

Surging commodity prices prove to be a double-edged sword for Latin America



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Changes in commodity prices have a significant impact on economic activity in LatAm, with economic cycles often determined by the rise and fall of a small number of basic materials. The positive shocks to commodity prices due to the remarkable recovery in the global demand for goods, which followed unprecedented Covid-related stimulus, and the war in Ukraine are having a mixed impact. While export countries are reaping the benefits, the surge in oil and food prices is having a negative effect on domestic activity, with disposable income and sentiment in decline.

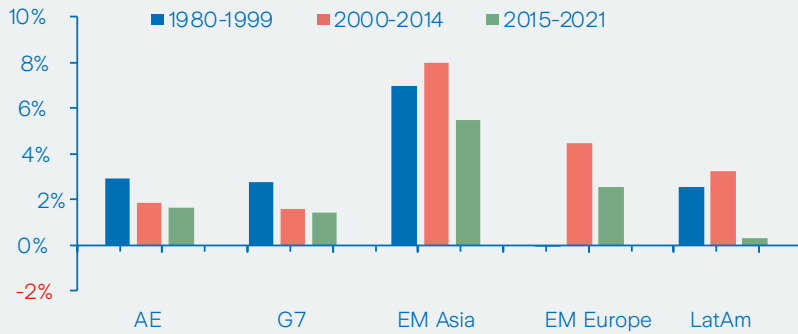
Unfortunately, we do not see the surge in commodity prices as the start of a new commodity supercycle like those which have benefitted the region in the past, but it does offer the potential to lift growth in the short term and allow some repositioning of economic models in a region that has suffered a structural decline in trend growth. From a financial market perspective, the commodity rally has been a boon, with the region significantly outperforming global stock markets this year. While the good news on the commodity front now seems largely reflected in prices, with inflation in the process of peaking and the rapid rise in interest rates expected to slow down by Q1 2023, prospects for financial assets appear to be good rather than great.

GDP growth in LatAm (% YoY)



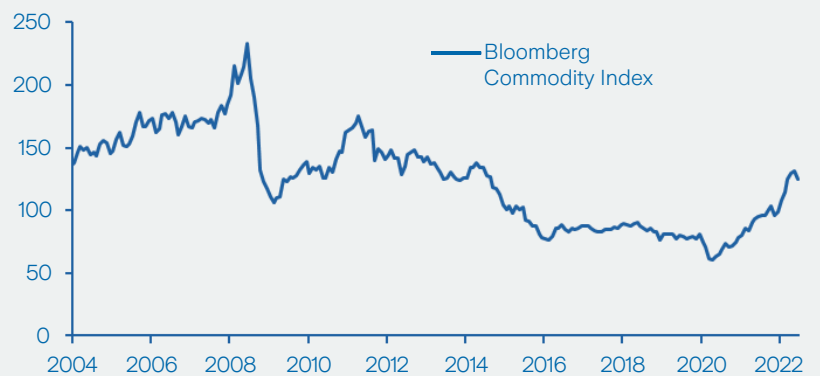
Source: IMF, ZIG

Annual average GDP growth during and after the commodity supercycle (%)



Source: IMF, ZIG

Bloomberg Commodity Index



Source: Bloomberg

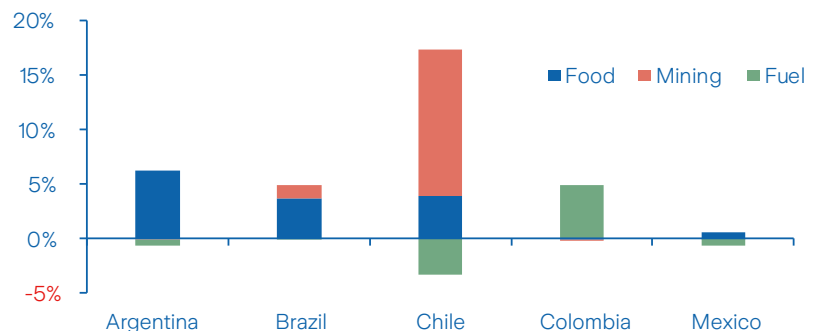
The economic impact of increases in commodity prices

The current increase in commodity prices, which started in 2020 and accelerated with the geopolitical crisis between Russia and Ukraine, is occurring at a challenging time for LatAm. The economy is facing supply chain constraints due to the pandemic, inflation rates that are significantly above most targets with central banks tightening aggressively, and the global economic outlook is deteriorating.

The economic impact of higher commodity prices is likely to have different implications among countries depending on the specific commodities that each country exports or imports. Furthermore, considering that energy and food prices have risen the most, the positive impact on the region should be lower than in a supercycle as the significant increases in energy prices for domestic use should partially offset gains from other commodity exports with more bifurcation between winners and losers this time. Those countries that are net exporters of food and energy will likely be the winners of this cycle, but the outlook is mixed.

Looking at the various countries in more detail we see that Argentina, Brazil, Chile, and Colombia all export commodities but have differences among them, as exhibited in Chart 4. For example, Chile and Colombia are opposites when it comes to energy trade, while Brazil and Argentina have food as their main commodity exports. Since Q4 2014, Mexico has been a net importer of oil and currently exports mainly manufactured goods to the United States.

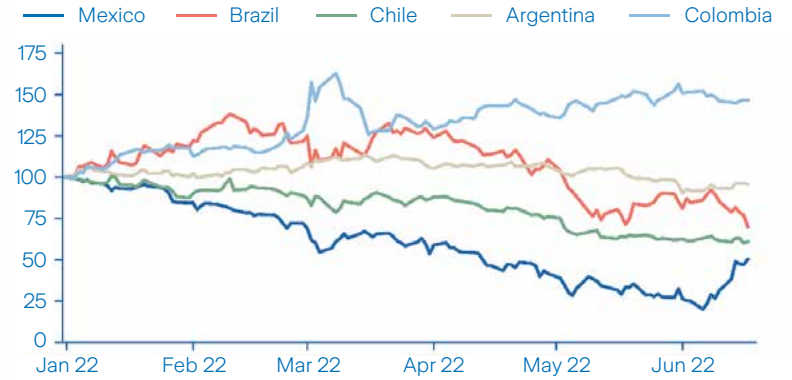
Net commodity exporters (% of GDP)



Source: UN Comtrade, ZIG

Colombia, a net oil exporter, has benefited the most in LatAm from the increase in the oil price, showing the greatest gain in the relative price of exports versus imports, measured as the improvement in commodities terms of trade¹ in 2022. The rise in soybean and grain prices has allowed Argentina to improve its fragile financial position. However, local political uncertainty will likely impede any long-lasting effect, while inflation also remains rampant undermining Argentina's outlook. Brazil is mainly a net exporter of metals and soft commodities thereby experiencing a net positive impact from rise in their price, which was one of the drivers of its economic resilience during Q1. Chile and Mexico, however, are both net importers of oil, and show a decline in terms of trade since the beginning of the year as energy prices have surged. Chile was able to compensate for part of the deterioration through its position as the world's largest copper exporter, with prices up by close to 100% since their lowest point during the pandemic despite a recent pull-back. However, the negative impact of oil prices, which are up by over 300% in the same period, more than offsets this. Therefore, Colombia, Brazil, and Argentina seem to be best positioned to benefit from the commodities boom.

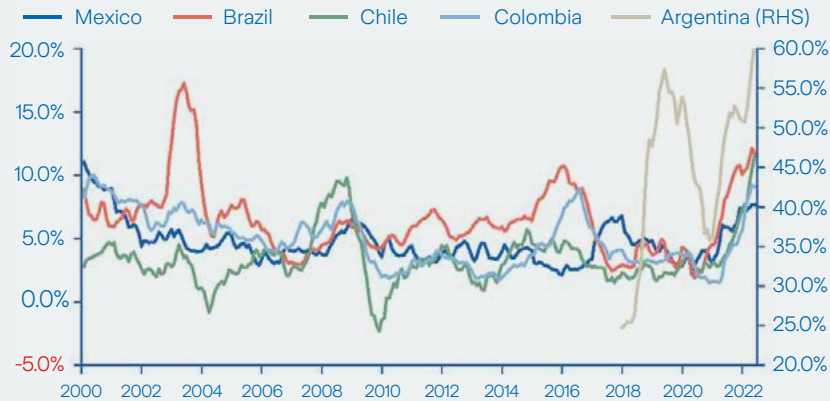
Commodity terms of trade index



Source: Bloomberg, Citigroup

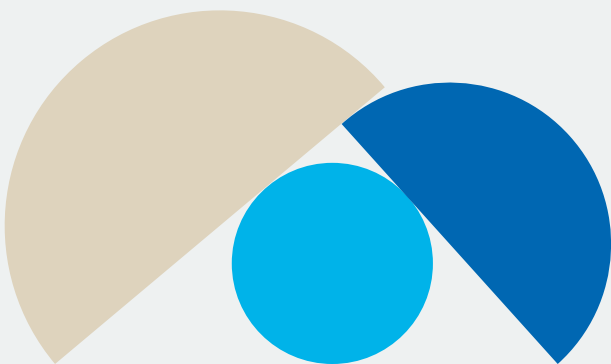
¹The commodity terms of trade measures the value of the commodities exports divided by the value of the commodities imports of a country

Headline inflation (% YoY)



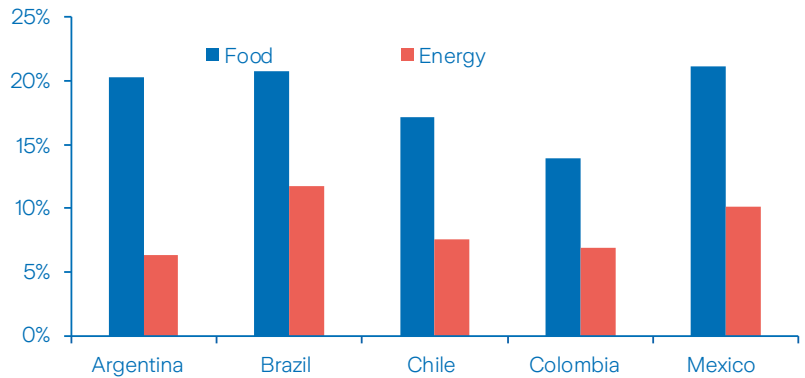
Source: Bloomberg

The most direct impact of the commodity price shock, however, is the additional inflation pressure. The spike in commodities, which are of course also consumed domestically, is occurring at a time when inflation is already high in LatAm. Energy and food have a large share of the CPI basket, weighing ~30%. Moreover, inflation is closely correlated among countries in LatAm, and food and energy price shocks have a negative impact. Higher inflation has led to a dramatic rise in interest rates, which have slowed domestic growth. While governments are receiving a boost to revenues from higher commodity prices, most of them are having to implement or increase subsidies to reduce the domestic impact of higher energy and food prices on inflation.



From a long-term perspective, the risks that the geopolitical conflict between Russia and Ukraine has brought to foreign trade flows can be seen as an opportunity. LatAm has a great wealth of natural resources, which may lead to a boom in capital investment in commodity production as buyers seek to diversify their suppliers, boosting economic activity and providing additional foreign trade flows to the region. However, political uncertainty and the future direction of economic policy are risks for the business environment, potentially undermining and clouding the economic growth outlook.

Food and energy weight in the CPI basket (%)



Source: INDEC, IBGE, INE, DANE, INEGI, ZIG

The financial market impacts of increases in commodity prices

The equity markets are showing positive performance in several countries in LatAm, despite the challenging global economic outlook and the persistent fall of most global equity markets during 2022. A key factor behind this resilience is the rise in commodity prices. The commodity sector weighs around 20% of the MSCI LatAm Index. Since Dec 2021, the MSCI LatAm and the S&P Industrial Metals Index resumed their positive correlation, as shown in the following chart. The MSCI LatAm has outperformed EMs and global markets YTD, led by countries more sensitive to commodities like Brazil, Chile, and Colombia. Brazil is a value player, with commodities and the financial sector representing around 70% of the MSCI Brazil Index. Colombia is also a value player, with energy related companies weighing around 30% of the index. In Chile, commodity related companies represent 50% of the index. In Mexico, the exposure of the equity index to commodities is lower and consequently the market is lagging this year. However, the index has a high exposure to the financial sector, which should benefit from higher interest rates. In the short-term, we expect the current negative investment sentiment to continue to weigh on the Mexican market, but in the medium-term its value composition is an attractive attribute for this market.

In Chile, the constitutional process for writing a new Magna Carta is reducing business confidence, impacting investment projects. In Brazil, as the presidential election approaches the political pressure to reduce inflation has increased, adding uncertainty regarding fiscal responsibility and undermining local asset prices. In Colombia, the recent election of leftist candidate Gustavo Petro as President will likely add more volatility and uncertainty to the equity and the FX markets. However, considering the attractive valuation, high dividend yields, and an expected end to the tightening cycle, we continue to see potentially good returns in Latin America in the medium term, but tactical, selective, and timely strategies will be key to profit in this volatile region.

The FX market is also highly correlated with commodity prices, with LatAm currencies being more resilient than other emerging market currencies despite the strength of the US dollar. However, the volatility in FX is expected to continue, and the performance of local currencies will depend on the reaction function of the local central banks and the Fed as well as the evolution of political uncertainty.

Correlation between the equity market and commodities



Source: Bloomberg



Conclusions

Despite the recent surge in commodity prices, we do not see this as the start of a new supercycle. While the region will benefit from the recent price moves, we do not think the economic activity will recover the growth rates of the first decade of the 00s nor be sustained above trend over the coming years. Nevertheless, LatAm's wealth in natural resources has the potential to push trend growth higher in the future if diversification of global commodity supply chains continues and business investment steps up. As the recent increase in commodity prices was mainly driven by supply constraints, the positive effects of higher commodity prices are likely lower than in the supercycle as the increases in energy prices should partially offset the gains and

the deterioration of the global outlook should reduce foreign trade flows. The higher output costs have increased inflation, which has reduced households' disposable income and forced central banks to tighten more aggressively. The high interest rates will harm economic growth, despite the tightening cycle being close to its end. Also, the unanticipated fiscal revenues due to high commodity prices are being used to cap food and energy prices, increasing the pressure on fiscal accounts and minimizing the potential for a positive outcome. Local assets will remain volatile in the short term, but we expect a positive performance once global sentiment improves and the local political uncertainty reduces.



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