

LATIN AMERICA: A FRESH START?

27/02/2024 | XAVIER HOVASSE

Following a recent research trip, Xavier Hovasse, Fund Manager and Head of Emerging Equities, retains conviction that the region can drive returns for the wider EM equity asset class.

Home to 650 million people and 20 countries, Latin America is a vast universe with a market cap of more than 2 trillion USD and 4,000 companies.

Since 2010, the region has been neglected by investors due to economic and political upheaval. At the beginning of this decade, Brazil suffered its worst recession, while Argentina has seen debt restructuring after defaulting on its international sovereign bonds. Questions around investing in the region continued to be raised with cabinet reshuffles and an impeachment vote in Peru, the victory of a far-right candidate in Chile and the swings from right to left in Brazil.

However, from 2022, the region experienced a turnaround, as it started to become a beneficiary from changing geopolitical landscape. Indeed, as a major exporter of commodities, Latin American producers have had a significant opportunity, serving as a new resource for importer countries at a time when war paralysed Ukraine and froze Russian operations. The region also benefitted from the nearshoring phenomenon, with the relocation of supply chains back to the region.

In 2023, Latin America was a bright spot in a somewhat lacklustre year for emerging markets, with the region's equity markets among the world's strongest performers. Despite Latin American equity markets historically depending on the strength of Chinese growth and commodity prices, the region outperformed in 2023, notwithstanding the underperformance of the Chinese economy and falling prices within oil and agriculture. We believe that recent economic and geopolitical structural tailwinds that have provided support for the region, will continue in the coming months and quarters.

AFTER A DIFFICULT DECADE, A FRESH AND STRONGER START?

The MSCI Latin America Index returned 25.1% in US dollar terms¹, slightly outperforming the MSCI World, which gained just over 24%. Broader emerging markets, as measured by the MSCI Emerging Markets Index returned less than 9.8%, impacted by subdued economic growth in China and capital outflows in context attractive cash rates in the developed markets. Much of Latin America's strength came from Mexico, with the MSCI Mexico Index up 41.5% in 2023, followed by Brazil which is up 33.4%.

We believe there are three main drivers for strong performance in the region:

A favorable economic backdrop

Despite countries such as Argentina hitting headlines due to triple-digit inflation (254% as of Jan. 2024²), inflation in the wider region has been moderating. Many of the region's central bankers got an aggressive head start on monetary tightening during the Covid 19 pandemic. As a result, inflation in Latin America peaked at 24% in March 2023 and has since fallen to 2021 levels. This early start gives policymakers runway to start, or continue, monetary easing to support their economy - a likely boon for Latin American stocks.

Moreover, after a decade of king dollar, the greenback may lose some of its momentum. And beyond the strength of the dollar index, with solid export activity and the price of exports rising, the terms of trade of Latin American countries are improving, leading to improvements in their trade balances. This should support their currencies versus the US dollar.

Benign political environment

For the first time in a long period, the region is experiencing a less concerning political environment and increasingly muted political risk. In most countries, elections are now behind us, most notably Brazil and Argentina. In Brazil, concerns over left-wing president Lula Da Silva abated as the centre-right Congress implemented checks and balances to ensure the previous finance minister, Paulo Guedes's orthodox monetary policy continued.

In Argentina, the victory of Javier Milei was welcomed by markets, with the hope of more restrictive policies and budget cuts that should improve the country's economic fundamentals. We see Argentina as a potential turnaround story if Milei succeeds in stabilizing the economy (inflation under control and lift the currency controls). However, given the challenges the country is facing, we believe it is too early to have a clear view on the country to build our exposure yet, so the country remains on our watchlist.

As for Mexico, we now have visibility of the two leading candidates for the 2024 presidential election. The favourite to win is Claudia Sheinbaum, head of the incumbent Morena party. Her campaign is based on continuing the path set by current president, Lopez Obrador, who has been remarkably orthodox in his fiscal and monetary policies. The other leading candidate is Xochitl Galvez, who comes from a centre-right alliance that's considered pro-free-market. Both contenders are fully aware that the geopolitical tensions between the US and China are throwing up major opportunities for Mexico, such as near-shoring (discussed in further detail below) and are likely to want to capitalise on these.

Attractive valuations in absolute terms and relative terms

Latin American stocks **are currently trading at attractive levels**, both historically and compared to global peers, and this even factoring in their recent strong operational performance. Latin America's 12-month forward price-earnings (P/E) ratio, at 9.0x, is just off its lowest level since 2008 and compares favourably with both the broader MSCI EM Index's average of 11.4x and the S&P 500 Index's 20.3x³.

Our view is that Latin American stocks are poised to outperform EM stocks more broadly due to the combination of attractive valuations, a supportive economic backdrop and a benign political environment.

BRIGHT SPOTS IN BRAZIL AND MEXICO

Mexico - the uncontested beneficiary of nearshoring and localisation trends

Mexico has emerged as a significant winner of the geopolitical tensions between the United States and China. Over the long-term, we believe the "nearshoring" trend, which drives global businesses to move supply chains closer to home, could substantially boost US investments in Mexico. The proportion of investments in the economy has risen from 16% to 24% over the past five years, with more than US\$11 billion of announced FDI plans according to IMF⁴, generally related to the automobile sector, electric vehicles (EV) and batteries, circuits, and automation, ensuring strong growth from which the equity market is benefiting.

Over the next five years we believe that Mexico could see a US\$155 billion surge in exports to the US⁵ or more than 10% of the country's GDP.

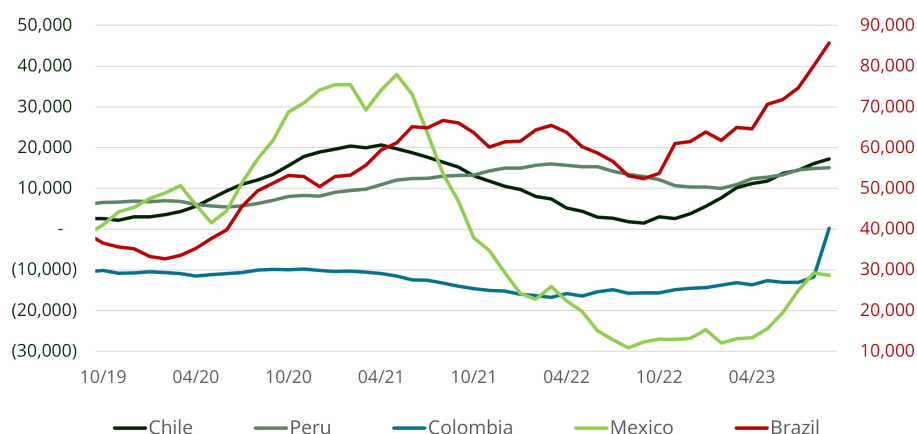
Lopez Obrador's Morena party has also shown a surprising degree of economic pragmatism which we believe will continue with the next president.

Brazil - a promising market

The Brazilian economy is demonstrably reaping the benefits of Bolsonaro and Guedes's reforms, most notably on the labour market, with the privatisation of some of the giants of the Brazilian economy.

Orthodox economic policy, which entailed the Brazilian central bank starting to hike interest rates as soon as March 2021, much earlier than the Fed or the European Central Bank (the ECB), has resulted in the country's inflation rate falling sharply (the headline consumer price index in the country went from a 27-year high of 12.1% in April 2022 to 4.6% in December 2023, within the central bank inflation target. This shift allowed the central bank to reverse its monetary policy, returning to easing mode which was a welcome development for equity markets.

Commodities Trade balances in Latam - 12-Month rolling



Source: Bloomberg, IMF, OECD, 31/12/2023.

Moreover⁶, as a major commodities exporter - 30% of global iron ore, second biggest exporter of raw sugar, soybeans, coffee corn and poultry meat - the Brazilian economy is benefiting from the improvement of agricultural and oil production which have risen sharply as a result of the high levels of investment over the last fifteen years. Agriculture growth is a boon to the economy, and a far more powerful structural driver than generally perceived. The sector accounts for 8% of GDP directly, but indirectly impacts 30% of GDP. Private entrepreneurs have invested a lot in technology, increasing yields by 3% per year over the past 30 years, doubling the average of other countries. With two harvests per year, sometimes even three, Brazilian agriculture is very competitive and provides a boost to economic growth.

As for oil, Brazil currently produces three million barrels of oil equivalent per day, but production is expected to exceed five million by 2029, which will provide significant support for Brazil's balance of payments, and therefore for its currency, the Brazilian real. The record high 90 bln\$ trade surplus of 2023 should remain in 2024.

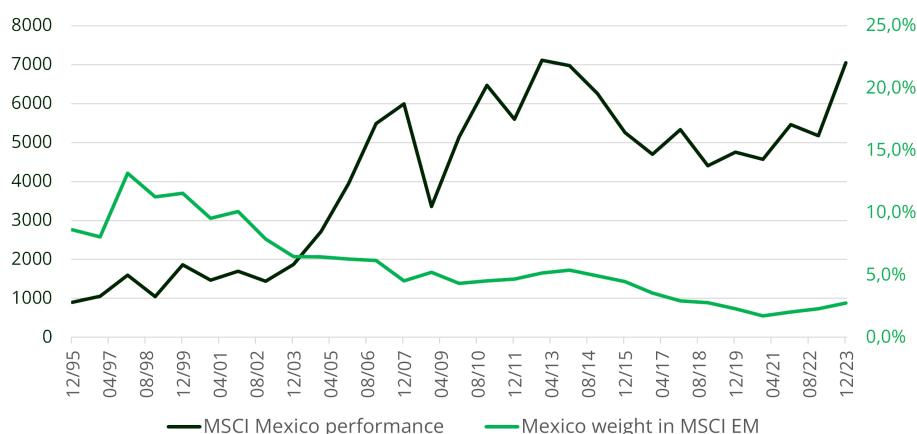
We believe these economic tailwinds in the agricultural and oil sectors are likely to drive robust expansion in trade for Brazil and boost Brazilian equities, which currently trade at a deep discount.

CONCLUSION

Latin American stock exposures are under owned weighted in global portfolios.

As things stand, we believe investors should reassess their exposure to opportunities within the region, especially within Brazil and Mexico.

Mexico: Market returns vs. weight in the index



Source: MSCI data, Bloomberg 31/12/2023.

For example⁸, the Mexican equity market is at an all-time high, whereas its weighting in the MSCI Emerging Markets index is at an all-time low (2.7%). This is a great illustration that indices are late to reflect the changes that we see in emerging markets. The region provides fertile ground for building concentrated high-conviction portfolios for active stock pickers looking for promising growth prospects like Carmignac.

Our outlook on Latin America is positive and we intend to continue shoring up our investments in the region (buying the dips) as we believe Latin America stands to benefit from structural trends, including the relocation of production plants to North America, and economic tailwinds, such as sustained commodities demand. The region also stands to benefit from the clean energy revolution, as it is among the biggest producers of green metals that are key for renewable technologies. As it stands, we have increased our regional exposure to more than 22% in our EM Equity portfolios. This is our highest LatAm exposure within the past eight years, with an overweight positioning versus the global EM equity indices (9% in the MSCI EM index⁹).

Investing in Latin America also enables us to diversify investments away from tech-heavy Asia and China; a valuable feature in periods of high interest rates and geopolitical uncertainty. As it allows for quality cyclical exposure avoiding the typical factor biases that may be attached to traditional ESG portfolios.

In a fast-changing and complex universe such as emerging markets, we believe it is even more crucial to invest via actively managed strategies in order to exploit the market inefficiencies and have exposure to the most attractive part of the universe while avoiding the unsustainable companies.

¹Source: Bloomberg, as of 29/12/2023.

²Year-on-year figure.

³Source : Bloomberg, as of 31/01/2024. The portfolios of Carmignac Funds are subject to change without notice.

⁴Source: IMF, Mexico 2023 ARTICLE IV consultation, November 2023.

⁵The portfolios of Carmignac Funds are subject to change without notice.

⁶Source: Bloomberg, IMF, OECD, 31/12/2023.

⁷The portfolios of Carmignac Funds are subject to change without notice.

⁸Source : MSCI data, Bloomberg, 31/12/2023.

⁹Source : Bloomberg, 31/12/2023.

SFDR - Fund Classification** :

Article 9



Recommended
minimum
investment horizon



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EQUITY: The Fund may be affected by stock price variations, the scale of which is dependent on external factors, stock trading volumes or market capitalization. **EMERGING MARKETS:** Operating conditions and supervision in "emerging" markets may deviate from the standards prevailing on the large international exchanges and have an impact on prices of listed instruments in which the Fund may invest. **CURRENCY:** Currency risk is linked to exposure to a currency other than the Fund's valuation currency, either through direct investment or the use of forward financial instruments.

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The Fund presents a risk of loss of capital.

* **Risk Scale from the KID (Key Information Document). Risk 1 does not mean a risk-free investment. This indicator may change over time. **

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