ANDBANK RESEARCH

Global Economics &
Markets

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Working paper - 37

Is there still any good option to invest?

Two markets that must be present in your portfolio: Chile & Peru *(through bonds, equity & Fx)*

January, 2013

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About the importance of not being libertine. Two examples.

Over the course of the 20th century, countries of Latin America gained the reputation for a lack of discipline in the public finance.

This fiscal profligacy played an important role in the countless episodes of spiraling debt, hyperinflation and defaults.

Nevertheless, some countries have made a considerable progress in the fiscal front.

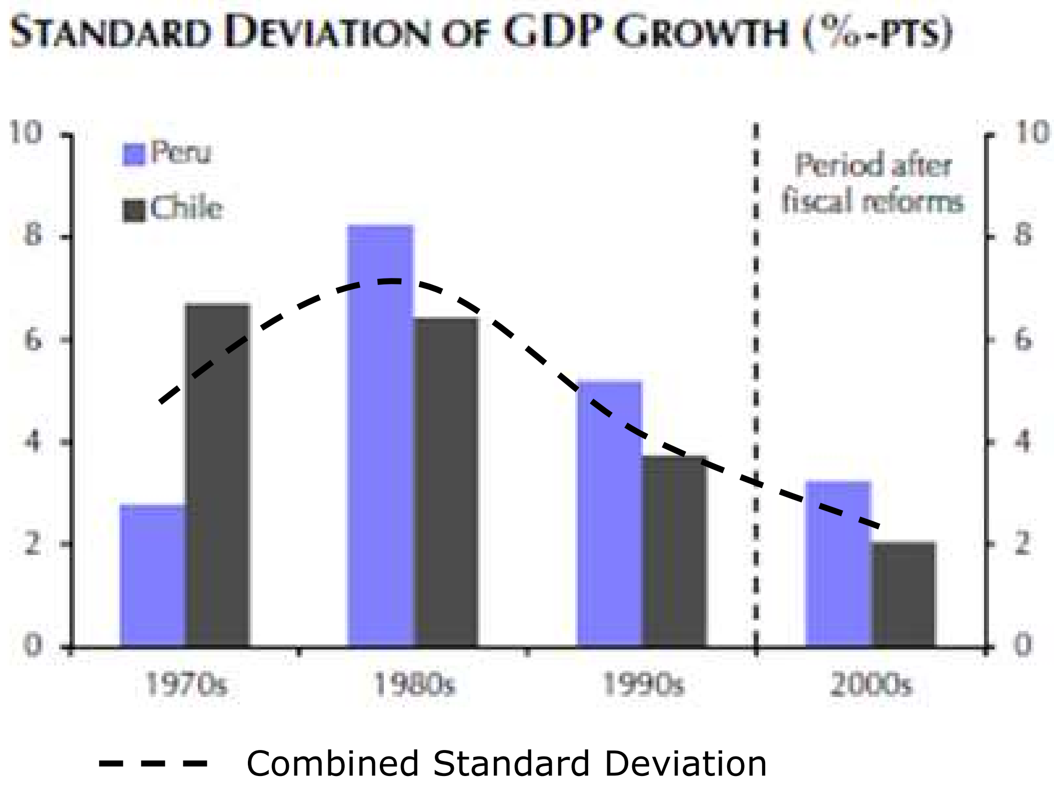
- **Chile: "Fiscal Stabilization Rule". 2000**
  - ✓ Structural target of government spending of 0.5% each year.
  - ✓ Setting conservative Long Term price for cooper.
  - ✓ Any surplus when either variable exceeds its LT level, is saved and accrued in two sovereign wealth funds, that will act as shock absorvers
  - ✓ The Chilean FEES (Fondo Estabilidad Económica y Social) has about US$15bn (or 6% of GDP)

- **Peru: "Fiscal Responsibility and Transparency Law" 1999**
  - ✓ Limits public deficit to 1% of GDP during downturns
  - ✓ Capping increases of expenditures during upturns
  - ✓ Any budget surplus is saved and accrued in a sovereign wealth fund (FEF) which currently has about US$5bn (or 3.6% og GDP)

The lower Fiscal profligacy results in 3 big advantages:

1st. A significant reduction in the volatility of growth. In other words, a much higher stability in the pace of activity.

See how in the decade of 70's the combined volatility (measured as the Standard Deviation) of GDP growth was 5%. In the 80's was 7%. In the 90's 4% to end up being 2.5% in the 12 year period starting in 2000 (just after laws of fiscal responsibility were applied)



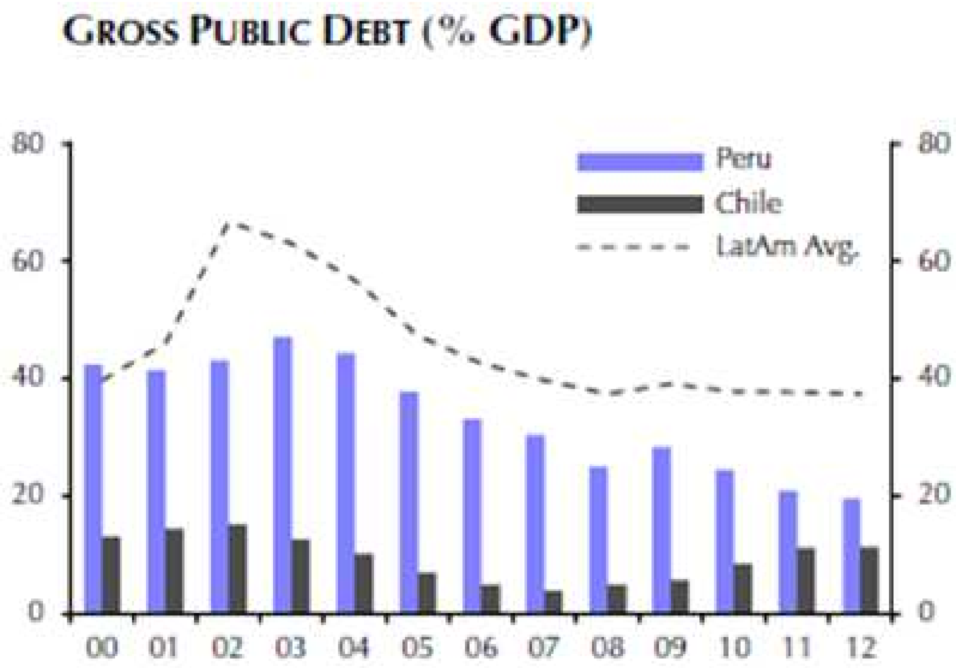
Source: Thomson Datastream, Capital Economics

The lower Fiscal profligacy results in 3 big advantages: 2nd. Less crowding out effect. Thus, more potential for private activity

Less fiscal profligacy helps to prevent a large build up of public debt, being easier for these economies to service the debt during recessionary periods, which means incurring in less crowding out effect.

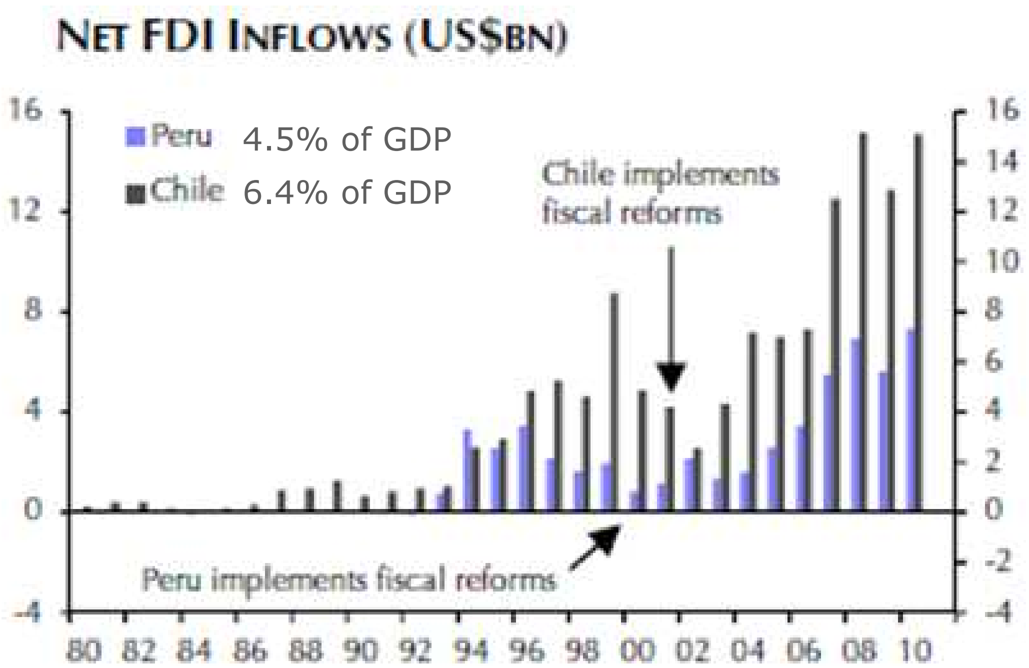
A lower crowding out effect during economic slowdown means that more financial resources (from government) can be allocated toward the real economy.

This represents more potential for private activity, making it more easy to overcome financial crisis for these countries



Source: Thomson, IMF, Capital Economics

The lower Fiscal profligacy results in 3 big advantages:
3rd. Higher support from abroad, that in turn, help boost long-term growth potential.



Public finances are in better shape and pattern a more stable pattern of economic growth are definitive factors in gaining confidence of international markets ...

... and when this happens, it is relatively easy to attract higher levels of foreign investments (direct) …

… that help to boost the country’s long-term growth potential.

Source: Thomson Datastream, Capital Economics

Once we know the advantages derived from a lesser profligacy … which countries actually represent a safe investment option?

The answer is quite simple: "Those who apply effective counter-cyclical fiscal policy".
But, before starting to analyze this, let me make you a brief introduction to the assessment of the effectiveness of fiscal policies.

- Government spending can be divided into Cyclical Factors (automatic stabilizers) or Discretionary Factors. If combined correctly, both can help to smooth the cycle acting as counter-cyclical elements.

- Using the **Hodrick-Prescot (HP)** filter, we can assess the effectiveness of a counter-cyclical fiscal policy.

    - ✓ There is a trend in GDP and Government Spending. GDP growth in a specific year can deviate from this trend (OUTPUT GAP), and Gov.Spending of a specific year can also deviate from its trend (SPENDING GAP).

    - ✓ If fiscal policy is used as an effective counter-cyclical instrument, then the following must be satisfied:

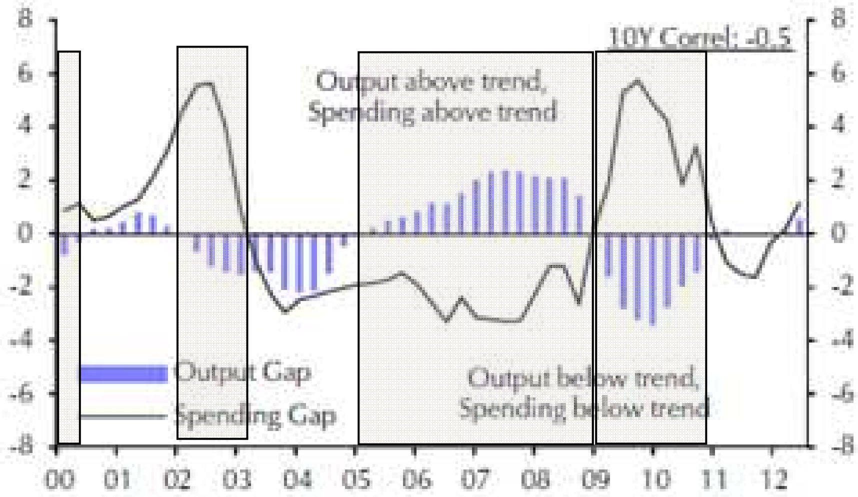
        1. When the economy growth is above potential (Positive Output Gap) => **then, Spending Gap must be Negative.**

        2. When the economy growth is below potential (Negative Output Gap) => **then, Spending Gap must be Positive.**

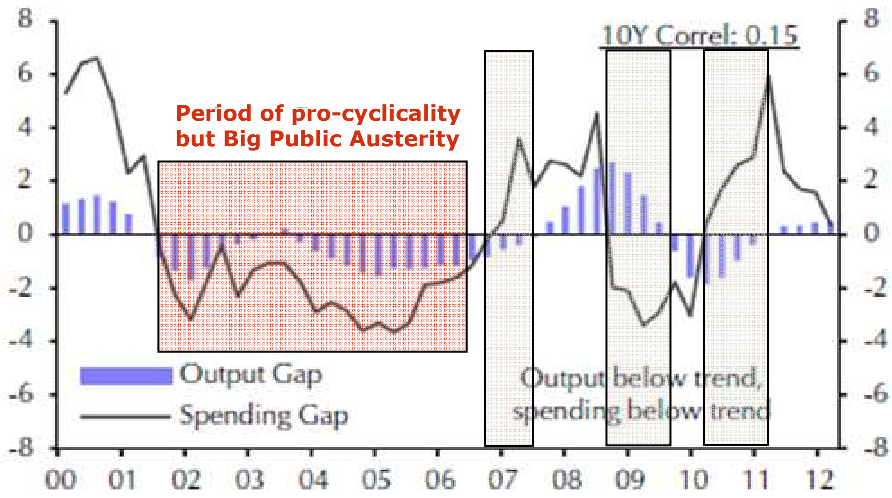
- With this in mind, we are ready to decide whether an economy applies a counter-cyclical fiscal policy (a necessary condition, and in most cases, sufficient) to justify the investment, and if this policy is more or less effective than the rest.

Let us see who actually applies effectively counter-cyclical policies.

CHILE OUTPUT & SPENDING 'GAPS' (%, 12M AVG.)



PERU OUTPUT & SPENDING 'GAPS' (%, 18M AVG.)



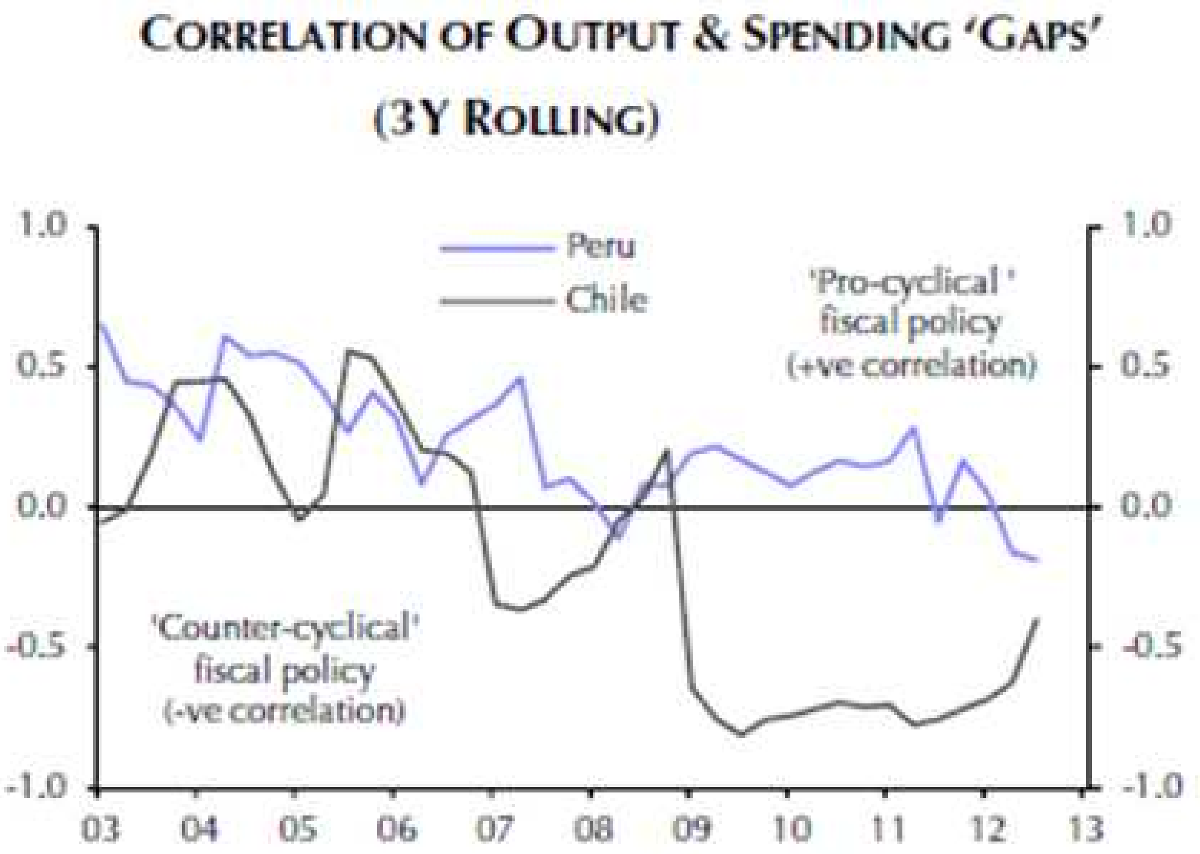
Chile's *fiscal policy has been counter-cyclical in 33 of the 52 quarters in the last 13 years. This is* ***63% of time****. Very few countries in the world can tell this same history of seriousness in economic policy.*

Peru's *fiscal policy has been counter-cyclical in 8-9 of the 52 quarters in the last 13 years. This is only 17% of time. But during a long period of time (2002-2006), the government implemented serious and constant austerity programs (pro-cyclical) that lead the country toward a more balanced budgetary stance, which in turn allowed the start of the countercyclical era of fiscal policy in subsequent periods. From 2007, Peru's fiscal policy has been countercyclical in 15 quarters of the 24 (this is* ***62% of time****)*

Source: Capital Economics

Thus, we can assert without fear of error, that these two countries (Chile and Peru) apply counter-cyclical policies … and belong to that small group of countries "economically responsible".

As demonstrated in this chart, given the negative correlation in the direction of GDP growth and Spending growth.



Source: Capital Economics

In summary: For the coming years Chile & Peru will benefit from the advantages of these political responsibility ... while will avoid the drawbacks of political profligacy.

This is how, in essence, we project the future for these two economies:

- ✓ Much higher **stability** in the pace of **industrial activity**, which will result in a much **lower volatility in GDP growth**.
- ✓ **Less crowding out effect** that will help to maintain economic pace and a **higher potential for private initiatives.**
- ✓ Increasingly **higher support from abroad** (both in **direct and portfolio investments**).
- ✓ ... that will **boost long-term growth potential** with no dangerous inflationary pressures, since balanced growth does not lead to bubbles.
- ✓ Outperformance in both **Equity and domestic bond markets**, as well as a potentially significant **currency appreciation**.

Source: Capital Economics

Some recommended instruments (retail class) that will benefit from our projections

- **Fixed Income Instruments**
  - ✓ UBS (Lux) Emerging Economies Fund - Latin American Bonds - USD (LU0055660533)
  - ✓ Andbank Latin America Credit Opportunity Fund – USD (LU0456465444)

- **Equity Instruments**
  - ✓ Aberdeen Global Latin American Equity Fund S 2 – USD (LU0476875785)
  - ✓ MFS Meridian Funds Latin America Equity A1 - USD Acc (LU0406714716)
  - ✓ MFS Meridian Funds Latin America Equity A1 - EUR Acc (LU0406714989)
  - ✓ Schroder ISF Latin America A - EUR Acc (LU0248181363)
  - ✓ Santander Chilean Equity I – USD (LU0620556422)
  - ✓ ETF - CS ETF (IE) on MSCI Chile B – USD (IE00B5NLL897)
  - ✓ ETF - db x-trackers MSCI Chile TRN Index ETF 1C – USD (LU0592217797)
  - ✓ ETF - Ishares MSCI Chile Investable – USD (US4642866408)
  - ✓ ETF - Ishares MSCI All Peru Index – USD (US4642898427)

Source: Capital Economics

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