0
Brazil	6.3	2.9	3.6	4.0	4.0	4.0
Chile	2.7	2.3	3.0	3.2	3.0	3.0
Colombia	5.8	4.1	3.7	3.5	3.0	3.0
Mexico	3.4	6.8	3.8	3.2	3.0	3.0
Peru	3.2	1.4	2.6	2.5	2.0	2.0

Source: S&amp;P Global Economics

Table 10

### Latin America Policy Rate

(%, Year-End)	2016	2017	2018f	2019f	2020f	2021f
Argentina	24.8	28.8	45.0	35.0	30.0	25.0
Brazil	13.8	7.0	6.5	7.5	8.0	8.0
Chile	3.5	2.5	2.5	3.5	4.0	4.5
Colombia	7.5	4.8	4.3	5.0	5.5	5.5
Mexico	5.8	7.3	7.8	7.0	7.0	7.0
Peru	4.3	3.3	2.8	3.8	4.3	4.3

Source: S&amp;P Global Economics

Table 11

### Latin America Exchange Rate (USD, Year-End)

	2016	2017	2018f	2019f	2020f	2021f
Argentina	15.9	18.7	30.0	33.0	35.0	40.0
Brazil	3.3	3.3	3.6	3.7	3.7	3.7
Chile	667	615	630	640	645	650
Colombia	3,002	2,984	2,950	3,000	3,050	3,050
Mexico	20.7	19.7	19.5	20.0	20.5	20.5
Peru	3.4	3.2	3.4	3.5	3.5	3.5

Source: S&amp;P Global Economics

Table 12

### Latin America Exchange Rate (USD, Average)

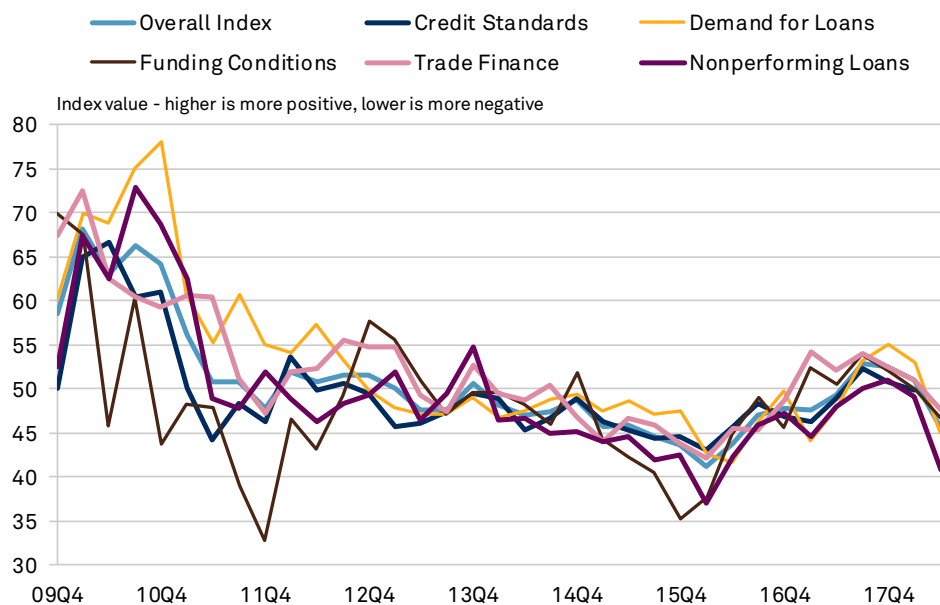
	2016	2017	2018f	2019f	2020f	2021f
Argentina	14.8	16.6	24.0	31.5	34.0	37.5
Brazil	3.5	3.2	3.5	3.6	3.7	3.7
Chile	677	649	620	635	643	648
Colombia	3,054	2,951	2,875	2,975	3,025	3,050
Mexico	18.7	18.9	19.4	19.8	20.3	20.5
Peru	3.4	3.3	3.3	3.4	3.5	3.5

Source: S&amp;P Global Economics

## Appendix 3: Financing conditions

Chart 6

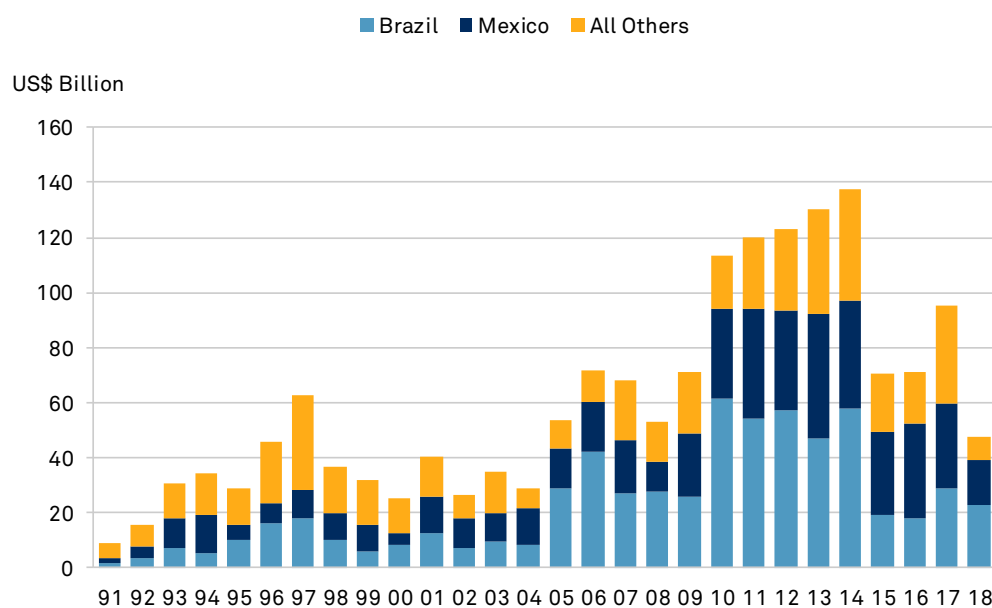
Institute of International Finance Survey of Lending, Latin America



Source: Institute of International Finance. Data as of May, 2018.

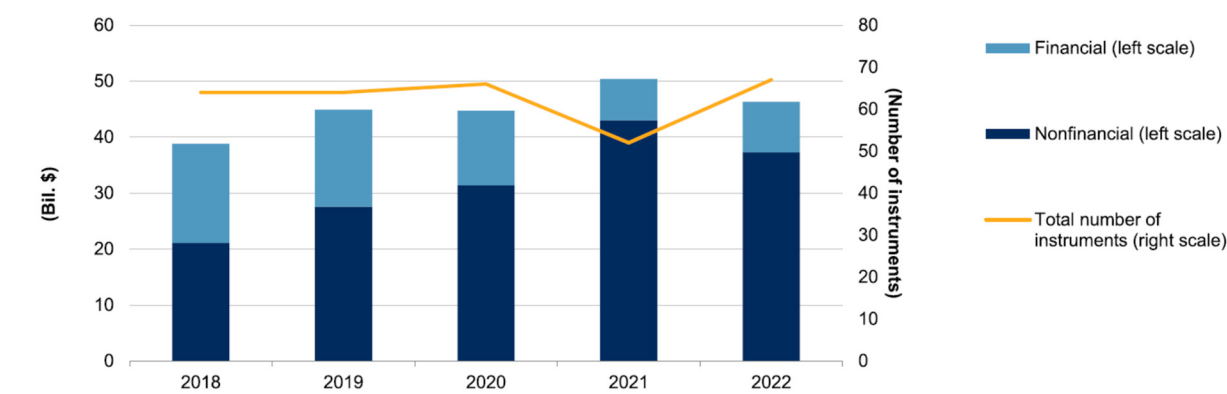
Chart 7

Latin America New Bond Issuance



Source: S&P Global Fixed Income Research, Thomson Reuters. Data as of June 18, 2018.

Chart 8  
Latin American Debt Maturities By Year



Source: S&P Global Fixed Income Research

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