August 2023

Latin American Mid-Year Update

Amid the current global landscape, the outlook for Latin America remains optimistic.

Cyclical:

- Central Banks in Latin America have started a cycle of interest rate cuts
- Inexpensive equity valuations
- Attractive bond yields and low risk of defaults

Structural:

- Privileged geographic location far from geopolitical conflicts
- Long-term support for commodity prices
- Good institutions that comply with checks and balances

Risks

- Internal socio-political events
- Global recession

A REGION WITH HIGH POTENTIAL

Markets are still facing growing geopolitical tensions at a global level. Central banks in developed countries are also sticking to their tight monetary policies, thus affecting growth prospects. However, there is room for Latin America to stay resilient and enjoy a privileged position in the present environment.

The global economy is expected to slow down and LatAm is no exception. The IMF projects positive growth for all countries other than Chile (Table 1) but several local institutions have adjusted their growth expectations upwards for a number of countries in the region (Brazil, Mexico and Chile). This is reflected in the stronger economic performance figures for the first quarter of the year, driven by resilient domestic demand, especially in services.

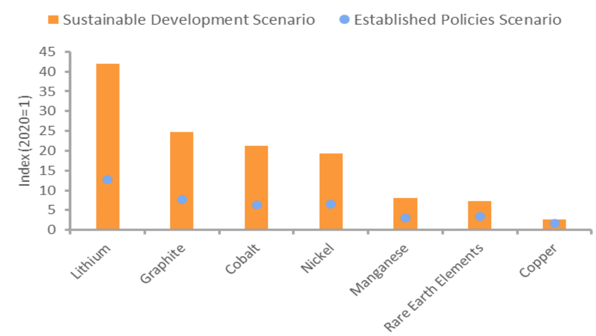
Latin America also benefits from cyclical and structural factors, including energy transition, which is making headway worldwide, and also provides long-term structural support to the region, as it produces greater demand for certain industrial metals. Some LatAm countries are leading producers of these inputs, such as copper and lithium. In a scenario where sustainable

TABLE 1: GROWTH PROSPECTS

IMF WEO Update April 2023	GDP growth (%)			Difference January 2023	
	2022	2023E	2024E	2023E	2024E
World	**3.4**	**2.8**	**3.0**	**-0.1**	**-0.1**
Latin America and Caribbean	**4.0**	**1.6**	**2.2**	**-0.2**	**0.1**
Brazil	2.9	0.9	1.5	-0.3	0.0
Mexico	3.1	1.8	1.6	0.1	0.0
Chile	2.4	-1.0	1.9	0.5	0.0
Colombia	7.5	1.0	1.9	-0.1	-0.2
Peru	2.7	2.4	3.0	-0.1	-0.2
Argentina	5.2	0.2	2.0	-1.8	0.0

Source: International Monetary Fund, April 2023.

FIGURE 1: DEMAND GROWTH FOR SELECTED MINERALS FROM CLEAN ENERGY TECHNOLOGIES BY SCENARIO
2040 vs. 2020



Source: International Energy Agency, data as of March 2023.

TABLE 2: INSTITUTIONALITY

	OPPOSITION PERCENTAGE IN THE SENATE	INDEPENDENCE: Judicial Branch	INDEPENDENCE: Central Bank
Brazil	43%	✓	✓
Mexico	52%	✓	✓
Chile	50%	✓	✓
Argentina	50%	✓	✗
Colombia	23%	✓	✓
Peru*	61%	✓	✓

Peru: Single Chamber Congress

Source: Compass.

development is achieved by 2040, growth in demand will more than double for certain industrial metals (Figure 1).

Furthermore, in the current climate of rising geopolitical tension and possible or ongoing armed conflicts (e.g., China-Taiwan and Ukraine-Russia), Latin America is geographically remote. While political volatility is a recurring feature, most of the major countries have managed to achieve institutional stability for more than two decades (Table 2).

In terms of cyclical factors, based on the prudent and timely actions of Latin American central banks, inflationary pressures are receding fast in the region (with the exception of Argentina). We observe gradual convergence towards inflation targets by 2024. In most of the region, the central banks' upwards monetary adjustments have already come to an end (Figure 2). Several countries are expected to cut their benchmark rates in the second half of the year, with Chile (in July) and Brazil (in August) being the first countries to launch a cycle of lower rates.

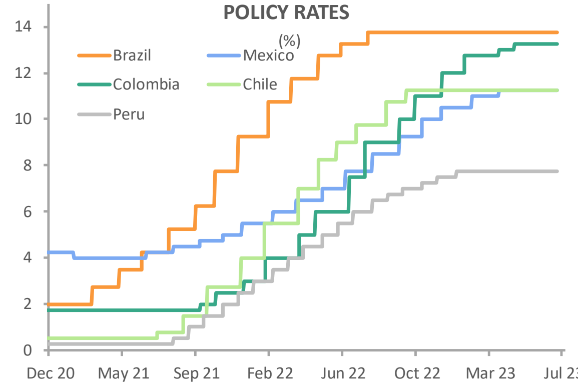
High rates and post-pandemic stabilization drove Latin American currencies higher during this year (Figure 3). These increases include the Colombian peso (22%), following the reduction of the country's current account deficit, and the Mexican peso (16.2%), which benefited from a steady inflow of capital and a resilient domestic demand, together with a significant interest rate spread with respect to the U.S. (600 bps.)

Lastly, the region as a whole has a relatively clear electoral/political horizon for the remainder of the year, thus easing political and economic uncertainty. Argentina will be conducting Primary, Open, Simultaneous and Mandatory (PASO) elections in August and presidential elections in October, where the opposition looks to be more likely to prevail, given the exacerbated social and economic crisis under the current government. Meanwhile, in December, Chile will be voting on the new constitutional draft, written by the committee of experts and the constitutional council in a more moderate tone that the previous one.

EACH COUNTRY HAS ITS PARTICULARITIES

The economy in **Brazil** performed better than expected after the GDP in Q1 delivered a surprising growth of 4.0% year-on-year (Figure 4), which was driven by positive agricultural and livestock figures. However, given the dynamics of these sectors, a slowdown is expected

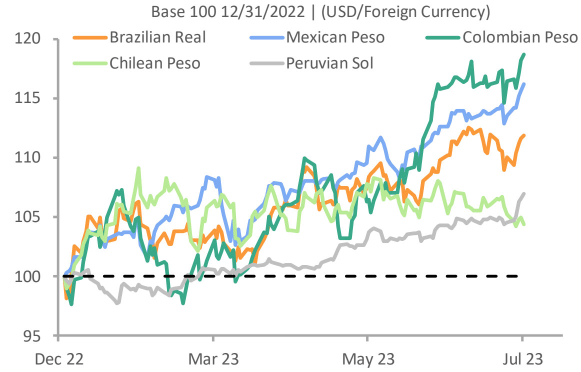
FIGURE 2. LATIN AMERICA: MONETARY POLICY RATES



Source: Bloomberg, data as of July 2023.

FIGURE 3. CURRENCY PERFORMANCE IN LATIN AMERICA

Base 100 12/31/2022 | (USD/Foreign Currency)



Source: Bloomberg, data as of July 2023.

Source: Compass.

in line with the global outlook, and the growth prospects for this year have been raised to 2.1% from 1.0% (IMF).

Noteworthy are the resilience of the services sector and the fact that its business expectations remain promising. Services PMI stands at 53.3 points, well into economic expansion territory (Figure 5). Good momentum in this sector is significant, given that it accounts for around 60% of GDP.

Meanwhile, inflation has been easing since last year, dropping in June to 3.2% over the twelve-month period (Figure 6). This was the result of well-timed monetary tightening (the Selic rate was raised by 1.175 bps to 13.75%). Based on the favorable performance of the latest inflation figures, the market is more confident with the prospect of benchmark rate cuts due to start in August (-25 bps) and expected to reach around 12% (-175 bps.) in December.

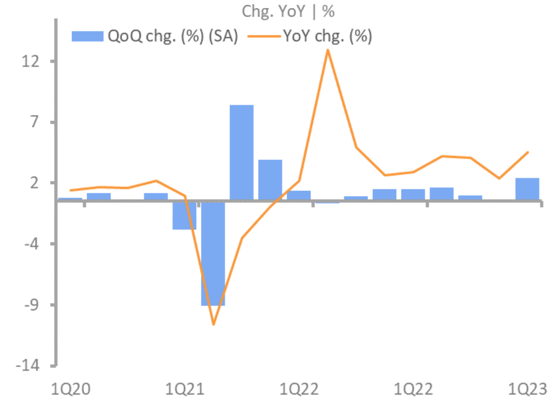
Furthermore, the Chamber of Deputies voted in favor of the fiscal rules without substantial changes to the government's proposal. However, some minor modifications were added to allow for greater spending control to keep 2024 fiscal spending lower than initially proposed. This was viewed positively by the market and is expected to be approved in the Senate, thus lowering the country's fiscal risk. The national monetary council also maintained its inflation target at 3% with a tolerance range of +/- 1.5%, and adopted a 2-year monetary policy horizon, which was also welcomed by the market.

In turn, for the second half of 2023, the government's agenda includes a discussion on taxes based on two projects: VAT and tax reform. With respect to VAT, between 3 and 5 current taxes are expected to be grouped together, simplifying the system. This measure has already been approved by the Chamber of Deputies and is pending approval –in all likelihood– by the Senate. The government also has a tax reform in mind, aimed at increasing tax revenues, with the following main pillars: 1) Taxation of exclusive funds, 2) Refund of taxes on dividends and 3) Amendment of wealth tax to avoid excesses. This will all depend on the results of congressional negotiations.

All in all, Brazil's outlook has improved, thanks to resilient economic activity and reduced political uncertainty, where pragmatism has prevailed after the government scaled back certain projects.

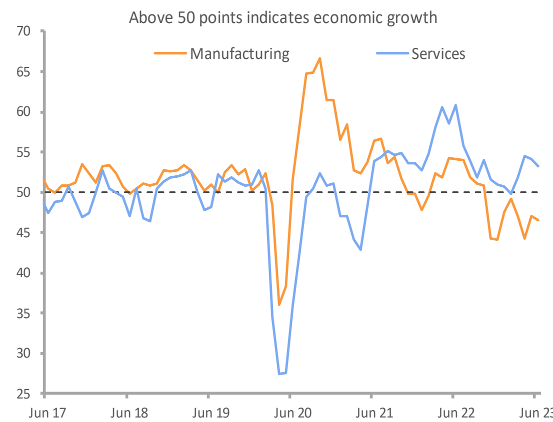
Mexico's economy remains buoyant, demonstrating resilient domestic demand and high remittance levels (Figure 7), which are driving consumption. This factor, together with positive business performance in the first quarter of this year, has led to an upward adjustment in the growth

FIGURE 4. BRAZIL: GDP



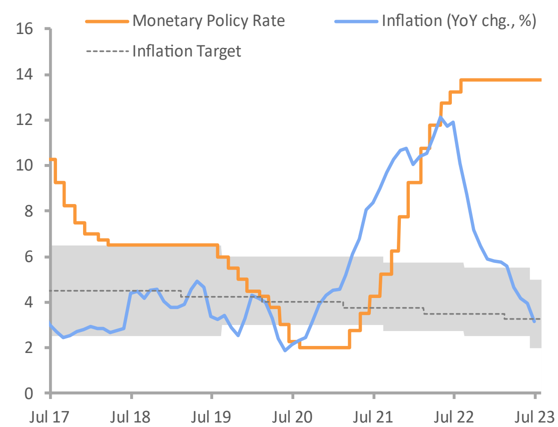
Source: IBGE, data as of March 2023.

FIGURE 5. BRAZIL: PMI MANUFACTURING AND SERVICES



Source: S&P Global, data as of July 2023.

FIGURE 6. BRAZIL: MONETARY POLICY



Source: Central Bank of Brazil, data as of July 2023.

outlook for 2023. The Central Bank (Banxico) expects GDP growth of 2.3% for this year, up from the 1.8% projected by the IMF in April.

Banxico has already stopped monetary tightening, holding the benchmark rate at 11.25% since its May meeting, as total and core inflation showed signs of easing, falling to 5.1% year-on-year in June (even services inflation peaked and an overall deceleration was recorded). As a result, the market expects the bank to stick to its benchmark rate in the coming months, with cuts of 25 bps due to fall in November and December of this year.

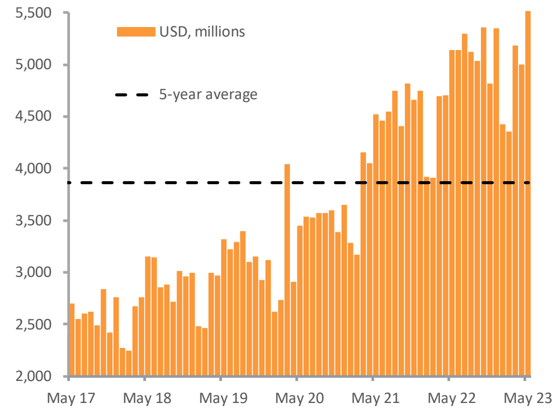
The de-globalization trend benefits Mexico structurally through nearshoring (moving a part of production to countries that are geographically closer). This will have a rapid and direct impact on the Mexican economy and is already taking place: U.S. imports from Mexico grew to more than 15% of the total (Figure 8). In addition, investment projects valued at approximately USD 28.6 billion have been announced in the country as of May of this year.

Economic activity in **Colombia** is expected to decelerate sharply this year (1.0% according to the IMF, Figure 9), driven mainly by declines in private consumption and a rapid drop in investment, reflecting the country's high political risk. This adjustment in the economy is expected to lead to normalization in the coming years, with more sustainable growth rates, albeit falling short of recent years.

After Banco de la República's aggressive monetary tightening, inflation finally peaked, and in June it dropped to 12.1% over twelve months (Figure 10). Nevertheless, slow convergence towards the target is expected for next year, ending 2023 with a projected 9.0%. At its June meeting, the Central Bank suspended its monetary tightening, keeping the benchmark rate steady at 13.25%, where it is expected to remain for the rest of the year.

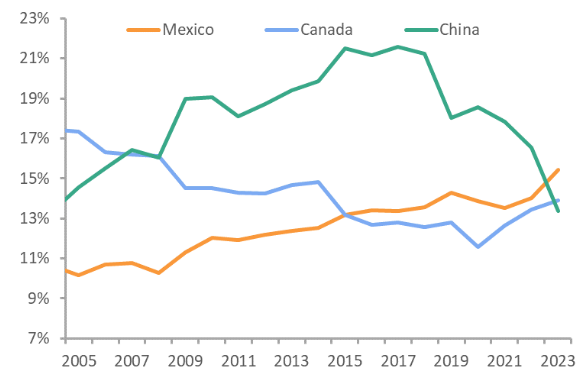
In a climate of high political uncertainty, several radical structural reforms are under discussion, including health and labor reforms, both of which passed in first debate. However, the pension bill did not gain the necessary quorum to be adopted before the legislative recess, representing a heavy setback for the government, although another proposal will be submitted during the second part of the year. However, there are still three more debates on health and labor reform scheduled for the second half of 2023, which will be challenging for a government with dwindling political capital, but nevertheless insisting on radical proposals and announcing a revised version of the labor reform to be submitted after the legislative recess. There is uncertainty in the Colombian market as a result of numerous structural reforms in the pipeline and an economic slowdown.

FIGURE 7. MEXICO: TOTAL REMITTANCES



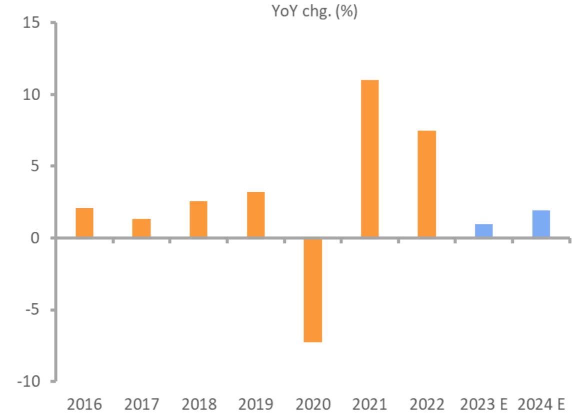
Source: Bloomberg, data as of July 2023.

FIGURE 8. U.S. IMPORTS BY COUNTRY OF ORIGIN
% of total



Source: US Census Bureau, data as of May 2023.

FIGURE 9. COLOMBIA: GROSS DOMESTIC PRODUCT
YoY chg. (%)



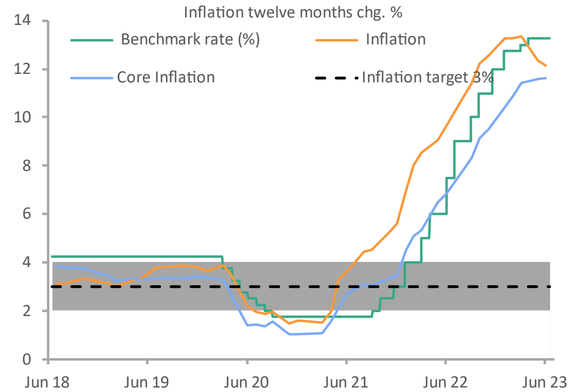
Source: International Monetary Fund, data as of April 2023.

In **Chile**, the economy performed surprisingly well in the first quarter, which wasboosted by the resilience of the services sector. However, it continues to decelerate with declines in activity, albeit reaching cyclical lows. Chile's Central Bank revised its growth range for 2023 downward, predicting a variation between -0.5% and 0.25% (Figure 11), with the only positive contribution coming from net exports.

Meanwhile, inflation continued to slow (Figure 12), dropping to 7.6% over twelve months in June, and as measured without volatility, falling to 9.1% year-on-year, with the expectation that this trend will continue. This factor, together with the more dovish announcement from the last monetary policy meeting (showing less restrictive bias), where the board decided to cut the MPR by 100 bps. ,with the swap curve internalizing a benchmark rate closing in December at 8.0% (-325 bps).

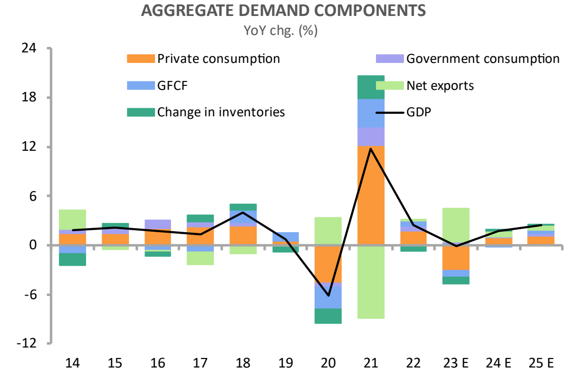
From a political standpoint, the expert commission finished preparing the preliminary draft, in a process characterized by moderation and consensus across the political spectrum. Work has continued within the constitutional council, tasked with preparing the draft bill and made up mainly of right-wing legislators. Furthermore, the *Partido Republicano* (strong right-wingers) has veto power and together with the *Chile Seguro* list (a moderate right-wing coalition) they exceed the quorum required to approve or incorporate new provisions into the bill. This therefore reduces the country's political risk, since radical proposals and overhauls are out of the question, providing institutional stability and market confidence. The process will conclude with a referendum on December 17 to vote on this new constitutional proposal. Thus, Chile's prospects have improved amid reduced political uncertainty –with the government also moderating its agenda– coupled with an upcoming cycle of interest rate cuts to boost the economy.

FIGURE 10. COLOMBIA: MONETARY POLICY



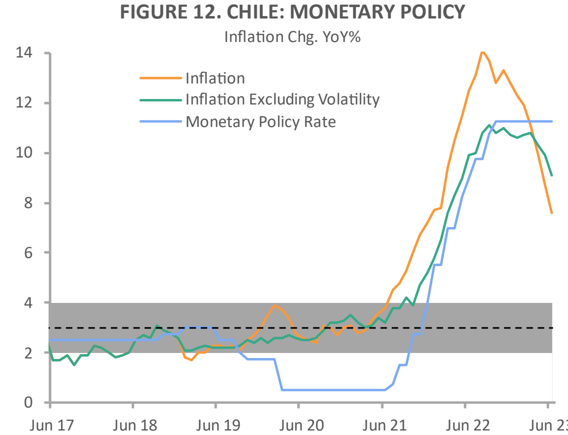
Source: Central Bank of the Republic of Colombia, data as of July 2023.

FIGURE 11: CHILE: GDP GROWTH AND THE IMPACT OF AGGREGATE DEMAND COMPONENTS



Source: Central Bank of Chile, data as of July 2023

FIGURE 12. CHILE: MONETARY POLICY



Source: INE, Central Bank of Chile, data as of July 2023

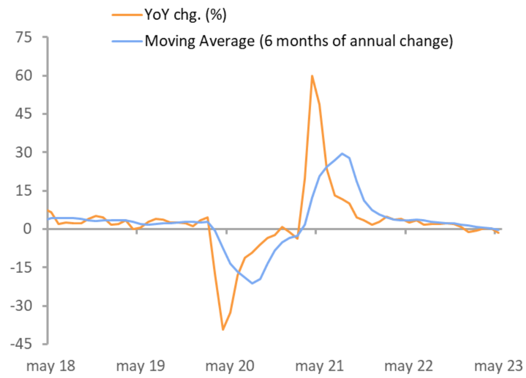
Peru's economy has continued to slow after May's economic activity (graph 13), with a disappointing contraction of 1.4% year-on-year, higher than the 0.5% expected, driven by a massive downturn in the fishing sector, which registered a 70.6% twelve-month decline. This factor, compounded by the effects of social mobilizations at the beginning of the year and adverse weather conditions (El Niño phenomenon), means that this year's growth outlook remains weak with growth expected to be around 1.5%.

Meanwhile, inflation is gradually slowing, currently standing at 6.5% in the twelve months to June (Figure 14), which is why the Central Bank held the benchmark rate at 7.75% at its July monetary policy meeting, and is expected to stay at this level until at least the fourth quarter of this year. Politically, the government continues to have high disapproval rates and limited political capital, but the status quo of a tense relationship with the congress is maintained, with the base scenario being that Dina Boluarte will conclude her term of office in 2026.

Argentina continues to face a challenging environment of macroeconomic imbalances, with economic activity affected by the worst drought in the last 30 years, leading the market consensus to downgrade the growth outlook for 2023 to -3.5%, from the 0.2% projected by the IMF in April. Meanwhile, inflation in June rose to 115.6% Y-o-Y (Figure 15), with inflationary pressures expected to continue and to end the year at around 150%. This is in addition to a negative level of net reserves, impacted by the lower harvest resulting from the drought, debt payments and by government interventions attempting to control the exchange rate gap between the official exchange rate and the blue-chip swap, which is around 100% (Figure 16).

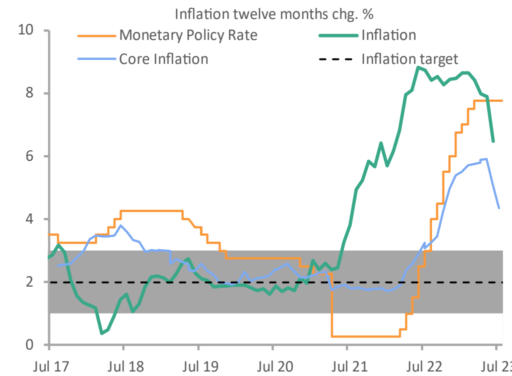
The Primary, Open, Simultaneous, and Mandatory (PASO) elections will be held on August 13 followed by the presidential elections on October 22. So far, the opposition is tipped to prevail in the presidential vote (Horacio Rodriguez Larreta for *Juntos por el Cambio*, being closer to the center than the other more radical right-wing candidate Patricia Bullrich), raising the risk that the ruling party will adopt populist measures during the year to reverse this situation, where its most likely candidate to win the primaries would be the current Minister of Economy, Sergio Massa. In turn, as the macroeconomic crisis deepens, the odds of more radical candidates such as Javier Milei are increasing, adding uncertainty given his controversial proposals (dollarizing the economy and getting rid of the Central Bank) along with having little political capital to negotiate and carry out his projects.

FIGURE 13: PERU: ECONOMIC ACTIVITY INDEX



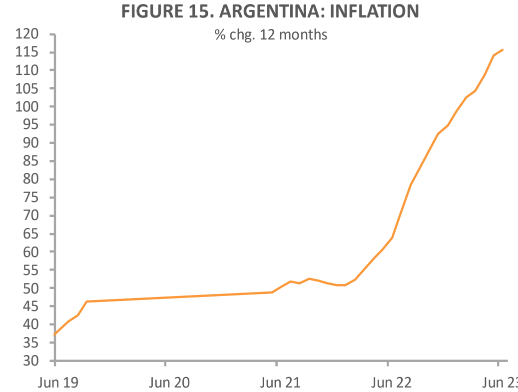
Source: INEI, data as of July 2023.

FIGURE 14. PERU: MONETARY POLICY



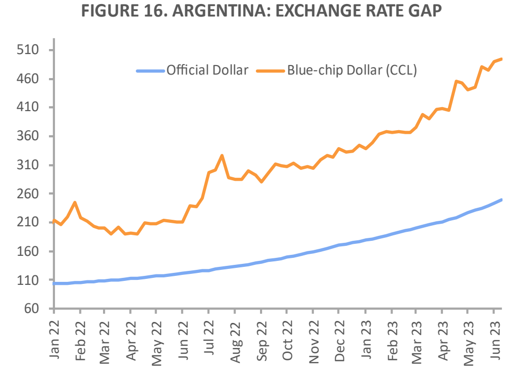
Source: Central Reserve Bank of Peru, data as of June 2023.

FIGURE 15. ARGENTINA: INFLATION



Source: INDEC, data as of June 2023.

FIGURE 16. ARGENTINA: EXCHANGE RATE GAP



Source: Bloomberg, data as of June 2023.

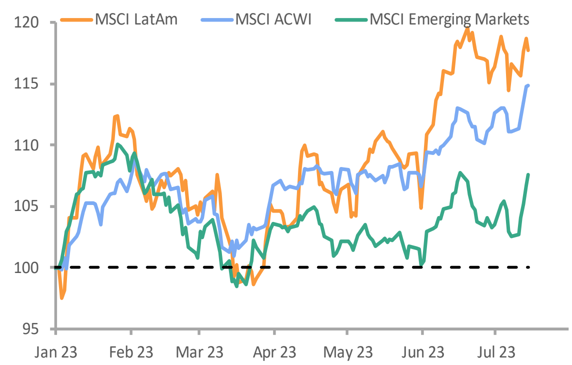
APPEAL OF LATIN AMERICAN STOCKS

So far this year, Latin American stocks have had an outstanding performance (Figure 17), and the region's equities maintain their upside potential.

- The geographic location is far removed from the current geopolitical conflicts; this benefits Latin American equities along with the structural support of nearshoring, especially in the case of Mexico
- The region's Central Banks have already put the monetary tightening cycles on hold and will soon begin lowering their benchmark rates, boosting the asset class, especially in the case of Brazil with its small-cap stocks (Table 3)
- Latin American companies experienced high ROE, exceeding the average of the last 5 years (Figure 18), together with high dividend yields (6% of the region vs. 3% for emerging markets)
- Valuations at a significant discount compared to their historical average and to the rest of emerging markets (Figures 1 and 20).

FIGURE 17. SHARE PERFORMANCE

Base 100: Jan 1 2023 | Returns in USD



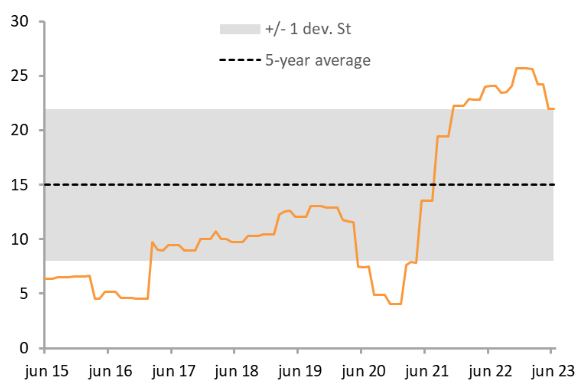
Source: Bloomberg, data as of July 14, 2023.

TABLE 3: STOCK PERFORMANCE IN RESPONSE TO INTEREST RATE CUTS

				USD Performance		Annualized
Cycle	Period	Mov. Selic Rate	Years	MSCI LatAm Small Caps (SC)	MSCI LatAm (LC)	Outperformance SC/LC
1	1999-2001	375	1.2	-4%	-14%	9%
2	2002-2002	100	0.7	-30%	-36%	8%
3	2003-2004	1000	1.2	70%	48%	18%
4	2005-2008	850	2.6	110%	154%	-10%
5	2008-2010	500	1.2	182%	108%	50%
6	2011-2013	525	1.7	6%	-7%	7%
7	**2016-2021**	**1225**	**4.4**	**20%**	**6%**	**3%**
	Median	**525**	**1.2**			**8%**
	Average	**654**	**1.8**			**12%**

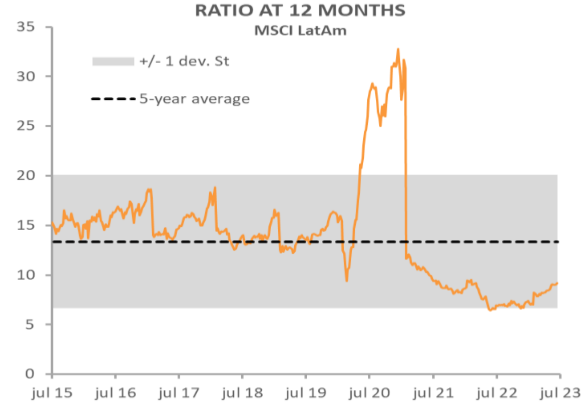
Source: Bloomberg.

FIGURE 18. ROE MSCI LATAM STOCKS

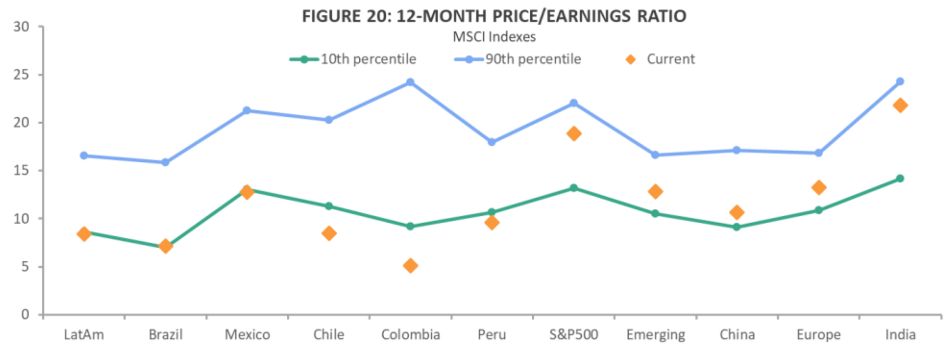


Source: Bloomberg, data as of June 30, 2023.

FIGURE 19. LATIN AMERICAN STOCKS: P/E RATIO AT 12 MONTHS



Source: Bloomberg, data as of July 14, 2023.

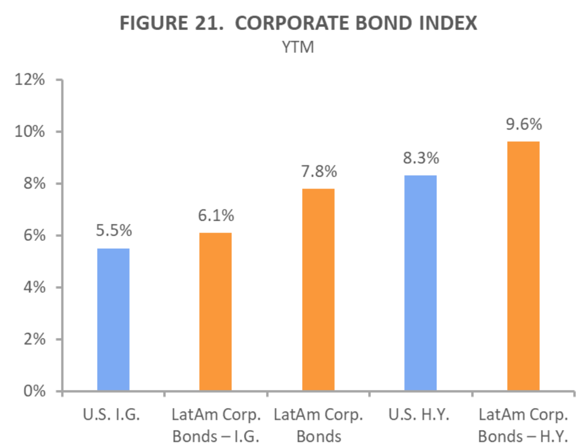


Source: Bloomberg, data as of June 30, 2023.

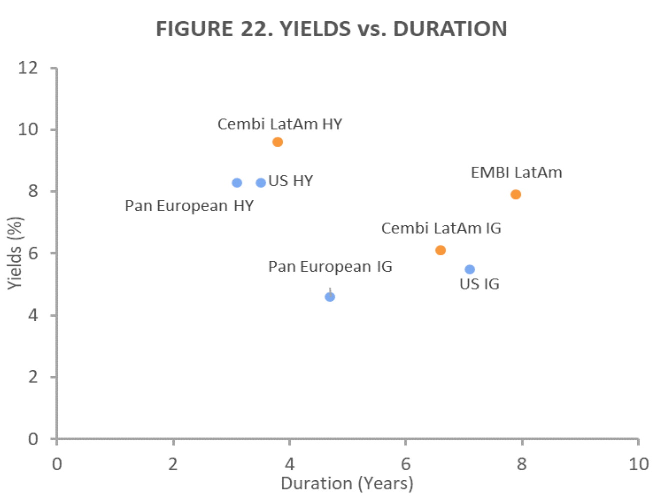
VALUE IN LATIN AMERICAN BONDS

Fixed yields in Latin America are also benefiting from factors that will provide support for the second half of the year. Fixed income yields in Latin America are also benefiting from factors that will provide support for the second half of the year. While Latin America's growth is expected to slacken off, the region has proved to be resilient. In addition, Latin American central banks embarked on early monetary tightening, which has now been completed in several countries and is poised to enter a cycle of benchmark rate cuts. This will boost economies in the second half of 2023 going into 2024.

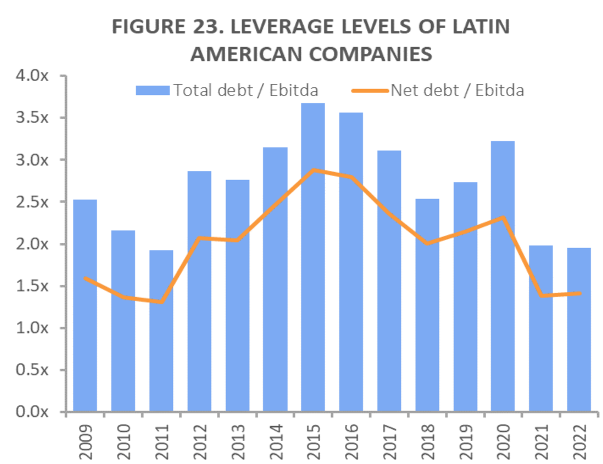
In a high global interest rate scenario, Latin American corporate bonds have high yield levels, thus performing strongly in terms of income (Figure 21), which in turn results in an attractive yield-to-duration ratio (a measure of sensitivity to movements in interest rates, Figure 22).



Source: Bloomberg, data as of July 14, 2023.



Source: Bloomberg, data as of June 30, 2023.

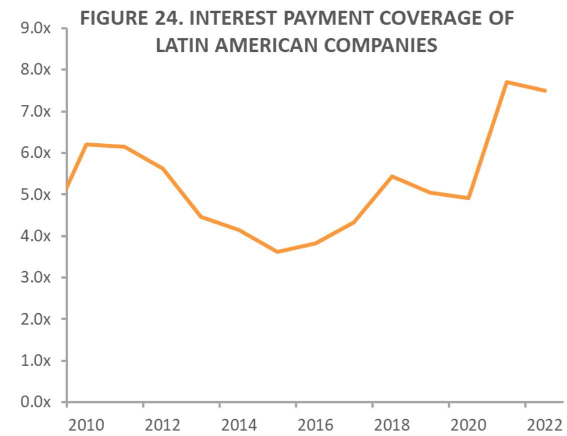


Source: JPMorgan, data as of May 2023.

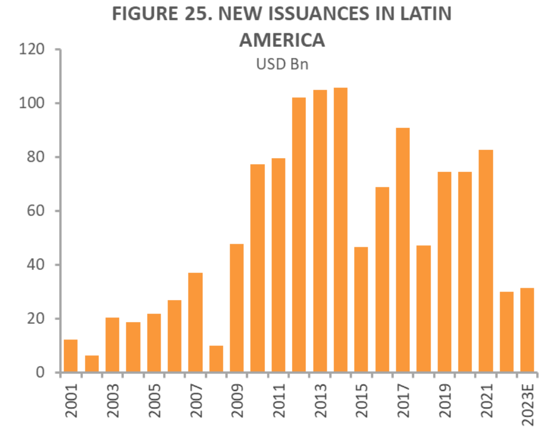
Latin American companies have undergone a deleveraging process, steadily reducing their indebtedness since 2016 to bring it to its lowest level in almost ten years (Figure 23), while maintaining a healthy level of interest payment coverage (Figure 24).

This relatively healthy debt and liquidity position has led to low default rates compared to other emerging regions (Table 4). Although the 2023 estimate has increased, it is explained by specific cases and is already internalized in market prices. Furthermore, no major increases are expected for the remainder of the year and normalization is expected towards next year.

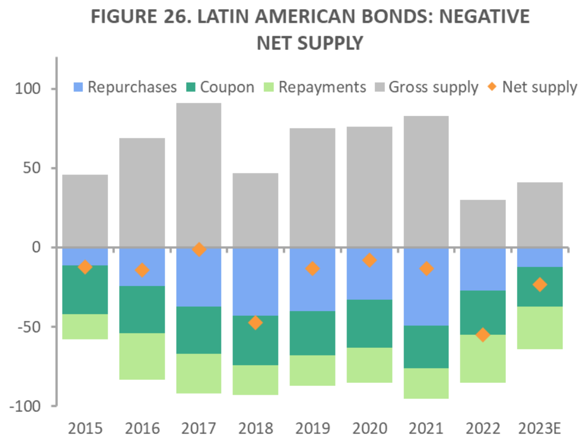
From a technical standpoint, Latin American bond issuance has been declining since 2015, causing a negative net supply, a pattern not expected to be reverted this year (Figure 25) and creating an entry opportunity for several names in the investable universe. This also generates a negative net supply (Figure 26) and provides support for bond prices.



Source: JPMorgan, data as of April 30, 2023.



Source: JPMorgan, data as of April 30, 2023.



Source: JPMorgan, data as of May 31, 2023.

TABLE 4: HY DEFAULT ESTIMATES

Default Rates on HY Corporate (%)								
Region	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023 YTD**	**2023E**
Asia	1.0	2.5	1.8	3.4	13.2	16.7	1.9	4.1
EM Europe	3.6	0.0	0.0	3.3	0.0	32.0	5.7	15.7
Latin America	**2.0**	**2.1**	**2.3**	**4.4**	**2.5**	**3.7**	**2.7**	**6.6**
M. E. and Africa	3.2	0.0	1.6	2.1	0.0	0.6	0.0	0.5
Global EM	2.2	1.6	1.7	3.5	7.1	14.1	2.4	10.7

Source: JPMorgan, data as of May 22, 2023.