

Latin America Sector Roundup Q3 2023

Lingering Risks Amid Positive Signs

July 19, 2023

This report does not constitute a rating action

Key Takeaways

- We project GDP growth in the region to slow in 2023, owing to a cyclical downturn in domestic demand. We expect growth to recover moderately in 2024, although below its potential. Inflation peaked in the region and will continue to trend lower in the coming months.
- We expect most central banks in the region to start reducing their benchmark interest rates toward the beginning of 2024. Financing costs are stabilizing as policy rates have reached their peak, while currently remaining at high levels.
- Slowing inflation and stabilizing financing conditions will support Latin American (LatAm) issuers' credit quality. Although slower growth will be a drag across the board and while market access has improved, debt costs have risen and our expectation of higher interest rates for a longer period will weigh on LatAm issuers' credit quality.

(Editor's Note: This report is an expansion of the "Sector Trends" section from our "Credit Conditions Emerging Markets Q3 2023: Enduring Risks" report, published June 27, 2023.)

Slowing Economy And High Rates Impeding Risks

Easing inflation and stabilizing financing conditions have brought some respite to LatAm issuers, while slower economic growth and lingering higher financing costs present a challenging panorama. Market access has been improving although amid more restrictive conditions including higher interest rates. LatAm corporations have been weathering challenging conditions thanks to manageable debt maturity schedules and overall sound liquidity.

We expect the region's economy to continue slowing for the rest of 2023 and to have only a modest rebound in 2024. The decline in domestic demand has been the result of a deterioration in investment amid high uncertainty over global economic growth and elevated financing costs. Furthermore, falling consumption will likely be the main cause of weaker GDP growth for the rest of the year. These factors, combined with lingering high financing costs, will narrow corporate earnings and could lead to downgrades, especially among highly-leveraged companies, those need that financing for working capital and those exposed to variable interest rates. Economic malaise will also depress bank's asset quality and we expect profitability to soften, although overall sound metrics should help them weather the temporary setback. The difficult economic panorama and political turbulence will continue to narrow the fiscal space for governments to address deeper economic and social challenges.

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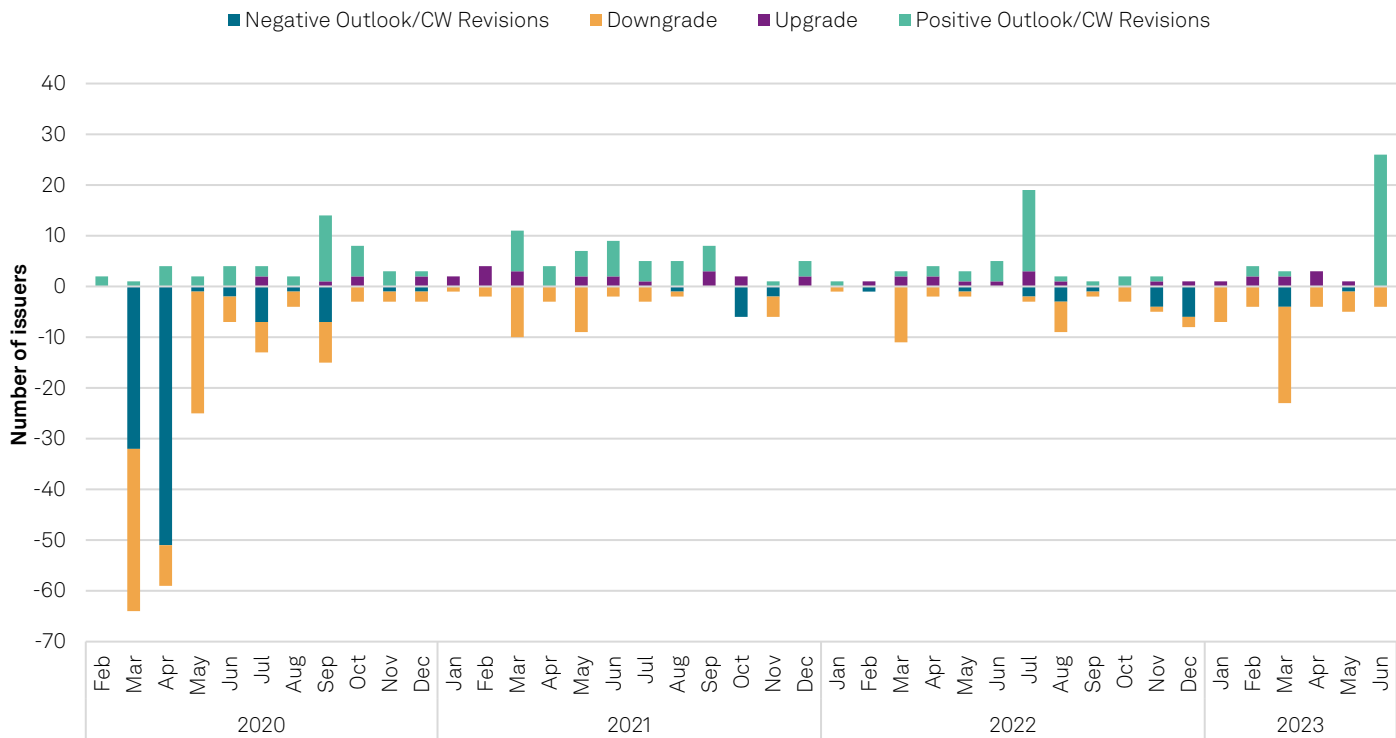
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Chart 1

A pause in the negative rating action momentum following the outlook revision to positive on Brazil
Number of rating actions in LatAm



Data as of June 30, 2023. Source: S&P Global Ratings Research & Insights.
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Macroeconomic Outlook

Cyclical Slowdown In 2023, Below-Potential Growth In 2024

We project GDP growth in the region to slow to 1.1% in 2023 from 3.7% in 2022, owing to a cyclical downturn in domestic demand. We forecast growth recovering moderately to 1.5% in 2024, though that's below potential that we estimate at 2.0%-2.5%. Below-trend growth among key trading partners in 2024 will keep export growth subdued in most of LatAm. We expect the region to return to its traditionally low potential growth rates in 2025-2026.

Table 1

LatAm: GDP growth and S&P Global Ratings forecasts

	2020	2021	2022	2023f	2024f	2025f	2026f
Argentina	(9.9)	10.4	5.2	(2.0)	0.5	2.0	2.1
Brazil	(3.6)	5.3	3.0	1.7	1.5	1.8	1.9
Chile	(6.2)	11.9	2.5	0.3	2.4	2.8	2.9
Colombia	(7.3)	11.0	7.3	1.4	2.0	2.9	3.0
Mexico	(8.2)	4.9	3.0	1.8	1.5	2.1	2.1
Peru	(11.1)	13.5	2.7	1.8	2.6	2.8	3.0
LatAm 6	(6.7)	7.2	3.7	1.1	1.5	2.1	2.2

Note: The LatAm GDP aggregate forecasts are based on PPP GDP weights. f--S&P Global Ratings forecast. Source: S&P Global.

We expect growth to be weaker in the second half of 2023 than in the first half of the year.

Domestic demand continues to slump in the region, following a strong performance in 2022 (see chart 2). Domestic demand contracted in Q1 2023 compared with Q4 2022 in every major LatAm economy, with the exception of Mexico, where strong remittances have propped up consumption. In most cases, domestic demand declined because of a deterioration in investment amid high uncertainty over global economic growth and elevated financing costs. Consumption has started to soften as well, and we expect this to be the main cause of weaker GDP growth in the rest of the year.

Inflation peaked in the region and will continue to decline in the coming months. Falling goods and commodities prices (food and energy) have been the main determinants of lower headline inflation across the region. Core prices have also started to soften in recent months, and we expect weaker domestic demand to cause core inflation to decrease. Furthermore, the recent strength in local currencies will also help curb inflation by lowering the cost of imported goods and services.

Chile and Brazil will start cutting interest rates this year, and the rest of the large economies in the region will do so in the first half of 2024. There is a very high likelihood that Chile's central bank will start lowering its benchmark interest rate in its late-July meeting, after hinting of doing so during its June monetary policy meeting. The Brazilian central bank is likely to follow suit as early as August, as inflation dynamics have improved markedly in recent months. We expect most other major central banks to start lowering interest rates toward early 2024, once there is greater visibility regarding the beginning of monetary policy easing in the U.S.--we expect the Fed to start cutting rates around the middle of 2024.



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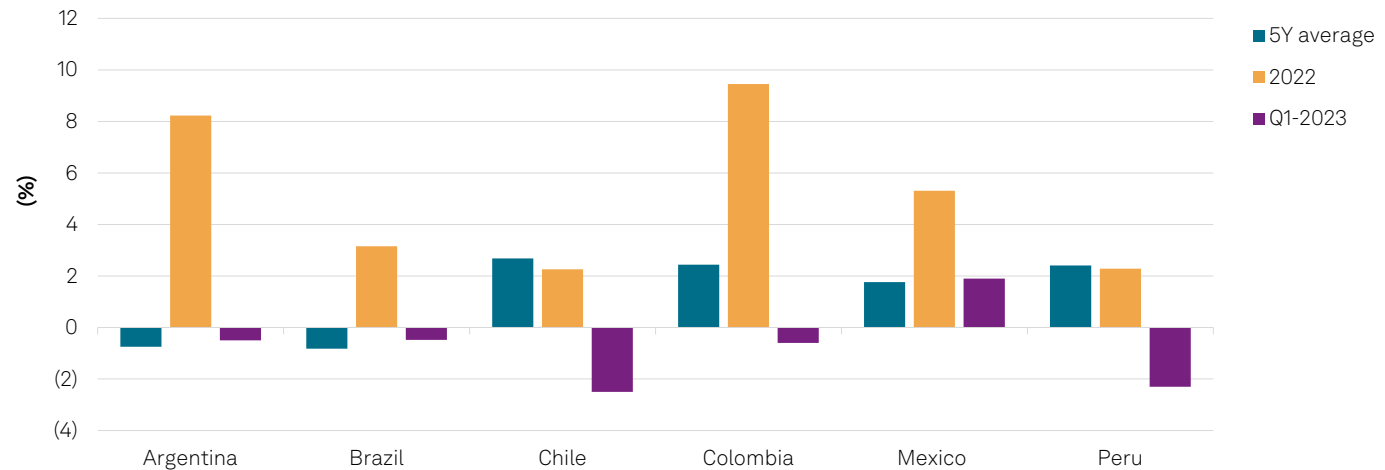
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Chart 2

Change in real domestic demand



Note: Five-year average is 2015-2019. Sources: Haver Analytics and S&P Global Ratings.
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The potential for slower-than-expected growth in China and the U.S. are key downside risks to the region. The initial rebound of China's economy, after lifting pandemic-related restrictions in late 2022, seems to be losing steam. This could dampen demand for key commodities that LatAm exports. While the U.S. economy continues to show resilience due to strong labor market dynamics, tight monetary conditions could cause a rapid deterioration in demand, with adverse implications for key trading partners, such as Mexico.

Elevated interest rates, in the absence of stronger economic growth, mean that fiscal strains will remain across most of the region. The margin of error for policy mistakes, especially fiscal related, is narrower. Given high levels of political polarization and social instability in some countries, pressure for greater government spending is likely to remain high. An erosion of fiscal accounts would cause domestic interest rates to rise further (higher fiscal risk premia), and potentially encourage capital outflows, hindering conditions to incentivize greater investment in the region.

Nearshoring remains a key upside for Mexico, but progress has been slow. Nearshoring has gained attention as supply-chain disruptions during the pandemic made a case for manufacturers to diversify the location of their operations to minimize production disruptions. Geopolitical dynamics may have also encouraged companies to consider diversify operations outside of China. Mexico's long-standing manufacturing links with, and access to, the U.S. market make it an obvious potential beneficiary for nearshoring. While investment in expanding industrial parks along Mexico's northern border has been rising in the last couple of years, most of it is related to firms that are already operating in the country and that are expanding capacity. If more companies shift their operations from other countries into Mexico, the impact on GDP growth could be substantial (see "For Mexico, Nearshoring's Potential Benefits--And Obstacles--Are Significant", published on Feb. 1, 2023).

Financing Conditions

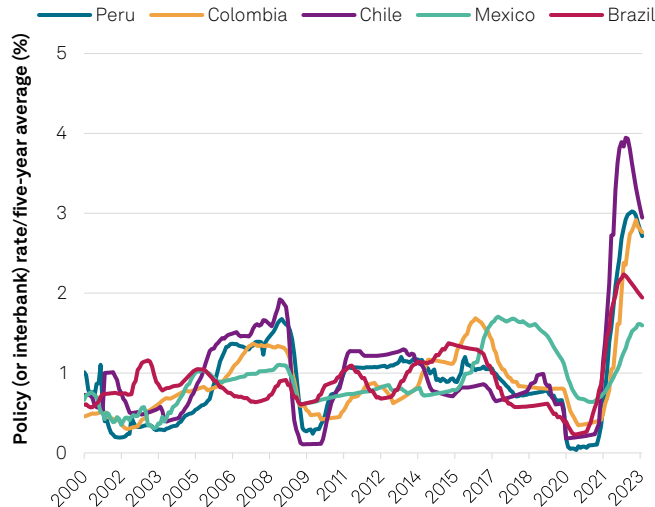
High Interest Rates Weigh on Credit Quality

Financing costs stabilizing from a high level. LatAm policy/interbank rates, along with inflation, have reached their peak (chart 3), while remaining at high levels: benchmarks are on average 290 basis points higher than pre-pandemic levels. Corporate spreads continue their gradual descent from the March pick-up. Nonetheless, the protracted scenario of high interest rates and tight financing conditions stresses LatAm corporations' credit quality, causing 12 out of the 14 downgrades across 18 key emerging markets (EM18) from April to June, with eight occurring in Brazil. Liquidity strains, refinancing risk, and necessary capital restructuring were the main reasons for negative corporate rating actions in LatAm.

Bond issuance remains weak. Significant financing costs and investors' aversion to low-rated issuers are reflected in subdued international issuance volumes that seem to follow the historically low trend of 2022 (chart 4). Domestic markets are still active, although they can't fully compensate for the foreign issuance decrease and may become more selective with weak economic activity and still high uncertainty ahead. Nonetheless, refinancing risk remains contained, as debt maturities are expected to hit their peak in 2027, with speculative-grade debt maturities at 35% in 2023-24 mainly among oil and gas entities and financial institutions, mostly located in Brazil.

Chart 3

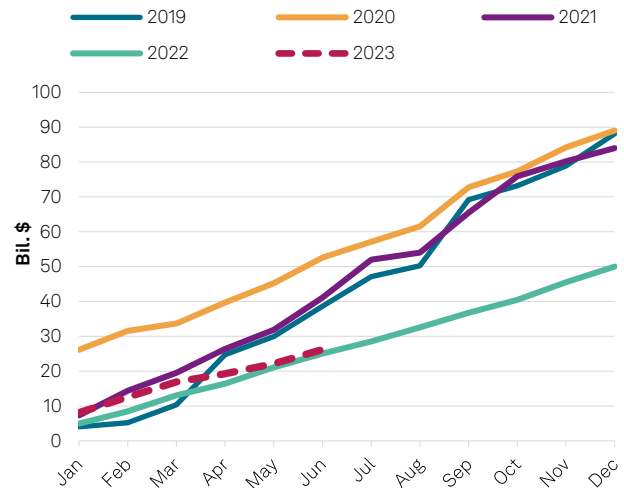
Stabilizing rates after unprecedented tightening



Sources: S&P Global Market Intelligence, Banco Central De Reserva Del Perú, Banco de México, Banco Central Do Brasil, Banco de la Republica (Colombia), Banco Central de Chile, and S&P Global Ratings.
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Chart 4

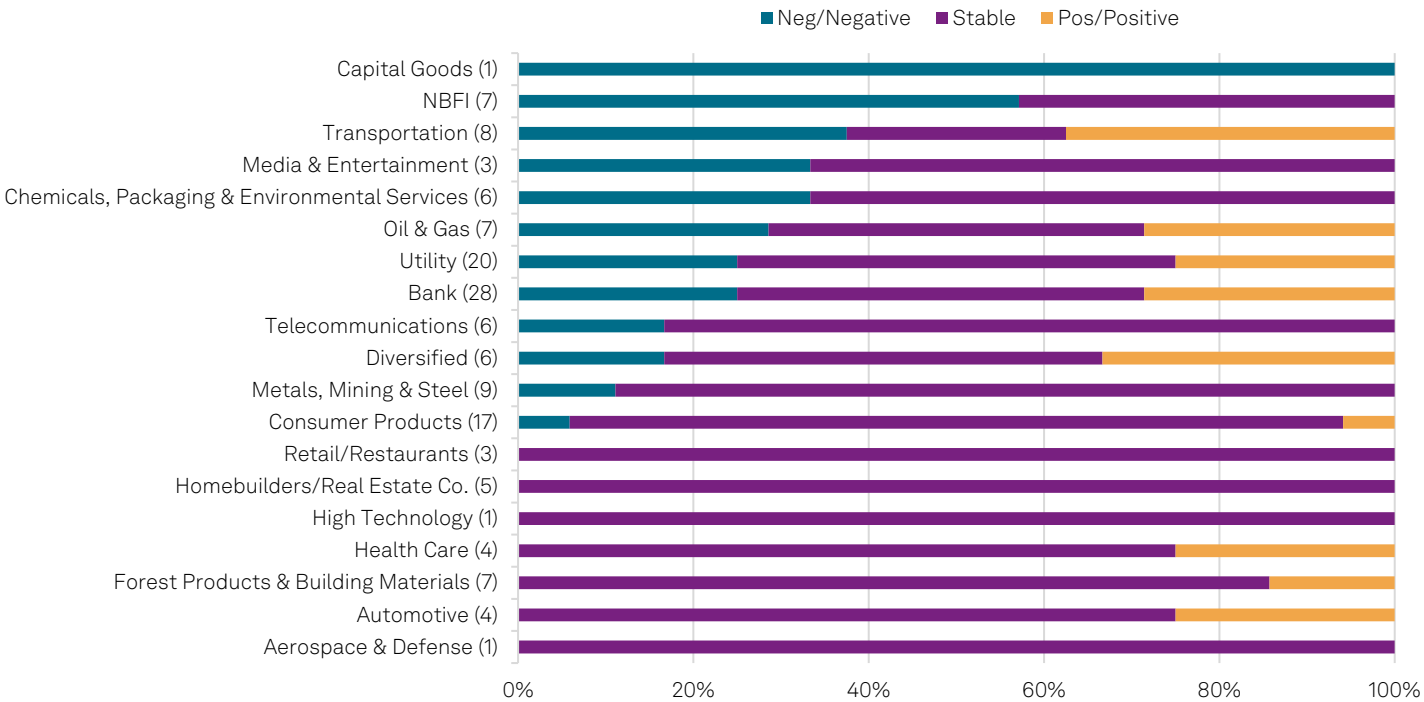
Issuance weakness remains (YTD cumulative)



Data as of June 30, 2023. Data including not rated.
Sources: S&P Global Ratings Credit Research & Insights and Refinitiv.
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Chart 5

Ratings are largely stable; the outlook revision on Brazil to positive moved the needle for some sectors
Outlook distribution of LatAm issuers by sector



Data as of June 30, 2023. Source: S&P Global Ratings Research & Insights.
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Sovereigns

Low GDP Growth Continues To Act As A Drag

What we expect for the next 12 months

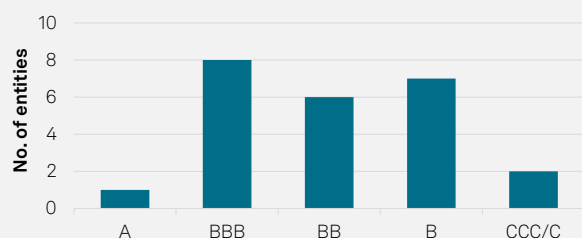
- Economic performance in much of LatAm and the Caribbean has modestly exceeded our projections earlier this year, but it remains weak in comparison with those of other regions of the world.
- Much of LatAm has lackluster GDP growth prospects, persistent but stabilizing inflation rates, and politically turbulent conditions that limit the room for policy maneuver for governments to address deeper economic and social challenges.
- Higher interest rates and a larger debt burden constrain fiscal policy, while inflation has led central banks to tighten monetary policy, constraining economic growth.



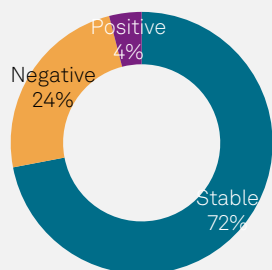
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Rating distribution



Outlook distribution



Note: As of July 4, 2023. Includes public ratings only.
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The LatAm and Caribbean region suffered a deep economic contraction during the pandemic years and has shown a poorer long-term GDP growth rate than other EMs. Sovereigns in the region now carry a higher burden of government debt than in pre-pandemic years, but it has declined across most countries from the 2020 peak (except in Chile and Peru).

The region's weak economic performance in recent years has heightened public distrust of political institutions, parties, and leaders in many countries. Political factors remain key drivers of sovereign ratings in the region, especially in Andean countries. **Chile enjoys greater political stability** than its Andean neighbors, but its government suffered a setback recently when Congress blocked an ambitious tax reform.

Peruvian politics have stabilized somewhat recently, despite the low popularity of both President Dina Boluarte and Congress. Our negative outlook on **the rating on** Peru reflects the risk that political impasse or further adverse developments reduce the predictability of policymaking or erode institutional stability, resulting in economically harmful policies. **In Colombia**, recent allegations of illegal financing of President Gustavo Petro's 2022 election campaign have made it harder for the administration to advance in Congress its ambitious reforms on pensions, health care, and labor laws. Adverse political developments could dampen private investment and GDP growth, making it harder to meet fiscal targets and reduce the burden of government debt.

We recently changed the outlook on our 'BB-' rating on Brazil to positive based on signs of greater certainty about fiscal and monetary policy that could benefit its currently low GDP growth prospects.

Mexico is somewhat benefiting from nearshoring investments. However, such investments are not enough to boost Mexico's real per capita GDP meaningfully, which we expect will grow less than 1% this year and in 2024.

Corporations

Coping With The New Credit Cycle

What we expect for the next 12 months

- We continue to view credit conditions in LatAm as broadly difficult, despite the net rating bias turning slightly positive recently.
- Although business conditions remain relatively satisfactory for most sectors, high interest rates are squeezing free cash flows and pressuring entities with weaker credit quality. That's especially concerning in Brazil where most of corporations are sensitive to interest-rate variability while the central bank is pursuing a tight monetary policy.
- Market access is not a near-term concern, and companies are avoiding issuing at current rates. We expect to see more market activity among investment-grade companies in the coming quarters, but conditions for speculative-grade issuers will remain challenging.



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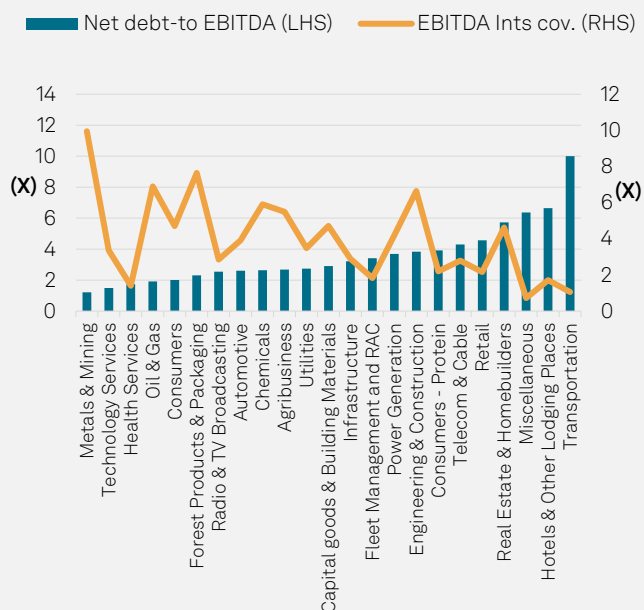
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Leverage trends



Source: S&P Global Ratings. Data as of March 2023 (last twelve months).
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Several corporate defaults in the first few months of the year amplified fears of a credit crunch.

A combination of persistently high interest rates (especially in Brazil); lower demand in key sectors like retail, homebuilding, and consumer; some margin compression; and a market freeze in international and in domestic markets could lead to additional defaults this year among some LatAm speculative-grade issuers, in our view. However, we think that risks of an overall credit crunch have receded.

Corporations are handling difficult conditions relatively well so far, but we think debt service is a major hurdle given high interest rates, especially in Brazil. Rating outlooks are predominantly stable and corporate defaults are at less than 1% among rated entities. Corporate debt levels remain manageable and cash reserves are sufficient to meet short-term debt.

Although we think bond maturities are manageable for the rest of 2023 and for 2024, **more than half of the corporate sectors in LatAm is struggling to create value for shareholders** because their pre-tax returns on capital are well below their borrowing costs. This is a major issue among Brazilian corporations, debt structures of which are very sensitive to interest-rate volatility and because the central bank still has a very tight grip on policy rates. We expect to see further credit deterioration in Brazil, especially among companies with weaker credit quality.

Access to international markets has been improving but remains well below historical averages.

Volumes of international bonds issued by LatAm corporations in the first five months of the year were roughly 10% above the same period in 2022 but remain 40% below the annual average for 2017-2021. The main domestic markets have also stayed subdued.

Financial Institutions

Asset Quality Is Taking A Hit From Soft Economy And High Interest Rates

What we expect for the next 12 months

- Although inflation is showing signs of moderation, still high interest rates, disappointing economic performance, and increased leverage continue to strain household disposable income.
- Banks continue tightening their underwriting standards while credit growth remains slow, further pressuring asset quality.
- Major banks' balance sheets remain robust with high provisioning buffers and adequate capitalization.



Primary credit analysts

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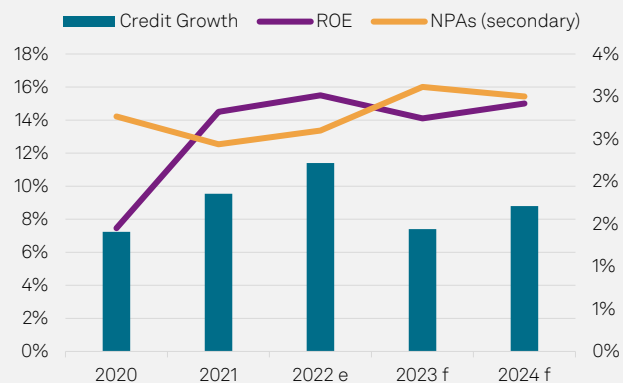
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Credit growth, ROE, and NPAs*



*Simple average among major LatAm economies: Brazil, Mexico, Chile, Colombia, Peru. e-- estimate, f-- forecast. Source: S&P Global Ratings. Copyright 2023 © by Standard & Poor's Financial Services LLC. All rights reserved

Profitability will continue to decline because of deteriorating asset quality that will require banks to continue strengthening their provision levels. LatAm banks are used to operating in **difficult** conditions and have sound regulatory capital and liquidity levels, which we expect will help them navigate the currently tough operating environment. Local regulators are typically stringent given the volatile economies, **while** regulations are implemented similarly across all regulated entities.

On the corporate side, banks are focusing on entities with stronger credit quality, such as large and midsize entities, while having less appetite for middle market, small companies, and microcredit. Overall, credit growth in this segment is also limited, and we continue to see asset quality weakening as a result.

We expect credit growth to slow, along with economic activity. While banks have sound capitalization and room to grow, we expect lending standards to remain tight as banks shield their balance sheets from the faltering economy and its effects on borrowers. We expect credit growth to moderately rebound in 2024, as economic activity improves.

LatAm banks' asset quality will likely deteriorate, although credit costs should remain manageable.

Furthermore, banks in the region have adequate profitability and provision levels, which should help them weather a temporary setback if **the** economy strengthens in 2024 as expected.

Insurance

Economic Risks Present Headwinds For Insurers

What we expect for the next 12 months

- Cooling economic growth in LatAm will pressure insurers' business prospects and key performance metrics.
- However, insurers in the region operate with healthy balance sheets, sound capitalization, and sufficient liquidity, enabling them to weather the slowdown.
- Stable credit trends prevail among LatAm insurers, although amid increasing risks amid prolonged economic doldrums.



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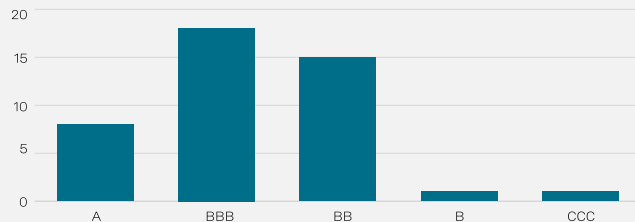
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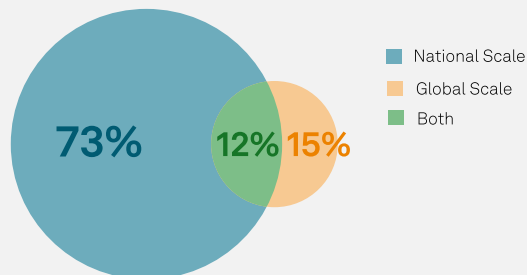
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Latin American insurers' ratings distribution



Global and national scale rating distribution of Latin American insurers



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As economic woes intensify, insurers' business growth prospects will be constrained. Therefore, we expect domestic demand to slow and unemployment to rise. This could hurt demand for insurance products and increase lapse rates in the next 12 months. A key driver of non-life premiums growth is based on higher prices, rather than on new business.

Strains on non-life insurers' technical results could intensify. Unemployment, social tensions, crime, and fraud could increase amid weak economic conditions, which could raise--in certain jurisdictions--claims for insurers.

Persistently high interest rates could hamper the credit quality of insurers' investments. This situation could be unsustainable for highly indebted issuers and could depress insurers' capitalization levels and liquidity positions.

Cybersecurity risks and climate change are increasing and becoming more costly. As a result, reinsurance costs are rising, as are investments in technology, hurting insurers' margins.

Conservative underwriting and investment policies will prevail. This will ease pressure on insurers' capitalization and liquidity levels.

Strutured Finance

Issuance Is Beginning To Pick Up

What we expect for the next 12 months

- We expect cross-border market new issuances to fuel an approximately 11% growth in total issuances across the region this year, despite potential weaknesses in collateral performance, while Brazil will remain the most active market in the region.
- Issuance volumes in Brazil are picking up, but remain subdued in Mexico.
- Ratings performance remains stable due to cushions in credit enhancement and deleveraging.



Primary credit analysts

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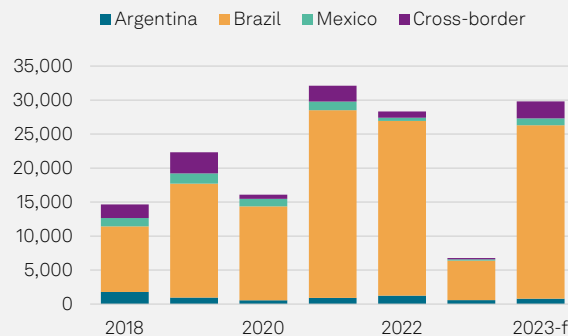
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SF market-wide new issuances (USD Millions)



. f - forecast. Source: S&P Global Ratings.
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Issuance volumes in Brazil are rising and we continue to observe interest in the cross-border market across the region. Therefore, our new issuance forecast is unchanged.

There are signs of stabilizing fiscal and monetary policies in Brazil. This could bolster economic growth and lift issuance volumes, particularly of repackaged securities. Inflationary pressures and high interest rates increased the financial burden on household leverage. However, inflation is cooling down and we expect that Brazil will be one of the first countries in the region to lower interest rates. This may improve the performance of consumer credit and residential financings.

Issuances remain subdued in Mexico across all asset classes. Nevertheless, activity could pick up in the second half, as companies plan to secure funding ahead of next year's elections. Performance remains solid amid stable collateral performance.

In Argentina, we continue to see new issuances in the ABS consumer sector. However, issuances may slow down in the second half of the year given the primary and national elections in August and October.

Infrastructure

Slow But Steady Improvement

What we expect for the next 12 months

- The weather phenomenon El Niño has been favoring hydrology in Brazil and Chile, and in conjunction with lower fuel prices (coal and gas), has eased spot energy prices across the region, except in Chile.
- Sluggish GDP growth across LatAm has dented traffic growth for transportation infrastructure assets. We project volumes increasing at an average 2x elasticity to GDP growth, considering the new baseline after the pandemic. However, traffic on Mexican toll roads located in the industrial regions in the northern part and close to the metropolitan areas of large cities, grew about 13% in Q1 2023.

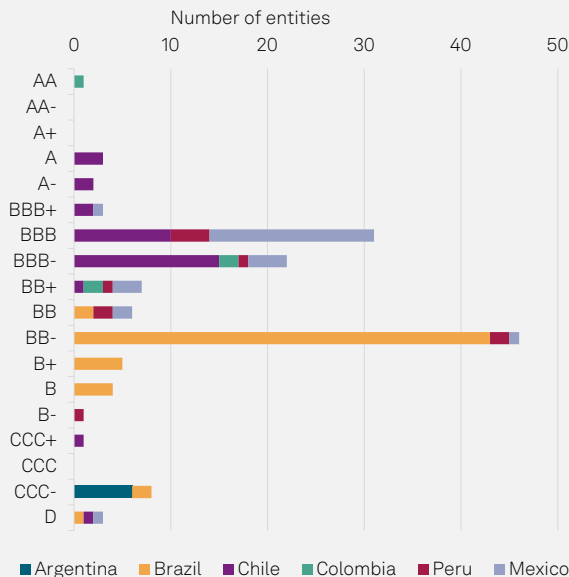


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Infrastructure rating distribution



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Chilean energy spot prices declined, but remain volatile, still pressured by decoupling and line capacity curtailment.

We anticipate lower average spot prices for the next 12 months compared with 2022, thanks to better hydrology prospects for this year and lower fuel prices. Regulatory changes should improve the outlook over the medium term, such as an updated framework for energy auctions, including pricing per zone and batteries.

Brazilian infrastructure companies' liquidity remains sound. Despite tight domestic capital markets in the first half of 2023, rated companies kept a robust cash position because they refinanced liabilities ahead of the 2022 general elections. Companies accessed credit markets, although at shorter tenors and higher costs, while diversifying funding sources, thanks to stable cash generation stability in the segment. Funding conditions are now improving, as indicated by recent issuances and planned transactions. Rated infrastructure companies have a R\$380 billion investment plan for the upcoming five years, and despite the expected decline in high interest rates that peaked at 13.75%, we expect the sector's credit metrics to slip in 2023, but to rebound starting in 2024.

Mexico grapples with power-supply bottlenecks. Lackluster investment in new energy capacity and transmission since 2019 will cause Mexico to fail to meet likely higher demand for the next three years--around 25% new capacity will be needed--for expansions in the manufacturing and automotive sectors arising from nearshoring, while maintaining adequate operational reserves in the system. Greater focus on renewable sources, in response to ESG international targets, could lead to curtailment and congestion of the transmission lines, increasing the risk of intermittence and blackouts, because the geographic areas with higher renewable energy potential aren't adjacent to areas of higher nearshoring opportunities.

We expect Peru's renewable energy capacity to expand, despite political and social volatility. The Peruvian power grid is dominated by hydroelectric and gas-run generators. Although persistent political and social disruptions could erode investment further, we anticipate expansion of renewable energy, currently consisting of wind and solar, in the upcoming three to five years given that renewable energy only accounts for 9% of the total generation.

Related Research

- Latin American Corporate And Infrastructure Midyear Credit Outlook 2023: Market Ice Cracks, Yet A Chill Remains, July 6, 2023
- Credit Conditions Emerging Markets Q3 2023: Inflation Peaked, Risks Remain, June 27, 2023
- Economic Outlook Emerging Markets Q3 2023: A Slowdown Ahead After Beating Expectations, June 26, 2023
- Emerging Markets Monthly Highlights: Resilience To Diverging External Trends, June 15, 2023
- Economic Research: Emerging Markets Real-Time Data: Service Sector Resilience Buys Economic Activity, June 12, 2023
- LatAm Financial Institutions Monitor 2Q 2023: Asset Quality Hurdles Cast A Growing Shadow May 9, 2023

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