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MARKET COMMENTARY

Ashmore

Latin America: The best investment proposition in the world today

By Jan Dehn and Gustavo Medeiros

Latin America was more severely impacted by the global shocks of the last few years than any other region in the world. To make matters worse, several countries in the region had become distinctly populist in their policies. However, many of the external and domestic headwinds are now turning into tailwinds. The economic cycle is improving and commodity prices have found a floor. Democracies are working as they should by allowing populations to vote for better governments to replace discredited populists.

Against this backdrop, Latin America today offers the cheapest valuations in all of EM, making the region perhaps the strongest investment proposition in the world today.

Latin America was more severely impacted by the recent external shocks than any other Emerging Markets (EM) region. The QE program in developed countries triggered a giant global portfolio shift that strongly favoured financial assets in developed countries, while exerting a chilling effect on asset prices and currencies across EM. In addition, there were adverse indirect consequences for EM local markets due to the sharply rising Dollar and falling commodity prices. Latin America's particular vulnerability stems from its greater dependence on commodities and disproportionately larger reliance on foreign savings and portfolio flows.

To add insult to injury, a number of Latin American countries had gradually become more populist over the last decade. Hence, when commodity prices dropped and foreign money pulled out there was little to keep them afloat. Even Latin American countries with good policies, which is the majority, in fact, were adversely impacted by the general bearish sentiment towards the region.

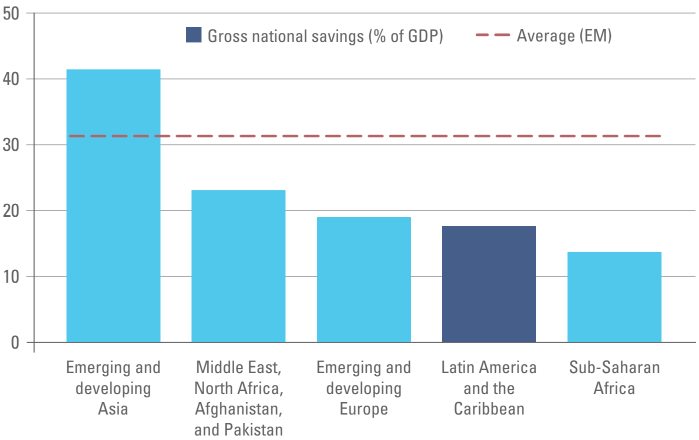
Sentiment is now changing. Today Latin America offers the best investment proposition of any region in the world. The case for investing in Latin America rests on the region's resilience during the recent headwinds, the nascent cyclical upswing, a more benign external environment and genuinely attractive valuations of asset prices. Latin America is today the cheapest market in all of EM. This opportunity, however, will not last forever. Investors should allocate now in order not to miss this once-in-a-decade opportunity.

The Four Gauchos of the Apocalypse

Their silhouettes were visible on the far horizon as far back as 2011, but it was not until May 2013 that the first of the four gauchos of Latin America's apocalypse rode into town.

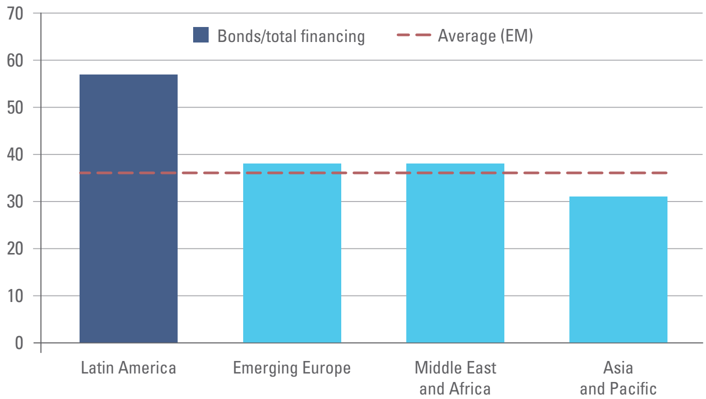
The first horseman arrived in the shape of a financing shock. The Taper Tantrum hurt Latin America badly, because Latin America's savings rates are lower than the rest of EM and because Latin America derives more of its total financing from bonds than other regions.[1] Latin America's savings rate is 17.6% compared to an average of 31% for EM as a whole, while Latin America gets no less than 57% of its total financing from bonds compared to just 36% for EM as a whole – see figures 1 and 2 below.

Fig 1: **Gross national savings (% of GDP)**



Sources: BAML, IMF, Ashmore.

Fig 2: **Bonds in total financing (%)**



Sources: BAML, IMF, Ashmore.

[1] Sub-Saharan Africa saves less as a percentage of GDP, but this is mainly due to the heavy dependence on foreign savings via foreign aid programs. Sub-Saharan Africa is the region on earth least integrated into global capital markets.

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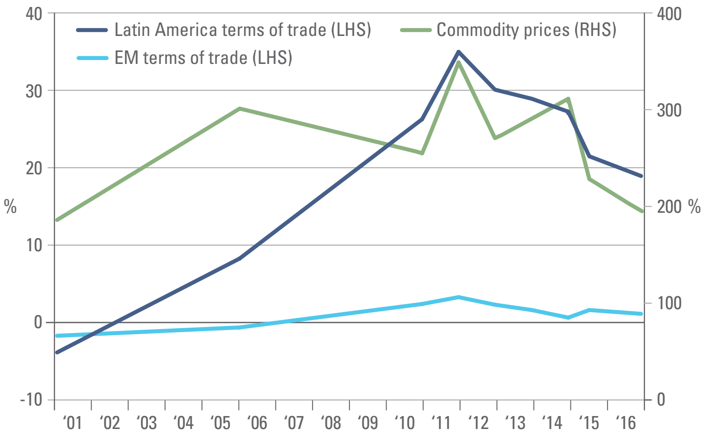
The next two Gauchos of the Apocalypse rode into town soon afterwards in the guise of a ferocious Dollar rally and crashing commodity prices. While Latin American currencies were not hit harder than other EM currencies Latin America's economies fared worse due to their greater sensitivity to commodity prices, particularly when the strong Dollar began to push down commodity prices very sharply in the middle of 2014.

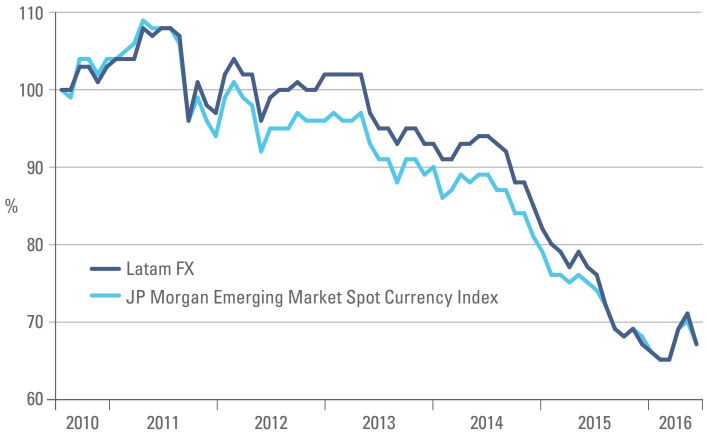
Fig 3: **Terms of trade and commodity prices**



Source: Thompson/Reuters, Citibank, JP Morgan, Ashmore.

The final Gaucho of the Apocalypse appeared in December 2015 – the supposed start of the Fed hiking cycle. This arrival had been feared well ahead of time, causing extensive damage to local sentiment long before the first hike actually took place. Latin American spreads and local bond yields started to underperform the broader EM markets as far back as 2013, but were only able to show signs of stabilisation after the first hike, i.e. in early 2016.

Fig 4: **USD vs EM currencies**



Source: Thompson/Reuters, Citibank, JP Morgan, Ashmore.

Limited Impact – cyclical downturns and institutional resilience

Despite the plethora of headwinds, Latin America's fundamentals in the end proved far more resilient than anyone had expected. The evidence of resilience is particularly evident in three areas, namely the economic cycle, default rates and institutions.

Cyclical downturns were unavoidable. Widespread capital flight caused tightening of financial conditions locally. Large currency moves also forced resources to move across sectors. However, Latin America's sizeable economic buffers ensured that these cyclical downturns did not morph into major structural malaise. Pass-through inflation from weaker currencies was relatively well contained without major damage to long-term inflation expectations in most countries. Eventually the weaker currencies and softer domestic demand began to help restore external competitiveness. Low starting levels of government and private sector debt helped limit the damage as did sizeable stocks of FX reserves and healthy banking systems. Some Latin American economies suffered quite severe recessions, but flexible credit lines with the IMF did not even have to be activated.

Latin America's default rates also remained low. Argentina was the only sovereign to default, yet this default was technical, triggered by a ban on coupon payments imposed by a judge in New York rather than problems of ability or willingness to pay. The default has since been cured with strong gains to investors. In corporate space, the corporate High Yield (HY) default rate for Latin America has averaged just 3.02% since QE began. This compares favourably to Latin America's long term default rate of 3.97% and the present HY default rate for US corporates of 6.25%. There have been notable spikes in the rates of default for Latin American corporates around major episodes of global financial tightening, particularly in 2013 and late 2015, but these were quickly reversed.

Latin America's institutions generally held up well in the face of a considerable populist onslaught. Democracy survived, even in the most extremely mismanaged economies of Venezuela and Argentina and somewhat less badly managed Brazil. These three countries all saw their central banks become less independent and the free flow of cross-border capital impeded. The quality of fiscal policy deteriorated as government policies also became more interventionist at microeconomic level. But this meant that, as soon as commodity prices dropped, these populist governments came under immediate and intense pressure, which soon translated into political transition and better policies. Brazil and Argentina have already adopted far more orthodox policies, while Peru has also become more orthodox. Venezuela may yet follow suit.

It is important to recognise, however, that the descent into populism was far from uniform across Latin America. Most of Central America as well as Chile, Mexico and Uruguay stayed entirely committed to open markets, inflation targeting and sensible fiscal policies.[2] Peru, Colombia and Panama launched major infrastructure investment programmes. Mexico and Colombia pursued serious economic reforms, including constitutional change.

[2] For further details on Central America and the Andeans see *"ANCEAM Six: Small and (almost) perfectly formed"*, The Emerging View, December 2015.

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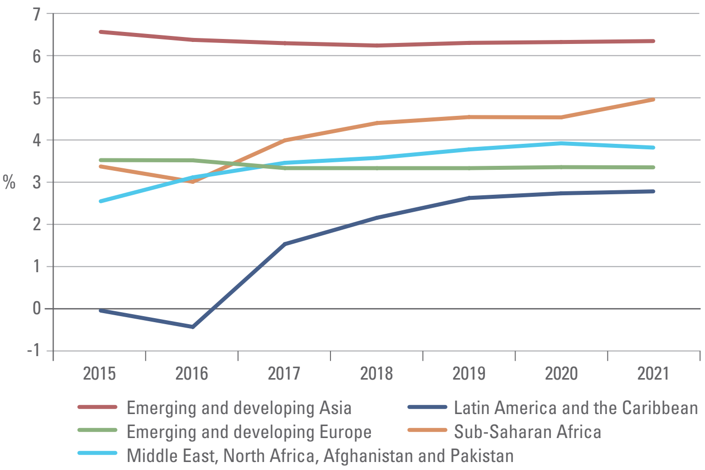
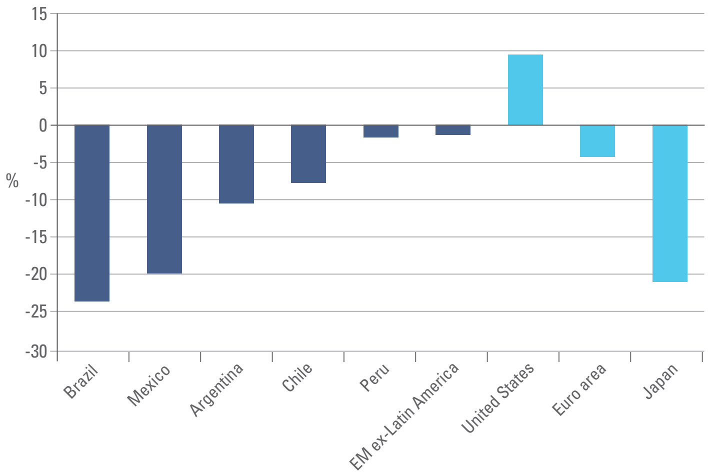
Fig 5: **IMF forecast for Latin American GDP growth (2015-2021)**



Source: IMF, Ashmore.

Fig 6: **REER (2010-2016 YTD)**



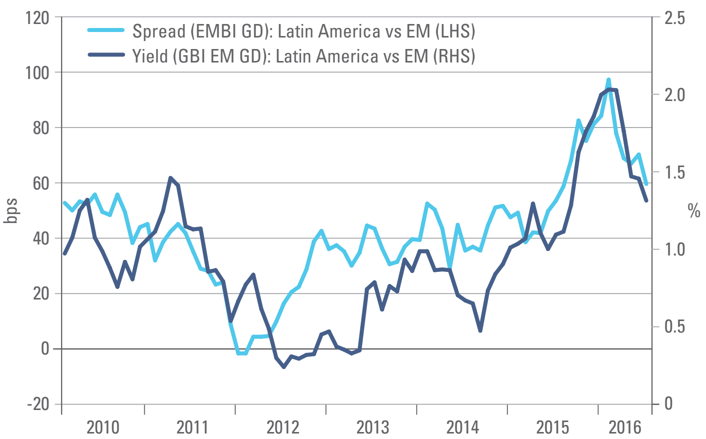
Source: IMF, Ashmore.

Outlook

Having weathered the global shocks without sacrificing the basic pillars of stability, where is Latin America heading today? We think the region offers the most outstanding investment opportunity in EM, possibly in the world. The investment case rests on the following four pillars:

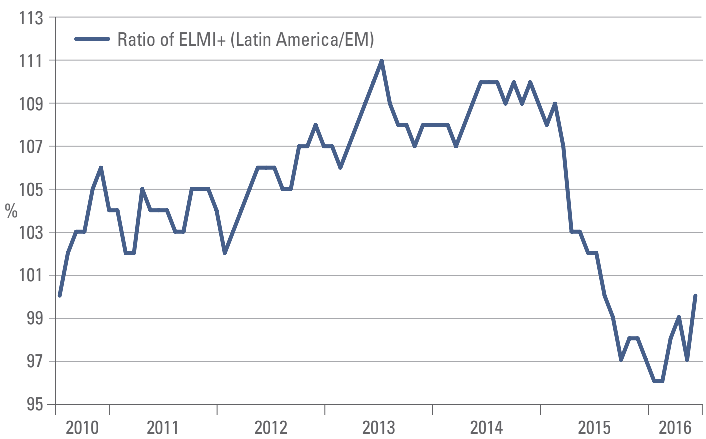
- A cyclical upswing: The IMF expects Latin America to have the fastest improvement in economic growth of any region in the world over the next 24 months. This is partly due to sharply improving real effective exchange rates (REER) – see figures 5 and 6 above. We share this view.
- Fading external headwinds: Commodity prices and the Dollar have both stabilised. Investors like to have money invested in currencies that go up, so the end of the Dollar rally is supportive for capital flows to EM. The fact that the start of the Fed hike cycle is a thing of the past also helps.
- Improving governance: Governance is improving rapidly in Latin America. Argentina and Brazil are already under new and better quality management. Sensible governments are in place in most Central American countries. The changing political environment in Venezuela is very likely to usher in a better government in the foreseeable future. In turn, that may have positive demonstration effects in countries such as Bolivia, Ecuador, Cuba and Nicaragua.
- Valuations: Latin American bonds offer the highest yields and spreads in EM, while Latin American currencies are the cheapest – see figures 7 and 8 below.

Fig 7: **Latin American spreads/yields vs. EM**



Source: Ashmore, JP Morgan, Bloomberg.

Fig 8: **Index of EM FX fwds: Latin vs. EM**



Source: Ashmore, JP Morgan, Bloomberg.

Conclusion

We expect Latin America to deliver the strongest fundamental improvements and the best asset price performance in EM over the next two years. Latin America was hit harder by external shocks in the past few years than other EM regions, but Latin America's economic and institutional buffers protected the basic economic and political fabric.

The economic cycle is now beginning to turn and external drags are fading. Additionally, the policy environment is improving in a number of highly influential countries in the region. As developed economies turn ever more populistic Latin America is heading in the opposite direction. All these factors add up to an attractive investment proposition.

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Country views

Brazil

Brazil has just embarked on the most profound structural reform drive since the Cardoso period of 1993 to 2002. Haunted by a ruthless and independent judiciary, the government has little choice in the matter. Interim president Michel Temer understands the importance of reform and the economic team is suited for the task. Spearheaded by the formidable former Central Bank Governor Henrique Meirelles, the economic team is full of technocrats who are putting together reforms that will transform the pernicious budgetary system and, political capital allowing, the unsustainable public pension plan and other entitlements.

The first and most important reform to be voted upon following the impeachment of President Dilma Rousseff is a constitutional reform that limits changes in expenditure to previous year's inflation for a period of twenty years. This implies that expenditures as a percentage of GDP are guaranteed to decline for the foreseeable future. The reform also obviates the need for permanent tax increases to balance the budget. In exchange for a grace period on their debt repayments, the government has secured the support of Brazil's States for the reform. State-owned companies are now overseen by technocrats working on indirect privatisations through asset sales and improving operational efficiency. The result will be a rebound in industrial confidence and employment should stabilise after years of severe deterioration.

The central bank is likely to welcome fiscal consolidation in the fight against inflation, which has already declined from 10.5% to below 9% and is likely to converge to 6.5% – 7% by the end of the year. This, in turn, should allow the central bank to cut rates to single digit levels already by 2017, helping investment. BRL will be allowed to appreciate, as it should, due to Brazil's net creditor status and the likely inflows of both portfolio and FDI capital. The main risks are political, but as the economy and confidence rebound these risks recede. A return of Dilma Rousseff to the presidency is almost out of question as she is no longer supported even by her own party.

Argentina

After less than a year in power, President Mauricio Macri has cut a deal with holdouts, opened Argentina to foreign capital, changed the taxation structure for soya exporters and allowed the currency to float. Grain exports are up and the economic data published by the government is now credible. A strong economic team has rebuilt confidence in the country's economy leading to much better prospects for investments in the future. Argentineans abroad are likely to repatriate capital and multinational companies will look to beef up their presence in this, the most European of Latin American countries. As Brazil, Uruguay and Paraguay are also managed by pragmatic presidents there is growing hope that a stronger Mercosur can emerge, which would improve prospects for trade agreements within the region and between Latin America and the US, similar to what happened in the Andean region.

That is not to say Argentina does not face a difficult period ahead. The Central Bank has had to hike short-term interest rates above 35% in order to rein in inflation, but inflation expectations are now declining as are short-term rates. ARS remains overvalued and further (mild) depreciation should be expected in the future, but strong inflows to the country as provinces and corporations benefit from access to global financial markets should prevent excessive depreciation pressures. Foreign currency returns to local Argentinian bonds and equities therefore look promising.

Venezuela

Venezuela is currently one of the best opportunities in the fixed income space. A large, important country in Latin America with vast natural resources, Venezuela was rated AAA in the 1970's. The economic and political situation deteriorated dramatically after Hugo Chavez gained power in 1999 and the country grew more dependent on oil revenues and debt. With the decline in oil prices from 2014 to 2016, the economy (and bond prices) declined sharply and President Maduro has been forced to devalue to reduce imports.

Distortions in the FX system and in the prices of staples create massive discrepancies between black market and official prices with long queues to purchase basic food products from state sponsored supermarkets. In spite of these problems the country's willingness to service debt remains extremely high. A default could lead to a halt in oil exports from the all-important state-owned oil company PDVSA, which is responsible for 100% of oil production in the country. Ability to pay has been deteriorating, but it is better than the market is currently pricing. The country has short-term liquidity problems, but not a solvency issue and is by no means over-leveraged. Venezuela holds the largest proven oil reserves in the world, with 300 billion barrels, but the US government estimates probable reserves to be as high as 510 billion barrels. With low extraction costs even at low oil prices the country's reserves are worth trillions of dollars.

The prospect of a change in government through a recall from office of President Maduro is improving and will likely usher in a far more pragmatic government. Fixing the exchange rate, lifting domestic energy subsidies and freeing up prices of staples can be achieved without parliamentary approval and would have a very large (+10% of GDP) impact on the fiscal and external accounts. Foreign companies are likely to be happy to invest alongside PDVSA if the government's attitude towards foreign capital improves, say, with a lifting of capital controls. In addition, a reform of the hydrocarbon law and privatisation would be huge positives, though they may take longer to fully implement.

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Andean and Central American countries

With a combined GDP of USD 642bn and a population of 108 million, the Andean and Central America countries of Colombia, Peru, Panama, Costa Rica, El Salvador and Guatemala (ANCEAM Six) stand out within Latin America on account of their stronger economic performance, higher quality policy-making and better overall business environments. They have consistently pursued stable, orthodox macroeconomic policies. The IMF sees the ANCEAM Six growing faster in the next five years than they have grown since the early 1990s and expects them to outgrow the rest of Latin America by a factor of two between now and 2020.

Even within this better-managed group of countries in Latin America there is evidence of a pull towards the centre. President Bachelet's popularity continues to decline in Chile. Proposals for taxes on the private corporate sector coincided with lower copper prices and led to a strong decline in the president's popularity, eventually forcing a U-turn and the replacement of the finance minister a year ago. In Peru, the population just elected Pedro Pablo Kuczinsky following a closely contested run-off with Keiko Fujimori. It is testament to the political sophistication of the Peruvian electorate that no candidate with populist credentials even got close to contesting the presidency.

Colombia has faced a significant terms of trade shock following the drop in oil prices in 2014, but the economy was in good enough shape to withstand the shock on account of deep reforms implemented in the first term of President Juan Manuel Santos. The government is aggressively investing in infrastructure and opening markets to foreign investors, while Santos's work on securing a lasting peace agreement with the FARC may yet turn out to be a game changer for Colombia. For more details on countries in this region see *"ANCEAM Six: Small and (almost) perfectly formed"*, The Emerging View, December 2015.

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