

## Latin America: Will the Chickens Come Home to Roost?

- Latin American equities could stage a strong rally in the months ahead, as rising earnings combine with easing currency concerns, lower interest rates and a reversal of sentiment.
- The longer-term outlook is far more uncertain. The region's Achilles' Heel is a low saving rate and a high dependency on capital inflow. Over the past decade, Latin America has benefited from improving global liquidity brought by continued disinflation. Although this is set to continue, the bulk of the process is behind us.
- In this context, Latin America's widening current account deficits could become unsustainable. Unless growth slows significantly, devaluation pressures will continue to mount.
- Two factors could postpone this long-term risk. One is a major currency appreciation in Asia, which will ease devaluation pressures in Latin America. The other is a shift toward monetary easing in the G7, which will further extend capital flow to emerging markets in the region.

Until the eruption of the Asian crisis in the middle of 1997, the long-term outlook for Latin American equities seemed highly bullish. Economists and analysts pointed to a powerful combination of structural and cyclical factors, which together were supposed to bail Latin America out of its troubled past. Equities looked set for a long bull market.

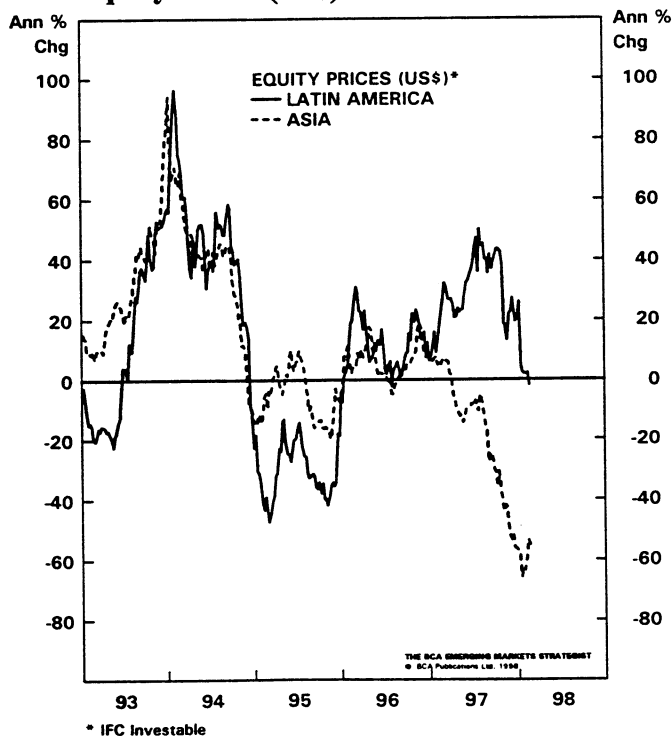
The array of positive forces indeed looked impressive: structural reform and benign global liquidity were underwriting a strong inflow of capital; economic growth was recovering rapidly from the aftershock of the Mexican crisis; liberalization and tight macroeconomic policies have pushed inflation to record lows; the region's banking system emerged strengthened from the previous crisis, so its reliquefaction provided ample liquidity to financial assets; and while equities did not appear cheap, valuation concerns were eased by booming profits and falling real interest rates.

The Asian crisis punctured the euphoria, and as the optimists ran for cover, Latin American equities came tumbling down. Taken as an asset class, stock prices are now where they were a year ago, giving up their 50% gain of early 1997 (Chart 1).

Much of this decline has been blamed on pure contagion. Over the past few years, international investors have tended to treat emerging markets as a single asset class, causing Latin America to move more or less in tandem with Asia (Chart 1). Although this positive correlation seems to have broken down since early 1997, the decoupling is more apparent than real. *Local*-currency performance remained correlated, with most of the divergence rooted in currency movements. The reason is that the Asian currencies have depreciated sharply, whereas those in Latin America held their ground, causing the *US\$ performance* of the two regions to diverge.

After nearly a year-long downturn, Asian equities seems to have found a bottom. Given the prospects for further gains in Asia (at least in the short term), and in light of the close correlation between the two markets, the key question for foreign investors is *whether Latin America will follow suit?*

Chart 1  
Equity Prices (US\$)



Our short term view is that the conditions for a rally are now falling into place. Until recently, equity markets in the region have been subject to two powerful *opposing* forces: confidence driven by earnings growth, offset by mounting fear of depreciation. The latter risk seems to be reaching a peak, at least temporarily, and as currency concerns ease, equities are likely to do well.

### The Earnings Backdrop

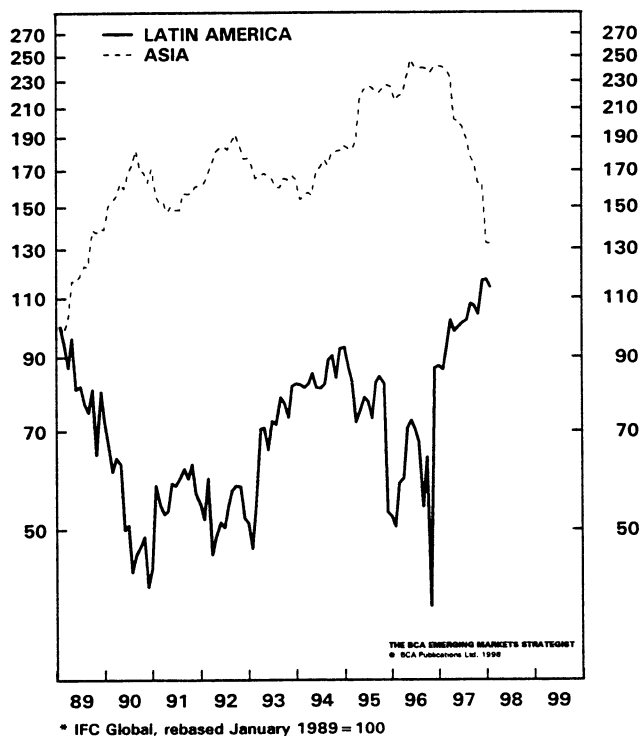
The main positive for Latin America is its phenomenal profit performance (Chart 2). Unlike Asia, where corporate earnings peaked in 1996 and then plunged, Latin America has seen profits soar by 130% since 1996.

And the good news is set to continue in the months ahead. Our own projections, based on proprietary models, suggest that the profit uptrend in the region will remain strong for much of the year (assuming the underlying currencies hold). Chart 3 on page 14 provides earnings-per-share forecast for the three leading markets, *relative* to the expected performance of world earnings as a whole.<sup>1</sup> Over the past year, all three countries have experienced strong economic growth, coupled with falling real rates of interest. Given that *reported* profits reflect conditions prevailing 12-18 month earlier, these favorable conditions should continue to feed into company bottom lines in the months ahead. Based on our forecasts, Argentina's profits are expected to outperform world earnings by 35%, Brazil's by 11% and Mexico's by a massive 105%.

The implications for equity prices of rising earnings are illustrated in Chart 4 on page 15. The top panel shows the price and earnings-per-share (EPS) performance of Latin America *relative* to the world average. Since late 1996, Latin America's EPS has outperformed the world average by about 75%. Initially, equity prices outperformed as well, but then the rally aborted, pushing Latin American stock prices back to the world average.

<sup>1</sup> Our forecasts are based on indicators such as the level of economic activity, interest rates, relative prices and wage costs. The underlying models and approach are described in two Special Reports of *The BCA Emerging Markets Strategist*: "Back to Basics: Earnings Growth and the Relative Performance of Emerging Markets" (June 26, 1997), and "Emerging Markets Earnings: The 'Good', the 'Bad' and the 'Ugly'" (November 10, 1997). For copies, please contact our circulation department (Tel: 514-499-9550; e-mail: circ@bcapub.com).

Chart 2  
Earnings Per Share (US\$)



The result, illustrated in the bottom panel, has been a *sharp widening of the Latin American "discount."* The premium/discount index measures how much more or less global investors are willing to pay for a dollar of Latin American earnings, *relative* to a dollar of world earnings.<sup>2</sup> This discount now stands at 50%.

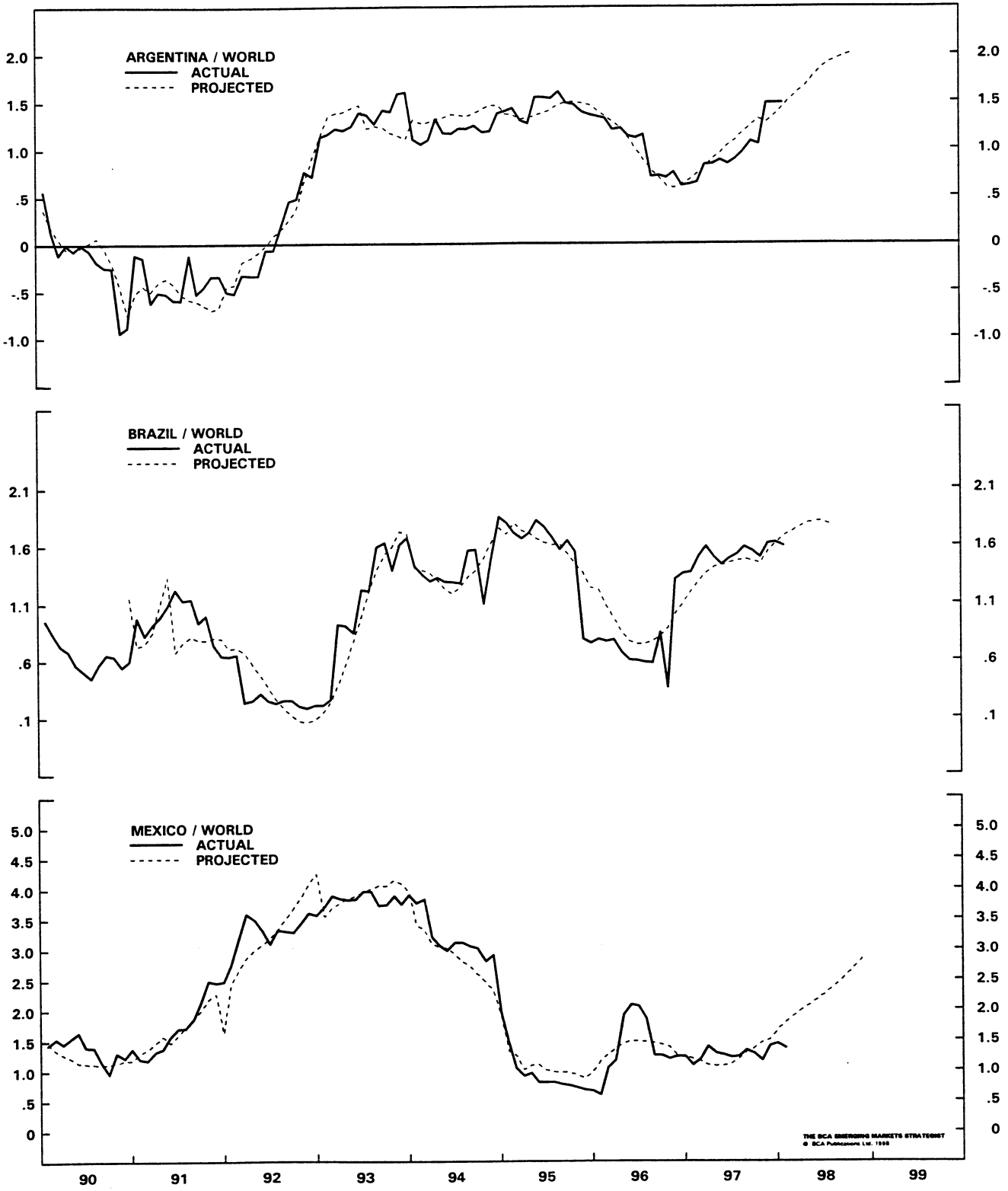
The premium/discount index provides a sense of global investors' sentiment toward Latin America. Over the past decade, this sentiment has gradually improved, as evident from the trend line in the bottom panel of Chart 4. The improvement has not been linear, however. Sentiment has swung strongly around the upward trend, moving between an extreme discount of 90% to a maximum premium of 20%.

In the past, these cyclical swings have offered investors strong buying opportunities in Latin American markets – the best ones being in 1989

<sup>2</sup> The premium/discount index is computed on the basis of the series in the top panel. For instance, in December 1997, the relative price index was 0.903 against a relative earnings index of 1.471. The ratio of the two indices was 0.614, representing a 38.6% discount. This same result can be obtained by dividing Latin America's P/E by the world P/E, subtracting one and multiplying by 100.

Chart 3  
**Relative Earnings Per Share\***

Feature Article



\* IFC Global for Latin America, Morgan Stanley for World

THE BCA EMERGING MARKETS STRATEGIST  
 © BCA Publications Ltd. 1998

Chart 4  
Latin America

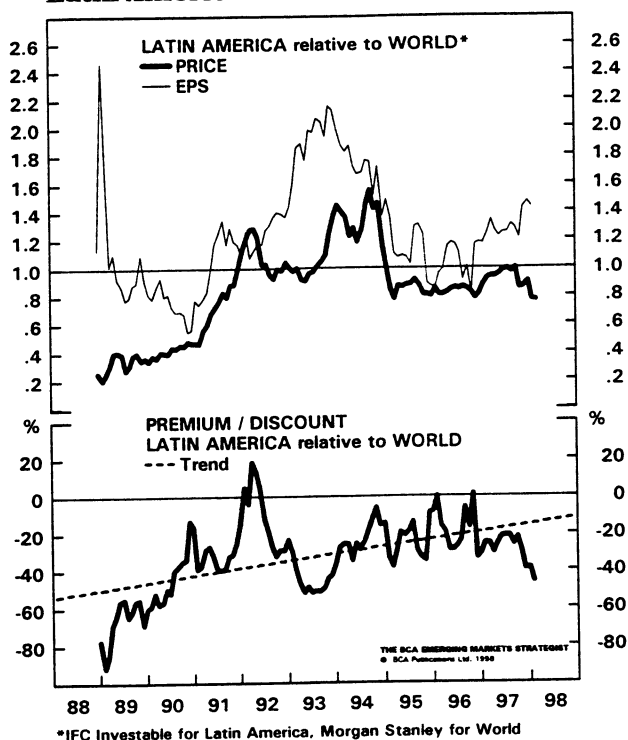
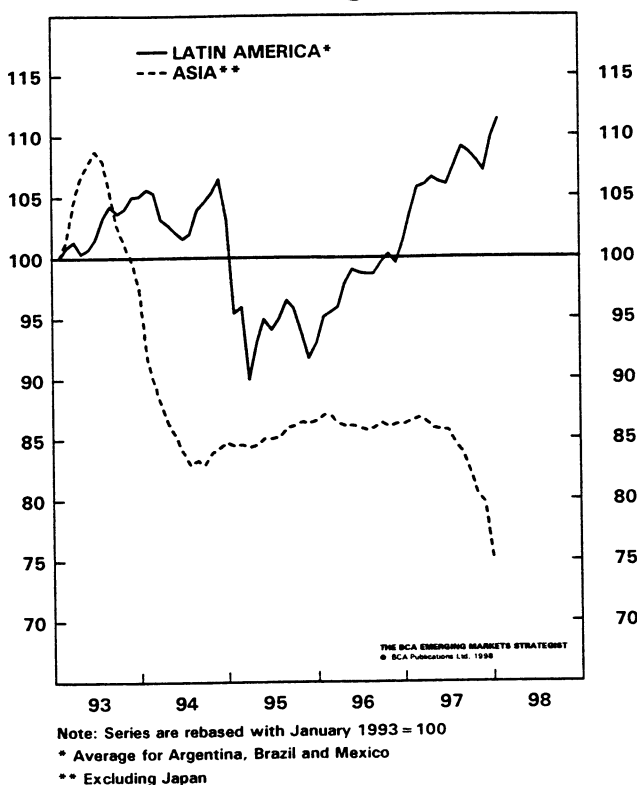


Chart 5  
Real Effective Exchange Rates



and in 1993. The current discount is again approaching cyclical lows, which suggests that investors may be offered yet another sweet entry point.

If our earnings projections prove correct, Latin American equities will merely need their discount to stabilize in order to outperform. The key question for investors is *when* will this happen. The answer depends largely on the currency outlook.

### Currency Risk

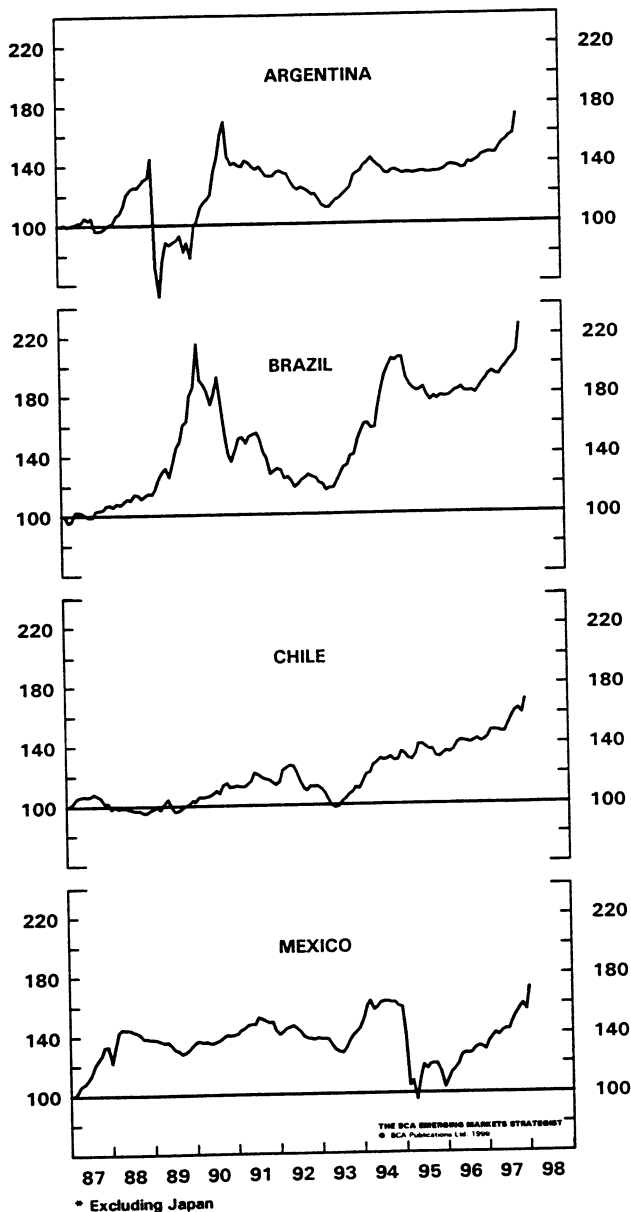
Over the past couple of years, the main head-wind for equities has been rising currency risk. As illustrated in Chart 5, since early 1996, the region's currencies have appreciated significantly in real effective terms – this at the time when Asian currencies have become increasingly cheaper.

The situation is also alarming from a longer-term perspective, particularly in light of the Asian currency depreciation (Chart 6 on page 16). The main concern is that this will erode Latin American competitiveness in “third markets” (mainly the developed economies). Relative to Asia, Argentina's real effective exchange rate has risen by 75% since January 1987, Brazil's by

130%, Chile's by 70% and Mexico's by 75%. This currency divergence has kept equity investors uneasy for two reasons:

- In order to alleviate external pressures, Latin America needs significant fiscal tightening, but so far this is happening only in Brazil. Interest rates in the region will therefore have to remain relatively high in order to sustain capital inflow, as well as to keep the current account deficit from exploding. The short-term outcome is to limit the flow of liquidity into financial assets; the longer term impact is to undermine corporate earnings, as higher capital costs feed into income statements. Both impacts are equity bearish.
- The situation would be even worse if the currencies were to depreciate. Here, too, the impact will be direct as well as indirect. The immediate effect on equity investors will come in the form of lower US\$ prices. In the longer term, a devaluation could end up harming more than helping Latin America. Compared with Asia *prior* to its current crisis, Latin America's external debt burden is higher, its export sectors smaller and its inflationary inertia stronger. Together, these factors suggest that a devaluation aftermath in the

Chart 6  
Real Effective Exchange Rates Relative to Asia\*



western hemisphere could be as dicey as it has been in Asia, if not more.<sup>3</sup>

Earnings growth and currency risk, therefore, have been working in *opposite* directions, and as long as this remains the case, the *net* impact on equity markets is difficult to determine.

Depreciation concerns, however, seem to be reaching a climax, at least temporarily. When this

<sup>3</sup> See, "The Day After: What if Latin America Devalues?" *The BCA Emerging Markets Strategist*, December 1997.

risk begins falling, both forces will be operating in the *same* direction, creating a bullish backdrop for equities.

### A Turning Point?

Chart 7 shows that during the 1990s, the premium/discount on Latin American equities was *inversely related* to currency risk (measured here on the basis of levels and rates of change of real effective exchange rates).

The last time sentiment was undermined by currency fears was in 1992/3. During that period, the market underperformed *despite* a massive upswing in relative earnings (see Chart 4 on page 15), a combination which greatly resembles the situation since late 1996. The 1992/3 downturn ended as currency concerns approached a peak. It was followed by an 18-month bull market, in which Latin American stocks outperformed world equities by almost 70% – before plunging into the 1994 Mexico crisis.

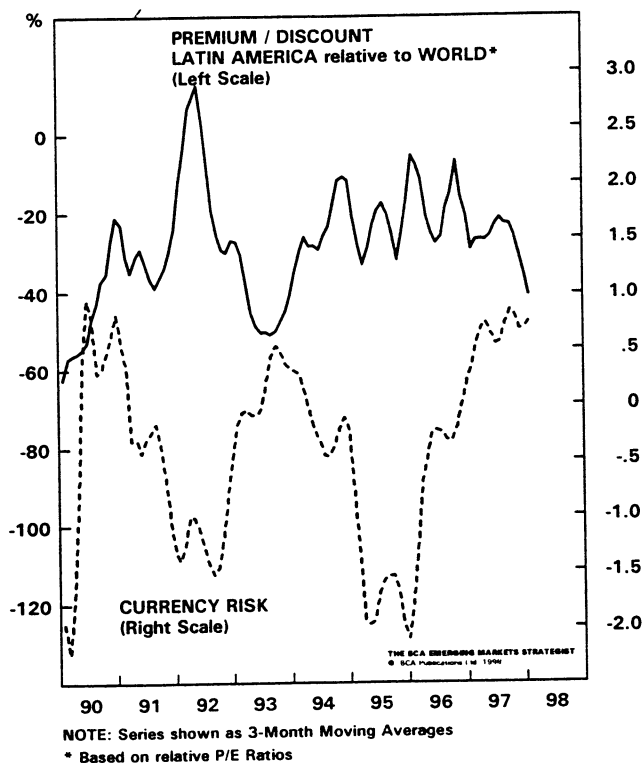
There is a good chance that Latin America is about to stage a replay of this scenario. Although currency risk should remain high, the next few months are likely to see at least a temporary easing of pressures:

- First, the principal soft-spot, Brazil, is slowing down. With elections only eight months away, the government is resolved to defend the currency at all cost, and has sharply tightened both monetary and fiscal policy;
- Secondly, Mexico has indicated it will accommodate a gradual weakening of the peso;
- And, finally, the apparent easing of the Asian financial crisis has boosted its own currencies, and will help alleviate investors' angst about Latin America.

Another point to note is that, unlike the big downturn in 1992/3, when sentiment dropped from record highs (20% premium), the present correction began with Latin American equities already trading at a 30% discount. With the current Latin American discount approaching a record distance from its trend line, downside risk is more limited now than during 1993.

*Taken together, these factors suggest that Latin American equities could stage a strong rally in the months ahead.* Earnings are set to rise rapidly, sentiment is approaching negative extremes, and currency risks are peaking. Once depreciation fears begin to recede, sentiment will likely

**Chart 7**  
**Equity Sentiment**  
**and Currency Risk**



stabilize or even improve, causing higher earnings to feed into higher equity prices.

### Back to the Future: What's Next

Beyond the short-term horizon, the equity outlook is far less bullish. A favorable combination of economic growth and falling inflation could be sustained only in the absence of severe external imbalances, which is hardly the case in Latin America.

Investors have been hit hard by such imbalances in the past. The market blood bath of 1994/5 was the consequence of massive external imbalances, heightened by currency risks and a spoiled outlook for corporate profits.

While Asia could legitimately be viewed as the trigger for the downturn in Latin America, homegrown problems suggest this was an accident waiting to happen. Our fax service had alerted investors as early as June 1997 to Latin America's rising risks, signaling Brazilian equities as a clear shorting opportunity.<sup>4</sup>

Latin America continues to face the serious structural problem of a low saving rate – less than 20% compared with close to 40% in Asia. Saving rates could be improved by lowering public

deficits, which Latin American governments have attempted to do in recent years. But the overall saving rate is also affected by other factors, such as the age structure of the population and the distribution of income, and these are much more difficult to change.

The consequence of this chronic saving shortage is a lingering external threat on growth, as illustrated in the top panel of Chart 8 on page 18. The chart shows the relationship between exports, imports and the flow of capital & invisibles.<sup>5</sup> Lacking enough domestic savings to finance its investment, Latin America needs a constant inflow of foreign finance. The onset of the 1980s debt crisis has triggered a massive and prolonged outflow of capital, which in turn forced countries in the region to run an offsetting trade surplus.

In principle, such surplus can be created by higher exports as well as lower imports. In practice, however, Latin America had only one route. After years of import substitution policies, its exports were hardly competitive on world markets, leaving it with little choice but to massively curtail imports. The consequence was the infamous "lost decade," in which the region's economy actually contracted.

The 1990s brought a reversal of fortune. Capital returned to Latin America *en masse*, allowing the trade balance to move again into deficit and growth to resume. The situation remains precarious, however, as evident from a comparison with Asia (bottom panel of Chart 8). In contrast to Latin America, where a fair chunk of the import bill is financed by capital flow, in Asia the bulk is covered by exports.

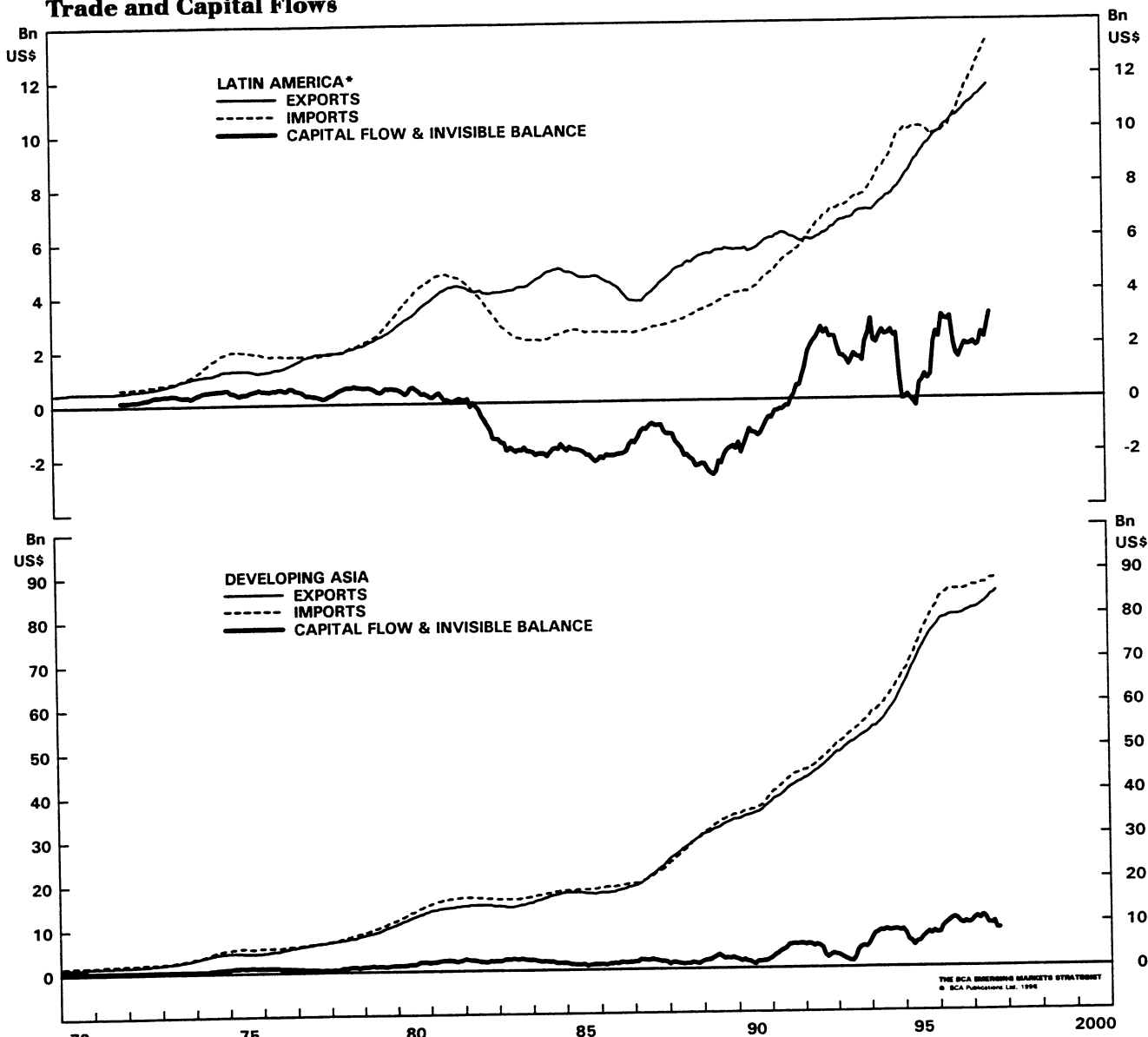
Capital inflow famine is therefore bound to hit Latin America far harder than Asia. The question is how likely is such a famine, and the answer has to do with both the supply and demand for funds.

Why has capital returned to Latin America during the 1990s? Part of the reason is that countries in the region have made considerable progress toward putting their house in order, but that is

<sup>4</sup> See "Sell Brazilian Equities," *The BCA Emerging Markets Strategist*, Fax, June 26, 1997.

<sup>5</sup> The capital flow & invisibles balance is computed as the difference between the change in reserves and the trade balance. Because reserves can go up or down, the trade deficit need not equal the capital flow & invisibles balance.

**Chart 8**  
**Trade and Capital Flows**



\* Total for Argentina, Brazil and Mexico  
Note: Series are shown as 12-Month Moving Averages

THE BCA EMERGING MARKETS STRATEGIST  
© BCA Publications Ltd. 1998

only one side of the story. The other, and possibly more important reason, is that the global supply of capital was expanding rapidly. Indeed, Latin America's ability to implement liberal political-economic reforms in the first place was to a large extent conditioned on increasing availability of such capital.

The key issue looking ahead, is how much longer can this positive backdrop last? Specifically,

- How fast can capital inflow continue to grow?
- And then, will the inflow be enough to finance Latin America's growing appetite for funds?

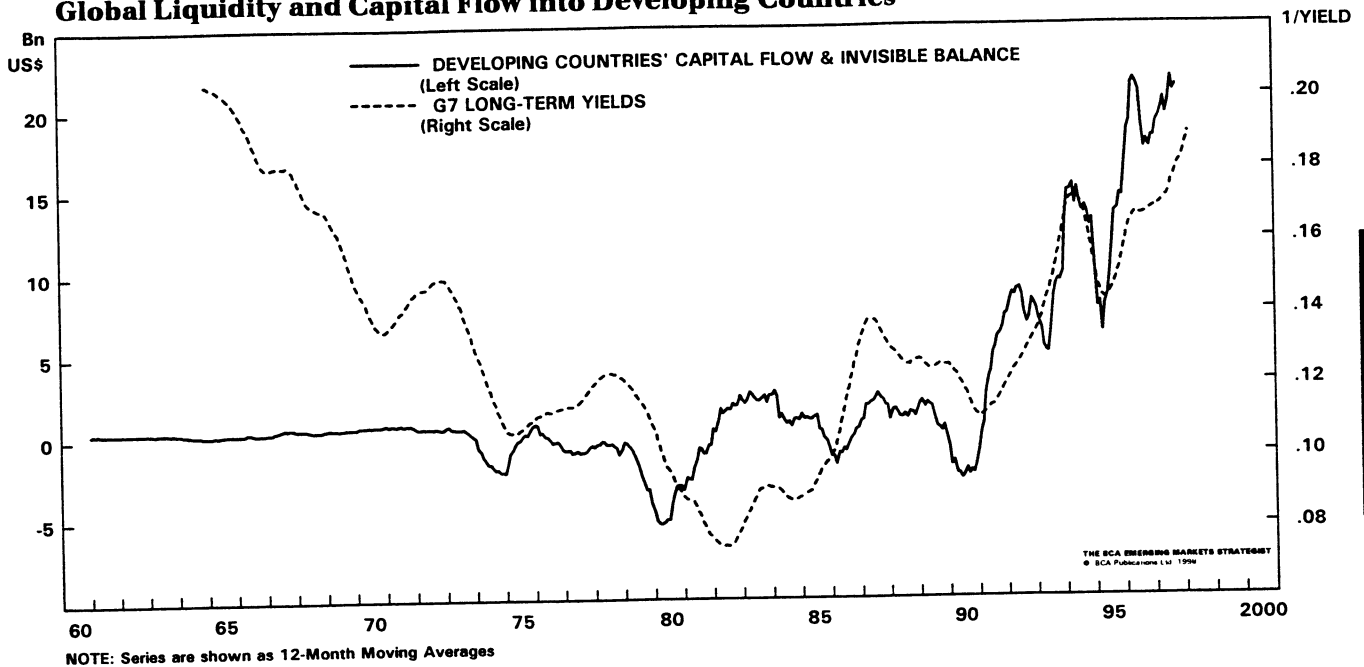
### The Global Liquidity Cycle

Chart 9 shows that the massive rise in capital flow into developing countries, from which Latin America benefited handsomely, was mainly the consequence of a prolonged drop in world interest rates.

So far, this trend of improving global liquidity remains intact. The *pace* of improvement, however, seems likely to decelerate relative to its hectic expansion in the early 1990s.

The reason is suggested in Chart 10. For the past fifteen years, the decline in interest rates was

Chart 9  
Global Liquidity and Capital Flow into Developing Countries



Feature Article

mainly the consequence of falling inflation, and the bulk of this *disinflation* process is now behind us.

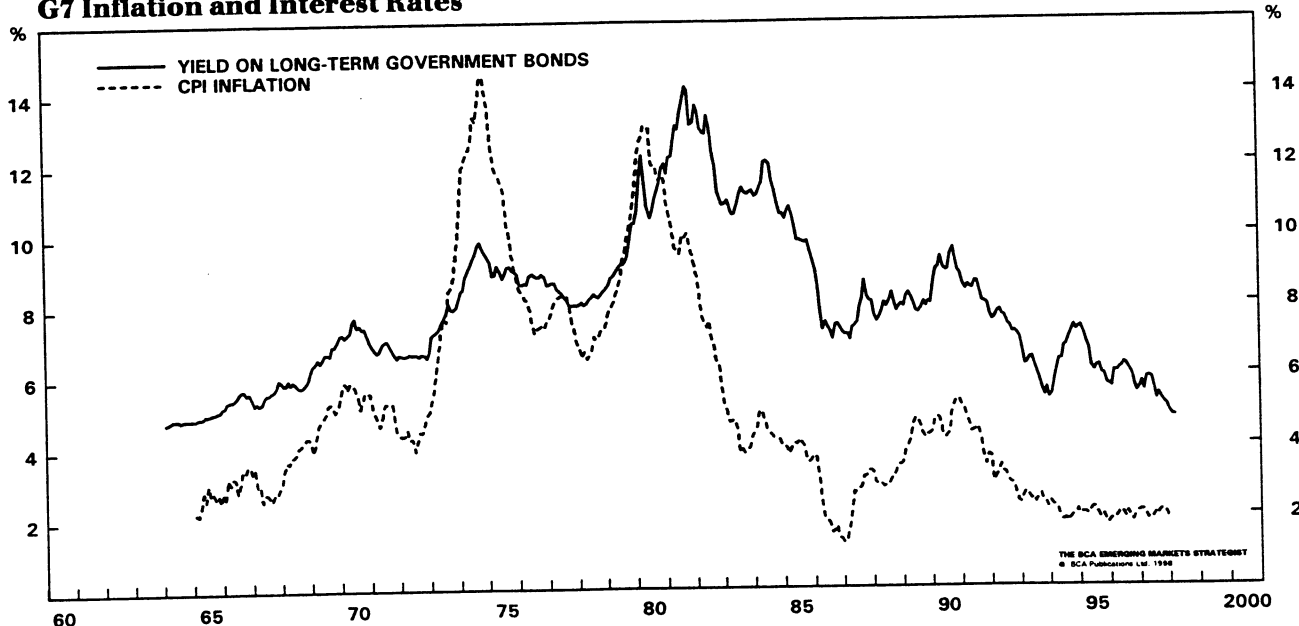
Interest rates are likely to drop further, but the impact on capital flow will be more moderate than it was in the early 1990s. There are three reasons for this:

- Inflation could drift lower, perhaps even into negative territory, but that will likely require an economic recession in the Western

countries, which will have *negative* implications for capital outflows.

- Nominal interest rates could benefit from a fall in *real* interest rates, but this will happen only on evidence that the global return on capital is falling. Because developing countries are now more synchronized into the G7 economic cycle than they were a decade ago, the prospect that they will benefit from a regional reallocation of capital is reduced.

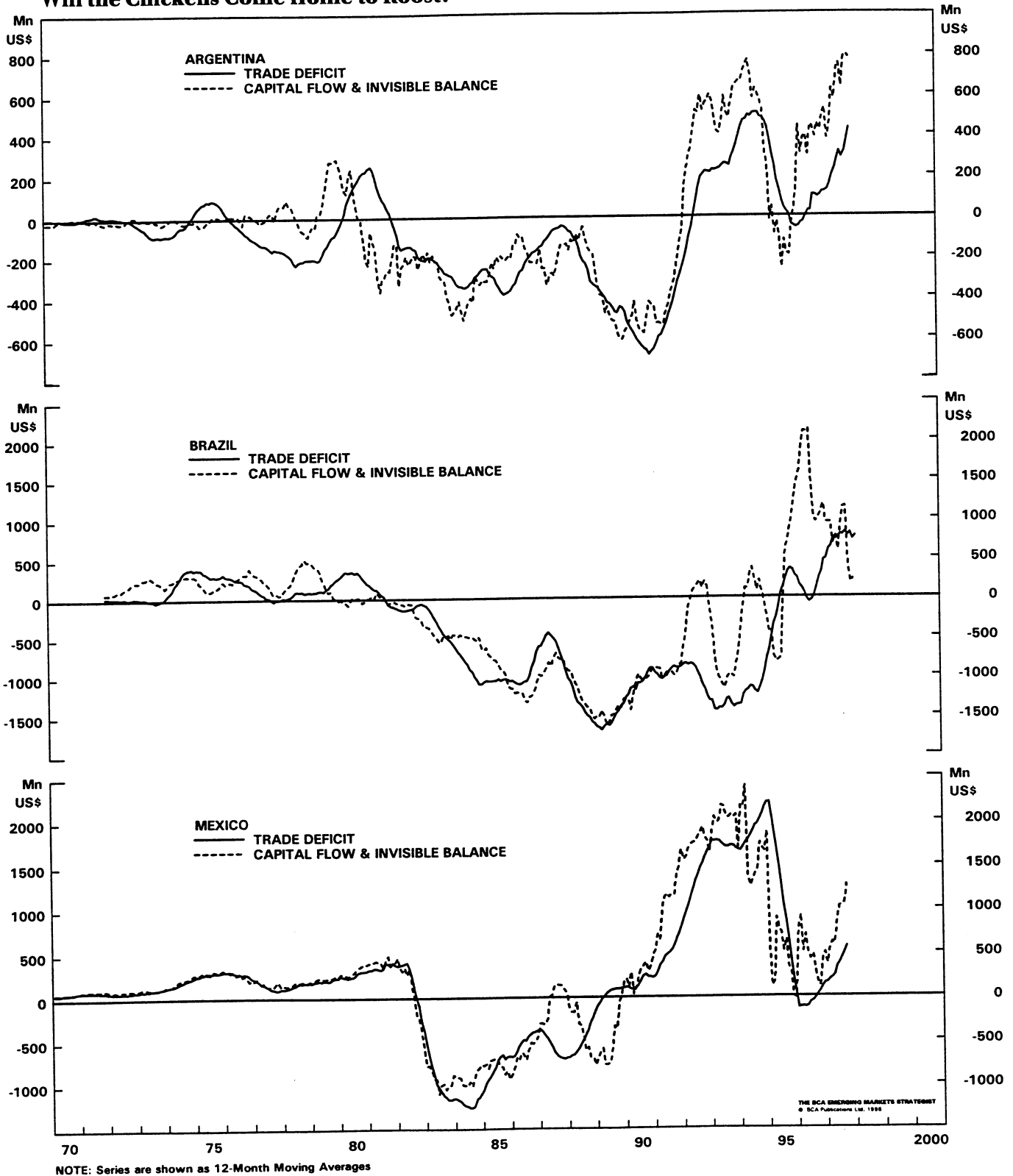
Chart 10  
G7 Inflation and Interest Rates





**Chart 11**  
**Will the Chickens Come Home to Roost?**

Feature Article



- Finally, there is the question of magnitude. If G7 long-term yields were to fall to 4% from current levels, this would represent a 15% decline – compared to declines of over 25% annually during the early 1990s.

The bottom line is that developing countries will continue to benefit from improving liquidity, but that these improvements will likely be slower than they were earlier in the decade.

The question is whether this slower pace of liquidity growth will be enough to satiate Latin America's growing demand for capital.

### **Will the Chickens Come Home to Roost?**

Latin America's growing addiction to capital inflow has made foreign investors increasingly edgy. The first casualty proved to be Brazil (Chart 11). Its capital flow & invisibles balance reached an all-time high in 1996, before dropping precipitously. By mid 1997, this flow was no longer sufficient to cover the trade deficit, leading to a massive downward pressure on the *real*. In its attempt to defend the currency, the government has sacrificed \$US 11.1 bn worth of foreign exchange reserves (18% of the total), doubled interest rates and implemented a significant fiscal contraction, sending the economy into recession.

The Brazilian slowdown, however, may not be enough to ward off risks for the *region as a whole*. To begin with, Brazil's general election is scheduled for October, suggesting the government may find it difficult to keep its foot firmly on the policy breaks. More importantly, the two other economies – Argentina and Mexico – remain robust, and as Chart 11 shows, their dependence on capital inflow is as strong as ever. The risk build-up is particularly evident in Argentina, where both capital flow and the trade deficit are reaching all time highs, though Mexico is not far behind.

This does not make a Latin American implosion imminent. Global liquidity continues to improve, and although its pace of growth will likely become more moderate, as long as investors do not get cold feet, capital will remain available.

Another mitigating factor, at least in the medium term, is the Asian situation. If the financial crisis has indeed reached a bottom, Asian currencies could continue to firm up. This will make Latin American currencies look less expensive, and hence less vulnerable to speculative attack.

Finally, if the Asian economic crisis ends up causing a global deceleration – as we expect it will – monetary policy in the G7 could move into easing, injecting further liquidity into world capital markets.

However, since none of these factors solve Latin America's saving shortage, its growing external imbalances will remain unsustainable. And the longer these imbalances are offset by favorable external circumstances, the greater the build-up of risk.

### **Investment Conclusion**

Taken as an asset class, Latin American equities face the prospect of a strong rally in the months ahead. Up until recently, the improving earnings outlook was offset by mounting fears of the devaluation, rising interest rates and reversal of foreign investor sentiment. Near-term currency risks are beginning to recede, however, and with the Asian markets finding a bottom, Latin American stocks now offer an attractive – albeit risky – opportunity for short-term investors.

Beyond the near term, equities remain hostage to their region's low saving rate, and its consequent dependence on foreign capital inflow. While the fifteen-year expansion of global liquidity is now decelerating, Latin America's trade imbalances are worsening. External pressures have already emerged in Brazil, and the likelihood is rising that they will eventually appear in other parts of the region.

Jonathan Nitzan  
Senior Editor