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Latin America Strategy

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Patience Is A Virtue

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Summary

- Latin America is caught between strong cross-winds. On one side, the region may benefit from tail winds from a global reflationary environment, characterized by easy monetary and fiscal policy, above trend growth and firm commodity prices. But domestic headwinds could partially counter this favorable set of global financial conditions. The Covid pandemic has not only had a severe negative economic impact, but also social with greater polarization and political fragmentation, features that the region was already dealing with before the health crisis. A number of important electoral cycles will take place in 2021 and institutional change and social pressure could come from its results.
- Regional economies have rebounded from the 2020 lows, but full economic recovery from the Covid-19 pandemic might not be achieved until late 2022. By contrast, we expect the global economy to fully recover in 2021 and likely enter an above trend growth cycle in the coming years.
- 2020 was an annus horribilis for Latin America's markets and economies. While 2021 might not be precisely an annus mirabilis, we see tactical opportunities for global portfolios. Given the sharp economic contraction and financial market underperformance, we look for the region to potentially outperform in 2021, in line with our Reversion to the Mean Outlook theme. The region's highly cyclical equity market was the worst performer in 2020, and saw some of the sharpest real exchange rate depreciations. These large performance dislocations relative to the rest of the world present an opportunity in our view. We caution, however, that this is a tactical and cyclical view and subject to the high levels of volatility that characterize the region. Unlike emerging Asia, where we see long-term secular growth opportunities, we fear that absent significant structural reforms, Latin America's growth path will remain a challenging one over the coming years, limiting long-term investment opportunities.

Post-Covid Recovery Favors Cyclical Markets. Stay Tactically Overweight

While most global markets managed to stage not only a remarkable recovery but also close on a high positive note, Latin America lagged behind. Global equities gained more than 14% in 2020, outperforming Latam, down 16%, by nearly 30%. Meanwhile, with the global economy expected to have contracted close to 4% in 2020, Latin America's GDP could have lost 7% as the pandemic hit hard and resources for countercyclical policies to cushion the impact of the pandemic were scarcer. It is not unusual for Latin America to underperform during periods of global shock or crisis. Risk aversion drives investors to reduce their most volatile positions first and more aggressively than others and Latin American markets fit the categorization of "riskiest" quite nicely. However, the periods when risk appetite increases and come back in vogue, tend to trigger the opposite risk seeking behavior. We look for the upcoming global economic recovery to be no different and expect Latin American markets to finally have their day in the sun, albeit if only temporary.

We must highlight that our tactical positive view on Latin American equities markets is predicated on its mean reversion characteristics which we believe are likely to be crystalized in full force in 2021 as the impact of low policy interest rates, the global vaccination process and continued developed market stimulus programs, increase investor risk appetite for the most depressed segments of the markets.

Even though Latam markets lagged, they have recovered strongly from their 2020 lows. This has been the case with many other markets laggards. Since November alone, when we made our final increase to the region's exposure, the Latam MSCI has gained around 10%, matching the performance of the S&P (figure 2). When compared to the March 2020 lows the rebound is an astonishing 77% -this of course after having collapsed 54% between January and March 2020.

Figure 1: Equity Markets 2020 Price Returns

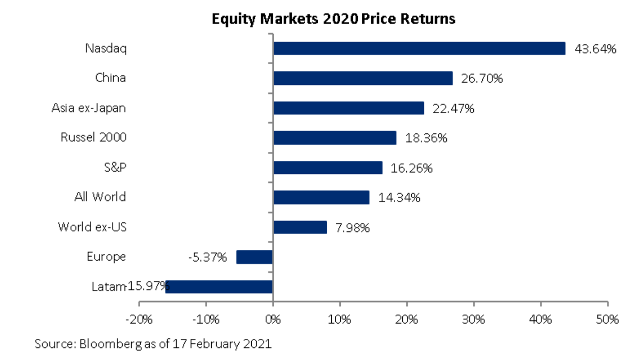
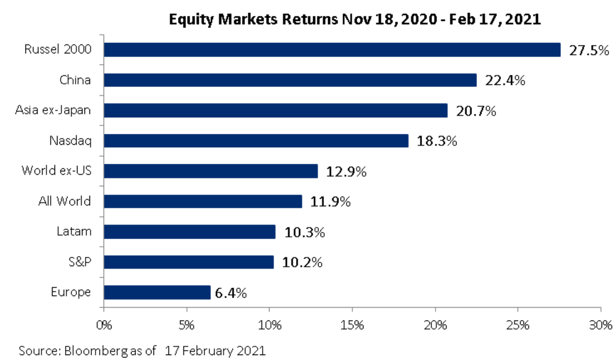


Figure 2: Equity Markets Returns (Nov 18, 2020 - Feb 17, 2021)



Source: Bloomberg as of Feb 17, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Vaccinating against Covid: How do the different countries stack up?

Vaccinations in Latam began in the last days of 2020 but only accelerated late January. Progress has been very uneven with shortages of doses and logistical complications. Chile has been most successful with around 12% of the population inoculated and with an increasing rate of vaccinations. Each of the rest of the major economies has only vaccinated less than 3% of their population as of 17 February. Brazil had initially increased distribution quickly but has seen supply issues recently. Argentina and Mexico have been very slow to increase vaccinations despite having started ahead of Brazil and Chile. Colombia is just beginning a three-phase inoculation plan. Peru, meanwhile, is mired in "vaccination gate", with high profile politicians being accused of having received the vaccine ahead of its public availability. As of late, Argentina and Brazil have also been involved in vaccination scandals, with the Health Minister of the former having had to resign over VIP vaccination centers.

As with the rest of the world, we would expect vaccination rates to accelerate in the coming months, but to lag relative to developed economies and with likely more complications along the way.

Figure 3: Covid and Vaccination Data

	Cases	Deaths	Recoveries	Vaccinations Doses Administered	Vaccinations as % population	Cases per 1mm Population	Deaths per 1mm Population
Global	110,027,378	2,432,977	69,823,139	186,969,804	2.4%	14,318	317
U.S.	27,829,771	490,775	7,807,570	56,989,329	17.4%	84,785	1,495
U.K.	4,083,092	119,159	11,099	16,499,549	24.7%	61,093	1,783
China	100,674	4,833	94,960	40,500,000	2.9%	72	3
Argentina	2,039,124	50,616	1,842,878	612,322	1.4%	45,376	1,126
Brazil	9,978,747	242,090	8,933,402	5,931,936	2.8%	47,282	1,147
Chile	784,314	19,659	743,306	2,375,725	12.5%	41,384	1,037
Colombia	2,207,701	58,134	2,099,628	-	0.0%	43,856	1,155
Mexico	2,013,563	177,061	1,571,071	915,383	0.7%	15,783	1,388
Peru	1,252,137	44,308	1,156,408	113,075	0.3%	38,515	1,363

Source: Bloomberg as of: *Thursday, February 18, 2021*

Source: Bloomberg as of Feb 17, 2021.

Figure 4: Number of vaccines administered

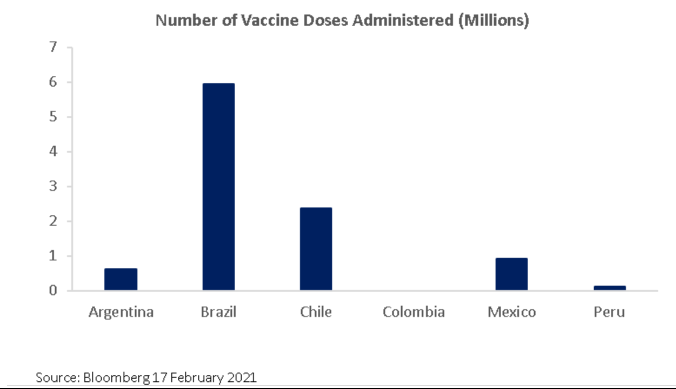
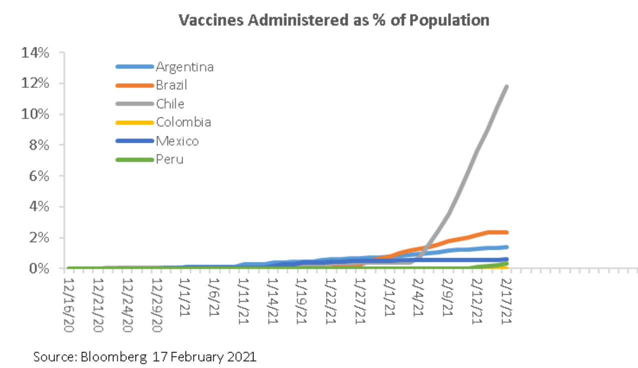


Figure 5: Vaccines administered as % of population



Source: Bloomberg as of Feb 17, 2021.

2021 Elections. What's at stake in the mayors?

Elections will take center stage in a number of Latam countries in 2021. Populist administrations are already present in Mexico, Brazil and Argentina. Further shifts to the left could happen given the health and economic crisis the region is undergoing. Of particular interest will be the general elections in Chile, Peru and Ecuador as well as the congressional midterms in Mexico and Argentina.

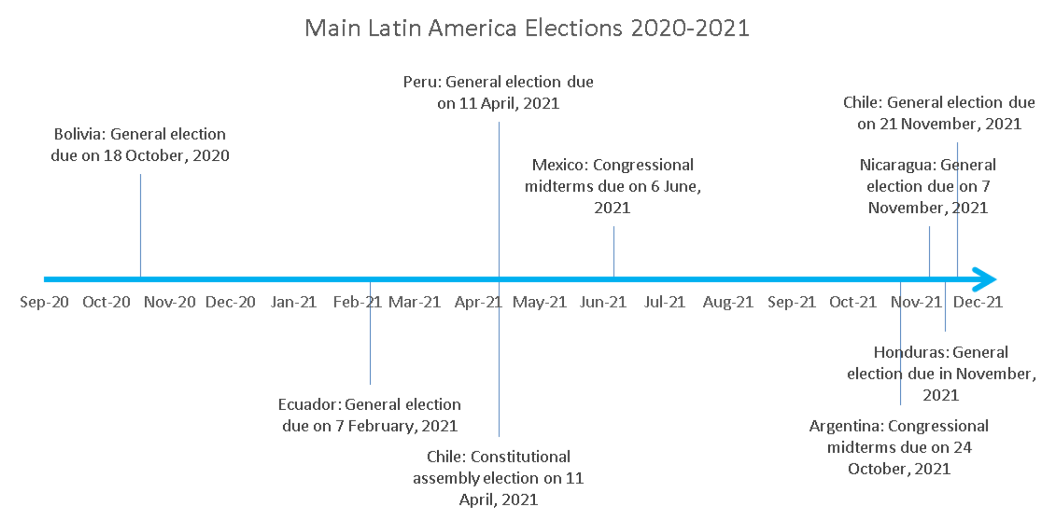
Peru – political uncertainty and scandals have been a fixture over the past four years, with tension peaking in November of 2020 with a constitutional crisis that resulted in the swearing of its third President in only one week. Incumbent Francisco Sagasti is now set to hand over power in the upcoming presidential elections of 11 April 2021 which boasts a field of 22 candidates and includes Geroge Forsyth -the national team's goalkeeper-, Keiko Fujimori –the daughter of former president Alberto Fujimori, currently in jail- and Ollanta Humala –former president awaiting sentencing for corruption charges.

Chile – a referendum held on 25 October 2020 that resulted in nearly 80% of the population voting in favor of changing the constitution through a specifically elected constitutional convention -which will later draft a new constitution to be ratified by referendum by mid-2022. The members of the constitutional convention are scheduled to be elected on 11 April 2021. General elections will follow on 21 November 2021. The combination of a new constitution with a new administration suggest a high level of political and policy uncertainty over the next 12-18 months.

Mexico – congressional midterm elections will take place on 6 June 2021 with all 500 Lower House seats up for grabs, along with 15 governors and more than 21,000 local seats. The results of these elections will be key to assess the probabilities of future attempts by the current administration to implement structural reform changes or reversal of previous policies.

Argentina – midterm congressional elections will take place on 24 October 2021. Half the seats of the Lower House and a third of the Senate are up for grabs. Strong discontent over the government handling of the pandemic and a deeper economic crisis could shake up its majority in the Senate. Argentina's complex political framework can't be analyzed with a standard lens however. Given the deep economic, social and health crisis, governability is likely to turn increasingly fragile and difficult no matter what the political outcome.

Figure 6: Main Latam elections 2021-2021



Source: Bloomberg as of Feb 18, 2021

Market Talk and Positioning.

After an early good start of 2021, Latam markets have underperformed under a combination of pressures stemming from the pandemic and political uncertainty. Unwinding our Latam equity exposure might be premature, notwithstanding the potential for broad market corrections. Historically, giving up too early on the recovery cycle has proven costly for returns. One of the most reliable fundamental variables we have tracked over the years is the level of the region's real effective exchange rate, a sort of coarse barometer for value. Over the last 25 years this measure of competitiveness has fluctuated between under and overvalued, accompanying the various economic expansions and crisis. Much like equities, Latam currencies have recovered from their cycle lows, but remain around 12% below their quarter century moving average, and well off -roughly 25%- below their overvalued top of the cycle levels. The relationship between real exchange rate rebounds and equity rallied has been a strong one over the years. On average, the 12 month forward return of the Latam MSCI has been over 34% when the region's real exchange rate is below 90 -currently at 84. When we look at the real exchange rates of individual countries, currencies like the Brazilian Real trade at more than 50% discount relative to their long-term average.

Figure 7: 1994 – current Latam real effective exchange rate ranges

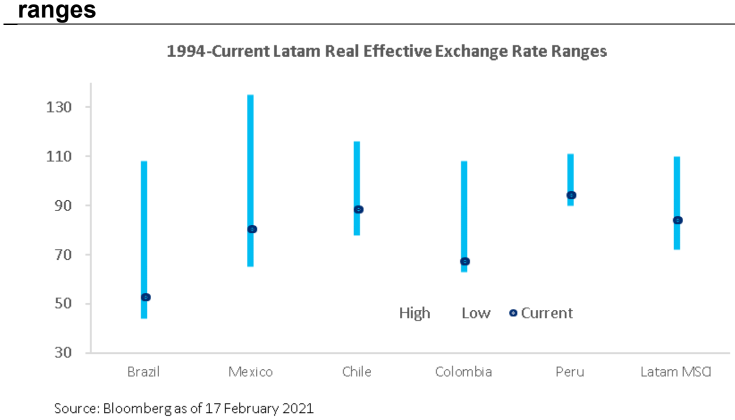
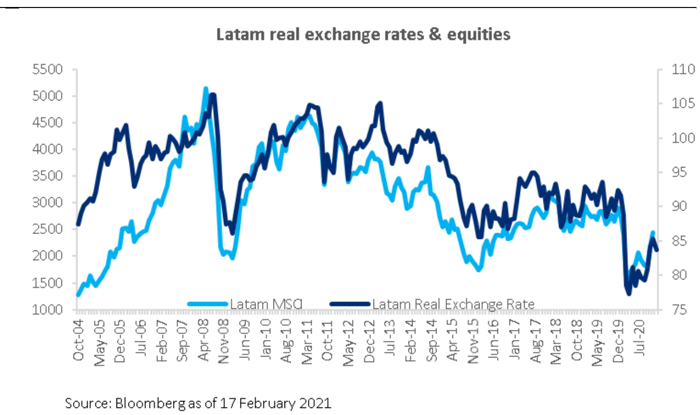


Figure 8: Latam real exchange rates vs. equities



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An additional tail wind that could compound the recovery of the exchange rates through the external accounts is a very supportive commodity outlook. The commodity index rallied nearly 10% in 2020 and is up another 7% in 2021. While it's early to categorize the commodity rally as the beginning of a super-cycle, expectations for average commodity prices that are key for Latam exports are supportive over the coming months. Brent crude is expected to trade near 70dpb in the next 3 months, roughly 10% higher current spot. Copper could have, for the first time since 2000, a structural demand growth driver in the acceleration of global de-carbonization. The metal may rally 84% from the March 2020 lows and may potentially reach $9,000/ton in the next 0-3 months and $10,000/ton in the next 6-12 months according to Citi Research analysis (Figure 9). Soybeans are also forecasted to remain firm over the coming 6-12 months.

Figure 9: Commodity prices forecast

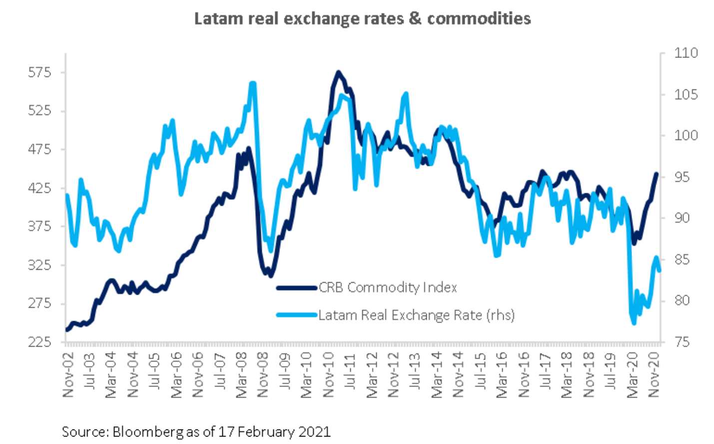
Citi Research Selected Commodity Forecasts

	Unit	Spot	0-3 month forecast	6-12 month forecast	0-3 month vs spot % chg	6-12 month vs spot % chg
Corn	USd/bu	550	500	600	-9%	9%
Soybean	USd/bu	1,375	1,400	1,600	2%	16%
Wheat	USd/bu	663	650	675	-2%	2%
Sugar	USd/lb	17.51	14.50	13.60	-17%	-22%
Coffee	USd/lb	128	115	125	-10%	-2%
Iron Ore	USD/MT	169	170	100	1%	-41%
Copper	USD/MT	8,403	9,000	10,000	7%	19%
Zinc	USD/MT	2,816	3,000	2,700	7%	-4%
Lead	USD/MT	2,103	2,150	2,200	2%	5%
Gold	USD/T.oz	1,773	1,850	2,100	4%	18%
Coal	USD/MT	115.61	100.00	140.00	-14%	21%
Brent crude	USD/bbl	63.93	70.00	67.00	9%	5%

Source: Citi Research. Spot as of: 17 February 2021

https://www.citivelocity.com/cv2/go/CommoditiesForecast

Figure 10: Latam real exchange rates vs. commodities



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Finally, within the region, we have placed particular emphasis on its largest economy, Brazil. While we continue to believe the economic rebound has the potential to be significant, we are witnessing pressure continue to build up on the economic and political side. The significant impact of the Covid health crisis has increased the need for government support. Brazil's fiscal resources, however, are constrained by stringent spending limits. The administration thus has been struggling to provide additional support without triggering fiscal discipline concerns. As a result, it has chosen to signal what could potentially be a concerning medium term direction.

Most recently, President Bolsonaro removed Petrobras' CEO Roberto Castello Branco, an orthodox trained economist who had been advocating for the company's independence from the federal government. His replacement is expected to be an army general loyal to Bolsonaro. It is not difficult to see why this level of interventionism can trigger investor concerns. The oil company's fuel price policy has been a target of debate for years, as domestic prices have been used to subsidize the population, at an estimated cost to the company of roughly $40bn between 2011-2014 alone. Fuel price hikes were also responsible for the trucker's strike in 2018 and the subsequent resignation of Pedro Parent, the company's CEO since 2016.

An extended, yet to be confirmed, interpretation of these recent events could be that President Bolsonaro will break away from MinFin Guedes and his reform agenda, and that more interventions are likely, setting the country up for a loss of investor confidence and a deepening of the health crisis and the economic downturn. While we don't rule out the possibility of this outcome, at present, we are of the view current events fall within the historical context of behavior and would not be surprised to see the administration counter with more pragmatic positive signaling in the coming weeks. Failure to shore up investor confidence would demand a reassessment of our overweight asset allocation exposure, which is currently based on the expected recovery dynamics of the post-Covid economy.

In the meantime, we look for short-term volatility to remain high and would suggest watching trading levels for breakouts that might trigger overshootings and signal lower levels ahead.

Figure 11: Brazil Exchange Rate (BRL)

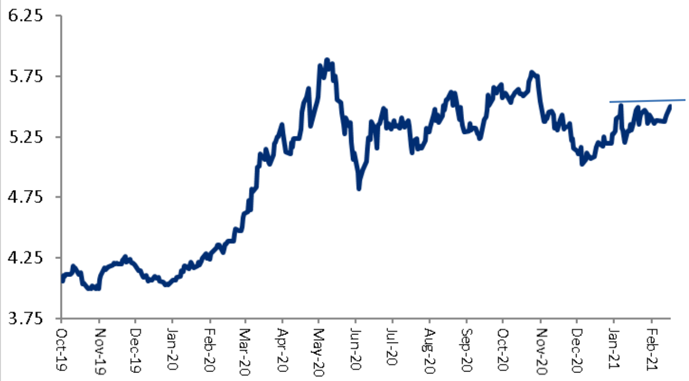
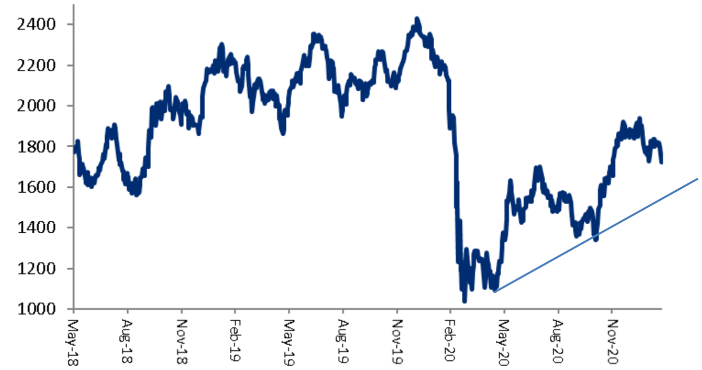


Figure 12: Brazil MSCI Equity Index



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