PINEBRIDGE INVESTMENTS

Emerging Markets In Focus: Latin America

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Regional Overview

The past few months have been a testing time for stock markets around the world. The end of the Federal Reserve's "Quantitative Easing" policy, the euro zone Debt Crisis and the co-called "Soft Patch" in the US have weighed heavily on investor confidence. It may not be that surprising to see emerging markets (EM) underperform developed markets (DM) in the current risk-off environment, but to see Latin America underperform the rest of EM by a huge margin is surprising. The MSCI Latin America index is down more than 10% as of June of this year, three times more than Asia and five times more than Europe, the Middle East and Africa (EMEA). Adjusted for currency moves, in US dollars, the differences are significantly smaller, but the underperformance remains.

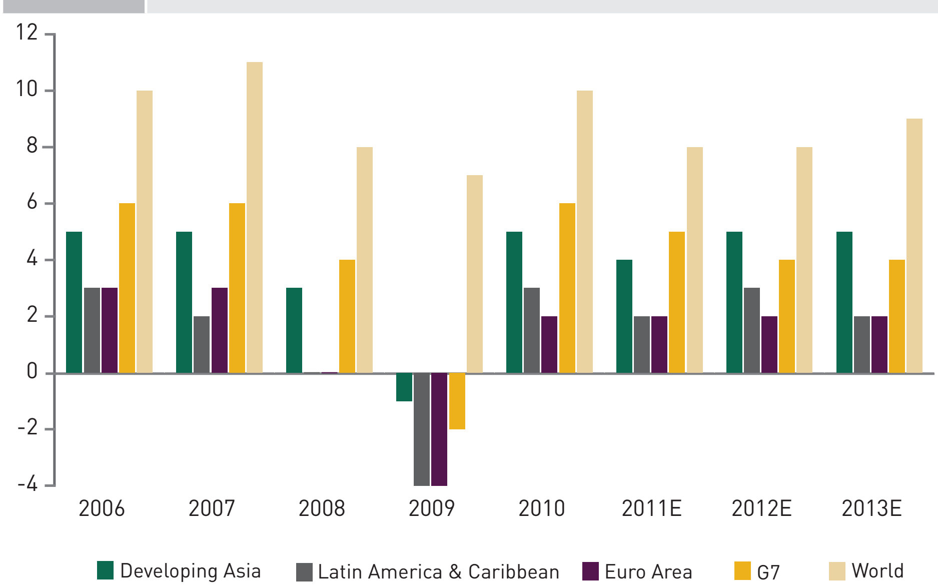
Looking at the relative macro performance in the first quarter, Latin America posted a slightly stronger growth rate, while the global economy slowed from an annualized rate of 4.8% in the fourth quarter of 2010 to 4.1% at the start of this year, on the back of weaker activity in Asia and EMEA. Central banks in the region are far more "ahead of the curve" compared to those in Asia or EMEA. Average real policy rates in Latin America are close to 2.4%, while the rest of the world still has broadly negative real rates. Latin America's macro fundamentals started the year on a bullish note, yet, what is weighing on financial markets now is the decline in commodity prices that started in May. The GSCI Energy Index is still up marginally for the year, but industrial materials and agricultural prices were down about 5% by the end of June.

The International Monetary Fund's (IMF) latest outlook update for the region had a fairly positive tone, stressing overheating and the challenge of strong capital inflows as key challenges. However, the IMF also encourages governments and central banks to maintain and improve macroprudential policies. Budget deficits didn't widen as much as balances in the developed world. Yet, the IMF felt governments should do more to reduce overall debt levels at times of strong growth and high commodity prices. Furthermore, strong domestic growth is generating renewed pressure on current accounts. The region's external accounts had been broadly balanced in the five years before the crisis. Since then, however, current account deficits are widening again, which, if unchecked, could sow the seeds for economic problems down the road.

Brazil/Mexico/Chile

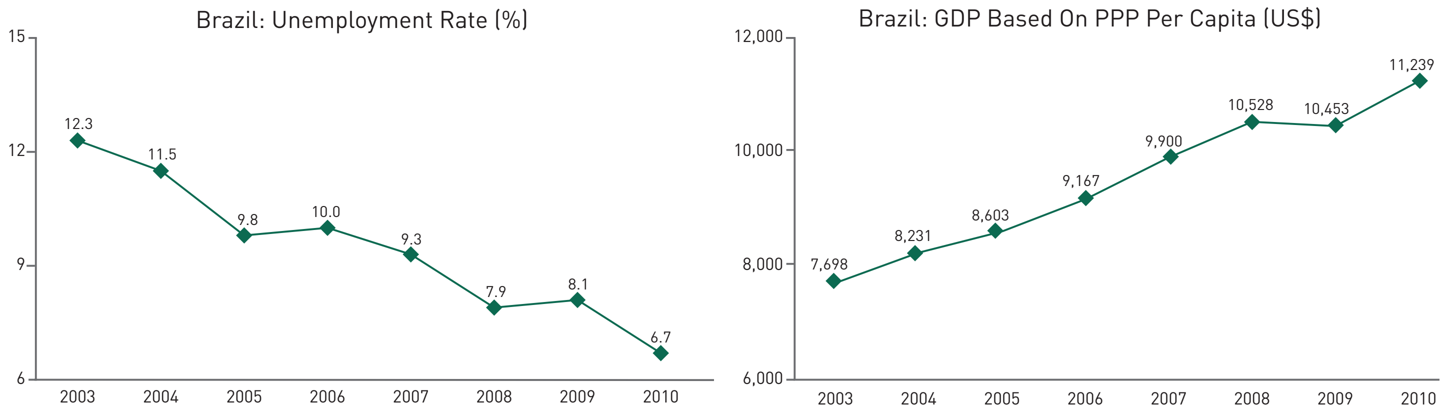
The overheating risk is still most relevant in Brazil. After a strong growth spurt in the first half of last year, with growth averaging 7.5%, the recovery slowed to a much more pedestrian 2.5% pace. The start of 2011 then saw a significant re-acceleration back to 5.9%. Downside risks to growth are mostly external and the sharp decline in commodity prices has already turned investors more bearish. Domestic demand, however, is still running at a very strong pace, driven by record low unemployment and rising real incomes. Banco Central do Brasil (BCB) has already raised rates seven times since last summer and has, by far, the highest real interest rate environment among all major economies. Lower commodity prices should slow growth from a very strong 7.5% pace last year to a more sustainable 5.5% trend in the next few years. However, the tight monetary policy and interest rate differential with the rest of the world suggest that the Brazilian real will add to the 5.5% gain vis-a-vis the dollar so far this year.

FIGURE 1 Real GDP Growth (%)



Source: International Monetary Fund. World Economic Outlook Database, April 2011.

FIGURE 2 Brazilian Economic Backdrop



Source: International Monetary Fund. World Economic Outlook Database, April 2011.

Mexico is facing a very different macro backdrop. The overwhelming issue here is the "Soft Patch" in US manufacturing. Growth slowed abruptly in the first quarter to an annualized rate of just 2.1%, after posting a 5.4% rate in 2010. As a result, inflation pressures have slowed further this year, which should allow Mexico's central bank (Banxico) to push a first rate increase out probably as far as the first half of next year. Surprisingly, the Mexican peso has not lagged much behind Brazil's real despite the weaker growth backdrop and a more than 450 basis point differential in real policy rates. Looking ahead, much will depend on the duration of the US "Soft Patch." Auto production is rebounding already and we expect Mexico's recovery momentum will pick up with it. Low inflation and a fairly strong peso suggest a weaker currency could be a growth buffer, if the US doesn't rebound as quickly as I am expecting.

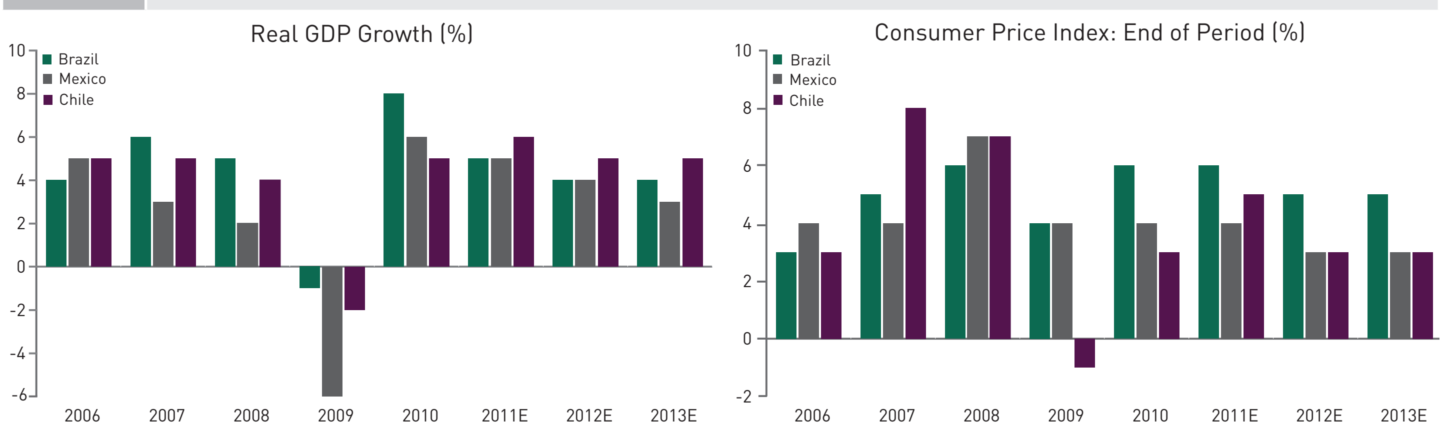
The effects of the 2010 earthquake on Chile's GDP growth trend are slowly dissipating. After a sharp -8.1% annualized decline in real GDP at the start of last year, growth rebounded strongly in the two middle quarters. Since then Chile's underlying recovery trend seems to have re-emerged, with growth averaging 4.8% in the past two quarters. Inflation has continued to drift higher in recent months, but Banco Central de Chile (BCCh) is well ahead of the curve, having raised rates 17 times already since starting the tightening cycle last summer. At 275 basis points, real policy rates are the second highest among the major economies in the region, which should allow BCCh to slow the pace of its tightening in the second half. The Chilean peso has held up well in the second quarter when most EM currencies lost ground against the US dollar. However, year-to-date it is lagging notably behind both Brazilian real and Mexican peso.

I expect Chile's growth momentum will remain fairly strong this year, pushing real GDP growth back above 6% before slowing to a more moderate 4.5% to 5% pace in the next two years.

Argentina/Andeans

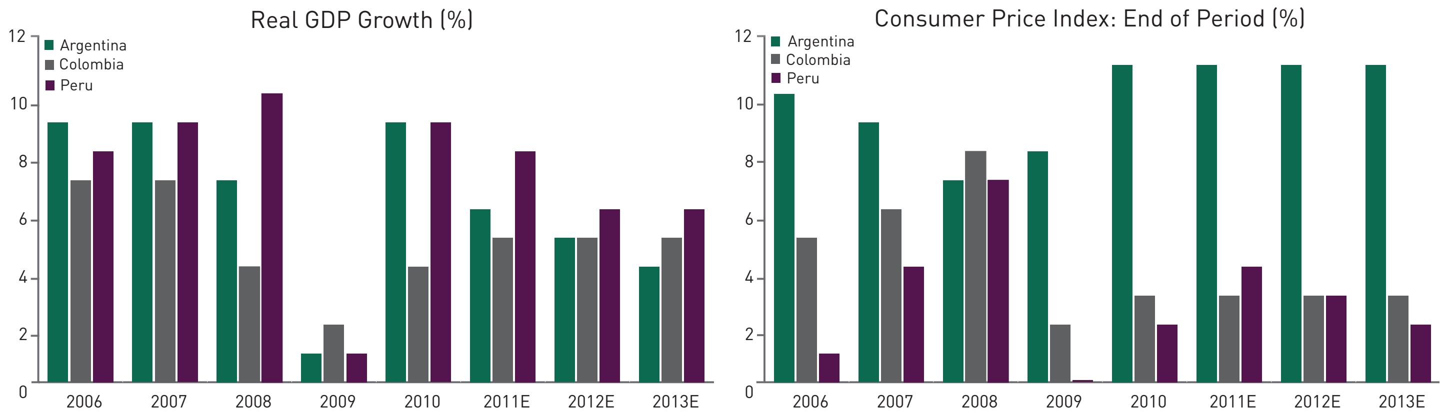
Presidential and legislative elections set for November are starting to cast their shadow over Argentina's macro outlook. President Cristina Fernandez de Kirchner is comfortably in the lead and a change at the head of government is unlikely. That is probably good news, as it should prevent a more serious slowdown in Argentina's recovery momentum. Nevertheless, after a China-like 9.2% growth rate last year the fastest pace in five years; 2011 should see a 'slowdown' to about 7% growth.

FIGURE 3 Brazil/Chile/Mexico Growth and Inflation



Source: International Monetary Fund. World Economic Outlook Database, April 2011.

FIGURE 4 Argentina/Colombia/Peru Growth and Inflation



Source: International Monetary Fund. World Economic Outlook Database, April 2011.

Colombia rebounded impressively at the end of 2010, following a weather-related slowdown in the third quarter of last year. The pace of inflation at just over 3% is fairly low, but on a gradually rising trajectory. The good news is that Banco de la Republica (BanRep) is ahead of the curve, with real policy rates well above 1%. Further rate increases are likely, if inflation pressures don't ease in the coming months. I expect GDP growth to match, and possibly even exceed, last year's 4.3% pace and the prospects of further fiscal reform should increase the country's growth potential down the road.

Peru's economic and financial market backdrop is clouded by uncertainty following Ollanta Humala's narrow election victory. Much depends on the policies the new government will implement. The economy recorded very strong growth last year, at +8.6% even outpacing Brazil. Year-to-date the Lima General Index is one of the worst performing stock markets, but that has much more to do with the election outcome than Peru's macro prospects. For now I expect growth will slow only moderately over the next few years. ■

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Markus Schomer is responsible for providing macro-economic forecasts, analysis and commentary for all PineBridge Investments groups, with a focus on global economic trends and their impact on financial markets. He holds degrees in Economics from the University of Bonn in Germany and the University of East Anglia in the UK. He also studied at the London School of Economics and is a CFA charterholder.