Mexico

LOSING ENERGY

- **Heightened uncertainty is leading to a slowdown in economic activity as investment stalls and public spending plans are delayed. Job creation is expected to cool down, leading to weaker private spending.**
- **Energy reforms have practically halted given significant changes in Pemex and the government. Market participants, analysts, rating agencies and investors have expressed concerns about the lack of a clear and convincing business plan in Pemex, thus putting pressure on the oil firms and sovereign ratings.**
- **Prospects for the Mexican economy are lackluster, with lower growth rates and plenty of risks on the horizon. Banco de Mexico is expected to remain firm on their monetary stance until core inflation presents a clear downward trend, perhaps in 2020Q1.**

The Mexican economy is losing energy. Real GDP grew only 1.7% y/y in 18Q4, presenting a marked contrast within its main components, as industrial production fell 0.9% while the services sector grew 2.7%. A large part of the industrial weakness is explained by the persistent decline in oil extraction (-8.2% real y/y in Q4) due to oilfield depletion and Pemex's structural problems. Adding to the weakness in Q4 was a decline in construction (-2.2% real y/y), which could reflect broader uncertainty.

Higher frequency indicators point to an extension of the slowdown. Job creation, as measured by the number of insured persons in the Mexican Social Security Institute (IMSS), is clearly decelerating (see chart 1). After a growth of 4.5% y/y and more than 850 thousand jobs created in the previous 12 months in April–May of last year, data for February show a marked deceleration to y/y growth of 3.1% and an increase of only 604 thousand jobs recorded. There is also a very clear downward trend in consumption and capital goods imports, that fell 5.3% and 5.5% y/y last February (chart 2).

The key narrative is that there are many factors producing high uncertainty that is curbing down investment, thus affecting job creation and then producing a more cautious consumer and a weaker economic activity.

Developments in the energy sector are a key factor affecting investment perspectives. The cancellation of oil and energy bidding processes as well as the delays in Pemex "farm-outs" have effectively halted the Energy Reform, which was expected to provide a large amount of investments for the country. There is also a widely controversial change in Pemex business plan, which now is preparing to build a new refinery in Dos Bocas, Tabasco, which markets, analysts and rating agencies reckon as a bad bet for a firm with a lot of operational problems and under financial stress. A financial support plan for Pemex is yet to be announced by the Government, which is considering using its "rainy day" fund

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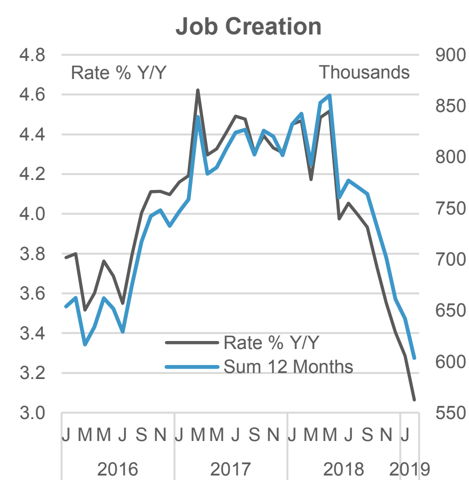
Mexico	2017	2018	2019f	2020f
Real GDP (annual % change)	2.1	2.0	1.4	1.3
CPI (y/y %, eop)	6.8	4.8	4.0	3.8
Central bank policy rate (%, eop)	7.25	8.25	8.25	7.50
Mexican peso (USDMXN, eop)	19.66	19.65	21.26	21.71

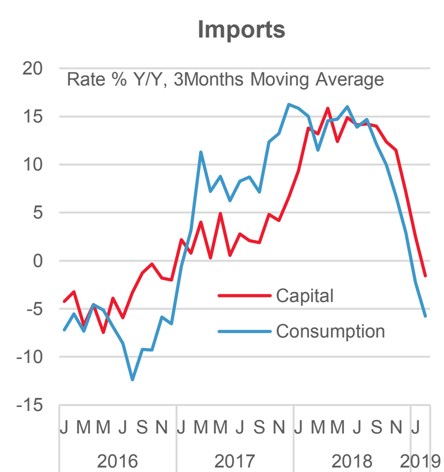
Source: Scotiabank Economics.

Chart 1



Source: Mexican Social Security Institute.

Chart 2

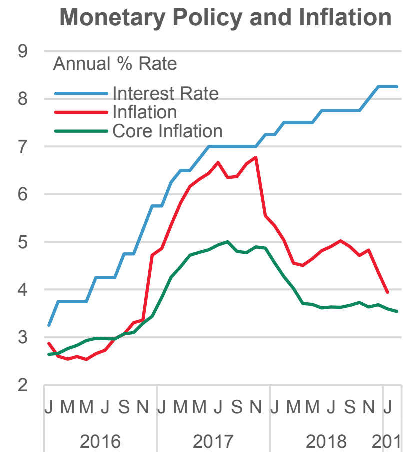


Source: Institute of Geography and Statistics.

(public revenue stabilization fund) as well as changing the tax regime of Pemex to alleviate the most urgent financial needs of the oil company. Pemex's finances are closely tied to the Government's, and if Pemex and the Federal Government are not able to provide a convincing business plan to restore the oil company's profitability, then both Pemex and sovereign debt ratings will be on a negative direction.

For the time being, one of the factors perceived as a clear positive is fiscal discipline. Hacienda set a target of a 1.0% of GDP primary surplus for 2019, and so far they are delivering on this commitment, with a primary balance above target in the first two months of the year (MXN 57.7 billion vs. 12.4 billion). There is, however, a risk of execution, as rating agencies have named it. As the economy weakens, tax revenues will be lower, as is already perceived in recent data, with tax collection and specially value added tax revenues below target (577.8 billion vs. 590.9 billion in the first case and 165.7 billion vs. 180.5 billion in the second). These numbers also suggest that economic activity is slowing down.

Chart 3



Sources: Banxico, Institute of Geography and Statistics.

There were some particular and unusual events in the first quarter that will have a negative but transitory impact on economic activity: an unfortunate disruption in fuel distribution in many states including large metropolitan areas, associated with fuel-theft combat, produced delays and many wasted hours for citizens in January. The blockade that some members of the Teacher's Union organized to railroads in Michoacán also caused economic disruptions. Finally, labor strikes in Matamoros, Tamaulipas, affecting several "maquiladoras", also had a toll on economic activity.

It is usual that in the first year of a new Government there is a delay in public spending, since the new officials have to pass the learning curve process of their new job. This year, however, a longer and deeper delay is expected, because a deep restructuring of the Federal Government is underway. The cap on wages of civil servants is leading to an exodus of human capital within the Government, with many vacancies in key positions and many newcomers without the required experience or skills.

Looking forward, the economy is expected to show a lackluster performance, with a 1.4% real growth in this year and 1.3% in 2020. Total investment is forecast to fall 3.1% in 2019 and 1.1% in 2020, while private consumption should expand by 1.6% in both years. Exports will remain as one of the engines for the economy, growing 4.8% and 3.8% in the non-oil sector for this year and the next in US dollar terms, provided that the US Government does not do something as extreme as putting tariffs on automobiles or shutting the border.

After the Federal Reserve made a significant change in its future guidance for their monetary policy, it is now expected that Banco de Mexico will keep its reference interest rate on hold for the reminder of the year and will start a reduction cycle at the beginning of 2020. This of course depends on the behavior of inflation, which we expect will decline gradually owing to the slowdown in growth. Financial markets in Mexico were already discounting a significant change in Banco de Mexico's tone and up to three cuts in the reference interest rate during this year. However, Banco de Mexico presented a firm tone and kept the upward bias in the balance of risks for inflation in their last monetary policy decision, meaning they are more inclined to wait and see. Worth noting is that, as public finances are expected to remain under pressure as the economy weakens, monetary policy becomes the most important anchor for the economy. Banxico knows this.

Regarding to the exchange rate, we anticipate high volatility throughout the year, as has happened in previous years, reacting to the fluctuations in expectations and in the global risk perception among international investors. In an adverse financial environment for emerging markets, a moderate depreciation of the national currency, reaching levels above 21 pesos per dollar by year-end, is expected.

More factors could produce an adverse economic scenario than a positive one, impelling a downward bias for economic activity in the outlook. Among those negative factors are: the possibility of greater financial problems in Pemex that could spread into the public finances that end up producing a sovereign rating downgrade; a potential erosion in the fiscal position if public revenues do not grow at the expected rate, a worsening in Mexico's rule of law; a more drastic contraction in foreign direct investment and total investment of the economy; new inflationary shocks that keep inflation from resuming its downward trend leading to a more restrictive monetary policy from Banco de México. On the external side, there is the possibility of global financial tensions due to events such as: an escalation of global trade frictions, a more abrupt slowdown in the global economy, a hard Brexit with negative global spillovers; a stronger deterioration among emerging markets and the possible surge of new geopolitical tensions.

Among the domestic factors that can produce a more favorable outlook for Mexico are: a convincing business plan for Pemex and the energy sector leading to greater productivity and profitability; a resumption of the oil and electricity auctions, a reallocation of social spending, actions to strengthen the rule of law; an injection of confidence into business sentiment to trigger investment; a growth in public revenues above what is expected as more taxpayers are included in the regulated sector; unexpected positive shocks that help reduce the inflation dynamics; and a shift of the sovereign rating to a positive outlook. External factors that could lead to a better scenario include: the dilution of global trade tensions, a successful agreement between the US and China; a considerable reduction in global risk perception, especially in emerging markets; and a pickup in the pace of economic activity in China and Europe.

Colombia

THE TALE OF TWO DEFICITS, IS IT SUSTAINABLE?

- **Colombian economic activity is gradually accelerating. Inflation and inflation expectations are under control, while the policy rate is slightly expansionary. A very gradual removal of monetary stimulus continues to be expected.**

- **External and fiscal imbalances in Colombia are growing at an uncomfortable pace. The recent relaxation of the fiscal rule and deterioration in the current account deficit for 2018 and 2019 might trigger a downgrade by ratings agencies, but investment grade should be maintained.**

The recovery of domestic demand recovery accelerated last year. While 2018 GDP grew 2.6% (from 1.4% in 2017) domestic demand rose 3.8% (from 1.2% in 2017). Recent indicators such as manufacturing activity, retail sales, energy demand, capital goods imports, point to further acceleration in domestic demand recovery. As the fiscal deficit has been larger than planned, the strength of domestic demand and fiscal deficit are leading to a larger deficit of the current account, raising some concerns. On the other hand, inflation pressures remain low despite the acceleration in growth as the economy is still running below potential.

The central government deficit was 3.1% of GDP last year after the independent fiscal committee allowed the government to borrow 0.4pp of GDP more than initially agreed in 2017, due to higher spare capacity in the economy. In fact, the most recent fiscal committee calculations says that economy will only run at potential by 2024 with the negative output gap widening to 3.7% in 2018. Additionally, the most recent fiscal committee decisions invoked an escape clause and increased the deficit target for 2019 by 0.3% to 2.7% and by 0.1% to 2.3% of GDP in 2020 to give the government a bit more room maneuver given the temporary spike in Venezuelan immigration and associated social expenditures. The size of the increase is reasonably small and hasn't, been much of an issue for markets. Rather, market concerns are focused on the ease with which it was raised suggests a much more flexible fiscal rule that thought.

The currency account deficit remains a concern. It stood at 3.4% of GDP in 2017 (in 2015 was 6.3% of GDP), it widened to 3.8% in 2018. Financing the deficit has thus far not been a challenge, as FDI has covered 105% of current account deficit (in 2018 was 87%). One interesting fact is that since domestic production of durable goods is low, economic expansions (especially investment) has been required a deterioration in current account deficit via higher capital and raw materials imports. The recent acceleration in domestic demand has followed this pattern, as imports of capital and raw materials have grown by close to 12% y/y. Normally imports of capital goods come with their own financing as a FDI but the large current account deficit means the recovery in domestic demand remains very reliant on external finance.

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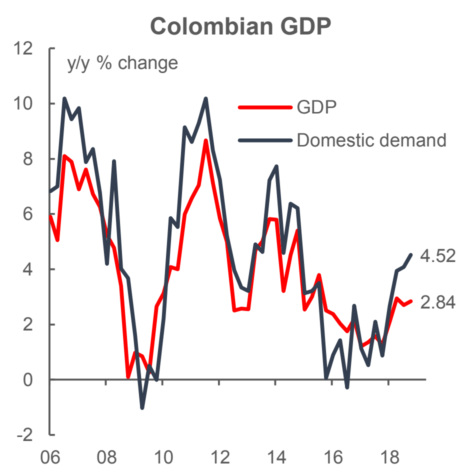
Colombia	2017	2018	2019f	2020f
Real GDP (annual % change)	1.8	2.6	3.4	3.8
CPI (y/y %, eop)	4.1	3.2	3.2	3.1
Central bank policy rate (%, eop)	4.75	4.25	4.50	4.75
Colombian peso (USDCOP, eop)	2,986	3,254	3,120	3,167

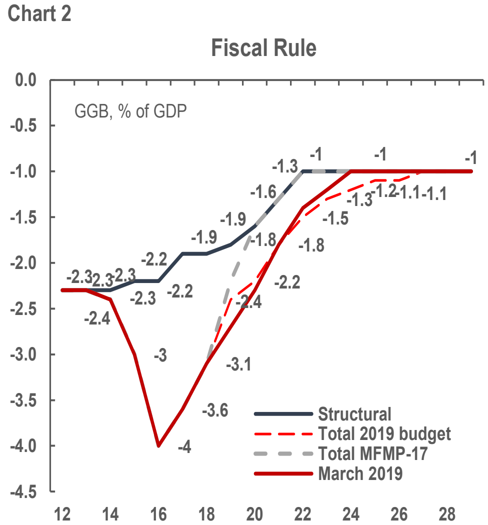
Source: Scotiabank Economics.

Chart 1



Sources: DANE, Scotiabank Economics.

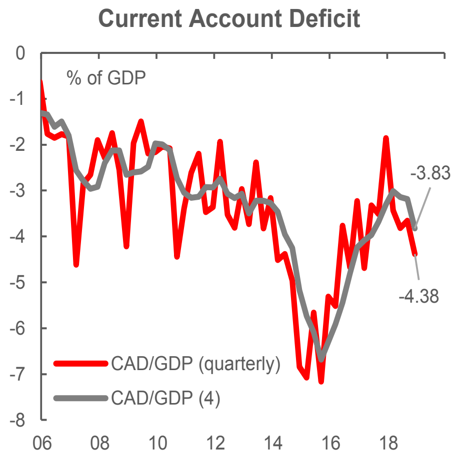
Chart 2



Sources: Comité de regla fiscal, Scotiabank Economics.

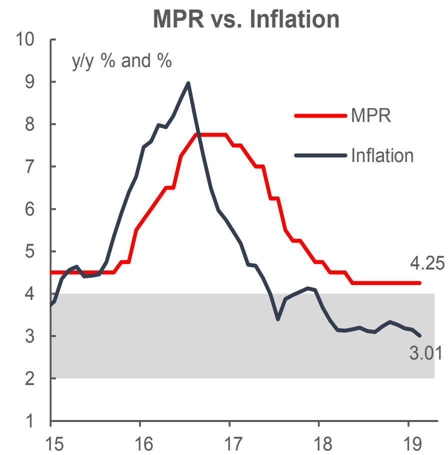
The elevated current account should not have an impact on the conduct of monetary policy, even though some analysts believe it will. BanRep has made it very clear that it considers the monetary policy rate an inappropriate tool to manage the country's external position. As a consequence, we do not believe BanRep will tighten policy to achieve this. With inflation will in the middle of the target range, inflation expectations well contained, and the Fed and ECB having adopted more dovish positions, there is no rush for BanRep to tighten policy in the face of strengthening growth. We anticipate that BanRep will keep the policy rate at 4.25% as long as inflation and inflation expectations remain close to target and the economy continue its gradual recovery. Therefore we think BanRep will only hike its policy rate once this year to 4.5% in September, once the growth outcomes in the first half of the year is released.

Chart 3



Sources: Banco de la República, Scotiabank Economics.

Chart 4



Sources: Banco de la República, DANE, Scotiabank Economics.

Peru

WITH 1Q2019 WEAKER THAN EXPECTED, WE SWITCH FROM UPSIDE TO DOWNSIDE RISK ON GDP GROWTH

- **A decline in government investment and resource sectors is impinging on growth.**
- **Consumption remains strong, but private investment is mild and patchy.**
- **Low inflation has the Central Bank signaling "less and later" on increasing its policy rate.**
- **The CB returned to the FX spot market after 14 months, to rein in the PEN appreciation.**
- **Macropolitics have improved, social conflict and corruption still a concern.**

We've lowered our 1Q19 GDP growth forecast from 3.7% to 3.2% y/y. GDP growth was a dismal 1.6% y/y, in January. February will be only slightly better. Most of quarterly growth will come in March, although this will largely be due to more working days as Easter will switch to April this year.

Two factors are behind GDP's underperformance in 1Q, namely, negative growth in resource sectors, and a sharp drop in public sector investment. Both were foreseen, but the magnitude has been greater than expected. The decline in fishing output (we expect -18% growth in 1Q) is temporary, and has to do with the impact of a weak Niño and shifts in fishing seasons. Mining GDP should end up in line with our forecast of 2.3% for the full year, as long as production at the Las Bambas copper mine is not too greatly affected by the social conflict that has been ongoing since February.

The main disappointment in 1Q, however, is public investment, down 6% in January and 29% in February. This reflects high rotation in regional and local governments since January 1, following last year's elections. Note that preliminary information suggests a rather sharp increase in March, however, so there is still hope. In general, public investment continues to be the swing factor for GDP growth in 2019. If it continues to be as weak as it has been in January–February, then reaching 4.0% aggregate GDP growth for the year will be more challenging. It is, however, a bit early to draw conclusions, as government investment is generally more volatile in the first quarter of each year.

Meanwhile, the private sector continues to fuel the economy. Consumption is robust enough for us to raise our 2019 forecast from 3.3% to 3.6%. Private investment, however, is showing initial signs of flagging a bit, judging from the deceleration of business loans growth, from 7.6% y/y, at the end of 2018, to 5.3% in February. Mining investment is the exception, having risen 48% y/y, in January. This should continue, despite social conflict. We have raised our forecasts for 2019 mining investment growth to 23%, from 14%. This represents an increase in

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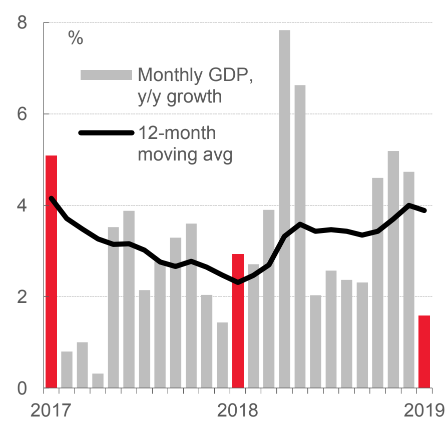
Peru	2017	2018	2019f	2020f
Real GDP (annual % change)	2.5	4.0	4.0	4.0
CPI (y/y %, eop)	1.4	2.2	2.4	2.5
Central bank policy rate (%, eop)	3.25	2.75	2.75	2.75
Peruvian sol (USDPEN, eop)	3.24	3.37	3.30	3.25

Source: Scotiabank Economics.

Chart 1



Sources: INEI; Forecasts: Scotiabank Peru Research.

total mining investment from US$4.95b in 2018, to US$6b in 2019, the highest figure in four years.

In sum, there is a divergence between resource sectors and non-resource sectors. At the same time, domestic demand leads growth, but its strength may have waned a little, due to low public investment. First quarter aggregate GDP growth overstates the magnitude of the slowdown, however, and is not indicative of a broad decline.

Inflation, at 2.2% to March, continues well within the Central Bank comfort zone. On balance, the CB perceives that upside inflation risks (low external demand and global market volatility) are compensated by downside risks (lower domestic demand), such that overall risk is neutral. With inflation near where it should be, an economy that is growing but not overheating, a well-behaved FX market, and metal prices that are neither hot nor cold, the CB has been more vocal about its intention to keep the reference rate stable, at 2.75%, for longer. The caveat to this view: the real rate is 0.35%, which means monetary policy is substantially expansionary for an economy growing at 4.0%. However, with the CB nested in its comfort zone, in an economy with very stable indicators, this low real rate is not factoring in on Central Bank decisions for the time being. At least, judging from the signals it is giving. As a result, we are changing our view of one reference rate hike in 2019, to none.

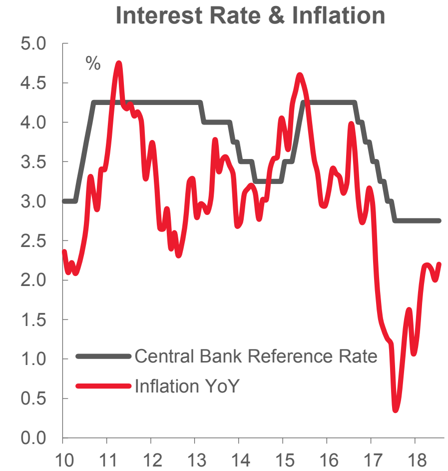
The Central Bank has changed its behavior in one area, however. After nearly 14 months of not intervening in the FX spot market, the Central Bank began to do so, in earnest, in March. This is likely linked to a US$3b inflow of offshore capital into sovereign bonds in 1Q. The CB tends to be more active in the FX market when it views large movements in short-term capital flows. Total offshore participation in sovereign bonds outstanding has risen to 51% in March, from 46% in December.

Peru's fiscal deficit fell to 2.1% in the twelve months to February, after ending 2018 at 2.5%. This is in line with our expectations of a 2.0% deficit for full-year 2019.

Politics continue to be messy, but are in general less of a threat than in 2018. Governability has improved, with a new cabinet, a stronger presidency and weaker opposition in Congress. The new cabinet that was appointed in March is likely to prove centrist and market friendly. Cabinet head Salvador del Solar is known to be reasonable, a good communicator, and non-corrupt, but has relatively little political experience, which is a risk. One of the first critical situations that Del Solar is facing is the social conflict surrounding MMG's Las Bambas copper mine. The access road to the mine has been blocked by a local community since early February, prompting Las Bambas to state that "force majeure will be declared under sales contract". Las Bambas represents 16% of the country's total copper output, or about 1% of total GDP, which will only impact our aggregate GDP forecast if output is affected for a prolonged time.

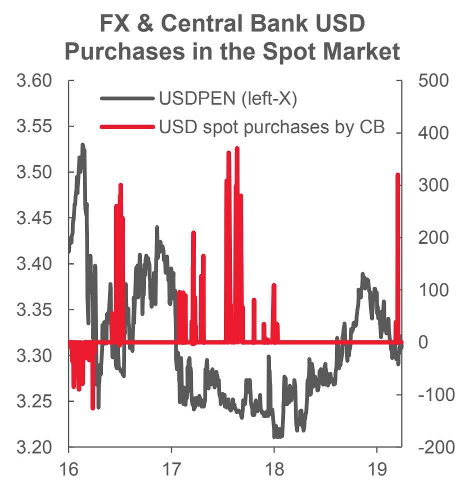
Finance Minister Carlos Oliva has been ratified, so we expect no major surprises in economic policy. Changes within the cabinet are likely to affect certain sectorial policies, but will not necessarily mean profound changes in overall policy guidelines or management. Del Solar will need to prove himself in establishing good relationships with regional governments, in accelerating government investment, and in managing the thorny, and ongoing, corruption issues in the country.

Chart 2



Sources: BCR, Scotiabank Peru Research.

Chart 3



Sources: BCR, Scotiabank Peru Research.

Chile

GROWTH TRACTION STILL ELUSIVE

- **We continue to anticipate an expansion of around 3.2% for the current year and next, with domestic demand led by investment and the velocity of the latter being highly conditioned, as usual, on the approval of political reforms and positive terms of trade. Growth is expected to accelerate as the year progresses.**
- **The unemployment rate is expected to decline only gradually, containing wage pressures and helping to keep a lid on inflation, which should reach 2.8% in 2019. As a result, the central bank should raise rates very gradually, with just one 25bp hike in Q4 and two more in H1 2020.**
- **Political developments are critical to the outlook, as reforms proposed by the Government are critical to improving the business environment.**

MACRO UPDATE

The Chilean economy grew 4% in 2018, in line with expectations, though growth slowed markedly as the year progressed. The difference between the very dynamic H1 (5%) and the rather sluggish H2 (3.1%) was notable and was evident in most of the sectors. Despite the fact that the last quarter of 2018 showed some acceleration compared with the previous one, the start of the current year has been weak. On the other hand, domestic demand grew 4.7% last year, led by investment (dominated by machinery), but consumption also increased 4% and government consumption slowed to 2.2%, its lowest pace in a decade. Most of the headwinds that pressed on expectations in H2, including the decrease in copper prices and the slow process of reforms pursued by the Government, may still be holding back growth. We maintain our forecast of growth around 3.2% for the current year and the next, with domestic demand led by investment and with the velocity of the latter highly conditioned, as usual, by the approval of political reforms and positive terms of trade. While some uptrend is undeniable and has been recently backed by reliable reports focused on planned investment, we expect the first half of the year to be slower in terms of growth than H2.

Consumption could be a laggard of the recovery because the labor market is not expected to rebound strongly in 2019. First, though arguably due to statistical anomalies, employment growth has remained low due to both cyclical and specific reasons. In 2018 the average unemployment rate reached to 6.9% and data for the first two months of 2019 did not show material improvements. Accordingly, the unemployment rate will remain elevated, and will lead to muted increases in wages and salaries. That will keep costs and inflation contained. As a reference, the 12 month inflation and core inflation (which excludes food and energy) are closer to 2% than to 3% (the central bank's inflation target for the next two years). Nevertheless, our inflation expectation is 2.8% for current year, while other market forecasts are higher. The main reasons for that divergence is weak service sector inflation, the effect of some regulated prices and a planned increase to the minimum wage in coming months, in addition to some upward effect from the exchange rate that is still in the pipeline.

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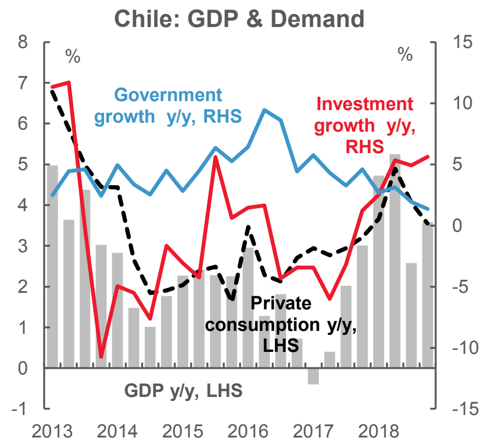
Chile	2017	2018	2019f	2020f
Real GDP (annual % change)	1.5	4.0	3.2	3.2
CPI (y/y %, eop)	2.3	2.6	2.8	3.0
Central bank policy rate (%, eop)	2.50	2.75	3.25	3.75
Chilean peso (USDCLP, eop)	615	694	650	640

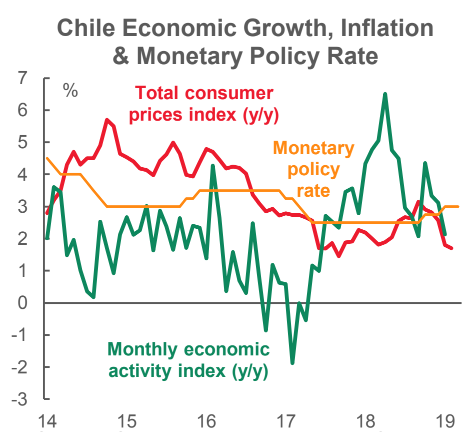
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Central Bank of Chile (BCCh).

Chart 2



Sources: Scotiabank Economics, Banco Central de Chile (BCCh), Instituto Nacional de Estadísticas (INE).

Accordingly, the monetary policy outlook is becoming less hawkish: the market that was calling for three MPR hikes last December (25bp each) to reach 3.5% or even 3.75% at the end of the current year is now mostly expecting one hike. That is our base case too, and we expect that to happen in Q4. Lower inflation, higher excess capacity and a more challenging external scenario are behind this new less hawkish normalization path, though we also expect a couple of hikes in the first half of next year. In the same line, the Central Bank adjusted downward growth and inflation projections for this year in its recently published Monetary Policy report. For the next report (due in June) it is expected that the Central Bank will revise the estimated neutral MPR, and most of the market is forecasting they will cut that estimate to a range between 3.75% and 4.25%.

POLITICAL PANORAMA: LAST YEAR WITHOUT ELECTIONS LIMITS TIME TO REACH AGREEMENTS

The political panorama has become critical in the sense that the final result of reforms proposed by the Government, whose coalition does not have majority in any Congress chamber, seems to be a determining factor to improving the business environment. First in the list of priority is the tax system reform, which will try to re-establish a link between corporate and personal income, which should stimulate and make easier the private investment process. The opposition is demanding some compensation (removing other tax exemptions, for example). More important than the volume of money involved in the change might be the style of the final solution and how fast it is reached in order to get a sharper picture for investors. We think the final result will unlikely be optimal, but some agreement with moderate opposition members could be reached to solve the impasse and to loosen some tax system knots. That could happen within 3 to 6 months. A simpler path is likely the pension system reform, which is expected to increase the contribution rate in order to improve future pensions, but the process would be gradual. On the other hand, the hardest work to be done is related to the labor reform, but in that case the Government has been intending to reach partial agreements. A more complete and powerful change is unlikely. There are no elections planned this year, so the Administration has an opportunity to focus on passing these key reforms without the burden of an electoral campaign.

MAIN RISKS: MORE OF THE SAME

The main risks haven't changed in some time. Foreign conditions are challenging and most of them are linked to the behavior of terms of trade. Copper prices have been rising moderately in the last three months, but risk of a correction due to a renewed weakness in China, for example, is the most important source of concern. Domestically, the main risk is political: the ability to reach agreements to approve critical reforms to enhance growth potential.