The investment case for Latin America

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Latin America has been one of the best performing markets globally in the first half of 2022. It was already benefiting from high commodity prices and this trend has been reinforced by the Russia/Ukraine conflict. Countries in the region have seen a sharp improvement in their terms of trade (the price of exports relative to imports) and with limited economic ties to Russia should see minimal disruption. The region's commodity exposure is broad ranging, from oil exporters (Brazil and Colombia), through exporters of industrial and precious metals (Brazil, Chile, Mexico, Peru) to soft commodities and agricultural products (Argentina, Brazil, Chile, Mexico).

Many countries had seen their equity markets underperform meaningfully last year and currencies have been very weak since the outbreak of the pandemic. In real terms, the region's currencies are not far from the lows seen in previous crises despite the significant improvement in the terms of trade, and the MSCI Latin America Index has fallen to a 30% discount to emerging markets on forward price to earnings (Latin America is on just seven times forward earnings), having historically traded at a small premium.

The discounted valuations and strong earnings momentum make Latin America a compelling investment proposition. Already this year, earnings estimates have been revised 42% and 32% higher for 2022 and 2023 respectively. This comes on top of 2022 earnings estimates being revised 21% higher over the course of last year and stands in stark contrast to the negative earnings momentum seen in the broader emerging markets.

The main risks from the conflict in Ukraine are a more severe impact on global growth and higher and more sustained inflation, which could lead to both a steeper and more prolonged hiking cycle in the US. Unlike in most Fed tightening cycles, Latin American central banks have been more proactive in raising interest rates and have been tightening for some time (Brazil has hiked rates by 10.75% over the past 15 months). This should leave them less vulnerable and better positioned for higher rates than at the outset of any previous Fed cycle.

As often seems to be the case in Latin America, domestic events exacerbate global trends. As the macro backdrop has improved with sharply higher commodity prices, so too the political landscape in Brazil has become more constructive. Former President Lula is leading the polls for October's presidential election and is looking to be more business friendly than previous Workers' Party administrations. He has already distanced himself from the far left of his party and left little doubt that he will adopt pragmatic, centrist policies if re-elected.

The most important confirmation of this is Lula's decision to select former Sao Paulo Governor Geraldo Alckmin as his running mate, who would then be his vice-president. Alckmin, and the centre-right

PSDB party that he founded in the 1980s, have been in opposition to Lula's Workers' Party for decades, but this alliance reflects Lula's understanding that to get elected and be able to govern the country effectively he needs to look beyond his leftist base. This increases the likelihood of at least a modest reform agenda which Brazil is still in need of to shore up government finances and raise economic growth potential.

The global and domestic trends are supportive for Latin American economies and markets, and valuations and currencies remain cheap. As the war in Ukraine drags on, Latin America is almost uniquely positioned in being geographically and economically insulated from the conflict while benefiting from the high commodity prices that are likely to persist.