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MACRO MORNING BRIEFING

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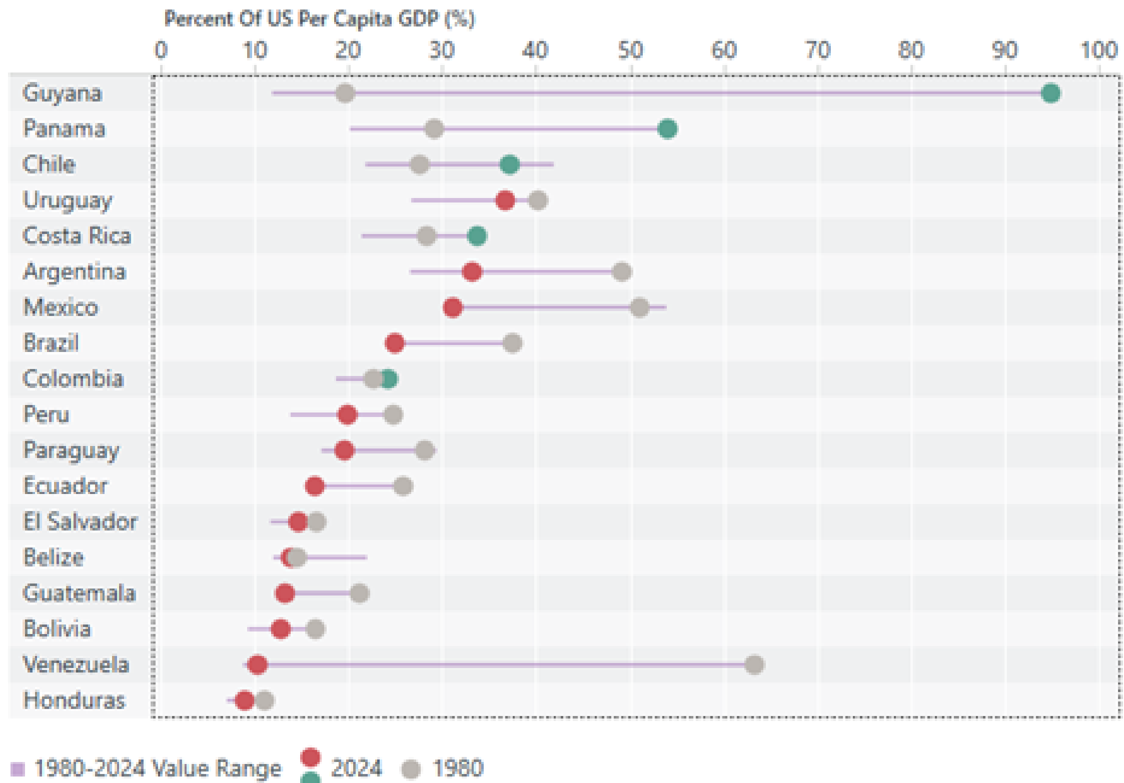
US-China-Latin America: Trade & Commodities

The relationship of China and the US to Latin America is changing. The US's approach to China and LatAm suggests familiarity with the Chinese idiom "sharing a bed but dreaming different dreams". Near-shoring of foreign direct investment into Mexico has changed the relationship of China to the US, as well as China's relationship with LatAm. The business cycle for China has shifted its relationship to LatAm in a post-pandemic world where politics seem in flux everywhere.

- The role of China in LatAm continues: it's the region's biggest trading partner and a key source of investment and borrowing. But there are limits – such as LatAm dependence on a few key commodities, e.g., soybeans, crude oil, lithium, copper – against the need for financing. There's also the matter of China's willingness to supply capital as the inventory cycle of EVs shifts, plus the ongoing squeeze on China's banks due to property-sector issues there.
- Mexico has become the satellite manufacturing hub for China and the US – divergence of trade to/from China stands out and is linked to US near-shoring.
- The carry trade that dominated in 2023 has extended into 2024, with most of the LatAm region seeing a resurgence of flows linked to rates, encouraged by lower volatility. And this has been despite the sharp repricing of the Federal Reserve's projected rate path, i.e., from six 25bp rate cuts this year to three, and the US 10y Treasury yield rebounding from 3.80% to 4.30%.
- The politics of LatAm are changing as well, alongside growth in both Mexico and Brazil weaker now than in the halcyon days for the US of the Washington Consensus and the advent of Brady Bonds. The China relationship is also changing, from the WTO-inspired reach for commodities and infrastructure investments in ports and roads to the tech race and 'Global South' agenda.

A Difficult 50 Years For Latin America



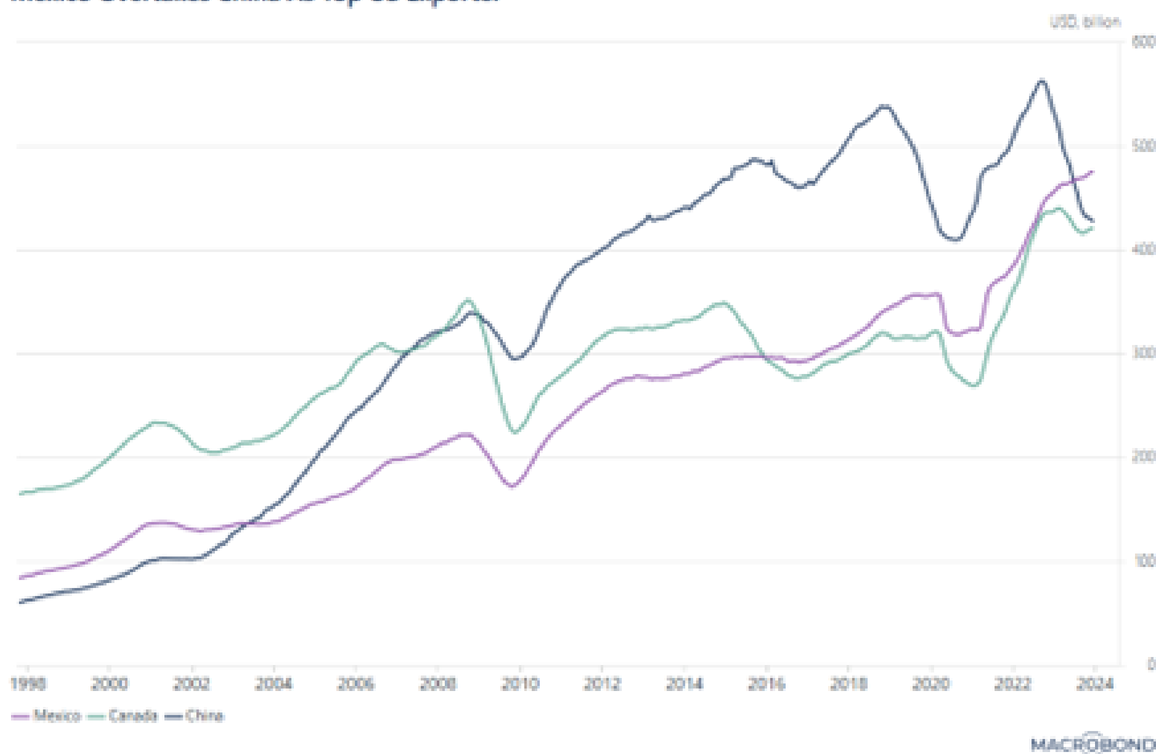
Source: IMF/World Bank, Macrobond, BNY Mellon

The worries about LatAm are linked to shifting politics, slower growth, and too much dependence on a few products. The region suffers from extraction economics. Growth on a per capita basis has stalled. Some experts blame missing out on growth on the region's dependence on China for higher-value manufactured products, which undercuts local industries. Others see the region suffering from inequality, weaker government institutions, and deficiencies in educational institutions. The notable recent exception is Mexico. The rise of China's influence in LatAm accelerated from 2009 but stalled after 2018. The region now faces a situation in which both the US and China are key drivers for growth. As of 2023, Beijing has free-trade agreements in place with Chile, Costa Rica, Ecuador, and Peru. Moreover, 21 Latin American countries so far have signed onto China's Belt and Road Initiative (BRI).

The WTO this week highlighted the risks of a new global architecture split between Chinese and US interests. The logical extension of the $1trn BRI would seem to be to capitalize on the 'Global South'. The architecture under construction revolves around a China-centric network of bilateral and regional "free-trade agreements" (FTAs), which allow for trade at low tariffs while also promoting direct investment flows. This network – currently includes 28 countries and territories that take close to 40% of China's exports – means that if the WTO's mandate to keep the world open for liberalized trade unravels, China will have at least a partial back-up system in place. None of China's FTAs include the US or countries inside the EU.

Another trend for China and the US is near-shoring – relocating production capacity closer to customers to limit vulnerability to geopolitical tensions. This is reconstituting China's global footprint. China's direct investment flows into Malaysia, Indonesia and other countries seen as near-shoring candidates have been on the rise. For the US, Mexico surpassed China as the largest trading partner in part because of the recovery of the auto industry post the pandemic – linked to supply chain disruptions and demand shifts. Another key factor is tariffs from the "Trump trade war" with China. Attempting to avoid those, Chinese firms have shifted assembly to Vietnam and Malaysia, as well as to Mexico. Chile, Bolivia and Argentina may need to revisit their terms-of-trade expectations. Furthermore, the concession given to Chinese battery makers may also depress prices and export receipts.

Mexico Exports More To US Than China Or Canada Does



Source: Macrobond, USTR, BNY Mellon

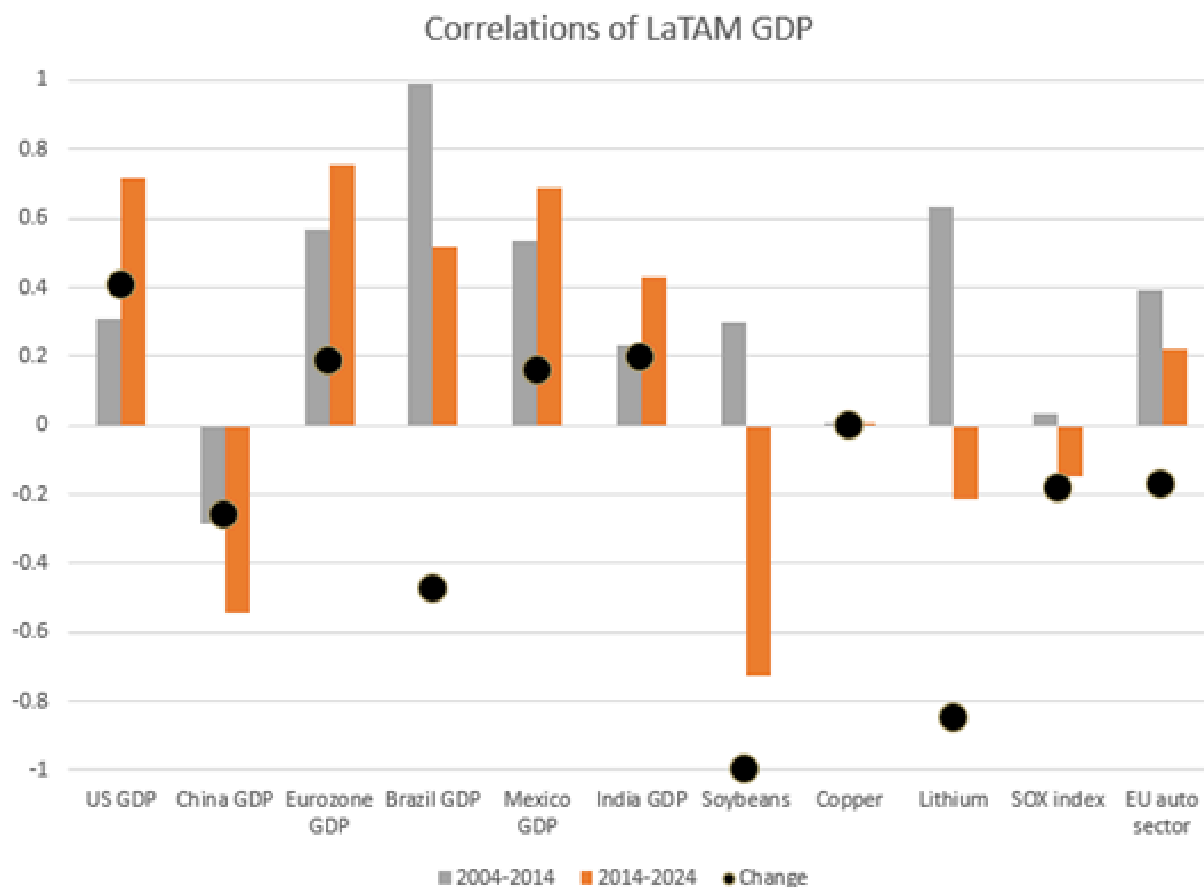
Likely because of US tariffs, the pandemic, the troubles in its property sector and the natural progression of its economy, China appears to have shifted focus from steady supply streams without price concerns to more opportunistic purchases of commodities. China seems aware that there are serious overcapacity issues in both its vehicle and battery sectors; margins are extremely thin, with implications across the entire supply chain. There are a few key takeaways from this shift.

- **China Commodity Price matters again**. The nature of China's demand for commodities is starting to shift – the trends that emerged in 2023 are likely to continue this year. The major change is that China is becoming an increasingly

price-sensitive buyer and appears more willing to use its purchasing power to try to influence prices. Oil is an example where inventory, along with other energy sources, is used to counter higher prices.

- **Iron Ore is an anomaly**. Unlike crude oil, which China can source from multiple producers, iron ore supply is highly concentrated and dominated by just two producers, Australia and Brazil. China also currently lacks a substantial stockpile of iron ore: port inventories dropped to a seven-year low last month. This means that when demand, or even sentiment, in the iron ore and steel markets improves, China has little choice but to tolerate rising prices. For 2024, this may mean ongoing strength in iron ore prices, especially if Beijing's efforts to revive the key property sector start to bear fruit.
- **Beijing's Technology focus keeps focus on semiconductor materials** - silicon, germanium and gallium. Current global reserves of gallium metal are about 280,000 tons. China has the largest reserves, 190,000 tons, which account for about 68% of global reserves. Natural reserves of gallium are extracted from aluminum and zinc production – Australia, Russia, France and Germany are the largest producers. China produces about 60% of the world's germanium and put export restrictions on this metal in August 2023. Indonesia has capitalized on its relationship by insisting that extraction and battery manufacturing must take place onshore, thereby moving up the value chain. LatAm commodity suppliers might want to consider doing likewise.

China And Commodity Interests Have Shifted For LatAm

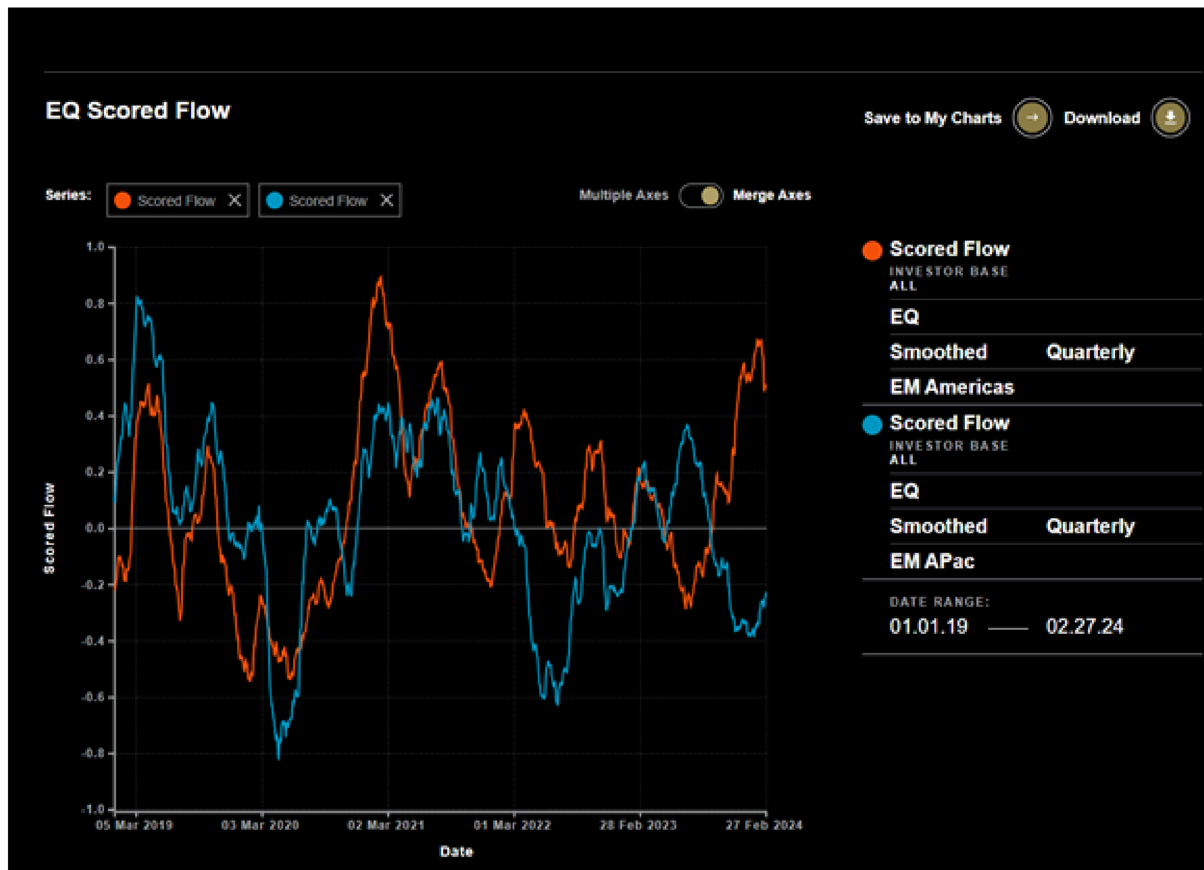


Source: Bloomberg, BNY Mellon

The shifting of markets is most clearly shown in how commodities correlate to growth in the LatAm region. For example, soybeans' role in GDP has shifted from significantly positive to negative. Food price concerns – driven recently by El Nino, aggravated by the Climate Change push, and complicated by US competition to sell more to China – show up in the correlations changing from 2004-2014 vs. 2014-2022. What seems clear here is that the baskets of commodities that drove LatAm growth in the last 20 years (2004-2024) have changed, and that the need for a new set of policies requires a shift to other parts of the world beyond US/China codependency. The correlation matrix of growth over the first and last 10 years highlights the shift of relationships between the US and China and materials, along with the switch of how Brazil and Mexico act as the largest regional drivers.

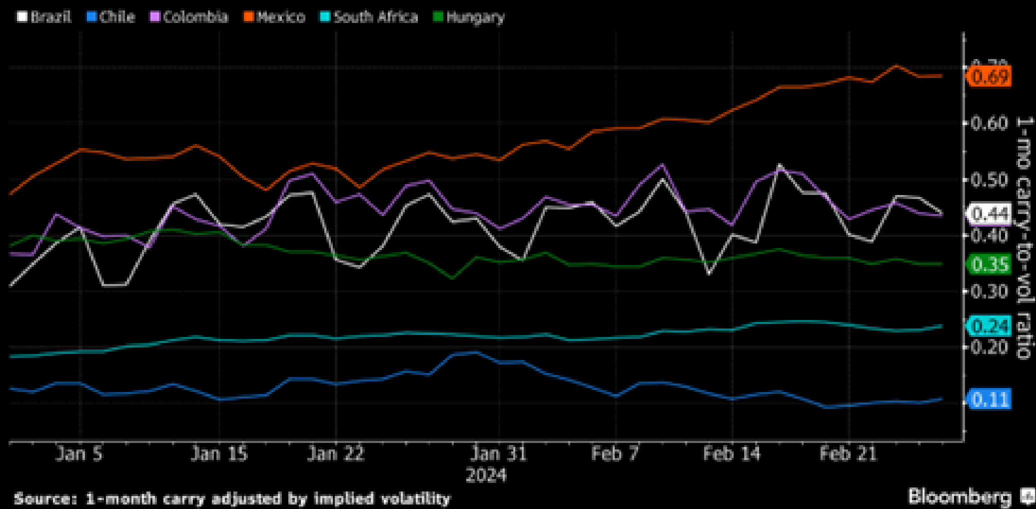
For investors, we think LatAm vs. APAC opportunities are interesting to consider this year. The equity flows we have seen in 2019 vs. 2024 highlight the shifts in views on how the US and China interact with both regions – the pre- and post-pandemic worlds have dramatically changed the convergence of global investment flows to one of divergence. The same holds for LatAm alone. Investors are shifting from viewing EM as a broad asset class to one far more idiosyncratic. Correlations and flows

suggest Mexico is in a very different position from Brazil, and both are different from the rest of the big economies in Central and South America.



Source: iFlow, BNY Mellon

What is still converging is FX options volatility. Both G10 and EM vols are low as we grind into the third month of 2024. The level of risk in markets for investors appears insufficiently reflected. This matters as lower volatility is not expected to remain in place all year; the carry trade is seen as a stopgap in the shift of policy moves ahead, overlayed with politics. Markets are in a calm that may be missing the larger shifts in trade happening globally, with FX losing some of its role as “shock absorber” between investment and trade flows. Notably, there have been fewer cross-border flows in bonds and stocks as 'home bias' has returned as a key factor. The lower volatility stems from not just mixed volumes of inflows and outflows, but also from active FX management by many central banks as they try to keep import-related inflation in check. The net result has been a comeback in the FX carry trade. This is a surprise outcome given the higher uncertainty of politics and growth in LatAm.



Source: Bloomberg, BNY Mellon

Bottom Line: The role of commodities in driving moves across LatAm FX is changing and the carry trade may obscure the larger economic shifts underway. The shift in investor bias from Brazil to Mexico may continue, even if Banxico cuts rates in March. The power of the economies of both the US and China to drive growth around the world is changing. The role of global politics has returned as a key factor driving policies that matter to growth and inflation. FX markets appear to have lost some of their elasticity, but that may be temporary – and could shift dramatically should the world return to convergence and globalization factors with a new global trading architecture. While that hasn't happened this week with the WTO meetings, over time it may be an opportunity for longer-term investors.

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