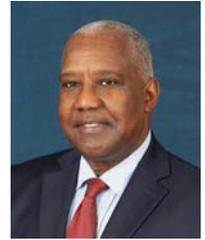


Major Country Developments June 2016



By Byron Shoulton

Overview

Hiring by the U.S. private sector cooled in May, a sign that concerns over the global economy may be starting to impact payroll growth at U.S. companies. Still, the official unemployment rate fell to 4.7% as a number of workers chose to discontinue seeking employment. Layoffs remain low and the economy continues to expand modestly, seven years after the recession. Meanwhile, the U.S. housing sector is close to completing the long road back from recession. Home prices have come back within 4% of its 2006 peak and are at near record highs across the U.S. This indicates the sector's recovery has strengthened. According to the S&P/Case-Shiller national home-price index, new-home sales posted their strongest month in more than eight years. The trend is expected to pick up pace as the U.S. enters the peak home selling season. Still, new home construction remains well below its pre-crisis peak, which suggests fewer homes will be available to meet demand, making prices stiffer especially for first time buyers.

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New U.S. tariffs on imports are boosting steel prices domestically and providing a lifeline to U.S. steel manufacturers who have had a tough time competing against cheap imports, especially from China. However, the strong U.S. dollar and rising costs for manufacturers of goods ranging from oil pipes to factory equipment and automobiles remain worrisome.

In the Eurozone, growth remains steady at near 1.5%. Nevertheless, momentum could slow slightly after rising in the first quarter. The possibility of "Brexit"

remains a serious risk factor affecting the longer-term outlook for the region.

The U.S. and Europe are scrambling to rebuild momentum for the Transatlantic Trade and Investment Partnership (TTIP) trade accord, amid signs that it is faltering under an increasingly bitter onslaught from politicians on both sides of the Atlantic. Hardening positions among French and German opponents of the deal forced the European Trade Commissioner to call for a renewed commitment from the 28 member states to the TTIP. Britain and Italy remain strong supporters. TTIP supporters have been blindsided by increasing opposition to trade deals in U.S. political circles.

The loss of global crude production (e.g. in Nigeria) helped push up oil prices to \$50 per barrel for the first time since last November. Approximately 96 million barrels of crude per day are produced globally, but supply exceeds demand by 1.4 million barrels a day. A series of disruptions including stepped up sabotage of oil pipelines in Nigeria, oil worker strikes in Kuwait, a blockade in Libya and wildfires in Canada have all contributed to the recent spike in crude prices. OPEC, the oil cartel, under prompting from Saudi Arabia, appears to have modified its approach declaring at a recent meeting that it is pleased with the direction of oil prices; but it reached no agreement on placing caps on current country production levels. Instead, the Saudis urged OPEC to steward the oil market to help move supply and demand back into balance.

Meanwhile, major oil producing countries including Nigeria and Venezuela continue on a downward spiral both economically and politically, as their govern-

ments run short of cash to pay for vital imports. The populace and businesses in both countries are not satisfied with controls on foreign currency availability that are in place; or the prolonged lack of basic supplies needed by households and industry.

Some U.S. oil producers have cut production and others have gone bankrupt, also helping to ease supply. There will likely be more defaults among U.S. energy firms, but there are some encouraging signs. The spread (or the difference in yield) between junk bonds of energy producers and safe U.S. Treasuries, has declined from 19.6 percentage points in February to about 8.7 percentage points as of the end of May. A spread under 10 percentage points indicates the sector is no longer considered distressed. The oil rally is pushing U.S. junk bonds to new heights, and bond prices could even go higher if oil prices continue to rise. Oil and junk bonds have traded in tandem in recent months, and the pattern is set to continue.

Saudi Arabia's government is about to launch its first bond issuance aimed at raising \$15 billion to beef up state finances in the face of dramatic falls in oil revenues over the past two years. The Kingdom's anticipated dollar denominated debt debut is one of the largest sales of emerging market debt ever. Investors and bankers have suggested that Saudi's 10-year borrowing rate could be around 4% - a higher rate than Qatar and Abu Dhabi paid in recent bond sales. Saudi Arabia is considered as being in a stronger position than many other governments that have tapped global capital markets for the first time. As a commodity producer with credit ratings of A1/A-/AA- credit markets calculated that Saudi Arabia can expect to pay about 150 basis points above U.S. Treasury yields to borrow from investors. However, the size of the planned debt sale and the lead taken by other borrowers in the region could raise Saudi's borrowing costs.

According to the OECD, past currency depreciations have raised the cost of servicing debt denominated in foreign currencies, especially for Brazil, Russia, Turkey and South Africa. The OECD warned that a rapid pace

of private debt accumulation could give rise to debt repayment problems in these and other countries, as economic growth and profits slow and financing costs increase.

Latin America

Latin America's outlook continues to be impacted by weakened commodity prices and severe GDP contractions in Brazil and Venezuela. Global banking appetite in the region appears less bullish toward new business and some foreign banks are reportedly exiting the region in an effort to cut losses. Most Latin American economies have seen growth projections revised downward for 2016, while inflation estimates have been raised as currencies such as the Brazilian real and the Colombian peso have plunged to record lows against the U.S. dollar. Many regional central banks have raised interest rates and a recent survey reveals the region is increasingly vulnerable to a global slowdown.

Given heightened international sensitivity to geopolitical risks during this stage of the global economic cycle, markets have been keenly watching Argentina, Peru, Brazil and Chile in particular. Funding has become harder to find for large energy and infrastructure projects over the past two years in the region. This is mainly due to weaker commodity prices, government budget cuts and institutional weakness in some Latin American countries. In response to these difficulties, new financing instruments are beginning to emerge, while others that are already operating in the market are being modified, with the aim of reducing risks and attracting investment funds and other investors to finance infrastructure, energy and mining projects in Mexico, Brazil, Peru, Colombia and others in the region.

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For the region as a whole, the expectation is for growth to pick up beginning in 2017 as external conditions become more favorable. However, the current downturn has exposed the region's enduring structural weakness of commodity dependence and the need for policies to diversify economies and encourage productivity gains if the region is to free itself from boom-bust cycles. Meanwhile, economic hardships induced by the end of the commodity boom and ballooning government deficits have started to unwind many of the advances achieved by tens of millions of Latin Americans over the past decade, when so many people joined the ranks of the middle class. The most dramatic example of this dynamic is in Brazil where an estimated forty million joined the middle class over the last 15 years. Discontent, corruption allegations and mismanagement have triggered the suspension and potential impeachment of President Dilma Rousseff. Although justified by a technical issue of budgetary overrun, her removal from office is a verdict on the stunning negative swing in Brazil's economic growth of more than 11 percentage points in five years – from 7.5% growth in 2010 to a 3.8% contraction in 2015-with a further 3.6% shrinkage of GDP forecast for 2016.

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Some Latin American countries that have struggled to acquire lending from global sources like the World Bank, or private capital markets, have often found a willing partner in China. China has already invested in countries like Venezuela, Argentina and Ecuador, which some international institutions, private investors and the U.S. have shunned. Some Western entities have refused to lend to these countries because of their authoritarian orientation or human rights violations, or more often due to concerns in capital markets about some countries respect for

contracts or ability to repay. China's almost indiscriminate lending in the region has at least funneled development funds to places that otherwise would be cash strapped.

The region has traditionally trailed other regions in terms of innovation, with low levels of investment in R&D, poor education standards and- in many countries- a weak policy backdrop. However, the region registered solid gains in export entrepreneurship in 2004-09, with a combination of free-trade agreements and improved export promotion policies boosting the conditions for innovation in terms of enhanced competition and larger markets for innovative products and services. This was reflected by the emergence of the region's largest multinational firms. More stable fiscal regimes led many to hope that higher investment in R&D would stimulate an increase in long-term growth rates. Yet these hopes have not materialized. Regional GDP growth has slowed steadily in recent years, from 4.7% in 2011 to 1.3% in 2014 before halting entirely in 2015. There have been suggestions that the short-term economic outlook- with regional GDP expected to contract in 2016- may finally prompt governments to take action to improve the business environment in order to improve conditions for entrepreneurial activity.

Even as moves toward suspension and impeachment of Brazil's president became obvious in May, expectations held firm that China would invest record amounts into building hydro dams, power lines, toll roads and transit systems across the region – with Brazil emerging as the top recipient of this investment. Chinese companies have already established themselves in Latin America, investing a total of \$42 billion in infrastructure from 2013-2015, particularly in resource mining.

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Chile

The economy grew by 2% in the first quarter of the year, according to the central bank. This was an improvement on the 1.3% growth posted during the final quarter of 2015. Growth has not strayed far from 2% since 2014, averaging that figure over the past nine quarters and coming in at 2.1% in full-year 2015. During that time, external factors, namely oversupplied global commodity markets and weak global demand, have contributed to a broad economic downshifting in Chile. Locally, a contentious domestic reform agenda has also reduced business confidence and restricted growth since 2013. This trend will continue throughout 2016 even as some shifts have been made in policy priorities and the composition of growth.

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Continued weakness in Chile's mining sector is key: it contracted (-1.9%) for the third consecutive quarter. The medium-term outlook for copper is poor because of demand uncertainty in China and increased copper output by competitors, such as neighboring Peru, will not help. Manufacturing appears unlikely to pick up the slack, as industrial output grew by a meager 0.9% so far this year. Isolated factors have also negatively affected key sectors – production in fisheries and paper products fell by 1.9% and 5.8% respectively.

Agriculture and services, for external consumption but especially for export, have become increasingly important drivers of overall GDP expansion and both showed strong growth so far in 2016. Energy has been a surprisingly strong performer as well, and the

prospect of exporting natural gas to Argentina bodes well for the sector in the coming months. The government has responded to economic malaise this year by giving increased attention to productivity and shifting its stance on the importance of growth versus reform. The President, Michelle Bachelet, in a speech to the Chilean legislature in May made clear to demonstrate her commitment to improving business confidence, but new initiatives (including expanding credit to small and medium size enterprises and cutting red tape) have yet to bear fruit.

China

China's extraordinarily rapid rise of debt, particularly in the corporate sector, has given rise to concerns that the country will have to pay close attention if it is to avoid a banking crisis. This comes from recent IMF and some investment bank concerns that a substantial portion of new lending in China in recent years has gone to state-owned companies producing over-supplied goods where profits have turned negative.

However, while lending more to corporates unable to pay interest and principal on previous loans means financial risks are clearly rising, it is likely that China is years away from a potential banking crisis, providing the authorities with a window to slow credit to a sustainable level. A key reason for this judgment is that while the ratio of debt to gross domestic product (GDP) is elevated, China also enjoys a high rate of national savings. The level of debt that a country can sustain depends significantly on the share of domestic savings in GDP.

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Also, China's debt build-up is mostly in domestic currency. Local companies have been paying down their foreign currency debt since the third quarter of 2014 and it now accounts for only 5% of domestic debt. By contrast, a recent study of other emerging markets found that the median foreign currency debt share of total debt is four times the Chinese share. Moreover, China remains a large net creditor to the rest of the world. Thus, the country is not vulnerable to a financial crisis such as the one in Asia in 1997, which was precipitated by a refusal of foreign lenders to roll over their credit to Asian corporates.

Meanwhile, demand growth in emerging markets will stand at 2.2%, its lowest rate since 1998. This predominantly reflects moderating economic expansion and declining energy intensity in China. Furthermore, the boost to apparent production provided by purchases for China's strategic petroleum reserves is likely to ebb. Oil consumption growth in China slowed from a double digit rate in 2010 to 4% in 2014-15. These factors will restrict consumption growth further over the medium term. Falling oil prices and purchases for the strategic reserve were key drivers of consumption in 2015, but they will provide less of a boost in 2016-17, as prices will begin to recover and strategic stocks will have been replenished. Meanwhile, slowing industrial capacity will put a brake on demand growth for diesel and gasoil, the main component of oil usage in China, which accounts for 30% of domestic consumption and is mainly used in industry. Against this backdrop, oil demand growth is expected to remain well below the rate of expansion in real GDP in 2016-2017.

Troubles in other major emerging economies – including Brazil and Russia, which are both forecast to face a second consecutive year of contraction, will further constrain demand growth outside the advanced economies of the OECD. This will be only partly offset by buoyant demand in fast growing India. In 2017 global demand is forecast to pick up

slightly to 1.4%, in line with a stronger global economy.

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FCIA's Deals Of the Month

Bank Policy: \$25mm limit of liability on bank import finance for a state owned Oil Company, 5 year tenor, Latin America

Key Accounts Non-Cancelable Limits Policy: \$50,000,000 limit of liability on export receivables for financing purposes, coal going to Steel Sector, Multi Countries