Latin America:

A Unique Regional Opportunity

The Emerging Markets Debt Team

Stone Harbor Investment Partners

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Executive Summary

- We believe Latin America fixed income markets will significantly outperform both developed and other emerging markets over the next few years.
- We think valuations in the region are now very attractive.
- The political cycle looks favorable in our view as most countries in the region have elected market friendly administrations committed to economic reforms.
- The region is showing strong signs of stabilization after the cyclical downturn that started in the second half of 2010 and growth acceleration is widely forecasted.
- The best way to express this view is, in our opinion, by investing in an unconstrained, dynamically managed, dedicated regional strategy.

Political Winds of Change

Latin America has long been a byword for political and economic instability that has colored the perceptions of investors. Three factors in particular have been seared into their consciousness: firstly, a history of rule by unstable military juntas interspersed by populist civilian regimes; secondly, the region's deep reliance on commodity exports producing huge swings in export revenues; thirdly, memories of bouts of hyperinflation that have occurred throughout the continent. Regardless of country differences, that background, together with high levels of external liabilities made the region an underperformer during most of the 1980s and 1990s and culminated in sovereign defaults and some of the largest debt restructurings in history.

Recent history, though, has shown new hope for the region as winds of change are transforming its political and economic landscape. The changes that we are witnessing make us believe Latin American fixed income will significantly outperform both developed and other emerging markets in the next few years.

The political prospects of Latin America are being redrawn and for the better in our view. We are witnessing clear breaks from the failed structures of the past driven by the electorate themselves.

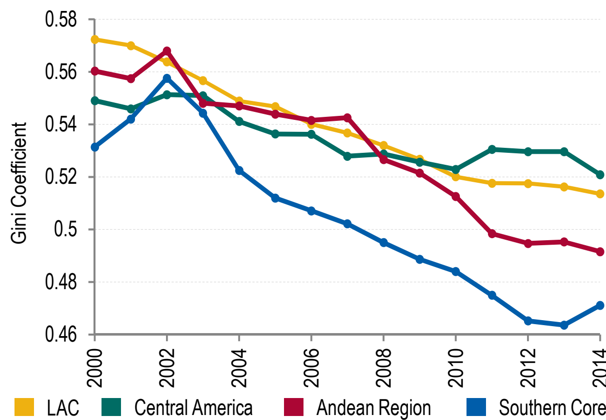
During the 1980s, as Latin American countries transitioned to democratic governments, the new administrations worked hard to adjust macroeconomic imbalances, mostly under the tutelage of the IMF. Privatization of public companies became the norm and foreign direct investment (FDI) into the region picked up significantly. Debt restructurings led to leaner and stronger balance sheets while fiscal efforts were put in place to drastically change debt trajectory and composition. Exchange rates became freely floating, capital controls were lifted and capital accounts opened.

Economies in Latin America, in aggregate, were doing better than in previous decades, but tough economic programs meant increases in unemployment, lower pensions and reduced investment in social programs. This led to rising inequalities in societies.

As the 1990s came to an end, a new breed of left leaning and more populist political parties, which opposed the "neo liberal and IMF imposed" economic policies of the previous decade, began to grow in popularity and win elections particularly in South America. Chavez (Venezuela, 1998), Lula (Brazil, 2002), Kirchner (Argentina, 2003), Morales (Bolivia, 2006), Correa (Ecuador, 2006) and Bachelet (Chile, 2014) are the main representatives of this movement which has been called Latin America's "pink tide" by some commentators.

During the first decade of the 21st century Latin America as a whole experienced solid economic growth. This was helped by improving commodity prices, which together with income redistribution policies, resulted in an expanding middle class. This can be seen in Figure 1, which maps the Gini coefficients of various Latin America regions over time. The steady lowering of the Gini coefficients indicates the reduction in the inequality of incomes during this period.

Fig 1: **Inequality Trends in Latin America**



Source: World Bank

The economic narrative, however, has changed more recently. Despite a brief period of high growth and strong capital inflows due to the massive Chinese stimulus program of 2008-2009, the region fell into a cyclical economic downturn during 2015 (see Figure 2). Progress in reducing inequality diminished, commodity prices dropped and growth momentum stalled. As the US Federal Reserve reversed its monetary expansion program in 2013, heavy capital outflows placed further strain on the region's economic activity levels.

What the most recent economic downturn has led, however, is a very different popular reaction in the new electoral cycle. Latin Americans have not been demanding wealth redistributive policies – although social issues were and still are very important – but rather, better governance. As such, countries began to elect candidates or put in place administrations with strong anticorruption agendas and perceived as "market friendly" with a focus on improving institutional credibility.

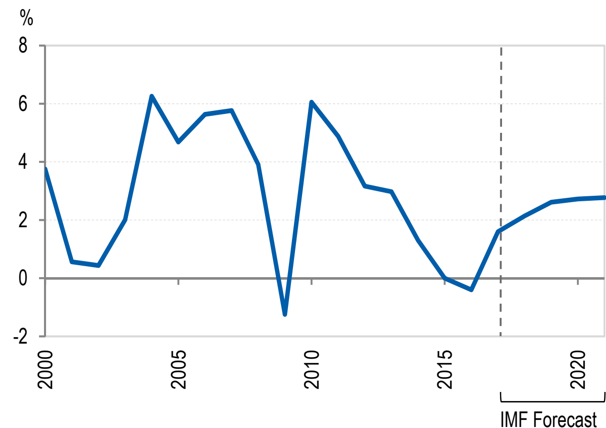
In Mexico, President Pena Nieto, elected in 2012, announced radical structural reforms particularly in the energy sector. In late 2015, Mauricio Macri was elected in Argentina and quickly reversed many of the previous administration's policies, dismantling capital controls and negotiating with bondholders to open up the country's capital markets. In 2016, a corruption scandal that engulfed Brazil for more than a year led to the replacement of President Rousseff by Vice President Michel Temer, who quickly put in place one of the most market friendly economic teams the country has seen in years. In Peru, Pablo Pedro Kuczynski, a US trained politician who had worked both at the IMF and the World Bank, was recently elected President. In Bolivia, President Evo Morales, a populist who espouses an indigenous-based social agenda, attempted to change the constitution to allow himself to run for reelection but his attempt to do so was blocked in a referendum. In Venezuela, the opposition recently won an important victory in Congress raising the possibility, albeit still uncertain, of an eventual shift away from the socialist regime popularized by Hugo Chavez.

While the change in the political landscape is not fully complete, the regional trend, in our view, is undeniable. Although there are no guarantees that this change will be permanent, the schedule of upcoming elections for the next two to four years appears to have limited risk of reversion to Latin America's populist past. We think this bodes well for the economic performance of the region in the next few years and provides strong support for our investment thesis.

Economic Fundamentals

After a period of solid economic growth between 2000 and 2010, most Latin American economies stalled in the following years. As a whole, the region did not grow in 2015 and is expected to contract by 1% in 2016. The region's growth average has been weighed down by the slowdown in important economies such as Venezuela and Brazil. Countries less dependent on commodity exports and with economies linked to the US through trade and remittances have fared better. Bright spots include economies in the north such as Mexico, Central America and the Caribbean. Prospects for 2017 and beyond, however, are improving according to most forecasts, including the IMF's.

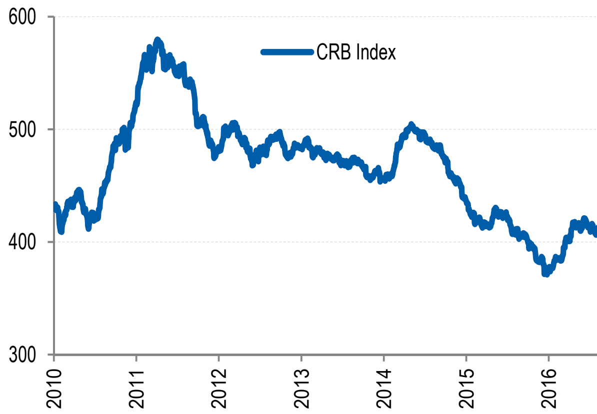
Fig 2: **Growth in Latin America (GDP % Change)**



Source: IMF/Haver Analytics

Latin America is not going to reduce its dependence on commodity exports in a hurry, but in our view the pain from sharp falls in commodity prices has already been felt for the most part.

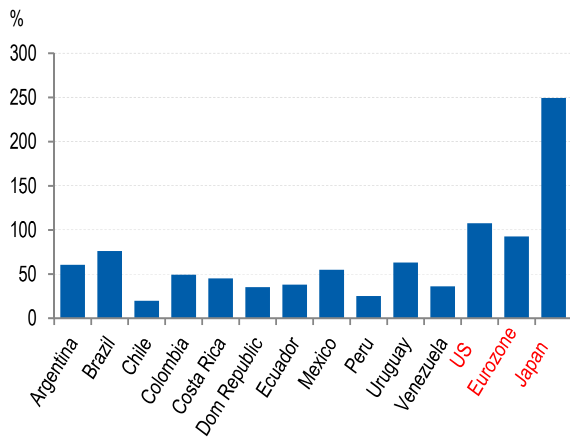
Fig 3: **Commodity Prices Stabilizing**



Source: Bloomberg

Lower commodity prices and low growth have affected debt dynamics, but while debt/GDP levels have generally increased across the region, we note several caveats. First, debt levels in Latin America remain well below those of countries in the developed world.

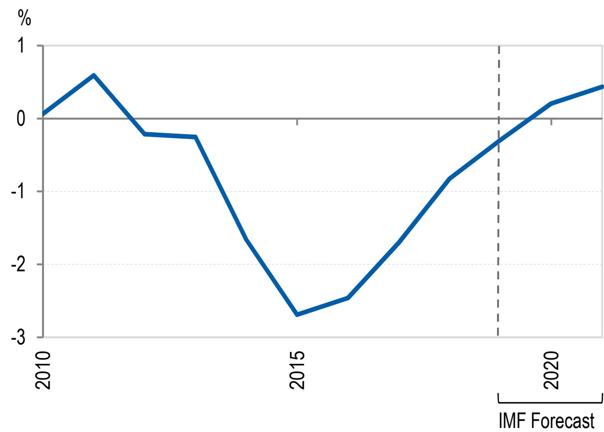
Fig 4: **Debt/GDP: Latin America, Europe, Japan, US (%)**



Source: IMF/Haver Analytics

Second, most governments have kept fiscal imbalances well under control and have addressed revenue shortfalls due to lower commodity prices via tax reforms (as is the case in both Mexico and Colombia).

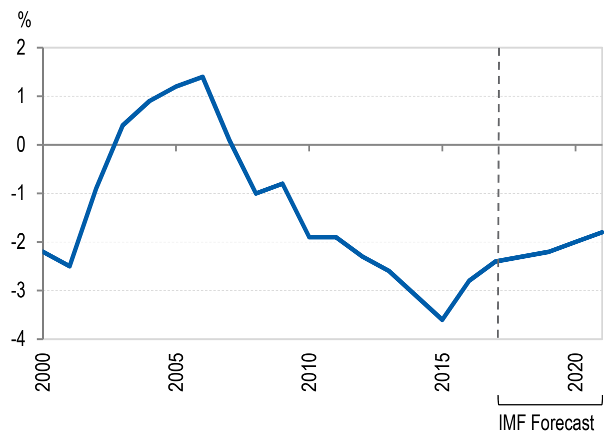
Fig 5: **Latin America Primary Fiscal Balances (% GDP)**



Source: IMF/Haver Analytics

Current account trends, which worried investors significantly during the temper tantrum event of 2013 are positive, particularly in some large countries like Brazil. While the region as a whole still has a deficit, the size is more than manageable, especially when considering that FDI is an important component of its financing (FDI inflows to the region have stabilized at around 3.5% of GDP as a long-run average). We expect this process to continue, particularly if our outlook for modestly improving commodity prices is correct.

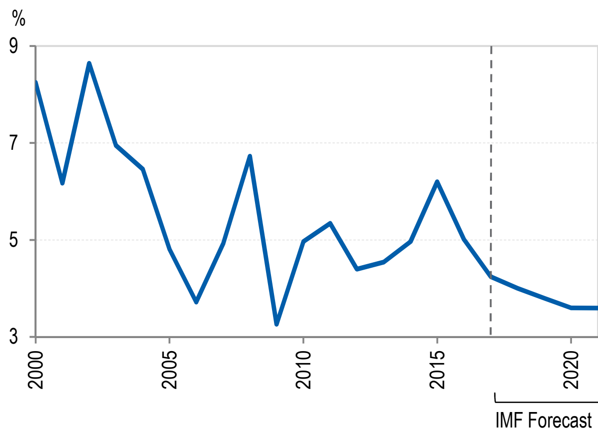
Fig 6: **Latin America Current Account (% GDP)**



Source: IMF/Haver Analytics

Inflation has traditionally been the Achilles heel of the region. What has changed in recent years has been an explicit strategy of inflation targeting as their monetary framework by Central Banks of most Latin American countries. That has resulted in the lowest and most stable inflation levels seen in the region in decades.

Fig 7: **Latin America Inflation (CPI % Change)**

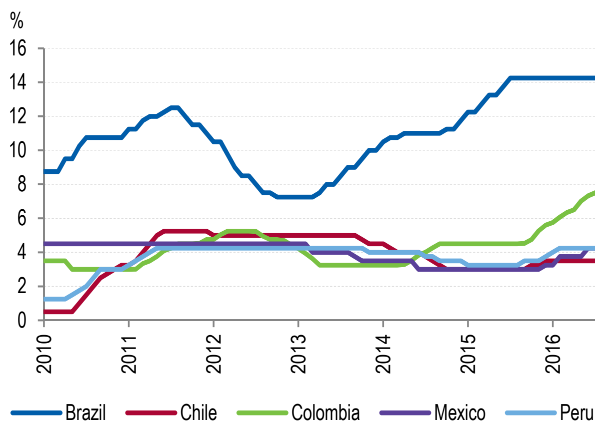


Source: IMF/Haver Analytics

Some of the largest countries experienced a spike in inflation rates over the last couple of years, mostly due to the effects of exchange rate depreciation and public utility prices readjustments (i.e. as part of the fiscal tightening many countries dismantled heavily subsidized utility prices).

However, Central Banks have tightened monetary policies significantly and as a result we expect a sharp drop in inflation levels over the next 6-12 months. As inflation begins to drop, we expect policy rates to normalize.

Fig 8: **Latin America Policy Rates**

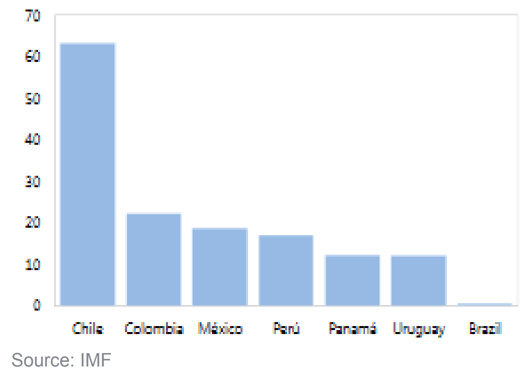


Source: Haver Analytics

In summary, from a macroeconomic fundamental point of view, despite a series of severe negative shocks over the last few years, the region has proven to be more resilient than expected and continues to work hard on addressing imbalances and vulnerabilities. Moreover, we believe we are at the bottom of the rating downgrade process and most likely we will not see further downgrades by agencies in the coming months.

Latin America Pension Funds

One of the most important structural reforms in the region during the 1990s was the establishment in many countries of private pension plans. Unlike other regions in the world, Latin America has a growing working age population, which resulted in a significant growth in pension assets that act as a very important and stable source of financing for both the public and private sectors. Current assets in the region's pension system have grown to more than $900bn and are doubling in size every five or six years in Brazil, Mexico, Chile, Peru and Colombia.

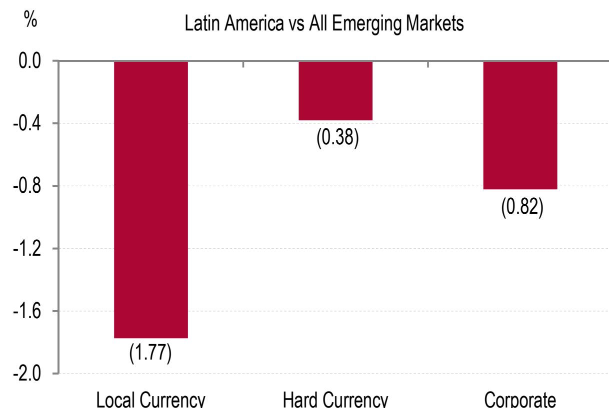


Source: IMF

Valuations

Latin America has underperformed emerging markets as a whole considerably since the taper tantrum of 2013. We believe that this will reverse going forward.

Fig 9: **Latin America Debt Performance Since Taper Tantrum (May 2013 - July 2016)**



As of 31 July 2016. Source: JP Morgan

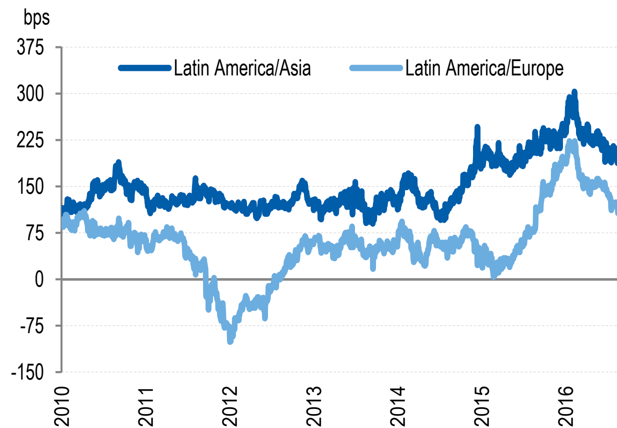
Given the favorable political background and macroeconomic fundamentals, we think Latin American fixed income assets are the most attractively valued in the emerging markets today. Clearly, there will be bouts of volatility in the coming months but, in our view, this would be well compensated for by the size of the risk premiums currently embedded in both sovereign and corporate fixed income instruments, as well as in exchange rates.

Fig 10: **Latin America Spreads**

Source: JP Morgan EMBI Global Diversified

At the hard currency denominated sovereign level, while spreads have begun to recover recently, Latin American debt offers a substantial yield pickup to both developed markets and other emerging markets, particularly in Central Europe and Asia.

Fig 11: **Latin America Spread vs Europe/Asia**



Source: JP Morgan

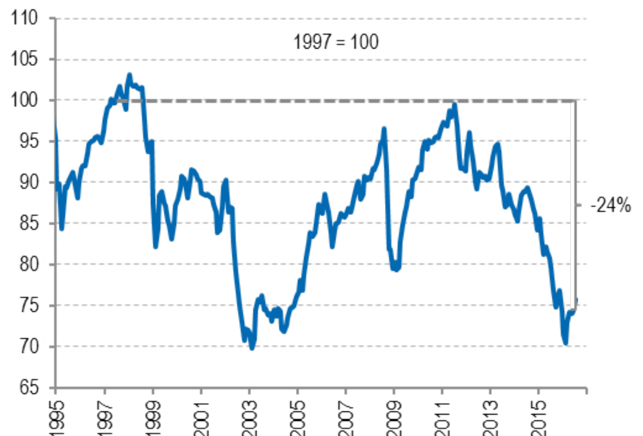
In our view, one clear example of a country having attractive credit spreads is Mexico. We believe these offer great value given the country's strong investment grade ratings and ability to service debt. While there's certainly a risk that a US change in stance towards free trade and NAFTA may create volatility, we believe Mexico's fundamentals will remain strong and improving as a result of its radical structural reform programs.

Fig 12: **Mexico Sovereign Spread since 2010**

Source: JP Morgan

Since 2012, Latin American currencies have depreciated considerably both in nominal and in real terms and we are at levels now not seen since the early 2000s.

Fig 13: **Latin America Real Effective Exchange Rates**



Source: JP Morgan

We are optimistic about a reversal of fortunes for Latin American currencies vs the US Dollar and other major currencies going forward. Clearly, the extent of this will depend on the evolution of commodity prices. However, even if commodity prices do not bounce significantly in the short term, higher growth rates and smaller current account deficits, combined with strong real rate support, means there is still room for appreciation. We also think that the new political climate in the region will lead to increase FDI inflows in the next few years.

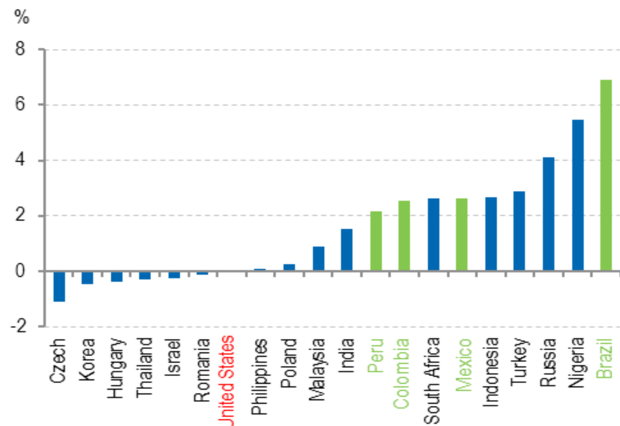
Local currency denominated bond yields have also widened considerably when compared to 2013, and offer more protection against aggressive monetary tightening by the US Federal Reserve.

Fig 14: **Latin America Local vs Developed Market Yields**

Source: JP Morgan GBI EM Global Diversified

Real yields in Latin America are also significant compared with other developed and emerging market bonds. As the effects of aggressive monetary tightening play out, we expect real yields to decline.

Fig 15: **Latin America Real Yields (%)**



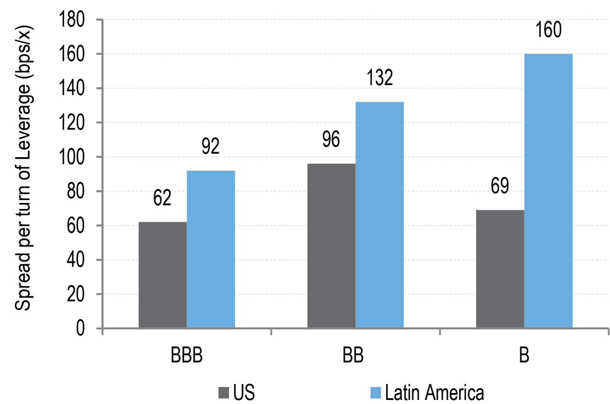
As of 31 July 2016. Source: Stone Harbor Investment Partners, Bloomberg

Latin American Corporates

We see Latin American corporate bonds as both fundamentally and technically better positioned than at any time in the last few years. While the region has been impacted by a confluence of lower commodity prices, political uncertainty and rating downgrades, these factors have now abated and Latin America issuers are adjusting to a new reality. As these adjustments become more fully understood by the market, Latin American corporates have the potential to outperform global credit markets.

Latin American corporates have historically traded at a discount to comparably rated developed markets corporate debt. The magnitude of the mispricing tends to fluctuate over market and technical cycles, but the core factors influencing the pricing of corporates arise from the differences in macroeconomic and legal factors among countries and regions. We would not expect these factors to be resolved in the short term. However, we believe the perceptions are often more negative than the realities.

Fig 16: **Latin American Corporate Valuations**



Source: Bank of America Securities, JP Morgan

The difference in bankruptcy law and creditor rights is often cited as a reason for increased risk premia for Latin American corporate debt. We agree that many emerging markets bankruptcy processes and laws are often much less transparent than in developed markets. However, over the last decade plus, default rates in Latin America have been comparable to those in US high yield, while ultimate recovery rates have been essentially the same.

Asset-liability mismatches are also a driver of mispricing relative to developed market peers. Latin American companies that borrow in US Dollars are presumed to be vulnerable to foreign exchange movements. But in reality a large part of the Latin American corporate debt universe is comprised of companies that either generate hard currencies through exports and other means, or are able to hedge net foreign currency exposure in a cost efficient manner. Moreover, while the depreciation of local currencies has inflated US Dollar-denominated liabilities, it has served to partially offset the decline in US Dollar-denominated commodity prices. The result has been commodity producers with higher leverage, but generating free cash flow through lower production costs, decreased capex and asset divestitures.

Another technical factor impacting the risk premia of Latin American corporate debt is the cross-over nature of the investor base. Developed markets investors often change the portfolio allocation to Latin American corporate debt as the global investment grade and high yield markets experience market cycles. In late 2015, the loss of Brazil's investment grade ratings resulted in a very weak technical position for many Brazilian corporates that were downgraded along with the sovereign debt. As the risk of downgrades diminish, we expect the allocation shifts to diminish as well.

Finally, another not yet fully recognized positive trend for Latin American corporates has been the liability management exercises that many corporates have completed through the new issue market this year. A large portion of the proceeds from new issuances this year has been to refinance existing bonds through calls, tenders and repurchases. This trend has also led to a stronger technical picture as net new issuance is negative for the year and bonds have migrated back to a more dedicated investor base.

Risks & Vulnerability Sources

We have argued the case for Latin American debt being a good opportunity for investors based on current valuations, the economic cycle and favorable politics. But what are the risks?

Clearly, commodity prices are very important. A sustained downturn from current levels will negatively impact capital flows and economic growth as well as external accounts and exchange rates. We are less concerned about the impact of lower commodity price on public finances, as most countries have already budgeted for such a scenario and made adjustments. However, lower levels of commodities may require another round of fiscal tightening and led for further currency depreciating.

US monetary policy also has important implications for the region. Although we think the experience of 2013 will not be repeated and we believe short term money has for the most part exited the market since then, unexpected tightening by the US Federal Reserve will not be positive. However, if this tightening is as a result of an improving growth outlook for the US, we think the volatility will be short lived.

The US election, and in general, the debate in some major countries about trade and openness, may also affect the region. In our view, while there's a possibility that a new US administration may ask for the renegotiation of some parts of NAFTA, the economic ties between Mexico and the US are too deeply established to be broken. Other countries with trade treaties with the US are probably much less at risk.

Conclusion

We believe that now is the right time to invest in a dynamically managed pool of Latin American assets. The combination of a greatly improved political environment, cheap valuations, a better global outlook and stable commodity prices will, in our view, result in regional outperformance. We think an unconstrained approach to the region, with the ability to invest in sovereign and corporate debt denominated in both hard and local currency is the best way to implement the investment strategy.

Latin America Fixed Income Markets

One important feature of Latin American markets in our view is their larger size and relatively high levels of liquidity, especially compared to other regions in emerging markets.

Market Cap as of August 2016	
Latin America Local Markets	USD 425 bn
Latin America Hard Currency Sovereign	USD 320 bn
Latin America Hard Currency Corporates	USD 267 bn

Source: JP Morgan

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Benchmark Definitions:

The JP Morgan EMBI Global Diversified (EMBI Global Diversified) limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.

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