LATIN AMERICAN OUTLOOK 2023

January 2023

In Brief

Amid the current global landscape, the outlook for Latin America finds support from several factors:

- Advantageous geographical location
- Long-term support for commodity prices
- Latin American central banks close to ending their monetary tightening cycle
- Relatively few election processes on the horizon, reducing political noise
- Absolute and relative values at attractive levels
- Attractive bond yields and low default risk
- Risks
  - Internal: macro/ social/political/institutional noise
  - Global: deeper-than-expected recession, geopolitics

TABLE 1

IMF WEO Update October 2022	GDP growth (%) 2021	2022E	2023E	Difference July 2022E	2023E
World	**6.1**	**3.2**	**2.7**	**0.0**	**-0.2**
Latin America and Caribbean	**6.8**	**3.5**	**1.7**	**0.5**	**-0.3**
Brazil	4.6	2.8	1.0	1.1	-0.1
Mexico	4.8	2.1	1.2	-0.3	0.0
Chile	11.7	2.0	-1.0	0.2	-1.0
Colombia	10.6	7.6	2.2	1.3	-1.3
Peru	13.3	2.7	2.6	-0.1	-0.4
Argentina	10.2	4.0	2.0	0.0	-1.0

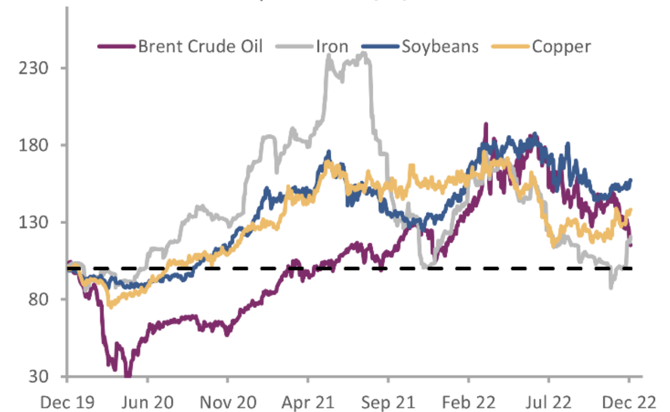
Source: International Monetary Fund, data as of October 2022.

Fair winds

Against a challenging global backdrop of inflationary pressures, fears of a recession and other complications, Latin America has fared remarkably well compared to other regions of the world. Thanks to a strong defensive performance by asset prices and a responsible monetary policy to tackle inflation, the region's prospects heading into 2023 has improved.

Although economic activity is expected to slow across the countries of the region, in line with the rest of the world, the IMF estimates economic expansion for all countries other than Chile (Table 1). Given its status as a net exporter, the region has benefited from high commodity prices, which in turn has led to significant improvements in the terms of trade for these countries (Figure 1).

Figure 1: INCREASE IN COMMODITY PRICES
USD | Base 100: 31/12/2019



Source: Bloomberg, data as of December 9, 2022.

This factor, which certainly benefits Latin America, has long-term structural support. Environmental stewardship, which includes the energy transition (dependent on industrial metals; see Table 2), is likely to lead to higher and more persistent demand and to increase the price of certain raw materials/commodities. Moreover, production costs across the region, notably for copper, iron and soybeans, are typically lower than in other countries, making it a highly competitive region in this realm.

TABLE 2

	Estimated demand growth, 2021-2035	2021 ranking of world production of key metals for energy transition: Argentina	Brazil	Chile	Colombia	Mexico	Peru
Copper	30%			1		10	2
Lead	13%					5	4
Nickel	78%		8				
Silver	2%	10		4		1	3
Zinc	14%					6	2
Lithium	659%	4	5	2			

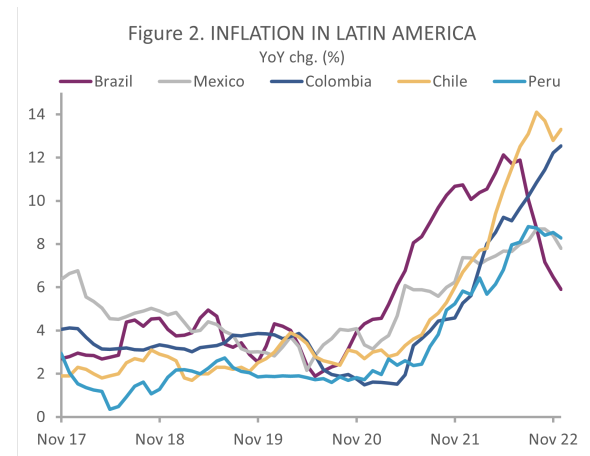
Source: Statista, UBS, Schroders Strategic Research Unit, data as of October 2022.

In addition, Latin American central banks have extensive experience with anti-inflationary policies. This led to an early start of monetary tightening within the region (second half of 2021) in the form of firm and resolute interest rate hikes. As a result, consumer prices have already peaked (with the exception of Colombia) and are now beginning to ease. However, the region is expected to move very slowly toward the target level, which should be achieved beginning in 2024.

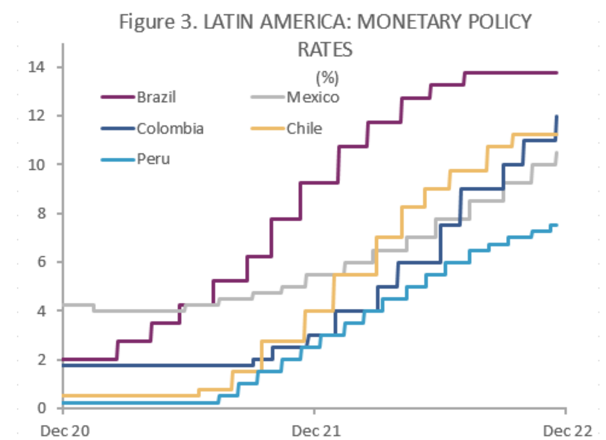
The cycle of interest rate hikes is close to ending across most of the region, and in some countries (such as Brazil and Chile) the benchmark rate has already peaked (see Figure 3). With inflation slowing and an economic slowdown/recession looming, expansionary monetary policy cycles with the ensuing interest rate cuts are expected to begin in the first half of 2023.

While Latin America tends to experience high levels of political volatility, with governments keen to promote populist projects that could undermine growth, institutions across the region have demonstrated their strength within functional democracies. Thus, reform processes tend to be modified following negotiations to ensure greater institutional stability. Notably, in 2022, various electoral processes took place across the region that ended with leftist governments, albeit subject to a legislative counterweight in the respective congresses.

There will be relatively few elections within the region as we move through 2023. In Argentina, presidential elections will be held in October and the ruling party will have a tough fight on its hands, given the social and economic turmoil that has unfolded during its term. In Chile, a new "constituent" process will be held during the year, involving an election in April for constitutional advisors, who will draw up a new draft constitution together with a committee of experts appointed by Congress, which will then be ratified in a plebiscite to be held on November 26.



Source: Bloomberg, data as of December 2022.



Source: Bloomberg, data as of December 2022

Source: Compass Group.

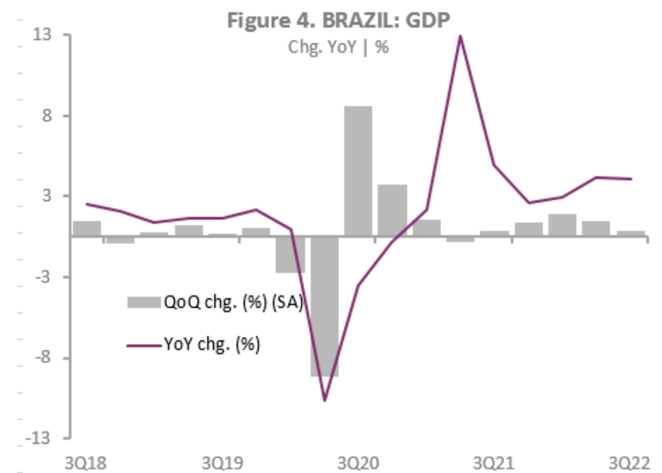
Country-by-country analysis

This year's growth projection for **Brazil**'s economy was upgraded by the IMF to 2.8% (from 1.7% in July), due to higher estimated growth within the services sector (60% of GDP) following the lifting of the mobility restrictions caused by the pandemic. GDP is expected to gain 0.75% in 2023, reflecting the global economic slowdown, coupled with tight monetary policy within the country.

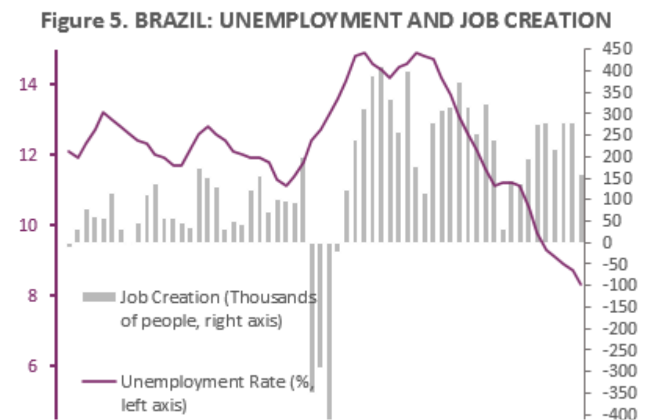
Notably, the labor market has performed strongly, supporting economic growth (see Figure 5). In October, the unemployment rate fell below 9% – its lowest level since May 2015 – after more than 159,000 jobs were created during the month. Labor market resilience is expected to prevail until early 2023, and then slow down in line with the economy.

Meanwhile, inflation has already peaked (12.1% annualized in April) and is falling rapidly, reaching 5.9% in the 12 months through November. This improvement is due to aggressive monetary tightening, in which the central bank raised its *Selic* rate by 1,175 bp to 13.75% and announced an end to the cycle of interest rate hikes (see Figure 6). The benchmark rate was expected to remain at this level throughout at least the first half of 2023, although given the increase in fiscal risk it is likely that the cycle of interest rate cuts will be delayed.

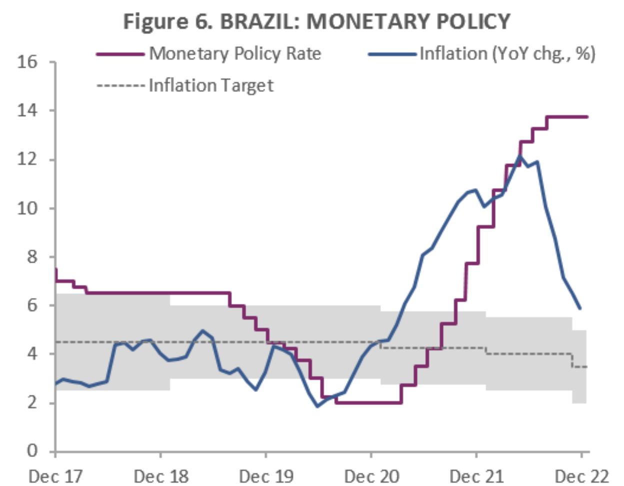
On the political front, presidential and legislative elections were held in October. Former president Luiz Inácio Lula Da Silva emerged victorious, resulting in a fragmented Congress in which the right-wing won more seats than expected, thus becoming a genuine counterweight to the president. However, Lula has pushed for a constitutional reform to ensure that the financing of the social transfer program known as "Auxilio Brasil" falls outside the fiscal spending rule ("Expenditure Ceiling"), which has increased fiscal risk in the country. This is due to the high level of government debt and because it is likely that taxes will have to be raised to offset the fuel tax cut made by the outgoing president this year. Meanwhile, Lula appointed Fernando Haddad, former governor of São Paulo and a member of the Workers' Party, as Finance Minister, even though rumors of his appointment generated a largely negative response in the market. While he



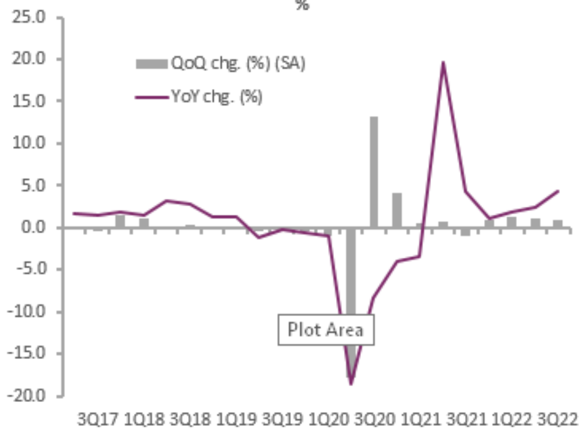
Source: IBGE, data as of December 2022



Source: IBGE, data as of December 2022



Source: Banco Central do Brasil, data as of December 2022.



Source: INEGI, data as of December 2022

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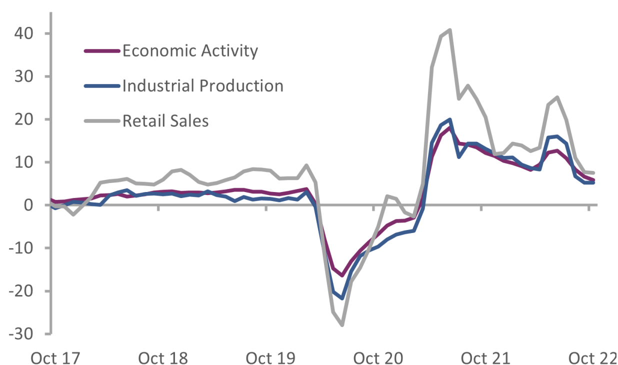


Source: DANE, data as of November 2022

has attempted to convey a message of restraint when it comes to fiscal spending, the market expects more than just rhetoric.

Although political noise increased and with it the risk premium, there is value to be found in Brazilian stocks. High-quality companies in defensive sectors, such as consumer staples and utilities, are currently outperforming. And best to steer clear of state-owned companies as long as the new government's policy regarding them remains unclear.

Mexico's economy has built up considerable momentum, and this trend is expected to continue through the end of this year (Figure 7). For 2023, the IMF estimates growth of 1.2% in Mexico, mirroring the slowdown affecting the rest of the world in general and more specifically the United States, its main trading partner.

The de-globalization trend benefits Mexico. Nearshoring (moving a part of production to countries that are geographically closer) by the United States will have a swift and direct impact on the Mexican economy. It is estimated that nearshoring could add an additional 1.0 to 2.5 percentage points of economic growth, given that manufacturing exports account for approximately 40% of GDP.

Monetary tightening through interest rate hikes began in mid-2021. Inflation appears to have peaked at 8.7% annually in September and since then has continued to abate, falling to 7.8% for the 12-month period through November. Banxico has hiked the monetary policy rate by 650 bps since last year to its current level of 10.5%. However, this has yet to have any negative impact on consumption. The resilience of the sector is down to the growth in remittances (up 14.1% annually in September, bringing in more than USD 42 billion in the first nine months of 2022), coupled with low levels of unemployment and significant wage increases (the minimum wage growth will be 20% next year).

Economic activity in **Colombia** has remained robust throughout the year (see Figure 9), thanks to rising oil prices (the country's main export) and the resilience of the consumer sector (partly as a result of the above). Although in recent months the economy has began to slow, it is the country in the region with the highest growth prospects for this year (7.6% according to the IMF), although the economy will then normalize and return to more sustainable economic growth rates. Meanwhile, the aggressive monetary adjustment of the

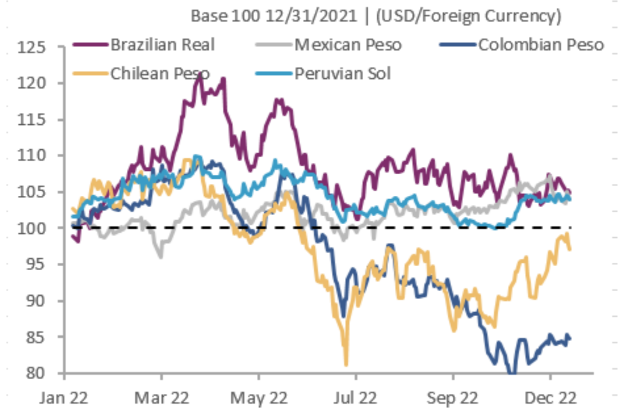
country's central bank to fight inflation (12.6% annual in November) has caused the benchmark rate to climb by 1,025 bp from mid-2021 to reach its current levels of 12%, thus generating tighter financial conditions. In addition, the high base of comparison led the IMF to estimate growth of 2.2% for 2023.

In August, Gustavo Petro, the first leftist president in Colombia's history, took office and is pursuing an agenda of aggressive structural reforms. However, the government has tried to act with restraint, since it does not have a parliamentary majority, with a notable example being the recently approved tax reform, which would raise 1.2% of GDP (the original proposal was 5% of GDP). In any case, the country's idiosyncratic risk has risen sharply. Colombia's high current account deficit (7.2% of GDP as of 3Q 2022) is also an issue, as it places considerable pressure on the currency: the Colombian peso has shed 17.5% of its value so far this year, making it the most depreciated currency in the region (see Figure 10).

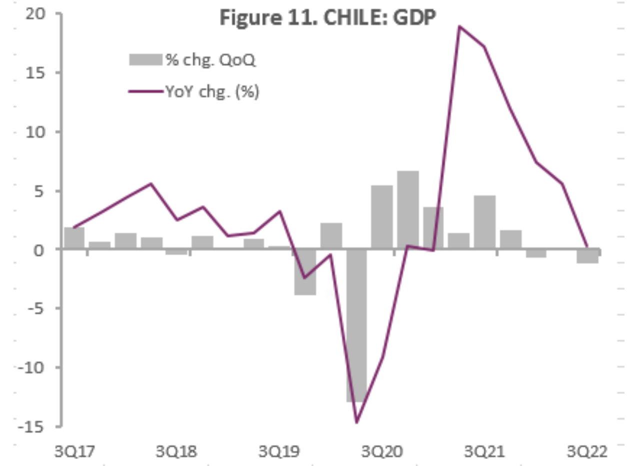
In **Chile**, the economy has slowed significantly since the high level of growth recorded in 2021 (see Figure 11). The Central Bank of Chile expects to see growth of 2.4% in 2022, followed by a contraction of between -0.75% and -1.75% in 2023. While the slowdown has been slower than originally estimated, given the resilience of the services sector, it is becoming increasingly evident, with the first year-on-year contraction in economic activity seen in September.

The Central Bank of Chile pulled the plug on its monetary tightening cycle after raising the benchmark rate by 1,075 bps from mid-2021 to its current level of 11.25%. Inflation peaked in August (14.1% YoY) and the central bank projects that after a slow convergence it will return to the 3% annual target. Given this situation, it is estimated that the benchmark rate will remain at this level until the end of the first quarter of 2023, at which point an expansionary monetary cycle (lower rates) will begin.

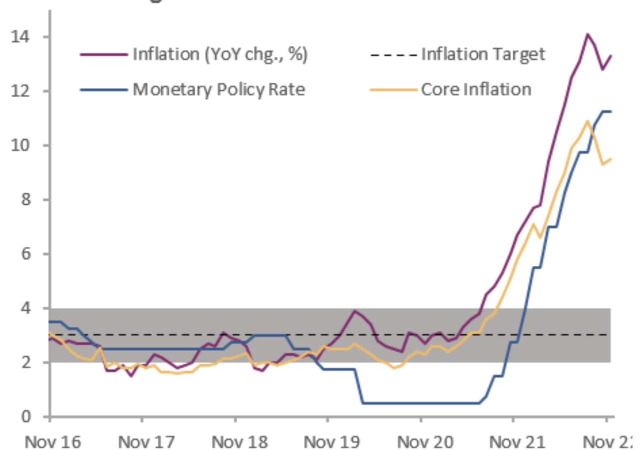
The political parties reached an agreement of sorts for the new constitutional process, in which the draft constitution will now be drawn up by a body including popularly elected advisors, though acting in conjunction with experts appointed by Congress, who hold veto power. This proposal will be ratified in a plebiscite to be held on December 17, 2023.



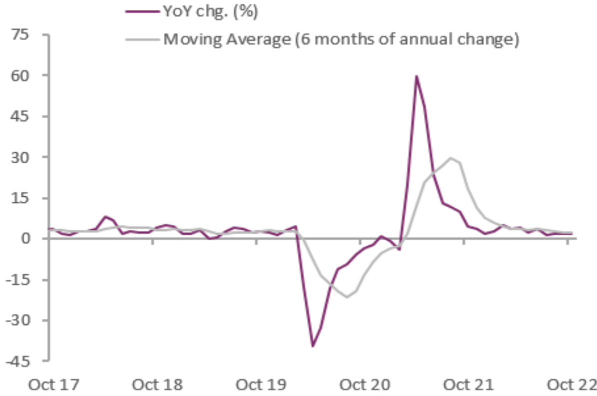
Source: Bloomberg, data as of December 15, 2022



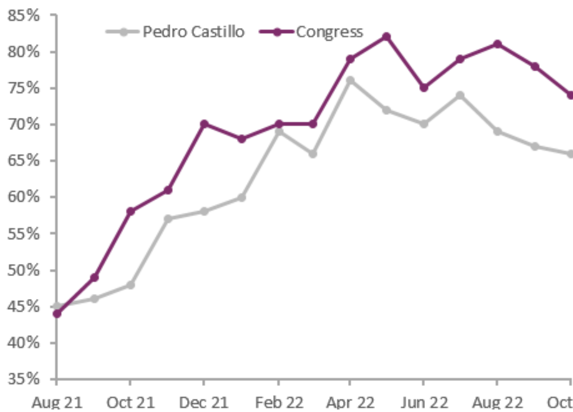
Source: Central Bank of Chile, data as of December 2022



Source: Central Bank of Chile, data as of November 2022



Source: INEI, data as of December 2022.



Source: Ipsos, data as of October 2022.

Source: INDEC, data as of December 2022

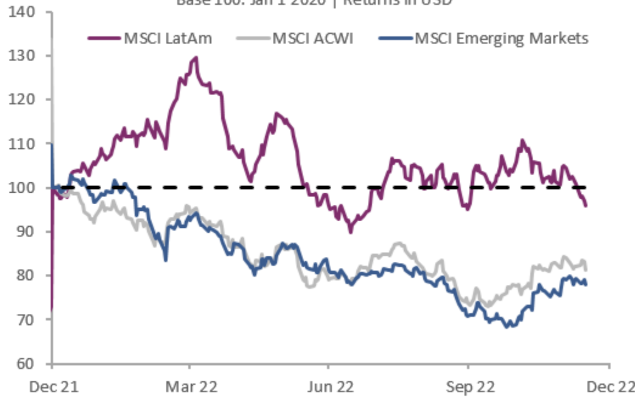
The government has also sought to push various tax and pension reform bills through Congress, although they are likely to emerge from the parliamentary process in a more diluted form before they become law. Given the refoundational (pensions) and radical (tax) nature of the reforms, a lengthy debate is expected in a Congress where the political forces are quite evenly balanced.

Peru's economy has slowed significantly as a result of lower manufacturing and mining production. In the specific case of mining, there have been frequent work stoppages due to disputes with local communities. Notably, the Las Bambas mine, which exports 2% of the world's copper, was operating at just 30% of its capacity in November. In view of the circumstances, the IMF estimates growth of 2.7% for this year and 2.6% in 2023. Inflation has picked up in the country once again, with the annual rate rising to 8.5% in November. So far, the Central Reserve Bank of Peru has raised the benchmark rate by 725 bp to its current level of 7.5%.

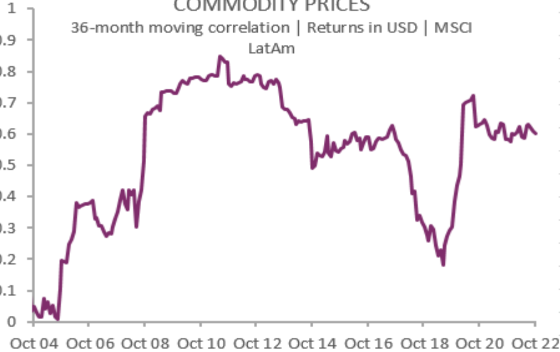
On the political front, the country has continued to endure an institutional crisis; tensions between the executive and legislative branches have persisted throughout the year, generating discontent among the citizens with respect to both branches (see Figure 14). The crisis has escalated to the point that on December 7 Pedro Castillo moved to dissolve Congress, although with no political or military support. In response, Congress convened a plenary session and voted for the third motion of impeachment against Castillo, which ultimately resulted in the president's removal from power, with former vice-president, Dina Boluarte, taking over. The new president appointed a technocratic cabinet and announced plans to bring forward the presidential and legislative elections to April 2024. However, the country has witnessed a wave of protests in the highland regions in support of Castillo and calling for the dissolution of Congress. This situation has kept the country on edge, with violence on the rise.

In **Argentina**, the complex economic and political scenario shows no sign of abating, with inflation spiraling to 92% annually in November (Figure 15) and expected to end the year at around 100%. Meanwhile, the central bank continues to increase the money supply (in October it expanded by more than 30% YoY), in a context of a highly depreciated currency, a country risk above 2,000 bp in bonds, and low international reserves. The central bank expects to meet the reserves target agreed upon with the IMF for the fourth quarter of this year thanks to its Soybean Dollar 2.0 program (exchange rate higher than the official exchange rate for soybean exports).

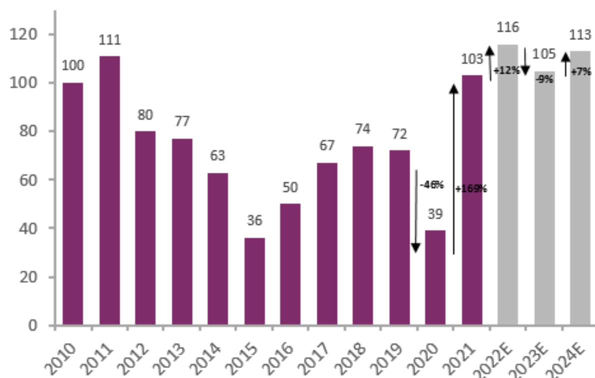
Presidential elections will be held in October 2023, in which the ruling party (Frente de Todos) faces a very competitive election, given the rampant inflation and bleak economic outlook. The ruling government coalition has yet to name a candidate, and the opposition seems to be the favorite at this stage according to the early polls.



Source: Bloomberg, data as of December 15, 2022



Source: Bloomberg, data as of October 31, 2022

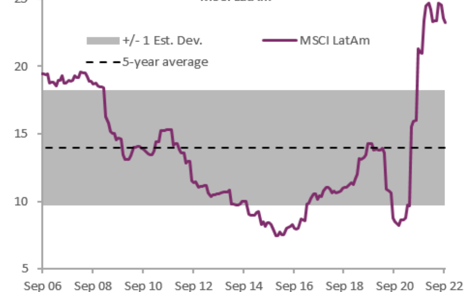


Source: Bloomberg and Morgan Stanley, data as of October 2022

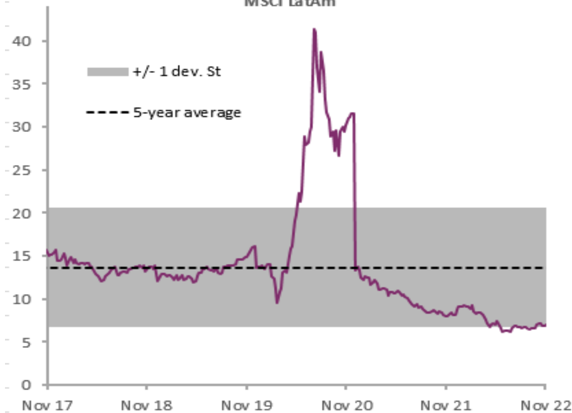
Why Latin American stocks?

Although Latin American stocks have been the best performers so far this year (Figure 16), there is still potential for further gains in the region's equities:

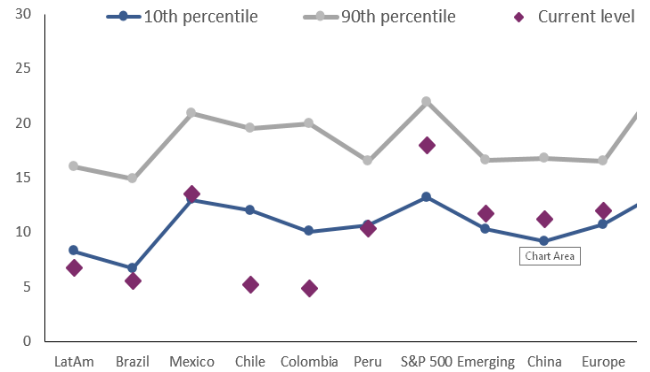
a) The interest rate hikes are either over or we are at the end of the contractionary monetary cycle;
b) Latin America boasts a privileged geographic location, shielding it from the current geopolitical conflicts and allowing it to benefit from the nearshoring trend resulting from deglobalization;
c) Latin America produces the raw materials needed for the energy transition (both the part needed now to bridge deficits and also moving forward) and part of the world's food supply. The new trends and the current global scenario will keep commodity prices stable, thus benefiting the region's stocks (Figure 17);
d) Corporate earnings of Latin American companies were quicker to recover from the shock caused by the pandemic, surpassing pre-pandemic levels and with profits expected to remain above pre-pandemic levels for the next few years (Figure 18). They also have high ROE, significantly above their 5-year average (Figure 19).
e) Attractive valuations (Figures 20 and 21) and high dividend yields (8% across the region vs. 3% for emerging markets).



Source: Bloomberg, data as of November 18, 2022



Source: Bloomberg, data as of November 18, 2022

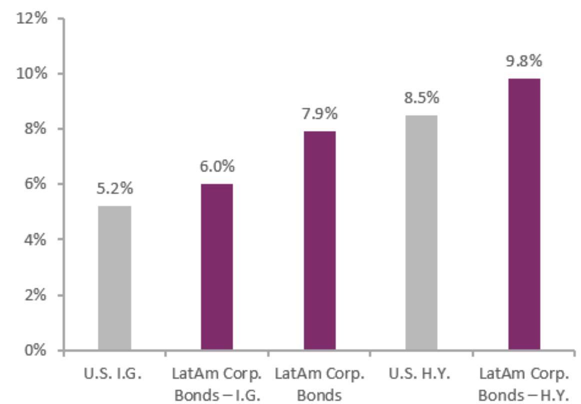


Source: Bloomberg, data as of November 18, 2022

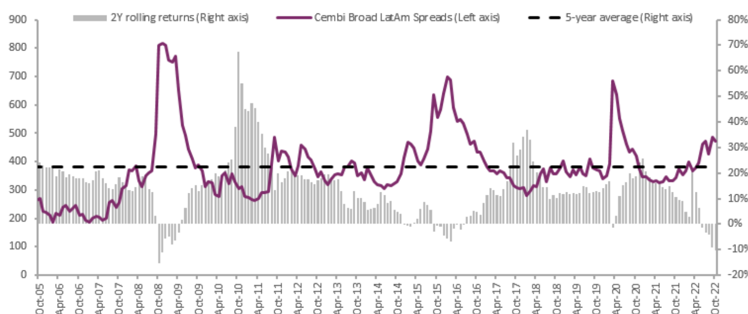
…and bonds as well

Aside from the positive momentum in Latin American equities, fixed income is also an interesting prospect.

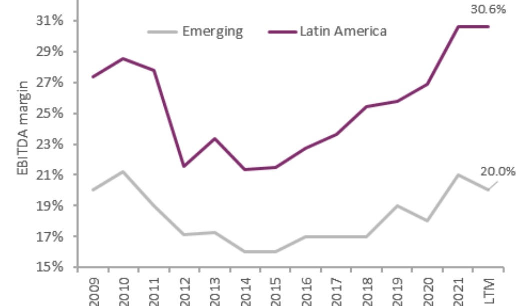
Interest rates have reached record highs, or are not far off, and this has generated high current yields along with potential capital gains, making it an attractive entry point. In addition, the spread (CEMBI Broad LatAm index) is above its 5-year average; a situation that has historically generated positive returns over the next two years (Figure 23).



Source: Bloomberg, data as of December 9, 2022

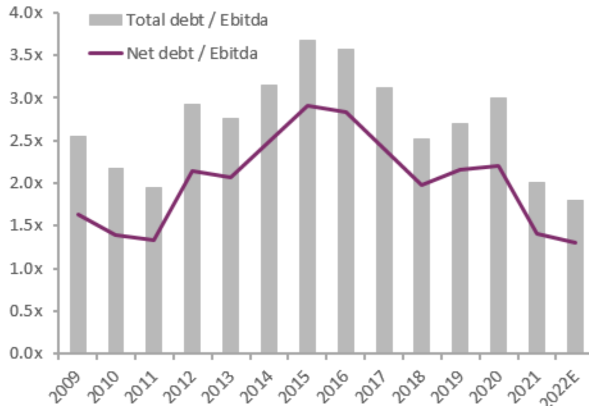


Source: Bloomberg, data as of October 29, 2022



Source: JPMorgan, data as of September 2022

Figure 25. LEVERAGE ON DOWNWARD PATH



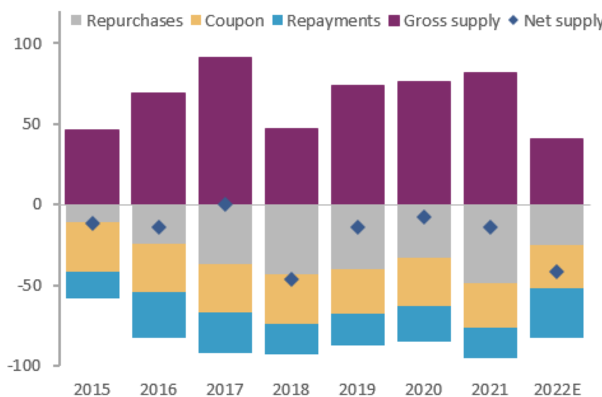
Source: JPMorgan, data as of November 21, 2022

TABLE 3

Default Rates on HY Corporate (%)							
Region	2017	2018	2019	2020	2021	2022E	2023E
Asia	1.0	2.5	1.8	3.4	13.2	16.0	11.4
EM Europe	3.6	0.0	0.0	3.3	0.0	21.7	27.4
Latin America	2.0	2.1	2.3	4.4	2.5	2.2	5.7
M. E. and Africa	3.2	0.0	1.6	2.1	0.0	0.0	0.7
Global EM	2.2	1.6	1.7	3.5	7.1	11.4	10.7

Source: JPMorgan, data as of November 8, 2022

Figure 26. LATIN AMERICAN BONDS: NEGATIVE NET SUPPLY



Source: JPMorgan and Barclays, data as of September 30, 2022

Latin American companies have strong balance sheets, thanks to the cost savings and efficiency gains achieved in recent years. This has improved their EBITDA margins ahead of other emerging economies (Figure 24). Moreover, Latin American companies have undergone a deleveraging process, steadily reducing their indebtedness since 2016 to bring it to its lowest level in almost ten years (Figure 25). While an increase in debt is expected moving forward, it will still remain low and will be better than the historical average.

This relatively healthy debt and liquidity position has led to low default rates compared to other emerging regions. Although defaults will likely increase next year, this will be limited to very specific cases. Even so, this risk remains relatively low (Table 3). As a result, Latin American companies are well positioned for a potential recession or a global context of higher long-term interest rates (versus the last decade).

From a technical standpoint, Latin American bond issuance has been declining since 2015, causing a negative net supply (Figure 26) and providing a support factor for bond prices.

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