Latin America: writing without rhythm

May 2016

The Latino dancers have lost their rhythm of late. Swathes of the South American region remain under intense pressure as macro headwinds continue to deepen current issues. Even some of Brazil's towns and cities - famous for their carnival celebrations in February - were forced to abandon the annual revelries as the country faces its worst recession since the 1930s. That is not to say the party is over for Latin America. It's arguably a case of postponement, so don't fold up the fancy dress and feathery floats just yet…

Feeling the squeeze

It was a difficult 2015 for Latin America, and 2016 has brought little in terms of relief as the region falls deeper into recession territory. Headlines remain unremittingly gloomy as the South American nations continue to suffer from an economic slowdown among its key trading partners, lower commodities prices and persistent domestic challenges. The outbreak of the mosquito-borne Zika virus has hardly helped matters and the flippant among us might argue that it is the only thing flourishing in a region currently characterised by political and economic dysfunction.

Brazil and Venezuela are in the most precarious positions, while the appointment of Mauricio Macri has raised Argentine growth prospects over the medium term. Tighter economic policy alongside weaker currencies should help to narrow currency account deficits across much of the region, although this will hinder the progress of an economic recovery going forward.

Oil: a slippery slope

The price of oil remains volatile and is a key character in this unfolding story. There was a sense of optimism surrounding talks in Doha where some of the world's biggest producers failed to agree on a deal to cap production levels in mid-April. Bloomberg sources report that crude oil fell 7% in trading the day after talks collapsed, yet prices since rebounded significantly to hit $47 per barrel – its highest level since early November – after a top energy monitor stated that the global market in near balance. This comes just 14 weeks after prices were down at $27 per barrel. Uncertainty surrounding this is doing little calm the choppy waters of Latin America's oil exporting nations, many of whom are under intense pressure already.

Why is oil such an important factor? While cheaper oil can be a boon for oil-importing nations as it drips through to consumers, for the likes of Venezuela where a significant chunk of export earnings spring from the commodity, depressed prices can spell economic disaster, as we have seen recently.

It's not all doom and gloom though. Various economists are forecasting an increase in oil prices over the medium-to-long term and when this happens, Latin America – and especially the economies for which oil accounts for a significant share of GDP, exports and fiscal revenues – will stand to benefit.

Currency crunch

Weakening local currencies are a direct reflection of the high levels of uncertainty in global financial markets and sharp falls in commodity prices. Brazil was the clear underperformer last year as political strains grew, while sovereign rating downgrades as well as persistent fiscal deterioration prompted a 33%[A] depreciation of the Brazilian real.

[A] JP Morgan: Emerging Markets Outlook and Strategy Report, January 2016.

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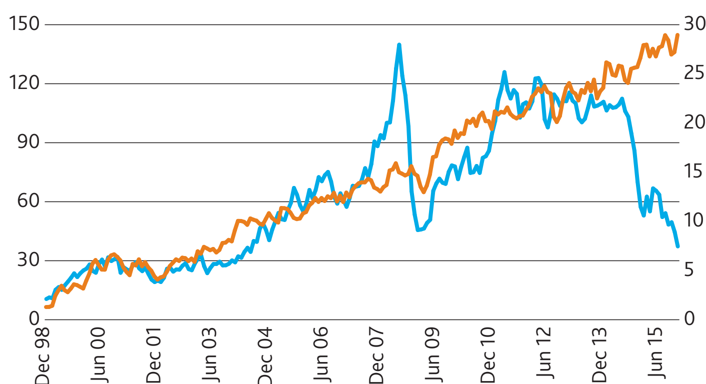
Encouragingly, there is evidence to suggest that Latin American currencies are stabilising. The Brazilian real, had a very strong March and finished the month +10.5% versus the US dollar (source: Bloomberg). The recent uptick in global commodity prices should also provide some breathing space before currencies really begin to feel the positive effects from a forecasted increase in export revenues.

The China syndrome

Many market commentators would suggest that China's slowing economy is the main reason for the drop in commodity prices. While this has certainly played its part – China is the largest consumer of raw materials after all – we believe it's more to do with the market becoming aware of excess supply, coupled with no imminent pick-up in demand from China, which has caused commodity prices to fall.

We acknowledge that waning Chinese demand remains a risk for Latin American exporters, but it is important to distinguish facts from fiction. And the fact is oil demand from China has not been anywhere near as weak as markets might suggest…

Oil prices vs. China's oil imports



Source: JP Morgan, Bloomberg, January 2016.

A turning tide?

Encouragingly, Latin America's is not as dire as many perceive it to be.

Latin American equities outperformed developed and emerging market equities benchmarks in the first two months of the year.[B] There are a number of challenges, there's no denying that, but a crisis? Not really, or certainly not to the extent some market commentators are portraying it to be. Brazil and Venezuela have some grueling issues to overcome but even these two South American nations have positive stories to share, not least because recent market volatility has lowered valuations to attractive levels making assets more affordable for foreign investors.

It has also been encouraging to see that a number of countries who have been so reliant on China's boom are starting to adjust to new realities. Governments are implementing structural reforms and diversification strategies, rather than simply waiting for a shift back to more favourable macro conditions and higher commodity prices. All-in-all, while Latin America's economic growth outlook remains on the weaker side, this year should fare better than last for many economies with a positive upward trend forecast thereafter.

Macri brings renewed hope in Argentina

Argentina's president, Mauricio Macri, has been a busy man since taking office in December. The former mayor of Buenos Aires has implemented a number of reforms already with his biggest scalp coming this week as Argentina returned to international capital markets. Part of this involved the settling of a decade-long legal dispute with the country's 'holdout creditors' in the US, something his predecessor, Cristina Kirchner, failed to do during her tenure.

Argentina recently sealed a $16.5bn sale of government debt which is the largest ever bond issue from an emerging market economy. Macri has clearly been given maximum credit by global bond investors as the deal was three times over-subscribed with almost $70bn of demand.

This is a very positive start to the Macri campaign but there's a long way to go before Argentina can truly say it's turned its fortunes around. With a long list of challenges including tackling inflation of near 30%, a very complex fiscal deficit of almost 8%, as well as a significant devaluation of the Argentine peso, there is plenty of work to be done. Economic data remains mixed and other new government policies will take time to deliver their promises. External threats also remain as Brazil's recession deepens.

On the contrary, the weaker peso is expected to boost exports and a swap agreement with China will beef up the Central Bank's coffers. Growth this year is expected to be flat as the economy braces itself for a 3.3% acceleration in 2017.

Dilemma for Dilma

Latin America's largest economy continues to plough deeper into recession territory. High inflation, large fiscal imbalances, political bedlam and corruptions scandals have dominated Brazil's economic news recently. Investors are under no illusions that the state of the domestic economy is not in great shape, and the 2016 outlook remains bleak in comparison to some other Latin American nations.

Is it all that bad, though? Well, frustratingly, yes and no.

On the negative side, Brazil's slump from Latin American stardom has stemmed from three key causes. The first being a sharp drop in global commodity prices which has had a significant impact on Brazil's export revenues. Second was the necessary tightening of fiscal policy thanks to overspending in the boom years. So, when the recent commodity bust arrived, the underlying vulnerabilities were exposed. With interest rates already being hiked aggressively last year, the government now wants – or arguably needs – to introduce some unpopular budgetary measures. One of which is the reintroduction of a tax on financial transactions, known as the CMPF, that was scrapped in 2007 after protests from business. These kinds of ostracised reforms will be necessary in order to bridge the widening fiscal gap. There is light at the end of the tunnel, but it looks like it could be a long tunnel currently.

[B] JP Morgan: Emerging Markets Outlook and Strategy Report, January 2016.

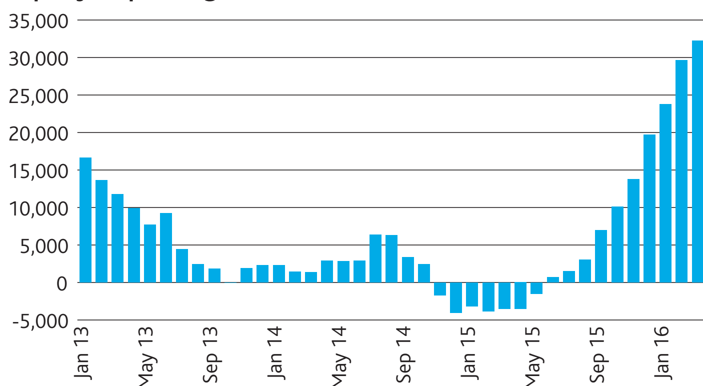
Finally, we have Brazil's political predicament. Corruption scandals surrounding the Lava Jato probe, as well as dishonesty among other political figures, have added to investors' concerns. We are currently in a transitional stage with outgoing President Dilma Rousseff now officially facing impeachment after the Brazilian senate reached the 55 vote threshold to remove Rousseff from office. This is the beginning of the end of a difficult time, and it gives investors a degree of clarity about the direction of travel, although there is still a long way to go.

Such distractions have prevented a coordinated policy response to the economic crisis, as well as muddying an already negative outlook, but it is easy to get drawn in to the political conundrum without acknowledging the positive stories emanating from Brazil.

While the economy has a long road to recovery, there is reason to believe that Brazil's current issues may be levelling off as the Brazilian real continues its rally. A true fiscal fix in the short term is unlikely, but the bleeding is expected to stop as political noise subsides. Inflation – which has been above the Central Bank's target over the last few years – is forecast to fall next year, bringing it comfortably back within the target. This will herald a powerful rate cutting cycle and we expect anywhere from 300-500bps in cuts over the next two years.

In terms of what's comes next, Vice President Michel Temer will take the reins while the trial against Rousseff is conducted. Volatility is likely to remain elevated during Temer's presidency due to the ongoing Lavo Jato investigations (which could bring damning evidence against him at any time) but he will bring with him a very market-friendly team. Economic headwinds will also remain, but with some tough fiscal measures and reform, and perhaps a bit of good fortune on the macro front, Brazil will hopefully return stronger.

Despite worsening fiscals, Brazil's external balance is rapidly improving



Source: Bloomberg, March 2016.

Fracas in Caracas

Venezuela should be treated with caution. The beleaguered country is in the midst of a serious economic crisis as it tops the Global Misery Index for the third consecutive year. Inflation could surpass 700% in 2016, according to the International Monetary Fund (IMF), while the scarcity of basic goods – even water –is expected to drastically worsen and fuel major social tensions. Much of the country is grappling with sporadic power cuts as economists forecast a contraction of around 5% in GDP this year, although a rebound to a small positive return is expected in 2017.

President Nicolás Maduro has tried desperately hard to rally support among oil producing nations in an attempt to persuade Saudi Arabia to cut crude oil production. Why? Because crude oil makes up a very significant part of export revenues and falling prices combined with years of mismanagement have put the economy under immense pressure. Economists are warning that default is almost inevitable as oil prices remain highly volatile and fellow OPEC[C] members continue to ramp up production.

In response, the Venezuelan leader has been forced to devalue the currency and raise gasoline prices. Even this is far too little, far too late. While the move will help to ease pressure on public finances, the economic measures are nowhere near to what is required to tackle the burgeoning budget deficit. Despite this, Maduro has made it a priority to meet payments on sovereign debt, even if that means squeezing imports further. With a total of $10.5b due this year, the government will be raiding its dwindling foreign reserves once again and the once hefty stock piles of gold are wearing thin. The government could turn to China for more loans, although the patience of the Chinese will surely be tested as a result.

With the current economic dynamics as they are, an 'orderly' default would arguably be the best bet for Venezuela. It should also mean that the nation's politicians confront the issues head on. But alas, default would cast doubt over the regime's existence and it could allow creditors to snatch assets abroad, sweep up oil cargoes and subsequently choke off the only significant source of revenue this little nation has.

Much like Brazil, the good news is the only way is up from here. A deep recession this year is inevitable, but there are ways to reduce the depth and length of it. Master Maduro clearly isn't so masterful, and the country needs someone in power who will come up with a clear and concise economic plan that will garner support from the international players. The hostility currently shown towards the IMF will also need to go.

[C] The Organization of Petroleum Exporting Nations.

Mexico top despite being Trump'd

Donald Trump may have called for a 'great, great wall' to be built along the US-Mexico border (which the latter should pay for too, apparently), but the country has been a relatively strong performer in Latin America with GDP growing 2.5% last year. Recent economic data has been largely positive with the Markit Manufacturing Purchasing Managers' Index inching up from 53.1 in February to 53.2 in March, marking a 10-month high. Markit also reported that the current weakness in the peso has boosted export sales.

Still, like many of its peers, Mexico's economy is largely dependent on oil and will continue to face headwinds on that front. Additionally, despite a recent rebound, there has been mounting pressure on the peso which led the Central Bank to raise interest rates by 50 basis points to 3.75%, while the government has announced another round of budget cuts. A slowdown in the US industrial sector may also dampen progress this year, although a weaker currency should boost exports which will continue to support consumer fundamentals.

Fasten your seatbelts…

A bumpy road lies ahead. Investing in Latin America has never been a smooth affair but the region can still produce some very good investment opportunities. The economic prospects for this year aren't particularly inspiring; subdued commodity prices will remain a key concern in the near term, and China's slowdown, however necessary and controlled it may be, will continue to play its part. Still, wider commodity prices are expected to receive a welcome boost down the line as growth returns to the region towards the second half of the year, although progress will be disparate. The opportunities are there but tactical regional and intra-country allocation will be necessary.

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