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LATIN AMERICA: Sentiment will decouple from other EMs

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Abstract

On November 27, Brazil's President Dilma Rousseff named Joaquim Levy, a respected former Treasury secretary, as her government's new finance minister.

In the run-up to this nomination, volatility increased in already jittery Brazilian financial markets: on November 27, the yield on Brazil's ten-year local bonds stood at 11.89%, a 113 basis-point (bp) decline since November 17, amid rumours that Rousseff might tap Levy for the post. Brazil remains a focal point for market concern given investor dislike of Rousseff and the challenge of undertaking reforms in stagflationary conditions. Yet foreign holdings of Brazilian domestic debt have risen this year in a sign of the resilience of Latin American (LATAM) debt markets to the expected tightening in US monetary policy and the oil price collapse.

Full text

EVENT: On November 27, Brazil's President Dilma Rousseff named Joaquim Levy, a respected former Treasury secretary, as her government's new finance minister.

SIGNIFICANCE: In the run-up to this nomination, volatility increased in already jittery Brazilian financial markets: on November 27, the yield on Brazil's ten-year local bonds stood at 11.89%, a 113 basis-point (bp) decline since November 17, amid rumours that Rousseff might tap Levy for the post. Brazil remains a focal point for market concern given investor dislike of Rousseff and the challenge of undertaking reforms in stagflationary conditions. Yet foreign holdings of Brazilian domestic debt have risen this year in a sign of the resilience of Latin

American (LATAM) debt markets to the expected tightening in US monetary policy and the oil price collapse.

ANALYSIS: Impacts.

Foreign participation in LATAM debt markets is rising, though less in Brazil, which has suffered from election-related uncertainty.

Despite the deterioration in sentiment towards EMs, LATAM debt markets will perform relatively well, in a sign of resilience.

Markets will differentiate between LATAM economies, as the risks posed by US monetary policy tightening bring policy credibility into focus.

Investor sentiment towards emerging markets (EMs) remains fragile. The 32% decline in oil prices since mid-June is a significant shock for energy-exporting countries, which together account for nearly one-third of EMs' total GDP, according to Bank of America-Merrill Lynch (BofA-ML).

Moreover, EM assets are suffering because of uncertainty about the timing and pace of monetary tightening in the United States. Over the past three months, EM stocks have fallen by nearly 7.2%, compared with a 3.5% rise in the benchmark S&P 500 index and a 3.3% fall in euro-area equities.

LATAM equities have dropped far more than the EM average (by 15.5% over the same period), dragged down by sharp declines in Brazilian and Colombian stocks, both down by 20.0%. On the other hand, Chilean and Mexican shares have fallen by 2.7% and 7.0% respectively.

In currency markets, while the Mexican peso has declined by 6.2% against the resurgent dollar since end-July, the Brazilian real has fallen by 13% because of pre-election fears that Rousseff, disliked by investors because of her interventionist policies, would win re-election, as proved to be the case (see PROSPECTS 2015: Brazil - November 17, 2014).

Meanwhile, LATAM debt markets have proved extremely resilient, with the notable exception of Brazil's, where the yield on ten-year local bonds shot up by 200 bp between September 1 and November 17, falling by 113 bp later on speculation that Rousseff would appoint a credible finance minister.

Foreign participation in LATAM bond markets.

On November 19, Mexico issued a 2 billion dollar ten-year dollar-denominated bond at a yield of just 3.6%, only 130 bp above its US equivalent. This is Mexico's fifth international bond sale this year and also the first LATAM debt sale to include revised collective action clauses, which prevent holders of less than 25% of Mexico's total debt from blocking a restructuring.

Even Argentina, which suffered a technical default in July and is still considered a financial pariah, benefited from a significant tightening in its benchmark sovereign spreads against US Treasuries, which have fallen by 130 bp this year amid speculation that the government may reach a deal with its 'holdout' creditors (see PROSPECTS 2015: Argentina - November 7, 2014).

The resilience of LATAM bond markets is most conspicuous in local currency debt, which is more vulnerable owing to the risk of currency depreciation, particularly given this year's significant strengthening in the dollar stemming from sharp divergences in global monetary policy.

According to BofA-ML, which monitors foreign participation in the largest EM domestic government bond markets, non-resident holdings of LATAM local debt, a key gauge of investor sentiment, have increased significantly this year, in sharp contrast to Emerging Europe, where holdings have remained stable or declined slightly because of the fall-out from the conflict in Ukraine.

	October	September	August	July	YTD	YTD %	Current holdings	Foreign Share
Czech Republic	n/a	0.4	0.1	-0.3	0	0%	8.7	14%
Hungary	0.1	0	-0.9	-0.8	-0.8	-4%	19.5	34%
Poland	n/a	1.3	-0.9	-1.1	1.3	2%	58.5	42%
Russia	n/a	n/a	n/a	-0.4	0.8	4%	21.6	25%
Israel	n/a	0.2	1.2	0.1	2.3	33%	6.9	5%
Turkey	0.7	-0.9	-1	1.3	0.5	1%	47.9	20%
Brazil	n/a	4.7	1.8	0.8	30.3	19%	162.1	19%
Mexico	2	1.3	0	-2.2	12.2	13%	97	50%
Peru	n/a	-0.2	-0.1	0.6	0.5	7%	7.6	40%
Colombia	n/a	0.6	0.2	1.1	7.8	50%	13.2	14%
Total so far	7.2	13.3	4.6	12.8	101.7		463.7	

Monthly foreign holdings (change in billion dollars - constant)
Source: BofA Merrill Lynch Global Research

	14-Nov	07-Nov	31-Oct	24-Oct	YTD	YTD %	Current holdings	Foreign Share
India	0.1	0	0	0.1	14.1	59%	23.7	4%
Hungary	0.1	0.2	-0.3	0	-0.6	-3%	19.9	34%
Turkey	0.5	0.4	-0.2	0.8	3.3	3%	48.5	20%
Mexico	n/a	1.8	-0.2	0.9	13.1	13%	98.4	50%

Weekly foreign holdings (change in billion dollars - constant)
Source: BofA Merrill Lynch Global Research

In September (the latest monthly available data), foreign holdings of Mexican and Colombian domestic bonds rose by 1.3 billion dollars and 600 million dollars respectively, according to BofA-ML. Indeed, non-resident purchases of Colombian bonds have increased by nearly 60% this year, boosting the share of foreign holdings to 14% of Colombia’s outstanding domestic debt.

More interestingly, Brazil, whose financial markets proved extremely volatile in the months leading to October’s election, has also attracted significant inflows, with foreign holdings of local debt rising by nearly 5 billion dollars in September, after a 1.8 billion dollar increase in August, according to BofA-ML. While this partly stemmed from mounting speculation (or hopes) that Rousseff would lose the election to a reform-oriented opponent, the significantly higher yields on offer have led to a steady increase in foreign holdings over the past year (see BRAZIL: Rousseff emerges weaker from polarising vote -

October 27, 2014).

Non-resident investors now account for 20% of Brazil’s local bond market, up from 10% at the beginning of 2013, but still significantly below the 56% share in Mexico, the highest among all EMs.

Policy credibility in focus.

While LATAM debt markets remain resilient, the region has suffered the sharpest deterioration in its growth outlook among developing economies. This is bringing the region’s vulnerability to external shocks into sharper focus, with particular attention being paid to the credibility of policy regimes in LATAM.

While Mexico’s central bank has been able to cut interest rates to a record low of 3.0% to help stimulate a weak economy (and is likely to keep rates on hold with inflation running only slightly above the upper-end of the target range), its Brazilian counterpart has been forced to raise rates to a punitive 11.25%, as inflation, currently running around the top of the 2.5-6.5% target band, has remained stubbornly high amid recession and the risk of Brazil being stripped of its investment-grade credit rating.

Investors are likely to become even more discriminating towards LATAM economies, favouring those, like Mexico, which benefit from increased policy flexibility and where the prospects for growth and much-needed structural reforms appear brighter (see PROSPECTS 2015: Mexico - November 10, 2014).

The biggest risk facing the region, and more broadly the EM asset class, is a sudden reassessment by investors of US monetary policy stemming from a stronger-than-expected growth pick-up. Bond markets still price in an overall accommodative US monetary policy stance, as the Fed is seen to tighten only gradually, therefore increasing the scope for an abrupt re-pricing of US monetary policy (see PROSPECTS 2015: Global bond markets - November 25, 2014).

CONCLUSION: While sentiment towards Brazilian assets will be shaped by the direction of economic policy under the newly nominated finance minister, investor perceptions of US monetary policy and the credibility of countries’ policy regimes will have a strong bearing on the performance of LATAM bond markets. There will be increasing differentiation between markets, with Mexico and, to a lesser extent, Colombia faring better than Brazil, whose Central Bank has lost inflation-fighting credibility despite raising rates aggressively.

Details

Subject	<p>Economic conditions; Politics; Banking industry; Bonds; Capital movement; Debt; Elections; Financial institutions; Political parties; Public policy; Stocks; Foreign exchange rates; Foreign investment; Government; Economic growth; Petroleum industry; Prices; Public sector; Securities markets; Emerging markets</p>
Location	<p>Latin America, Caribbean area, Argentina, Brazil, Chile, Colombia, Mexico, United States, US</p>
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Identifier / keyword	<p>Latin America, Caribbean area, Argentina, Brazil, Chile, Colombia, Mexico, United States, US, Economic conditions, Politics, Banking industry, Bonds, Capital movement, Debt, Elections, Financial institutions, Political parties, Public policy, Stocks, Foreign exchange rates, Foreign investment, Government, Economic growth, Petroleum industry, Prices, Public sector</p>
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