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Latin America and the Caribbean

Weak Credit Conditions Will Improve Through 2017, but Gradually and Unevenly

» **Latin America's weak credit conditions will persist through 2017 as economies continue to adjust to political realities and sluggish global growth.** Commodity prices are stabilizing and domestic political uncertainties seem contained, but overall credit conditions will improve only gradually and unevenly.

» **Persistently weak economic momentum will remain a risk for Latin American sovereign credit quality through at least late 2017.** Various fiscal metrics such as government debt ratios will deteriorate moderately but persistently. Currencies will remain highly volatile but will depreciate far less than in 2015 and early 2016, and most countries will have ample international reserves to protect against external shocks, with abundant liquidity ensuring reasonable access to international markets.

» **Weak economic conditions will weigh on Latin American banks' asset quality and profitability.** Problem loans are rising across the region, and in Brazil borrowers will remain stressed even as the economy emerges from a two-year recession. Tepid credit demand in Latin America will limit loan growth, crimping earnings. But Latin American banks are generally well prepared to manage these risks, with ample access to stable funding, high reserve coverage and strong liquidity.

» **Muted growth, weak commodity prices and risk aversion will strain corporate credit conditions through 2017, but impacts vary.** Credit conditions will remain difficult for oil/gas and mining/metals companies, but more locally/regionally focused consumer-related entities as well as those with international cost advantages will see some improvement.

» **Infrastructure development will be a key policy objective across Latin America.** The public sector's weakness will compel governments to involve the private sector for both financing and construction of new infrastructure, but private-sector appetite and involvement will vary by country. Institutional challenges and an anti-corruption drive will further delay new projects.

» **Weak economic conditions will generally limit asset growth and securitization volumes, depending largely on each country's unemployment and growth.** Mexico's market for residential mortgage-backed securities will remain strong, while in Brazil, high unemployment threatens to increase delinquencies among individual borrowers. In Argentina, economic activity remains low despite economic reforms, and lower salaries and higher unemployment threaten the performance of consumer assets.

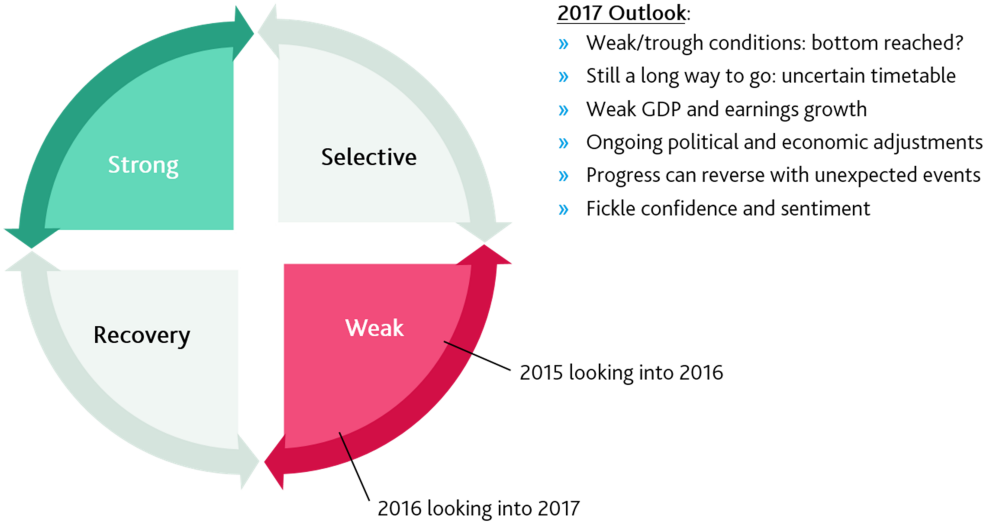
Latin America's Weak Credit Conditions Will Persist Through 2017

BILL WOLFE, SENIOR VICE PRESIDENT, CORPORATE FINANCE GROUP

Our outlook for Latin American credit conditions has improved during the past year, but we continue to expect weak or trough conditions through 2017 (see Exhibit 1). Since our report last September (Latin America: Global Headwinds Pressure Credit Conditions in Region, 2 September 2015) conditions deteriorated with weak general economic growth and tepid earnings before improving in mid-2016 as growth in China steadied along with net inflows of investment funding. However, Latin America has a long way to go, and with fickle confidence and sentiment, ongoing political and economic adjustments, and the risk of sudden reversals, the timeframe for additional progress and eventual normalization of conditions is uncertain (refer to our concurrent presentation Longer for Lower - Latin American Credit Perspectives, 24 August 2016).

Exhibit 1

Signs of Recovery Remain Vulnerable



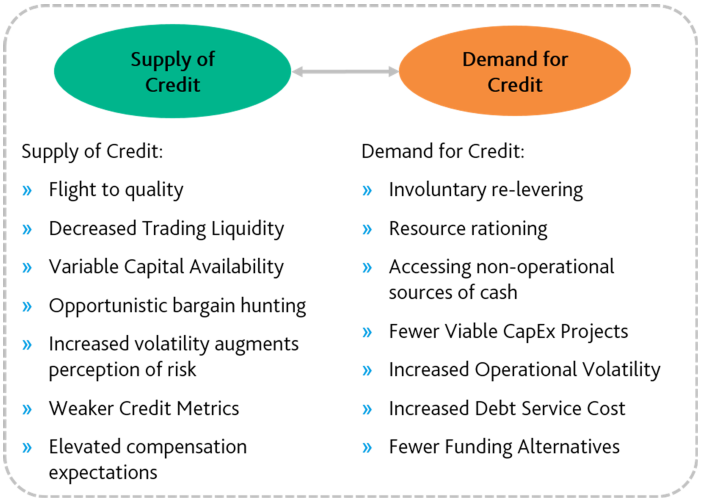
Source: Moody's Investors Service

We continue to see behaviors representative of weak credit conditions, and do not expect change in advance of clearer indications of improved regional macroeconomic conditions being evident. For investors who supply credit to issuers, we see opportunistic bargain hunting and expect continued orientation towards higher quality, with a requirement for generally wider credit spreads and more conservative non-price terms such as tenor.

On the demand side of the equation, we expect many issuers to display reciprocal behaviors, such as resource rationing (reduced operating spending; capital expenditure cuts; reduced dividends) and declining cash flow causing involuntary increases in leverage, as companies grapple with the adverse environment. This dynamic often also involves liquidity pressure. We also expect continued restructuring activity as issuers look to reduce costs, as well as continued accessing of non-operational sources of cash via asset sales (see Exhibit 2). For many companies that have already taken remedial steps, their tide may be turning and these behaviors will be less evident.

Exhibit 2

Challenging Latin American Credit Conditions



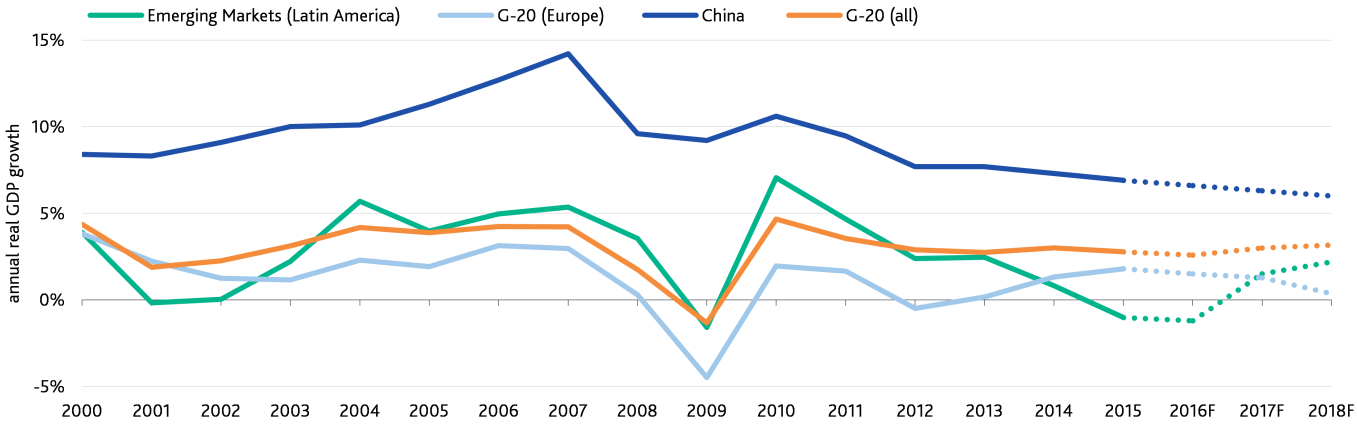
Source: Moody's Investors Service

The Age of Diminished Expectations

While the worst may be over, underlying real economies will have to continue adjusting to local political realities and prospects of lower-for-longer global growth through 2017 (see Exhibit 3). Four inter-related macroeconomic influences will continue to hinder credit conditions, if not always in perfect lockstep: prolonged, muted global economic growth; China's ongoing slowdown; lethargic growth in Europe; and the prospect of higher US interest rates.

Exhibit 3

Expectations Muted for Real GDP Growth



Source: Moody's Investors Service

These influences will continue sapping confidence, even without the unknown consequences of event risks. Rising nationalist/protectionist pressures, the pending US election outcome, the potential fragmentation of Europe, sovereignty disputes in the South China Sea, the Syrian conflict and refugee crisis all pose risks for both sides of the credit demand/supply equation. Regardless, the Chinese economy continues to slow (we recently upped our GDP growth forecast for China, showing a softer downwards trajectory), and with modest G-20 growth likely to persist, the outside world offers little help for Latin American prospects.

Latin America's credit conditions will improve gradually and unevenly. Global prices are stabilizing for the commodities on which Latin America depends heavily, and the region's domestic political uncertainties seem contained for now. Yet fundamentals are starting from a weak base and economic growth looks set to remaining slow for a prolonged period. Today's commodity price performance reflects oversupply rather than suppressed demand, and while stronger global growth would help, a return to equilibrium will require supply

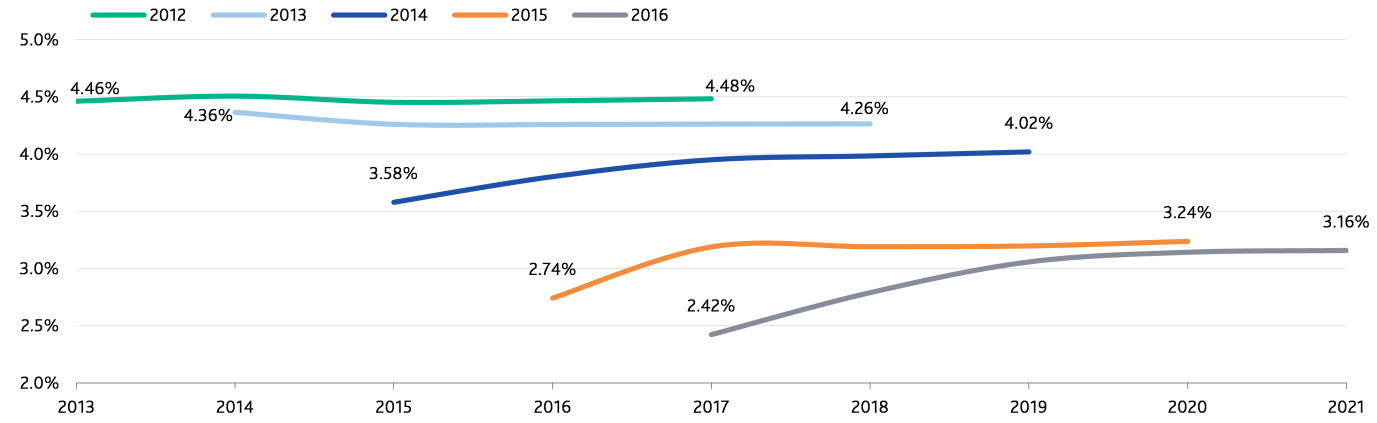
adjustments from such hard-hit industries as oil and natural gas and metals and mining, that feature significant economies of scale and very large production facilities. Supply becomes even harder to adjust when motivated by political and economic strategies.

Low growth is likely to persist for longer than we expected even a couple of years ago, and will tend to be generally lower than what Latin America has experienced over the past 10 years. Moreover, since the 2008-09 financial crisis, various commentators have continually lowered their growth expectations (see Exhibit 4), and a V-shaped recovery is not in the cards for 2017. We now expect a longer trough with a weaker recovery leading to future growth much lower than historic norms.

Exhibit 4

Successive Forecasts for Large Latin American Economies Show Lower Growth for Longer Periods

Five-Year GDP Forecasts, 2012-16



Source: International Monetary Fund, World Economic Outlook

The Latin American response to lower-for-longer growth varies according to the financial flexibility of particular countries, financial institutions, infrastructure projects, companies and structured finance entities—and according to how quickly they began reacting as the paradigm of lower growth for a longer period developed. Many entities assumed above-trend growth would be sustainable, compounding their error by misconstruing slower growth as a cyclical rather than structural phenomenon, supported in their views by market commentators continually overestimating growth potential.

Fundamentals Rule and Vary Case-by-case

Latin America's growth will not accelerate without structural reforms that improve productivity or change the character of economic activity there. And since structural reforms are politically challenging to implement, with benefits appearing only after a long lag, they offer limited near-term improvements for growth rates and credit conditions. Further, Latin America's economic recovery will ebb and flow as the region absorbs reforms (or a lack of reforms), and the ongoing recovery in credit conditions will remain delicate through 2017. Progress will vary dramatically by country, with confidence likely to remain subdued in some countries amid the slow pace of growth from very low starting points.

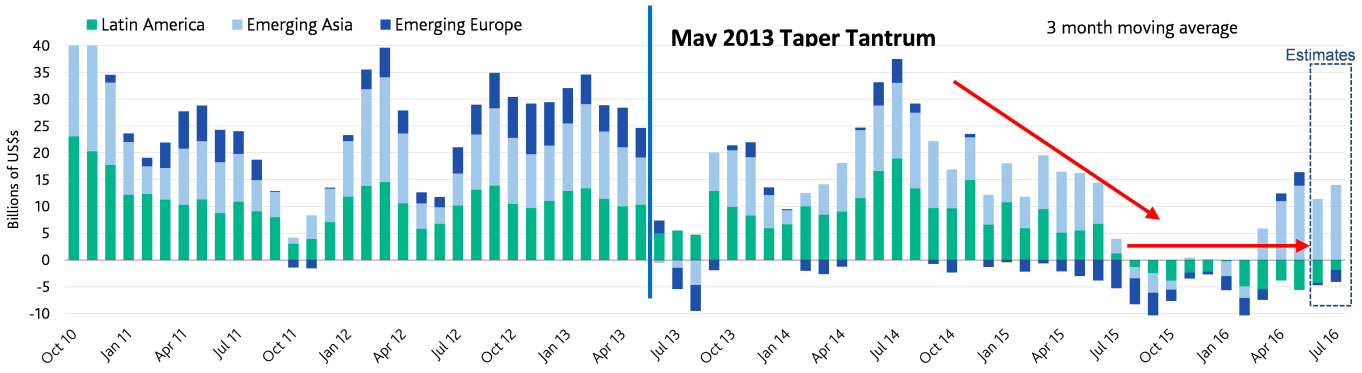
Credit supply will also be inconsistent through 2017, with cautious investors still awaiting clearer indications of improved regional macroeconomic conditions or fundamentals. As both investors and borrowers keep adjusting to a difficult global macroeconomic environment, including still-low commodity prices, Latin American credit conditions will remain uneven, even without considering domestic challenges and exogenous complications.

Since the May 2013 "Taper Tantrum," capital flows into Latin America have varied according to newsworthy events and evolving US monetary policy (see Exhibit 5). While inflows surged throughout the 2010-14 period of US quantitative easing, they have subsequently subsided. Slower Latin American general economic growth is likely to continue to dampen investor interest there, and the prospect of higher yields if the US increases interest rates would probably divert further capital from Latin America.

Exhibit 5

Net Capital Flows Return to Neutral After 'Taper Tantrum' Volatility

Three-Month Moving Averages, October 2010-July 2016



Source: Institute of International Finance; Moody's Investors Service

Global macroeconomic stress will weigh on credit conditions across Latin America through 2017, but will affect different countries and lines of activity differently over time, depending on their specific liquidity and financial flexibility considerations. Entities that reacted quickly to the longer-for-lower growth paradigm are better positioned to access credit markets; those that did not will find more limited or very expensive receptions to their credit needs during 2017.

Sovereign: Credit Conditions Will Remain Stable but Weak in 2017

MAURO LEOS, VICE PRESIDENT - SENIOR CREDIT OFFICER, SOVEREIGN GROUP

Persistently weak economic momentum will continue to hurt sovereign credit prospects across Latin America, with limited room for improvement before late 2017 or early 2018, with weak commodity prices dampening near-term and medium-term economic growth. Yet certain fiscal trends look more favorable for 2017, with stronger exchange rates and decent access to international credit markets.

Latin America's economic momentum has turned negative since late 2015, leaving external and domestic conditions relatively unfavorable for growth. Even with signs of some modest recoveries in certain countries, we anticipate persistently weak annual growth rates. "Lower-for-longer" commodity prices and economic conditions will become the norm in coming years, despite a modest recent recovery for commodity prices from record lows earlier in 2016. As Latin American governments use up the limited fiscal space they had built up in previous years, a moderate but persistent deterioration in government debt ratios, among other fiscal measures, will limit positive rating actions.

Still, Latin American exchange rates will not deteriorate as severely through 2017 as they did in 2015 and early 2016, even if they remain highly volatile. Balance-of-payment risk will remain low in Latin America, since most countries have more than sufficient international reserves today to protect against external shocks. Access to international credit markets will be better than originally feared, despite abundant liquidity from global quantitative easing efforts and increased risk aversion diverting interest from Latin America as investors strenuously search for yield (see Exhibit 6).

Exhibit 6
Summary Overview - Sovereign Issuers

Summary Overview	Mexico A3 negative	Brazil Ba2 negative	Chile Aa3 stable	Peru A3 stable	Argentina B3 stable
Sovereigns	Weak economic performance	Improving economic and financial conditions from low point	Weak confidence/ growth	Improving confidence/ growth	Improving economic and financial conditions from low point

Legend
- Positive
- Neutral
- Weak
- Negative

Source: Moody's Investors Service

Financial Institutions: Economic Difficulties Weigh on Banks' Asset Quality and Earnings

AARON FREEDMAN, ASSOCIATE MANAGING DIRECTOR, FINANCIAL INSTITUTIONS GROUP

Problem loans are rising across Latin America, where tepid credit demand will limit loan growth, crimping earnings for banks. But Latin American banks generally will have ample access to stable funding, high reserve coverage and strong liquidity (see Exhibit 7).

In Brazil (Ba2 negative), loan delinquencies, which have been climbing since 2014, will rise further through late 2017 and early 2018. Although the economy may begin to stabilize after the country's two-year economic recession, we foresee further deterioration for such leading indicators of bank asset quality as industrial earnings, the economic activity index and retail sales. Non-performing loan ratios for Brazilian banks that we rate will average 4.9% by the end of 2017, up from 2.8% in 2015. High lending rates continue to support net interest margins, but loan origination will remain weak as banks' risk aversion and high credit costs further cut profitability across the banking system.

Aggressive write-off practices will mask climbing asset risk in Mexico (A3 negative), where banks keep rapidly expanding their loan books despite muted economic growth and the continued strain on the country's large oil sector. Bank exposures to PEMEX (Baa3 negative), the troubled state oil company, remain high, with a broad network of PEMEX suppliers and historically oil-financed state and local governments dependent on federal transfers. Increased lending in the risky consumer and small and medium-sized enterprise segments, also fuel asset risk.

In Chile (Aa3 stable), soft mining activity that dampens economic growth will cut the banks' high profitability, and asset quality will deteriorate. Credit growth will slow to 8% annually through the end of 2017 from the 12% 2013-15 average, reducing lenders' earnings amid stress from high competition, interest rate caps on consumer loans, higher provisioning and liquidity requirements and higher income tax rates. Banks will also have to meet rising capital standards as the government begins enforcing minimum stress-test holdings under Basel III.

Contracting growth and high inflation in Argentina (B3 stable) will weigh on banks through 2017, but recent policy improvements pave the way for an eventual banking rebound. As Argentina's economy liberalizes amid continued low prices for agricultural exports, loan growth will remain slow through 2017 after adjusting for inflation, and higher funding costs and rising loan loss provisioning needs will weigh on profitability. Still, the deterioration in asset quality will remain contained amid low corporate leverage, and regulations that restrict borrowers from making deposits in US dollars will limit foreign-exchange risks.

The outlook is more balanced in Peru (A3 stable), where the new administration's plan to boost infrastructure spending and reduce economic informality will increase the demand for both consumer and corporate credit. Healthy economic activity will limit further deterioration of asset quality despite continued robust loan growth. Credit will continue to rise at a rapid 16%-18% pace in 2016, relatively unchanged from 2015, supporting strong profitability for banks. Improving confidence in Peru's sol currency will reduce deposits in US dollars, easing the currency mismatches on the banks' balance sheets.

Exhibit 7
Summary Overview - Financial Institutions

Summary Overview	Mexico A3 negative	Brazil Ba2 negative	Chile Aa3 stable	Peru A3 stable	Argentina B3 stable
Financial Institutions	Muted GDP growth and high oil exposures raise asset risks and limit opportunities to boost earnings.	Although the economy is starting to stabilize following a deep recession, asset risks will remain elevated and banks will continue to be risk averse.	Depressed copper prices and weak business confidence continue to weigh on economic activity, which will be a drag on banks' profitability asset quality.	Recovering growth will support credit demand and helps contain loan delinquencies, while loan de-dollarization will continue.	Despite persistent high inflation and higher real funding costs, positive policy changes have bolstered long-term business prospects and should help contain any deterioration in asset quality.

Legend
- Positive
- Stable
- Negative

Source: Moody's Investors Service

Non-Financial Corporates: Dynamics for 2017 Differ by Sector and Country

MARIANNA WALTZ, MANAGING DIRECTOR, CORPORATE FINANCE GROUP

Muted economic growth, weak commodity prices and risk aversion will all keep corporate credit conditions under stress in Latin America well into 2017, but the impact will vary by industry and by country. For the most part, companies exposed to their domestic economies in Mexico, Chile and Peru have the advantage of stronger economic activity at home, while Brazilian companies face more difficult conditions. In Argentina, credit conditions remain tough, but ongoing political changes and expectations for a more market-friendly environment are boosting business and investor confidence there. Local strengths will help improve certain sectors, while sectors that produce globally traded commodities will keep struggling (see Exhibits 8-9; also see our recent reports on corporate credit quality in Argentina, Brazil, Chile, Mexico and Peru, 1 August 2016).

Credit conditions will remain difficult for Latin American oil/gas and mining/metals companies, but companies more focused on local or regional trade will see some improvement, along with companies that can benefit significantly from cost advantages. Latin American pulp/paper and protein producers will remain stronger than the oil/gas or mining/metals companies, and other consumer-driven sectors will draw some strength from regional or local factors (see High Yield Interest, Latin American Edition, 2 August 2016).

Although Latin America is generally less dependent on oil than other parts of the world, the decline in oil prices will weaken credit fundamentals across various sectors, dragging on the economies of oil-producing countries. Brazil's steel industry will continue to struggle through mid-to-late 2017 as weak consumer confidence, lackluster industrial production and poor growth expectations hinder the main steel-consuming industries. Global overcapacity in steel will persist for several more years, limiting exports and increasing competition at home.

Brazil's economic recession has caused a sharp deceleration in Brazil's real estate sector, with mortgage financing and home sales declining since 2014, ending a decade-long boom. Lower household income and higher borrowing costs for new mortgages will weigh on demand for houses through at least mid-2017.

Soft economic expansion will limit growth for Latin America's telecom industry, whose combined EBITDA margins will gradually decline through 2018. A slowdown in middle-class growth and spending power will force operators to offer more lower-margin convergent services in increasingly mature markets, even as demand rises for faster internet speeds, smartphones and bundled services.

Brazil's large sugar-ethanol producers will benefit as a global sugar deficit reduces their inventories, raising average international prices during the 2016-17 harvest.

Exhibit 8

Summary Overview - Non-Financial Corporates (by Country)

Summary Overview	Mexico A3 negative	Brazil Ba2 negative	Chile Aa3 stable	Peru A3 stable	Argentina B3 stable
Non-Financial Corporations	Low oil prices hit Pemex and energy reform hard; US recovery provides support for several sectors	Weak commodity prices suppress cash flow. Lower exchange rates only partially compensate for depressed prices. Very weak economy and negative investor sentiment	Low growth. Weak copper prices. Political uncertainty and tax reforms, but solid fundamentals	Pressure in mining and construction. 2016 recovery in public investments and consumption	Economic stagnation. High inflation; Increased market volatility

Legend

- Positive
- Neutral
- Weak
- Negative

Source: Moody's Investors Service

Exhibit 9

Summary Overview - Non-Financial Corporates (by Sector)

	Oil & Gas	Metals	Pulp & Paper	Protein	Agriculture / Sugar Ethanol	Construction	Telecom	Retail
Commodity Prices						-	-	-
Foreign Exchange Rates	Mixed					-	-	Mixed
Tighter Funding Environment	Mixed	Mixed	Mixed				Mixed	
Government Infrastructure Plans		-	-	-	-		-	-
Exposure to Domestic Economies	High	Low	Medium	Medium	Medium	High	High	High

Legend

- Positive
- Neutral
- Weak
- Negative

Source: Moody's Investors Service

Project and Infrastructure Finance: Governments Committed to Infrastructure Development

ALEJANDRO OLIVO, ASSOCIATE MANAGING DIRECTOR, PUBLIC PROJECT AND INFRASTRUCTURE FINANCE GROUP

Infrastructure development will be a key policy objective across Latin America through 2017 as the region's tentative economic recovery gradually translates into improved operating and financial metrics for utilities and infrastructure assets. Performance will continue to vary widely across countries and segments (see Exhibit 10), but airport traffic will grow rapidly, while toll-road traffic will vary widely, booming in urban areas in various countries and showing resilience in Brazil in general, despite that country's ongoing recession.

Exhibit 10

Summary Overview - Project / Infrastructure Finance

Summary Overview	Mexico A3 negative	Brazil Ba2 negative	Chile Aa3 stable	Peru A3 stable	Argentina B3 stable
Project / Infrastructure Finance: Cross-border issuances for well-known projects with clear government support mechanisms. Limited penetration within long-term domestic institutional investors	Tenders to expand Gas pipeline network gaining momentum. Financial pressures within PEMEX and ongoing transformation of CFE fostering asset sales and joint ventures	Gradual signs of a more supportive regulatory environment. Higher borrowing costs. High dependence on more limited public sector financing. Potential execution delays prompted by ongoing corruption scandals. Revenue frustration due to prolonged domestic recession. Delays in infrastructure concession auctions.	Stable and supportive policy environment. Growing focus in extending the use of natural gas	Positive expectations on the continuity of the ongoing momentum	The Slow development of a more supportive regulatory framework facing resistance. Growing pipeline of new energy tenders in thermal and renewables

Legend

- Positive
- Neutral
- Weak
- Negative

Source: Moody's Investors Service

The sluggish worldwide economic environment has led to a growing reliance on infrastructure investment as a key counter-cyclical instrument. In previous years, white elephants flourished at such times. Today, however, Latin America's governments tend to prioritize more viable infrastructure projects, studying the business sustainability of infrastructure assets, including electric utilities, toll roads under concession and water utilities. In Brazil, for example, electric and water utilities will benefit generally from more supportive tariff reviews, although consumer demand will be very weak.

But lower-for-longer growth will continue to erode governments' already limited ability to maneuver amid increasingly vocal social opposition over increases in charges for public services. Extreme social resistance would bring a return of the "subsidized normal."

Governments across Latin America appear increasingly willing to rely on the private sector for both the financing and undertaking of infrastructure projects, but private-sector appetite and involvement will be slow to materialize. The pace and depth of private sector involvement will vary by country, segment, and the robustness and consistent application of sector-specific regulations.

Other hazards could derail infrastructure investment. Institutional challenges and ongoing political developments will further delay projects, with the slow pace of new regulation delaying electricity reform in Mexico, and Brazil's new interim government pursuing

regulatory changes in a number of areas. Prevalent political distractions raise the risk of further delays, if not the derailment of Latin America's infrastructure agenda.

Structured Finance: Funding Varies by Country

MARTIN FERNANDEZ-ROMERO, VICE PRESIDENT - SENIOR CREDIT OFFICER, STRUCTURED FINANCE GROUP

Weak economic conditions will generally limit asset growth and securitization volumes in Latin America, depending largely on each country's unemployment and growth (see Exhibit 11). Today's lower-for- longer growth scenario will limit asset growth for most originators, thereby reducing securitization volumes.

Exhibit 11

Summary Overview - Structured Finance

Summary Overview	Mexico A3 negative	Brazil Ba2 negative	Chile Aa3 stable	Peru A3 stable	Argentina B3 stable
	Sound macroeconomic fundamentals; stable performance in the mortgage market	High unemployment - potential negative impact via higher delinquencies for individual borrowers			Positive economic reforms, but still weak macroeconomic performance; recessionary enviroment and higher unemployement could deteriorate asset's performance

Legend

- Positive
- Neutral
- Weak
- Negative

Source: Moody's Investors Service

The Mexican economy has shown resilience to lower commodity prices, largely thanks to the economic dynamism of the US, its largest trading partner, and most transactions involving residential mortgage-backed securities have performed at or above expectations. As of June 2016, mortgages with payroll deduction mechanisms, such as those granted by Mexico's mortgage providers INFONAVIT and FOVISSSTE, were 5.91% and 4.03%, respectively, according to Moody's Mexican RMBS Index.

In Brazil, we have not yet seen significant deterioration in performance for the underlying assets of the securitized pools—even with the country's difficult economic conditions. But we have downgraded several transactions in 2016 based on close credit-quality ties to certain companies or financial institutions whose economic prospects have worsened. Higher unemployment will hurt pool performance for consumer and auto loans, with delinquencies for individual borrowers increasing in 2017, since pool performance tends to lag unemployment by several months. Finally, securitization transactions backed by trade receivables will continue to show stable performance, even with more companies filing for judicial recovery, thanks to strong transaction structures and tight eligibility requirements that have compelled securitizations to buy higher-quality receivables.

In Argentina, higher unemployment and declining consumer purchasing power will limit the number of deals backed by consumer assets, which represent the majority of Argentine securitizations. Argentina's new government has already taken profound economic reforms, but the process entails some short-term costs. Currency devaluation led to a spike in inflation during the first half of 2016, reducing consumer purchasing power even as the government ended electricity and fuel subsidies, has affected the purchasing power of consumers. Tightening monetary policy and contagion from Brazil will also stifle economic activity and securitizations in Argentina.

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