**ANDBANK RESEARCH**

Global Economics & Markets

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# Working paper - 78

## *LatAm – A negative overall drawing but … still some good investment opportunities left.*

*Mexico, Brazil, Argentina, Chile, Peru … Economy & Markets*

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Private Bankers

*Economies in Latin America have slowed further in the first half of 2014 and there is now little chance of a rebound in the foreseeable future.*

*The key factors that drove the strong growth in the past decade are crumbling. The global commodities boom has ended and the rapid credit growth will have to cool.*

*Additionally, most policy makers seem shying away from the much needed reforms to overcome the old and structural drawbacks that are heavily weighing in these economies, specially in Brazil and Argentina.*

*Argentina and Venezuela remain stuck in balance of payments crises and GDP is on course to contract in both countries, with Venezuela having strong chances to follow Argentina into default.*

*Despite this negative reading, Latam still has a polyhedral reading, which makes that there are still some good investment opportunities in the region.*

# Mexico – A hopeful perspective.

- **Activity.**
  - ✓ **The Mexican economy seems to be entering a sweet spot** of accelerating GDP growth, falling inflation and thus record low interest rates.
  - ✓ **Current data masks a better dynamics:** The y/y % growth of GDP was of just 1.6% in Q2 (from 1.9% in Q1) but this deceleration apparently masks a sustained improvement in q/q pace during the 1H 2014: Output expanded by a seasonally-adjusted 1% in Q2 (up from +0.4% in Q1, and +0.2% in Q4 2013).
  - ✓ **A hopeful perspective:**
    1. ***Compelling reasons:*** There are good reasons to expect the economy to continue to build momentum: (1) Domestic demand looks set to be bolstered by a 2% of GDP of fiscal stimulus aimed at infrastructure and housing. (2) The neighboring US economy is on track to register slightly stronger growth in the 2H 2014. (3) An ambitious private-public investment plan worth up to 25% oh GDP during 2014-2018 and (4) The macro reforms that are currently implemented, specially those aimed at boosting competence in the sectors considered as strategic (Telecommunications, transport, financial services and energy)
    2. ***Improved estimates:*** In light of all this, some international experts are now raising their estimates for GDP growth to around 4% in the 2015-2016 period.
    3. ***Benign inflation:*** Despite the stronger economic growth, it is unlikely to see a raise in inflation (good for bonds) due to: (1) In the near-term, a reversal of the impact of indirect tax hikes will put inflation down towards the central bank's 3% target and, (2) the slack in economy after 18 months of weak growth means that "capacity pressures" are far from building on the supply-side of the economy.
    4. ***Low rates:*** With the inflation remaining close to target for the foreseeable future, there is no need for aggressive rate hikes, which in turn will be supportive for the economy. I expect rates to remain at their historic low of 3% for at least 1 year, with the first hike not until 2016.

- **Market implications.**
  - ✓ **Fx: Bullish.** Target at 12.75. Current 13.20
  - ✓ **Bonds (in local): Bullish.** 10yr yield Target 6.00%. Current 5.8% (>7% 12month return in hard curr)*
  - ✓ **Equity: Bullish.** Having reached our 2014 target of 45.500, and according to our assumptions for the economy, we foresee additional gains for the IPC index.

* Projected 1 Yr return of investing in the local currency bond and then translated into hard currency. We thus consider: coupon, price and Fx return.

# Brazil – Brazil is now in full recession

- **Activity.**
  - ✓ **A new step back:** Brazil's economy has suffered fresh downturn again in recent months. GDP contracted by 0.6% q/q in Q2 (accelerating the contraction pace from -0.2% q/q seen in Q1), and what is even worse, with some GDP trackers suggesting that GDP pace has deteriorated even more in Q3.
  - ✓ **A dire outlook:** (1) Investment remains extremely weak (certainly an old structural defect**). (2)** Consumption is starting to fade (and will continue doing so as the terms of commerce have turned the corner). (3) There is no sign that weaker growth is reining in the large Current Account deficit, leaving the economy to further bouts of turbulence in global financial markets. (4) Inflation has peaked at 7% but will be slow to fall back. As such, there is little room for monetary easing.

- **Policy:**
  - ✓ Attention is now focused on October's election. The emergence of Marina Silva has increased the chance of a change in government, what paved the way for a rally in the equity market in anticipation that this might spur the wave of reforms needed to restore economic vigor.
  - ✓ We suspect that investors may be overly optimistic. For now, we do not foresee a major shift in policy, meaning that growth will remain lackluster in 2015-2016.

- **Market implications:** Brazilian assets have rallied so far this year (helped by a continued improvement in global risk appetite), although they have lost steam recently. Many of the vulnerabilities that put Brazil in the spotlight in 2013 still remain
  - ✓ **Fx: Bearish.** Target at 2.40/2.50. Current 2.27 (-7% potential performance)
  - ✓ **Bonds (local): Bearish.** 10yr yield Target 12.00%. Current 11.5% (0% 12 month return in hard curr)
  - ✓ **Equity: Bearish.** Target Bovespa at 52.317. Current 57.790

* Projected 1 Yr return of investing in the local currency bond and then translated into hard currency. We thus consider: coupon, price and Fx return.

# Argentina – Default to prolong recession

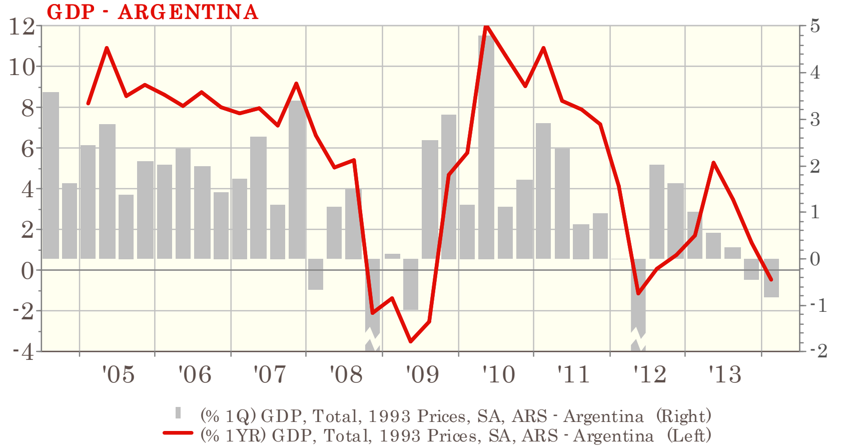
- **Judicial Process & negotiations.**
  - ✓ There is a lot of uncertainty about how policymakers will proceed. One temporary solution may be to swap defaulted bonds into Argentine law although this represents circumvent court rulings. Certainly, not a reassuring solution.
  - ✓ There is now very little hope of the Argentine government's debt dispute being resolved before 2016. As such, the government will remain barred from international debt markets until a deal can be reached.
  - ✓ Nevertheless, agreements such as those achieved with China or Russia can soften the lack of market access, although these will not represent a complete alternative.

- **Activity.**
  - ✓ Given that a shortage of fx drove the economy into recession again in Q1 (-0.8% q/q, from -0.5% q/q in 4Q13), the latest default threatens to weigh on the economy in two ways: (1) It has already driven up borrowing costs for local governments and private agents, (2) if the debt dispute turns ugly it could spark capital flight, and (3) Capital flight would also put renewed pressure on the peso (exacerbating CA problems through over-billing of importers and under-billing of exporters, inflation, etc.)
  - ✓ With foreign exchange reserves at eight-year low of $29bn, the government does not have ammunition to defend the official peso. With the black market weakening sharply (the blue is at 14.2), we still think a devaluation of 20% or more in the official peso will take place soon.
  - ✓ We expect GDP to contract by up to 2% this year, while output could also fall in 2015 if the debt dispute turns ugly.

- **Policy.**
  - ✓ The dire state of the economy puts even more focus on the next year's presidential election. Success for a continuity candidate would leave the economy stuck in the doldrums.
  - ✓ Nevertheless, if President Fernandez is succeeded by a moderate (as we believe), Argentina could make a return to international markets.
  - ✓ In that regard, the two candidates leading the polls (Massa from Frente Renovador and Macri from Pro) represent different degrees of rupture, being the latest the clearest option for change. But even if Masa wins, we believe that at least a semblance of change would take place, and that would help.
  - ✓ **The new government is likely to show a strong interest in fixing the problems that keep away Argentina from financial markets. Investors, as always, will try to get ahead (basically through the bond market).**

# Argentina – Default to prolong recession

- **Market implications.**
  - ✓ **Fx: Bearish.** Target at 10 - 10.5 from the current 8.4.
  - ✓ **Bonds:**
    - ✓ **Local Law: Neutral to Overweight** in the Bonar 24 (USD-Local law) at 87.5 (from 98). The coupons on these bonds should not be affected.
    - ✓ **NY Law: Underweight** Global bond 17 (USD-NY law) at 85 (from 98). While the uncertainty persist about how the policy makers proceed, we believe there could be better entry points in these bonds. At the end, we expect some sort of agreement.
  - ✓ **Equity: Neutral-Overweight in** Argentine ADR in USD (as an effective way for domestic investors to be exposed to USD).

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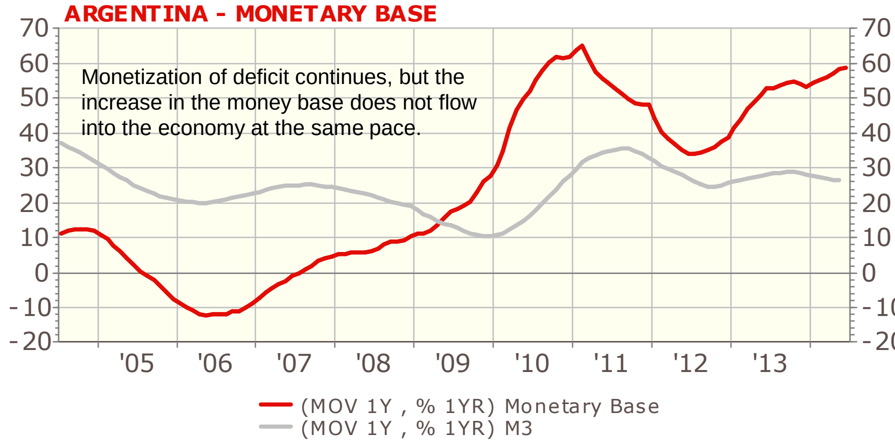


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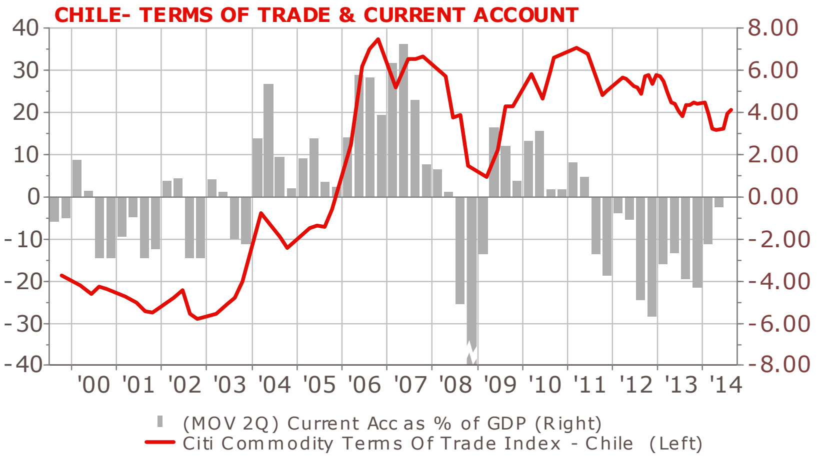
# Chile – Chinese slowdown still weights

- **Activity.**
  - ✓ **Weakest expansion in five years.** GDP pace dropped to 1.9% y/y in Q2 (from 2.4% y/y in Q1).
  - ✓ In the negative side we have a consumer spending that remains broadly stagnant (due to the end of copper boom and the resulting deterioration of the terms of trade).
  - ✓ In the positive side we see how a significant portion of this slowdown comes from (1) a contraction in government consumption, and (2) a reduction in exports to China, a factor that could be eventually temporary –although admittedly exports of copper seem unlikely to bounce back in the short term due to a cooling in the Chinese property sector-.
  - ✓ **The Outlook for GDP growth is of a gradual recovery in the pace:** Circa 2% in 2014, 3.5% in 2015 and 3.75% in 2016)
- **Rates.**
  - ✓ **Central Bank:** Inflation has remained above the upper-bound of the BCC's 2-4% target range but we expect it to fall back into the target range. As such, we think there is room for further monetary easing (that could help activity). Rates may remain on hold at 3.75% until year end although if we are right on assumption for inflation, we could pencil another 50bp cut by year end.
  - ✓ **Big improvement in Current Account:** Rate cuts can not be aggressive since could put pressure on the Peso (and the CA deficit, which in turn is showing a clear improvement –from 3.5% in 2013 to 2.5%).
  - ✓ **Market implications: Fx - Bullish.** Fundamental Target at 520. Current 590 (+13% potential appreciation)

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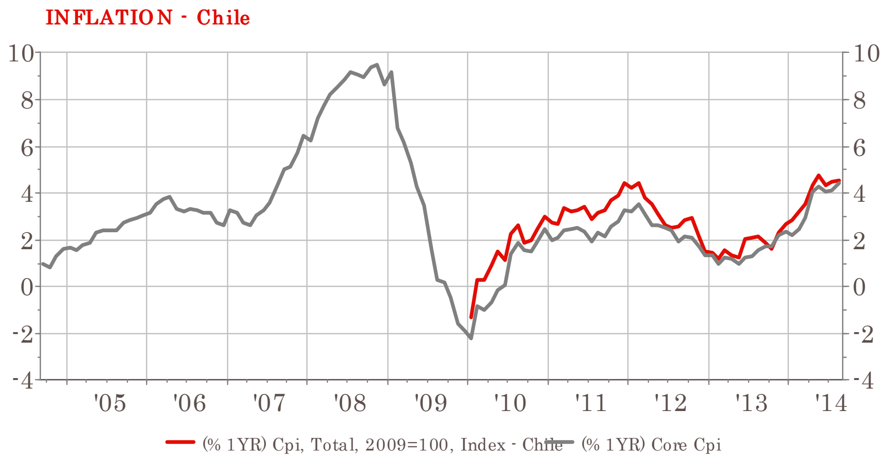



Central Bank of Chile

# Peru – Reforms versus populist spending!

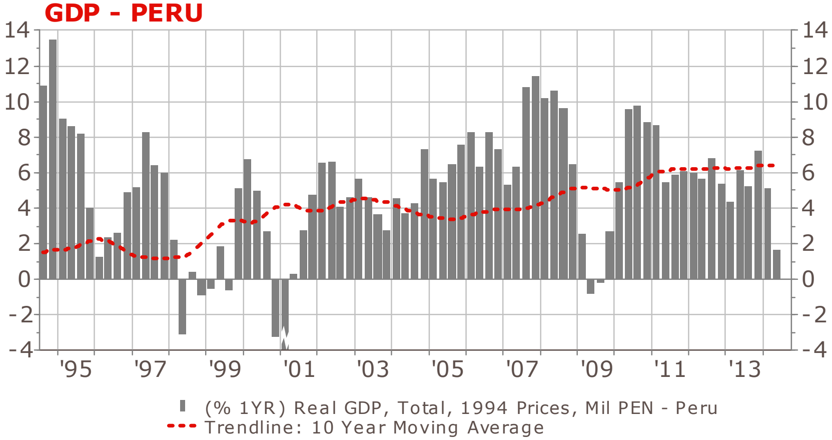
- **Reforms.**
  - ✓ The fact that the Peruvian government has responded to weaker economic growth with reforms rather than populist spending is positive.
  - ✓ GDP pace has slowed to 4.5% in the 1H2014, due in large part to the ending of commodities boom. The commodities boom drove growth in two ways: (1) It attracted large foreign investments into mining projects, and (2) lead to large improvement in the terms of commerce that helped to fund domestic demand.
  - ✓ The reforms are aimed at boosting business investment via two main channels:
    1. Introducing new tax incentives.
       - i. The introduction of a "lock-in" tax rate for mining firms on investments of $500m
       - ii. One of the major reform will be a "tax amnesty" allowing firms and individuals to write-off debts owed to the state-owned pension and the healthcare systems (ONP & EcSalud). According to the Finance Ministry this will benefit 180k taxpayers and write-off around $7.1bn
    2. By cutting red tape
       - i. A reduction in the time that state agencies have to approve projects.
       - ii. Allowing permits to be granted at different levels of government.
       - iii. A reduction in the maximum penalties that the OEFA (the environmental regulator) can impose for environmental infringements.
       - iv. Measures to streamline the public-private partnership (PPP).

- **The assessment.**
  - ✓ The positive:
    1. Peru's economy seems to be at full capacity –inflation is at 3.5% y/y in June -above the 1%-3% target range-, unemployment has fallen to historic lows, and current account deficit is large-. Stimulus spending would be more likely to add to these imbalances. By contrast, supply-side measure are more prudent and creates lasting benefits.
    2. Policymakers estimate that these measures could add 1.5-3.0% pts to GDP growth in the coming years. As such, The government expects now growth to return to 6-7%. In our view, this may seem too optimistic, but after this the GDP pace could remain at a consistent 5% for the coming years.

# Peru – Reforms versus populist spending!

✓ The negative aspects:
1. It will take time for these supply-side reforms to feed through into stronger economic growth –Mining projects take time to generate returns-.
2. The reforms will do nothing to reduce the economy's reliance on the natural resources sector, keeping Peru vulnerable to swing in commodity prices. This will make the anti-cyclical policies to gain importance.
3. Rising commodity exports will put pressure on the real exchange rate (this could erode the competitiveness of local firms)

- **Market implications.**
  ✓ **Fx: Bullish**. Target at 2.65. Current 2.86 (+8% potential appreciation)

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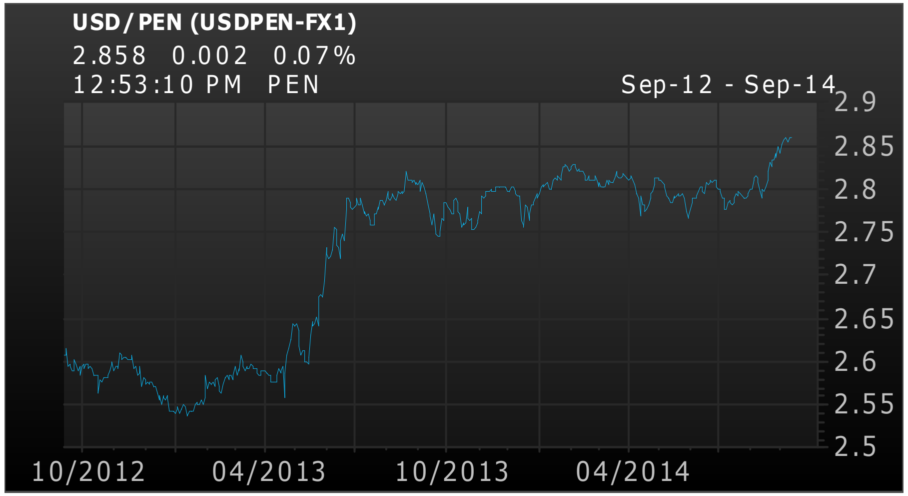

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