S&P Global
Ratings

Latin America Sector Roundup Q2 2023

Slower Growth, Tighter Financing Compound Pain

April 26, 2023

This report does not constitute a rating action

Key Takeaways

- We project GDP growth in the region to slow to 0.9% in 2023 and to gradually recover in 2024, although below its historical trend. LatAm's growth will remain constrained by elevated interest rates, high uncertainty over global economic growth, and a challenging political landscape across most of the region. These factors will keep investment subdued.
- Slower economic growth and high interest rates will test issuers across the region. LatAm corporations are dealing with mounting cost inflation and diminishing capacity to pass through prices, while tight financing conditions could gradually intensify pressures. These factors are also narrowing the fiscal room for maneuver across many governments. In the meantime, households' disposable income is eroding, while social demands grow. Ultimately, weakening payment capacity could hit LatAm banks' asset quality and profits, despite improving net interest margins.
- LatAm countries are undergoing the most severe tightening of financing conditions seen in recent history, as central banks in the region and abroad fight inflation.

(Editor's Note: This report is an expansion of the "Sector Trends" section from our "Credit Conditions Emerging Markets Q2 2023: Enduring Risks" report, published March 28, 2023.)

Intensifying Pressures Will Test LatAm Issuers

LatAm's issuers have been resilient to recent shocks, but enduring risks, slow growth, and high interest rates will challenge corporations, sovereigns, and banks across the region. This will likely erode LatAm issuers' credit fundamentals, which we expect to drive up the negative bias, and the number of downgrades and defaults, the latter of which especially among the lower rated issuers ('B-' and below).

We expect some sectors to remain resilient to weakening conditions. For example, the region's utilities should weather the challenges by passing through cost increases, as regulation permits. Other sectors including commodity-driven businesses--agribusiness, forest products and packaging, metals and mining, and oil and gas--should post a robust performance, although prices will slip from 2021-2022 highs. While we expect banks' asset quality to weaken over the next few quarters, large banks in the region will likely continue thriving, given their stable and relatively cheap funding bases, mainly consisting of retail deposits, and because of rising net

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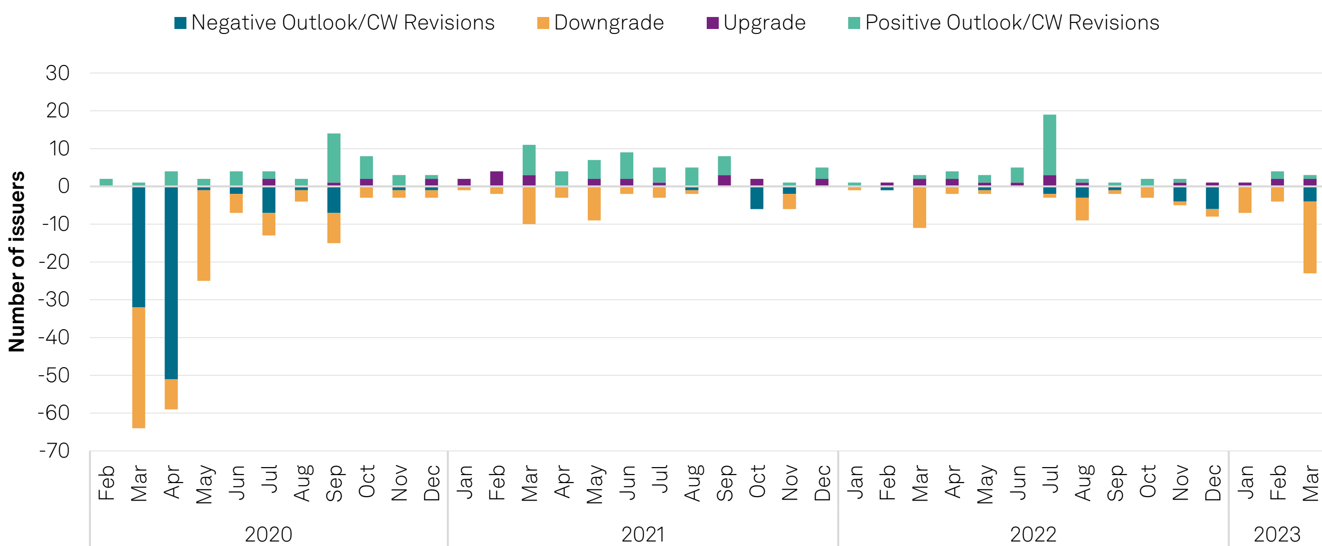
interest margins. Smaller banks and non-bank financial institutions (NBFIs), on the other hand, will probably struggle as funding costs rise and asset quality take a hit. Slowing economy and rising interest rates will further pressure LatAm sovereigns' fiscal accounts, limiting room for maneuver.

Chart 1

LatAm rating actions point to rising pressures

Number of rating actions in LatAm



Data as of March 31, 2023. Source: S&P Global Ratings Research & Insights.

Macroeconomic Outlook

Cyclical Slowdown In 2023, Subdued Recovery In 2024

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We project GDP growth in the region to slow to 0.9% in 2023 from 3.6% in 2022, broadly unchanged from our previous projection in November. Sluggish GDP growth will be driven primarily by a cyclical slowdown in domestic demand, after it expanded robustly in 2022 due to the continued normalization in the services sector in the aftermath of the pandemic. Weaker external demand among key trading partners, primarily the U.S., will also mean export volumes will be lower in 2023 than in 2022.

Table 1

LatAm: GDP growth and S&P Global Ratings forecasts

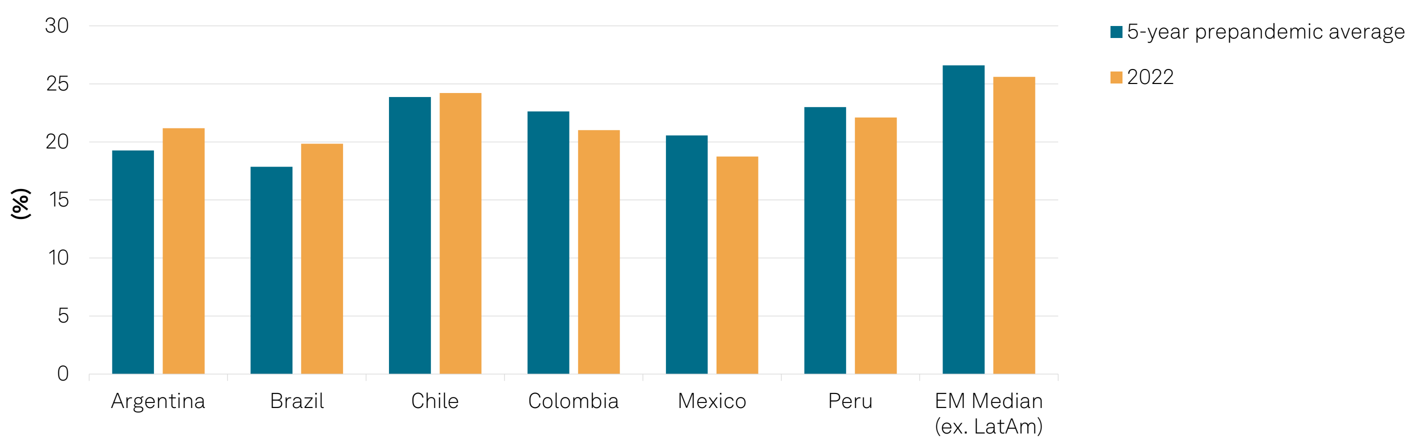
	2020	2021	2022	2023f	2024f	2025f	2026f
Argentina	(9.9)	10.4	5.2	0.0	1.7	1.8	2.1
Brazil	(3.6)	5.3	3.0	0.8	1.7	2.0	2.0
Chile	(6.2)	11.9	2.5	(0.4)	2.6	2.8	2.8
Colombia	(7.3)	11.0	7.5	1.1	2.6	3.0	3.0
Mexico	(8.2)	4.9	3.1	1.3	1.7	2.1	2.1
Peru	(11.1)	13.8	2.7	2.0	2.8	2.9	3.0
LatAm 6	(6.3)	6.9	3.6	0.9	1.9	2.2	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 GDP growth to recover to 1.9% in 2024 but remain below the region's historical pace of 2.0%-2.5%. This is due to interest rates remaining elevated amid high uncertainty over global economic growth and political landscape across most of the region. All of those factors will keep investment subdued in LatAm.

Chart 2

Real fixed investment as a share of GDP



Note: Five-year pre-pandemic average is 2015-2019. Sources: Haver Analytics and S&P Global Ratings.

We expect most central banks in the region to start reducing their benchmark interest rates towards the beginning of 2024, as the Fed eases its monetary policy, which we expect to begin next year. Two exceptions are Chile and Brazil, which we anticipate to start cutting interest rates in the second half of this year--we see a more rapid decline in inflation and clearer signs of economic weakness in the coming months in both countries. Observed inflation will remain above targets across all of the major economies in LatAm through the end of 2023, but we forecast inflation expectations to start to converge towards targets by the end of this year.

The potential for economic stress as a result of further social and political instability remains a key downside risk to our growth outlook for LatAm. In the absence of substantially faster economic growth, currently higher interest rates will strain fiscal dynamics to a greater degree than during recent years when interest rates were at record-low levels. This means that the margin of error for policy mistakes, especially fiscal-related, is narrower. A deterioration of fiscal picture would further raise pressure on domestic interest rates (higher fiscal risk premia), and potentially encourage capital outflows, hindering conditions to incentivize greater investment in the region.

The expected rebound in China's growth creates some upside for the region, but countries that will benefit the most are outside of LatAm. We expect emerging markets in Asia to benefit the most from the re-opening of the China's economy, mainly through a revival in Chinese tourism in those countries (see "Which Emerging Markets Benefit The Most From A Reopening In China?", published on Feb. 1, 2023). However, if the reactivation of the Chinese economy were also to be accompanied by a strong recovery in infrastructure that increases demand for industrial metals, buoying several exporters of those commodities would benefit, including Brazil, Chile, and Peru.

Nearshoring had the potential to increase Mexico's GDP growth significantly, but substantial obstacles remain. Nearshoring has gained attention as supply-chain disruptions during the COVID-19 pandemic made a case for manufacturers to diversify the location of their operations to minimize production disruptions. Tensions between the U.S. and China, especially around technology, may have also encouraged companies to move some manufacturing production out of China. Mexico's long-standing manufacturing linkages with, and access to, the U.S. market make it an obvious potential beneficiary for nearshoring. In a hypothetical scenario in which 1% of total manufacturing output from China is shifted to Mexico gradually in the next five years, we estimate its annual real GDP growth would average 2.6%, compared with our 2.0% baseline (see "For Mexico, Nearshoring's Potential Benefits--And Obstacles--Are Significant", published on Feb. 1, 2023). However, impediments to advancing nearshoring in Mexico are considerable. These include inadequate supply of water and energy (especially clean energy), as well as security-related concerns.

Financing Conditions

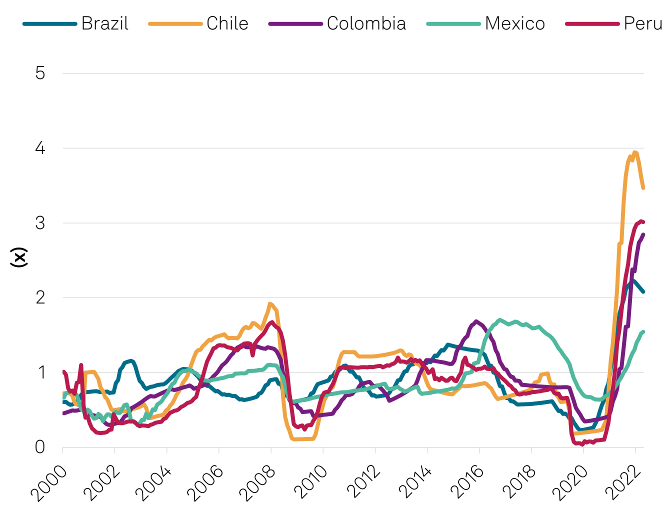
Unprecedented Monetary Tightening Weigh On Financing Conditions

Financing costs stay high. LatAm countries are undergoing the most severe tightening of financing conditions seen in recent history (chart 3), because of the protracted fight to tame sticky inflation. Corporate spreads picked up in March despite a monthly slide in government benchmark yields, as liquidity risk and defaults mount. We view Brazilian corporations as more exposed to credit stress, due to the significant share of floating interest-rate debt on their balance sheets and interest burden stemming from it.

Low bond issuance. The elevated financing costs and restrained investor risk appetite are reflected in subdued international issuance volumes that seem to repeat the historically low trend of 2022 (chart 4). While domestic markets supported issuance levels last year, they may become more selective during a prolonged period of weak activity and high uncertainty. Nonetheless, refinancing risk remains contained, as the maturity wall is only expected to hit its peak in 2027, with speculative-grade debt maturities at 36% in 2023-24 mainly among oil and gas and financial institutions issuers.

Chart 3

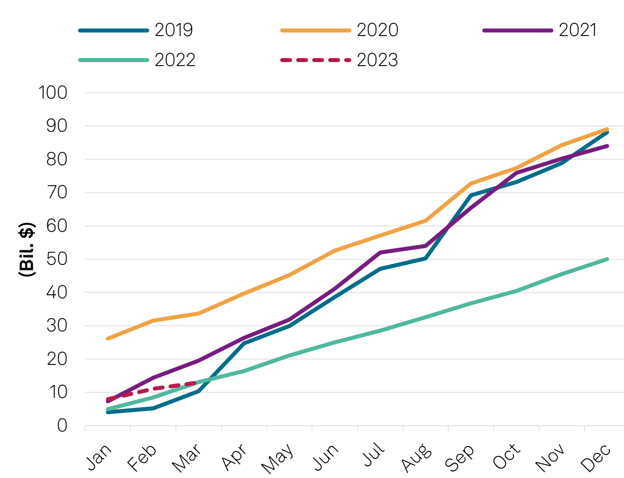
Unprecedented monetary tightening



Sources: Domestic monetary authorities and S&P Global Ratings.

Chart 4

Debt issuance hasn't recovered (YTD cumulative)

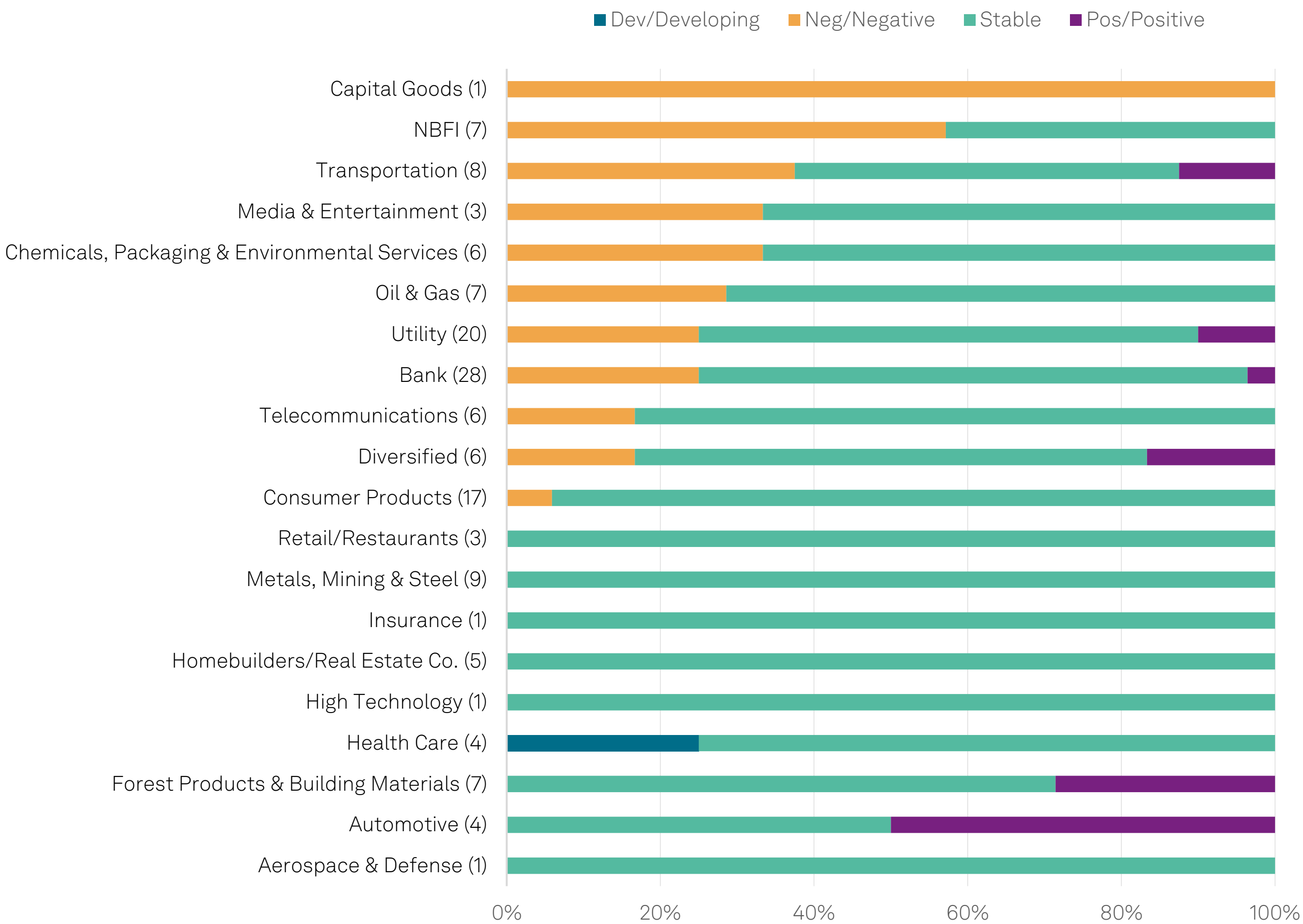


Data as of March 31, 2023. Data including not rated (NR).
Sources: S&P Global Ratings Credit Research & Insights and Refinitiv.

Chart 5

Some sectors might remain resilient, others started showing strains

Outlook distribution of LatAm issuers by sector



Data as of March 31, 2023. Source: S&P Global Ratings Research & Insights.

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Sovereigns

Tough Conditions Limit LatAm Sovereigns' Room For Maneuver

What we expect for the next 12 months

- The economic panorama in the region reflects low and shaky GDP growth prospects, persistent inflation, rising interest rates, and political factors that crimp governments' ability to react forcefully to such challenges.
- All sovereigns in the region now carry a higher burden of debt than prior to the pandemic.
- The combination of higher interest rates and larger debt constrains fiscal policy, while inflation forces central banks to tighten monetary policy.

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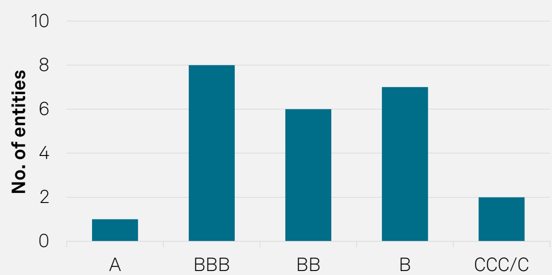
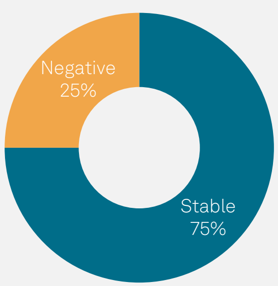
Rating distribution



Outlook distribution



Note: As of March 31, 2023. Includes public ratings only.
Source: S&P Global Ratings

Recent financial market instability in the U.S. and Europe is likely to have a bigger indirect than direct impact on the region. It could delay interest-rate increases by central banks in advanced countries but is likely to tighten financial conditions for countries in LatAm. Uncertainty about monetary policy in advanced countries will reverberate in LatAm, given its heavier dependence on external financing than much of Asia. At same time, inflation remains high, especially in Brazil and Colombia, contributing to high domestic interest rates.

Central banks face a difficult trade-off. They can depress GDP growth in the near term by acting forcefully to cap inflation (anchoring expectations of future inflation) and sustaining long-term stability; or loosen monetary policy to prevent high interest rates from curbing economic growth and increasing sovereigns' debt service costs, but run the risk of higher, more persistent inflation rates.

The sovereign rating trajectory in the region over the next couple of years will largely depend on the rate of GDP growth, fiscal policies, and the cost of money. The recent rise in inflation (and inflation expectations) across much of the world has contributed to higher interest rates, reducing the fiscal wiggle room for many governments.

External shocks have been cushioned by monetary flexibility, typically based on a flexible exchange rate, inflation-targeting monetary policy, and growth of domestic capital markets that reduces reliance on external funding. Central banks in Mexico, Colombia, Peru, Chile, and Brazil undertook timely steps to contain inflation and anchor expectations, safeguarding monetary flexibility (a key factor in sovereign credit ratings). Decelerating inflation should blunt the recent rise in interest rates and lead some central banks to cut policy rates.

Corporations

Country-Specific Factors Weigh On Corporate Credit Quality

What we expect for the next 12 months

- Liquidity and refinancing risk to increasingly become drivers of corporate credit risk.
- Commodity prices will drive top-line growth for exporters in the region, although cost inflation is systematically undermining profitability for a wide group of industries.
- The prevalence of prudent financial management and a disciplined use of debt would be supportive of rating performance.

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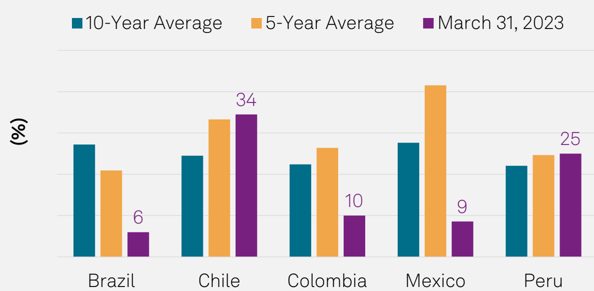
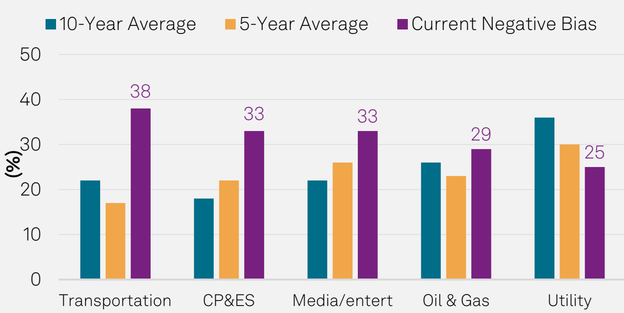
Negative bias by country



Top 5 sectors with highest negative bias



Data as of March 31, 2023. Source: S&P Global Ratings.

Non-financial corporations still withstand difficult business conditions, although we're starting to see some cracks in rating performance. Most sectors have been resilient to an extended period of headwinds related to COVID-19 lockdowns, supply-chain bottlenecks, and a geopolitical conflict that triggered a general rise in inflation and borrowing costs. However, the recent emergence of country-specific risks is increasingly weighing on corporate credit quality.

Financing conditions in Brazil are far from normalizing. Credit spreads almost doubled from a year ago. This is particularly problematic because Brazilian corporations have historically relied on variable-rate debt, which increased since 2021. The significant share of floating-rate debt on corporate balance sheets poses a threat for many corporations, the median EBITDA interest coverage ratios of which have deteriorated, widening the gap with their peers in other countries in the region. In addition, the reporting of accounting inconsistencies of Americanas S.A. with respect to supplier financing operations still harms investor sentiment and is limiting access to the domestic capital markets.

The Argentine corporate sector is heavily exposed to sovereign risk, and to our transfer and convertibility assessment. The exposure to further restrictions to access or transfer funds abroad, or a scenario of a deep recession, would likely prevent many companies from generating cash flow streams in domestic currency to service foreign-currency obligations.

Nearshoring in Mexico has gained a lot of traction and growth potential for some sectors. Companies with sizable operations in industrial regions have a favorable position, particularly those participating in the real estate, housing, and building materials sectors. Corporate sectors in Mexico that would receive the more immediate benefits from nearshoring investments will be those that are engaged in export manufacturing activities, such as autos, durable goods, and agricultural products. For industries that are already integrated in cross-border supply chains, nearshoring would help expand sourcing capabilities in Mexico, stimulate improvements to logistics services, and protect the competitive manufacturing cost structure.

Financial Institutions

Asset Quality To Continue Weakening In 2023

What we expect for the next 12 months

- Asset quality deterioration due to sluggish economies and high interest rates remain the key risk for banks in LatAm. This will likely hurt profitability.
- Regional banks are indirectly exposed to the failures of Silicon Valley Bank and Signature Bank, which has increased risk aversion among institutional investors.
- Credit growth will likely moderate amid lackluster economic growth, a protracted period of high interest rates, private banks' tighter underwriting practices, and uncertainty regarding the economic policies the new and current governments will implement.

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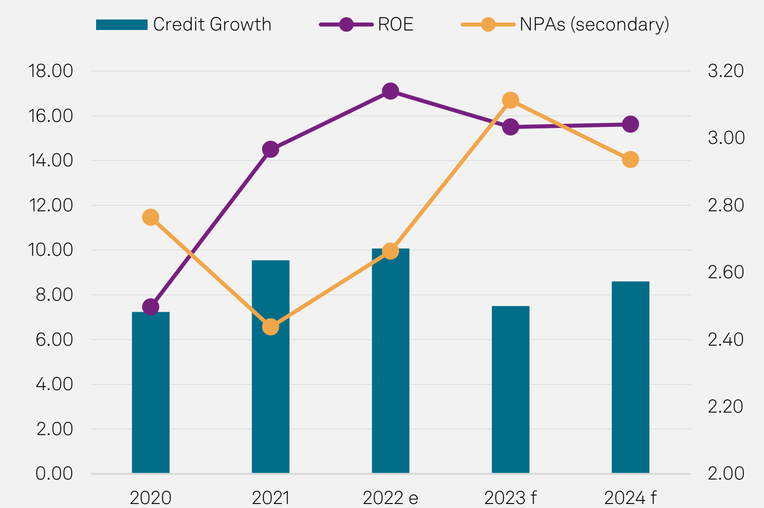
Credit growth, ROE, and NPAs*



*Simple average among major LatAm economies: Brazil, Mexico, Chile, Colombia, Peru. e--estimate, f--forecast. Source: S&P Global Ratings.

The failures of Silicon Valley Bank and Signature Bank have no immediate impact on the ratings on LatAm banks. However, we could see the indirect effect--in the form of the institutional investors' increasing risk aversion--result in higher funding costs and scarce funding for the regional financial institutions. Such trends were already present across LatAm banking sectors, but recent U.S. banking troubles will amplify them.

Financing conditions continue to tighten as rates stay higher for longer. While local banks are mainly funded by retail deposits, they still suffer from high funding costs. We consider that major LatAm banks have sound franchises, which should support their funding profiles, but smaller and concentrated financial institutions may be more exposed to these pressures and subject to the flight-to-quality effects.

Persistent inflation, higher financing costs, and limits on passing on those costs to prices represent a significant challenge for corporate borrowers' future performance. As a result, we expect regional banks' asset quality to deteriorate. Moreover, weak economies are squeezing consumers' disposable income, which will further pressure banks' asset quality.

A sharper-than-expected downturn in advanced economies and local socio-political tensions could hurt key LatAm economies. Slower economic activity could imperil the regional corporate sectors' fundamentals and banks' asset quality. Unemployment could rise, hitting households already burdened by inflation.

Insurance

Dim Economic Prospects Present Headwinds For Insurers

What we expect for the next 12 months

- We expect LatAm's economic growth to stagnate this year, which will weigh on insurers' business and operating conditions.
- However, insurers' healthy balance sheets, sound capitalization, and sufficient liquidity will enable them to weather the turmoil.
- Most rated insurers in the region have a stable outlook. However, we do not rule out an increasing negative outlook bias in the next 12 months due to weakening economic conditions.

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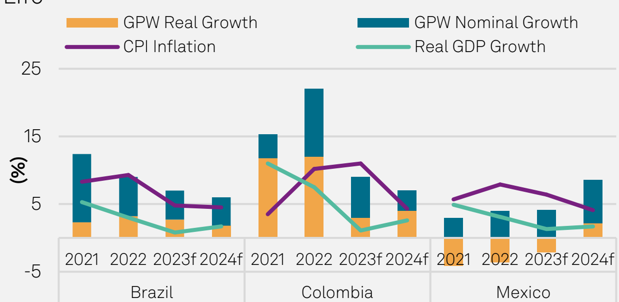
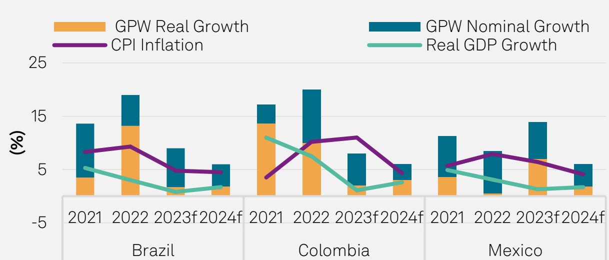
Business growth prospects

Life



Non-life



GPW - Gross Premium Written. f - forecast. Source: S&P Global Ratings.

Downside risks

Business growth will be limited by faltering economic dynamics amid high inflation and interest rates. Therefore, we expect households and companies' income capacity to weaken and unemployment to rise. This could reduce demand for insurance products and increase lapse rates in the next 12 months.

Persistently high inflation will bite into non-life insurers' technical results given that mobility restrictions are lifted. Unemployment, social tensions, crime, and fraud could increase amid weak economic conditions, which could result--in certain jurisdictions--in higher claims for insurers.

Capitalization and liquidity might be pressured by eroding credit quality of investments. High interest rates could strain highly indebted governments and companies, potentially weakening insurers' investment portfolios and, therefore, depress insurers' capitalization levels and liquidity positions.

Climate change risks are increasing and becoming more costly. As a result, global reinsurers' losses have widened, and we expect these entities to transfer part of the impact to insurers through higher prices and adjustments in reinsurance schemes, denting LatAm insurers' technical results.

Buffers

Insurers operate with healthy balance sheets, sound capitalization, and sufficient liquidity. Moreover, we expect insurers to maintain conservative underwriting and investment policies. In addition, the experience gained from operating during previous times of economic stress will help them to navigate the upcoming obstacles.

Strutured Finance

We Still Expect Volume Growth In New Issuances In 2023

What we expect for the next 12 months

- We still 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, and Brazil will remain the most active market in the region.
- However, LatAm structured finance issuances have been below our expectations in the first months of 2023.
- Ratings performance remains stable due to cushions in credit enhancement and deleveraging.

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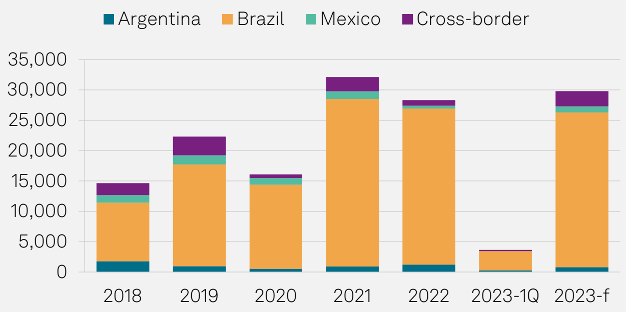
SF market-wide new issuances



. f - forecast. Source: S&P Global Ratings.

Macroeconomic woes will likely continue straining collateral performance in Brazil in 2023. Furthermore, the lack of clarity about the fiscal policy that the new government will adopt, as well the unknown side-effects from the recent judicial recovery filings of a number of corporate issuers will likely keep investor sentiment cautious.

In Mexico, the default of the country's largest NBFI remains a significant challenge for the equipment asset-backed securities (ABS) sector.

Long-term inflationary pressures and persistently high interest rates could increase the financial burden on household leverage, which is already at a record high in Brazil, and hurts the performance of assets backed by secured consumer credits and residential financings.

NBFIs' new issuance volume in Mexico was subpar last year with only 12 transactions totaling $500 million (mainly led by equipment ABS securitizations), and issuance volumes have been very low in 2023. We believe this contraction mainly reflects tough financing conditions Mexican NBFIs have been experiencing since the start of the pandemic and the negative impact that the defaults of several large industry players have had on investor sentiment.

Infrastructure

Favorable Hydrology And Lower Commodity Prices Bring Some Relief

What we expect for the next 12 months

- Favorable hydrology and lower commodities prices to reduce spot-market prices across the region.
- Full pass-through of inflation to rates, according to contractual and/or regulatory frameworks for utilities and toll roads, including in Chile and Colombia.
- Given abnormal rating volatility in 2023 so far, with three utility defaults by April, we continue to monitor closely short-term liquidity of Chile-based Inversiones Latin America Power Limitada (ILAP; CCC-/Watch Dev/--). But we don't expect a systemic issue to occur, as defaults were due to specific risks.
- We continue to monitor the early termination of concession of Peru-based Rutas de Lima S.A.C. (B-/Watch Neg/--), and the potential impact on its notes and our view of the contractual framework in the country.

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High interest rates to weigh on funds from operations and refinancing costs. Less than 5% of Brazilian toll roads' debt has fixed rates, pressuring debt service while reference interest rate remains high. Even though about 60% of debt is linked to inflation, there's a one-year time lag to recover inflation pass-through through rates that are adjusted annually. This should continue to lift working capital needs among some operators. A similar, bit to a lower extent, trend is occurring among rated Mexican toll roads, given that less than 15% of their debt has fixed rates.

Exposure to spot-price volatility. While favorable hydrology in Brazil and Colombia should continue to reduce spot prices in 2023, and lower commodity prices should dampen the marginal cost in Chile, these are uncontrolled factors. Pressure from unprecedented price volatility in 2022 in the Chilean market has weakened the financial flexibility of both smaller operators like Guacolda Energia S.A. (CCC+/Negative/--) and ILAP, and large incumbents such as Engie Chile S.A. (BBB/Watch Neg/--).

Social unrest in Peru. Despite the political crisis and escalating violence during the protests in the southern departments of Peru and in the city of Lima in early 2023, infrastructure assets that we rate maintained sound performance, with no negative rating impact so far. Still, the risk of persistent political and social disruption could further erode the country's economy and take a toll on infrastructure issuers in the future.

Higher financing cost. Except for Brazilian utilities, the rated entities in this industry don't have a significant concentration of debt maturities in 2023. At the same time, higher cost of funding should delay the deployment of expansionary capex, particularly among the Brazilian sanitation sector players that have large ongoing investments.

Related Research

- Emerging Markets Monthly Highlights: Some Bright Spots, Tough Crosscurrents, April 19, 2023
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- Credit Conditions Emerging Markets Q2 2023: Enduring Risks, March 28, 2023
- Economic Outlook Emerging Markets Q2 2023: Global Crosscurrent Make For A Bumpy Deceleration, March 27, 2023
- Credit Stress Looms In Latin America As Financing Costs Surge, March 22, 2023
- Latin American Corporate And Infrastructure Credit Outlook 2023: Dwindling Fundamentals, Elusive Funding, Feb. 13, 2023