Latin America

What might 2016 hold in store?

Ian Simmons, Portfolio Advisor

reviews the investment outlook for this battered region over the year ahead

January 2016

December was unusually busy in terms of newsflow both inside the Latin American region (impeachment filings and ratings downgrades in Brazil) and externally (Fed hikes and commodity price collapses). However, none of this changed our expectation for ‘more of the same’ when it comes to the region’s markets, at least for the first few months of the year. Our portfolio positioning reflects broadly unchanged views on where the most attractive risk/reward opportunities can be found. Growth as a style was rewarded across emerging markets in 2015, while Value has generally been the wrong place to be, especially in Latin America where many state-owned or commodity-linked companies have moved from cheap, to even cheaper. While growth remains scarce, we would not be surprised to see these trends continue, as companies able to deliver even double-digit increases in earnings are likely to be rewarded by investors. We had temporary periods of volatility in 2015 where value names performed incredibly well for a few weeks before giving back all their gains over subsequent months. With headline news, especially in Brazil, likely to drive short-term market swings we can expect the same again for the start of 2016. Our aim as always is to remain patient and wait for interesting entry points on names we have identified as long-term winners rather than attempt to time these low quality rallies.

Comparing the two largest markets, Brazil and Mexico, highlights some important contrasts that explain our positioning.

Mexico looks set for another year of rising GDP growth in 2016 and the attraction here is that we don’t see much derailing this outcome. This growth is coming from multiple sources, which inevitably means risks are more diversified. The first is the exposure to the US economic recovery, particularly via auto and aerospace manufacturing, two large industries which are increasingly locating themselves in much lower cost Mexico. A weaker currency only serves to enhance the country’s productivity advantages. The second is the internal reform story. Mexico is one of a very short list of emerging market countries making tangible progress in implementing much needed reforms. The most important of these is energy reform, which is allowing Mexican and international private companies to drill for oil and gas in the country alongside state-owned Pemex for the first time in the company’s 77 year history. Both these pillars of growth are boons for employment and infrastructure investment. Alongside these, the more traditional emerging market themes of rising formal employment, a growing middle class and increasing credit penetration are at last showing signs of sustainable improvement in Mexico. The country is several years behind Brazil in this respect and these drivers can be expected to be a source of longer term growth in consumer-related names.

Of course, as bottom-up stock pickers, we need to see more than an attractive top-down story to justify our current 9% overweight in the country. Valuations are not cheap but we continue to find stocks, often in off-index small and mid caps which tap specifically into one of the three broad areas of interest mentioned above. At the very least, should multiples be maintained (and right now we don’t see a reason for them to fall), then we should see a share price return in line with the growth in earnings and cashflow. Companies in

Mexico operate in a much lower rate environment than Brazil, thereby justifying a higher PE multiple for the market. Additionally, the universe consists of several high quality private sector operators with leading market share and consequent high returns.

We do not see the same representation of state-owned or cyclical commodity companies in Mexico as in Brazil, yet another reason why multiple comparisons between the two countries are mostly redundant. Having said all this, we are very aware of the large consensus underweight in Brazil, and the long-term potential of this market. A pick-up in private equity activity and the re-emergence of international industry buyers suggests that those with a genuinely long-term view (five years and over) and dollars to spend are starting to find pockets of value in strategic assets in Brazil. While hesitant to pin down timing on an inflection point, we do believe there will come a time in the next 6-18 months when all possible bad news is priced into Brazil and we see a reversal of its fortunes. Stockmarkets will inevitably move several months before the economy bottoms out and when this happens we could see some flows out of Mexico. Justified or not, the effect could be some stagnation or even deterioration in the multiples we see in the Mexican market. As mentioned earlier, this is a risk we remain comfortable with for now especially given the strong fundamentals of our holdings.

Brazil is currently dominated by news from the political arena. The recession there has been exacerbated by a stalemate in congress which has prevented any major fiscal adjustment taking place. Now that impeachment proceedings have started, the stalemate looks set to remain until the end of the first quarter when the next round of voting occurs as politicians will be more concerned with keeping their jobs and staying out of jail (as the corruption investigation widens) than making tough decisions for the good of the country.

The impeachment announcement is a double-edged sword. While the prospect of Dilma being replaced is certainly a relief to the market, we currently see the chances of securing enough support as low, and in the meantime, policy decisions are unlikely as there is no point any congressman committing to support a proposal which may be the last action of an outgoing president. Without a determined effort to cut spending and raise taxes (respectively, the most and least preferred options), the primary surplus goals look optimistic and gross debt to GDP ratios will continue rising. As this dilemma has been well flagged we do not think too many people were surprised by Brazil's downgrade to junk status in 2015 by two of the three rating agencies. We will see in the New Year if this affects fixed income investors' willingness to be positioned in the government's debt.

Without the ability to use expansionary monetary or fiscal policy to stimulate growth in this recession, the currency is feeling the pressure and a more competitive exchange rate will ultimately be part of the solution for Brazil. Although we have seen a large move in recent years most economists agree that there is more downside than upside from current levels. Our worst (and base) case scenario is that within three years, the country will change for the better – a reasonable time horizon for most investors to consider.

The October 2018 election will almost certainly bring a new political party to power as the Workers' Party founded by Lula and currently backing Dilma Rousseff as president is likely to suffer the consequences of the worst recession in a hundred years, rising unemployment, high inflation and a corruption scandal. Any of the other potential winners in 2018 have a much more market-aligned ideology and we expect the Brazilian market to perform well in advance of the election: see Brazil in the first half of 2014 and Argentina over the last two years for evidence of investors pricing in anticipated change. A best case scenario is that Dilma is forced out or resigns well before 2018, and a more centrist party with political will to make meaningful reforms takes over. A swing to the left by Dilma in an attempt to appease disgruntled voters would be a concern, but would not ultimately change the fact that the 2018 election should provide us with better news. We remain underweight Brazil as we look for better valuations on the local market, currently in line with long-term averages, and/or a weaker currency, to remove some of the downside for us as foreign investors. We will be watching political news carefully to see if the probability of change as early as 2016 rises from relatively low levels today.

In the meantime, our strategy at a stock level remains the same. With risk free rates and commodity prices moving to levels unforeseen just a year ago, and multiple political scenarios on the table, we do not see much point in trying to look for the 'right' index level to become more positive on Brazil as a whole. What we do know is that we are looking at stocks today with depressed earnings courtesy of the recession, and depressed valuations as growth momentum is poor and Brazil remains out of favour. When one, or both, of these metrics reverts, the potential rewards for investors with a three-year plus horizon are large. As and when high quality companies that are well known to us see their share prices drop to levels that reward us for another potentially tough year in 2016 we will gradually increase our exposure. As December closed we bought back into Raia Drogasil, Brazil's largest pharmacy chain expecting close to 20% earnings growth in 2016. This was a successful holding for us through 2014 and 2015 which we exited as valuations became stretched. Having fallen 25% in dollar terms since then we were happy to restart a position in a company that is in a dwindling minority still able to raise growth guidance for 2016.

We expect growth stocks to retain their relatively higher multiples so long as they continue to deliver, but if the market over-penalises them for slowing in another year of negative GDP growth, we will potentially look to build positions where we have confidence on their longer term trajectory. We think there will be enough volatility for patient investors to access some desirable names at attractive valuations, especially in hard currency terms. Any company that has leading brands, dominant market share, pricing power and a strong balance sheet to capitalise on weakness among competitors should be in a favourable position to survive this recession and prosper again in the future. Select exporters, and those with business overseas, continue to be well positioned to benefit from currency weakness and some of these names provide a natural hedge within the portfolio.

There will come a time when buying more Brazil, or increasing the beta within the existing holdings, will be the right thing to do. It is a large liquid market, with plenty of high quality, privately owned companies that we are certain global and emerging market investors are keeping a close eye on. Anecdotal evidence suggests that more potential investors are 'kicking the tyres' in Brazil than since the Financial Crisis and reported disclosures suggest some major investment firms have been buying up significant stakes in some of these names with a view to better years ahead. The silver lining of the investment thesis now is that it is hard to envisage much 'new' bad news – Brazil's problems are well known, and either an economic turnaround or stock level valuations will prove to be a trigger for renewed performance.

Outside Brazil and Mexico, the Andean countries all offer an interesting combination of opportunities. At a macro level, they are facing commodity price headwinds, but as we tend not to get our exposure in mining companies this is proving less relevant for our holdings. Regardless of commodity prices, we should be looking for a year of 2.5-3% GDP growth in Chile, Colombia and Peru – a solid outcome, albeit lower than the average levels of the last decade. We like Peru, but really this is just one specific banking sector holding seeing valuation levels close to 2008 lows. We recently added to Chile where most of the pain from uncertain policy changes and currency weakness seems to be behind us, and initiated an Argentina holding where the election outcome was the one we wanted and the new president has started his reform agenda impressively. This group of countries still merit attention as lower liquidity can lead to some appealing valuation anomalies in stocks which are often only at the very beginning of multi-year growth paths.

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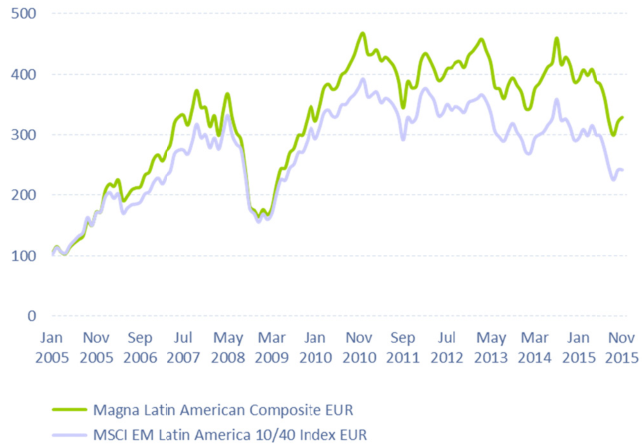
Investors can access the Latin American region via Charlemagne Capital's Magna Latin American Fund, the performance of which is shown below.



Period to 30 Nov 2015	Fund	Index	Relative
1 Month	2.4%	0.2%	2.2%
3 Months	2.3%	-1.4%	3.7%
From 30 Dec 2014	-15.2%	-16.8%	1.6%
1 Year	-20.9%	-22.7%	1.8%
Annualized data:			
3 Years	-7.2%	-10.5%	3.3%
5 Years	-6.3%	-8.6%	2.2%
Since inception (31 Dec 2004)	11.5%	8.4%	3.1%

Gross EUR

Chart rebased to 31 Dec 2004 = 100

Fund returns are based on a composite of all share classes

The Index is the MSCI EM Latin America 10/40 Index

The Magna Latin American Composite is based on all share classes of the Magna Latin American Fund. Charlemagne Capital claims compliance with the Global Investment Performance Standards (GIPS®), as verified for the period 1 Jun 2000 through 31 Dec 2014 by Ashland Partners. A copy of the verification report and a presentation that adheres to GIPS standards are available upon request.

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