Latin America’s economies find themselves in a precarious position. Gross domestic product growth, excluding recent economic crises, fell to historic lows (see chart 1) earlier this year and they are all struggling with domestic political challenges, the collateral fallout from the US and China’s trade bust-up, and debt that makes them especially vulnerable to fluctuations in the US dollar. Yet while collectively they are among the worst performing emerging markets and it is difficult to build a positive investment scenario for any one of them, each has different issues.

First some common threads. The trade dispute between China and the US has had a profound impact on the region and accounts for much of the external economic risks. Still, with mostly low inflation, emerging central banks have room to cut interest rates, and indeed this year, Brazil, Mexico, Peru and Chile have already done so. However, the outlook for commodity prices is under pressure as China’s economy slows and trade flows continue to be disrupted.

Brazil: geopolitics and pensions

The region’s largest economy and 8th-biggest in the world, is suffering from low productivity growth and an ageing population. On the face of it, Brazil’s economic recovery looks as though it is in its early stages, with spare capacity, an almost-balanced current account and inflation more than halving since 2016. The Brazilian Central Bank (BCB) re-started its interest rate easing in July, taking rates to a historical low of 6.0%, and boosting expectations of more to follow.

The recovery stalled following corruption scandals, worsening public security and low growth. Together with promises of being tough on crime, this helped the right wing Jair Bolsonaro to presidential office last year.

Now, growth has declined steadily since the start of the year. In 2018, real GDP expanded 1.1% and may rise 0.8 percent this year, according to the International Monetary Fund. That has disappointed investors who had held their political noses at Bolsonaro’s appointment and hoped for a quick economic turnaround.

The key issue facing Brazil is the urgent need to reform the benefits system and raise the retirement age. The pensions system drove the public deficit to 7.0% of GDP earlier this year and unreformed, Brazil’s debt will be as large as its entire economy within three years. Pension and tax reform along with a recently approved economic bill could have a tremendous impact. The package before congress may enhance GDP growth to as much as 2.4 percent in 2020, says the IMF.

Key takeaways

- Low growth and political challenges in Latin America are compounded by the US/China trade dispute
- Latin America’s economies are among the worst performing emerging markets
- Central banks have room to cut interest rates further
- Risk of more currency weakness may undermine central bank easing

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However, President Bolsonaro finds himself increasingly isolated geopolitically. Relationships between the president and the rest of the world have deteriorated amid international concerns over Amazon fires, and protectionist sentiments.

**Mexico: oil and deficit**

Rising trade tensions have also undermined demand for Mexico’s goods exports. In contrast to Brazil, Mexico has a modest budget deficit. Still, Mexico’s economy is all about Pemex, the national oil company. Falling production has turned the country into a net oil importer and in June, Fitch downgraded the credit rating of Pemex to “junk” and Moody’s put the company on a negative outlook. In office since last year, President Andrés Manuel López Obrador, known as AMLO, is reported to be considering contracts with the private sector to operate some fields, which may improve oil output.

After Trump’s 2016 election, the Mexican peso fell and inflation accelerated, pushing the central bank into a hiking cycle. That cycle is ending as policymakers cut rates to 8% in August 2019 (see chart 2). The US Fed’s dovish stance in recent months should give the central bank further margin for rate cuts in the coming months.

Without efforts to cut taxes and more improvements to Pemex’s productivity (in addition to a recent capital injections and tax relief), the government’s fiscal deficit can only deteriorate. And while any improvement in the wider US/China trade picture would help, in his relations with the US, the leftist/populist AMLO cannot appear to make concessions on sensitive subjects such as immigration or border security.

**Argentina: default and capital controls**

Argentina’s list of ills include high inflation, foreign exchange-denominated debt, significant external account and budget shortfall. Argentina slid into recession last year and is now staggering through its third default since 2000.

Primary elections in August upset expectations with a wide margin of victory for the presidential challenger Alberto Fernandez, who will take on incumbent Mauricio Macri in October.

The political uncertainty has added to tensions over an unpopular IMF package, designed to help the country service public debt which stands at 80% of GDP, and four-fifths of which is in foreign currency, mostly USD. The peso has weakened as much as 22% against the USD in the last month. This added to the difficulties of Argentina’s debt and increases inflation pressures, pushing the central bank to consider tightening interest rates.

Against a chorus of questions about Argentina’s ability to service its debts, on 1 September the government introduced capital controls, limiting transfers and purchases of US dollars to USD10,000 per month in an effort to support the peso. This can only further hurt Mr Macri’s odds of re-election. The country is in crisis-management mode, and remains one of the most unstable emerging markets.

![Chart 1 – Contracting continent](https://example.com/chart1.png)

*Sources: Bloomberg, Lombard Odier calculations*
Chile and Peru: Copper and China

Last week, Chile’s central bank cut interest rates and its economic growth forecast to reflect the changing trade demand and rising inflation. Economic growth probably peaked last year and the country’s dependence on foreign-currency debt in the non-financial sector is among emerging economies’ highest.

Chile produces almost one-third of the world’s copper, which accounts for as much as one-sixth of the country’s GDP and prices may fall on average around 9% this year, compared with 2018, according to the central bank. Copper is an important barometer of economic activity and China is the world’s biggest copper consumer, making Chile vulnerable to a Chinese slowdown.

Peru’s economic fundamentals look sound, with a strong investment pipeline from 2018, a solid business environment and accommodative financial conditions, including a low current account deficit. The country is also the world’s second-biggest copper producer, but here, anti-mining protests blocked operations in the country in recent weeks.

That seems resolved for now and Peru may become one of the fastest-growing economies in the region as the government works to diversify the economy away from mining and consumption rises as the country’s middle class expands. In common with Chile, Peru is vulnerable to any Chinese slowdown in the shorter run, and remains dependent on foreign investment.

Colombia: FARC and FDI

With its high oil dependence, which accounts for half of exports, Colombia is vulnerable to external shocks and working to reduce its current account deficit. Politically, the country is divided over peace with the rebel FARC and contending with an influx of refugees from neighbouring Venezuela. Still, investor-friendly lower withholding tax and strengthened legal rights mean it continues to attract foreign direct investment. The central bank has cut rates to 4.25% and unless oil prices collapse, we expect policymakers to keep rates on hold and possibly start a hiking cycle later this year.

Looking for a catalyst

Any further currency weakness may undermine central banks’ abilities to continue easing rates further and even force those with high levels of debt in foreign currencies to reverse course and raise rates again.

An end to trade tensions would be the single greatest catalyst for an improvement in Latin America’s economic fortunes, with the possible exception of Argentina’s challenges. Meantime, lower interest rates will undoubtedly go way to mitigating the region’s economic pressures.

For now, as investors, we know that carry strategies can offer opportunities. However, more generally, it is difficult to be anything other than cautious in this environment, where such a range of external or domestic shocks may further undermine Latin America’s economies.

Chart 2 – Latin America’s central bank rates

Source: Central banks
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