Latin America: Truce or new era?

April 2024

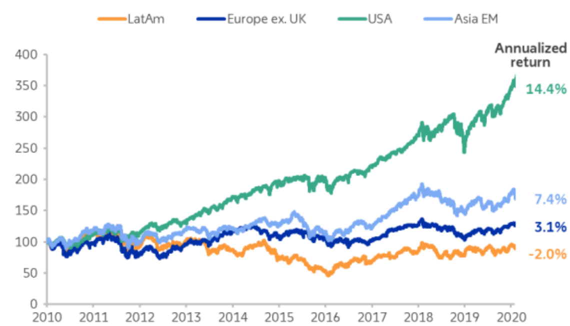
- Cyclical and structural factors support investments in Latin American assets:
  - Cyclical
    - Political pragmatism
    - Distance from armed conflicts and geopolitical tensions
    - Monetary discipline with an early start of interest rate cuts
  - Structural
    - Energy transition
    - Stable democracy and institutionality
    - Global fragmentation
  - Attractive valuations and favorable earnings momentum
  - High fixed income yields with a limited level of risk
- Risks include global inflation and higher rates, deep global recession, geopolitics, elections, and idiosyncratic factors.

EMERGING SIGNS OF RECOVERY AFTER A LOST DECADE

Between 2010 and 2020, Latin American economies did not grow, but rather contracted by an average of 0.4% per year. However, since the post-pandemic recovery, the regional economic momentum has resumed.

In the equity markets, the story is similar and the annualized return for the decade ending 2020 was USD -2.0% for the MSCI Latin America index. This was well below other regions (Graph 1). However, since 2021, there have been emerging signs of recovery; the stock markets have regained strength, outperforming other regions (Table 1). Furthermore, LatAm equity markets have increased preponderance in the global and emerging indices.

GRAPH 1. LATIN AMERICAN EQUITIES: MAJOR LAG
MSCI indices in USD | Base 100 = 12/31/2009 | Points



Source: Bloomberg.

TRUCE OR NEW ERA?

It is worth asking whether the trend of the last two years for Latin American markets is just a "truce" after a disappointing decade, or could it be the beginning of a new era?

Cyclical and structural factors point to what appears to be a regime change. The region's assets have attractive fundamentals to keep standing out in global markets.

Table 1. Stock Market annual performance (%, in USD)

2019	2020	2021	2022	2023
USA 28.8	Emerging Asia 26.0	USA 25.2	LatAm 8.9	LatAm 25.1
Europe 20.0	USA 18.4	Europe 13.8	Europe -17.3	USA 25.0
LatAm 17.5	Europe 3.1	Emerging Asia -6.6	USA -20.5	Europe 16.4
Emerging Asia 16.6	LatAm -13.8	LatAm -8.1	Emerging Asia -22.8	Emerging Asia 5.6

Source: Bloomberg.

CYCLICAL FACTORS FAVORING LATIN AMERICA

Cyclical factors have provided an additional boost to the performance of regional assets, as some have reaffirmed the region's structural strengths. The following is a summary of the tailwinds that Latin America is experiencing in this part of the cycle.

1. Political pragmatism

Political volatility is inherent to the region, which is different from other developed markets. The impact of these swings on the prices of the different asset classes is significant.

However, governments and congresses have shown pragmatism. Radical reforms that were included in some of the government programs have not been approved and institutionalism has prevailed.

In Brazil, for example, the Finance Minister has been a key figure in promoting fiscal responsibility. Following the primary fiscal surplus figure in January, the market is ruling out a revision of the 2024 fiscal target in March.

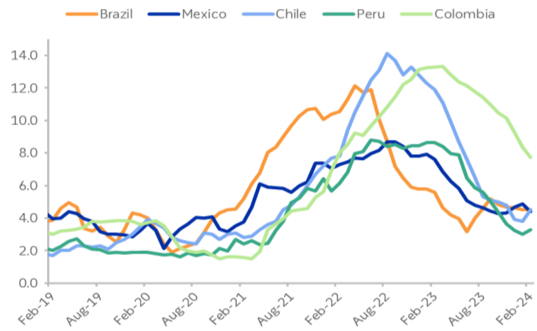
In Mexico, with the exception of the constitutional reform proposals announced in the last month, AMLO's government has proven to be pragmatic. It maintains an approval rating above 50% and has been characterized, -although somewhat less so in the 2024 budget,- for being fiscally responsible.

In the cases of Chile, Peru and Colombia, presidential disapproval is evident, and the loss of political capital (especially for Colombia's president Petro) has prevented the approval of radical and structural reforms. In Peru, dissatisfaction with the executive led the government to lean somewhat more to the right and coordinate with Congress to stay in office until 2026. Finally, the election of Javier Milei in Argentina, a clear outsider, showed that the population no longer wants more of the same.

2. Monetary discipline is paying off

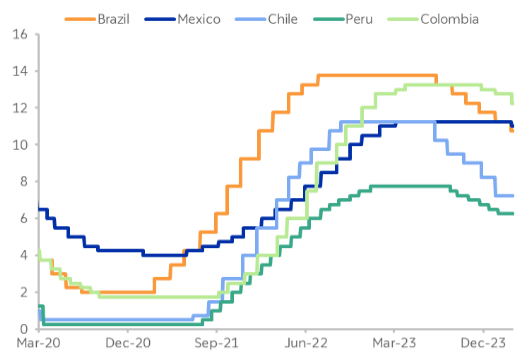
The inflationary period experienced worldwide after the pandemic was a phenomenon not observed in developed countries since the 1980s. However, given the region's experience with episodes of high inflation, central banks made early and aggressive monetary adjustments, raising reference rates rapidly to counteract the accelerated and sustained growth of price levels. This managed to reverse the upward trend of inflation (Table 2).

GRAPH 2. INFLATION
%Chg. YoY



Source: Statistical institutes of the region, data as of February 2024.

GRAPH 3. REFERENCE RATES
%



Source: Central banks, data as of March 2024.

Table 2	Reference rate (%)		
	2023	2024e	Expectation of cut 2024 (bps.)
Brazil	11.75	9.75	-200
Mexico	11.25	9.75	-150
Colombia	13.00	8.00	-500
Chile	8.25	4.50	-375
Peru	6.75	4.50	-225

Source: Central banks, Compass.

The experience of the region's monetary authorities allowed them to anticipate the cycle of cuts. In the second half of 2023, central banks began to partially reverse the increases they had carried out in their reference rates. **In this context (and in chronological order), Uruguay, Chile, Brazil, Peru, Colombia and Mexico have already started with reference rate cuts**, giving a break to financial conditions which limited economic growth to a lesser extent. (Graph 3) This easing is expected to continue for the rest of the year (Table 2).

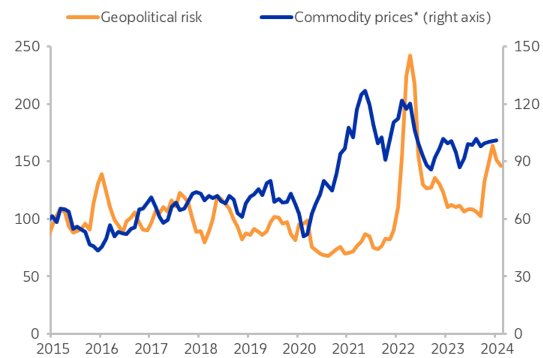
On the other hand, the Central Bank of Argentina announced a cut in the monetary policy rate (for deposit liabilities) to 80% (from 100%) and eliminated the minimum rate for term deposits.

3. Geographical distance from armed conflicts and geopolitical tensions

Geopolitical tensions have risen in recent years due to ongoing military conflicts. These, together with trade disputes and other clashes, have heightened the sense of geopolitical risk globally.

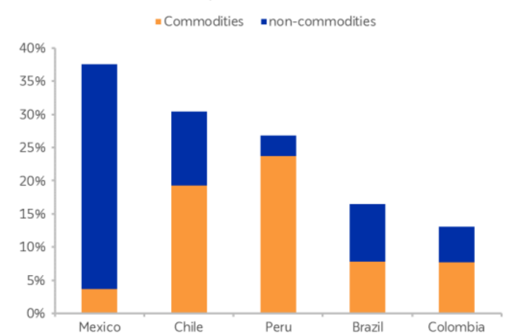
However, the region has benefitted in several ways. Since we are geographically distant, supply chains -especially with the West- are not altered. Thus, we can be a focal point of trade diversification with other regions. In addition, there is a positive correlation between the level of global geopolitical risk and *commodity* prices (Figure 4). A higher level of *commodity* prices is particularly favorable for the region (Graph 5), since countries in the region are small and have open economies. These countries have a high share of exports in their production matrix and, with the exception of Mexico, a high share of raw materials in exported goods.

GRAPH 4. GEOPOLITICAL RISK RISES WITH COMMODITY PRICES



* Simple average between oil, copper and iron in base 100.
Source: Bloomberg, Caldara, Dario, and Matteo Lacoviello(2021).

GRAPH 5. ECONOMIES WITH A COMMODITY EXPORT BIAS
Exports as % of GDP



Source: IMF, DANE, BCRP, INEGI, INDEC, BCCH, Ministério do Desenvolvimento, Indústria, Comércio e Serviços

STRUCTURAL FACTORS FAVORING THE REGION

Despite the political ups and downs and the emerging nature of the region, there are structural factors that provide some stability and confidence to investors when investing in Latin American assets.

1. Democracies that work

According to the democracy index constructed by *The Economist Intelligence Unit* (2023), the countries in the region maintain a higher level of democracy compared to the rest of the emerging nations, with *the* exception of small economies with low capital market depth.

Of the 167 countries analyzed by the index, only 24 of them are characterized as "full democracies," of which two countries in the region (Uruguay and Costa Rica) are included. Among the other economies analyzed, Argentina, Brazil, Chile, and Colombia are classified as "deficient democracies," a category they share with countries such as the United States and Belgium. Mexico and Peru are hybrid regimes, as are countries such as Hong Kong, Turkey, and Morocco. However, none of them are classified as authoritarian regimes, as is the case of Cuba, Venezuela, Saudi Arabia and China.

In this way, and with its weaknesses, the international analysis shows that democracies in the region work. This is also evident when analyzing the independence of central banks, judicial systems and the counterweight faced by the executive powers in the congresses, which prevents the approval of radical initiatives and maintains a certain stability.

2. Energy transition

The region produces key commodities for the energy transition, and the evolution and increase in demand will support greater growth and economic stability. For example, Latin America has around 50% of global reserves of lithium, 35% of copper and 20% of iron. All of the above are used intensively in renewable energies and transport electrification. Relevant examples worth mentioning are the following: an electric vehicle battery uses around 8 kilos of lithium and 35 kilos of nickel while a wind turbine is made with 5% to 17% iron.

At the same time, the potential increase in demand for these raw materials associated with a transition to renewable energies and the electrification of transportation is significant. In the scenario in which the "net zero" committed in the Paris Agreement (bringing carbon emissions to zero) is achieved, the demand for copper would triple by 2040 (Graph 6).

3. Global fragmentation and nearshoring

The economic and political globalization that began in the 1980s is showing some reversal. With the increase in geopolitical risk, disruptions in supply chains that began during COVID and trade tensions, among other factors, trade relations between the world's economic giants began to deteriorate.

For example, following the trade restrictions imposed by the U.S. on China, the former opted to secure the supply of certain products and intensified its trade relationship with Mexico. Given Mexico's geographic proximity, possible geopolitical conflicts and global pandemics can be prevented from interrupting supply. This phenomenon is known as nearshoring and is formally defined as the transfer of part of the production to another country with lower costs and geographical proximity. Mexico became the main supplier of U.S. imports in 2023, surpassing China and Canada, which had occupied the first position for at least the last 20 years.

The authorities of the Western European and North American powers began to talk about energy and food security in response to what happened during the pandemic. This was exacerbated by the Russian invasion of Ukraine. In this context, the region takes on a key role in global trade, thanks to the disproportionate amount of natural resources it possesses. Besides raw materials for the energy transition, Latin America has 31% of fresh water and 15% of land mass. This translates into figures estimated by the Food and Agriculture Organization of the United Nations (FAO), which suggest that Latin America and the Caribbean produce 53% of global agricultural production.

In this way, and in a context of greater global fragmentation between the West and the East, the region has an opportunity, with trade routes free of tensions and conflicts, to acquire a more prominent role in global trade.

OTHER CHALLENGES AND OPPORTUNITIES

Latin America grew around 2.5% in 2023, which compares to 4.1% in 2022. This estimate was revised upwards from the IMF's previous *World Economic Outlook*. Looking ahead, the scenario becomes more challenging. The IMF projects growth of 1.9% for this year, which would accelerate to 2.5% next year, correcting downwards the estimate for 2024 (Figure 7).

On the other hand, the greater expansion projected for the two largest economies in the region, Brazil, and Mexico, stands out. However, Argentina is the major detractor; given the fiscal adjustment proposed by the government, the IMF went from forecasting a growth of 2.8% for 2024, to an economic contraction of the same magnitude.

On the Chilean, Peruvian and Colombian side, growth expectations point to economic activity beginning to normalize after a tough 2023.

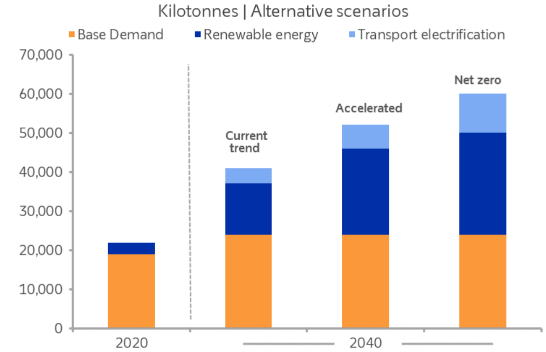
On the economic momentum side, performance is mixed. **Mexico** enjoys an economic activity that is growing in annual terms but is slowing down in the most recent period. Within the sectors, expansions linked to local activity, such as construction, continue to stand out. At the same time, Mexico's structural support from nearshoring gives an additional boost to economic activity, considering that its main trading partner is the U.S., whose economy is expected to remain dynamic.

In the case of **Brazil**, momentum is positive, but also deteriorating to some extent. However, the successive upward surprise in data releases relative to market expectations stands out, which is in line with economic resilience.

In **Chile,** the economic adjustment was severe and necessary after the consumption boom derived from the expansive policies during the pandemic, together with the withdrawals of pension funds. In recent months, economic data began to show signs of normalization, which was supported by the low base of comparison left by 2023.

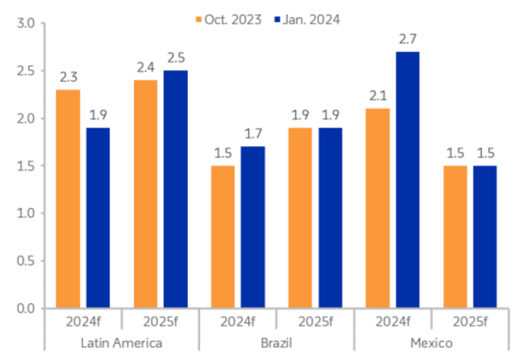
In **Colombia, Peru and Argentina**, the outlook is more negative, but 2024 will be a better year for the Peruvian economy, with a deteriorated starting point. Each country with its particularities, what lies ahead is especially challenging for Argentina which, with the policies promoted by the new government, will undergo a period of high economic instability.

GRAPH 6. ENERGY TRANSITION DRIVES COPPER DEMAND
Kilotonnes | Alternative scenarios



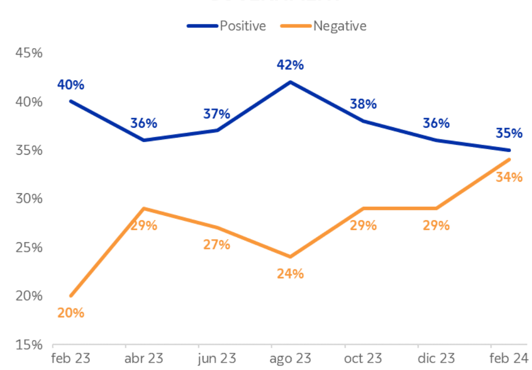
Source: Bp Energy Outlook, July 2023.

GRAPH 7. ECONOMIC GROWTH FORECASTS
%



Source: International Monetary Fund.

GRAPH 8 APPROVAL OF LULA'S GOVERNMENT



Source: Quaest, data as of February 2024.

LET PRAGMATISM CONTINUE TO REIGN

Brazil to meet fiscal target

January left a primary fiscal surplus of R$ 102.1 billion, which gave the government hope of avoiding, or at least postponing, the revision of the fiscal target of primary balance equal to 0% of GDP for 2024. Thus, with the publication of the fiscal report of March 22 (which is published every two months), the tax collection figures led the market to rule out an adjustment of the target for this year. However, it might be necessary to adjust the 2025 target in a future date (primary surplus of 0.5% of GDP).

In 2023, the legislative discussion in Brazil was marked by the approval (and progress) of tax reforms, with the intention of reaching the fiscal target. Regarding the next tax reform, it is likely that the project will be divided, and the discussion of tax changes will be postponed until the end of this year.

Approval of Lula's administration has dropped according to the latest polls (Graph 8), which warned the executive power and led him, in his first ministerial meeting of 2024, to convey to the cabinet the need to implement programs and improve communication. Concerns about food prices, health and security were among the priorities. However, in the absence of announcements of populist measures, the authority seems not to be "panicking" yet.

Nevertheless, and considering the October municipal elections, these could lead the executive to impart populist measures to maintain control of some municipalities. Although it is too early to think about results, the market estimates that the legislative agenda will be paused in the middle of the year and the political focus will be concentrated on voting.

On the Central Bank side, the term of the current governor Roberto Campos Neto expires at the end of 2024. The market has internalized that he will be replaced by Gabriel Galípolo, who is a member of COPOM and has a political bias close to the executive branch.

Mexico, tale of two halves

In Mexico, the year will be separated by the outcome of the June 2024 elections. In addition to voting for the new president of Mexico, 128 senators, 500 deputies, some governorships, municipal presidencies, unions, and councils will be elected. **The market has internalized that the next president will be the pro-government candidate Claudia Sheinbaum (Graph 9), but the resulting composition of the Congress will determine whether it will be possible for her to advance (or not) in her government program.** The base scenario is that Morena will not obtain a constitutional majority.

In an economic context, AMLO's government will have culminated with a minimum wage hike of ~180% (nominal) from start to finish. With this in mind, an eventual Morena government could mean greater fiscal pressures and pose a risk, considering that they announced 20 constitutional reforms in February. Some of the reforms are associated with higher expenditures, such as the minimum wage reform (which allows it to increase more than inflation) and the pension reform (with a 100% replacement rate financed with fiscal coffers). The latter has a low probability of being approved.

Going forward, **the government's commitment to economic growth and the installation of incentives to promote nearshoring,** a structural trend that favors the Mexican economy and reflects the pragmatism of the executive, **will be decisive.** Mexico is one of the main winners of the partial decoupling between the U.S. and China. This has led to reallocate investments outside the Asian giant to countries with greater proximity to the main Western economies, as well as with lower costs, estimating that it can add more than 1 percentage point of annual GDP in an optimistic scenario.

Chile, less uncertainty

In the run-up to 2024, policies in Chile will likely focus on the urgent needs of the population which have been sidelined for four years on account of the constitutional reform debate.

The government has watered down its objectives in a context in which it lacks a majority in the Senate (Graph 10). Therefore, pro-growth measures are needed during this year, which will allow the country to emerge from economic stagnation.

To that end, **the government has highlighted pension, fiscal and health reforms respectively as its legislative priorities for this year.** Thus, these issues will lead the political agenda in the first half of the year.

As in Brazil, Chile will hold regional elections in October, which will again confront a fatigued electorate that has had more than 10 elections since 2020. This might paralyze legislative work and, due to rule changes that will debut automatic registration and mandatory voting, elevate electoral participation in the context of widespread presidential disapproval (Graph 11).

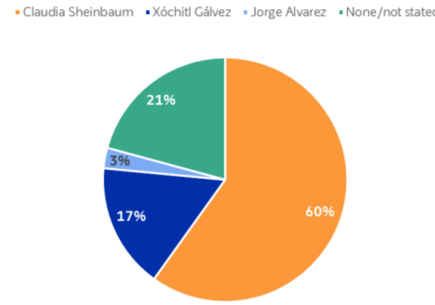
Peru, status quo

The base scenario that Dina Boluarte will continue in power until 2026 together with the current Congress remains, with a high but stable degree of instability and a government that has been on "survival mode" to avoid suffering the same fate as the previous ones.

There have been events that add political volatility to the scenario, such as the corruption cases in the public prosecutor's office, the resignation of the prime minister associated with an irregular contract and money transfer in the public sector, and the embezzlement accusation against the president. Furthermore, the reinstatement of bicameralism was approved, which in turn reintroduces parliamentary reelection. According to the market, this would not reduce political volatility.

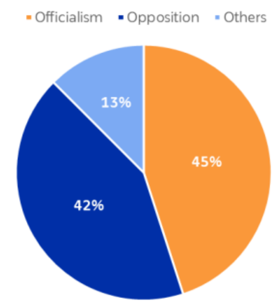
Lastly, the eventual approval of the seventh withdrawal of pension funds is postponed and would materialize in the second quarter.

GRAPH 9. MEXICO PRESIDENTIAL POLL
Gross preference | %



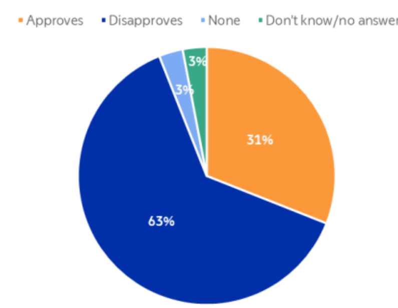
Source: Mitofsky, February 2024.

GRAPH 10. COMPOSITION OF THE CHILEAN SENATE
%



Source: Senate of Chile.

GRAPH 11. PRESIDENTIAL APPROVAL IN CHILE
%



Source: CADEM, data as of March 15, 2024

Colombia, the government loses power

The ruling party in Colombia has quickly lost political capital as Petro garners the worst presidential approval in the region. **This was made evident by the results of the 2023 regional elections, in which the opposition triumphed by large majorities as the government coalition fractured and lost partial representation in Congress**.

The Petro administration's controversial reforms have lost popularity, slowing their progress and leaving them at risk of being shelved if not approved before June 20. The administration's key legislative objectives, namely health, pension, and labor reforms, are all facing difficulties in the legislative body. The latter has been postponed and the first two reforms are experiencing significant gridlock in Congress.

As a last-ditch attempt at restoring some political credibility, the president's latest announcement consisted of calling for a constituent assembly around a series of issues. **Although the president shared a list of eight points, the approval of none of these items are likely to pass without absolute majorities in Congress.**

Argentina: what goes up, must come down

The inauguration of the new government came with the announcement of sweeping reforms to reduce the fiscal deficit. Among them were the Decree of Necessity and Urgency (which includes more than 300 items aimed at deregulating the economy), currency devaluation, and the introduction of Omnibus spending package, which included the reduction of the number of deputies and privatization of some public companies) among others. Both, the decree and the Omnibus law failed in Congress, although a compressed version of the latter was announced, which has roughly one third of the articles.

The government's objective with these sweeping reforms is to swiftly correct the significant macroeconomic imbalances through a sharp reduction in the supply of money and of aggregate demand, so that positive trends for inflation and the overall economy appear sooner rather than later. As a result, economic activity figures for the end of 2023 and the beginning of 2024 have shown significant deterioration, while on the other hand the inflation rate has dropped considerably, as in February it registered a month-over-month increase 13.2%, roughly half of the peak rate of growth the Milei administration saw in December.

The government confidence index (GCI) remains high but declined in February for the second consecutive month. At the same time, after 100 days in office, presidential approval reached 51.5%. On the other hand, the same survey saw 59.8% of respondents indicate that the country's economic situation is worse than before Milei took office.

LATIN AMERICAN STOCKS OVERPUNISHED

Latin American equities were among the big winners in 2023, where they enjoyed a double digit "Santa Rally" during the last two months of the year. Looking ahead towards 2024, the region's risky assets have the economic underpinnings and solid fundamentals to maintain outperformance.

In this context, and in contrast to other regions of the world, **valuations continue to be attractive** (Graph 12). Thus, and in historical terms, the discount of Colombian stocks stands out with a 12-month P/E forward trading at roughly 0.8 standard deviations below 5-year average, while Mexico, Chile and Brazil exhibit a smaller, but still attractive, discount.

In addition, **profit growth projections for this year are positive**, and have adjusted upwards in recent months, pointing to a 7.5% increase in 2024 and an 8.0% increase in 2025, leaving behind the declines of 2023 (Figure 13).

Cuts in the benchmark rate are expected to support economic activity and risky assets, as they provide cheaper debt and bring rates for discounting cash flows to levels closer to those seen during the last ten years. The **macroeconomic stability** of the region, which will allow it to maintain its growth rate in 2024, also supports stock performance.

The outlook of the region continues to improve through the **momentum of investment flows**, as net inflows to the region's main ETF amounted to 30% of AUM in the last year.

BONDS THAT PAY, WITH LESS RISK

Regarding fixed income, a number of factors also support the investment thesis for this region relative to other areas.

Corporate bond yields are higher than counterparts in developed countries, as companies maintain low levels of leverage since they peaked in the second quarter of 2016 (Graph 14). Thus, Latin American bonds pay more when adjusted for issuer credit risk (Graph 15).

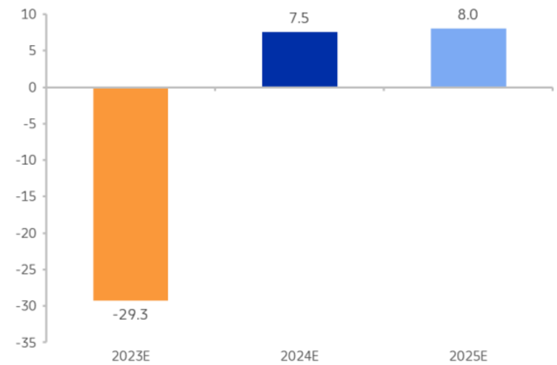
The improvement in average credit quality compares positively with indices of other emerging regions, as evidenced by **relatively stable default rates** that haven't experienced the striking increases seen in recent years in other regions more exposed to geopolitical conflicts (Table 3).

On the local debt side, interest rates have attractive accruals, in addition to potential capital gains. With respect to currencies, there is some appreciation capacity, with the exception of the Mexican peso.

GRAPH 12. VALUATIONS
Best Price/Earnings | MSCI Indices

Source: Bloomberg, data as of March 20, 2024.

GRAPH 13. LATIN AMERICA: LESS TO MORE
Estimated earnings growth | YoY % Chg.



Source: MSCI, Facset, data as of March 15, 2024.

Table 3. Default rates								2024F	
	2017	2018	2019	2020	2021	2022	2023	Ex. 100% quas	Inc. 100% quasi
Asia	1.0%	2.5%	1.8%	3.4%	13.3%	16.8%	10.0%	4.5%	4.5%
Europe EM	3.6%	0.0%	0.0%	3.3%	0.0%	31.4%	20.8%	3.0%	2.6%
Latin America	2.0%	2.1%	2.3%	4.4%	2.5%	3.7%	5.4%	5.6%	3.9%
EMEA	3.2%	0.0%	1.8%	2.1%	0.0%	0.6%	0.0%	0.5%	0.4%

Source: JP Morgan, data as of year-end 2023. Ex./Inc. 100% quasi = Excludes/includes quasi-sovereign paper.

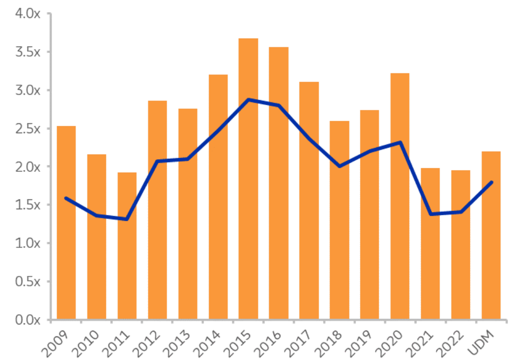
EVERY SCENARIO INVOLVES RISKS

Despite the positive outlook, the region is still subject to both global and local risks.

Globally, there is a risk that economic growth will stabilize at structurally lower levels, while both inflation and interest rates will remain higher for longer. Despite the particular tailwinds for the Latin American economies, external circumstances and the possibility of borrowing at structurally higher rates could dampen economic activity.

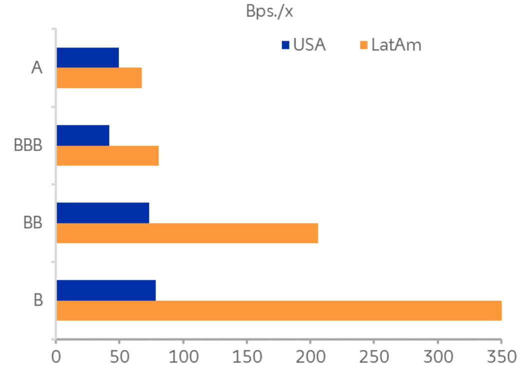
On the other hand, there is a possibility of a deep global recession, which was the expected scenario in 2023. Said slowdown would likely come from the U.S. or China, as the former could suffer a potential policy error by the Fed to keep rates high for too long; while the latter could suffer from the lack of substantial fiscal stimulus or an eventual bursting of the real estate crisis that could lead to the economy collapsing.

GRAPH 14. DEBT RATIOS



Source: JP Morgan, data as of November 28, 2023 (UDM = last twelve months).

GRAPH 15. SPREAD PER TURN OF LEVERAGE
Bps./x



Source: Bank of America, data as of January 31, 2024.

On the other hand, 2024 will be a year full of elections, as more than half of the world's population will heading to the polls. Of particular importance for the region are the outcomes of the U.S. elections in November, as well as those in Mexico and Brazil in June and October, respectively.

Finally, the particularities of the region have caused it to go through periods of high volatility, which have had effects on financial markets and risk perception. Support for populist measures, social unrest, or the exacerbation of security and immigration problems, among other factors, could cause challenges to governability and permeate investor sentiment.

NEW ERA FOR LATIN AMERICAN ASSETS

To conclude, both cyclical and structural factors suggest that, rather than a truce for Latin American assets, we are entering a new era. This can be summarized in the pragmatism shown by the regional political class, the monetary discipline that has allowed for the early start of interest rate cutting cycles and the distance from ongoing armed conflicts. On the structural side, and despite political ups and downs, the region has functioning institutions and robust democracies, the energy transition will provide an additional boost to the economy region-wide, and global fragmentation and nearshoring trends create new opportunities for the region's participation in global trade.

All of the above provides support for Latin American economies to have a stable economic growth trajectory, which also favors investment in the region's different asset classes.

On the equity side, valuations look attractive in historical terms and relative to peers, which seems to be somewhat unjustified and has supported the outperformance thesis of Latin American markets. The region's bonds offer high yields and lower risk, as well as attractive carry.

Despite the presence of some risk, their likelihood for materializing is not significant. The last two years, which have seen significant improvements in the region's markets, have been the starting point for a new era of investments in Latin America.