FISCH»Asset Management

Bellerive 241 | P.O. Box
CH-8034 Zurich

info@fam.ch | www.fam.ch
T +41 44 284 24 24

»Latin America: Optimism has returned!

Research May 2024

Marketing material

Tanja Kusterer
Portfolio Manager
Emerging Markets

Latin America offers substantial opportunities. During a research trip lasting several weeks to the very bottom of South America, we were able to see this for ourselves. However, heterogeneous opportunities and idiosyncratic risks require investors to do their homework. In this short paper, we show which segments we have identified as attractive in Chile, Brazil and Argentina, and how we assess the economic and political situation.

The global economy has so far proved surprisingly resilient, despite significant interest rate hikes by central banks. The major emerging markets are also experiencing robust growth and are benefiting, in part, from a reorganisation of global supply chains. Growth expectations for India and Brazil, in particular, have now been revised upwards by the International Monetary Fund, to 6.8% and 2.2% respectively, for 2024. However, political risks have also been a particularly major issue in Latin America in recent years: Left-wing governments have come to power in the largest economies, including Chile, Brazil and Colombia. At the same time, there has been an increase in protests in Peru and Chile, for example, and in Argentina, Javier Milei, a character who is difficult to assess, was elected to office.

Against this backdrop, we wanted to gain a better understanding of the economic situation and political developments in Latin America, and spent several weeks in the region, specifically in Chile, Brazil and Argentina. In total, we held more than 50 meetings, including with companies from various industries, economists, local investors, and experts from the financial industry. In the end, we were convinced that the political risks have greatly reduced over the past few months. Similarly, we were also positively surprised by the optimistic economic outlook. Optimism has returned!

Chile

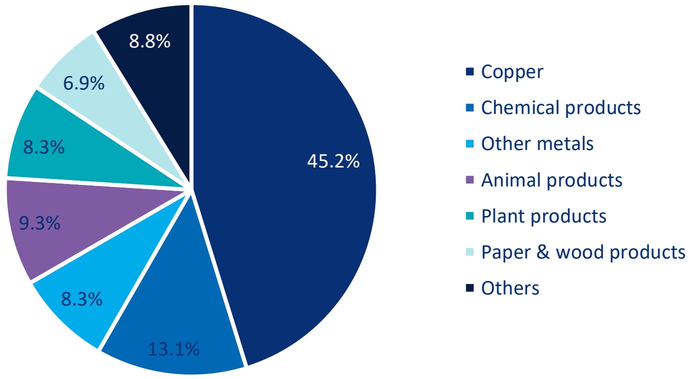
In Chile (in particular), the aforementioned political risks have been prevalent in recent years: As a result of the violent social protests in the fall of 2019, a referendum was held on the plan to write a new constitution, but the new text was rejected twice by the people. A possible third attempt at a new constitution has since been put on the back-burner and new protests have also failed to materialise. Gabriel Boric, a left-wing president, was elected to office in 2022, but the reform agenda is not currently expected to bring about any drastic changes for the market. Accordingly, the political environment has improved significantly in the meantime and is likely to remain calmer in the future.

In addition to this development, the local economy is also on the verge of recovery from the difficulties of last year – Chile recorded economic growth of just 0.2% in 2023. Since the beginning of the year, economic indicators, including production and labour data, have accelerated and economists' expectations for 2024 have been raised to over 2% economic growth. Lower interest rates should also support this development. Chile has been a pioneer in monetary easing, and the central bank has already cut its key interest rate by 4.75% since last summer. In this environment, locally active companies are expecting a gradual recovery in consumption. In some cases, this development has already been registered by retail companies with higher sales in the department store and shopping centre segments, albeit still at low levels.

» Copper producers should benefit from higher commodity prices in the longer term.

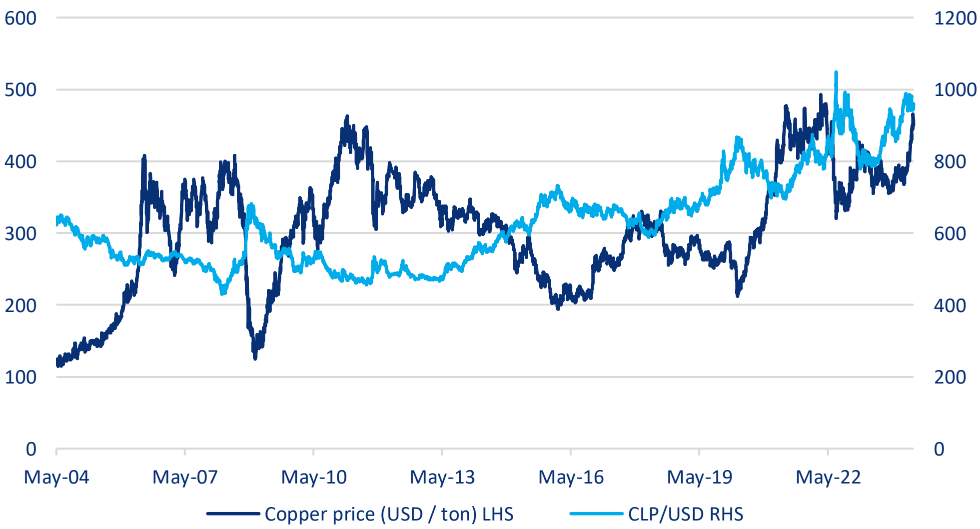
Conversely, Chile remains extremely dependent on commodity prices, especially copper. Chile is the world's largest copper producer with a market share of 24% and copper exports account for around half of the country's total exports (see Chart 1). On the demand side, the copper price continues to benefit from investments in green technologies, electromobility and the energy transition in general, as well as the short-term upturn in the global economy, stockpiling and expected interest rate cuts. On the supply side, production has been disappointing in recent years and the quality of copper deposits has also declined, which is driving up operating costs. In addition, the discovery of new high-quality deposits has been slow and there is a lack of new and attractive projects, particularly in Chile. In the medium term, this dynamic is expected to result in a balanced supply and demand picture, while a structural deficit, and thus higher commodity prices, are expected in the longer term. This is a development that should both benefit local copper producers and continue to positively support growth in the country in the future.

Chart 1: Exports by product category (2022)



Source: Bloomberg, JP Morgan, OEC, BACI

Chart 2: Copper price and Chilean peso exchange rate



Source: Bloomberg, JP Morgan, OEC, BACI

Overall, we encountered an optimistic mood in Chile. We also take a consistently positive view of economic and political developments, and believe that the country continues to deserve its status as a “safe haven” for solid investment-grade investments in Latin America.

Brazil

In our view, the lights are also green in Brazil. Despite initial uncertainty, policy under President Lula has developed quite positively for financial markets. Fiscal policy has so far remained more restrictive than expected, and the government has been able to push through both a long-overdue consumption tax reform and a new fiscal rule. The country is also performing better than expected economically, and the retail sector, in particular, has surprised on the upside with growth of 5.7% year-on-year since the start of the year (as at March 2024). In this environment, Brazil was recently upgraded from BB- to BB by two rating agencies, and experts expect further upgrades in the next one to two years, which we believe is realistic.

On the credit side, the situation has now also normalised following the surprising default on the bond of retailer Americanas due to an accounting scandal and six other securities in the first half of 2023. Although these defaults were partly due to idiosyncratic events and in some cases unsustainable business models, they were exacerbated or accelerated by the high interest rate levels. With the start of the interest rate reduction cycle, the pressure on companies has now eased. Companies that have a higher proportion of local debt with variable interest rates are particularly likely to benefit from this.

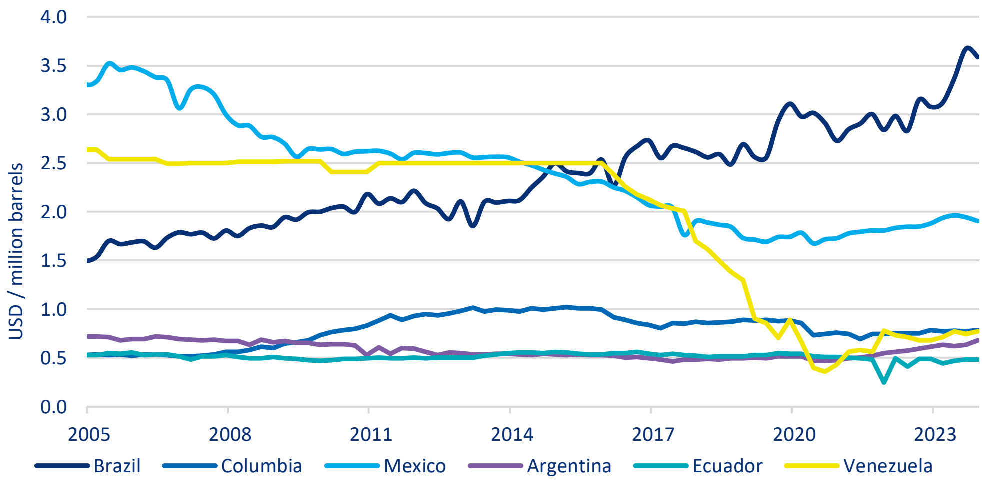
» Oil production is likely to increase 50% by 2029.

In view of the improved environment, Brazil also recorded the highest volume of new issues in Latin America in the first quarter. In addition, debutants have been coming to the market again after an extended absence, in some cases with attractive coupons of 9-10%. At the company level, the outlook for various commodity prices, including oil, iron ore and pulp, is an important topic. As the world's largest exporter of agricultural products, there is a sharp focus on the harvest outlook. A solid season is expected overall for maize, for example, but this, together with high inventories, is putting pressure on prices. Protein and corn-based ethanol producers in particular are likely to benefit from this development by virtue of lower input costs. Average prices for maize in the first quarter were around 40% lower than in the same period the previous year. Prices and volumes are expected to remain similar for the time being, but the impact of the flooding in Rio Grande do Sul, an important region for agricultural production in Brazil, on crop yields and therefore prices is not yet foreseeable.

Oil production remains an important growth factor for the country. An increase in production of 50% is forecast for the country by 2029 (see Charts 3 and 4). This should increase GDP growth by a total of 3% over the next five years. In this context, we prefer issuers that can benefit from this potential, such as an oil transshipment port next to the strategically important Campos Basin.

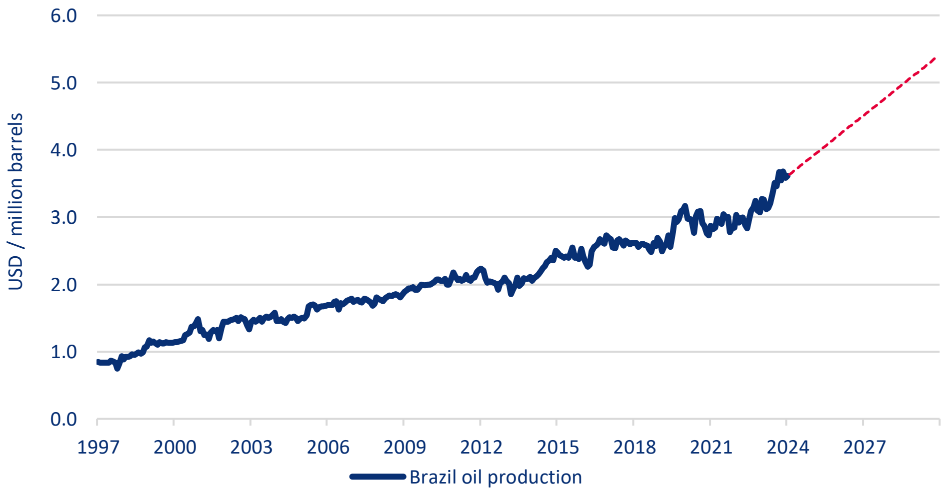
Political points of discussion included the government's influence on state-owned companies, compliance with the fiscal rule and progress with the upcoming income tax reform. Overall, we believe that these risks are currently limited and that the positive drivers in terms of economic growth and the outlook for commodities outweigh them. Accordingly, we currently view Brazil as an attractive investment market, but prefer export companies.

Chart 3: Oil production in Brazil significantly exceeds other countries in Latin America



Source: Bloomberg, BofA

Chart 4: Brazil's oil production should continue to rise sharply



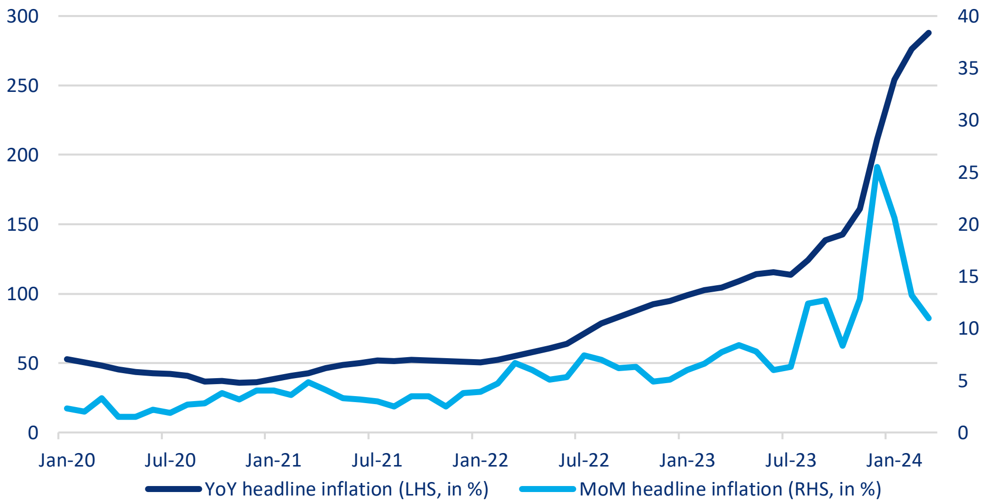
Source: Bloomberg, BofA

Argentina

There was great euphoria among both the population and international investors when Javier Milei was elected as Argentina's new president in November 2023. The positive sentiment has continued following the elections almost six months ago, and government bonds rose by 66% (period from November 20 to April 30). The probability of default implied by the current prices is still around 50% until 2027, but this raises the question of the extent to which this scenario is justified.

The government has already been able to celebrate some successes in the first few months of its tenure. Monthly inflation fell to 11.0% in March (see chart 5) and the central bank's net reserves rose by around USD 9 billion. The government has so far shown a strong willingness to push through fiscal consolidation and the stabilisation programme, even at the expense of economic development. For example, social security contributions have been cut, import taxes and electricity prices have been increased, and public works have been suspended. The more far-reaching reforms, such as the “omnibus law” and the fiscal pact, have also overcome an initial hurdle with the approval of Congress.

Chart 5: Exorbitant inflation has significantly declined



Source: Bloomberg

» The support of the government by the population remains a key factor.

On a less positive note, the economy has weakened significantly since the beginning of the year: a contraction of 3-4% is expected for the year as a whole. The middle class appears to be cutting back on discretionary spending in particular, and restaurants and gyms appear to be emptier. There are also more and more stories of middle-class families transferring their children from private to public schools because they can no longer afford the higher fees. Protests and strikes are also on the rise. However, the government's continued support among the population, and thus its ability to assert itself politically, remains the most important success factor, but also the biggest risk.

Positive performance drivers for the coming months include the announcement of a new programme with the International Monetary Fund, the implementation of the omnibus bill or fiscal pact in the Senate, the further accumulation of currency reserves and possible steps in currency management, including the gradual lifting of capital controls. We believe that progress in this direction is quite meaningful.

Overall, however, there is a lot at stake at the moment. In a positive scenario, with further political successes, and thus the gradual reopening of the country to the capital market, we still see room for upside even at current valuations. Conversely, the risks are significant, above all the test of patience demanded of the population. In the worst-case scenario, Milei could lose the support of the population and no longer be able to push through reforms. Overall, we consider the current ratings to be balanced due to the high level of uncertainty regarding the direction in which the country will develop.

In summary, we conclude that the outlook for Latin America in terms of the economic situation, together with robust local demand, lower interest rates and favourable developments in commodity prices, has improved significantly in recent months. At the same time, the political situation is likely to remain calmer in the future and no elections with major changes in the political landscape are anticipated in the key markets in the medium term. We therefore remain optimistic about investments in the region.

Disclaimer

This documentation is intended for professional investors only. The information and opinions contained in this publication are for information purposes only and do not constitute a solicitation, recommendation, an offer to buy or sell investment instruments or other services, or engage in any other kind of transaction. It is not directed to persons in any jurisdiction where the provision of such information would violate local laws and regulation. No liability shall be accepted for the accuracy and completeness of the information. Any opinions and views reflect the current judgment of the authors and may change without notice. Past performance is not a reliable indicator of future results or current or future trends. There is no guarantee that forecasts will be realised. Unless otherwise stated, text, images and layout of this publication are the exclusive property of Fisch Asset Management AG and/or its related, affiliated and subsidiary companies. Fisch Asset Management AG has not independently verified the information from other sources and Fisch Asset Management AG gives no assurance, expressed or implied, as to whether such information is accurate, true or complete.

Fisch Asset Management AG accepts no liability for damages arising directly or indirectly as a result of this document.