PERSPECTIVE

A Lens on Latin America

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This month, the World Bank and the International Monetary Fund (IMF) will hold their joint annual meeting in Lima, Peru, marking the first time such an event has been held in Latin America in almost 50 years. The organizations' annual meeting provides a forum for finance ministers and central bank governors from around the world to discuss economic and financial issues, and policies tied to promoting economic growth and reducing poverty. The agenda covers a range of issues the region is facing today—including infrastructure, sustainable development, the impact of commodity prices, social and economic inequality, and unemployment.

Peru: A Model of Progress

The choice of Peru for this year's meeting is noteworthy, as the country has been changing and transforming. In conjunction with the event, the IMF published a book that chronicles Peru's challenges, policies and successes over the past 30 years titled, *Peru: Staying the Course of Economic Success.* In the book's forward, IMF Managing Director Christine Lagarde states: "When I think of Peru and its accomplishments, I am reminded of the old adage by Sophocles that 'success depends on effort.' The narrative of Peru's economic transformation over the last three decades clearly demonstrates the validity of this well-worn proverb." I would agree.

Peru's long-term economic achievements have been considered a model for other countries in the region, but over the past few months, worries about a near-term rise in US interest rates, potentially slowing growth in China (a significant market for many Latin American exporters) and currency weakness against the strengthening US dollar have weighed on Latin American markets. Peru has certainly been affected by these factors, but seems to be weathering the challenges better than some other countries. Peru's gross domestic product (GDP) is forecasted to grow 3.0%–3.9% this year, compared with less than 1% for Latin America as a whole,[1] and its currency, the nuevo sol, has depreciated just over 7% this year against the US dollar, less than most other Latin American currencies; Brazil's real has fallen 34%, while Colombia's peso has fallen 22%.[2]

Peru has benefited from its great mineral wealth; it is the world's second-largest producer of silver, the third-largest supplier of copper and a key producer of gold and zinc.[3] Healthy prices for these and other key exports helped drive average GDP growth of 5.6% from 2009–2013 and allowed the government to make great strides in reducing the country's poverty rate. While lower commodity prices have recently hurt Peru, copper output is expected to rise as new mines come on line in the next few years—potentially pushing Peru ahead of Chile as the world's second-largest producer—and a rebound in prices could offer an economic boost. Officials in Peru have been looking for avenues to diversify its economy away from mining, and have enacted reforms to spur investment, engaging in a number of trade partnerships, deals and negotiations including the Trans-Pacific Partnership. Infrastructure has also received heightened attention from the public and private sectors.

One potential setback for Peru in terms of its progress could be a possible downgrade by index provider MSCI, which has stated it is considering reclassification of Peru from emerging- to frontier-market status because of the poor liquidity of Peruvian stocks. On September 30, MSCI announced it would give the country until June 2016 to address its concerns. It may seem like linguistics, but the index designation is important in terms of retaining and attracting foreign investor assets. Peru currently has a weighting of 0.4% in the MSCI Emerging Markets Index, but could have a much larger weighting in the MSCI Frontier Markets Index. Peru is taking actions to lure foreign investors—who are already responsible for roughly a third of its stock market trading volume. These actions include a 10-year plan to make Peru a financial hub in Latin America, as well as tax reforms that are more investor-friendly.

Additionally, while Peru has had the lowest annual average inflation rate over the past decade (2.9%) in Latin America,[4] a recent increase in inflation prompted Peru's central bank to raise its benchmark interest rate to 3.5% in September, despite concerns about slowing growth.

Brazil Battling Headwinds

The last time the World Bank and the IMF held an annual meeting in Latin America was in 1967, in Brazil. Brazil's economy has grown and changed a lot since then. In recent days, Brazil has been battling a number of headwinds that seem to have grown to gale force strength this year. Its market has been hurt by lower commodity prices, political concerns, weak economic data, an increase in interest rates and a credit downgrade. Brazil is currently going through a tough political phase, given the recent corruption scandals surrounding state-owned oil giant Petrobras. Many named politicians are under investigation, and many participants are already in jail or have been convicted. We view this as a sign of the independence of the legal system, which seems to be undeterred by the politicians.

The opportunity within this scandal is to execute deep government reform, including streamlining by the potential reduction of the number of government departments and the revamping of the tax code, while doing something about the social security structural deficit. In the short term, we could see some immediate improvement, including privatization of a large number of assets in infrastructure (roads, airports, ports), and more flexible rules so foreigners can participate in bids to own airlines and farm land, in addition to an aggressive plan to sell US$58 billion in assets from Petrobras.

Apart from the scandal, Brazil's economy has been suffering from a recession this year with inflation rising in June to its highest level in more than 11 years, forcing the central bank to raise its benchmark interest rate in July by 50 basis points to 14.25%, its highest level since August 2006. Meanwhile, continued weakness in the Brazilian economy and a decline in government revenues during the first half of 2015 led the government to reduce its budget targets for 2015 and 2016. Citing Brazil's economic weakness and high debt levels, international ratings agency Standard & Poor's downgraded the outlook for Brazil's foreign currency debt from stable to negative, and then lowered the long-term foreign and local currency sovereign ratings on Brazil to BB+ and BBB-, respectively. President Dilma Rousseff's failure to set clear fiscal targets may have contributed to the sovereign downgrade. When her second four-year term started in January, the target for the 2016 primary fiscal surplus (the government budget balance before interest payments) was 2%, but that target has been missed. Now, the government is talking about a budget deficit.

In an attempt to dig itself out, Brazil's government recently announced a US$17 billion austerity package, which includes spending cuts and tax increases. Finance Minister Joaquim Levy is running into his own headwinds from a wide range of special interest groups that oppose these measures. Even the tax department auditors' union is fighting for higher wages and called for a day to switch off all computers linked to the tax department systems. Clearly, Levy is having a hard time cutting government spending despite the economic crisis facing the country. One of the most contentious issues is the proposal to impose a tax on all financial transactions, which seems unlikely to be approved by the Brazilian Congress.

This means that without government spending cuts (resisted by government workers) and without increased tax income (resisted by the population at large) the near-term prognosis does not look good for Brazil. While Brazil's situation seems dire, this does not mean that we, as investors, will be abandoning Brazil or Brazilian stocks. We are bottom-up stock pickers and take a longer-term view. We believe Brazil—South America's largest economy—will survive and companies located there can too; so we plan to continue investing there and are looking for potential bargains.

As I have stated before, when investor sentiment is at extreme lows, I believe the best opportunities can be uncovered if one is patient, and selective. Brazil has incredible resources, not only in terms of natural resources but also human resources. We think the manner in which Brazil's government institutes reforms to utilize its resources most effectively will be key to its economic fate. Within the next three to five years we could see tremendous changes—if the will is there.

We would emphasize our belief in the importance of reducing government bureaucracy and spending in Brazil. We believe policies that support growth in the private sector, particularly small- to medium-sized companies, could contribute greatly to the growth of the economy. I think the leaders should make it easier for people to do business in Brazil. The country also needs to continue its focus on fighting corruption. If the economy does not revive, companies' earnings will likely not be very good, so we do need to be cautious. It's not only about the president, but also Congress where we see change needed. We believe there has to be a change in attitude. If there are enough reform-minded people, change can happen. Brazil is not the only country with these issues, but we think the potential growth is so great in Brazil that it is a shame the government hasn't been more effective.

Opportunities in Latin America

In our opinion, Latin America overall continues to be an attractive investment destination despite near-term headwinds. The region possesses some of the world's largest and lowest-cost sources of key commodities, including oil, metals, minerals and agricultural products, and we believe longer-term demand trends for most basic materials are set to improve as global and emerging-market economic growth improves.

Rapid advances in technology have helped fuel growth spurts in Latin American countries, as markets take advantage of technological advancements while leapfrogging over the development phase. We also think a major reason to be optimistic about growth in the region is tied to demographic trends. Younger age groups generally dominate populations in emerging nations including Latin America, in contrast to many parts of the developed world, that have aging populations.

The market tends to be forward thinking, while economic statistics are backward looking. This sometimes leads to a mismatch. In periods when the markets are out of favor, we look for investments that we believe have been unfairly punished by the general downturn in investor sentiment and appear undervalued relative to their true potential. Recently, we have been seeing several such opportunities among a number of Latin American equities. We look forward to the dialogue and ideas that will result from the World Bank and the IMF's meeting in the region this year.

What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

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1. Source: IMF World Economic Outlook database, April 2015; World Bank. There is no assurance that any estimate or forecast will be realized.

2. Source: Thompson Reuters, as of September 22, 2015.

3. Source: CIA World Factbook, 2014.

4. Source: IMF World Economic Outlook database, April 2015, from 2004–2014.